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Economic Outlook for 2010: Better days in store

Economics Team

Nor Zahidi Alias
Chief Economist
+ 603 2092 5398
zahidi@marc.com.my

Mohd Afzanizam Abd. Rashid
AVP (Economics)
+ 603 2092 5398
afzanizam@marc.com.my

James Foo Kok Chye
Economic Analyst
+ 603 2092 5398
jamesfoo@marc.com.my

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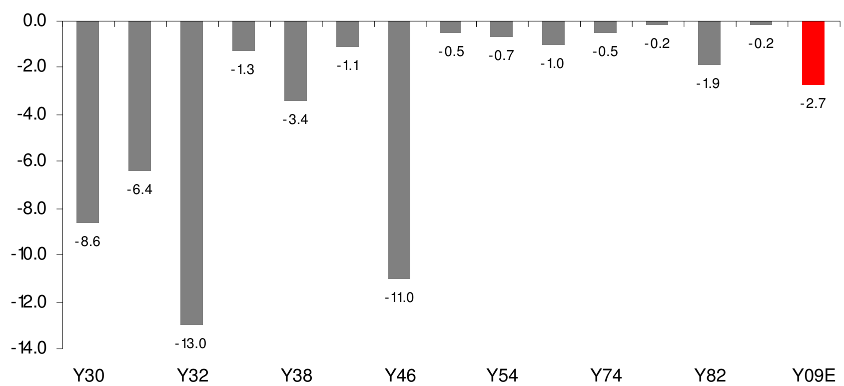
Major economies in retrospect

US economy: Worst recession post-World War II

The years of economic expansion finally ended when the economy was officially mired in a recession in 4Q2007, with gross domestic product (GDP) contracting the most since World War II (2009: -2.7%, according to the IMF estimate). The recession is by far more serious than the post-dotcom bubble recession in 2001 when the economy posted a minuscule growth of 0.8%. Fortunately, policymakers responded swiftly by calibrating fiscal injections to stem huge losses in the banking system while the Federal Reserve (Fed) initiated liquidity operations via asset-purchase programs to restore confidence in the financial markets.

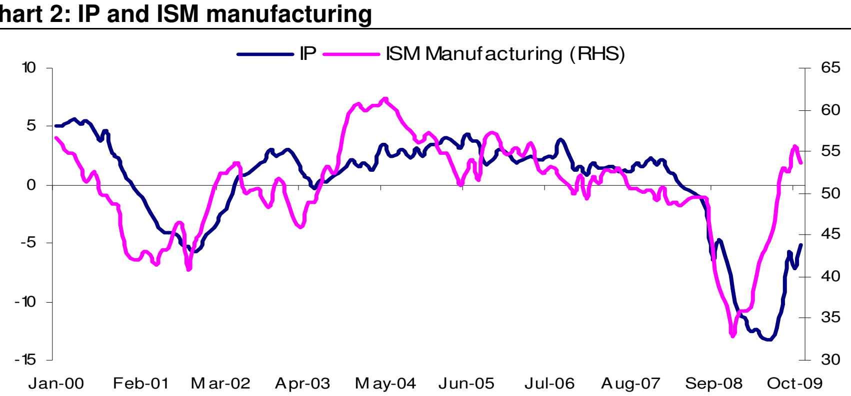
Chart 1: Historical GDP contraction since 1930



Source: US Bureau of Economic Analysis (BEA) and IMF

These measures resulted in a pickup in real economic activity by 2H2009, as evidenced by the first positive month-on-month (m-o-m) industrial production (IP) number since July 2009. In the same vein, the Institute for Supply Management (ISM) manufacturing index managed to surpass its critical level of 50 points in August, signalling an expansionary manufacturing sector. This bodes well for the labour market as businesses begin to gear up for higher production. There was a significant reduction in the number of job losses in November 2009 from -111,000 to -11,000, while the nation's unemployment rate dipped to 10.0% from 10.2% in October 2009. High-frequency data such as the weekly initial jobless claims (IJC) also suggest that the labour market is on the mend with the latest reading showing an improvement to 457,000 compared to April's peak of 660,000.

Chart 2: IP and ISM manufacturing



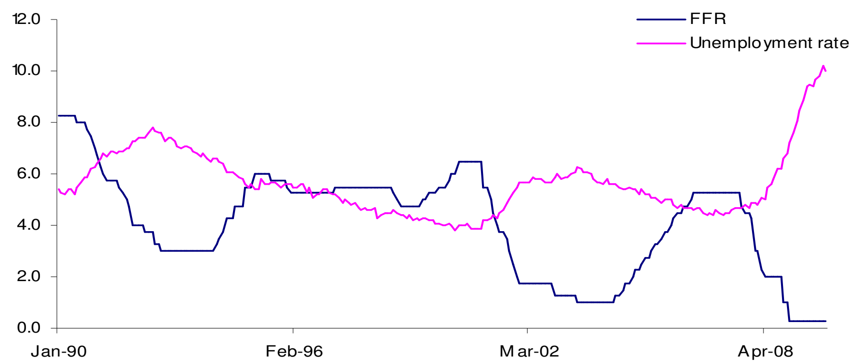
Source: Bloomberg

The ongoing recovery in the labour market is now being translated into higher spending by American consumers, the linchpin of the US economy. This was reflected in retail sales which climbed by 1.3% m-o-m in November following a 1.1% expansion in the preceding month, suggesting that consumer spending will likely be strong in 4Q2009, especially during the festive season in December. Already, the GDP in 3Q2009 turned positive for the first time since 3Q2008 when it grew by 2.2%, led by personal consumption expenditure (2.8% versus -0.9% in the preceding quarter) and investment (5.0% versus -23.7% in the preceding quarter).

