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BNM Annual Report for 2018 – easing monetary policy is warranted

Rising downside risks to growth

The BNM's annual report for 2018 was published yesterday and we attended the analyst briefing to hear from the horse's mouth. The session started with the presentation by Deputy Governor Datuk Shaik Abdul Rasheed bin Abdul Ghaffour, covering the global and domestic economic landscape. The session followed with Deputy Governor Jessica Chew Cheng Lian where she walked us through on 2018 Financial Stability and Payment Systems Report. Finally, the question and answers session which moderated by Governor Datuk Nor Shamsiah Binti Mohd Yunus. In a nutshell, the tone was pretty much guarded and a sense of heightened uncertainty was quite apparent. This was reflected in the **range forecast of between 4.3% and 4.8% for 2019 GDP growth (2018: 4.7%) with point estimates of 4.7% (Bank Islam: 4.5%).**

Domestic demand which accounted for 92.9% of total GDP is expected to grow moderately by 4.4% in 2019 from 5.6%. This was predicated on contraction in public expenditure of 1.8% (2018: 0.1%) driven by 7.1% (2018: -5.2%) decline in public investment. Similarly, private consumption growth is set to record slower growth of 6.6% after recording an above-trend growth in the preceding year. This is very much expected from the consumers as sentiments have been weak in view of rising cost of living, elevated levels of household indebtedness and challenging prospect for labour markets. However, private investment is expected to accelerate to 4.9% growth in 2019 (2018: 4.5%), suggesting private firms have been actively expanding their production capacity in order to improve their economies of scale. Nonetheless, real exports and imports are most likely to experience flattish growth of 0.1% (2018: 1.5%) and 0.0% (2018: 0.1%) respectively. The ongoing trade spat between the US and China as well as the uncertain fate of UK Brexit are most likely to drag Malaysia's external demand this year.

Inflation rate likely to be contained this year

Inflation rate is expected to record range forecast of 0.7% - 1.7% in 2019 (2018: 1.0%). Domestic factors that will drive up prices albeit moderately include the lapse of in the combined impact of the changes in consumption tax policy i.e. zero GST rate from June 2018 to August 2018, increase in minimum wage, higher electricity tariff surcharge for businesses. However, this will be offset by lower fuel prices whereby the ceiling price for RON95 and Diesel will be kept at RM2.08 per liter and RM2.18 per liter respectively. Such arrangement would remain in place until the implementation of targeted fuel subsidy in 2Q2019.

Table 1: BNM's macroeconomic variables projection

Growth	2015	2016	2017	2018	2019F
GDP	**5.0%**	**4.2%**	**5.9%**	**4.7%**	**4.3%~ 4.8%**
By expenditure:					
Domestic Demand	5.1%	4.3%	6.5%	5.6%	4.4%
Consumption	5.7%	4.9%	6.7%	7.2%	5.6%
-Public	4.4%	0.9%	5.4%	3.3%	1.2%
-Private	6.0%	6.0%	7.0%	8.1%	6.6%
Investment	3.6%	2.7%	6.2%	1.4%	1.3%
-Public	-1.1%	-0.5%	0.1%	-5.2%	-7.1%
-Private	6.3%	4.3%	9.3%	4.5%	4.9%
Exports	0.3%	1.1%	9.6%	1.5%	0.1%
Imports	0.8%	1.1%	11.0%	0.1%	0.0%
Net Export	-3.7%	1.5%	-1.1%	13.4%	0.1%
By industry:					
Agriculture	1.4%	-5.2%	7.2%	-0.4%	2.8%
Mining and quarrying	5.3%	2.1%	1.0%	-1.5%	0.8%
Manufacturing	4.8%	4.4%	6.0%	5.0%	4.8%
Construction	8.4%	7.4%	6.7%	4.2%	3.0%
Services	5.3%	5.7%	6.2%	6.8%	5.7%

Other macroeconomic variables	2015	2016	2017	2018	2019F
Consumer Price Index (CPI)	2.1%	2.1%	3.7%	1.0%	0.7% ~ 1.7%
Unemployment rate	3.1%	3.4%	3.4%	3.4%	3.3% ~ 3.5%
Gross exports	1.6%	1.2%	18.9%	6.8%	3.4%
Gross imports	19.9%	1.9%	19.9%	4.9%	4.5%
Current account balance % of GDP	3.0%	2.4%	3.0%	2.3%	1.9%

