Masters of Science (Banking)

UUM-IBBM

WBB 6013: SEMINAR IN BANKING

To Lend or Not to Lend, That is the Question – Economic
Considerations for Malaysian Bankers

By

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Abstract

The research aims to see if a few macroeconomic indicators can provide a broader
perspective to Malaysian bankers & help sharpen one of the criteria of the 7 C's of
Credit – **Conditions** – by pin-pointing which economic indicators that can be most
helpful to bankers. Statistical analysis was conducted using SPSS: Correlation. The
results show that there is a strong correlation between the chosen Macro economic
factors that allows for a good indication of "Conditions". The conclusion is that
bankers could use them as indicators when considering "**Conditions"**.

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1.0   INTRODUCTION

The purpose of the research is to see if a few macroeconomic indicators can provide a broader perspective to Malaysian bankers to augment existing loan procedures & bank loan policies in order to reach a loan decision faster, either to accept or reject a loan application to the private consumer. It is hoped that this research can help sharpen one of the criteria of the 7 C's of Credit – **Conditions** – by pin-pointing which economic indicators that can be most helpful to bankers. In light of the **2008 Global Financial Crisis**, it seems pertinent and urgent that bankers have a reliable set of indicators to guide them in their decision making for this purpose. In order to understand the fundamentals of **Conditions**, however, it is useful to first consider the Malaysian economy with a view of critically examining its key components and history.

2.0 THE MALAYSIAN ECONOMY - OVERVIEW

Malaysia achieved its independence from the United Kingdom on the 31st of August 1957. During the span of 51 years of independence, Malaysia has encountered five major economic crises. The first economic crisis was called the "Early Commodity Crisis" which occurred between 1956 and 1972, then the first oil crisis of 1973 and 1974, brought about by the worldwide increase in oil prices, then the second commodity/oil crisis of 1980 to 1981. During the period of 1985 to 1986 occurred the electronic/third commodity crisis and finally the most recent financial and currency crisis of 1997 to 1998. These economic crises indicate that the Malaysian economy is one of the most open in the world and external shocks have a profound effect on its condition.

The real economy just after independence in 1957 was dominated by the primary sector which consisted of agriculture and mining. The primary sector was the major contributor of the GDP. It was also a major source of employment. Agriculture involved rubber cultivation, palm oil, rice cultivation, fisheries, and forestry activities which accounted for 39.3% of the GDP and employed 58.3% of the total labour force. Mining activities was primarily for tin, which contributed to 6.4% of the GDP.

Towards the 1960s the Malaysian economy slowly switched toward the adoption of an import-substitution strategy as it was evident that Malaysia's comparative advantage had shifted from primary produce to industrialization. Import substitution was an essential part of

the growth strategy according to the **First Malaysia Plan of 1966 to 1970**. There were two main reasons as to why the Malaysian Government adopted this strategy. They were:

i) The rapid population growth

ii) The need to have economic diversification - i.e. to eliminate total dependence on primary sector produce like rubber and tin.

There were some shortcomings of the import substitution strategy. Firstly, the problem lies on the inefficiency of the manufacturing industry which was affected by the size of the domestic market which was just not big enough, and as such it did not create sufficient consumption to create efficiency of scale. Here we touch the second problem, where the small domestic market could not sustain the long-term requirements of the strategy. Thirdly, the objectives of the Government for setting up the strategy were not achieved. As a result of the import substitution strategy was replaced with an export-oriented strategy.

The export-oriented strategy was a success since its introduction on 1968 right up to 1990. This strategy's first measure was to incorporate tax holidays to firms granted pioneer status and also to give additional tax holidays based on the nature of the product, location of the firm and the content of local raw materials. An incentive was given in the form of granting investment tax credit to establishments that did not qualify for pioneer status but the Government still wanted to encourage them. Export incentives were also offered to both new and existing establishments intending to expand their facilities.