Monetary tightening: How soon will it happen?

As the economy starts to heal and the recovery begins to look more sustainable, concerns over the removal of monetary stimulus programs are emerging. Australia, for instance, made a bold move to raise its policy rate by 75 bps over three consecutive months since October 2009; such moves may be more appropriate for Asian economies as they are more resilient. The Fed, however, is not expected to rush the tightening mode, and the latest remark by Fed Chairman Ben Bernanke that policy accommodation is in for "an extended period" suggests that the possibility of a rate hike is quite remote in the near term.

Chart 3: US unemployment rate and the Federal Funds Rate (FFR) (%)



Source: Bloomberg

Similarly, Japan's economy is facing a deflationary threat that prompted the Bank of Japan to introduce another asset-purchase program amounting to 10 trillion yen in early December 2009. In addition, the authority has endorsed an additional fiscal injection worth 7.2 trillion yen in order to spur economic activity. In the Eurozone, the persistent appreciation of the euro may affect the nascent recovery in the region, making it riskier for policymakers to hike up rates as it could boost the strength of the currency and cause a negative impact on the region's exports.

Still a mixed feeling

Despite the ongoing recovery, there are mixed feelings about the global economy outlook for 2010. For one thing, the potential default by Dubai World has sparked concerns over the durability of the recovery, as this will have important repercussions on banks' liquidity and pose a threat of yet another credit crunch. Another factor would be a series of sovereign downgrades of European economies such as Ireland and Greece following rising public debts. Adding to that is the risk of policy mistakes such as premature withdrawals of monetary and fiscal stimuli, especially in Asian economies which are now concerned about the emergence of mini bubbles in the property sector. These could easily affect investors' sentiment and potentially cause instability in the financial markets as well as in capital flows.

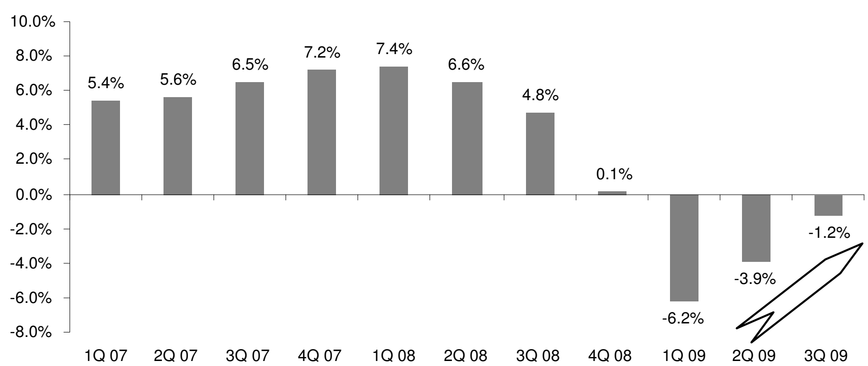
Malaysian economic review

Recession of 2009

Being a small and open economy, Malaysia was not spared from the financial crisis that hit the global economy in 2009. Following a collapse in external demand that hit the economy since 4Q2008, industrial production declined dramatically, causing the GDP to contract by as much as 6.2% year-on-year (y-o-y) in 1Q2009, its steepest decline since 4Q1998. The weakness in the external sector later reverberated across the domestic economy, dragging private consumption down by 0.7% in 1Q2009, its first contraction since 1Q1999. In 2Q2009, economic contraction continued, albeit at a slower pace than in the earlier quarter as the external sector began to stabilise following concerted efforts by global central banks and massive fiscal measures introduced by developed and emerging economies.

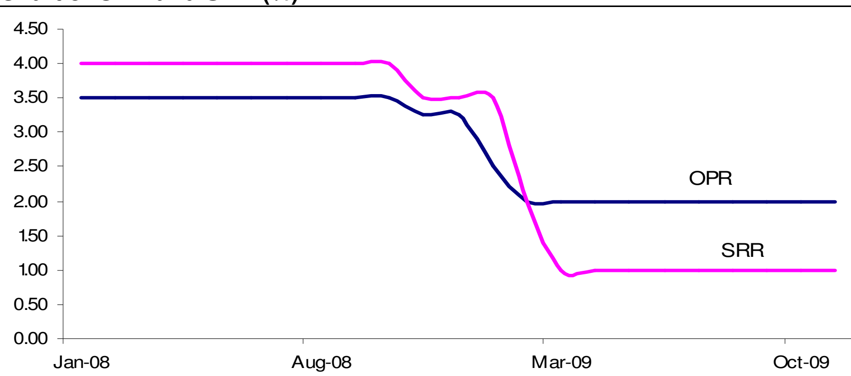
In response to the rapid deterioration in economic activity since the final quarter of 2008, Bank Negara Malaysia (BNM) turned aggressive and slashed its benchmark Overnight Policy Rate (OPR) by 150 bps within four months. Since then, the OPR was left unchanged at 2.00% while the Statutory Reserve Requirement (SRR) was kept at 1.0% to reduce financial intermediation costs and to ensure sufficient liquidity in the economy. This move was complemented by fiscal measures through an introduction of a huge second stimulus package in March 2009 amounting to RM60 billion to alleviate the severity of the downturn.

