Economic Research

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The 2012 Bank Negara Malaysia Annual Report

MALAYSIAN RATING CORPORATION BERHAD
(364803-V)

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In a nutshell

- With the risk of global economic uncertainties diminishing, Bank Negara Malaysia (BNM) is becoming more upbeat in its assessment, projecting a gross domestic product (GDP) growth of between 5.0%-6.0% in 2013 (central tendency of 5.5%) after a 5.6% expansion in 2012. While global economic recovery will support modest improvements in trade performance and help Malaysia sustain a relatively strong growth, domestic demand will remain the key pillar upholding the economy in 2013. In this regard, MARC's GDP growth projection of 5.3% for 2013 is in line with BNM's projection. Our view is premised on the robust pace of investments and private consumption as well as convincing positive developments in the major economies, particularly the United States (US) and China.

- The overall banking sector remains healthy, with the shift to Basel III compliance now underway. Overall loan growth decelerated in 2012 but remains at a relatively healthy pace of 10.4% (2011: 13.6%). We are comfortable with the lower growth figure, as it indicates a sustainable pace of growth in keeping with the expansion of the economy, and not a build-up of excess credit. Capital ratios are more than adequate with aggregate risk-weighted capital and core capital ratios standing at 15.2% and 13.4% for 2012. BNM's stress test of the banking system, including multiple downside risks occurring simultaneously, suggests capital ratios will continue to remain strong, even under the stricter Basel III guidelines.

- The issue of household debt continues to hog the limelight. This is hardly surprising as its ratio to GDP continued to rise to 80.5% in 2012 (75.8% of GDP in 2011). In this regard, the focus of the discussion was on lending by non-bank financial institutions (NBFI) which according to BNM continued to expand significantly in 2012. Statistics indicate that NBFIs collectively extended 57% of personal financing credit to households. In its report, BNM noted that "the strong credit expansion [by NBFIs] was primarily driven by the increase in personal financing activity which rose at its fastest pace to date by 30%".

- Aggressive lending practices by NBFIs are also evidenced by BNM statistics which showed the number of approvals of new personal financing facilities reaching 600,000 (MYR43 billion), up by a hefty 63.7% from 2011. This is substantially higher than the facilities approved by banks which according to BNM declined by 6.2% to MYR19.4 billion in 2012. Despite these statistics, we concur with BNM's view that the risk of financial instability is largely mitigated by the fact that NBFIs only accounted for 12% of total credit to the household sector and linkages with the broader financial sector are limited. In addition, a large portion of these facilities (80%) are provided to salaried households in the government sector. As such, systemic financial risk is containable, although wider socio-economic implications of high household indebtedness remain.

- As we pointed out in our BNM report last year, we feel that more measures should be introduced to moderate enthusiasm in lending to certain segments (i.e. consumption credit). What is of concern is that borrowers who are in the relatively low income bracket (i.e. households with income less than MYR3,000 per month) will be hard pressed if economic conditions turn against them. We concur with BNM's view that they are over-leveraged (up to nearly 10 times of median income according to the 2011 Annual Report). In addition, the pace of growth in lending for this purpose is still relatively elevated, especially for Development Finance Institutions (DFI) which recorded an increase to MYR59 billion in 2012 from MYR17 billion in 2006. While we do not foresee extreme financial instability to arise in the event of rising defaults, we think that the impact on future private consumption should not be underestimated. This is due to the fact that credit standards will likely be tightened in the event of rising defaults, hurting financial conditions for the bulk of Malaysian households (approximately 50% of total) whose incomes are less than MYR3,000 per month.

- The concerns over rising home prices were also highlighted as the average price increase surged at a double-digit pace in three consecutive quarters between 4Q2011 and 2Q2012 as opposed to an average rise of only 3.2% between 2001 and 2009. Although BNM noted that the increases were mainly driven by demographic changes as well as rising home purchases for investment purposes, we feel that easy financing facilities have exacerbated the situation. For instance, the innovative arrangements between developers and buyers such as the Developer Interest Bearing Schemes (DIBS) have led to price increases, as developers hike up home prices to offset interest charges incurred by them. As such, we think that such schemes should be reviewed in order to moderate the level of speculation in the housing market. At the same time, we think extremely accommodating lending facilities that push up individuals' financial commitment to more than 60% of their net income should be monitored.

