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SOCIO-ECONOMIC RESEARCH CENTRE

Bank Negara Malaysia Annual Report 2016 – Is The Economy Doing Well?

23 March 2017

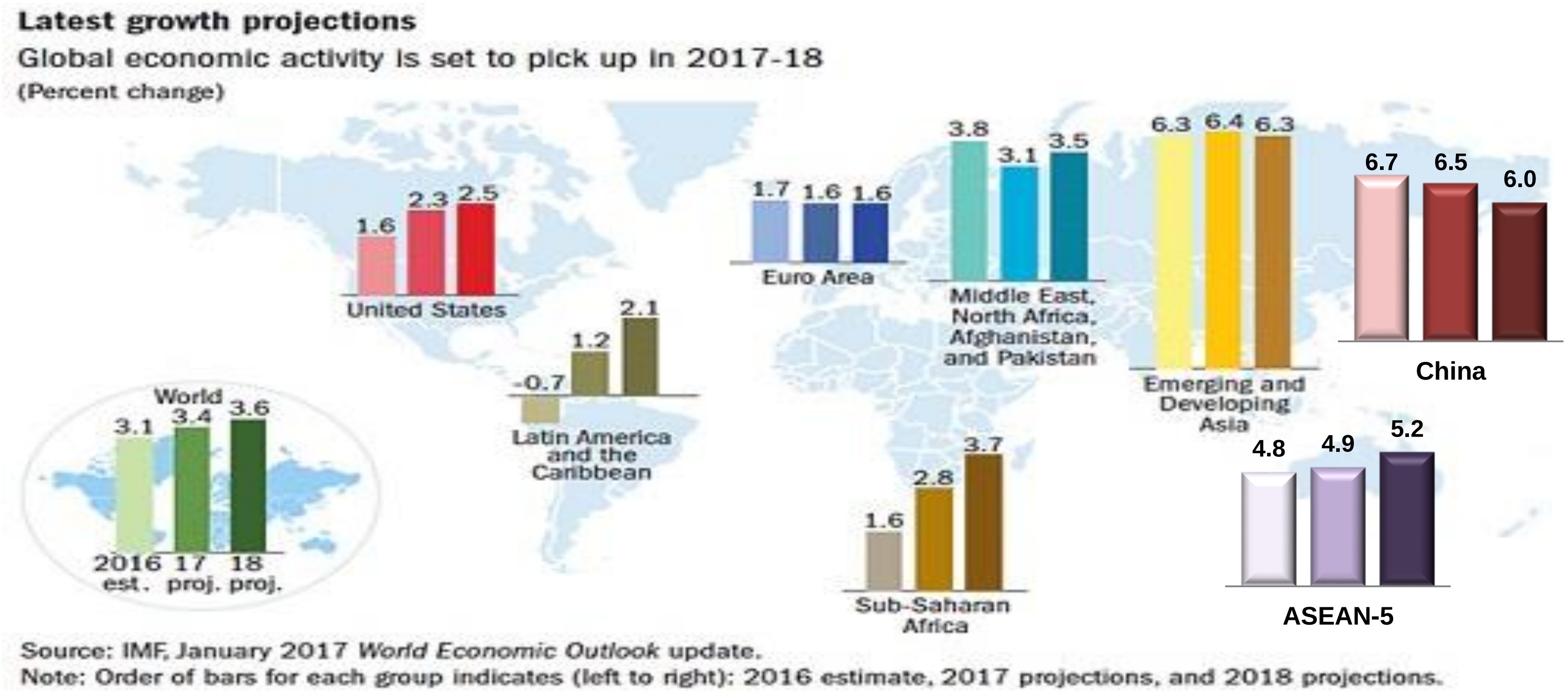
SERC

AGENDA

- Global economic activity pick up pace
- Economic outlook for 2017 – Where is the economy heading?
- Sources of growth – Moving on twin engines
- Issues and challenges
- Managing risks from household indebtedness
- Conclusion

THE GLOBAL ECONOMY IS ON A CRUISING SPEED…

- **Global growth will pick up pace** (3.4% in 2017 and 3.6% in 2018) against estimated 3.1% in 2016. But, the growth estimate remains below 4.2% pa in 1998-2007.
- The **US economy is gaining traction**; a modest recovery in eurozone and Japan.
- **China's growth reassuring** (6.5% in 2017 vs. 6.7% in 2016) amid growing worries about high debt risk.



DOWNSIDE RISKS TO THE GLOBAL ECONOMY

Despite positive global outlook, there are **new and prevailing downside risks** that would render the still moderate global economy highly susceptibility to adverse shocks.

1. The **potential retreat of globalisation** in advanced economies and the **US's trade protectionism mindset** could hamper the recovery in global trade.
2. **Lingering uncertainties** associated with the duration and outcome of the Brexit's negotiation process may dampen investor and business sentiments, thus impacting global financial markets.
3. **Monetary policy divergence** between the US and the other major economies will intensify in 2017. This will lead to changes in investor's risk perception, causing extreme volatility in the currency markets and capital flows. The governments and corporations with highly leveraged balance sheets may suffer financial distress inflicted by higher borrowing costs and the impact of strong US dollar.
4. **Geopolitical risks** in relation to domestic conflicts, terrorism attacks and territorial disputes remain, which could affect sentiments in the global financial markets and dampen trade and economic activity.

HERE's HOW THE ECONOMY IS DOING

Key indicators	2015	2016	2017*f* (BNM)	2017*f* (SERC)
Real GDP growth (%)^	5.0	4.2	4.3-4.8	4.3
Private consumption growth (%)^	6.0	6.1	6.0	5.7
Private investment growth (%)^	6.4	4.4	4.1	4.5
Income per capita (RM)	36,078	37,738	39,656	39,858
Unemployment (%)	3.1	3.5	3.6-3.8	3.6
Inflation (%)	2.1	2.1	3.0-4.0	3.0-4.0
Export Growth (%)	1.6	1.1	5.5	5.0
Current account surplus				
RM billion	34.7	25.2	17.4	18.4
% of GDP	3.0	1.3	1.3	1.4
Budget deficit				
RM billion	37.2	38.4	40.3	39.3
% of GDP	3.2	3.1	3.0	3.0
Federal government debt				
RM billion	630.5	648.5	-	-
% of GDP	54.5	52.7	-	-

Source: Bank Negara Malaysia; SERC
^ Constant 2010 prices

- **Cautiously optimistic outlook.** Bank Negara Malaysia (BNM) expects this year's GDP growth to grow by 4.3-4.8% (4.2% in 2016), in line with the Ministry of Finance's forecast made in October (SERC: 4.3% in 2017).
- **Still decent domestic demand.** Consumer spending (54.0% of GDP) will grow by 6.0% in 2017 (6.1% in 2016) while private investment growth paces slower (4.1% in 2017 vs. 4.4% in 2016).
- **Exports recovering.** Exports are estimated to grow by 5.5% in 2017 (1.1% in 2016), riding on higher demand for electronics and electrical products, improved crude oil and commodity prices.
- **Higher inflation trajectory**. Headline inflation is projected to rise by 3.0-4.0% in 2017 (2.1% in 2016), induced by the pass-through impact of the increase in global oil prices on domestic retail fuel prices. Weak ringgit also plays a part.

SOURCES OF GROWTH: MOVING ON TWO ENGINES

- **Domestic demand** will continue to be the main driver of growth, underpinned primarily by private sector, aided by stronger exports.
- **All economic sectors** are expected to **register positive growth**.

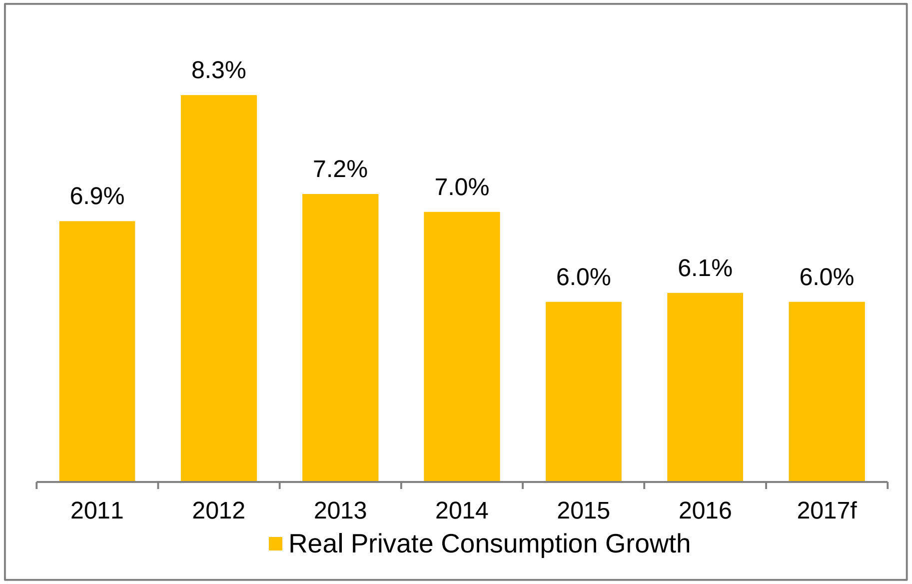
(% change, 2010=100)	**% of GDP in 2017***	**2014**	**2015**	**2016**	**2017*f* (BNM)**	**2017*f* (SERC)**
GDP by demand component						
Private consumption	54.0	7.0	6.0	6.1	6.0	5.7
Private investment	16.8	11.1	6.4	4.4	4.1	4.5
Public consumption	12.5	4.3	4.4	1.0	-0.2	-0.5
Public investment	8.3	-4.7	-1.0	-0.5	1.5	2.0
Exports of goods and services	68.4	5.0	0.6	0.1	2.2	2.7
Imports of goods and services	60.3	4.0	1.2	0.4	1.8	2.2
GDP by economic sector						
Agriculture	8.0	2.1	1.2	-5.1	4.0	1.5
Mining & quarrying	8.7	3.5	4.7	2.7	2.7	2.3
Manufacturing	22.9	6.2	4.9	4.4	4.3	4.2
Construction	4.7	11.7	8.2	7.4	8.0	8.5
Services	54.4	6.6	5.1	5.6	4.9	4.9
Overall GDP	**100.0**	**6.0**	**5.0**	**4.2**	**4.3-4.8**	**4.3**