Chart 4: GDP growth y-o-y (%)



Source: CEIC

Chart 5: OPR and SRR (%)



Source: CEIC

Budget deficit and pressure on sovereign rating

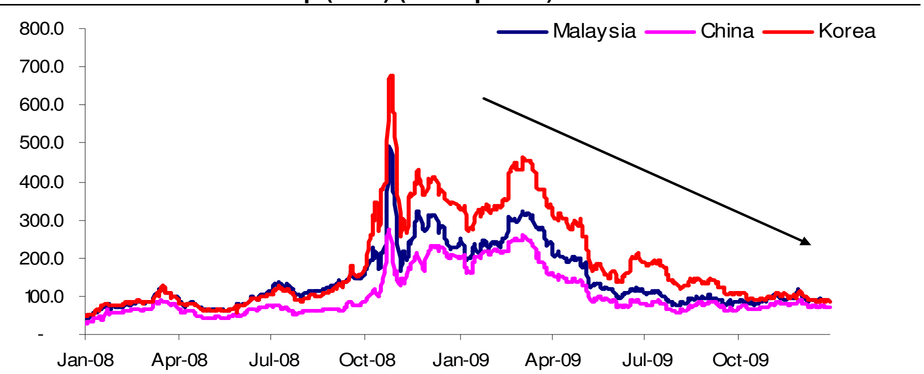
The huge fiscal deficits of 7.4% of GDP anticipated to be incurred by the government in 2009 and the move by Fitch Ratings to downgrade Malaysia's local currency rating from A+ to A in June 2009 raised serious concerns among policymakers. Adding to that is the worry about the budget gap which has persisted since the Asian Financial Crisis in 1998. As a result, when the government unveiled Budget 2010 in October 2009, it set an ambitious target to reduce fiscal deficits dramatically to 5.6% of GDP in 2010, before pushing it lower in the future years. This, according to the government, will be achieved mainly through a sharp 11.3% reduction in total expenditure. Government operating expenditure, the culprit behind the steep rise in total expenditure, is expected to be trimmed by 13.7%.

Turbulence in financial markets

Following the credit crunch that hit major economies in 2009, Malaysia's financial markets took a beating as risk aversion escalated among global investors. In the equity market, the FTSE Bursa Malaysia Kuala Lumpur Composite Index (FBM KLCI) slumped by 44.5% to 840.9 points from its historical high of 1,516.2 points reached in January 2008. As investors rushed for safe haven, yields for government bonds (Malaysian Government Securities, or MGS) plummeted. Yields for 5- and 10-year MGS fell to 2.66% and 2.95% from 4.24% and 4.90% respectively. Panic selling also led to outflows of capital from Malaysian shores, as reflected in the RM22.1 billion net outflows of portfolio investment between 1Q2009 and 2Q2009.

In the currency market, the ringgit went on a rollercoaster ride as global investors fled for safe haven in anticipation of the worst recession since the Great Depression in the 1930s. The ringgit, which traded around RM3.46 per USD on the first trading day in January, weakened sharply to RM3.73 in the first week of March as more signs of the Malaysian economy heading for a recession emerged. In addition, the rush for safe haven in US government bonds magnified the drop in the ringgit against the USD. Since then, however, the ringgit started to strengthen against the greenback as confidence returned to the financial market following better prospects of a recovery in the global economy. By October 2009, the ringgit touched a 14-month high of RM3.35 per USD.

Chart 6: Credit default swap (CDS) (basis points)

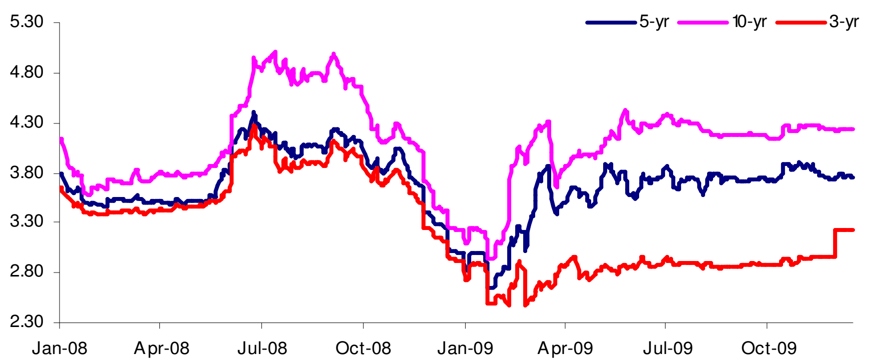


Source: Bloomberg

Chart 7: FBM KLCI (LHS) and the ringgit against the greenback (RHS)