- On interest rates, we sense that BNM is slowly moving away from any downward bias as the economy exhibits persistent strength even in the face of global headwinds. Pressures from consumer prices are practically non-existent, although the Consumer Price Index (CPI) is expected to climb from last year's level primarily due to the low base effect. In addition, lingering concerns over the household debt level will continue to complicate the situation if the Overnight Policy Rate (OPR) is lowered without strong justification. On the other hand, there are also reasons to suggest that BNM will not rush to nudge up the policy rate unnecessarily as the nascent recovery of the global economy has yet to find a firm footing. We also view BNM's latest Monetary Policy Committee (MPC) meeting statements positively as it indirectly implies that the central bank is comfortable with the current level of the OPR. We do not foresee changes to the policy rate in 2013 unless significant changes in economic fundamentals take place.

- Once again, the concerns over rising foreign holdings of Malaysian Government Securities (MGS) which reached 44.6% of total outstanding MGS and the possibility of capital outflows were downplayed by the authorities. This, in our view, signals some comfort among BNM officials arising from two-way flows of capital which will not significantly disrupt the stability of the financial markets even if portfolio outflows accelerate in the near term. In addition, some portion of foreign holdings of MGS is held by the official sector (i.e. other central banks) and the market is also well supported by ample domestic funds. We concur with BNM's view on this matter. However, we also wish to highlight that on the past two occasions when foreign investors unwound their positions in a big way – in 2H05 and between 2Q08-1Q09 – foreign holdings of MGS dropped by half of their peak levels. If for any reason this were to occur again, our estimates suggests that the ringgit may weaken to circa MYR3.30 per US dollar (USD). Possible events that may trigger this could be a significant recovery of the US economy that may spark expectations of an earlier-than-expected US Federal Reserve (Fed) rate hike and concerns over political developments relating to the upcoming General Election.

Introduction

The MARC Economic Research team attended the analyst briefing that was held in conjunction with the release of the BNM Annual Report 2012 on March 20, 2013. There was a solid turnout at the event with a diverse crowd comprising sell- as well as buy-side analysts from institutions like research houses and investment banks.

During the question-and-answer session, there was notable interest amongst attendees in BNM's potential response to escalating household debt, aggressive lending by NBFIs and rising home prices. We proffer below some of our thoughts on the key takeaways from the presentations made by senior BNM officials.

Global economy in 2013

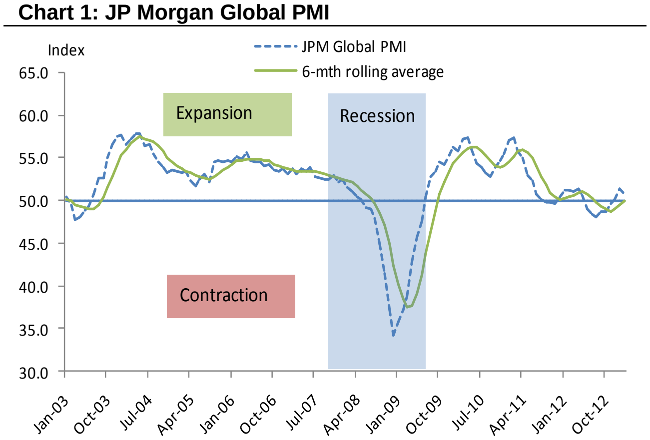
With prospects of global economy recovery brightening, BNM is targeting a growth rate of between 5.0% - 6.0% this year (central tendency of 5.5%) after a 5.6% expansion in 2012. While global economic recovery will support modest improvements in trade performance and help Malaysia sustain a relatively strong growth, domestic demand will remain the key pillar upholding the economy in 2013.

Judging by global macroeconomic and financial market indicators, global economic conditions are noticeably on the mend. Industrial production is slowly picking up, evidenced by JPMorgan and Markit Purchasing Managers' Indexes (PMI) in recent months. In the US, the Institute for Supply Management's (ISM) manufacturing index climbed to the highest level since June 2011, the third consecutive monthly expansion. Except for a minor blip in November 2012 following uncertainty over the fiscal cliff, the manufacturing sector had expanded for 42 consecutive months. In terms of growth, we expect the US to register a growth rate of between 2.3% - 2.8% this year as corporate spending improves and consumer spending accelerates.

In China, the PMI has been above the 50-point demarcation line for five consecutive months, although it softened slightly in February according to the 'flash' estimate. We are of the view that China's economy may have bottomed out in 3Q2012 when GDP growth decelerated to 7.4% before recovering to 7.9% in the final quarter of 2012.

