ECONOMICS: ASIAN PERSPECTIVES

HOUSING SLUMP AND POLICY CONSTRAINTS POSE RISK TO MALAYSIA'S GROWTH

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After rising strongly for years, Malaysia's highly leveraged property market is facing strong headwinds amid prospects of a supply overhang and growing pressure on household finances. Risks to financial-system stability and growth may be increasing, calling for a soft-landing plan by the government and the central bank.

Leveraged Housing Market

After a significant surge in property prices across Asia in recent years, lackluster economic growth is putting the region's housing markets at risk.

Some markets, such as Hong Kong and Singapore, have already seen early signs of a market correction, but implications for the health of the financial system have been limited so far because of timely macroprudential measures that have curbed transaction volumes and homebuyers' exposure to elevated prices. Tighter loan-to-value (LTV) ratios also provide a greater equity buffer for home owners.

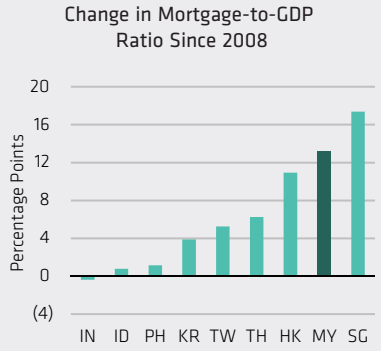
We are more concerned, however, about Malaysia. Its housing cycle has been the second-most leveraged in the region since quantitative easing policies by major global central banks began in 2009, with the mortgage-to-GDP ratio swelling conspicuously (*Display 1*). Moreover, Malaysia's macroprudential measures seem to be less effective than those in other markets.

In Malaysia, property transaction volumes have remained buoyant until recently despite soaring prices (*Display 2*), and the LTV ratio has also remained high. Currently, a 90% LTV ratio remains common for residential mortgages, and Bank Negara Malaysia (BNM) only requires a 70% LTV for a borrower purchasing a third house. In addition, the government has sponsored zero-down-payment schemes for young, low income households, effectively exposing those financially weak families to housing market risks. The mindset of potential homebuyers is also worrying, as there seems to be an absence of fear—perhaps because there has been no major housing market correction over the past two decades, even during the 1997 Asian Financial Crisis.

Potential Supply Shock

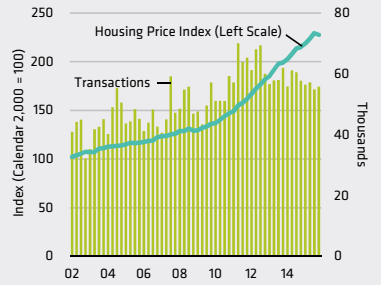
Those who remain sanguine about Malaysia's housing market, including policymakers, will argue that the youth population is growing and that favorable demographics will continue to underpin real estate prices. Even though we agree that the long-term outlook for housing demand in Malaysia is more positive than those in other Asian economies, the risk of a cyclical housing price correction and a resultant negative economic spillover still worries us. Both supply and demand dynamics are becoming less favorable.

Display 1
Malaysia's Housing Cycle Is Highly Leveraged



As of April 28, 2016
HK = Hong Kong, ID = Indonesia, IN = India, KR = South Korea, MY = Malaysia, PH = Philippines, SG = Singapore, TH = Thailand and TW = Taiwan
Source: CEIC Data and AB

Display 2
Transactions Have Remained Brisk Until Recently



As of April 28, 2016
Source: CEIC Data and AB

In a delayed response to the housing market boom, the pace of residential construction has risen well above the historical average (*Display 3*). This hasn't translated into a surge in unsold units just yet, but the growing stock will likely pressure prices going forward.

Domestic Demand Faces Headwinds

On the demand side, sustained job creation and wage growth hold the key. Unfortunately, the strength in Malaysia's domestic demand after the 2008–2009 global recession has relied on leverage in the household and public sectors, and we have reservations about its sustainability.

The labor force expansion after the global recession has been impressive. Employment has increased by 28% since 2008, of which about 40% was related to real estate, construction and public sectors (*Display 4*). Likewise, a breakdown of GDP growth by industry also shows that construction and public sectors have been the growth engines (*Display 5*). But now, those sectors are coming under pressure.

First, lower commodity prices have forced public enterprises—many of which, such as Petronas, are related to natural resource business—to cut capital expenditure. This is creating a major drag on the country's construction cycle.

Second, commercial properties are also facing a supply overhang similar to that in the residential market. Total floor space for office and commercial complexes has increased by 30% and 46%, respectively, since the global recession, with more supply in the pipeline. The occupancy rate has been declining, which implies that the construction cycle has peaked—as has related labor demand.

Third, the public sector won't be able to continue carrying the load. The government's fiscal debt is close to a ceiling of 55% of GDP. Cash positions of nonfinancial public enterprises (NFPE) has also deteriorated significantly in recent years (*Display 6, next page*).

The investment downturn puts construction-related jobs at risk. And slackening domestic demand may threaten jobs in the retail and hospitality industries, which have also been key job creators.

As the tide turns for the worse in the labor market, the debt-servicing capability of households comes into question. Malaysia's banking system is more exposed to consumer credit than its regional peers (*Display 7, next page*), with such lending accounting for 57% of the loan book.

BNM has always argued that household debt, equivalent to 89% of GDP, is well covered by household financial assets, which amount to 183% of GDP. However, excluding illiquid assets such as insurance and employee provident fund (EPF), household financial assets would be less than 120% of GDP. Taking income disparity into account, the financial positions of low income families may be more vulnerable than the market and policymakers recognize.