Source: CEIC

Chart 8: MGS yield (%)



Source: CEIC

The turnaround in 2H2009

Following a turnaround in major and emerging economies such as the US, Euro, Japan, China and India in 3Q2009, Malaysia's GDP contraction moderated to 1.2% from -3.9% in 2Q2009. The improvement was primarily attributed to a recovery in exports as well as a rebound in private consumption following a more stable labour market, evidenced by a drop in unemployment to 3.6% in 2Q2009 from 4% in the earlier quarter. Rising optimism was also reflected in a sharp turnaround in equity market indices across the region, boosting business and consumer sentiments. Malaysia's FBM KLCI surged by 51.1% since hitting its low in March 2009 while the MIER's Consumer Sentiment Index (CSI) rebounded to above the 100-point boom-or-bust threshold for two consecutive quarters in 3Q2009. In the same vein, the sequential trend showed that GDP actually grew by 5.7% quarter-on-quarter (q-o-q) in 3Q2009 after expanding by 4.8% q-o-q in the earlier quarter. Prior to that, GDP contracted by 3.4% and 7.8% q-o-q in 4Q2008 and 1Q2009 respectively.

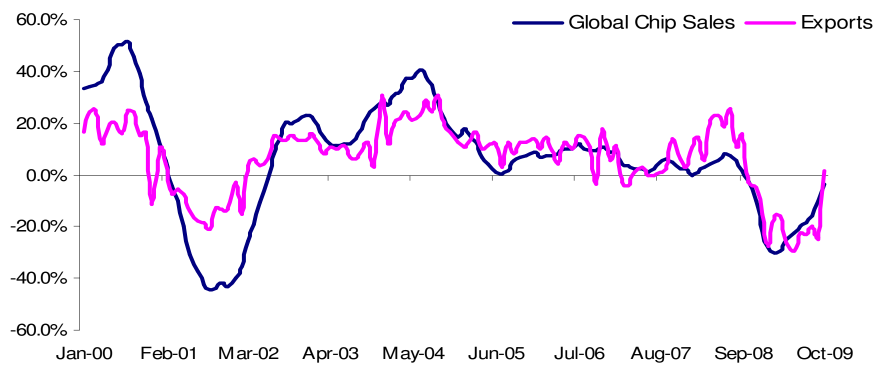
Delving into details, private consumption, which constitutes more than half of the Malaysian economy, expanded further by 1.5% in 3Q2009 after gaining a modest 0.5% in the earlier quarter while total investment contracted at a more moderate pace of 7.9% compared with -9.6% in 2Q2009. Real exports rebounded slightly, contracting at a milder pace of 13.4% in 3Q2009, after plunging by as much as 17.3% in 2Q2009. On the supply side, reflecting a recovery in Malaysia's external demand, the manufacturing sector improved markedly, declining by only 8.6% in 3Q2009 compared with a 14.5% contraction in the preceding quarter. The services sector, which accounts for roughly 57% of GDP, edged higher, growing by 3.4% against the 1.6% expansion in the earlier quarter.

Exports resuscitated the economy

The improvement in 2H2009 was primarily fueled by a turnaround in global trade which supported Malaysian export performance. This is evidenced by export figures which showed an unexpected positive growth of 1.6% y-o-y in October after slumping more than 24% in September. More encouragingly, exports of electrical & electronic (E&E) products, Malaysia's major export component, posted a marked improvement with a double-digit expansion of 18.4% in October. This compares with an average 18.9% contraction in the preceding nine months.

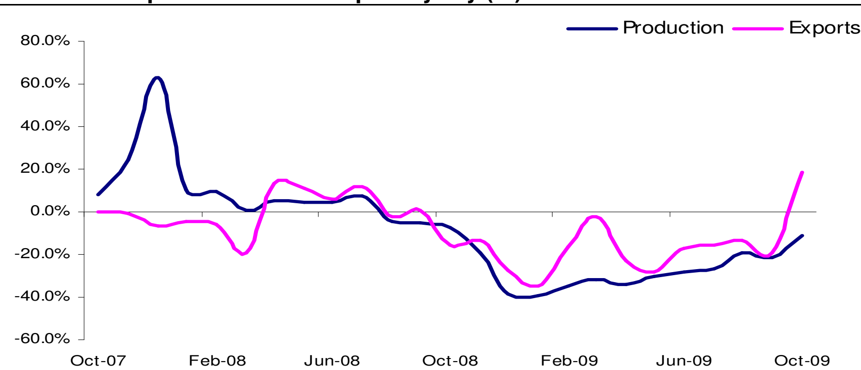
A rebound in exports augured well with Malaysia's industrial production, which showed an improvement as manufacturers scrambled to ensure sufficient inventories for the next few months. As a result, the industrial production index (IPI) rebounded and grew by 0.7% y-o-y in October after contracting by 6.0% in the earlier month. The improvement was largely underpinned by higher electricity and manufacturing output which rose by 13.4% and 1.0% respectively. On a month-on-month comparison, October's IPI was 5.7% higher (September: -2.4% m-o-m), signalling better prospects for the economy in 4Q2009.