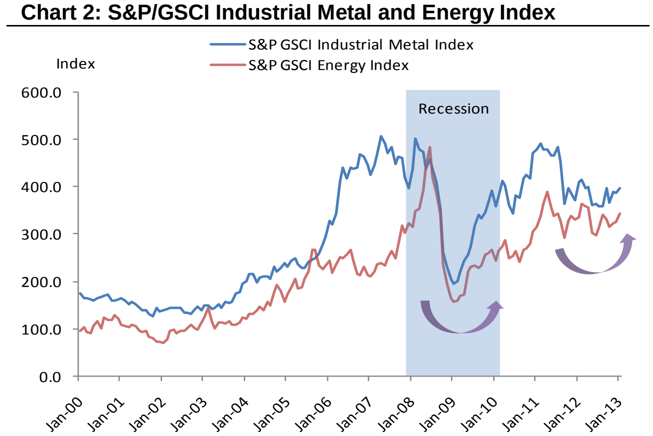
Other signs of a global economic recovery include the upturn in commodity prices, surging equity prices worldwide and decreasing demand for gold which has commonly been used to hedge against expected inflation from aggressive Quantitative Easing (QE) policies. For commodities, the S&P/Goldman Sachs (GSCI) Industrial Metal Index has recovered by 11% from its recent low in July 2012 while the GSCI Energy Index has strengthened by 17% from its cyclical low in September 2011. Both indices have leapt by 103% and 120% respectively from their lows in January 2009 during the height of the Great Recession.

Chart 1: JP Morgan Global PMI



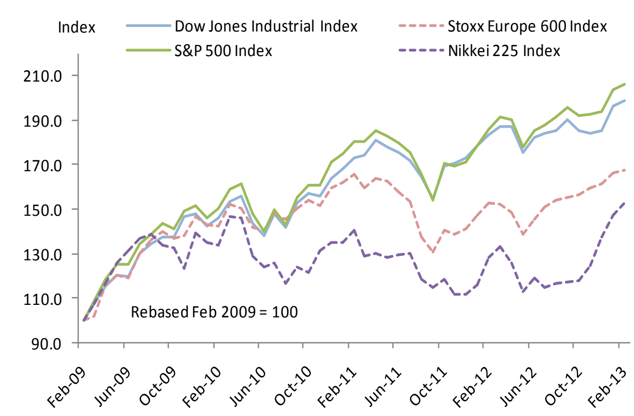
Source: Bloomberg, MARC Economic Research

Chart 2: S&P/GSCI Industrial Metal and Energy Index



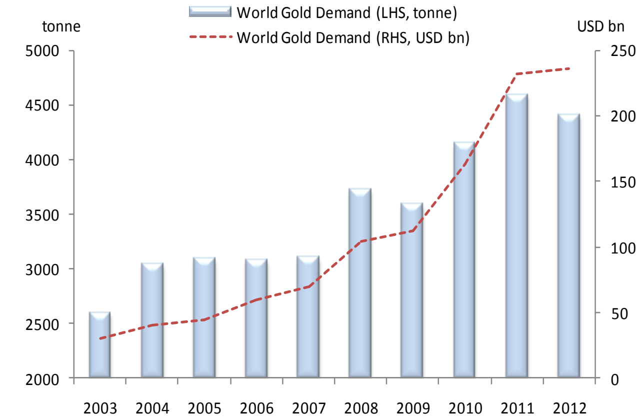
Source: Bloomberg, MARC Economic Research

Chart 3: Global equity indexes



Source: Bloomberg, MARC Economic Research

Chart 4: World gold demand



Source: World Gold Council, MARC Economic Research

Gold, on the other hand, has lost its shine, moderating by 13.5% as investors' sentiment shifted, favouring riskier but higher yielding asset classes such as equities. At the same time, the fear of rising inflationary pressures has subsided as investors sense that central bankers will no longer expand their QE policies in view of the improvement in the global economy. Gold prices have dipped below USD1,600 per troy ounce as of February 2013 from as high as USD1,900 per troy ounce in September 2011. At the same time, world gold demand has dropped by 4.0% in 2012, the first decline since 2009 in terms of volume.

Global equities, which commonly provide early signals on the future direction of the broader economy, have also responded favourably. The Dow broke its major resistance – the highest level prior to the Great Recession – while the S&P is flirting with its all-time high as well. Earnings have surprised on the upside with more than 70% of S&P companies recording profits above their mean estimates. In Japan, the Topix index broke a one-year high of 1051.65 points in mid-March 2013 while the Nikkei index surged by 20% year-to-date.