Source: Bank Negara Malaysia; SERC
** % Share to GDP of 2017 from BNM*

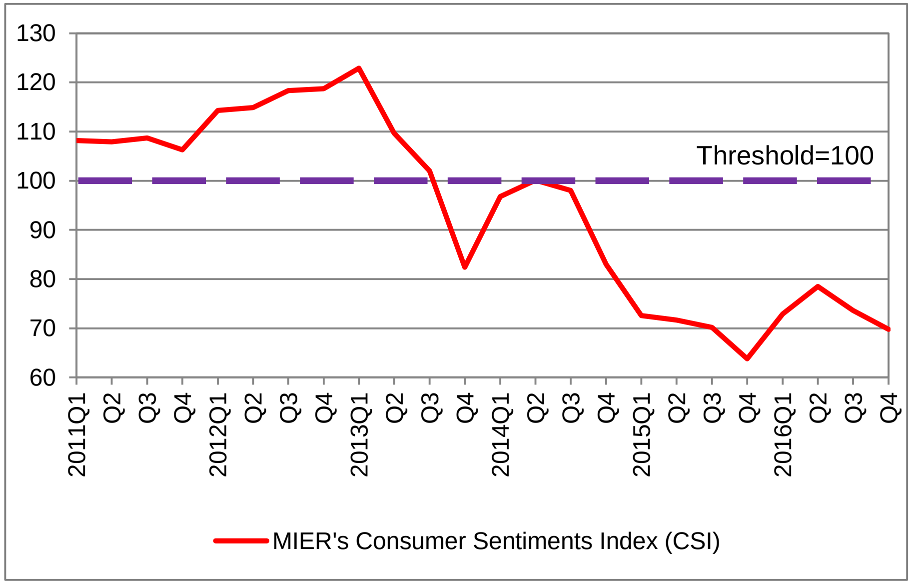
CONSUMER SPENDING SET TO GROW 6.0% IN 2017

- Amid rising inflationary pressures**, consumer spending** is expected to be supported by a stable labour market and continued wage growth as well as the implementation of selected income-support measures (cash handouts and 3% pts reduction in EPF employees' contribution rate).
- **SERC's comments**: *Broadly, consumer sentiment remains cautious and weak, weighed by rising inflation pressures and continued worries about job prospects. BNM expects unemployment rate to edge higher (3.6% – 3.8%; 2016: 3.5%). Households still grappling with rising cost of living though the cash handouts provided some relief to the low-and middle-income households. Higher fuel prices and other cost-driven inflation pressures have taken a toll on consumer spending.*

Private consumption growth trend



Consumer sentiments remain weak

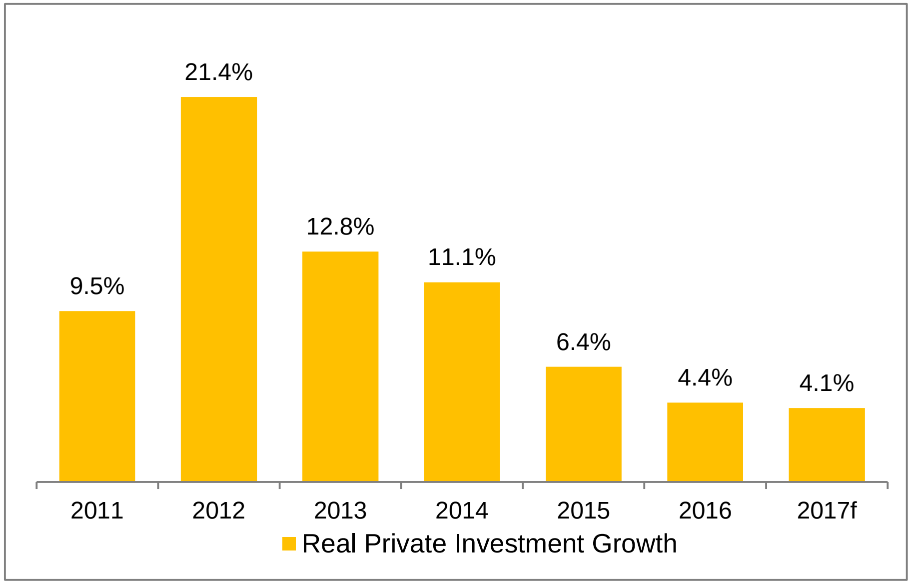


Source: Bank Negara Malaysia; Malaysian Institute of Economic Research (MIER)

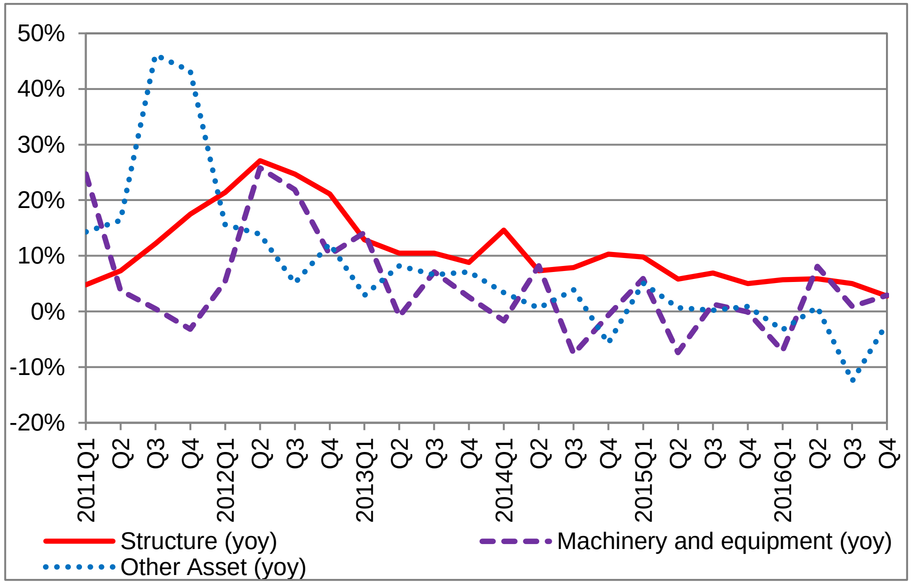
PRIVATE INVESTMENT GROWING, THOUGH UNEVENLY

- **Private investment** growth is projected to **slow further to 4.1% in 2017** from 4.4% in 2016, marking the fifth consecutive year of moderation as companies are expected to remain cautious amidst continued uncertainty in the economic environment.
- **SERC's comments**: *The on-going implementation of public transport projects and continued investment in manufacturing and services should keep private investment going. But, high cost of doing business, including unresolved issues associated with foreign workers and regulatory practices, the weakening ringgit as well as lingering uncertainty about the General Election 14 (GE14) may temper investors' sentiment.*