Source: BNM Annual Report 2018

Other macroeconomic variables are pointing to moderate growth

Other variables such as unemployment rate, gross exports and imports suggests that the economy is shifting into lower gear. Declining current account surplus balance from 2.3% of GDP in 2018 to 1.9% in 2019 indicates that the savings-investment gap is narrowing. This was largely due to lower surplus balance in goods account from RM121.4 billion in 2018 to RM116.2 billion in 2019. Primary income balance is expected to record wider deficits of RM50.2 billion in 2019 from RM49.4 billion in 2018, reflecting increasing repatriation of investment income by the foreign investors. Meanwhile, secondary income deficits balance fairly stable at RM18.2 billion in 2019 from RM18.8 billion in the preceding year as overseas remittances by the foreign labour remain significant.

Some policy announcement on further liberalisation of foreign exchange administration (FEA)

The BNM has further liberalised the FEA whereby residents can hedge their foreign currency obligation will be extended to 12 months. Residents could also obtain approval from the BNM to hedge their foreign currency obligation beyond 12 month period. The move is to facilitate efficient financial planning by businesses and will be effective immediately. The Small and Medium Enterprise (SME) with net import obligation are also allowed to receive foreign currency payment from resident exporters for their domestic trade in goods and services. The measure will be effective 2 May 2019.

Our view

The prevailing condition such as weak business sentiments as well as heightened external uncertainties warrants for an interventionists policies from the central bank. The potential output growth which takes into account the input factor of labour, capital and technology is likely to be in the region of 4.6% to 5.1% in 2019 after sustaining at 5.0% in the previous two years. The number entails that the productive capacity is weakening which is very much in line with the excess capacity currently experienced by the key industries (rubber gloves, semiconductor, properties, oil & gas etc). As such, the BNM is of the view that the output gap which is the difference between the actual output level and the potential output level is likely to be marginally negative in 2019. Against a backdrop of lower inflation rate in 2019 and challenging external sector, **we foresee the BNM would reduce the Overnight Policy Rate (OPR) by 25 basis points to 3.00% whereby 7 May 2019 would be the earliest date for the OPR cut.**