Chart 9: Global chip sales (GCS) and Malaysia's export growth y-o-y (%)



Source: CEIC

Chart 10: E&E production and exports y-o-y (%)

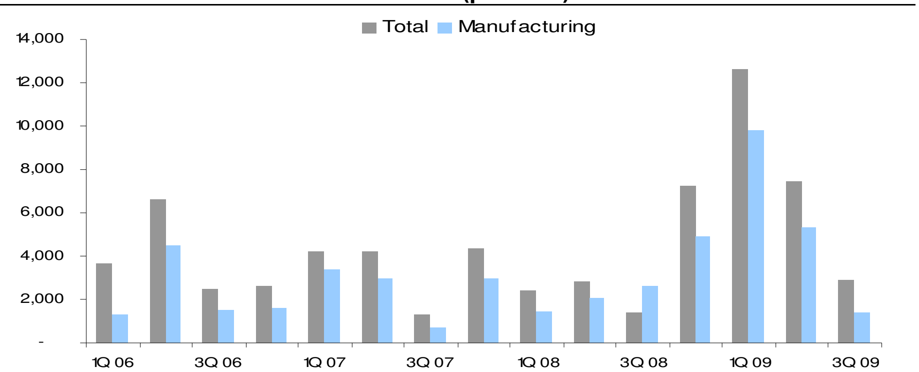


Source: CEIC

A rebound in domestic demand

Against such a backdrop, the number of retrenched workers substantially declined to 2,879 in 3Q2009 from 12,590 in 1Q2009. The decline was led by lower retrenchment in the manufacturing sector which saw the number of unemployed workers falling from 9,778 in 1Q2009 to 1,411 in 3Q2009. In the same vein, the unemployment rate declined to 3.6% in 2Q2009 from 4.0% in 1Q2009. The positive development in the overall labour market, particularly in the manufacturing sector, was attributed to an improved sentiment among manufacturers who received more orders from domestic and export-oriented industries following a turnaround in global trade. With a more stable labour market, private consumption is expected to strengthen, albeit at a slower pace than its average growth in the past several years. This will, in our view, help the domestic economy register a 1.8% growth in 2009 before accelerating further to 2.4% in 2010.

Chart 11: Number of retrenched workers (persons)



Source: CEIC

2010: Outlook and concerns

Will growth trajectory change beyond 2010?

We maintain our GDP growth forecast for 2010 at 3.6% despite the government's expectation of a 5% expansion. While acknowledging the possible upward bias in our growth forecast for 2010 following higher-than-expected exports and industrial production since October 2009, we are cautious about the possibility of future speed bumps that the global economy may face. They include:

- Moderate expansion of the US economy following the end of some stimulus measures such as "cash for clunkers" and the first-time home buyers' tax credit that may hamper consumer and bank lending.

- A relapse in global trade due to higher commodity prices. A continued acceleration in commodity prices such as crude oil, iron ore and palm oil as well as the re-emergence of higher volatility in the financial markets may hamper global trade activity, particularly in 2H2010.

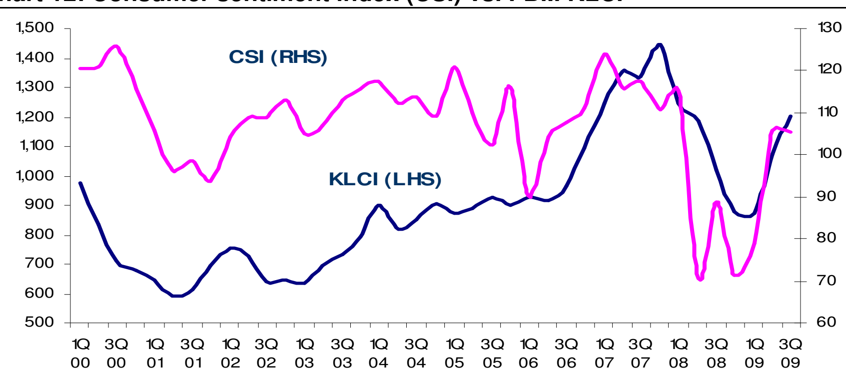
- Premature tightening of monetary policies in some countries following signs of buildup in inflationary pressures. Australia, which is highly dependent on China trade, has raised its benchmark interest rate three times in a bid to avert rising inflation.

- Increasing lending restrictions due to rising property prices in countries like Hong Kong and Singapore. Hong Kong property prices have escalated by more than 8% in 2Q2009 and 3Q2009, the sharpest increases since 4Q2007, while Singapore's home prices have surged by 15.8% in 3Q2009 after averaging 2.5% and 7.0% in 2006 and 2007 respectively.

There are also domestic factors that may affect the recovery in 2010. They include:

- Moderate growth in consumer spending due to: (1) removal of certain types of subsidies that may lead to higher prices of selected goods (i.e. rice, petroleum); and (2) possible correction in equity prices following a recent surge in the benchmark FBM KLCI from its low in March 2009, causing an overstretched valuation in terms of price-earnings multiples for 2010.

