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Economic Outlook 2011: The tail-end of the rollercoaster ride

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In a nutshell

The global economy was in considerably better shape in 2010 following a mild rebound of the economy of the United States (US) and a sharp recovery in Asian economies which brought relief to the business community and policymakers alike. However, the US' high unemployment rate and euro-zone countries' bloated fiscal deficits as well as rising government debt levels have cast a pall on the near-term outlook. Indeed, deceleration in industrial production and weak labour-market conditions will continue to weigh on the growth of advanced economies, while the threat of massive capital inflows arising from quantitative-easing measures in low-growth developed nations with low interest-rate regimes into some Asian economies with high growth potential will prevent a smooth recovery in the near future.

We believe that the focus in 2011 will largely be on events in the euro zone, as the impact of the fiscal consolidation which is now taking place in the region will be closely monitored. We opine that the drastic measures currently implemented in some countries in the region will not only affect short-term economic growth, but also impinge on global sentiment, leading to more volatility in capital flows which, in turn, will complicate liquidity management in many Asian economies.

Notwithstanding these challenges, we think that the prospects of the global economy as a whole are not entirely discouraging as resilient Asian economies continue to provide strong support, as evidenced by the twin economic engines of Asia (i.e. China and India) which are still struggling to cool their economies following their stronger-than-expected growth rates in recent quarters. Indeed, the International Monetary Fund (IMF) forecasts robust growth of 8.5% and 5.8% for developing Asia and the Asian-5 countries respectively for the period between 2011 and 2015 - in veritably stark contrast with the projected mediocre expansion of advanced economies by a mere 2.5%.

As for Malaysia, after a sharp rebound in 2010 following the 1.7% contraction in the preceding year, a moderation in economic activities is expected to take place, with gross domestic product (GDP) growth continuing to normalise but remaining higher than the long-term trend. The moderation is anticipated to be largely attributed to the weakening of the external sector in 1H2011, as demand for the country's major exports such as electrical and electronics (E&E) manufactures by advanced economies soften. The offsetting effect, however, will come from the commodities side where prices of crude palm oil (CPO) and crude oil are anticipated to remain relatively firm.

On the domestic front, the support will come from private consumption, which has largely been responsible for the country's growth since the 1997/98 Asian Financial Crisis (AFC). Major indicators for private consumption, such as retail sales, labour-market conditions and access to credit, remain supportive, suggesting a sustainable growth in consumer spending throughout 2011. Given this scenario, we foresee Malaysia's GDP growth to moderate to circa 5.3% in 2011, from the expected growth of 7.2% in 2010. Notwithstanding this moderation, the expansion will stay above our long-term growth estimate of between 4.5% and 5%.

Other macro variables remain under control. Inflation is expected to creep up but stay below the 3% mark due to the lack of demand-driven factors that offset rising food and fuel prices arising from the government's subsidy-rationalisation efforts to reduce the burden on its coffers. Government finances are accordingly expected to be relatively stable in 2011, owing to the stable tax revenue base (the tax revenue-to-GDP ratio improved from 14.8% in 2007 to 15.7% in 2009), which was better than other regional countries. In addition, petroleum-related revenue will likely provide an additional buffer to government coffers, as crude oil prices are expected to remain steady following rising oil demand by such emerging economies as China and India.

In terms of debt sustainability, the Malaysian government's ability to meet its obligations has been demonstrated by the decline in its debt-service charge ratio to 10.2% in the first nine months of 2010 alone, with the ratio now well below the historical average of 15.6%. Additionally, analysis of the debt-maturity profile reveals that the bulk of the government's debt will mature after three years, suggesting that the risk of an asset-liability mismatch is fairly low for the Malaysian government.

On interest rates, we think that demand-led inflation, if it happens, will not be a major trigger for future rate increases, as Bank Negara Malaysia (BNM) will likely resort to administrative measures instead. Furthermore, the need to sustain the growth momentum could mean that the policy rate will remain status quo in 1H2011. In the medium term, however, Malaysia's stable economic growth above its long-term trend, coupled with the need to address financial imbalances, could lead to further normalisation, which we think will happen in 2H2011. This premise is also based on our estimate for the natural rate that stands at 3.5%, suggesting that the present state of Malaysia's monetary policy is still accommodative by historical standards.

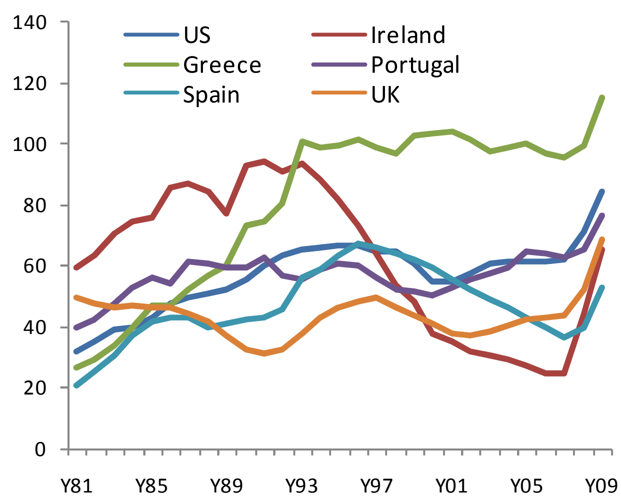
The Global Economy - Review and Prospects

2010: The year in review

From a growth perspective, the global economy was in considerably better shape in 2010. A mild rebound in the US economy and a sharp recovery in Asian economies brought relief to the business community and policymakers alike. However, the US' high unemployment rate and euro-zone countries' bloated fiscal deficits as well as rising government debt levels have cast a pall on the near-term outlook (Chart 1). The IMF's global economic growth forecast for 2011, revised downward from 4.3% to 4.2% in October's World Economic Outlook (WEO), indicates a moderation in growth for many countries in the near term. This, to some extent, reflects the prospects of further weaknesses in the European economy following the region's austerity drive, a mediocre expansion of the US economy and slower momentum in some of the Asian economies.

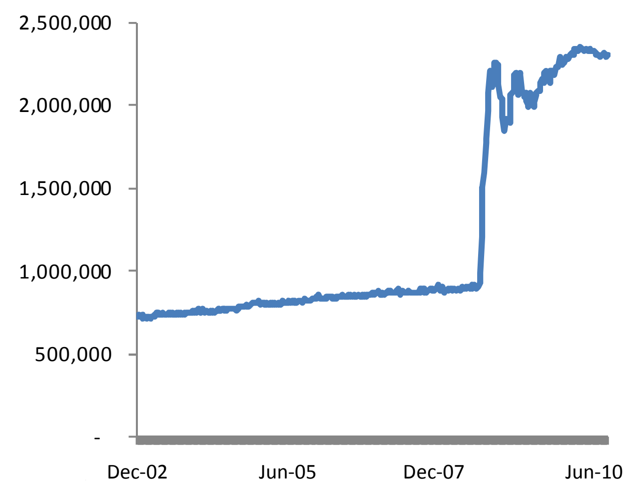
According to a study by the IMF, a reduction in the fiscal deficit equivalent to 1% of GDP will reduce a country's output by approximately 0.5 percentage point within two years, and will raise the unemployment rate by about 0.3 percentage point. In addition, such a deficit cutback will drag consumption and investment down in the short term. Despite the less-upbeat outlook for the global economy, we draw comfort from the developed nations' monetary authorities continuing to support their economies through the provision of a large amount of liquidity in the banking system. A famous example of this is the recent USD600 billion asset-purchase program initiated by the US Federal Reserve (Fed) to sustain the prevailing low interest-rate environment so needed to revive investments in the face of a weak labour market. As a result, the Fed's total assets continue to be on an uptrend (Chart 2).

