Economic Research

KDN No.: PP14787/11/2012(030811)

MALAYSIAN RATING CORPORATION BERHAD
(364803-V)

Vol.: ER/006/2012

Malaysia: Current economic landscape and policy repercussions

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23 April 2012

In a nutshell

- Policymakers face challenges in maneuvering the economy in 2012 given the continued soft economic growth in Malaysia as a result of a slowdown in emerging Asian markets and weak global demand as well as domestic issues such as rising government debt and persistently high household debt levels. Based on the rhetoric from the authorities, we do not discount the possibility of changes in policy direction that may take place in the near term. Despite these hunches, we maintain for now our macro forecast for 4.4% GDP growth which we had indicated in our Bank Negara Malaysia (BNM) Annual Report publication in March 2012, but will review our projections if there are significant changes in economic indicators such as loan growth, private consumption and inflation.

- Based on recent discussions with BNM officials, we view the probability of a rate cut as rather slim in 2012 unless there is an unexpectedly deep economic downturn as officials have voiced their concerns over overstretched household balance sheets in the past few years. In addition, contrary to market expectations, we feel that relatively elevated food prices could have a greater dampening effect on private consumption, especially if the government raises pump prices in response to stronger global oil prices.

- The impact of BNM's prudent lending guidelines may continue to bite loan growth in the next few quarters. In reality, such a guideline may prove to be positive for the economy in the long run as excesses in lending towards certain segments need to be curbed. In the short term however, the repercussions may be reflected in weaker loan growth. With the loan approval rate expected to decline under the stricter lending guidelines, loan growth is likely to moderate to a single-digit pace in 2012. Forward looking indicators for loans have already shown initial signs of weakness in recent months despite the spurt in the number of applications in February 2012.

- If the adjustment in pump prices takes place, the initial impact on inflation numbers may be greater than expected due to increases in transportation and other energy-related indices in the consumer price index (CPI). While we do not expect a jump in headline inflation if pump prices are revised upward, we sense that policymakers will intervene through non-monetary measures to alleviate the price pressure on consumers.

Current economic landscape

The Malaysian economy is experiencing another period of soft economic growth amidst a slowdown in emerging Asian countries as global demand weakens due to the European debt crisis. Of significant note is the downward pressure on Malaysia's external trade performance as Asia's export machine slows, especially countries which are heavily dependent on demand from Europe. Although February's release of trade and industrial production statistics sparked some hopes of better days ahead, the overall prospects remain uncertain. This is evidenced by recent downgrades in the growth forecast for 2012 by the World Bank and Asian Development Bank to 4.6% and 4% respectively. Adding to that, some domestic issues such as rising government debt, persistently high household debt and a possible adjustment in pump prices have emerged as primary challenges to policy makers this year.

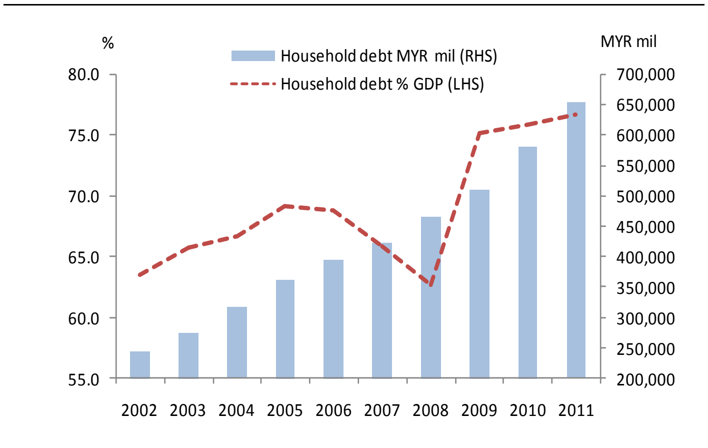
The recent BNM Annual Report released by the central bank summarised the challenges faced by the Malaysian economy in the short and medium term. Based on the report and the statements given by BNM officials, we believe that policies are now being crafted with the aim of addressing macro imbalances despite the risk of a slowdown in certain areas of the economy.