Private investment growth trend



Capital investment by type

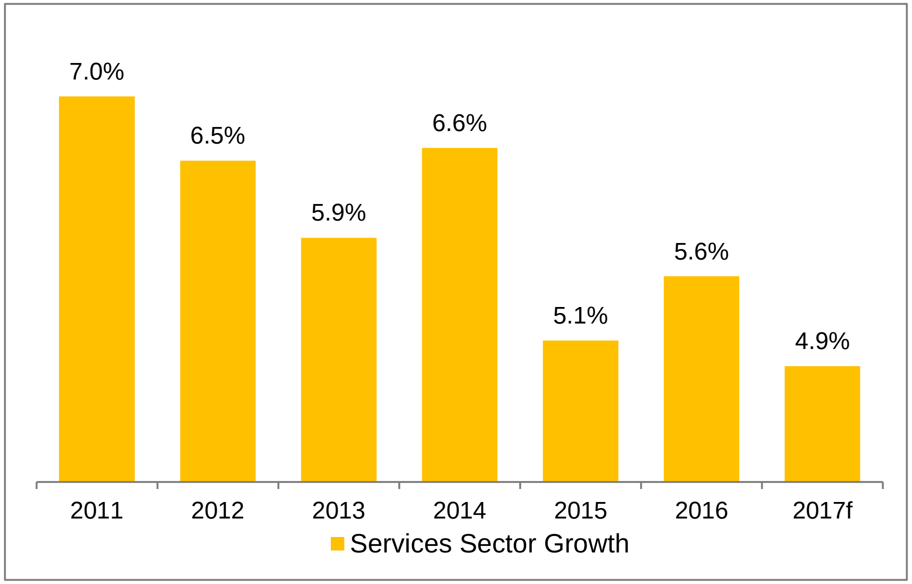


Source: Bank Negara Malaysia; Department of Statistics, Malaysia

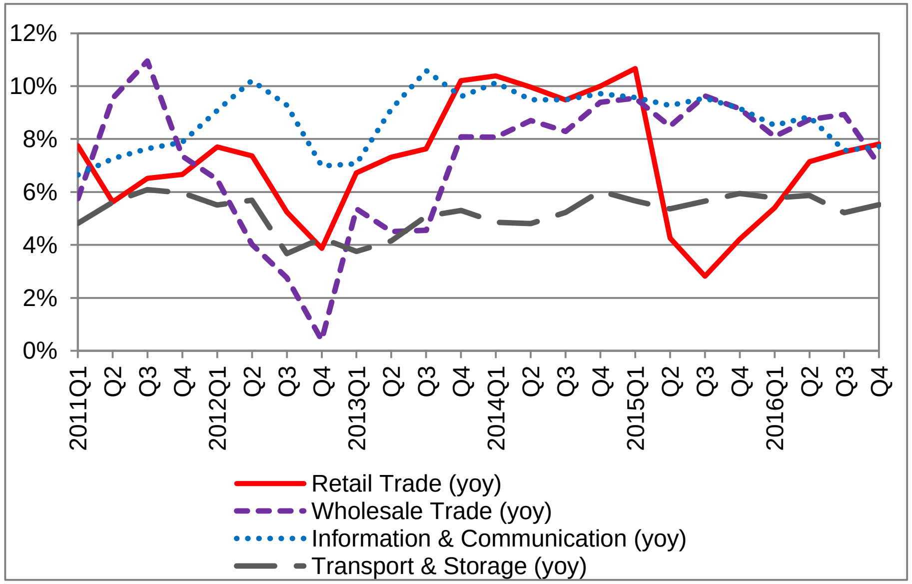
SERVICES: DOMINANT DRIVER OF GDP GROWTH

- The **services sector** is estimated to grow at a moderate pace (4.9% in 2017 vs. 5.6% in 2016), driven by the wholesale and retail trade, food and beverages and accommodation, information and communication as well as transportation.
- The number of tourist arrivals is targeted at 31.8 million this year (26.8 million in 2016) with targeted tourist income of RM118 billion.
- **SERC's comments:** *The expansion in services sector will be driven by domestic consumption, tourism and leisure as well as moderate trade activity. Major events are expected to boost tourists arrival and spending: Visiting ASEAN@50th anniversary; play host for the 29th South-east Asia (SEA) Games (19-31 August) and the 9th Para ASEAN Games*.

Output growth of services sector



Performance of sub services sectors

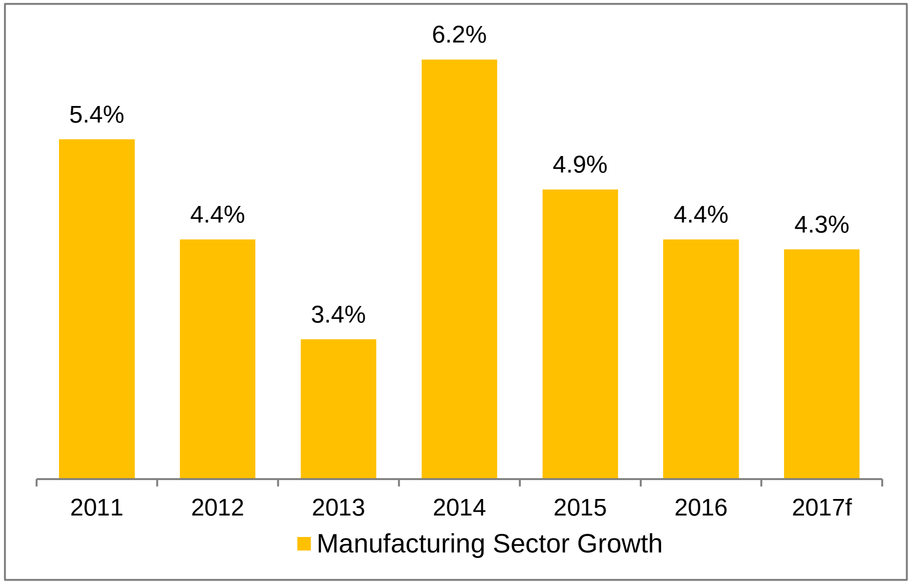


Source: Bank Negara Malaysia

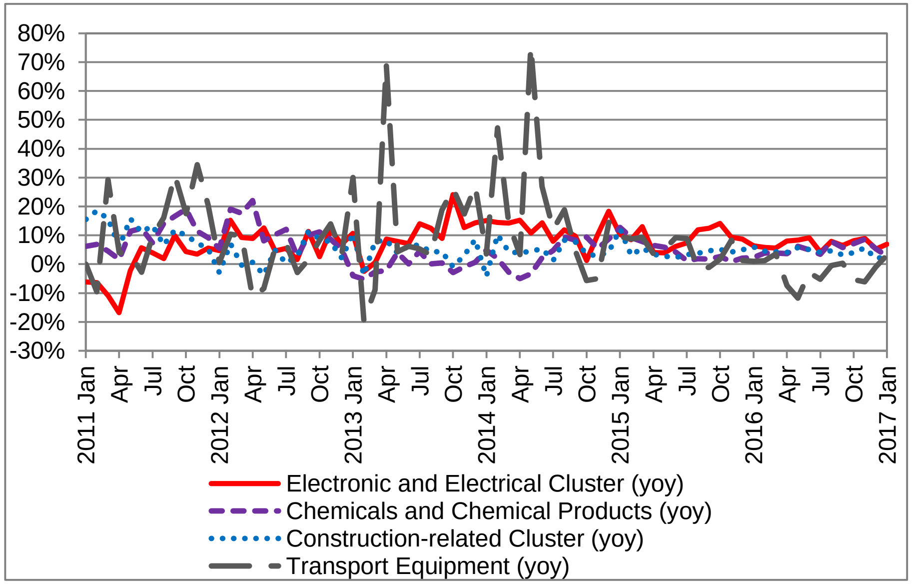
MANUFACTURING: STILL GROWING ALBEIT MODERATELY

- The **manufacturing sector** will sustain at 4.3% growth in 2017 (4.4% in 2016), underpinned by the export-oriented industries on continued demand for electronics in tandem with recent recovery in global semiconductor sales as well as chemical-related products.
- Growth in the domestic-oriented industries will be underpinned by production of food and construction-related products benefitting from the public infrastructure projects and property development.
- **SERC's comments**: *Challenging global and domestic economic environment, high cost of doing business, lingering issues about foreign workers and the impact of weak ringgit could dampen the sector's growth via costlier imported inputs.*