Chart 1: Government debt as a % of GDP



Source: IMF

Chart 2: The Fed's total assets (USD Million)

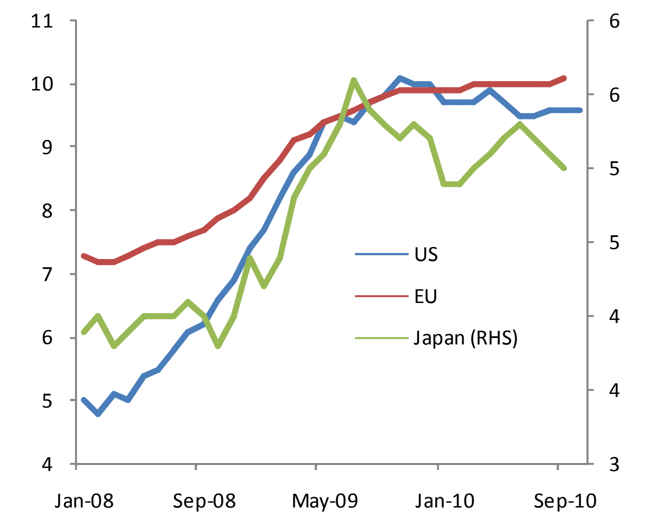


Source: US Federal Reserve

Advanced economies – deceleration in production & weak labour market

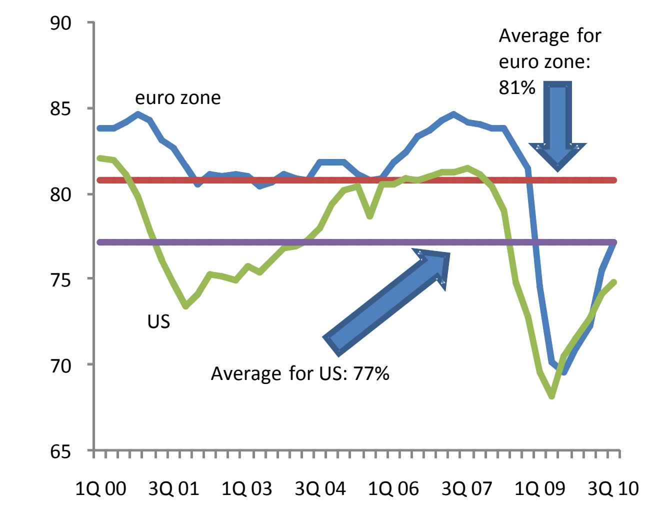
Industrial production in many advanced economies peaked in 1H2010, and businesses are turning cautious in the wake of slower domestic and external demand. Additionally, capacity-utilisation (CAPU) rates continued to languish below full capacity levels, suggesting that demand for factors of production (particularly labour) will remain low as businesses focus on raising productivity rates. In the US, for instance, output per hour has risen by 1.9% in 3Q2010 (2Q2010: -1.8%), causing the unemployment rate to remain relatively unchanged at nearly 10% of the labour force. In the euro zone, rising jobless rates are expected to persist following the deep austerity measures undertaken by several countries to rein in their budget deficits and government debt levels. Slower investment, as reflected by the 3.1% contraction in gross fixed capital formation in 1H2010 and a CAPU which was well below its long-term average (Chart 4), also suggests that businesses remain pessimistic about the prospects of recovery in the immediate term.

Chart 3: Unemployment rates of Group of 3 (G3) economies (%)



Source: Bloomberg

Chart 4: US and euro-zone CAPU rates (%)

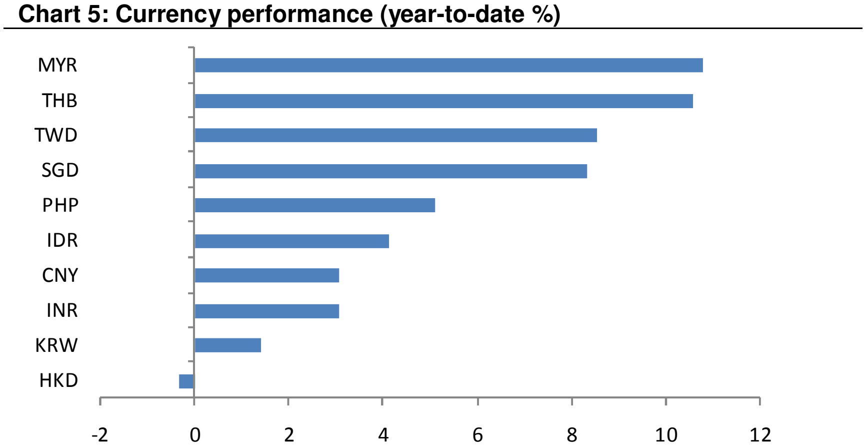


Source: Bloomberg

Problems in Asia - capital inflows, asset & consumer price inflation

While growth has been commendable for many Asian economies, massive capital inflows arising from monetary policy laxity in advanced countries have led to a steep appreciation in the former's currencies. For instance, on a year-to-date basis, the Malaysian ringgit (MYR) appreciated by a hefty 10.8%, the most among regional currencies, followed by the Thai baht (THB) and Singapore Dollar (SGD) which strengthened by 10.6% and 8.3% respectively as both economies benefited from strong growth momentum in 1H2010. However, such massive inflows of capital have raised concerns about the possibility of a sharp reversal (i.e. capital outflows) which can result in greater exchange rate volatility and consequently destabilise the economy. As such, several measures have been introduced in some countries to discourage the inflows of short-term capital ("hot" money). Indonesia, for instance, has introduced a one-month holding period requirement on central bank bills for domestic as well as foreign investors in June 2010, while in Korea, limits on foreign-currency derivative positions were introduced to discourage banks' short-term foreign-currency borrowings which could minimise the risk of a sudden capital outflow.

Chart 5: Currency performance (year-to-date %)

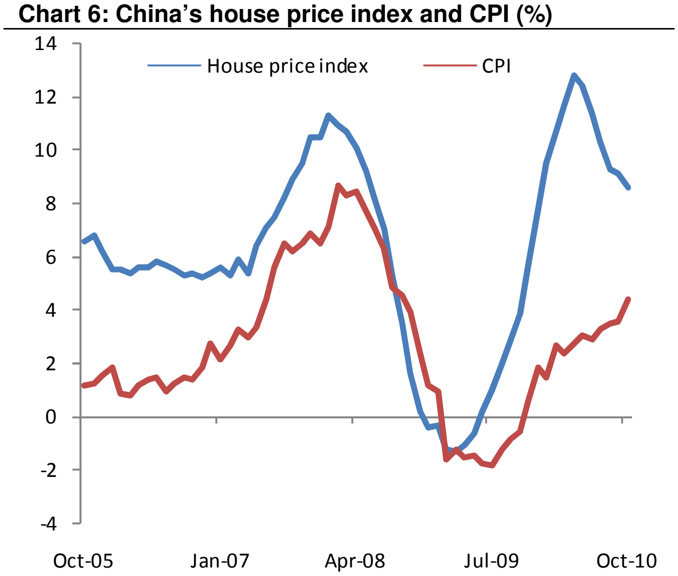


Source: Bloomberg

In China, where property prices have surged dramatically in recent times, measures were implemented to reduce lending to the sector, including the imposition of a minimum 30% down-payment requirement on first-home buyers and measures to curb lending by commercial banks for purchases of third homes and above. Apart from that, China's central bank has also raised the banks' reserve requirements by a total of 200 basis points (bps) to 18.5% since February 2010 in order to remove excess liquidity in the system. Thus far, the measures have been quite successful, judging by the moderation in the house price index from a high of 12.8% year-on-year (y-o-y) in April to 8.6% in October. However, on the consumer side, the upward pressure on general prices continued to build, as evidenced by the consumer price index (CPI) rising to 5.1% y-o-y in November from 1.5% in January 2010. As a result, the benchmark one-year lending rate was raised by a total of 50 bps from 5.31% to 5.81% in December to help ease inflationary pressures.

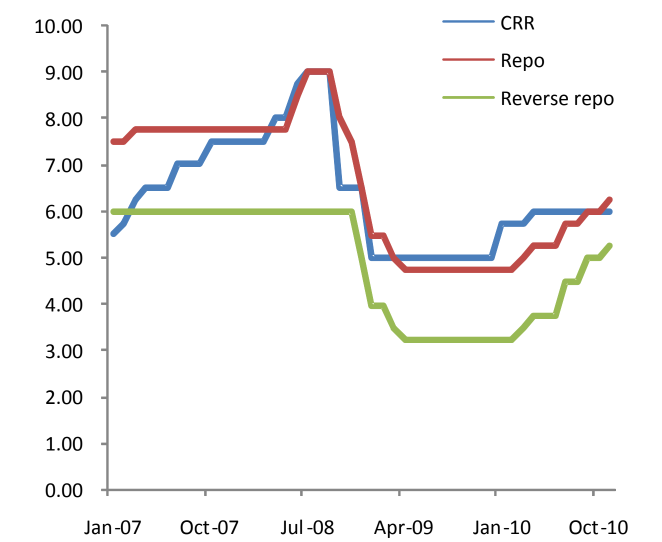
As for India, demand-led inflation was the main driver of price increases, and led to multiple hikes in policy rates. The latest macro releases in 3Q2010 showed that India's GDP growth continued at a blistering pace, surging by 8.9% y-o-y (2Q2010: 8.9%). Strong growth was led by higher private final consumption expenditure (PFCE) which grew by 9.3% against 7.8% in the preceding quarter. As the PFCE constituted 60.6% of the country's total output, the economy is evidently being largely driven by domestic factors. Thus far, high-frequency statistics, such as passenger-car sales which grew by an average of 28.3% in the first 10 months of the year (2009: +21.9%), suggest that the strong momentum will likely continue in the near term. Such a trend points to a strong expansion in PFCE. In response to upbeat macro statistics, the Reserve Bank of India (RBI) raised its policy rates several times to quell inflationary threats. To date, the cash reserve ratio (CRR), repurchase (repo) and reverse repurchase (reverse repo) rates have been raised by a total of 100, 150 and 200 bps respectively to 6.00%, 6.25% and 5.25% accordingly.