Chart 12: Consumer sentiment index (CSI) vs. FBM KLCI



Source: CEIC

- Lack of foreign direct investments (FDI) as risk aversion curbs capital spending by foreign companies. In addition, volatility of capital flows is expected to affect Asian currencies, including the ringgit, causing portfolio investors to remain extra cautious.

- Lackluster growth in lending activity will curtail business expansion. Although the BNM has maintained its benchmark interest rate at 2%, banks have been raising lending rates to offset margin compressions, as evidenced by recent increases in mortgage and hire-purchase rates.

In our opinion, it is not growth in 2010 that is of utmost importance - economic growth can be boosted for a year (especially after economic activity plunged dramatically in 2009) and short-term measures can provide the means to achieve even the 5% targeted growth for 2010. More critical is the long-term growth trajectory which may be affected if private investment does not improve from the present level.

In 2008, the ratio of private investment to GDP declined to 11%, well below the 33% level registered in 1997 prior to the Asian Financial Crisis. This is due to the continued decline in FDI as reflected in its ratio to GDP of 3%, down from approximately 6% in the years prior to the Asian Financial Crisis. In this regard, we are of the view that Malaysia can further improve the ease of doing business following a continued deterioration in the assessment of its "institutional framework", as reflected in the World Economic Forum's *Global Competitiveness Report 2009-2010*. Against such a backdrop, we think that such measures as synchronising state and federal investment regulations and shortening the process of acquiring properties by foreigners, amongst others, will be needed to lure foreign investors into the country.

Table 1: MARC's GDP growth forecast

	2007	2008	2009F	2010F
GDP	6.2%	4.6%	-2.2%	3.6%
Consumption Expenditure	9.6%	9.0%	2.0%	3.1%
Private Consumption	10.4%	8.5%	1.9%	4.6%
Public Consumption	6.5%	10.9%	2.5%	-2.8%
Investment	9.6%	0.8%	1.0%	0.4%
Private Investment	11.8%	0.8%	-18.5%	3.9%
Public Investment	7.1%	0.7%	23.0%	-2.3%
Exports	4.5%	1.3%	-11.5%	5.2%
Imports	6.0%	1.9%	-12.0%	7.5%

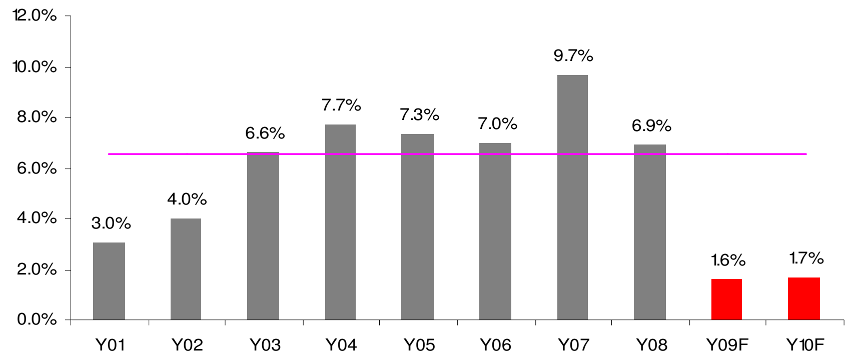
Inflation to remain benign

CPI inflation is not expected to be a major issue in 2010. In fact, in 2H2009, the concern was more on the persistent negative inflation numbers (deflation) which resulted from the high base recorded in 2008 following a sharp increase in fuel prices. In 3Q2009, the CPI contracted by 2.3% y-o-y, its first quarterly negative growth since 3Q1986.

Going into 2010, we foresee CPI inflation to be in the region of 2.4%, well below its 40-year average of 3.7% as the economy slowly recovers from the recession. The lower-than-average forecast is based on the assumption of a weaker-than-average growth in domestic demand as well as below-average levels of capacity utilisation (CAPU) in the manufacturing sector.

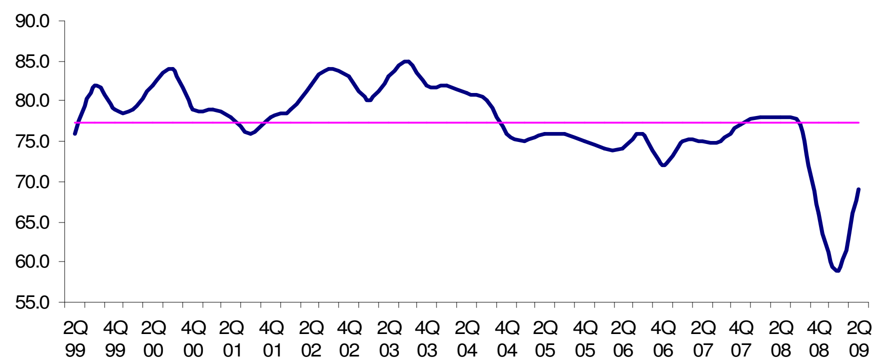
Notwithstanding our expectation of a benign inflationary environment, we anticipate price increases in certain consumer goods to have some impact on consumer spending. For instance, the restructuring of rice subsidies through the SUBUR program means higher prices for those who do not fall in the income group targeted by the government. Profiteering activities may further push prices up for some essential consumer goods. In addition, the government's intention to further reduce petroleum subsidies may lead to higher pump prices, especially if global crude oil prices continue to climb.