2.1   The Malaysian Economy – Before The 1997 Crisis

Over the years, the Malaysian government is reputed as one that implements prudent fiscal policies, maintaining budgets that are close to the balance. Based on the graph below, it shows that there was a significant surplus of revenue over current expenditures. Bank Negara Malaysia, the central bank, did the job of maintaining strict management of the growth internal liquidity, in the interests of limiting any inflationary pressure resulting from economic expansions.

Government Defic
World Bank's Figures
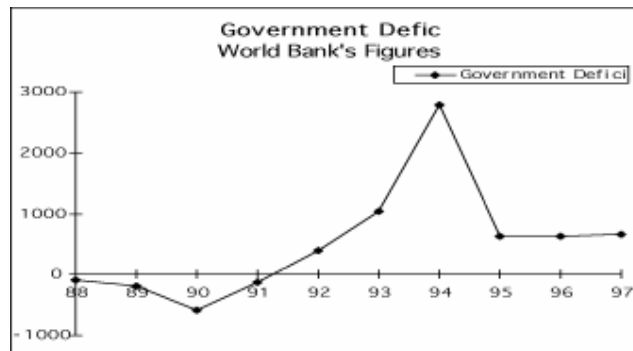
In the early 1990s, the Kuala Lumpur Stock Exchange (KLSE) was a target for overseas fund managers eager to buy into emerging markets because Malaysia offered political stability, strong currency, sound economic fundamentals i.e. low debt, fast economic growth and moderate low inflation.

Malaysia's well developed infrastructure and administration also attracted Foreign Direct Investment (FDI) which has reduced overseas borrowing. New markets were also broken into as FDI simplified the process of it.

2.2 The 1997 Financial /Currency Crisis

The financial crisis began in Thailand sometime in July 1997. Many economists have different views as to what really triggered the crisis. According to some, it was the poor economic fundamentals and policy inconsistencies that caused the crisis. Others argue that Asia fell victim to a financial panic. Fundamentalists say that there were serious structural problems, regulatory inadequacies and close links between public and private institutions that caused the Asian crisis.

There were political pressures to maintain high rates of economic growth which led to the long tradition of public guarantees on private projects (some undertaken under Government control) directly subsidized or supported by policies of directed credit to favoured firms or industries.

The adverse consequences of these structural and policy distortions were critically magnified by the rapid process of capital imbalance. Moreover, there was a sharp appreciation in value of the US Dollar relative to the Japanese Yen and European currencies since the second half of 1995 which led to deteriorating cost effectiveness in most Asian countries whose

currencies were pegged on the US Dollar. These cumulative effects of these structural, policy and real imbalances triggered the financial crisis of 1997. However there was nothing wrong with the Asian economy as they were performing well and were still exhibiting robust growth prior to the crisis.

According to Okposin and Cheng (2000), the financial crisis was further deepened because there was misinformation given to the public and foreign investors. Firstly, foreign media questioned the strength of the economy and the leadership of individual Asian nations. Secondly, the investors themselves perceived that all East Asian economies were identical and faced similar problems of the same magnitude. It was because of this that the market confidence was affected.

2.3 Impact Of The 1997 Financial Crisis On Malaysia

The impact of the financial crisis differs from one country to another. In Malaysia, the Ringgit lost about 40% of it's value within half a year. The 40% devaluation of the Ringgit is equal to a reduction of per capita income of the country from US $ 5000 to US $ 3000. In total GDP terms, it amounts to approximately US $40 billion yearly. Approximately US $100 billion was wiped out from the Malaysian stock market, the KLSE (**Kuala Lumpur Stock Exchange**). In total, the nation lost about US $ 140 billion in a single year.

 Large scale infrastructure projects totaling more than RM60 billion - the Bakun hydro-electronic dam, the Northern Region International Airport, the Highland Highway and the Kuala Lumpur Linear City included - have been deferred under government austerity measures and many top civil servants took a pay cut.