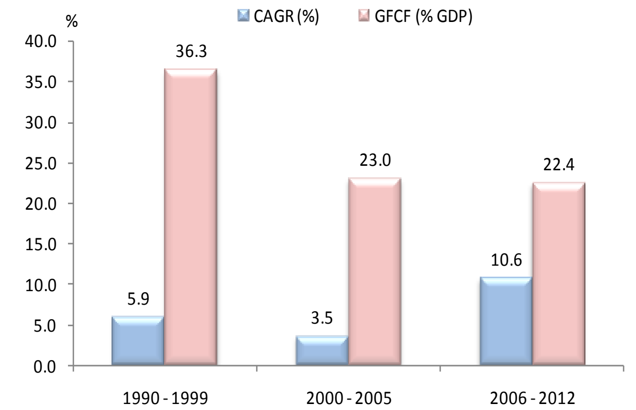
Malaysia – supported by investments and private consumption

MARC's GDP growth projection for 2013 (+5.3%) is in line with BNM's projection. Similar to BNM, we foresee the economy to continue exhibiting resilience in investment and private consumption. The story behind investment is well-known. Investment spending has been substantially boosted by major infrastructure and property projects, not least of which are the MYRapid Transit (MRT) and Refinery and Petrochemical Integrated Development (RAPID) projects under the Economic Transformation Programme (ETP).

Scrutinizing the breakdown, investment expenditure was about evenly divided between structures and machinery & equipment, but the former category showed continued strong growth at 25.0% year-on-year (y-o-y) in 4Q2012, despite the slowdown in the growth of the latter category to 7.6% y-o-y in the same quarter from 22.3% in 3Q2012. The contribution to growth in total investments has accelerated to 4.7 percentage points in 2012 from 1.5 percentage points in 2011. Total investments have risen by 83.4% between 2006 and 2012 (10.6% on a compound annual growth rate [CAGR] basis), compared with 18.9% between 2000 and 2005 (3.5% on CAGR basis) in nominal terms, despite their ratios to GDP dropping marginally to 22.4% from 23.0% in 2000 – 2005.

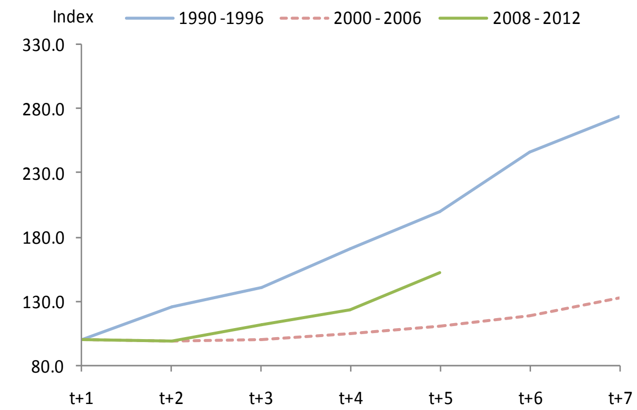
With more mega projects in the pipeline such as the Tun Razak Exchange (TRX), Menara Warisan, and RAPID, to name a few, the momentum in investments will not likely fade in 2013.

Chart 5: Growth in total investments and % of GDP (current price)



Source: CEIC, MARC Economic Research

Chart 6: Total investments (re-based)



Source: CEIC, MARC Economic Research

Consumer spending growth has not subsided and will not likely do so in the near term. A favourable job market as reflected by the low unemployment rate of circa 3% and easy access to credit has fueled private consumption in the past several years. With the Malaysian economy expected to grow at around 5.3% (according to our estimates), retrenchments will likely remain relatively low, thus keeping the unemployment rate below 3.5%. We expect consumer spending will likely stay robust in the near term as job security remains relatively favourable, wage growth has been sustained, welfare transfers such as BR1M 2.0 have been renewed, and with the implementation of the minimum wage in January 2013.

Credit growth in both banking and non-bank financial institutions will also likely remain strong in 2013 as stiff competition continues to induce financial institutions to fight to maintain or expand their market share. For instance, between 2006 and 2012, loans from banking institutions categorised as “consumption credit” grew by an average of 8.4% p.a. on a CAGR basis. However, loans by DFIs under the same category expanded by a more robust pace of 22.5% p.a. on a CAGR basis. A breakdown of consumption credit reveals that credit card loans expanded at higher pace at about 8.9% p.a. for banking institutions and 50.2% p.a. for DFIs respectively between 2006 and 2012.