Output growth of manufacturing sector



Performance of key industries

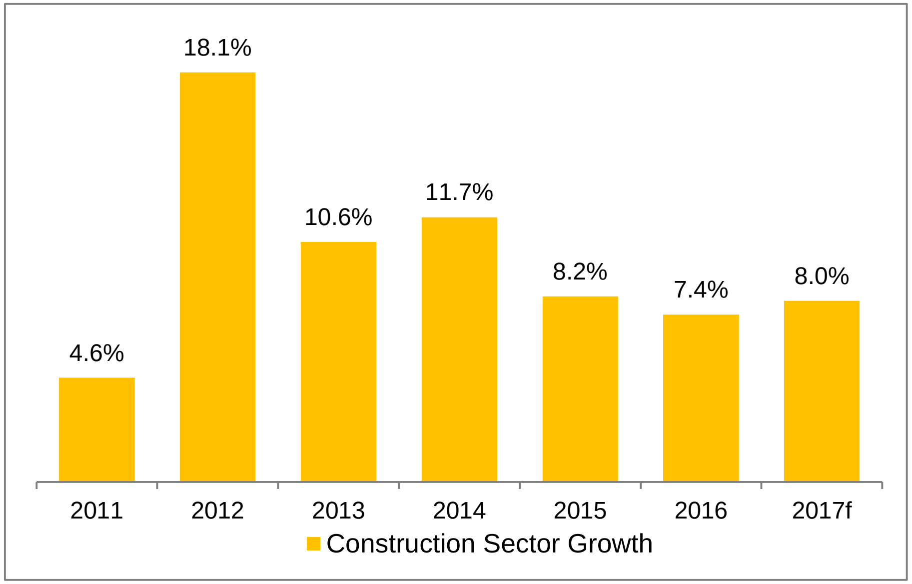


Source: Bank Negara Malaysia; Department of Statistics, Malaysia

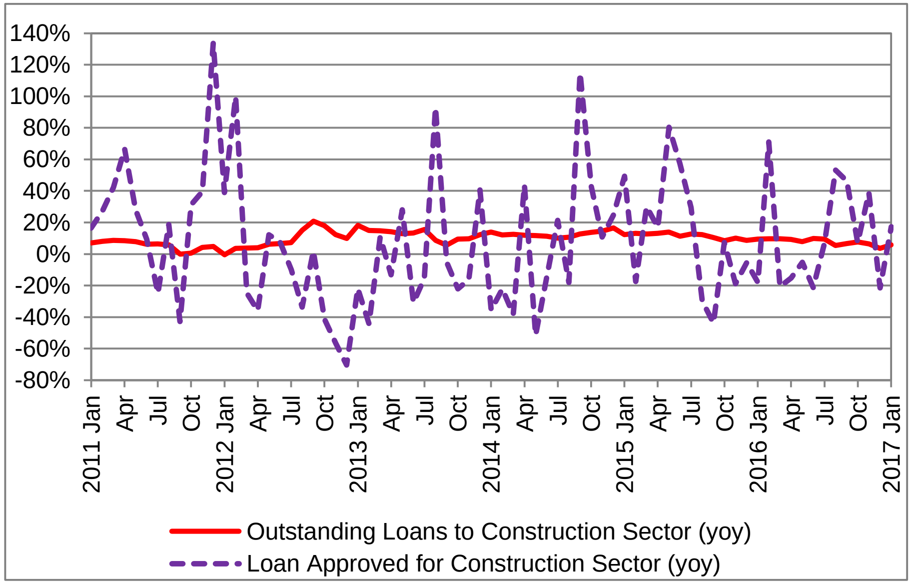
CONSTRUCTION: PROMISING OUTLOOK

- Growth in the **construction sector** is projected to expand at a faster pace in 2017 (8.0% vs. 7.4% in 2016), driven mainly by new and existing civil engineering projects in the utilities, transportation and petrochemical segments.
- Public spending on transportation projects (MRT, LRT, rail, HSR), highways (Pan Borneo Highway), ports and the public-driven affordable housing development.
- **SERC's comments**: *An estimated RM212 billion value of construction jobs covering on-going and new ones over the next five years. China-led contracts are potential strong catalysts. Positive spillovers and multiplier effects on more than 140 sub-sectors.*

Output growth of construction sector



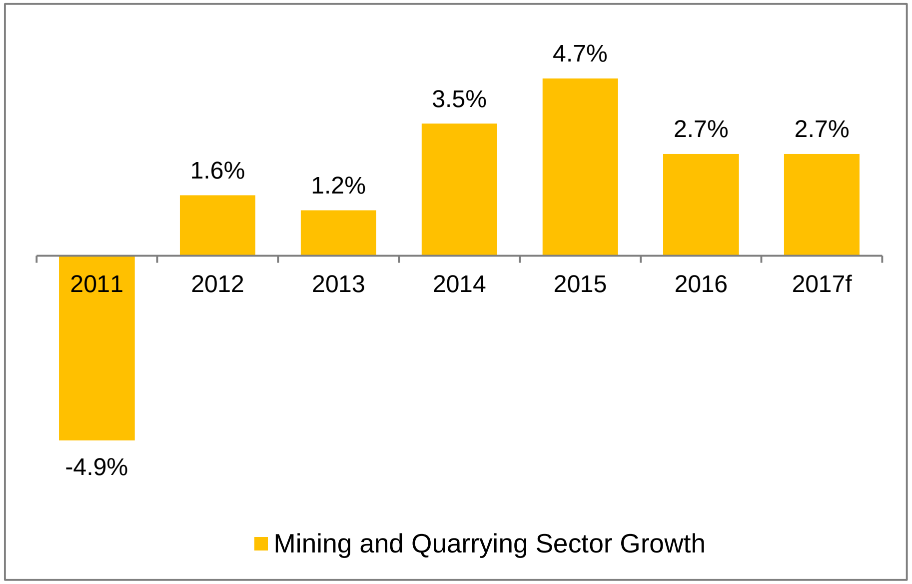
Indicators of construction sector



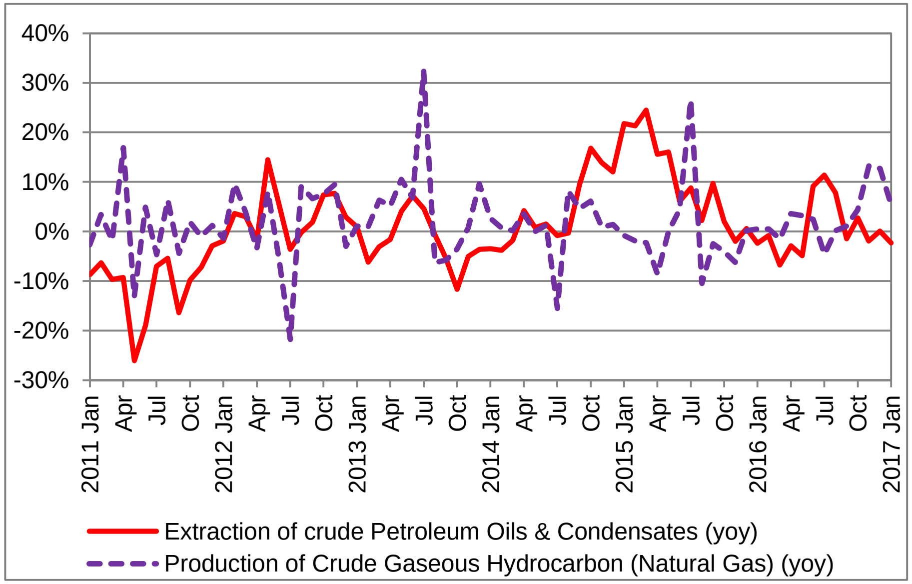
Source: Bank Negara Malaysia

- The **mining sector** growth is estimated to remain unchanged at 2.7% in 2017, the same rate as in 2016.
- The growth will be supported by acceleration of natural gas production from the LNG Train 9 and PETRONAS' FLNG Satu facilities as well as production from the new Malikai oil field.
- Complying with the OPEC's oil output cut deal, PETRONAS's voluntary 20,000 barrels per day crude oil supply adjustment is expected to dampen the sector's performance in the first half of the year. BNM estimates crude oil price to average between US$50-55 per barrel in 2017 vs. SERC's US$55-60 per barrel (US$43.67 in 2016). Liquefied natural gas (LNG)'s price is assumed at RM1,350 per tonne (RM1,267 in 2016).