Chart 6: China's house price index and CPI (%)



Source: Bloomberg

Chart 7: RBI's policy rates (%)



Source: Bloomberg

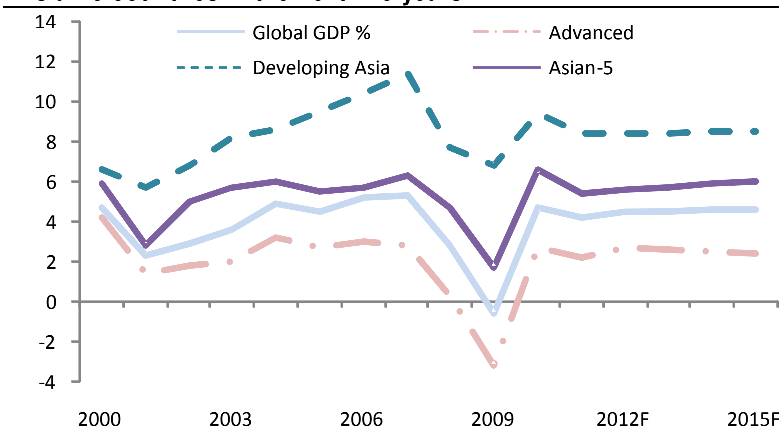
What's in store for the global economy in 2011?

Going forward, we opine that the focus will largely be on events in the euro zone, as the impact of fiscal consolidation which is now taking place in the region will be closely monitored. A common policy mix, such as tax hikes and spending cuts, will likely be the primary tools to be deployed as ruling governments are determined to close their budget gaps to meet the mandatory target of 3.0% of GDP in the next two years or so. Such drastic measures will not only affect short-term economic growth, but will also impinge on global sentiment, leading to greater volatility in capital flows which, in turn, will complicate liquidity management in many Asian economies.

In light of the austerity drive in the euro-area countries, we believe that the advanced economies will grow at subpar rates, in line with the IMF forecast of a 2.2% expansion in 2011 (30-year average: 2.5%). In the US, the downward pressure on personal consumption expenditure, its main engine of growth, will likely persist as the excesses in the labour market have yet to be removed. This is evidenced by a significant gap between the unemployment rate (which currently stands at 9.8%) and the level of the non-accelerating inflation rate of unemployment (NAIRU) at 4.8%. However, in the medium term, we foresee a less bleak outlook for the world's largest economy as the lag effect of huge liquidity injections (including the latest USD600 billion by the Fed) will re-invigorate corporate spending and business investments. In addition, the Bush tax breaks, which will be extended by another two years by the Obama administration, will have some positive effect on the economy.

Similarly, the prospects of the global economy as a whole are not entirely discouraging, as resilient Asian economies will continue to provide strong support, as evidenced by the strength of the twin economic engines of Asia (China and India) which are still struggling to cool their economies following stronger-than-expected growth rates in recent quarters. India posted a growth of 8.9% in 3Q2010, while China reported a strong 9.6% expansion, albeit slower than 1Q2010's 11.9% growth. According to the IMF, average growth rates for developing Asia and Asian-5 countries will remain strong at 8.5% and 5.8% respectively between 2011 and 2015 - in veritably stark contrast with the projected mediocre expansion of advanced economies by a mere 2.5%.

Chart 8: IMF growth forecasts for global, advanced, developing Asia and Asian-5 countries in the next five years



Source: IMF
Note: F = Forecast

In Asia, the key thing to monitor is the trend in capital flows and its concomitant effect on asset prices, as monetary authorities weigh their policy options to curtail upward pressure on asset prices while at the same time maintain interest rates at sufficiently low levels to support growth. Not surprisingly, rumours of possible impositions of capital controls have surfaced in some Asian countries as concerns over the adverse implications of massive capital inflows have heightened among policymakers.

Another factor worth noting is that while economic growth rates in many Asian countries remain stronger than those of advanced nations, they are expected to decelerate as the low-base effect wears off and restocking activities wane following mounting worries about slower demand by advanced economies. This is based on the latest forecast for future sales of E&E products – Asia's main exports - by the Semiconductor Industry Association (SIA) that predicted growth will moderate to 6.0% and 3.4% in 2011 and 2012 respectively after a strong performance of 32.8% in 2010.

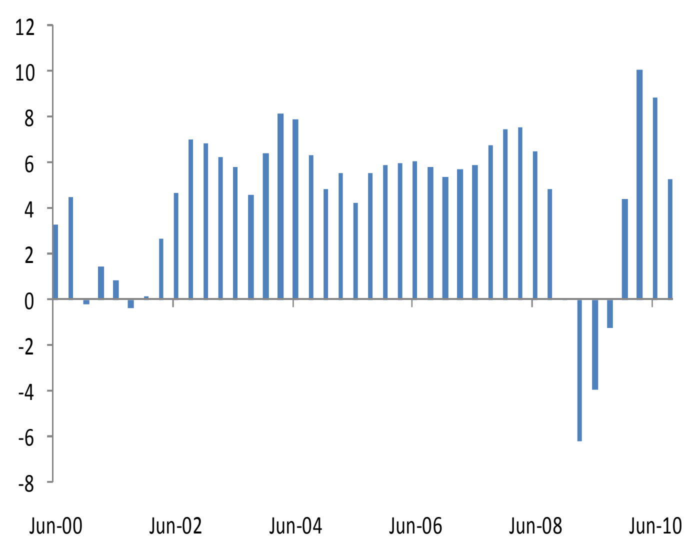
Malaysian Economic Review and Prospects

Bouncing back from the depths

Riding on the wave of economic rebound that swept through emerging economies in the region, Malaysia recorded an impressive y-o-y GDP growth of 10.1% in 1Q2010, attributed to the two government stimulus packages worth RM67 billion in total, inventory-restocking activities as well as the low-base effect of last year (1Q2009: -6.2%). Indeed, the industrial production index (IPI) registered a noteworthy 13.8% y-o-y growth in the first quarter on the back of heartening growth in the manufacturing and mining subcomponents. However, as the year progressed, the global economic recovery experienced headwinds arising from the euro zone's sovereign debt crisis and the resulting demand-detracting austerity drive in debt-plagued nations, tensions in the Korean peninsula, high US unemployment and China's efforts to cool its overheating economy. Accordingly, export-dependent Malaysia saw its growth moderating to 8.9% and 5.3% in 2Q2010 and 3Q2010 respectively.

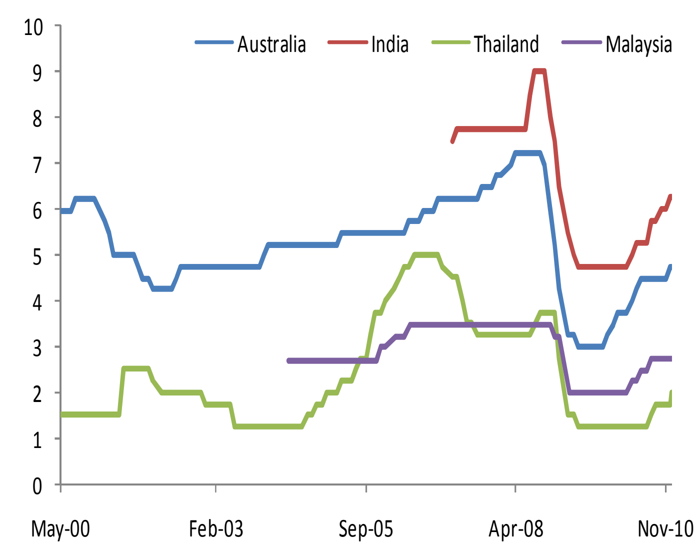
As the economy treaded more firmly on the recovery path, the BNM took pre-emptive steps to curb financial imbalances arising from surging property prices in certain areas and rising consumption credit which led to a continuous high level of household debt of more than 70% of the country's GDP. Consequently, the central bank raised the Overnight Policy Rate (OPR) three times in 2010 by 25 bps each, with the OPR standing at 2.75% at present from 2.00% initially. With developed nations facing low growth prospects and all-time low interest rates, emerging economies such as Malaysia, with promising growth, favourable economic fundamentals and positive interest-rate differentials, have become natural targets for "hot" money in search of higher returns. Speculation is rife that the local property and stock markets have been driven to unsustainable highs by such capital inflows. In response, the BNM has lowered the loan-to-value ratio to 70% for purchases of third properties and above, a move that has been widely acclaimed by property players as the majority of house buyers at present are only looking to purchase their first or second properties.

Chart 9: GDP (y-o-y%)



Source: Bloomberg

Chart 10: Benchmark interest rates



Source: Bloomberg

Narrowing the budgetary gap

Due to the RM67 billion stimulus packages implemented last year, the government continues to sustain a budget deficit that has been a perennial issue since the AFC. The shortfall is estimated to amount to 5.6% of GDP this year, down from a revised 7.0% in 2009, due to the government's stepped-up initiatives to slash operating expenditure by 3.1% and improve revenue collection by 2.2%. The rationalisation of subsidies for goods such as sugar and petrol is a case in point – the government recently upped the prices of RON95 and RON97 petrol by 5 sen and 15 sen to RM1.90 and RM2.30 per litre respectively, while the price of sugar was boosted by 20 sen to RM2.10/kg. This follows the first subsidy rationalisation which came into effect on 16 July 2010, and the Performance Management and Delivery Unit (PEMANDU) estimates that RM1.18 billion in expected additional government expenditure (due to the rising trend of global crude oil prices) will be saved.

