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Malaysia's 1Q2011 economic report card

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In a nutshell

Malaysia's 1Q2011 gross domestic product (GDP) growth came in within our expectations, having clocked in at 4.6% (our forecast: 4.7%, market forecast: 4.9%) after expanding by 4.8% in the preceding quarter. As anticipated, the expansion was fuelled by a sustained growth in domestic demand, underpinned by robust private consumption which grew by 6.7% (4Q2010: 6.4%). An overall improvement in the labour market (as evidenced by the decline in the unemployment rate) and continued easy access to credit for consumers were the major drivers of consumer spending in 1Q2011.

The economy was also supported by investments which grew by 6.5%, albeit slower than the preceding quarter when it grew by 10%. It contributed 1.3 percentage points to the growth chalked up in 1Q2011. Although a breakdown in total investment was not provided, we opine that private investments have been a primary driver for total investments following high capacity utilisation (CAPU) rates and the implementation of planned capital investment projects.

External-sector conditions have also improved, with the growth in real exports rebounding by 3.7%, up from 1.7% recorded in the preceding quarter. Strong commodity prices and an upward momentum in the growth of emerging economies as well as stable demand from major developed countries have helped Malaysia's exports perform better in 1Q2011. However, with the strong growth in imports, net exports subtracted 4 percentage points from the headline growth.

Going forward, judging by key leading indicators such as loan growth, equity market performance and the Organisation for Economic Cooperation and Development (OECD) composite leading indicators, we foresee a sustained growth of the economy that will average at around 5.8% in 2H2011. We have penciled in a growth forecast of 4.6% for the second quarter of this year and project an average growth of 5.3% for the whole of 2011 based on these indicators.

We hold the view that the overall economic expansion will be primarily supported by resilient consumer spending and relatively stable growth in private investments. Stable and favourable labour market conditions, with the unemployment rate staying below the 10-year average of 3.4%, are major catalysts for brisk consumer spending going forward. At the same time, easy access to credit provided by banks as well as other financial intermediaries like cooperatives and building societies will keep consumers' enthusiasm levels up throughout the year. Similarly, prices of crude palm oil and rubber, which have gained by 122% and 237% respectively since their lows in 4Q2008, provide the means for those in these sectors to support their spending in the near future.

Sustained momentum in the growth of private investments is also expected to provide a helping hand to the economy this year. With the amount of investments anticipated to surpass the government's target of RM83 billion in 2011, gross fixed capital formation (GFCF) will likely register another commendable growth rate of nearly 10%. Indeed, the anticipated steady recovery of the United States (US), the world's largest economy, while slower than its long-term average, will also stimulate the flow of global foreign direct investments (FDI) to emerging economies with high growth potential. This includes Malaysia, despite the various hiccups faced by the country in the past few years.

Malaysia's external sector will also benefit from the stronger momentum in global trade in 2H2011 once the US economy starts to show more meaningful signs of recovery following an expected improvement in its labour market. While it is true that the jobless rate remains high by historical standards, and that the country's economic outlook is clouded by the tug-of-war between the current administration and Republicans on issues like the country's debt limit and budget-deficit reduction plan, many forward-looking indicators suggest that the recovery will continue throughout 2H2011.

This backdrop is certainly critical for Asian countries as a whole as they remain very much dependent on the US as the final destination for their products. On top of this, the ongoing strength of major Asian economies such as China and India, despite having moderated following measures to cool these economies, also provide a crucial buffer against sharp declines in trade with the Group of 3 economies.

With rapid increases in global food and crude oil prices, inflation will become a critical factor in Malaysia's policy mix in the near term. Although the consumer price index (CPI) grew by 2.8% in 1Q2011, another inflationary gauge – the GDP deflator – revealed that prices have risen by 6.1%. Judging by the core and headline numbers, we are of the view that the upward pressure on consumer prices is still largely attributed to the cost factor. Nevertheless, some indications, such as the tight labour market and a sharp rebound in the CAPU rate in the manufacturing sector, are warning signs that inflation may be later driven by demand factors, which, if not properly contained, will require aggressive countermeasures in the future, something that policymakers will try to avoid, in our opinion.