Output growth of mining sector



Crude oil and natural gas output

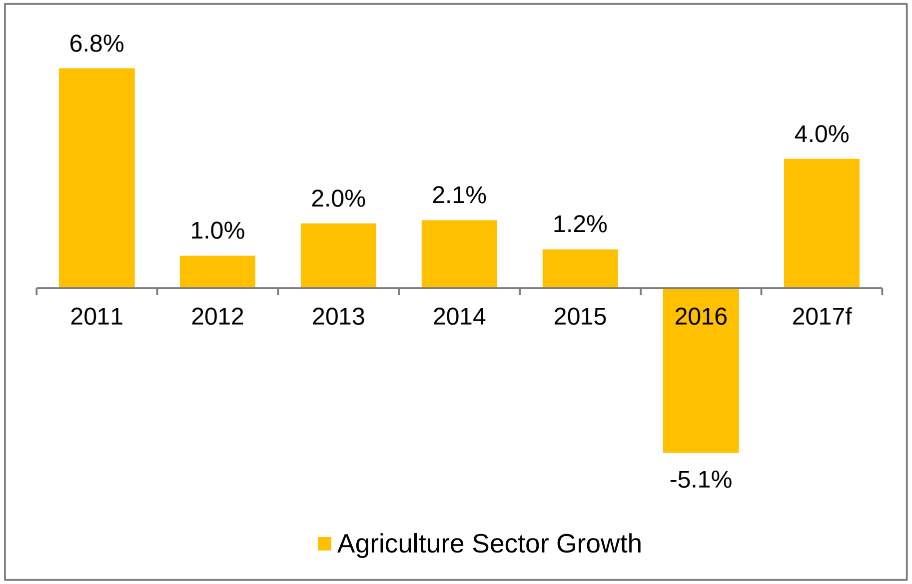


Source: Bank Negara Malaysia; Department of Statistics, Malaysia

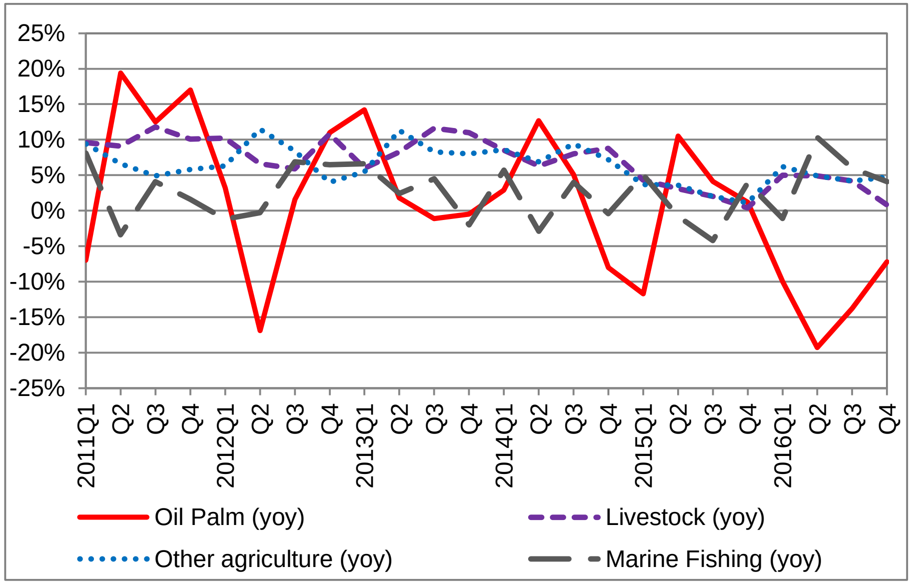
AGRICULTURE: FROM CONTRACTION TO EXPANSION

- The **agriculture sector** is expected to rebound to 4.0% in 2017 from a decline of 4.7% in 2016, mainly attributable to the recovery of crude palm oil yields from the adverse impact of El Niño.
- BNM's assumption of palm oil price is RM2,700 per tonne for 2017, which is the same level as SERC's (RM2,572 in 2016).

Output growth of agriculture sector



Subsectors of agriculture

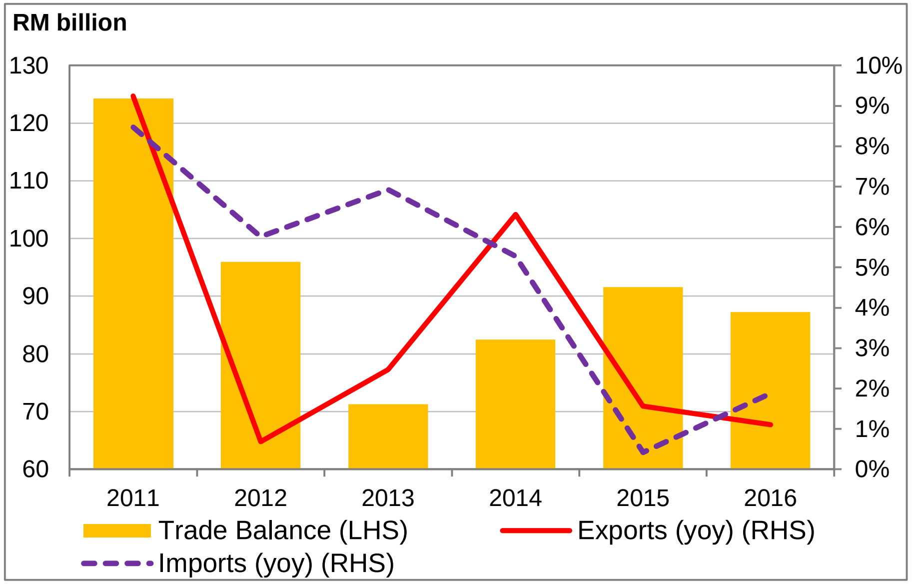


Source: Bank Negara Malaysia; Department of Statistics, Malaysia

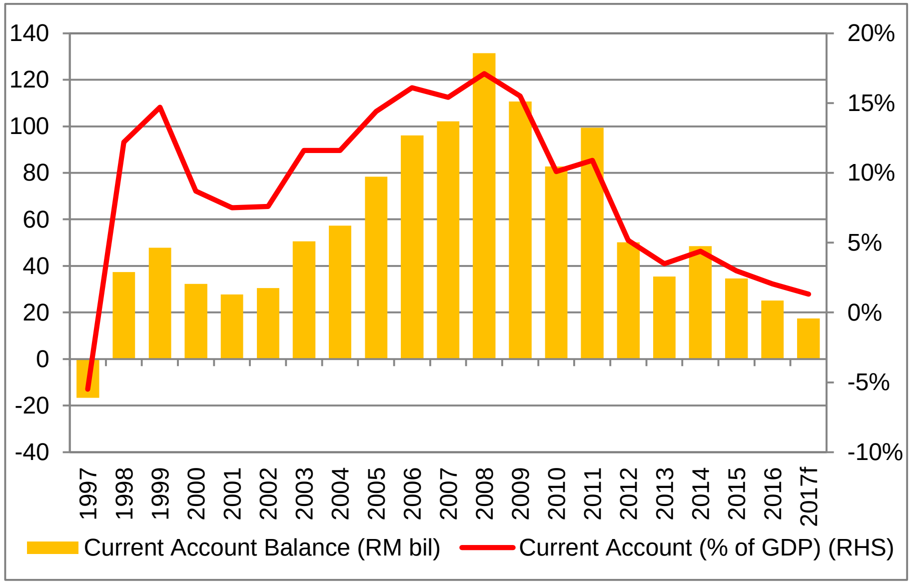
THE EXTERNAL SECTOR REMAINS CAUTIOUSLY POSITIVE

- **Exports** are expected to expand higher (5.5% vs. 1.1% in 2016), underpinned by the improvements in global growth and commodity prices.
- Malaysia's **current account surplus will narrow to RM17.4 billion or 1.3% of GDP in 2017** (a surplus of RM25.2 billion or 1.3% of GDP in 2016).
- **SERC's comments:** *There are risks to global trade environment threatened by policy uncertainties associated with Trump's strong assertive of a free and fair trade policy, targeting at those countries running huge trade surpluses with the US, namely China and Japan as well as the trade deal in NAFTA.*