Stocks, bonds and the ringgit all in high demand

The influx of hot money has benefited both the equity and bond markets, causing the benchmark FTSE Bursa Malaysia Kuala Lumpur Composite Index (FBM KLCI) to surge by a magnificent 17%, or 212.45 points in the year to date. While the market is trading above its post-AFC average price multiples of approximately 17 times, the massive inflows of foreign money have led to speculations that there is still some room for further rises in the stock market. Similarly, Malaysian Government Securities (MGS) also lured foreign investors, as demonstrated by the increase in the foreign portion of shareholdings to RM71.87 billion as at October – a record high – from RM45.04 billion in January, representing a massive 27.6% of total outstanding MGS. The ringgit also benefited from the improved investor sentiment, having appreciated by 4.2% against the greenback in the past six months, or 10.8% in the year to date.

Private consumption and investment – the economy's two pillars of support

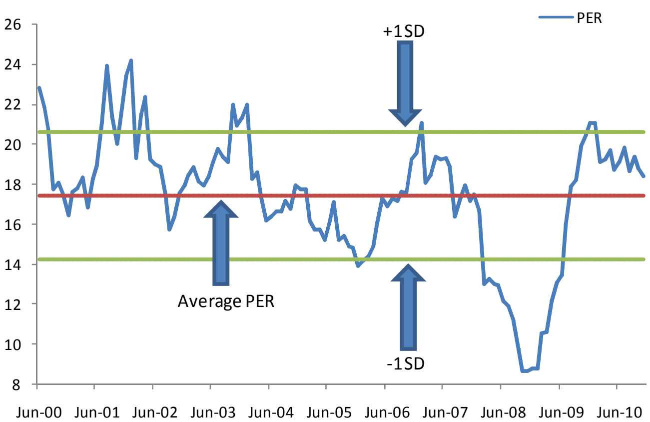
As growth of the manufacturing and services sectors remain commendable, contributing an average of 4.3 and 4.6 percentage points respectively to growth in 1H2010, labour-market conditions remain favourable, as evidenced by the unemployment rate falling to 3.2% in 3Q2010 from 2Q2010's 3.4%. Against this backdrop and a strong equity market, business and consumer sentiments are positive at present, according to the Malaysian Institute of Economic Research (MIER) business conditions index (BCI) and consumer sentiments index (CSI) which remain above the 100-point boom-or-bust threshold in 3Q2010 (BCI: 104.9; CSI: 115.8, a 2.5-year high). These have and will continue to bode well for private consumption, which constitutes more than half of the Malaysian economy. Indeed, private consumption grew by 7.1% y-o-y in 3Q2010, as opposed to the weak expansion of 1.3% in the previous corresponding period.

With the government looking to reduce the budget deficit, the reins have thus been handed over to the private sector to drive growth. It is with this in mind that the government pushed forth the Economic Transformation Programme (ETP), the Government Transformation Programme (GTP), the 10th Malaysia Plan (10MP) and the New Economic Model (NEM), all of which place emphasis on private investment becoming the economy's next driver of growth.

There have been some early signs of success – efforts to improve urban transportation under the GTP have taken off with the decisions to invest an estimated RM36 billion in the mass rapid transit (MRT) system for Greater Kuala Lumpur (KL) which is scheduled to start work by July 2011. PEMANDU and the Home Ministry also reported in December that street crimes in the country were down by almost 40%, with certain parts of KL experiencing a 47% reduction. Additionally, a survey by international market research specialist TNS Research International showed that the overall crime rate in the country has dropped by 16.24% in the first eight months. Serious crime has also dropped by 3.4% in five months. In dealing with corruption, the perennial thorn in the country's side, the Malaysian Anti-Corruption Commission (MACC) has also become instrumental in bringing more prominent corruption cases to the courts this year.

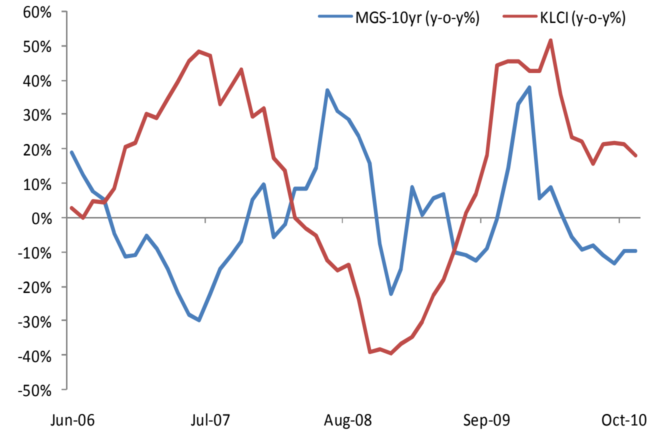
Successful implementation of the ETP will transform Malaysia's economy towards a service-based economy, with the services sector growing from 58% to 65% by 2020. More than 3.3 million new jobs will be created in this period, spread across the country in urban and rural areas, and these new jobs will result in a shift towards middle- and high-income salary brackets.

Chart 11: Price-earnings ratio of FBM KLCI



Source: Bloomberg

Chart 12: MGS 10-Year and Ringgit



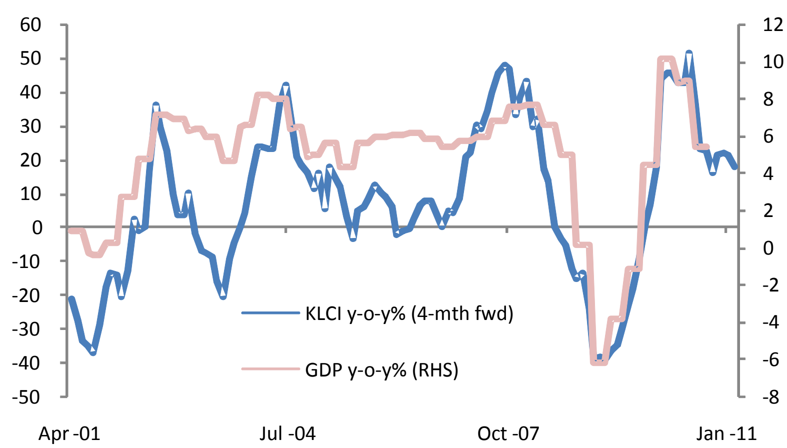
Source: Bloomberg

Expectations for 2011

Growth - back to Goldilocks

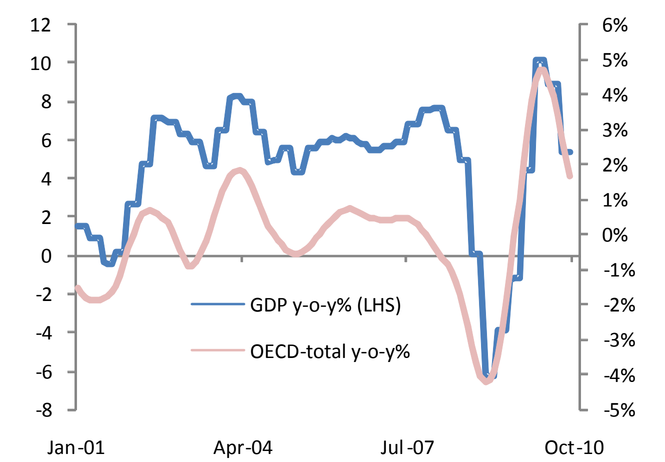
After a sharp rebound in 2010 following the 1.7% contraction in the preceding year, Malaysia's GDP growth in 2011 is anticipated to normalise but remain higher than its long-term trend of 4.5% to 5%. The moderation in growth in the next one to two quarters is expected to continue, judging by high-frequency statistics and leading indicators such as equity-market movements and the Organisation for Economic Co-operation and Development (OECD) composite leading indicators (CLI) which are currently moving downward. The benchmark equity market, i.e. the FBM KLCI, leading the economy by approximately four months, has now turned downward, portending slower growth in the next few quarters (Chart 13). Similarly, the sharp decline in the OECD CLI and a more moderate outlook for the manufacturing sector (which accounts for roughly one-third of the economy) suggests softer growth in the near term. In the medium term, however, just as in the previous years, Malaysia's growth trajectory will hinge on two major factors, namely the global economic development and the strength of private consumption in supporting domestic demand.