Given this scenario, we believe that another hike in Malaysia's overnight policy rate (OPR) of 25 basis points (bps) is already on the cards. Indeed, the resilient growth momentum (albeit lower than in the past few quarters), the continued acceleration in loan growth and the buildup in inflationary pressure combined will likely drive Bank Negara Malaysia (BNM) to maintain a tighter monetary stance. Strong growth in asset prices, as reflected in the increases in equity and home prices by 78% and 12% respectively since their recent lows, will also become important considerations for the central bank in pushing the rate higher.

Notwithstanding this, we are of the view that for the OPR to reach 3.5% - the highest level since it was introduced in 2004 - the economy has to sail without much turbulence, locally or globally – something which is not the case at this juncture. Indeed, the dust has yet to settle in the euro region despite the strength exhibited by the region's two dominant economies of Germany and France, both of which have significantly outperformed their peers in the bloc. As for the emerging economies, while their growth continued to outpace that of other regions, their efforts to overcome the problem of economic overheating (i.e. surging prices of assets like property and stocks) will likely lead to more moderate growth rates in the near future.

There are, of course, several concerns arising from Malaysia's considerable dependence on consumers as a major driver of economic growth. The overstretched consumer sector, if not properly monitored, will eventually erode consumers' ability to sustain their consumption binge in the longer term. While it is true that the amount of bad debt in the household segment is minimal among banking institutions, easy access to credit, as evidenced by the double-digit growth rate of loans, will eventually hit the consumer sector if rates are aggressively adjusted upwards. At present, some segments of consumers are already adjusting their spending patterns following the recent BNM guidelines to limit the number of credit cards held by those below a certain income threshold. On that score, we see a lower probability of the OPR being pushed to 3.5% this year unless macro conditions sufficiently convince policymakers that the growth momentum is way beyond its long-term potential. We applaud BNM's move to introduce new guidelines on credit cards and raise capital charges on longer-tenured personal financing and housing loans where the loan-to-value (LTV) ratio exceeds 90%.

On the investment side, we foresee an increase in the momentum of private investments in the medium term as a result of the dedication of the Performance Management and Delivery Unit (PEMANDU) in achieving the government's aspirations by the year 2020. Constant updates on new entry-point projects (EPPs) and other crucial statistics indicate the government's commitment to addressing this structural issue which has plagued the nation since the 1997/98 Asian Financial Crisis. As such, we feel that private investment growth will be more commendable in the medium term than in the past years. Taking a longer-term perspective, however, there are concerns with regards to issues like income distribution, number of jobs created and the benefits to small businesses. For instance, while the number of EPPs achieved so far has been commendable (41% of the targeted EPPs), the number of jobs to be created stood at only 10% of what is envisioned in the programme. Notwithstanding this, we feel that the overall positive effect on the economy will eventually help address the structural problem faced by the economy in the last decade.

With the prospects of the US dollar (USD) being clouded by issues like the US' debt limit, budget deficits and sovereign rating as well as the fact that Malaysia's OPR is likely going to continue trending upward to alleviate inflationary pressure in the economy, the ringgit is expected to remain relatively strong in the near future. Its strength, however, is largely attributed to the less-than-sanguine outlook of the greenback, as reflected by an across-the-board decline in the US trade-weighted index. For as long as the rhetoric of the US Federal Reserve (Fed) suggests that an ultra-accommodative stance will continue in the near future, the ringgit will likely remain within the trading range of RM2.95-RM3.05/USD. However, once the greenback starts to get investors' attention due to factors like rising speculation on rate hikes in the US, lower risk-adjusted returns in emerging economies or increasing risk aversion, the appreciation of Asian currencies, including the ringgit, will likely taper off. In addition, BNM's liberalisation measures on direct investment abroad to encourage two-way capital flows will promote stability of the ringgit's movement and prevent the currency from experiencing a sharp appreciation. We now foresee a strong resistance at RM3.07/USD and a support at RM2.95/USD.