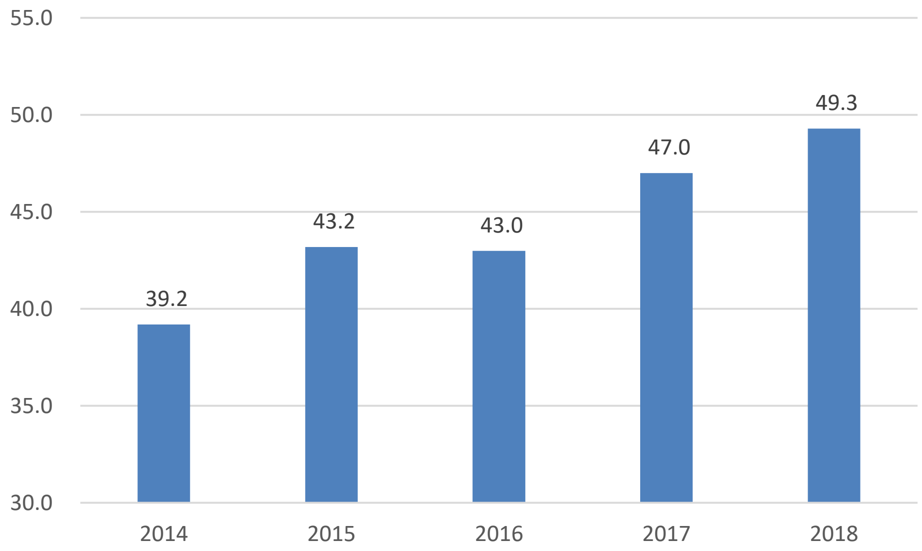
Table 2: Malaysia's potential growth

Year	Potential Output Growth (%)
2017	5.0
2018e	5.0
2019F	4.6 -5.1

Source: BNM Annual Report 2018

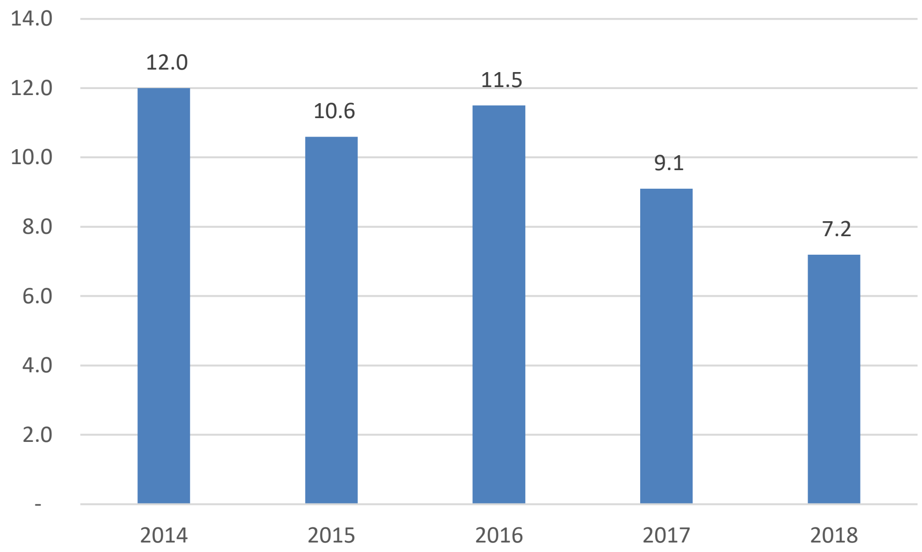
Despite rising external risks, the BNM opined that the financial stability risks are broadly stable. Nonetheless, the BNM appears to be cautious on the property sector especially in the office space and shopping complex segment. This is in light of rising incoming supply for the sector. As for non-financial corporations, sectors that warrants for a close scrutiny would be Oil & Gas, property-related and construction sectors. Therefore, in view of the recent weaknesses in corporate earnings in the 4Q2018, credit risks in the non-financial corporation is expected to be elevated. Key financial metrics such as **Debt-to-Equity (DE) and Interest Coverage Ratio (ICR) should be closely monitored. As of 2018, DE and ICR stood at 49.3% and 7.2 times from 47% and 9.1 times in 2017**. This showed that business credit worthiness appears deteriorating. **All in all, the overall outlook is cautious.**

Chart 1: Debt-to-Equity (DE) ratio



Source: Financial Stability and Payment Systems Report 2018

Chart 2: Interest Coverage Ratio (ICR)



Source: Financial Stability and Payment Systems Report 2018

Table 3: Outlook of Risks to Domestic Financial Stability

Risk Area	Sector	Risk Outlook	Direction of Risks (2019 vs 2018)
Credit risk	Household	• Pockets of risks are expected to persist among more leveraged borrowers that have taken loans to purchase higher-valued properties and for personal use. Borrowers who are more dependent on variable income and those earning lower income and living in urban areas may also face greater challenges servicing their debt. • Government initiatives are expected to partly alleviate cost of living pressures, while stable income and employment prospects along with responsible lending practices will continue to support overall household debt servicing capacity.	↔
	Property market	• Continued soft market conditions amid affordability issues may see the level of unsold housing units rise further in the short term. • However, adjustments in house prices are expected to be orderly given continued firm demand for affordable homes and housing by owner-occupiers, sustained lending by banks and policies by the Government aimed at better aligning housing demand and supply. • Risks are expected to remain elevated in the office space and shopping complex segment, given the large incoming supply. Further unabated supply will increase future risks.	↔
	Non-financial corporations	• Business conditions are likely to remain challenging in the O&G, property-related and construction sectors. • Volatility in global oil prices could adversely impact income and investment in the O&G sector but the gradual recovery from recent supply disruptions should provide some support to firms. • Property developers may continue to record sluggish sales performance amid a soft property market. • Businesses generally have healthy financial buffers. However, uncertainties from a prolonged trade war may impact businesses more broadly, resulting in lower profitability and investments, which could erode these buffers.	↔
Market risk		• The pace of US monetary policy normalisation, escalating trade tensions and rising geopolitical risks may lead to non-resident outflows from the region which could pose upward pressure on yields and reduce market liquidity. The presence of strong domestic institutional investors, including financial institutions, is expected to continue providing support and liquidity to domestic financial markets on the back of attractive valuations.	↔
Liquidity and funding risk		• Persistent and prolonged outflows may reduce overall liquidity to levels that could lead to market fragmentation and drive funding costs higher. • Banks are expected to remain resilient to funding shocks, supported by adequate liquidity buffers and continued progress in accumulating stable sources of longer-term funding.	↔
Contagion risk		• Contagion risk from non-bank financial institutions (NBFIs) to the financial system is expected to remain low. Measures to strengthen the governance and management of some NBFIs will support improvements in performance and greater resilience to changes in financial market conditions going forward.	↔