Chart 13: Malaysia's domestic demand growth and average (%)



Source: CEIC

Chart 14: CAPU (%)



Source: CEIC

Ringgit to gain from greenback weaknesses

Since hitting its low of RM3.73 in March 2009, the ringgit has appreciated against the USD as the greenback was sidelined following a decline in risk aversion. The ringgit strengthened by almost 8% at the end of December from its lowest level in March 2009. Going forward, we envisage the ringgit to weaken slightly as the USD starts to strengthen following an anticipated series of bad news starting from Dubai's debt debacle and sovereign downgrades by international rating agencies. As such, we see a temporary end of the ringgit's rally at RM3.36 as it hits the 61.8% Fibonacci retracement. Two major support levels for the ringgit will be at RM3.44 and RM3.47.

In the medium term, however, we believe that the ringgit may hover around RM3.20 – RM3.30 per USD as investors are expected to shy away from the greenback for two main reasons: (1) declining risk aversion; and (2) US structural problems such as huge budget and current account deficits. A relatively faster recovery of the Malaysian economy vis-à-vis the US economy and the ringgit's 7% undervaluation based on Nominal Effective Exchange Rate (NEER) also suggest that the medium-term prospects look favourable for the ringgit against the USD.

Will margin compression lead to higher rates?

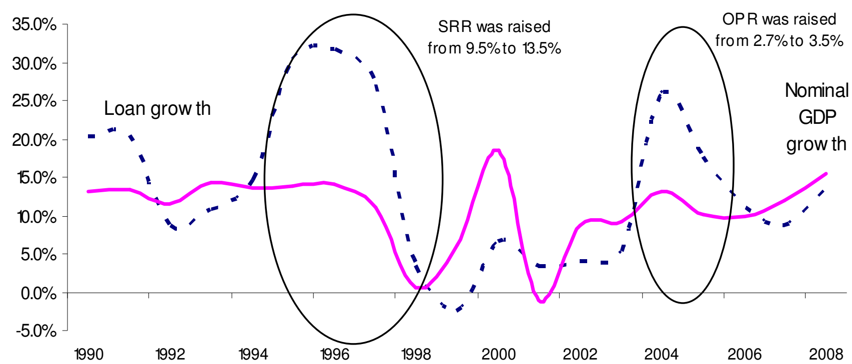
In view of the nascent global recovery and fragile domestic economy, we anticipate the BNM to hold the policy rate unchanged until at least the end of 1H2010. In the absence of a strong pickup in domestic demand in 1H2010 and in view of the fragile outlook of the global economy, the BNM may decide to hold the OPR steady until the end of 2010 for the following reasons:

- The government is targeting a 5% growth in 2010 which requires an extended period of low interest rates to support domestic demand, particularly private consumption.

- Inflation is not expected to be a major concern in 2010 as low CAPU in the manufacturing sector will prevent upward pressure on wages and on inflation in general.

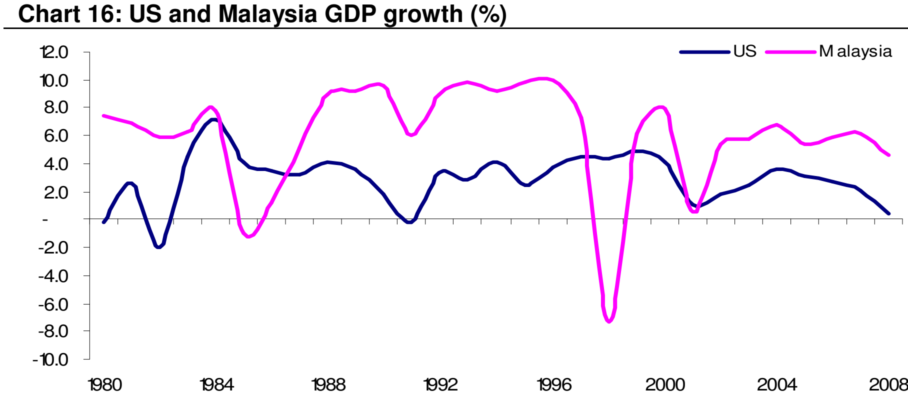
- History seems to suggest that monetary tightening generally occurs when signs of an asset bubble emerge in the economy, as indicated by a considerable gap between growth in commercial bank loans and nominal GDP. For instance, rates were raised in 2005 when loan growth for commercial banks exceeded nominal GDP growth. Thus far, nominal GDP growth has continued to contract at a double-digit pace since 1Q2009, signaling the absence of an asset bubble.