Direction of the policy rate

Financial market players continue to debate on the direction of Malaysia's policy rate (overnight policy rate or OPR) in the next few quarters. Based on the rhetoric from BNM officials during the release of the 2011 BNM Annual Report in March, we believe that the probability of a rate cut in 2012 is slim unless there is an unexpectedly deep economic downturn as officials have voiced their concerns over overstretched household balance sheets.

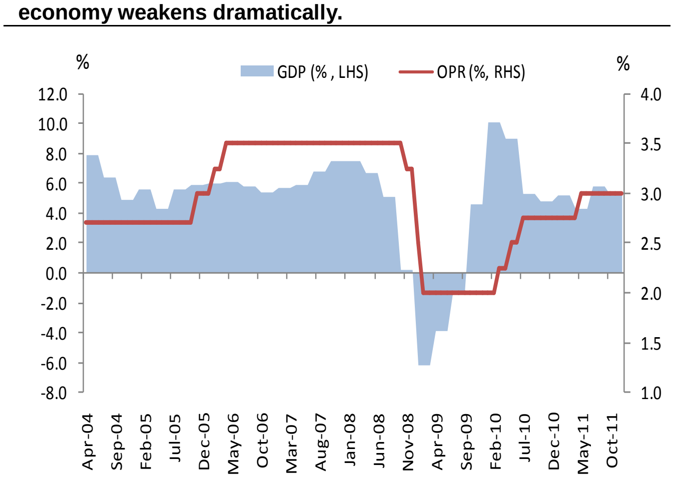
On the issue of inflation – another important indication of the direction of the OPR – we feel that although it is anticipated to remain under control, it may have a greater dampening effect on private consumption, especially if global oil prices remain relatively strong as they have in the past few months. In addition, despite the weakness in Europe and in emerging economies, namely China and India, global growth momentum will likely recover after a short period of softness following a stronger recovery of the United States (US) economy and positive policy responses in Asia. We are of the view that China will start to take more aggressive measures to bolster its economy should growth momentum slow more than expected. All these will provide an important buffer against any sharp downturn in Malaysia's economic growth.

Chart 1: Household debt to GDP remain elevated and will prevent BNM from softening its tone in order to address these imbalances.



Source: CEIC, BNM

Chart 2: Trends in GDP growth and OPR indicate that there may be limited downside for interest rates unless the economy weakens dramatically.



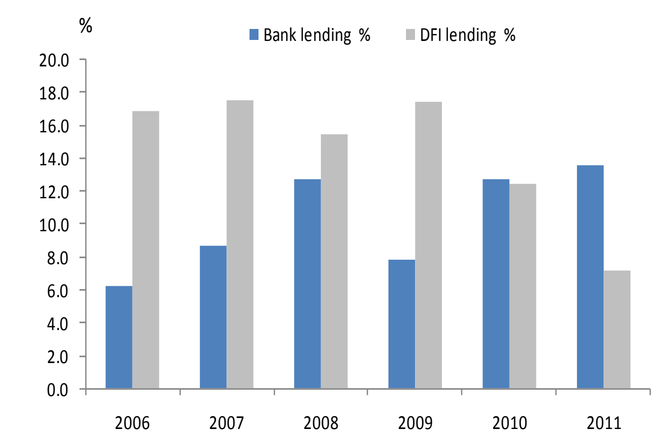
Source: CEIC, BNM

- *Chart 1* – Household balance sheets remain overstretched, with the level of household debt remaining above 75% of gross domestic product (GDP) in 2011 despite rising at a slower pace of 12.5% (2010:+13.7%). While a big chunk of the debt was related to mortgage and hire purchases, the uneven distribution of debt relative to debtors' income profile as highlighted by BNM suggests that certain groups of borrowers will come under tremendous financial pressure if an economic downturn takes place.
- *Chart 2* – Lowering the OPR in an environment of a mild economic slowdown may not be an appropriate policy choice as it may send wrong signals about the central bank's seriousness in addressing the household debt problem. Of course, an unexpected sharp downturn in economic activity will change the entire scenario.