Chart 13: FBM KLCI (4-mth fwd) and Malaysia's GDP growth (y-o-y%)



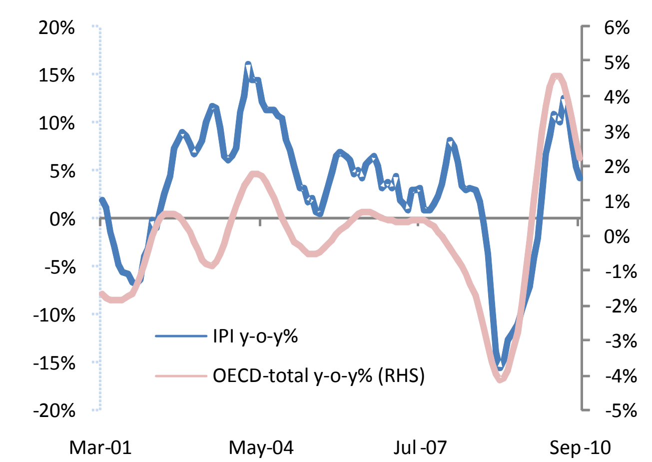
Source: Bloomberg

Chart 14: Growth of OECD CLI and Malaysia's GDP growth (y-o-y%)



Source: Bloomberg

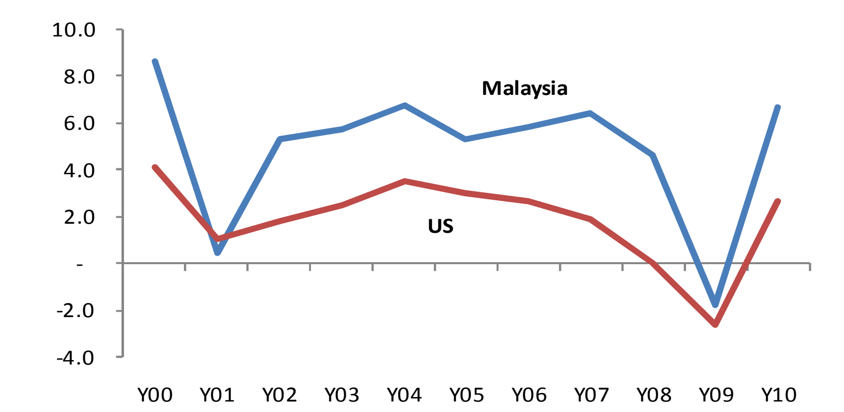
Chart 15: Growth of OECD CLI and Malaysia's IPI (y-o-y%)



Source: Bloomberg

On the external front, the US' economic strength will have a strong bearing on Malaysia's economic performance through direct and indirect trades. Although the proportion of Malaysian exports to the US shrank to 9.7% in the first 10 months of 2010 (2000: 20.5%), while the proportion of exports to countries in the Association of Southeast Asian Nations (ASEAN) has remained steady at 25.3% (2000: 26.5%), the US remains an important final destination for a major chunk of ASEAN exports. Therefore, it is not surprising that the overall correlation between Malaysia's and the US' economies remains high over the years (Chart 16). With the US economy expected to continue being saddled with high unemployment, growth will be slightly lower than its long-term trend. However, as mentioned, the lag effect of huge liquidity injections will likely provide some support to the economy that would otherwise grow at a minuscule rate.

Chart 16: Malaysia and US GDP growth



Source: IMF

Table 1: IMF growth forecasts and estimates for selected countries

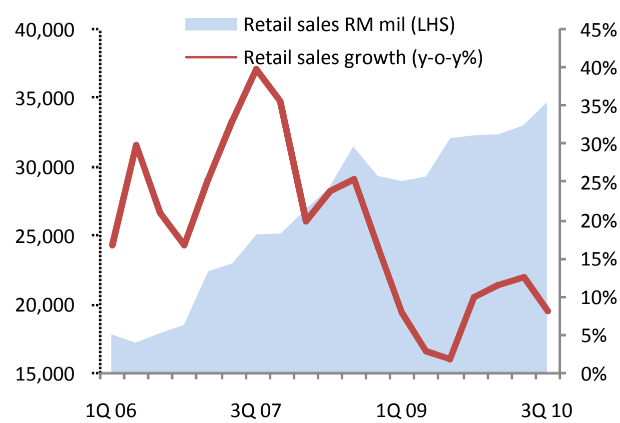
	2010			2011		
	Jul-10	Oct-10	Variance	Jul-10	Oct-10	Variance
World	4.6	4.8	0.2	4.3	4.2	-0.1
US	3.3	2.6	-0.7	2.9	2.3	-0.6
Euro	1.0	1.7	0.7	1.3	1.5	0.2
Japan	2.4	2.8	0.4	1.8	1.5	-0.3
China	10.5	10.5	0.0	9.6	9.6	0.0
India	9.4	9.7	0.3	8.4	8.4	0.0

Sources: WEO, IMF

Going forward, we opine that the external sector will exert downward pressure on the domestic economy, especially in 1H2011, as demand for major products such as E&E manufactures by advanced economies soften. The offsetting effect, however, will come from the commodities side, where prices of CPO and crude oil are expected to remain relatively firm.

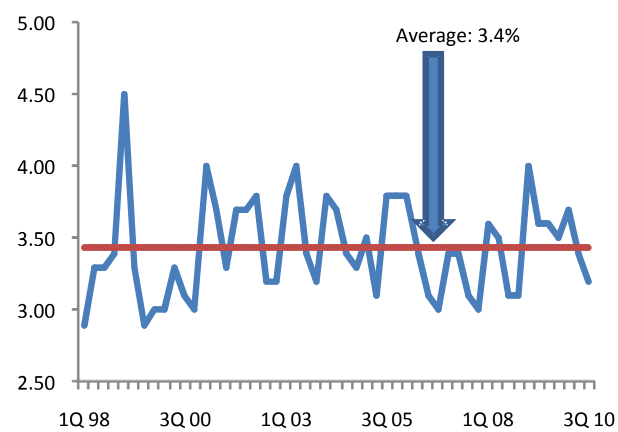
On the domestic front, the demand will largely be supported by private consumption which has primarily been responsible for the country's growth since the AFC. A major indicator for private consumption – retail sales – continued to remain firm in the past few quarters, rising to RM34.6 billion in 3Q2010 from the low of RM29 billion in the recent cycle, despite the decline in its growth trend. Major factors that support private consumption, i.e. the labour market and access to credit, remain favourable, suggesting that consumers will likely be driving domestic demand. Interestingly, the unemployment rate has declined to 3.1% in 3Q2010, below its long-term average of 3.4%, providing an important catalyst for private consumption. Similarly, consumer sentiment, another indicator of private consumption, has remained upbeat, suggesting a sustainable growth in private consumption throughout 2011.

Chart 17: Retail sales (RM mil)



Source: CEIC

Chart 18: Labour market (unemployment rate with ave.)



Source: CEIC

Given the above scenario, we foresee Malaysia's GDP growth to moderate to circa 5.3% in 2011, from the estimated growth of 7.2% in 2010. Notwithstanding the moderation, the growth will remain above our long-term growth estimate of between 4.5% and 5%. On the demand side, we anticipate growth to be generally supported by private consumption which will grow by 5.8%, offsetting the impact of softer net exports. Private investments are also expected to continue rising, albeit at a slower pace of 8.0% in 2011 after a rebound to 8.6% in 2010. On the supply side, we anticipate the manufacturing and services sectors to be the major components in driving growth, expanding by 7.5% and 5.7% respectively.

Table 2: GDP (demand and supply sides)

	2008	2009	2010E	2011F
GDP	**4.7%**	**-1.7%**	**7.2%**	**5.3%**
By expenditure				
Domestic demand	6.8%	-0.5%	5.9%	5.2%
Consumption	9.0%	1.2%	5.2%	5.4%
-Private	8.5%	0.7%	5.9%	5.8%
-Public	10.7%	3.1%	2.5%	3.9%
Investment	0.7%	-5.6%	8.0%	4.5%
-Private	1.0%	-17.2%	8.6%	8.0%
-Public	0.5%	8.0%	7.4%	1.2%
Real exports	1.6%	-10.4%	12.3%	8.8%
Real imports	2.2%	-12.3%	16.9%	9.4%
By industry				
Agriculture	4.3%	0.4%	4.8%	4.4%
Mining & quarrying	-2.4%	-3.8%	-0.6%	3.0%
Manufacturing	1.3%	-9.4%	10.4%	7.5%
Construction	4.2%	5.8%	5.3%	3.8%
Services	7.4%	2.6%	7.2%	5.7%

Source: MARC Economic Research
Note: E = Estimate; F = Forecast

Inflation - rising but not alarming

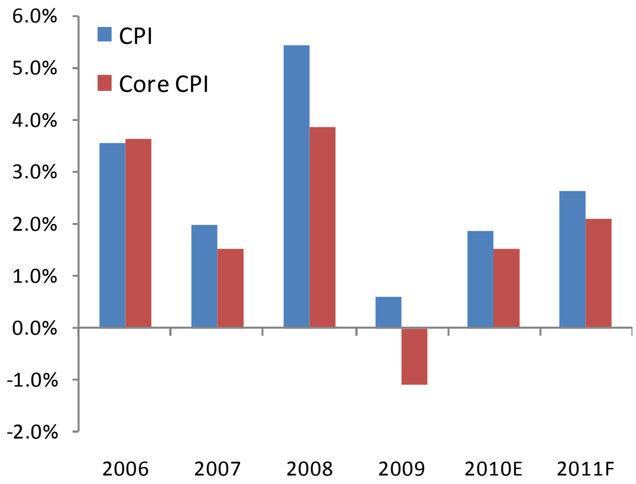
In 2011, inflation is expected to creep up but stay below the 3% mark due to the lack of demand-driven factors that offset rising food and fuel prices arising from the government's subsidy-rationalisation efforts to reduce the burden on its coffers.