The economic growth, previously growing at about 8% every year, contracted in real GDP terms. The impact of the financial crisis on the economic growth was evident towards the end of 1997 when the real GDP began to slow down and then registered negative growth beginning the first quarter of 1998.   This is the first time the real GDP registered negative growth since 1985. Please refer to graph on the next page.

This contraction in the real GDP resulted in slower employment growth and increased the rate of unemployment and retrenchment. The good news was that the unemployment rate did not reach an alarming level as there were many industries that were facing labour shortages and were able to absorb these retrenched workers. The largest decline in unemployment was from the construction sector. Private investment contracted due to the uncertainties from

volatile exchange rates, declines in both local and external demand, existence of excess capacity and the tight liquidity position encountered since the financial crisis in July 1997. FDI showed a declining trend over the period between January 1997 and December 1998.

The exchange rate of the Ringgit against major currencies was unfavourable for Malaysia. The Ringgit depreciated by 40% against the US Dollar between July 1, 1997 and December 31, 1997. The KLSE **Composite Index** declined during this period too. The movements of the stock prices on the KLSE were affected by several factors, including exchange rates fluctuations, developments in regional economics and a sharp loss of confidence in emerging markets by international investors. The corporate sector was also affected by the crisis and this was reflected by the decline in the number of new companies registered and the increase in the number of business closures.

Because the economy contracted, the poverty level increased slightly in 1998 as there were limited employment and income earning opportunities. The poor performance of the stock market also seriously constrained the ability of the corporate sector from obtaining funds through investments and sale of stocks from the KLSE. The consumption patterns of Malaysians were also affected as shown in the general decline in consumer spending. Sales of cars and property plummeted. The increase in interest rates meant more hardships for the public. For example, a family or individual who is servicing a loan for RM 100,000 had to pay an extra 20% more in monthly repayments.

Lastly, the currency depreciation affected the public's capacity to pursue higher education abroad. Financial assistance for education abroad was either stopped or reduced drastically. Most of the "**Bumiputera**" students were affected because they were solely dependent on Government aid. The cost of education increased sharply and more and more students had to pursue their higher education locally, and since the Government supported Universities like **Universiti Putra Malaysia** had only limited places, private colleges sprung up to fill the gap and created a new industry in the process.

2.4   The 7'Cs of Credit

Following the Certified Credit Professional Handbook, before a loan can be made, a banker must evaluate the broad risk factors in evaluating credit, and a possible general model that can be used to assess a potential borrower's basic credit factors is known as the 7 C's of Credit. It is important to note that all the "C's" are important, but may be listed in the order of

importance sequentially as Character, Capacity, Capital, Conditions, Collateral, Control and Common Business Sense.

Here, "Conditions" have been described as macroeconomic issues like globalization, foreign currency markets, economies of major trading partners, legislative and regulatory frameworks as well as social trends. Certainly this is a wide list of issues, and while it is useful for bankers to bear these issues in mind, it may be said that such a wide list of descriptors lack focus and may even be disadvantageous due to its vague nature. In this paper, it is the search for the most relevant macroeconomic factors that should be included and considered by Malaysian bankers in "Conditions" that is being investigated in order to sharpen the list of criteria that must be considered by bankers – by pin-pointing which economic indicators that can be most helpful to bankers for them to accurately make lending decisions.

3.0   CRITERIA

The use of secondary data is extensive. However, the sources of secondary data are considered by the researcher to be extremely reliable, as they were sourced from **Bank Negara Malaysia** (BNM), the **International Monetary Fund** (IMF) or the **Department of Statistics, Malaysia**. A snapshot of the past two economic recessions (1986 & 1998) is examined and contrasted with the 2008 Malaysian economic performance in the present Global Financial Crisis to check correlation & to test if these economic indicators are able to provide a reliable signal to help determine a loan decision. In addition, data from the year immediately prior to each economic slowdown (1985, 1997 & 2007) is examined for comparison.