Lending growth momentum will taper off

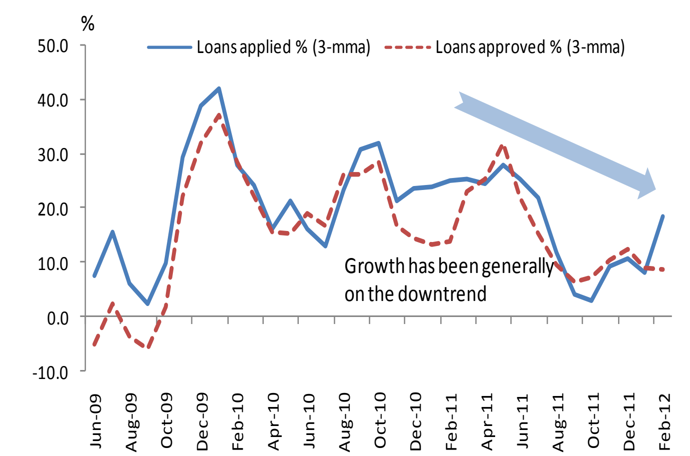
Lending growth has been robust since the economy recovered from the 2009 recession. However, following BNM's introduction of more stringent lending guidelines that took effect in January 2012, loan growth may moderate. Forward-looking indicators for loans have already shown initial signs of weaknesses in recent months despite the spurt in the number of applications in February 2012. With the loan approval rate expected to decline under the stricter lending guidelines by BNM, loan growth is likely moderate to a single-digit pace in 2012.

Chart 3: Growth in lending by banking institutions and DFIs has remained relatively strong, leading to higher indebtedness among households.



Source: CEIC, BNM

Chart 4: Loan applications and approvals (banking institutions) will likely moderate following BNM's introduction of prudent lending guidelines.



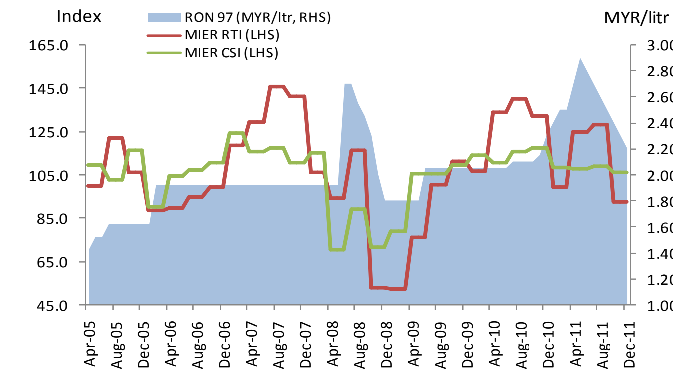
Source: CEIC, BNM, MARC Economic Research

- *Chart 3* – Loan growth in the banking sector has continued to register a double-digit pace since 2008, fueled by strong demand from both household and business sectors. In February 2012, household loans expanded at a robust 12.1% rate while business loans grew by 11.7% on a year-on-year basis. For non-bank institutions, although loan growth by development financial institutions (DFIs) moderated in 2011, expanding by a single-digit pace of 7.2% on an annual basis, lending to certain segments such as consumption credit remained relatively brisk at 11% in 2011. Loans for credit cards also grew strongly, expanding by 27.8% in 2011. In the past 6 years, the average annual loan growth in these two segments was an astounding 24.4% and 62.9% respectively, prompting officials to propose measures to slow the pace in lending in these two segments.
- *Chart 4* – Analysing the recent data on loan applications and approvals – based on 3-month moving average – suggests that the downtrend has not reversed. As such, the overall loan growth may moderate this year.

Momentum in private consumption will moderate

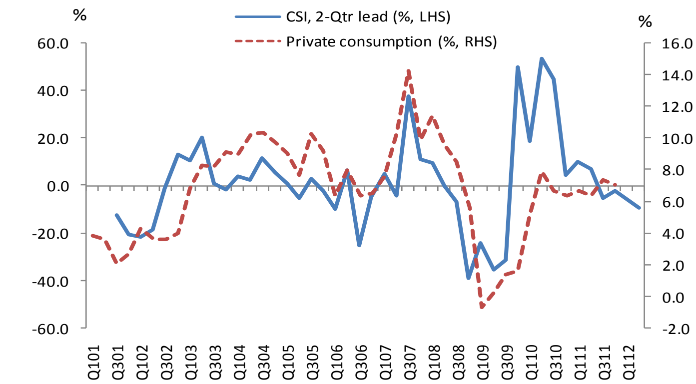
As lending moderates in 2012, the growth momentum in private consumption will likely soften as consumers will find it harder to finance their consumption activities. Although the labour market has remained relatively stable, rising global oil prices may lead to a slight adjustment in pump prices, dampening consumer sentiment and slashing a portion of private consumption.