As for food prices, we foresee continuous upward pressure following the sustainably strong commodity prices attributed to the uncertainty in weather conditions. In this light, Malaysia, being a net food importer, is expected to bear the brunt of strong commodity prices due to low self-sufficiency in food production leading to a pressing need to raise imports of relevant commodities such as rice, sugar, milk and flour in order to meet local demand. As for fuel, we anticipate further adjustments in petrol prices (particularly for RON97) by 10 to 20 sen in view of steady and strong prices of crude oil. Sustainable economic growth above its long-term potential means that Malaysia will likely take the opportunity to reduce the burden on the government's financial position by trimming fuel subsidies for those who can afford to pay for RON97.

On the other hand, on the demand side, the small output gap for 2011 of -0.6%[1] suggests that demand-driven factors that are normally responsible for higher inflation are less visible. For instance, the decline in manufacturers' CAPU in 3Q2010 to 75% (2Q2010: 76%; long-term average: 78%) reflects the growing spare capacity in the sector. Against such a backdrop, we project the CPI to post a moderate increase of 2.6% in 2011, up from an estimated 1.9% in 2010, with core inflation edging up to 2.1% (2010 estimate: 1.5%).

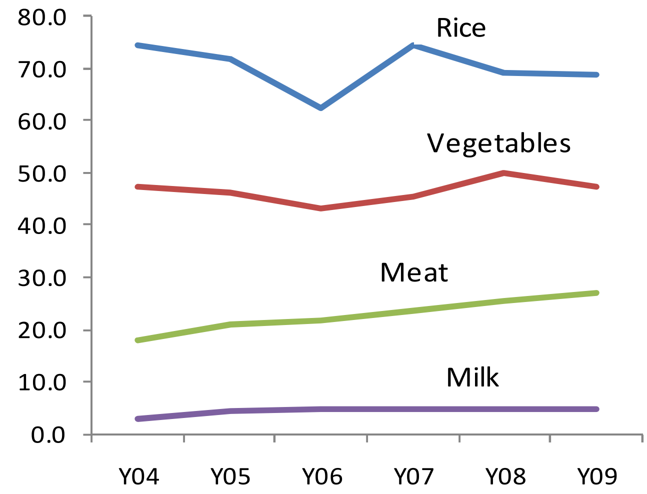
[1] Output gap is the difference between actual GDP and potential GDP which later will be expressed as a percentage of potential GDP. Potential GDP is derived from the production function of y = {k,l}, where k = capital investment and l = labour force.

Chart 19: Headline and core CPI



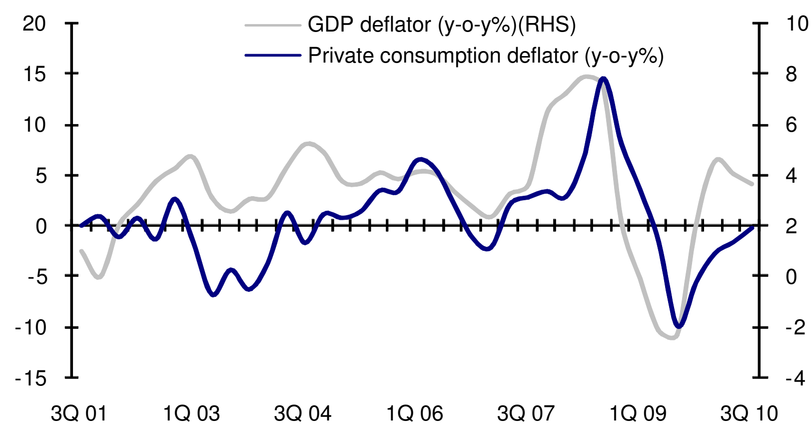
Source: MARC Economic Research
Note: E = Estimate; F = Forecast

Chart 20: Food self-sufficiency levels (%)



Source: Ministry of Agriculture and Agro-Based Industry

Chart 21: Implicit deflators for GDP and private consumption



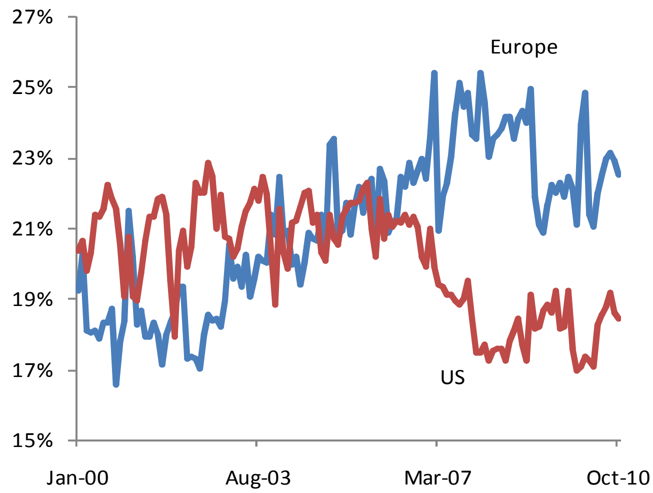
Source: Bloomberg

In terms of implicit deflators (alternative gauges of inflation) the divergence between the private consumption and GDP deflators is worth noting. While the implicit deflator for private consumption – an indicator for inflation in the private sector – is in line with the CPI, the implicit deflator for GDP is suggesting stronger price pressures, having grown by 4.1% in 3Q2010 after peaking at 6.1% in 1Q2010. However, the moderation in its growth suggests that inflation may not be a pressing issue in the near term.

External trade

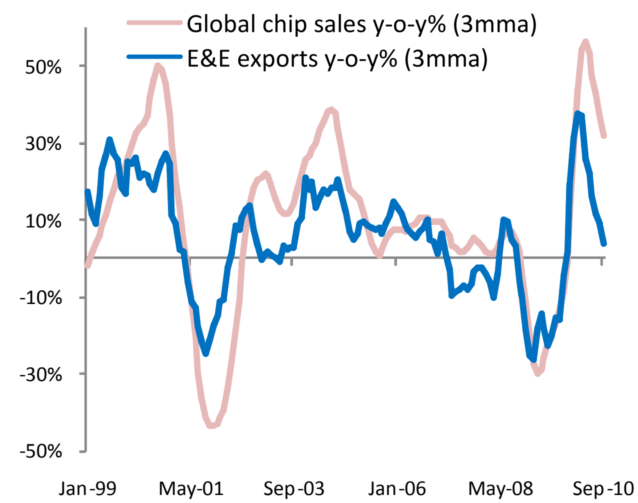
Malaysia's external trade performance will largely hinge on the health of developed economies, particularly the G3 nations which consumed a total of 31.6% of our exports in recent years. While exports to ASEAN countries have helped buffer the drop in demand from the G3 economies, the bulk of Malaysian exports to ASEAN have been re-exported to major economies as their final destinations. For instance, although Malaysian exports to China have increased to about 12.6% of total exports from a mere 3.1% in the early part of the millennium, China's shipments to the US and European economies have remained relatively stable, accounting for more than 40% of its total exports over the years.

Chart 22: China's total exports to the US and Europe



Source: MARC Economic Research

Chart 23: Global chip sales and Malaysia's exports of E&E products (y-o-y%)

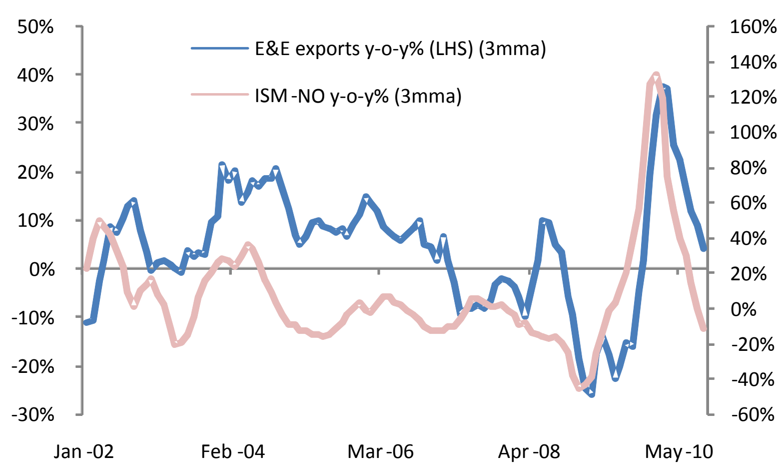


Source: Ministry of Agriculture and Agro-Based Industry

Since a big chunk of Malaysian exports ended up in the US market (through direct and indirect exports), and given the fact that exports are mainly comprised of E&E-related products, two primary indicators can then be used to assess the prospects of external trade performance, and these are (1) the US Institute for Supply Management (ISM) new orders index, and (2) global chip sales and the US book-to-bill (BTB) ratio.