Table 1: GDP growth regionally

Growth %y-o-y	2009	2010	2011	2012
Malaysia	-1.5	7.2	5.1	5.6
Indonesia	4.6	6.2	6.5	6.2
Philippines	1.1	7.6	3.9	6.6
Singapore	-0.8	14.8	5.2	1.3
Thailand	-2.3	7.8	0.1	6.4

Source: CEIC, MARC Economic Research

Table 2: GDP – demand side (%)

Growth %y-o-y	2009	2010	2011	2012	MARC 2013F	BNM 2013F	MoF 2013F
GDP	-1.5	7.2	5.1	5.6	5.3	5.0 - 6.0	4.5 - 5.5
Domestic Demand	0.3	7.0	8.2	10.6	7.3	8.1	5.6
Private Consumption	0.6	6.6	7.1	7.7	6.2	7.1	5.7
Public Consumption	4.9	2.9	16.1	5.0	3.6	3.6	-1.2
Private Investment	-7.4	15.5	12.2	22.0	14.0	15.6	13.3
Public Investment	2.9	5.0	-0.3	17.1	6.3	7.5	4.2
Real Exports	-10.9	11.3	4.2	0.1	4.0	1.8	2.8
Real Imports	-12.7	15.6	6.2	4.5	6.4	3.9	3.6

Source: CEIC, BNM, MoF, MARC Economic Research

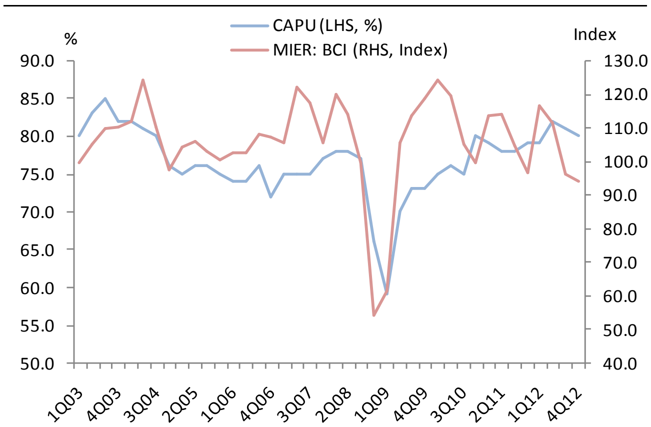
Inflation and Interest rates

Inflation is not expected to be a major concern in 2013, although the CPI will likely climb from a two-year low of 1.7% in 2012. An expected higher inflation rate will come on the back of a low base last year as well as the repercussions from the introduction of the minimum wage and higher salaries for civil servants. A recovery of commodity prices will also induce higher consumer prices in 2013. In this regard, we maintain our CPI growth target of 2.5% for 2013.

Malaysia's policy rate remained unchanged for an eleventh straight meeting of the Monetary Policy Committee. We think there will be a tendency for it to maintain status quo in the next one year, although a significant upside in growth could risk a marginal increase in the policy rate. The recent decision by BNM to hold the OPR unchanged at 3.00% during its MPC meeting in March signals the central bank's unwillingness to alter its stance unless macroeconomic fundamentals change significantly. In particular, BNM views "*the current stance of monetary policy to be appropriate given the outlook for inflation and growth*". The last sentence in its policy statement is crucial from our point of view as it differs from the previous statements which emphasised that the policy rate *"is supportive of the economy".* By this we think that the central bank is slowly turning away from its downward bias and engaged in passive tightening, especially when 4Q2012 GDP growth proved to be way above expectations.

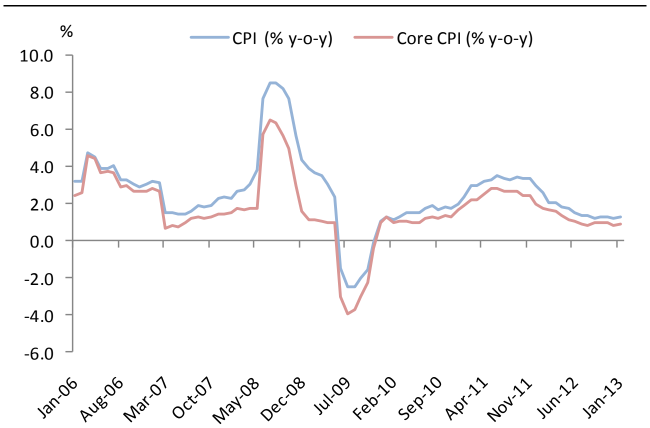
There are also reasons for the BNM not to rush in nudging up the policy rate. The most critical in our view is the nascent recovery of the global economy which has yet to find a firm footing. Added to this is the debt burden of households which will naturally be magnified if interest rates start to creep up.

