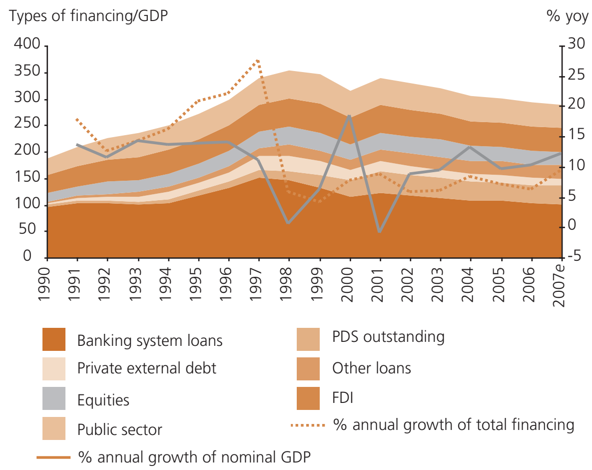
The Evolution of Financing Sources for the Malaysian Economy

Since the early 1990s, amidst relatively strong and sustained growth, the Malaysian economy has undergone significant structural change and has become more diversified. The financial system, which plays a pivotal role in facilitating and supporting economic growth, has also undergone significant transformation. Financial deepening, coupled with the changing sources of growth of the economy, has contributed to the changing structure of the sources, types and level of financing.

The financing ratio (total financing[1] as a percentage to GDP) has steadily moderated since 2001, with financing growing at a slower pace compared with nominal GDP (see chart 2.50). This is a clear divergence from the trend for most of the 1990s, when financing growth exceeded the growth of GDP. The moderating trend in the ratio can be largely attributed to structural changes in the economy, with private consumption gaining prominence over private investment as the key growth driver. Such a marked shift in growth patterns was evident when comparing the periods before and after the Asian crisis. During the pre-crisis period (1990-1997), the economy was driven mainly by investment, with a higher volume of financing for capital-intensive industries and large infrastructure projects. Loans extended to the business sector experienced a strong average annual growth of 30% over the period. With the sources of growth of the economy shifting from investment to consumption, especially since 2001, the financing needs of the economy became less intense. In the post-crisis period (2001-2007), the corporate sector focused on de-leveraging and following the period of over investment, private investment began to decelerate. Consequently, the financing profile of businesses also changed, with businesses mainly borrowing short term to meet working capital needs, reducing their long–term loans for investment and relying more on the bond market, thus causing loans outstanding of the business sector to advance at a slower pace. At the same time, the shift in bank financing to the household sector resulted in a significant reduction in the average size of loans disbursed, mainly because financing to households for the purchase of fixed assets and consumption durables were smaller compared to the amount required for investment outlays by businesses. The combination of these factors led to a decline in the financing intensity by the banking institutions.

Chart 2.50
Financing Ratio of the Malaysian Economy, 1990-2007



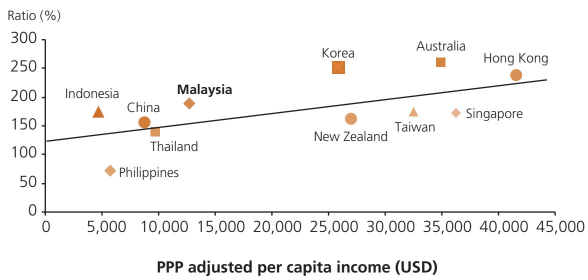
e Estimate
Source: Bank Negara Malaysia calculations

[1] Total financing comprises of two main components: (1) Domestic sources which consist of loans from the banking institutions, PDS, equities and loans from other domestic non-bank financial institutions (development financial institutions, Employee Provident Fund, insurance companies, leasing and factoring companies, the Treasury Housing Loan Division and Malaysia Building Society Berhad). (2) External sources which consist of foreign direct investments as well as short and long-term borrowings from abroad.

The different sectors of the economy also exhibited varying degrees of financing intensity, which is defined as the ratio of financing to sectoral output. The construction sector, which was one of the primary drivers of economic growth during the pre-crisis period, was characterised by a high financing intensity, as more capital was needed for construction and large infrastructure projects. The manufacturing and services sector, which became the biggest contributors to economic growth after the crisis, have lower financing requirements. The lower financing intensity in the manufacturing sector could be attributable to the large presence of MNCs, which rely more on internally generated funds for their operations. The services sector requires less financing for their investments given that the nature of their operations are less capital intensive. The shift in the sectors that drive economic growth thus is also a key factor accounting for the moderation in the financing to GDP ratio.

Although the financing to GDP ratio has moderated over the past several years, it has remained at a relatively high level. A cross-country comparison indicated that at 189%, the ratio of outstanding banking system loans and private debt securities to GDP for Malaysia was relatively high given its level of development, compared to some other regional countries (see chart 2.51). This was due to several factors. With regards to bank financing, Malaysia has a successful policy of promoting financial inclusion across regions and sectors. Households, for example, faced minimal constraints in accessing bank financing. Even as early as the first half of the 1990s, lending for the purchase of properties and cars had already accounted 20.4% of the total outstanding loans of the banking system (2007: 41.8% of total outstanding loans). An added impetus to the growth in household loans was that in the aftermath of the Asian crisis, the banking institutions shifted their focus from the business sector to the financing of the household sector as part of their business diversification strategies. Combined with the Government's policy of raising home ownership, which was manifested through various measures, household borrowing experienced marked growth in 2001-2005.