Growth in the ISM new orders index, having surged by more than 100% on a y-o-y basis in January and February 2010, has tapered off and even contracted in recent months (Chart 24). At the same time, the prospects of a weaker E&E sector can be seen from SIA's latest forecast of global chip sales which indicates a likelihood of a 6% expansion in 2011, down from the estimated 32.8% growth in 2010. At the same time, the US BTB ratio has been steadily declining from the peak of 1.23 in July 2010 to 1.03 in September 2010. All these point to a much softer performance of Malaysia's external trade going forward.

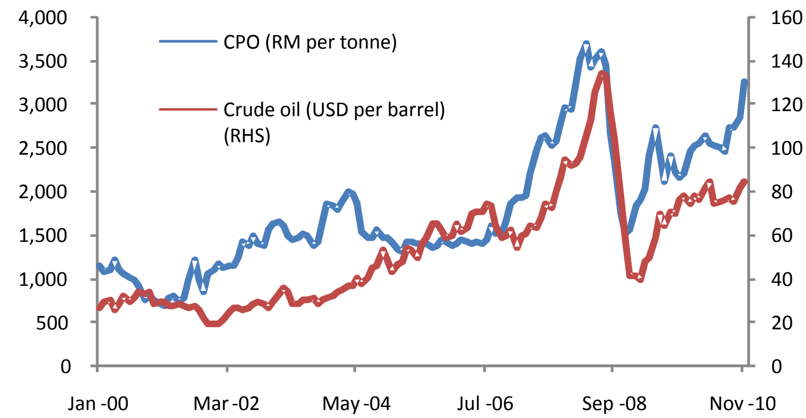
Chart 24: ISM new orders index and Malaysia's E&E exports (y-o-y%)



Source: Bloomberg

While E&E exports are expected to exert downward pressure on Malaysia's external trade performance, commodities are anticipated to provide some buffer against a sharp contraction in exports following the relatively strong and stable prices of CPO and crude oil. The IMF, in its latest forecast, anticipates average crude oil prices to be in the region of USD80.00 per barrel in 2011. At the same time, resilient demand from emerging Asia (i.e. China) following strong economic growth may entail persistent upward pressure on oil prices.

Chart 25: Prices of CPO and crude oil



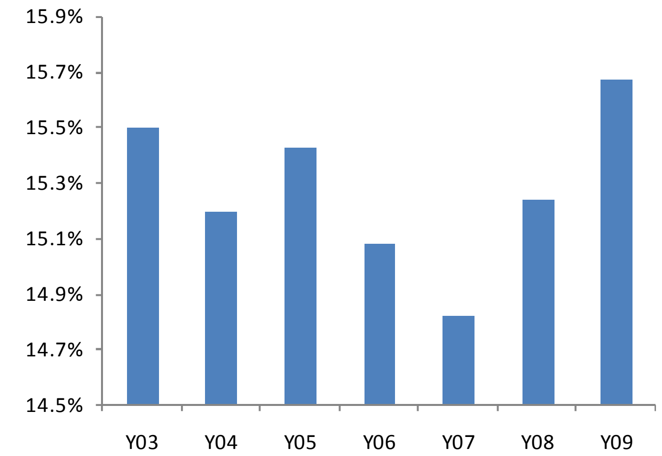
Source: Bloomberg

With external demand likely to soften, especially in 1H2011, Malaysia's real exports are anticipated to moderate to 8.8% in 2011 from the estimated 12.3% in 2010. Imports, on the other hand, are expected to expand at a more moderate pace of 9.4% (2010 estimate: 16.9%), leading to lower net contribution to growth in 2011.

Sustainable fiscal position

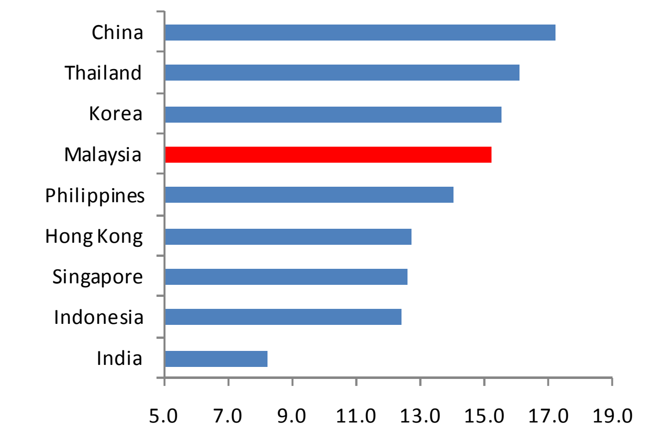
Government finances are expected to be relatively favourable in 2011, owing to the stable tax revenue base. The tax revenue-to-GDP ratio has improved from 14.8% in 2007 to 15.7% in 2009, a relatively better level than other countries in the Asian region. In fact, Malaysia's five-year median tax-to-GDP ratio of 15.2% is higher than Singapore and Hong Kong, implying a high degree of efficiency in tax administration which contributed to the stability of the tax revenue stream. The e-filing system, which was introduced in February 2006, has received good response from taxpayers, as evidenced by the more than 1.9 million users in 2010. We view such conditions as a credit positive, as higher tax collection entails stability in revenue stream. Apart from that, petroleum-related revenue will likely provide an additional buffer to government coffers, as crude oil prices are expected to remain steady against the backdrop of rising oil demand from emerging economies such as China and India. However, our concerns stem from the expenditure side, whereby cases of overspending by some government agencies can potentially undermine fiscal management and detract from the multiplier effect on the economy. According to the Auditor General's 2009 report, about 11 ministries had overspent their allocation for emoluments, supplies and services, assets acquisition and grants and fixtures.

Chart 26: Tax revenue as a % of GDP



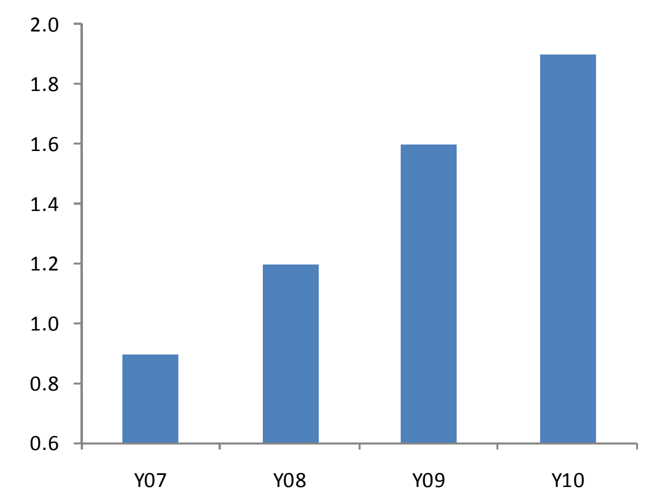
Source: CEIC

Chart 27: Tax revenue as a % of GDP (five-year median)



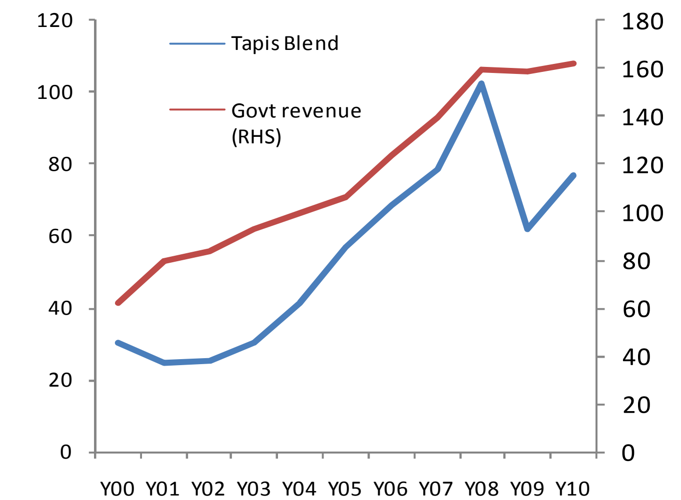
Source: Asian Development Bank

Chart 28: E-filing users (millions)



Sources: Inland Revenue Board, Ministry of Finance & MARC Economic Research

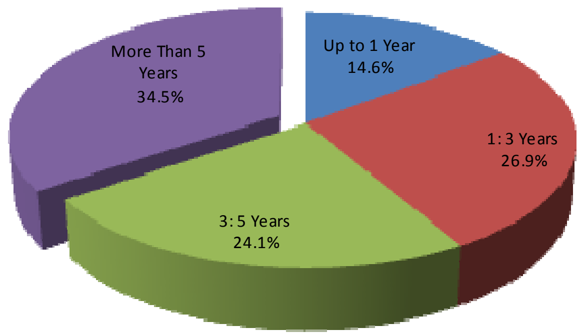
Chart 29: Tapis blend (USD per barrel) & government revenue (RM billion)