Chart 7: CAPU and MIER: Business Condition Index



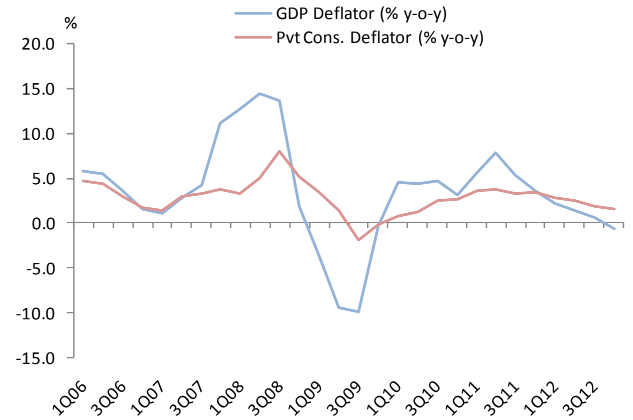
Source: CEIC, MARC Economic Research

Chart 8: CPI and core-CPI



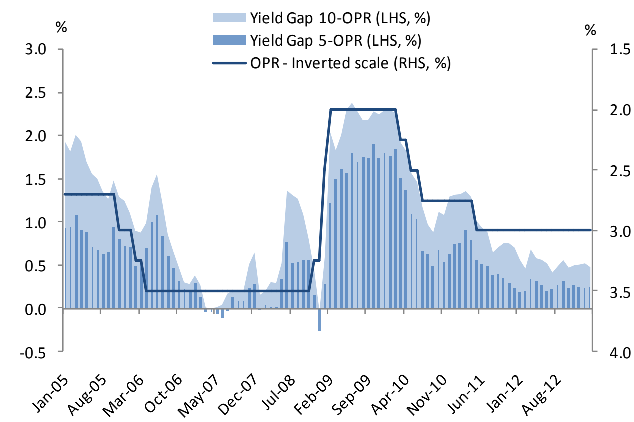
Source: CEIC, MARC Economic Research

Chart 9: GDP and private consumption deflator



Source: CEIC, MARC Economic Research

Chart 10: OPR and yield gap (MGS 10y, 5y – OPR)



Source: CEIC, MARC Economic Research

Capital flows and ringgit

Overall, we still hold to our view that was presented in our Annual Outlook 2013 that the long-term trend of the ringgit against the USD is still on the upside (strengthening of the ringgit). Judging by macro fundamentals which look rather favourable in the medium term, we expect real GDP growth to be in the range of 5.0% in the next few years, consistent with long-term potential output growth. As such, the outlook for the ringgit is quite favourable.

Notwithstanding this, we do not rule out the possible rise in the volatility of the ringgit against the greenback, especially if foreign investors become overly concerned about the political scenario in view of the upcoming General Election. In addition, the rising appeal of dollar-denominated assets following upbeat momentum in the US financial markets and economy may spark expectations of an earlier-than-expected hike in US interest rates. This may take away some of the spotlight on the ringgit against the USD in the short term.

Despite the possibility of the above scenario, the concerns over huge foreign holdings of MGS which reached 44.6% of the total outstanding MGS and the possibility of capital outflows were downplayed by the authorities. This, in our view, signals some comfort among BNM officials arising from two-way flows of capital which will not significantly disrupt the stability of the financial markets even if portfolio outflows accelerate in the near term. In addition, some portion of foreign holdings of MGS is held by the official sector (i.e. other central banks) and the market is also well supported by ample domestic funds. We concur with BNM's view on this matter.

However, we also wish to highlight that in the past two occasions when foreign investors unwound their positions in a big way – in 2H05 and between 2Q08-1Q09 – foreign holdings of MGS fell by approximately half their initial level. For instance, in 2H05 when MYR20 billion worth of capital flowed out from Malaysian shores, foreign holdings of MGS dropped to 4.7% of total MGS outstanding from 8.5% at the time when the outflows started. Similarly, between 2Q08-1Q09, when RM122 billion worth of portfolio capital flowed out during the Great Recession, foreign holdings of MGS dropped by half from 24.6% to 12.5% of total outstanding MGS (Table 3).

Table 3: Foreign holdings of MGS, MYR/USD and FBM KLCI

	Foreign holdings of MGS (RM mil)	Foreign holdings of MGS (% of outstanding MGS)	MYR/USD	KLCI (index)
Jul-05	13,658	8.5%	3.7505	937.39
Jan-06	7,862	4.7%	3.7505	914.01
Changes	-5,796	-3.8%	0.0%	-2.5%
Apr-08	50,026	24.6%	3.1597	1279.86
Mar-09	26,720	12.5%	3.6475	872.55
Changes	-23,306	-12.1%	-13.4%	-31.8%

Source: CEIC, Bloomberg, MARC Economic Research

On both occasions the equity market reacted negatively, although during 2H05 the benchmark FBM KLCI fell only marginally (-2.5%). During the Great Recession, however, the KLCI fell more dramatically by almost 32% from its peak. Similarly, the ringgit reacted differently, hardly falling during the outflows of capital in 2H05 but plunging by 13.4% during the Great Recession in 2008-09, despite substantial central bank intervention to meet US dollar demand. The stability of the ringgit during the first event was partly due to strong economic fundamentals at that time coupled with a 30 bps interest rate hike undertaken by BNM.