Chart 2.51
Financing[1] to GDP Ratio and PPP Adjusted per Capita Income: Country Comparison in 2007



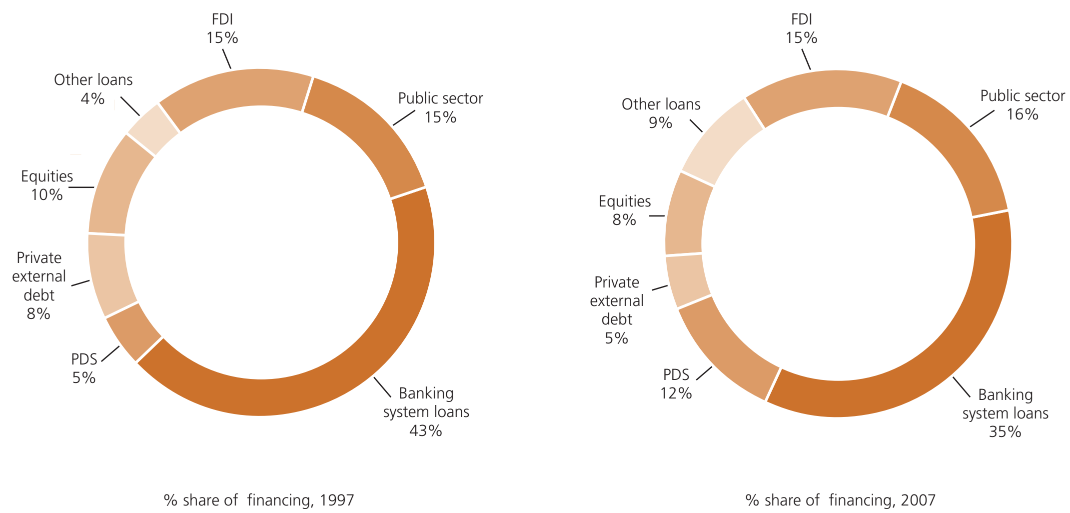
[1] Financing comprises of only banking system loans as well as private and public bonds outstanding

Source: Based on Bank Negara Malaysia calculations; data from Asian Bonds Online, CEIC and World Economic Outlook databases.

There were also significant changes in the sources of financing for the economy. In the last decade, the financial system in Malaysia has strengthened significantly and undergone significant transformation thus creating a more diversified and deeper financial system. Of significance has been the growing importance of the capital market in providing medium to long-term funding for corporates. Bank Negara Malaysia, together with other agencies undertook various measures to develop a strong market infrastructure and a comprehensive legal and regulatory framework to support the growth of the bond market. The Asian Development Bank, in June 2006, ranked the Malaysian debt securities market as the second largest in Asia after Japan. The share of financing through the issuance of PDS grew substantially from 5% of total financing in 1997 to 12% in

2007 (see chart 2.52). Although the share of loans extended by the banking system relative to overall financing declined from 43% to 35%, the banking system, nevertheless, remains an important source of financing for the working capital of businesses as well as for funding household investment and consumption. Over the same period, the share of household loans to total banking system loans increased from 33% to 56%. The role of other domestic intermediaries, namely the development financial institutions (DFIs), insurance companies and housing credit institutions as alternative providers of financing has also become more important. These institutions complemented the banking institutions by providing financing to selected sectors of the economy. More specialised institutions such as the DFIs have been increasing their financing, especially to the SMEs. As a result, financing from DFIs has expanded strongly at an average annual growth rate of 33% over the last seven years, to account for a larger share of 5.1% of total financing as at end-2007 (1.0% as at end-1997).

Chart 2.52
Sources of Financing



A distinctive development in the financing of the economy has been the growing importance of Islamic financing. Bank Negara Malaysia has implemented a range of measures to develop the Islamic finance industry, which have yielded significant results. Over the period of 2001-2007, financing via Islamic instruments expanded significantly at an average annual growth of 23% to support funding for new growth areas and to serve as an alternative source of financing for the economy.

In recent years, new measures have been introduced to deepen and enhance the efficiency of the financial system. Among others, key measures include the liberalisation of foreign exchange administration rules to allow multilateral financial institutions and multinational corporations to issue both ringgit and non-ringgit denominated instruments in the capital market; the launch of Malaysia International Islamic Financial Centre (MIFC) initiative; allowing locally incorporated foreign banks to establish Islamic subsidiaries; and the introduction of web-based Fully Automated System for Issuing/ Tendering (FAST). With these measures, the financial system will continue to evolve and become more effective in intermediating financial resources and risks, and supporting the continued transformation of the Malaysian economy.