Chart 15: Previous monetary tightening cycles



Source: CEIC

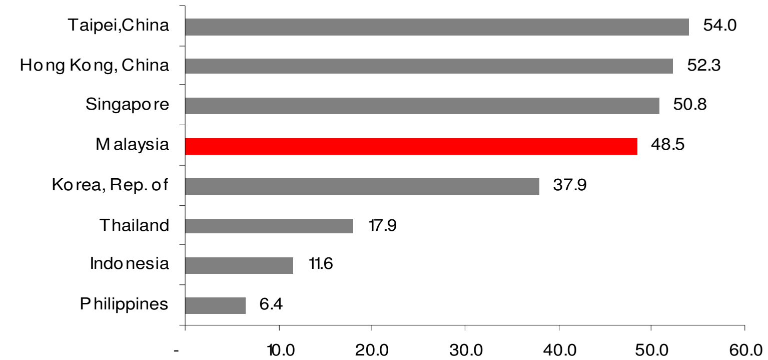
Chart 16: US and Malaysia GDP growth (%)



Source: CEIC

There is, however, a related issue worth noting. Although the policy rate may remain unchanged in 2010, banks may still raise their lending rates as they did in 2009. In 2009, the rates for hire purchase and mortgages were raised primarily because of intense competition in the banking sector which resulted in lower net interest margins. Additionally, as variable-rate loans comprise a fairly sizeable share in banks' balance sheets, the upward adjustment will have an immediate effect on the profitability level. Our concern stems from the banks' ability to easily raise lending rates which will increase household debt payments and could exert upward pressure on delinquency rates. This is critical considering that Malaysia's household-debt-to-GDP ratio is among the highest in the region.

Chart 17: Household indebtedness as a percentage of GDP in 2008



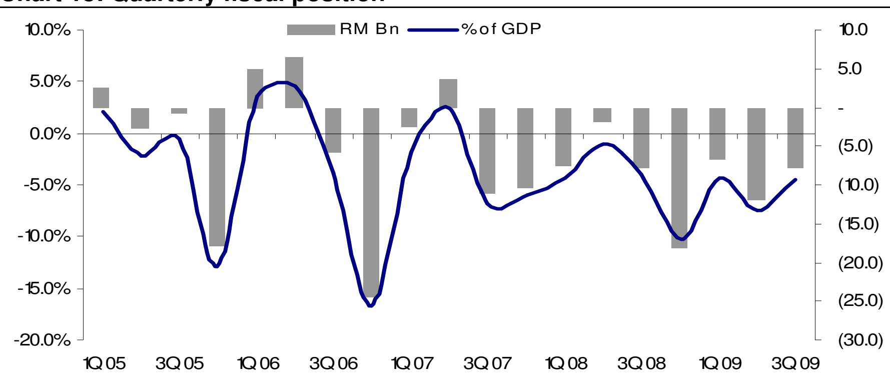
Source: Asian Economic Monitor July 2009, ADB

No more horsing around with the fiscal deficit

We are now more optimistic about the prospects of budget deficits in 2010. Our discussions with policymakers suggested that the government is taking serious steps to ensure the budget gap will be substantially reduced in 2010. The actual budget deficit in 2009 may even be lower than the estimated RM51.1 billion (7.4% of GDP) as the government only incurred a deficit of RM26.4 billion in the first nine months of the year.

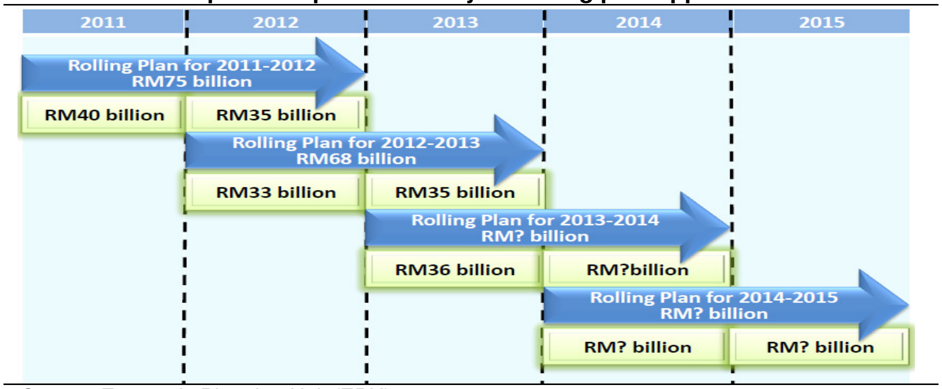
We expect the government to be vigilant with respect to its finances in 2010, and the two-year rolling plan in the Tenth Malaysia Plan (10MP) as mooted by the government bodes well for greater transparency as well as flexibility in the execution of development expenditure. Apart from that, the expected global economic recovery in 2010 will likely have a positive effect on government coffers. This is based on the assumption that oil-related revenue will be slightly higher than expected following stronger global demand for oil in 2010. With an upside bias on government revenue coupled with a cautious stance on spending, we believe that the targeted fiscal-deficit ratio of 5.6% of GDP will be achieved in 2010.

Chart 18: Quarterly fiscal position



Source: CEIC

Chart 19: Development expenditure - 2-year rolling plan approach



Source: Economic Planning Unit (EPU)

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