	GDP (USD Billion)	**Exports % to GDP**	**Inflation**	**Unemployment**	**Net NPL**
1985	31.2	49.1%	2.5%	6.9%	30.1%
1986	27.7	49.4%	0.4%	8.3%	n.a
1997	97.8	80.5%	2.7%	2.7%	4.1%
1998	71.1	102.9%	5.3%	4.0%	7.6%
2007	186.72	125.0%	2.0%	3.3%	5.3%
Oct 2008	143.89	109.2%	7.6%	3.5%	2.4%

3.1   The Variables & Their Selection

As shown above, there are 5 factors that are being examined for correlation. The reason for their selection is as follows:

a) **Gross Domestic Product (GDP)**

The GDP is one of the measures of the income and output of a country's economy. Therefore to look into the GDP is a good way to look at the country's productivity and it gives a general overview of the health of the economy. It makes a good dependent variable for this reason.

b) **Export % to GDP**

Since Malaysia is an active trading nation, it is important to look at how exports have contributed to the economy, since exports imply production which in turn requires manpower, among other factors of production. Effectively, the higher the level of exports, the higher the requirement for the factors of production. Also, it gives a good indicator of the macro economy, since it implies the economic health of Malaysia's major trading partners.

c) **Inflation**

Inflation is a general rise in the prices of goods and services over a period of time and as such causes the loss of purchasing power. It can have an adverse effect on the economy, as uncertainty over the inflation rate may discourage savings and investments. The erosion of purchasing power means that consumers will have to spend more just to maintain their present lifestyles, and as such may have less money for repayment of loans.

d) **Unemployment**

Okun's Law states that for every 2% GDP fall relative to potential GDP, there is a 1% increase in unemployment. Therefore, when the economy operates in a productive capacity, there will only be the "Natural Rate of Unemployment", which is according to **William Beveridge**, should be at 3% unemployment. Others, like the **Organisation for Economic Co-operation and Development** (**OECD**), states that full employment is at 4% unemployment.

e) **Net Non-Performing Loans (NPL's)**

Non – Performing Loans are loans that are in default, or close to being in default. According to the **International Monetary Fund** (**IMF**), NPL's occur when payments of capital and interest are past due by 90 days or more, or payments are less than 90 days overdue, but there are other good reasons to doubt that the payments will be made in full. NPL's should be of particular interest to bankers thinking about giving out loans due to obvious reasons!

3.2 Hypotheses

Data analysed from the secondary data sources will be used to determine whether there is any relationship between the Malaysian GDP and the other variables of Export % to GDP, Inflation, Unemployment and Net NPL's. In meeting this objective, the researcher hopes to find a relationship between the Malaysian GDP and the other variables. This result will then be used to conclude whether such variables are useful macroeconomic indicators to help Malaysian bankers determine "Conditions".

Hypothesis:

H_0 : Null Hypothesis : The correlation between the Malaysian GDP and the variables of Export % to GDP, Inflation, Unemployment and Net NPL's is zero (ie there is no relationship between the variables)

H_1 : Alternative Hypothesis: The correlation between the Malaysian GDP and the variables of Export % to GDP, Inflation, Unemployment and Net NPL's is not zero

Therefore, only those correlations where the value of the p is below 0.05 are significantly different from zero.

a) + 1 if there is a perfect positive correlation between variables

b) – 1 if there is perfect negative correlation between variables

c) Between 0 and + 1 if there is some positive correlation

d) Between 0 and – 1 if there is some negative correlation

The closer the coefficient is to 1.0, the greater the positive correlation, and vice-versa.

4.0 ANALYSIS OF FINDINGS

This portion of the paper contains the findings from the method employed in Part Three in the gathering of data. In the following paragraphs, the results from the secondary data are presented and interpreted.

This chapter is organised as follows. The first portion reports and interprets the findings obtained from the secondary data (i.e. BNM Annual Reports and other similar sources).