Exports are recovering



Current account remains in surplus, albeit still small

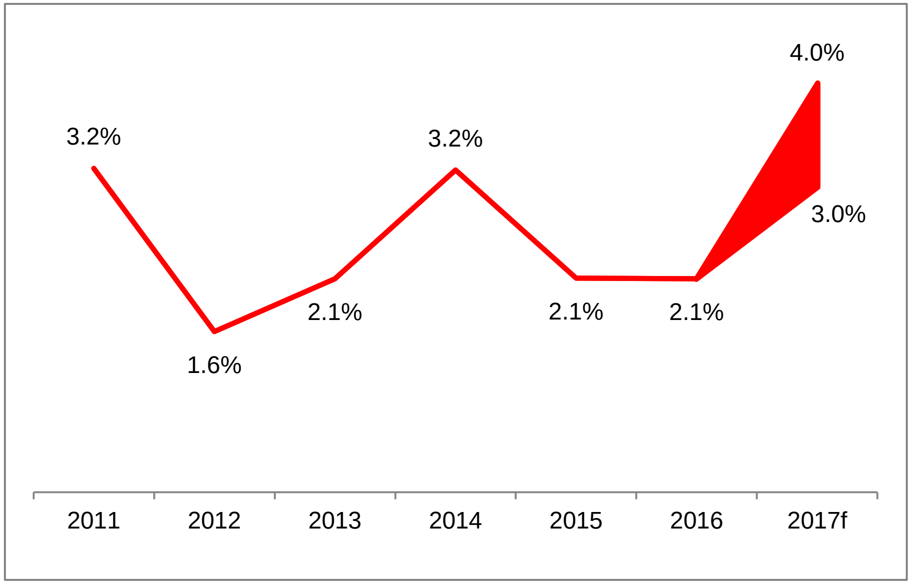


Source: Bank Negara Malaysia

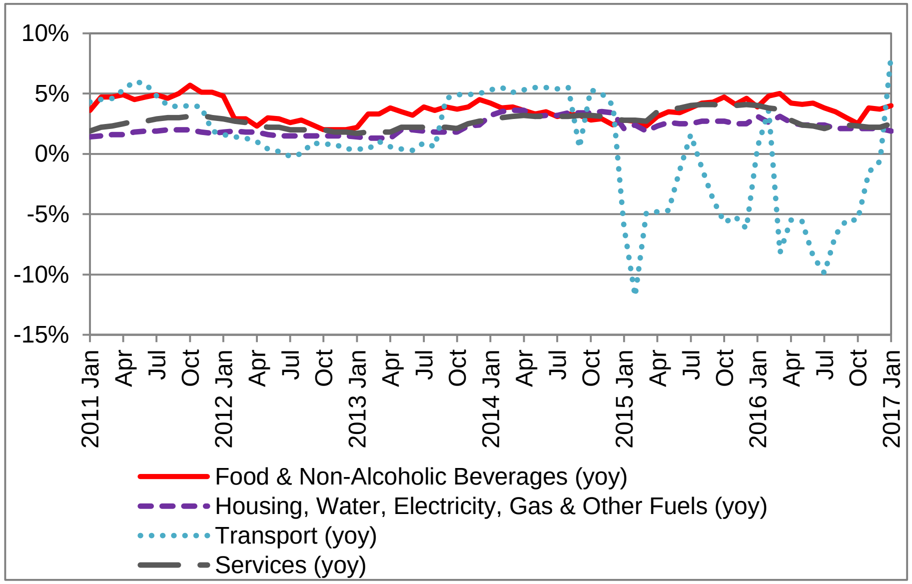
INFLATION COMES ROARING BACK

- BNM expects **headline inflation** to average between **3.0% - 4.0% in 2017** (2016: 2.1%), reflecting primarily the pass-through impact of the increase in global oil prices on domestic retail fuel prices. This cost-driven inflation, however, is not expected to cause significant spillovers into the broader price trends, given the stable domestic demand.
- **SERC's comments:** *We concur with Bank Negara Malaysia's assessment that headline inflation would remain relatively high in the first half-year. Cost-induced price pressures along with other indirect costs such as the spillover effect of the weakening ringgit would fuel higher consumer price inflation this year. We estimate inflation to increase by 3.0-4.0% in 2017, with an average increase of 4.0-4.2% in 1H before moderating to 3.0-3.5% in 2H.*

Headline inflation trend



Key components of CPI



Source: Bank Negara Malaysia; Department of Statistics, Malaysia

WHERE DO INTEREST RATES GO FROM HERE?

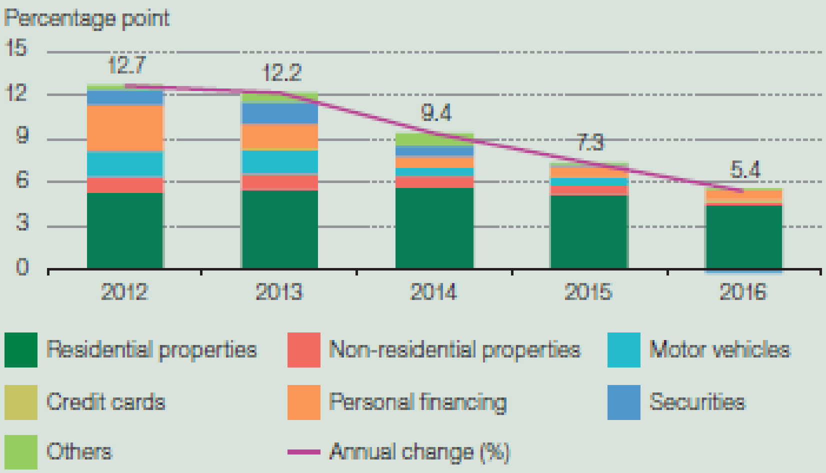
- Bank Negara Malaysia (BNM) **warns of challenging external and domestic economic environment when calibrating the monetary policy stance in 2017** while continue to monitor closely the risk of destabilizing financial imbalances, although these have largely remained contained.
- **Higher domestic inflation, volatile capital flows** and **lingering uncertainties in the global economic and financial environmen**t will influence the conduct of monetary and liquidity management.
- **SERC's comments**: *Bank Negara Malaysia is unlikely to change the course of monetary policy anytime soon in spite of the developing of cost-driven inflation pressures. Demand-induced price pressure is contained as core inflation increased 2.3% in January amid moderate economic growth. BNM expects higher inflation reading in the first half-year will recede in 2H as the transitory impact of petrol price adjustment subsides. It also expects core inflation to rise moderately.*
- *We believe that the central bank* ***will hold the policy rate steady at 3.0% this year*** *as the risks to economic growth are somewhat contained*.

- Total **household debt moderated further by 5.4% to RM1,086.2 billion or 88.4% of GDP in 2016** from 89.1% of GDP in 2015 (2015: +7.3%; 2010: +14.2%), extending the slower pace of growth sustained since 2010.
- **Households' balance sheets remained in good shape**. Both household **financial assets and liquid financial assets** remained high at 2.1 and 1.4 times of debt respectively.

Household debt sustained its moderating growth since 2010

Chart 1.1

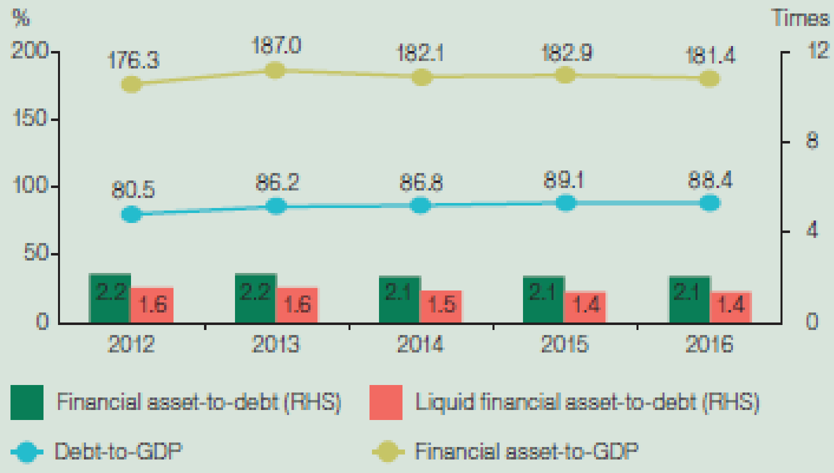
Household Sector: Contribution to Growth in Debt



Households maintained aggregate financial assets at two times of debt

Chart 1.2

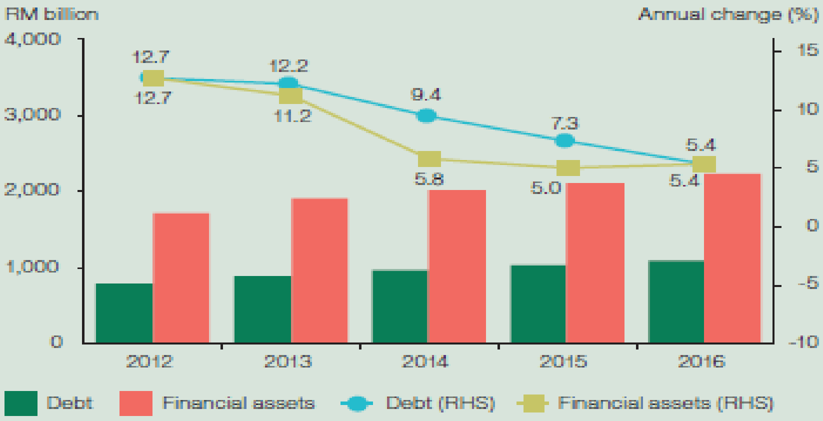
Household Sector: Key Ratios



Growth in household financial assets matched that of household debt

Chart 1.3

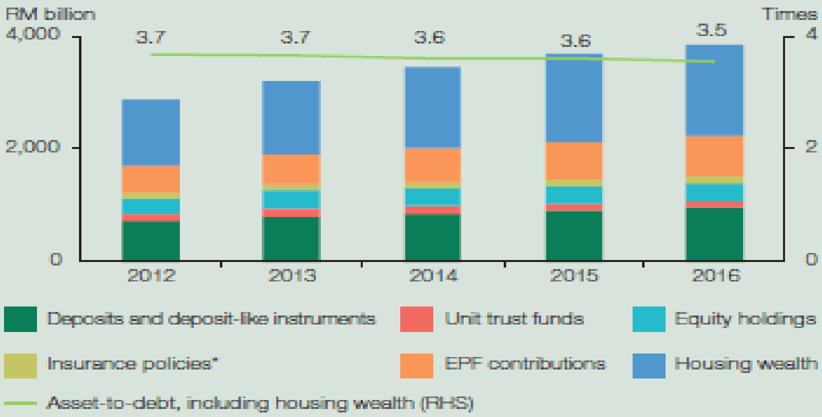
Household Sector: Debts and Financial Assets