Chart 5: The relationship between prices of RON 97 and CSI, RPI tends to indicate that rising pump prices will affect consumer sentiment and retail trade.



Source: CEIC

Chart 6: Close correlation between MIER's CSI and private consumption suggests that consumer sentiment provides a good gauge for future trends in private consumption.



Source: CEIC, MARC Economic Research

- *Chart 5* – Although the headline CPI is expected to remain benign in 2012 following softer domestic demand, rising global crude oil prices may induce cost push inflation and lead to minor adjustments in pump prices if the government wishes to stay on track in achieving the deficit target of 4.7% of GDP in 2012. Based on past experiences, higher pump prices normally led to a deterioration in consumer sentiment. This can be seen in the downtrend in MIER's Consumer Sentiment Index (CSI) and Retail Trade Index (RTI).
- *Chart 6* – Since the CSI normally provides a good gauge for future consumption patterns in Malaysia, the latest trend in the CSI suggests that future momentum in private consumption will moderate in 2012.

Inflationary issues will be addressed through non-monetary measures

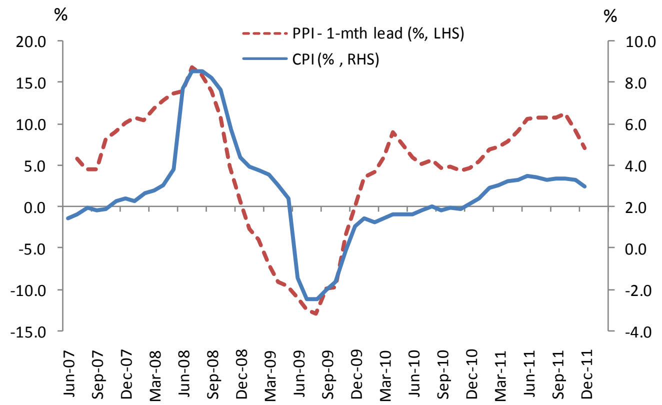
If the adjustment in pump prices takes place, the initial impact on inflation numbers may be greater than expected due to the increases in transportation and other energy-related indices in the consumer price index (CPI). Past experiences suggest that higher production costs tend to be passed on to consumers which lead to higher prices of food and non-food items in the CPI basket. While we do not expect a jump in the headline inflation if pump prices are revised upward, we sense that policymakers will intervene through non-monetary measures to relieve the price pressure on consumers. In the past, the Malaysian government utilised several non-monetary strategies to alleviate the upward pressure on consumer prices, particularly on food items. These include:

(1) Control of prices through better enforcement of the Price Control Act, 1946 and Control of Supplies Act, 1961. This is normally done through periodical price revisions of the controlled items (which are mostly foodstuff) that fall under the Act. Traders are required to display prices of all items of daily necessities. A body like the National Price Council that was introduced in 2008 will also monitor prices and host a call center and strengthen the national stockpile of relevant goods.

(2) Control of supply of certain products (ie wheat) by limiting the amount of exports to other countries. This is done by, for instance, the Ministry of Domestic Trade and Consumer Affairs which controls exports at the border of Malaysia and Thailand.

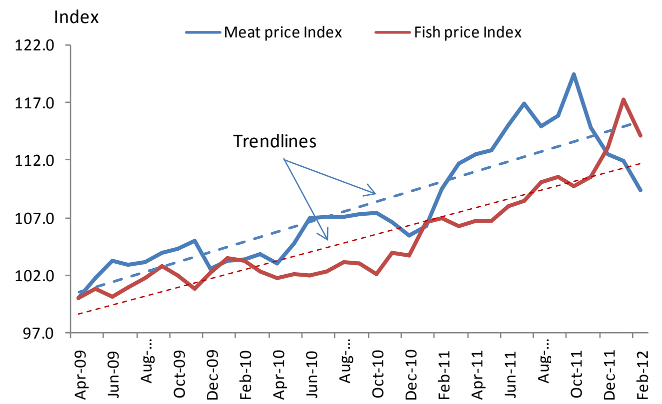
(3) Continue to subsidise certain consumer items rather than making a drastic removal of subsidies to prevent sharp increases in their prices.