Then, the hypothesis of the data collected from the secondary data sources would be confirmed. The last part would present a summary of all findings and its interpretation.

4.1 Reporting Findings & Interpretation of Data

	GDP (USD Billion)	Exports % to GDP	Inflation	Unemployment	Net NPL
1985	31.2	49.1%	2.5%	6.9%	30.1%
1986	27.7	49.4%	0.4%	8.3%	n.a
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Oct 2008	143.89	109.2%	7.6%	3.5%	2.4%

Here, we see the various variables are sampled in snapshots of 2 successive years that represents the periods when Malaysia was experiencing economic difficulties. For example, the 1986 Economic Recession, the 1998 Asian Financial Crisis and the 2008 Global Financial Crisis, all have data from the year preceding each economic difficulties – 1985, 1996 and 2007 respectively. This serves to compare how the Malaysian economy was performing immediately prior to each of the economic difficulties.

We see that from the **GDP performance**, within the last 23 years from 1985 to 2008, there has been tremendous growth in the GDP. However, on closer examination, we also see a drop of GDP in the years 1986 and 1998, indicating economic recession. However, the most up-to-date data for 2008 is only available until October 2008, and even then we can see the GDP

results are very similar between 2007 and 2008, indicating that Malaysia in 2008 may not be affected badly by the Global Financial Crisis. (See chart overleaf)
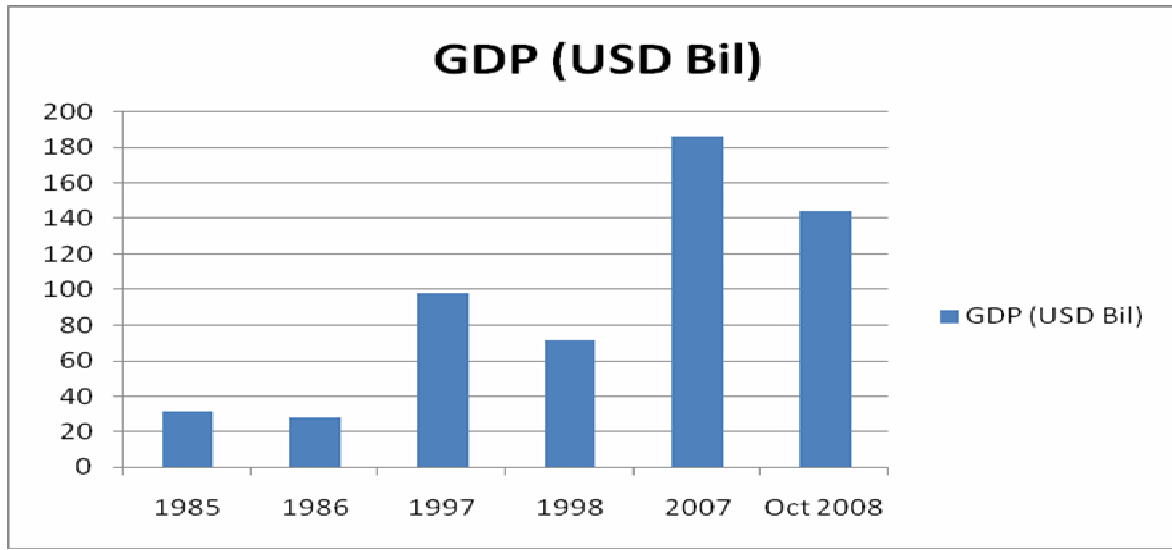
Export % to GDP also experienced growth in the last 23 years, however the percentage is higher in the year the economic recessions hit in 1986 and 1998, compared to the non-economic crisis years of 1985 and 1997. A few factors may cause this phenomena, for example the Malaysian exports of oil continued to do good business despite the overall slowdown in the economy in 1986 and the devaluation of the Ringgit in 1998 compared to the major currencies in the world (USD and GBP for example) allowed for more exports because Malaysian made goods are now cheaper to buy. However, we see that this trend does not continue in the 2007 and 2008 period, indicating that there is no slowdown in GDP in 2008.