Including housing wealth, household assets stood above three times of debt

Chart 1.4

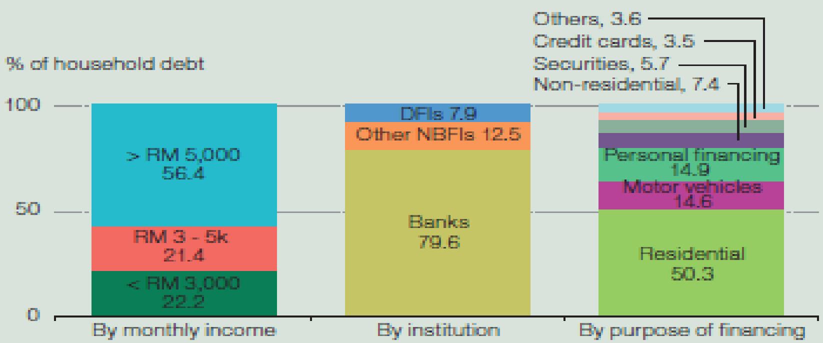
Household Sector: Composition of Assets



Share of borrowings by vulnerable households reduced further

Chart 1.5

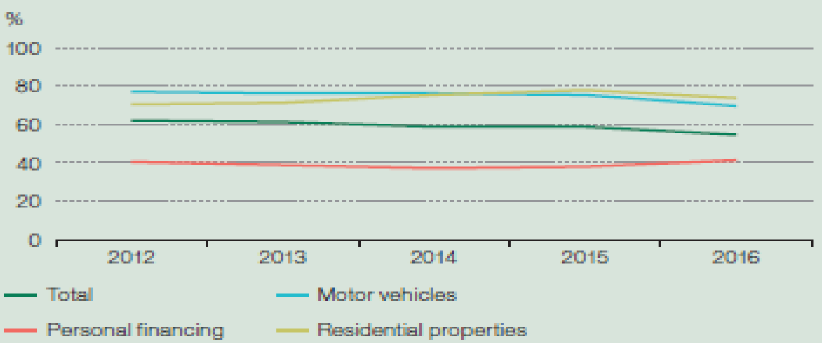
Household Sector: Profile of Borrowings



Sustained supply of financing to eligible households

Chart 1.6

Household Sector: Approval Rate



Source: Bank Negara Malaysia, Bloomberg, Department of Statistics, Malaysia, National Property Information Centre, Securities Commission Malaysia and internal computation

* Surrender value

MANAGING HOUSEHOLD INDEBTEDNESS RISKS (CONT'D)

- The **share of borrowings** by these households **with monthly earnings of up to RM3,000 declined further to account for 22.2%** (2015: 22.8%; 2014: 24.3%) of total household debt. But, their **aggregate leverage** (measured as a ratio of outstanding debt to annual income) i**ncreased slightly to 8.1 times** (2015: 7.7 times), largely driven by higher borrowings for house purchases, which grew by 4.2% (2015: +1.6%).
- Bank Negara Malaysia highlighted that key **potential sources of risks to domestic financial stability** continue to stem from **high levels of domestic debt, elevated property prices in some segments of residential property** and an **oversupply of commercial property, and heightened volatility in financial markets**. Risks from household lending remained largely contained.
- The central bank warns that the **undersupply of affordable homes for the masses** is **likely to worsen** going forward given current trends in income and demographic factors.
- BNM reiterates that **macroprudential measures do not in any way hamper access to financing** for eligible borrowers including those who are first-time buyers. **Rejection rates for housing loan applications** fell further to 23.6% in 2016 (2012-2015: 26.1%).

DISTRIBUTION OF HOUSEHOLD DEBT

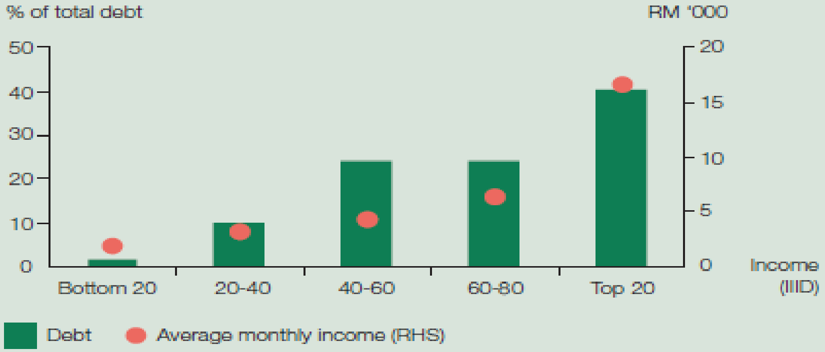
- At end-2015, the **largest share of debt (about 40%) is owed by individuals in the top 20 income group**, with their average debt level more than twice that of other borrower groups. The debt servicing capacity is reasonably healthy as indicated by more prudent debt service ratios.
- Borrowers in the **more vulnerable income segments in the bottom 40 income group**, accounted for only 11.4% of total debt. They are more likely to face difficulty servicing their debt in the event of a payment shock, given thinner buffers. **More than half (53%) of borrowings remain sensitive to changes in interest rates** which can have a disproportionate impact on debt repayment capacity given the low absolute income levels.
- About two-thirds of total debt is acquired by those living in major employment centres (Selangor, Johor, Kuala Lumpur and Penang). Most of these borrowers are of the age between 30 and 40 years old in the 40-60 income group.

Note: Bottom 20 income group : Individuals earning ≤RM2,500 per month; 20-40 income group : Individuals earning RM2,501-3,500 per month; 40-60 income group : Individuals earning RM3,501-5,000 per month; 60-80 income group : Individuals earning RM5,001-8,000 per month; Top 20 income group : Individuals earning ≥RM8,000 per month

HOUSEHOLD DEBT PROFILE BY INCOME GROUP

Chart 1

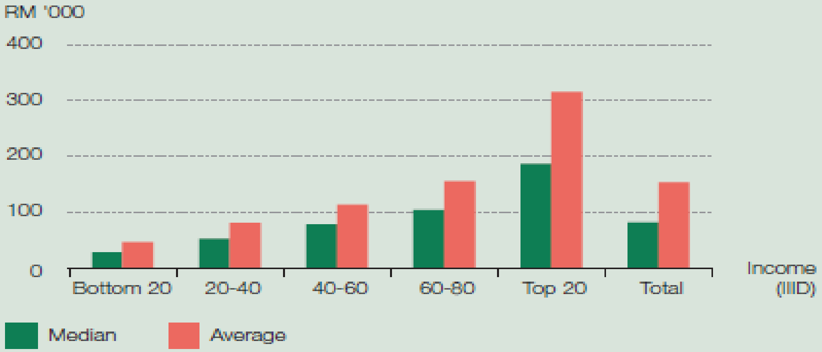
Household Income and Distribution of Debt by Income