Judging by the strong correlation between the ringgit and the level of foreign holdings of MGS, we foresee the ringgit may experience similar weakness should foreign investors decide to unwind their positions in a big way as in the past. In particular, if economic and political uncertainties spark jitters among foreign investors and cause them to trim their holdings of MGS by as much as they did in the past two occasions – half from their peak levels – we estimate the ringgit to flip back to circa MYR3.30 per USD.

Issue of household debt

The frequently discussed issue of household debt was once again highlighted by BNM officials. In 2012, the household debt level stood at 80.5% of GDP, slightly higher than its level in the preceding year (2011: 75.8%). To be fair, BNM has taken numerous efforts to curb the household debt level from escalating further. Some of the steps undertaken include various macro prudential measures to curb over-lending by banking and non-bank institutions to relevant sectors.

Once again, BNM has maintained that the risks arising from the elevated level of Malaysia's household debt is somewhat mitigated by even larger holdings of financial assets. In other words, in the event of an economic downturn, such assets can be utilised to cover the debt of an individual.

Notwithstanding this, we still think that with the relatively skewed income distribution – where approximately 50% of households earned less than MYR3,000 per month – the financial burden is still overwhelmingly high on the low income group. As mentioned in the 2011 BNM Annual Report, the leveraged position of this income group, defined as the amount of outstanding debt to the median income, was as high as almost 10 times. In addition, most of the households that fall under this category of income do not possess valuable assets like residential houses which tend to appreciate in value over time.

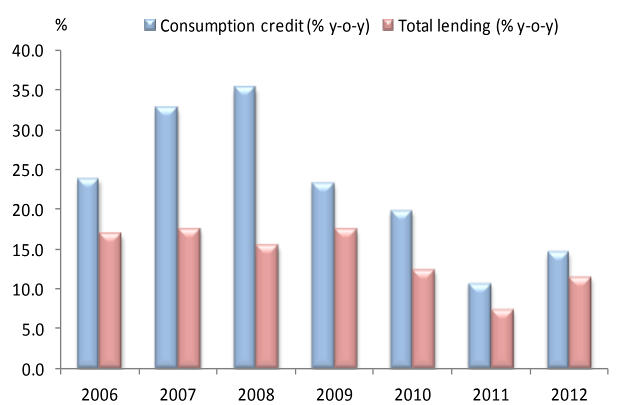
We wish to reiterate that our concern is also based on the amount of household savings that we estimate for 2012 (an extrapolation from 2008 statistics provided by the Department of Statistics). Our estimate suggests that even under optimistic assumptions, the rate of household savings in 2012 was less than 10% of the group's highest annual income. Bear in mind that this is an average figure which does not take into consideration the skewed income distribution. The actual quantum of savings for most of the households with income levels below MYR3,000 per month could be less for this group.

What it boils down to is that any economic downturn will most likely cause this group of people to default on their debt. Admittedly, the positive aspect of it is that only a small portion of outstanding debt belongs to this group. As such, the impact on the banking sector will not be too pronounced. Even so, we view that a notable increase in the amount of bad debt and write-offs for this group will lead to stricter credit standards that will further moderate the growth in lending for low income groups. In addition, there will likely be a negative impact on private consumption as this group of households normally has higher propensity to consume than higher income groups.

Another concern is the lending trend by NBFIs which accelerated in 2012. Statistics indicate that NBFIs collectively extended 57% of personal financing credit to households. In its report, BNM noted that "the strong credit expansion [by NBFIs] was primarily driven by the increase in personal financing activity which rose at its fastest pace to date by 30%".

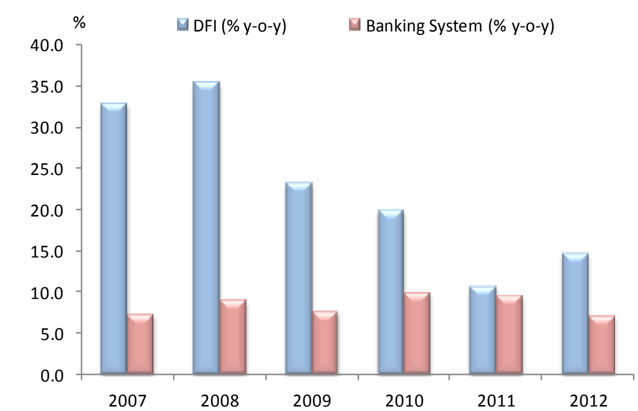
Aggressive lending practices by NBFIs are also evidenced by BNM statistics which showed the number of approvals of new personal financing facilities reaching 600,000 (MYR43 billion), up by a hefty 63.7% from 2011. This is substantially higher than the facilities approved by banks which according to BNM declined by 6.2% to MYR19.4 billion in 2012. Despite these statistics, we concur with BNM's view that the risk of financial instability is largely mitigated by the fact that NBFIs only accounted for 12% of total credit to the household sector and linkages with the broader financial sector are limited. In addition, a large portion of these facilities (80%) are provided to salaried households in the government sector. As such, systemic financial risk is containable, although wider socio-economic implications of high household indebtedness remain.