Inflation certainly jumped during the 23 year period, however this is to be expected due to increases in the M3 money supply over the years. Most notably, Inflation was in its highest in 2008 within that 23 year period, at 7.8% in October 2008, showing that the effect of sustained high oil prices over 2007 and 2008 has an adverse effect on Malaysian consumers.

Unemployment was highest in 1986, at 8.3%, but conversely unemployment is at 23 year lows in 2007 and 2008 at 3.3% to 3.5%. Again, this shows the Malaysian economy performing at peak productivity in 2008.

Net NPL is also at 23 year lows in 2008, indicating stricter credit control measures and the ability of borrowers to service their loans despite the Global Financial Crisis.

4.2 Hypothesis Testing

Descriptive Statistics

	Mean	Std. Deviation	N
GDP USD (Bil)	93.06833	63.180982	6
Export % to GDP	86.01667	31.863045	6
Inflation	3.40667	2.599490	6
Unemployment	4.78333	2.264877	6
Net NPL	9.90000	11.449672	5

Correlations

		GDP USD (Bil)	Export % to GDP	Inflation	Unemployment	Net NPL
GDP USD (Bil)	Pearson Correlation	1	.905(*)	.359	-.779	-.731
	Sig. (2-tailed)		.013	.484	.068	.161
	N	6	6	6	6	5
Export % to GDP	Pearson Correlation	.905(*)	1	.543	-.821(*)	-.820
	Sig. (2-tailed)	.013		.265	.045	.089
	N	6	6	6	6	5
Inflation	Pearson Correlation	.359	.543	1	-.541	-.399
	Sig. (2-tailed)	.484	.265		.267	.505
	N	6	6	6	6	5
Unemployment	Pearson Correlation	-.779	-.821(*)	-.541	1	.971(**)
	Sig. (2-tailed)	.068	.045	.267		.006
	N	6	6	6	6	5
Net NPL	Pearson Correlation	-.731	-.820	-.399	.971(**)	1
	Sig. (2-tailed)	.161	.089	.505	.006	
	N	5	5	5	5	5

* Correlation is significant at the 0.05 level (2-tailed).
** Correlation is significant at the 0.01 level (2-tailed).
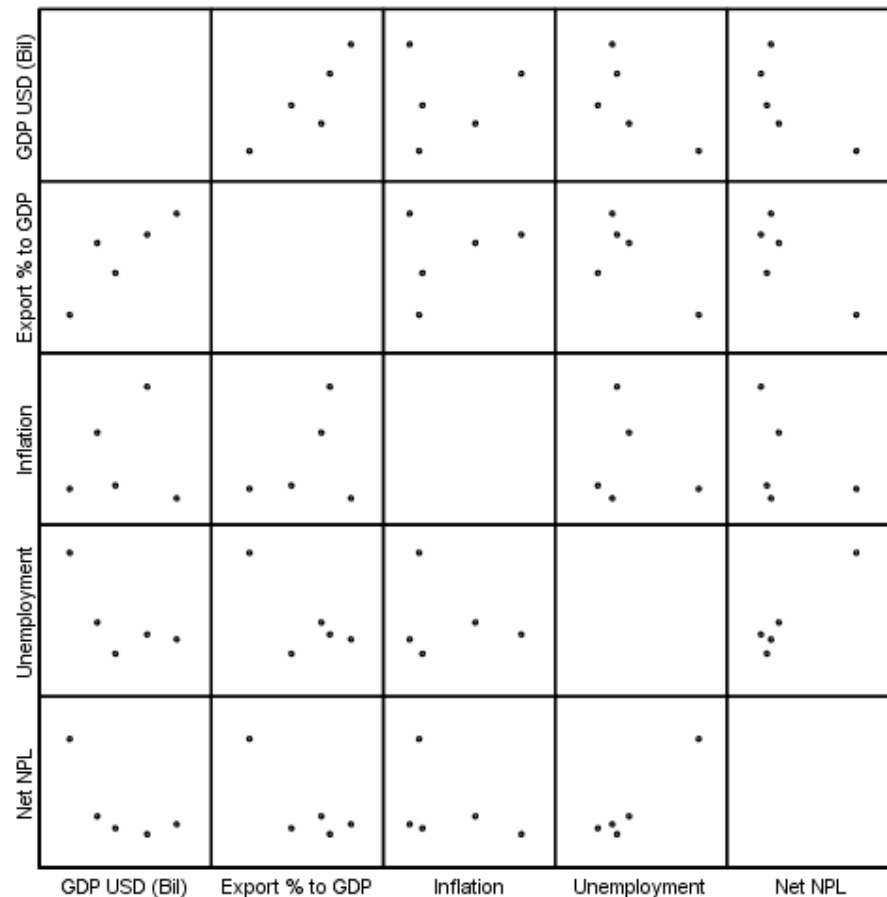
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H_1 : Alternative Hypothesis: The correlation between the Malaysian GDP and the variables of Export % to GDP, Inflation, Unemployment and Net NPL's is not zero