Source: Bank Negara Malaysia

Chart 2

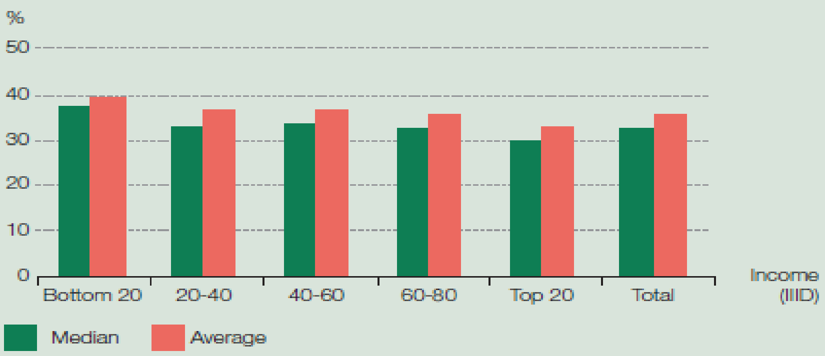
Debt per Borrower by Income Group



Source: Bank Negara Malaysia

Chart 3

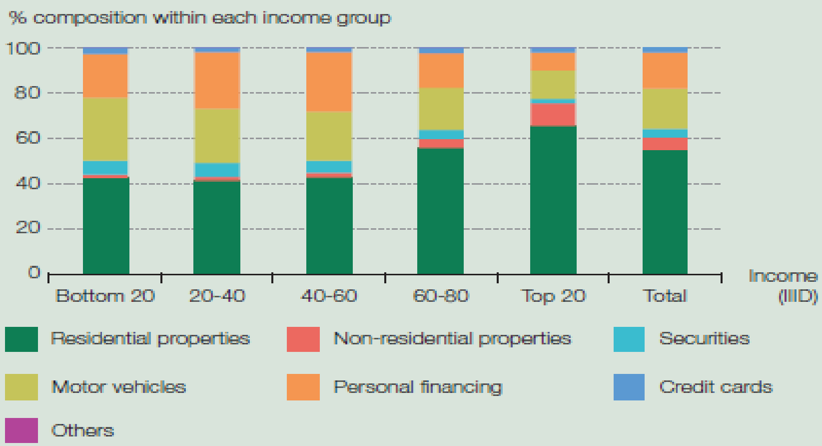
Debt Service Ratio by Income Group



Source: Bank Negara Malaysia

Chart 4

Debt by Loan Purpose by Income Group

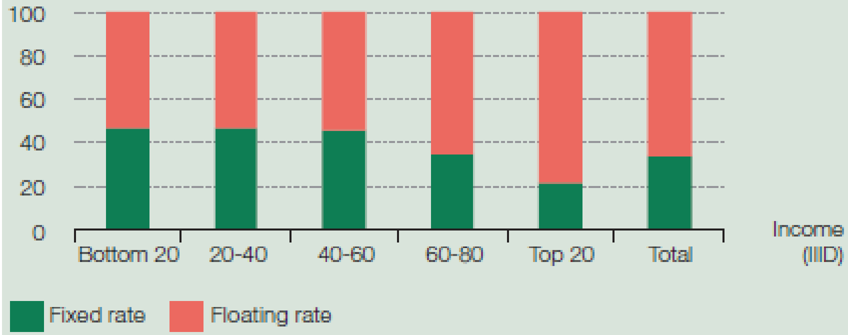


Source: Bank Negara Malaysia

HOUSEHOLD DEBT REPAYMENT CAPACITY

Debt by Type of Interest Rate by Income Group

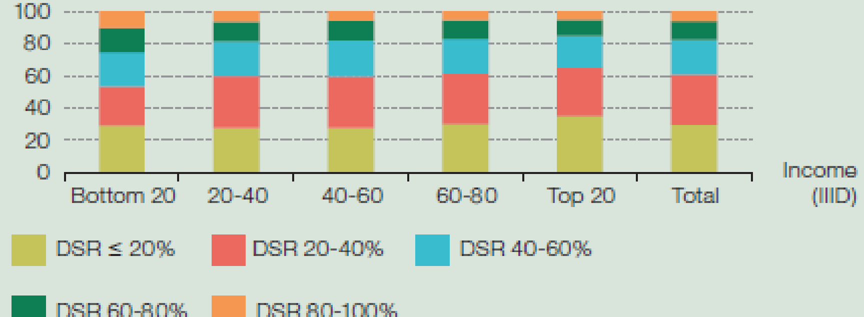
% composition within each income group



Source: Bank Negara Malaysia

Debt Service Ratio for Borrowers by Income Group

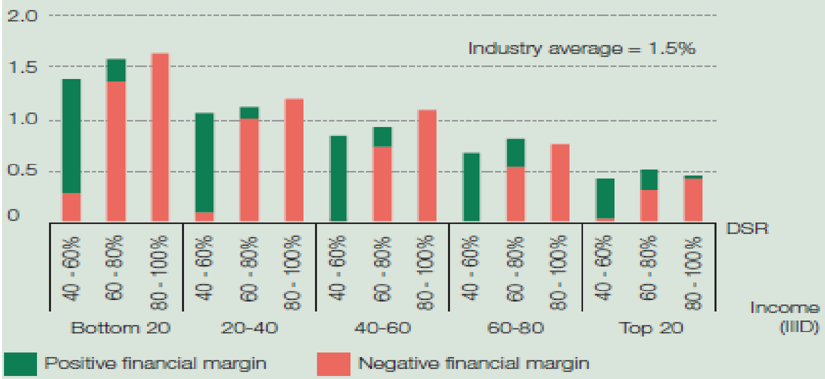
% of number of borrowers within each income group



Source: Bank Negara Malaysia

Gross Delinquent Loans

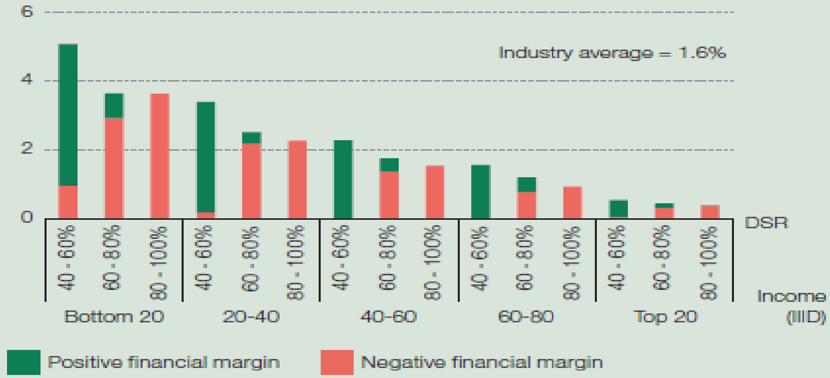
Ratio (%)



Source: Bank Negara Malaysia

Gross Impaired Loans

Ratio (%)



Source: Bank Negara Malaysia

HERE ARE FIVE KEY ISSUES FACING THE ECONOMY

1. **High inflationary environment**. The inflation outlook is subjected to three key risks: 1) higher than expected global oil prices; 2) the pass-through effect of the weakening ringgit; and 3) imported inflation pressures from Malaysia's trading partners.
2. **Persistent narrower current account surplus** due to moderate exports expansion relative imports. This underscores the importance of advancing structural reform measures to promote trade and investment diversification and competitiveness, and more importantly to move up the value chain.
3. **Overdependence on foreign workers**, resulting in large outflows of foreign exchange in the form of repatriation of workers' remittances abroad, which rose from RM17 billion in 2008 to RM30 billion in 2016.
4. **Addressing affordable housing**. The undersupply of affordable homes is likely to worsen going forward given current trends in income and demographic factors. This calls for a carefully-designed strategy of policy interventions from both the Government and the private sector.
5. **High youth unemployment**, which is estimated to reach 10.7% in 2015, more than three times higher than the national unemployment rate of 3.1%. Graduate employability is a rising concern.

MALAYSIA FACES CHALLENGES IN POSITION OF STRENGTH

Positive prospects for Malaysia will be **subjected to a plethora of policy and political uncertainties in advanced economies** that bring about varying degree of implications for the Malaysian economy as follows:

1. The **potential threat of trade protectionism** in the advanced economies, in particular the US would put a damper on the global trade, which is struggling to regain growth traction since the 2008-09 Global Financial Crisis.

2. The material risks could emanate from **faster Fed's rate hikes and diminishing hopes of the US fiscal stimulus**. The widening interest rate differentials and strong US dollar could lead to tighter and more uncertain financial market conditions, with higher volatility in capital flows and exchange rates. **Uncertainty over the UK and EU negotiations and geopolitical developments** also pose a challenge to the policy environment.

3. The potential **occurrence of external risks and uncertainties** would have **negative spillovers to the Malaysian economy via trade and financial channels**. The abrupt exchange rate and financial volatility would adversely affect both consumer and investor sentiments and labour market conditions.

4. The **persistent domestic headwinds** such as the **higher cost of living, cost-driven inflation pressures and weak sentiments** could also **moderate the growth of domestic demand**.

SERC's comments: *While there is upshot to this year's growth outlook, there are real external and domestic risks that could temper Malaysia's economic growth momentum despite buffered by the strength of economic and financial fundamentals. Any policy misstep could derail the growth track and erode investors' confidence. The policymakers must remain vigilant and focus on the prescription of credible and consistent policies to make Malaysia a conducive and competitive environment of doing business.*

CONCLUSION

- The **global economy continues to stay on positive track**, buoyed by expectations that the Trump administration's reflationary policies will boost the growth trajectory of the US economy and corporate earnings, helping to lift the global growth prospects.
- But, **downside risks to global growth still prevalent**. These include the potential implications from the Trump administration's shaping of trade and economic policies, the impact of higher US interest rates, the rise in protectionism, potential complications associated with the Brexit's negotiation process as well as the political uncertainties associated with a slate of impending European elections.
- The **Malaysian economy will perform better this year.** BNM estimates real GDP growth of 4.3-4.8% in 2017 vs. SERC's 4.3% (4.2% in 2016), **supported by continued expansion of domestic demand as well as improved export growth**. The growth estimate is premised on the strength of consumer spending, which may face hurdles from higher cost of living, cost-driven inflation pressures and weak sentiments. Exports too could falter if there is trade flow disruption from the trade protectionism mindset as well as financial markets volatility.

CONCLUSION

- **Inflationary pressures are developing in recent months**, reflecting the combined impact of fuel prices adjustment, the spillover effect of the ringgit's depreciation on imported goods and services and other cost-related pressures. The central bank estimates headline inflation to average 3.0-4.0% in 2017, meeting SERC's estimation.
- We **do not expect BNM to ease interest rate further** going by continued expansion of economic growth amid the developing of cost-induced inflationary pressures, inflicted by higher fuel prices. We expect **BNM to keep the overnight policy rate (OPR) at 3.00% in 2017** for now.
- **The ringgit appears stabilizing though the downside pressure remains prevalent**. With the Trump's pro-business and pro-growth policies lifting higher inflation risk, underpinning the Fed's rate hikes and hence, support the US dollar rally at least in the first half-year of 2017. BNM's foreign exchange market stabilization measures have seen some improvement in balancing the supply and demand of the ringgit as well as the conversion of export proceeds into ringgit**.** BNM uses market consensus of RM4.40 per US$ for this year vs. SERC's RM4.20-4.40 (RM4.4860 at end-2016).

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SOCIO-ECONOMIC RESEARCH CENTRE

SERC

谢谢

THANK YOU

Address	: 6th Floor, Wisma Chinese Chamber, 258, Jalan Ampang, 50450 Kuala Lumpur, Malaysia.
Tel	: 603 - 4260 3116 / 3119
Fax	: 603 - 4260 3118
Email	: serc@acccimserc.com
Website	: http://www.acccimserc.com

SERC