Chart 11: Lending growth by DFIs – total and for consumption credit



Source: BNM Financial Stability and Payment Systems Report (various issues), MARC Economic Research

Chart 12: Consumption credit by DFI and banking system



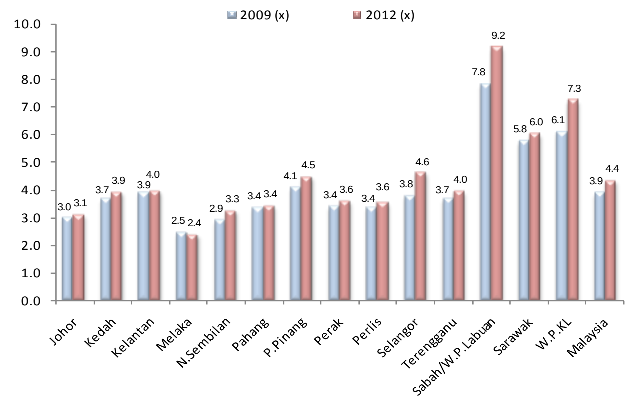
Source: BNM Financial Stability and Payment Systems Report (various issues), CEIC, MARC Economic Research

Rising home prices

Rapid increases in home prices in major cities were also highlighted during the discussion with central bank officials. Admittedly, this is not a new issue – however, measures put forward to deal with it have not eased concerns about escalating home prices in some cities pushing up the cost of living for some groups of the population.

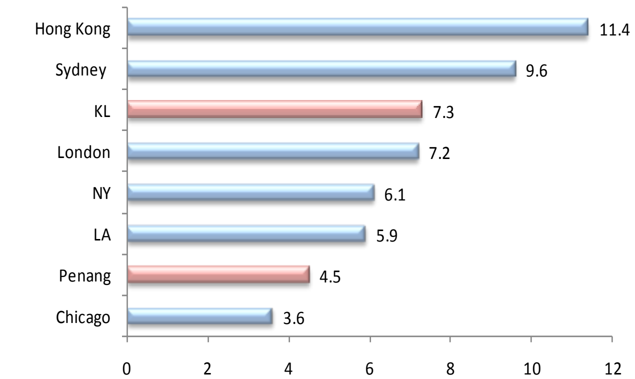
We have presented some of the statistics in our previous reports (chart 13 and 14). The ratio of average home prices to income in some cities – i.e. Sabah, Wilayah Persekutuan Kuala Lumpur – are actually comparable to some of those in major cities around the world (i.e. London, Los Angeles, Chicago). Secondly, although financial institutions are now using net income as a guideline to provide loans as required by BNM, many of them are willing to consider applicants who already have high financial commitments. This will make it easy for buyers to purchase properties even though they are financially stretched.

Chart 13: Ratio of average home prices to income (Malaysia)



Source: DOS, NAPIC, MARC Economic Research

Chart 14: Ratio of average home prices to income (selected cities)



Source:Annual Demographic International Housing Affordability Survey 2011, NAPIC, MARC Economic Research

Although BNM has introduced selected measures to avert a further spiraling of property prices, financiers and developers have continued to introduce innovative financing packages in an effort to expand their businesses and protect their market shares. One of them is the *Developer Interest Bearing Scheme* (DIBS) where developers initially absorb the cost of interest payments during the period of construction in order to entice more buyers. In order to protect their margins, however, developers factor in these initial costs into house prices. This partly explains the increase in home prices in some places.

We are of the opinion that the above-mentioned practices should be controlled especially at a time when home affordability (measured by average home price to average income) has persistently declined. While we applaud the government's effort to partially ease the housing problem with affordable houses (i.e. to be built by PR1MA), we still think that more serious measures should be introduced to control the demand side of the equation. Measures to review DIBS, imposing higher stamp duties and taxes on foreign and non-individual buyers should be considered (as Singapore has done) in order to contain the acceleration in home prices.

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