Source: BNM

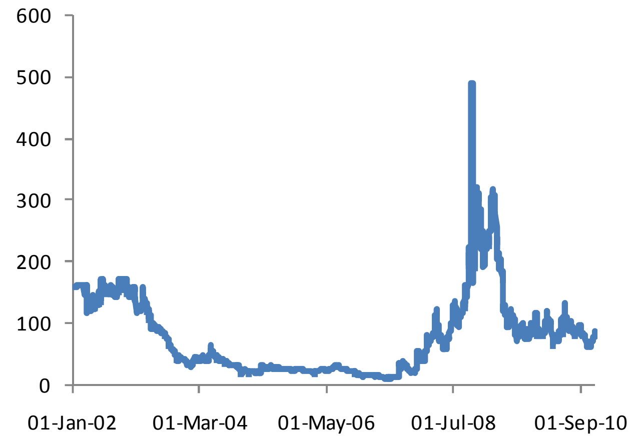
In terms of debt sustainability, the Malaysian government's ability to pay has been demonstrated by the decline in its debt-service charge ratio to 10.2% in the first nine months of 2010, well below the historical average of 15.6%. Additionally, an analysis of the maturity profile reveals that approximately 58.6% of the government's debt will mature after three years (after five years: 34.5%), suggesting that the risk of an asset-liability mismatch is fairly low for the Malaysian government, as a big chunk of maturing debt obligations is long-term in nature (Chart 30). Against such a backdrop, the rise in government debt-to-GDP ratio should not cause undue concern due to the relatively low credit risk, as evidenced by the credit default swap (CDS) spread which now lingers at around 90 bps, compared with the 492 bps recorded during the height of the global credit crisis in 2008.

Chart 30: Government debt maturity profile as of September 2010 (% of total debt)



Source: CEIC

Chart 31: Government of Malaysia five-year CDS spread (bps)



Source: MARC Fixed Income Research

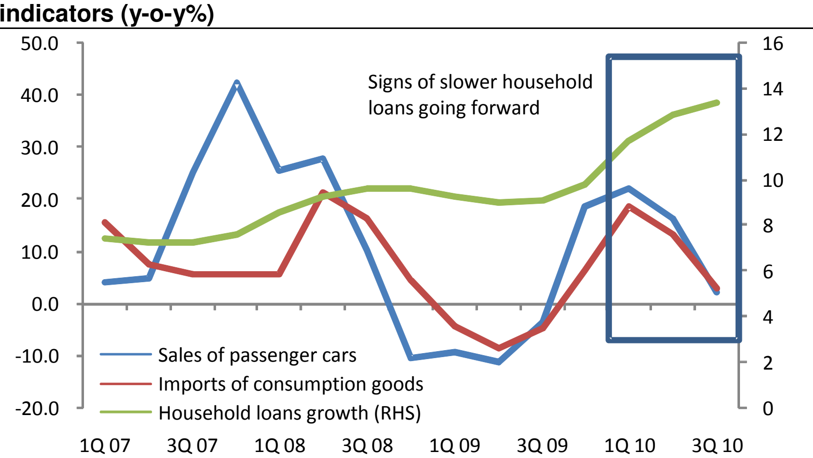
Monetary policy: pro-growth agenda remains

Contrary to common belief, we think that demand-led inflation, if it happens, will not be a major trigger for future rate increases, as the BNM will likely resort to administrative measures instead. The latest move to lower the loan-to-value (LTV) ratio to 70% for purchases of the third home and above signals that the central bank is serious about clamping down on speculative activities without fiddling with the policy rate.

Additionally, other indicators for household loans growth are portending a slower expansion in the near term, suggesting that the current policy rate is appropriate in the next six months. This is premised on single-digit growth rates reported for passenger-car sales as well as for imports of consumption goods in 3Q2010 (2.4% y-o-y and 3.2% respectively). Hence, the need to sustain the growth momentum in the immediate term could mean that the policy rate will stand pat in 1H2011.

Going forward, however, stable economic growth above the long-term trend, coupled with the need to address financial imbalances, could lead to further interest-rate normalisation, which we think would happen in 2H2011. Such an argument is also based on our estimate for the natural rate (using Taylor's rule) which stands at 3.5%, suggesting that the present state of Malaysia's monetary policy is still accommodative (OPR is currently at 2.75%) by historical standards. In this light, we believe the OPR can only be adjusted upwards between 25 to 50 bps in 2H2011 should growth resume uninterrupted.

Chart 32: Household loans growth versus private consumption indicators (y-o-y%)



Source: BNM

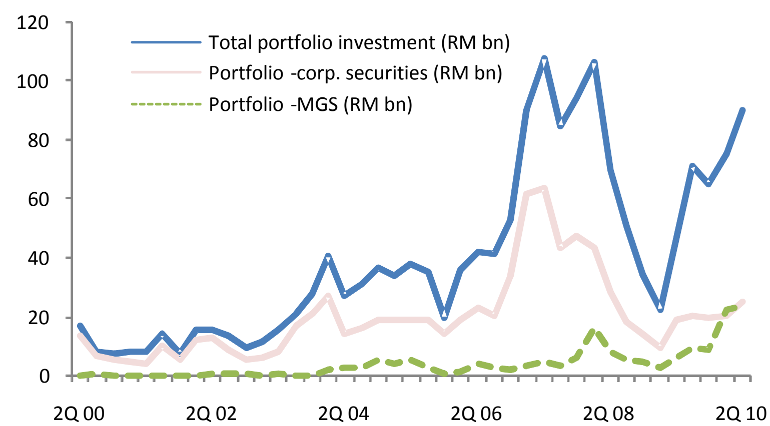
Ringgit to consolidate

The ringgit's stellar performance has been attributed to the influx of liquidity as international investors shunned developed economies following the quantitative-easing policies instituted by the Fed, the European Central Bank (ECB) and to some extent, the Bank of Japan (BoJ). The resulting global focus on investing in emerging markets has led to a significant appreciation of Asian currencies in 2010. In South East Asia, the strengthening of currencies has been especially noticeable in countries such as Malaysia, Thailand, and Singapore, which recorded respective appreciation rates of 10.8%, 10.6% and 8.3% in the year to date.

The trend of the ringgit has been influenced by several factors, namely: (1) total capital inflows following anticipation of a better macro outlook as a whole due to measures implemented by the Malaysian government to address structural problems; (2) the USD's weakness arising from anticipation of a sustained accommodative monetary policy by the Fed; and (3) portfolio inflows into the country as a result of better prospects of the financial market.

As for Malaysia, rigorous efforts by the government to revive private investments via the GTP, ETP and the NEM are the additional pull factors that will induce stronger inflows in the medium term. However, should the US economy start to show a convincing recovery phase due to, say, an improvement in capital spending, there will be some capital flowing back to USD-denominated assets because of the possible anticipation of interest-rate hikes. This will strengthen the greenback against major currencies, including the ringgit. Similarly, if portfolio inflows start to moderate following overstretched valuations in the equity and bond markets in Malaysia, the ringgit will likely stop its ascension and consolidate against the USD.

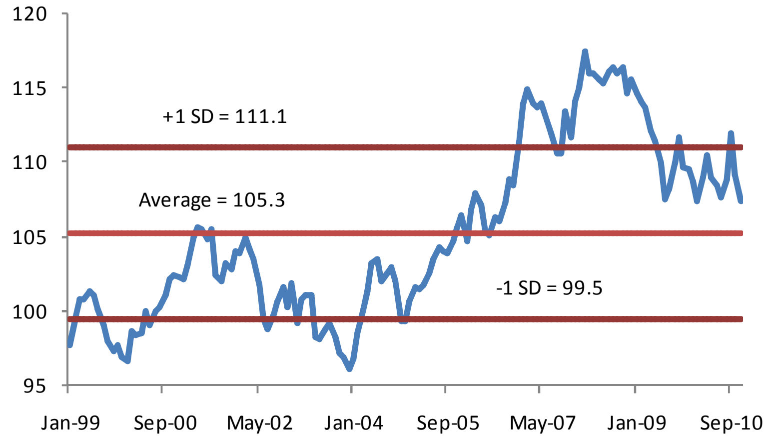
Chart 33: Portfolio inflows into MGS and corporate securities



Source: BNM

The ringgit's real effective exchange rate (REER) has risen continuously since end-2003 from below one-standard deviation (SD) of its long-term trend post-AFC to surpass its one-SD above the mean in 2007. Since 2H2009, however, the REER has declined slightly but remained above the 100-demarcation line that separates the undervaluation-overvaluation against its major trading partners.

Chart 34: Malaysia's REER



Source: MARC Economic Research

Going forward, as the US economic sentiment improves following a possible rebound in capital spending in the US, a stronger greenback will likely take the shine off the ringgit in 2011, in spite of the inflows of capital into Malaysian shores. As such, we anticipate the ringgit to average circa RM3.10 to RM3.20 against the USD in 2011, almost the same average as last year's, but slightly weaker than the present RM3.09.

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