Chart 7: Movements in CPI and PPI (1-mth lead) indicate that higher costs were normally passed on to consumers, resulting in higher CPI in subsequent months.



Source: CEIC, MARC Economic Research

Chart 8: Rising prices of food component (ie meat and fish) will likely be addressed through non-monetary measures.



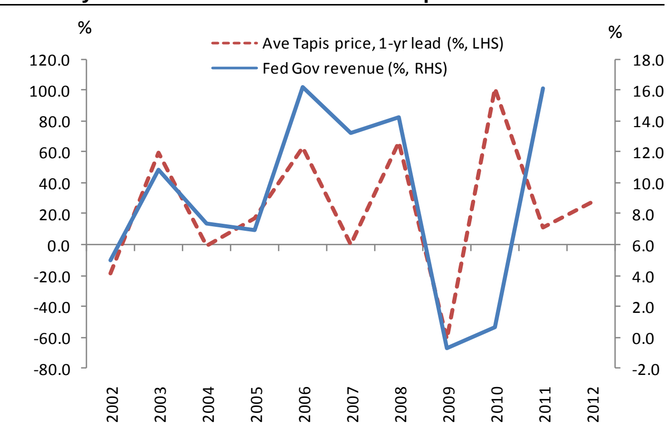
Source: CEIC, MARC Economic Research

- *Chart 7* – Producer Price Index (PPI) normally leads the CPI by a month, suggesting that higher costs tend to be passed on by producers to consumers. If pump prices are adjusted upward, higher transport and energy-related indices will likely lead to higher CPI as well.
- *Chart 8* – As food prices remain on the uptrend, the government will likely utilise non-monetary policies to ensure that consumers will not be hard hit by rising prices.

Fiscal policy will be the primary tool

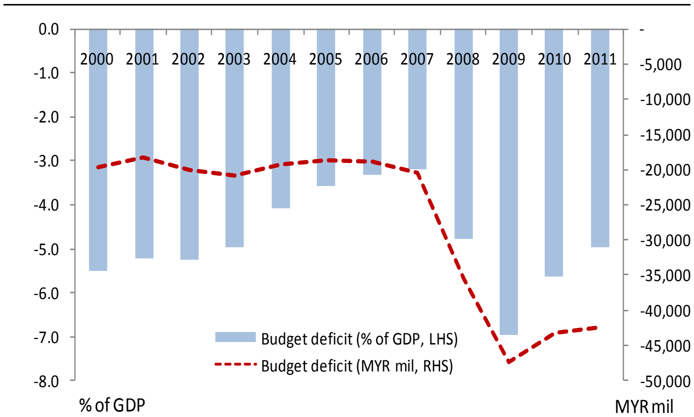
Since monetary policy is unlikely be utilised to counter any weaknesses in economic growth in 2012, fiscal policy will take up the slack if a meaningful downturn materialises. As such, more supplementary budgets may be introduced on top of the RM6 billion already announced after Budget 2012 last year. Notwithstanding this, we are of the view that the government will keep the budget deficit target on track as concerns over the budget gap will affect the stability of the financial market. We feel that the 4.7% budget deficit target will likely be achieved through higher tax collections following stronger oil revenue arising from strong global oil prices.

Chart 9: Total federal government revenue tends to move in tandem with global oil prices. Persistently strong oil prices will be positive for government coffers and the additional revenue will likely be utilised in the event of a sharp slowdown.



Source: CEIC, MARC Economic Research

Chart 10: Government fiscal position as % of GDP is improving but will not likely achieve the government's target by 2015 if additional spending is required to support the growth in 2012.



Source: CEIC

- *Chart 9* – Excluding 2001 and 2009 (recessionary years), the federal government's revenue increased by an average of 10.1% per annum. Based on the assumption that Malaysia's GDP will expand circa 4.4% this year, government revenue is anticipated to reach RM200 billion. As such, supplementary budgets will not dent the government's coffers significantly if growth falls short of expectations.
- *Chart 10* – However, since the extra revenue could have been utilised to ease the pressure on the government's financial position, extra expenditure will likely sacrifice the opportunity to speed up the reduction in the fiscal gap.

Published and Printed by:

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