Fiscal Buffer for a Soft Landing

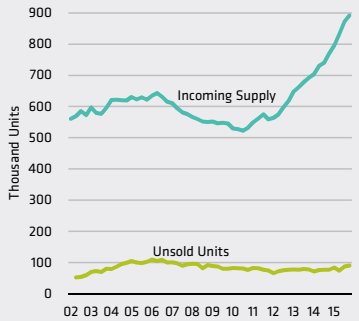
In the light of systematic risks stemming from a potential housing market correction, we think policymakers could utilize the remaining—but depleted—policy buffers to engineer a soft landing for the economy. However, after years of expansionary fiscal policy, and with the large presence of foreign investors making the domestic debt market vulnerable to policy surprises, authorities have less maneuvering space than they did in 2008.

Still, even though Malaysia's fiscal debt is higher than those in the rest of the region, the government also holds sizable liquid financial assets. This is due to the government's large presence in the economy, with NFPEs dominating many key industries.

Direct equity holdings by the ministry of finance and sovereign wealth fund Khazanah in listed companies, such as Petronas, Tenaga Nasional and Axiata, amount to 17% of GDP. These equity holdings are highly liquid and can provide fiscal ammunition if need be. Moreover, even though the EPF has been reducing its holdings in government securities in recent years (*Display 8, next page*), it can alter its portfolio allocations to help fund government coffers. Furthermore, ownerships in many insurance companies and local banks, which have ties with the government, can utilize excess cash to purchase government securities if needed.

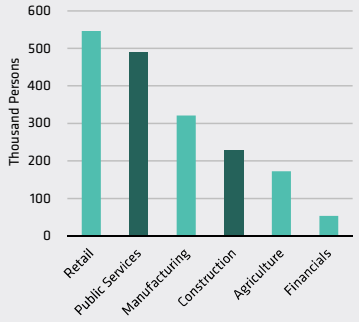
So, even though Malaysia's official and contingent fiscal liabilities have been hefty,

Display 3
Sizable Supply Pipeline Ahead



As of April 28, 2016
Source: CEIC Data and AB

Display 4
Jobs Stability Key to Housing Demand



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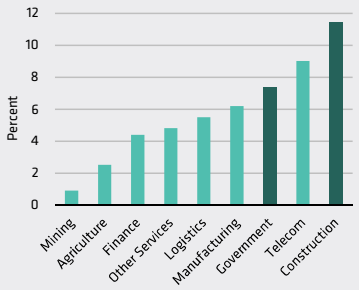
Source: CEIC Data and AB

Display 5
Construction, Public Services Drove Growth



As of April 28, 2016
Source: CEIC Data and AB

the government still has some leeway to avert a hard landing.

BNM Eyes Ringgit Stability

Meanwhile, BNM's monetary policy options have been constrained by concerns about the ringgit's weakness. At one point last year, there were even speculations that BNM could resort to capital-account restrictions. So, the ringgit's stability and foreign investors' confidence will be critical to any monetary policy measures.

The downturn in the investment cycle and slackening domestic consumption justify lower policy rates. And lower rates would, in turn, ease the financial burden on the leveraged households, supporting a soft-landing scenario.

Therefore, BNM may consider easing policy in the coming months if the current stability in market sentiment stays. However, insufficient foreign reserves and heavy foreign positioning in the domestic debt market remain a key vulnerability of Malaysia's external position. The risk of dislocative investor reaction will likely tie BNM's hands.

Investment Implications

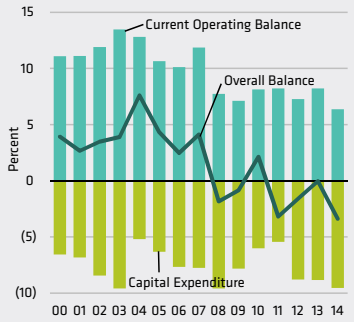
Malaysia has some leeway to engineer to accommodate an economic soft landing, but not enough to drive a V-shaped recovery à la 2009. Maneuvering space is limited in everything from foreign reserves, fiscal spending and monetary policy. This does not bode well for the country's sovereign rating.

If commodity prices weaken again or more negative news headlines like the 1MDB debt dispute emerge, we expect sovereign spreads, credit default swap (CDS) spreads and the ringgit's exchange rate to bear the brunt.

Despite concerns over heavy foreign holdings, local-currency Malaysian government securities (MGS) may be buffered from external shocks owing to sizable domestic savings and the dominance of public savings institutions. Even in a soft-landing scenario, growth may remain below its potential rate for some time, supporting MGS performance—so long as there are no disorderly portfolio outflows. ■

Display 6
NFPEs' Cash Flow Has Turned Negative

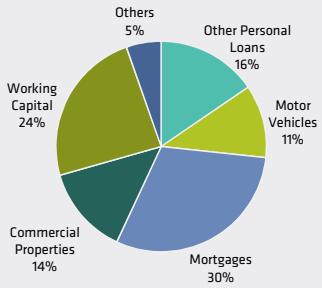
NFPEs' Operating Balance and Investment



As of April 28, 2016
Source: CEIC Data and AB

Display 7
Banks Have Sizable Exposure to Consumers

Breakdown of Banks' Loan Book



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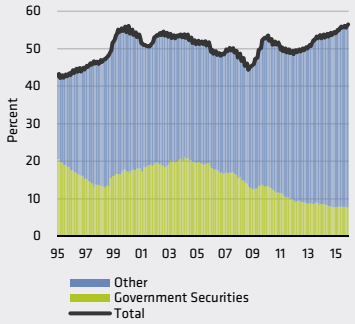
Display 8
EPF Can Provide Fiscal Ammunition

EPF's Assets



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