↔ Stable ↑ Increasing ↓ Decreasing

Source: Financial Stability and Payment Systems Report 2018

Table 4: Key financial indicators

	As at end				
	2014	2015	2016	2017	2018p
	% (or otherwise stated)				
Banking System					
Total Capital Ratio	15.9	16.6	16.5	17.8	17.4
Tier 1 Capital Ratio	14.0	14.2	14.0	14.9	13.9
Common Equity Tier 1 Capital Ratio	13.3	13.3	13.1	14.0	13.1
Return on Assets	1.5	1.3	1.3	1.5	1.4
Return on Equity	15.2	12.3	12.5	13.1	12.6
Liquid Assets to Total Assets	13.3	-	-	-	-
Liquid Assets to Short-term Liabilities	42.6	-	-	-	-
Liquidity Coverage Ratio[1]	-	127.4	124.3	134.9	143.2
Net Impaired Loans Ratio	1.2	1.2	1.2	1.1	0.9
Capital Charge on Interest Rate Risk in the Trading Book to Capital Base	1.4	1.2	1.1	1.0	1.1
Net Open Position in FC to Capital Base	4.7	6.1	6.3	6.1	5.8
Equity Holdings to Capital Base	1.3	0.7	1.5	1.9	0.5
Insurance and Takaful Sector					
Capital Adequacy Ratio	243.5	245.2	243.1	233.0	244.9
Life Insurance and Family Takaful					
Excess Income over Outgo (RM billion)	13.8	12.0	13.3	19.0	9.5
New Business Premium / Contribution (RM billion)	12.9	13.2	14.2	15.1	15.9
Capital Adequacy Ratio[2]	235.8	242.5	238.4	226.2	237.1
General Insurance and General Takaful					
Underwriting Profit (RM billion)	1.8	1.3	1.8	1.3	1.8
Operating Profit (RM billion)	3.2	2.7	3.4	2.7	3.0
Gross Direct Premium / Contribution (RM billion)	19.1	19.5	19.7	19.9	20.4
Claims Ratio	57.5	60.2	55.9	58.6	56.5
Capital Adequacy Ratio[2]	272.2	258.2	266.2	268.8	275.7
Household (HH) Sector					
HH Debt (RM billion)	952.7	1,023.2	1,080.5	1,133.8	1,187.3
HH Financial Asset (RM billion)	2,015.0	2,119.3	2,232.4	2,420.5	2,540.5
HH Debt-to-GDP Ratio	86.1	88.4	87.8	83.8	83.0
HH Financial Asset to Total HH Debt Ratio	211.5	207.1	206.6	213.5	214.0
HH Liquid Financial Asset to Total HH Debt Ratio	148.7	143.4	141.4	145.7	143.1
Impaired Loans Ratio of HH Sector	1.7	1.5	1.5	1.4	1.2
Business Sector					
Return on Assets	6.0	4.9	4.6	4.4	3.6
Return on Equity	10.2	8.8	7.9	7.7	6.7
Debt-to-Equity Ratio	39.2	43.2	43.0	47.0	49.3
Interest Coverage Ratio (times)	12.0	10.6	11.5	9.1	7.2
Operating Margin	15.9	14.8	14.5	14.5	12.8
Impaired Loans Ratio of Business Sector	2.6	2.5	2.5	2.6	2.3
Development Financial Institutions[3]					
Lending to Targeted Sectors (% change)	7.0	5.5	5.7	0.1	-0.3
Deposits Mobilised (% change)	5.3	2.0	6.4	4.8	1.9
Impaired Loans Ratio	5.0	4.8	5.9	5.1	5.8
Return on Assets	1.6	1.4	1.0	1.4	1.5

[1] The Liquidity Coverage Ratio (LCR) Framework takes effect on 1 June 2015 and supersedes the guidelines on Liquidity Framework and Liquidity Framework-i issued on 1 July 1998

[2] Figures from 2014 to 2017 include composite insurers and takaful operators. Figures in 2018 reflect the capital position after the splitting of composite licenses, hence, they are not comparable with those in 2014-2017

[3] Refers to development financial institutions under the Development Financial Institutions Act 2002

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Note : Figures may not necessarily add up due to rounding

Source: Financial Stability and Payment Systems Report 2018