Analysis

From the SPSS analysis of correlation, it is found that there is correlation between the variables at the 0.05 and 0.01 level, and therefore the Alternative Hypothesis (H$_1$) is accepted.

CORRELATION GRAPH

4.3   Summary of Findings

It is found that there is strong correlation between the Malaysian GDP and the variables of Export % to GDP, Inflation, Unemployment and Net NPL's. Further, the snapshots of 3 different economic periods of 1985-1986, 1996-1997 and 2007-2008 served as a window to glimpse how each variable behaved and how other variables reacted to each other. It also allowed the researcher to compare and contrast each period to decisively determine if the Malaysian economy is headed for recession in 2008.

For example, Unemployment has a strong positive correlation to Net NPL, and stronger Export performance has a positive correlation to GDP and a strong negative correlation to Unemployment, meaning the greater the economic activity, the lower the rate of unemployment. This set of economic indicators enables a better and more accurate indicator for the determination of Conditions.

5.0   CONCLUSION

The purpose of the research is to see if a few well chosen macroeconomic indicators can provide a broader perspective to Malaysian bankers to augment existing loan procedures & bank loan policies in order to reach a loan decision faster, either to accept or reject a loan application to the private consumer. It has been shown in this research that the variables chosen, namely the Malaysian GDP, Export % to GDP, Inflation, Unemployment and Net NPL's, can help sharpen one of the criteria of the 7 C's of Credit – **Conditions** – thereby allowing a more accurate determination of the 7 C's of Credit overall. This should give greater assurances to Malaysian bankers when it comes to making sense of the economic performance of the country in the Global Financial Crisis.

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LEARNING POINTS

Authors: Okposin and Cheng

Title: *Economic Crises In Malaysia : Causes, Implications and Policy Prescriptions*

Learning points:

A fuller understanding of the Malaysian economy since independence and which economic factors to consider to focus on for the writing of this paper.

Authors: Case and Fair

Title: *Principles of Economics*

Learning points:

A fuller understanding of economic theories. It enabled me to relate the writings of Okposin and Cheng and see the applicable theories in action. A valuable reference tool.

Authors: AJ Veal

Title: *Business Research Methods, A Managerial Approach*, 2nd Edition

Learning points:

A deeper understanding of statistical theories and the use of SPSS. It enabled me to perform statistical analysis of the data and relate statistical theories to real life. A valuable research tool.

Authors: Anonymous

Title: CCP Handbook, Institut Bank-Bank Malaysia.

Learning points: The practical knowledge necessary for all bankers, and serves as a point of reference of the state of knowledge of Malaysian Bankers. It also serves as a practical guide to banking procedures and processes that applies to Malaysian Bankers. The main inspiration for the author's research.