Headline growth numbers in line with expectations

Malaysia's 1Q2011 GDP grew by 4.6%, in line with our expectations and the market's (our forecast: 4.7%; market forecast: 4.9%) after expanding by 4.8% in the preceding quarter. The moderation in growth is partly due to the high base recorded in 1Q2010 when GDP growth accelerated to a cyclical peak of 10.1% year-on-year. Compared with neighbouring countries, Malaysia's 1Q2011 growth trailed behind Indonesia (6.5%) and Singapore (8.5%), but is likely to be higher than Thailand, which has yet to release its growth numbers.

Table 1: GDP components

	1Q10	2Q10	3Q10	4Q10	1Q11
GDP	**10.1%**	**9.0%**	**5.3%**	**4.8%**	**4.6%**
By expenditure					
Domestic Demand	5.5%	9.1%	4.9%	5.9%	6.6%
Consumption Expenditure	5.4%	7.8%	3.3%	4.8%	6.6%
Private Consumption	5.2%	7.9%	6.7%	6.4%	6.7%
Public Consumption	6.7%	7.3%	-9.8%	0.1%	6.1%
GFCF	5.8%	12.9%	10.1%	10.0%	6.5%
Exports	19.1%	14.0%	6.8%	1.7%	3.7%
Imports	27.8%	22.6%	11.2%	3.5%	8.4%
By industry					
Agriculture	7.2%	2.8%	3.0%	-3.9%	-0.3%
Mining and Quarrying	1.0%	1.5%	-0.7%	-1.2%	-3.0%
Manufacturing	17.1%	16.0%	7.6%	6.2%	5.4%
Construction	8.6%	4.1%	2.8%	5.6%	3.8%
Services	8.6%	7.4%	5.3%	6.1%	5.9%

Sources: Department of Statistics (DoS), CEIC

Table 2: Growth comparisons

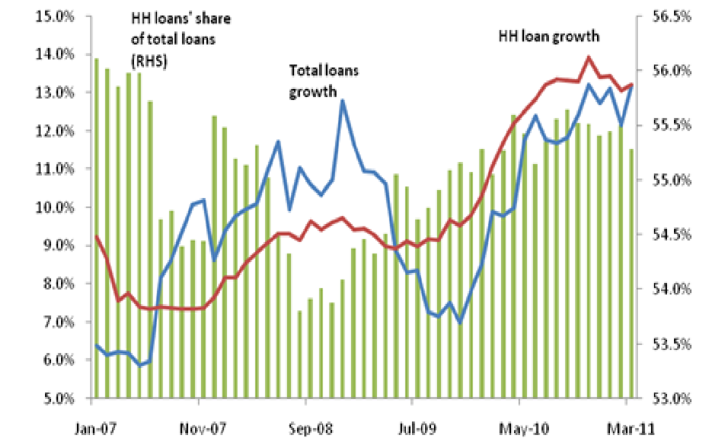
	2010	4Q2010	1Q2011	2011 (f)
Malaysia	**7.2%**	**4.8%**	**4.6%**	**5.0-6.0%**
Singapore	14.5%	12.0%	8.5%	4.0-6.0%
Indonesia	6.1%	6.9%	6.5%	6.4%
Thailand	7.8%	3.8%	-	3.5-4.5%

Sources: Various databases
Note: f = government forecast

As anticipated, the expansion was driven by sustained growth in domestic demand, underpinned by robust private consumption which grew by 6.7% (4Q2010: 6.4%). An improvement in the labour market (as reflected by the decline in the unemployment rate) and continued easy access to credit for consumers were the major drivers of consumer spending in 1Q2011. Loan growth accelerated to 13.2% in March, driven by rapid increases in household loans (see Chart 1). Indeed, household loans have been growing at double-digit clips since April 2010 following aggressive efforts by banks to focus on the consumer segment as the sector was considered relatively safe due to favourable labour market conditions. Increasingly robust risk management tools have also induced banks to extend lending to households which were not eligible for such loans previously. In addition, strong stock market performance and relatively high prices of assets such as properties have bolstered incomes and helped sustain private consumption in the first three months of the year (see Charts 3 and 4).

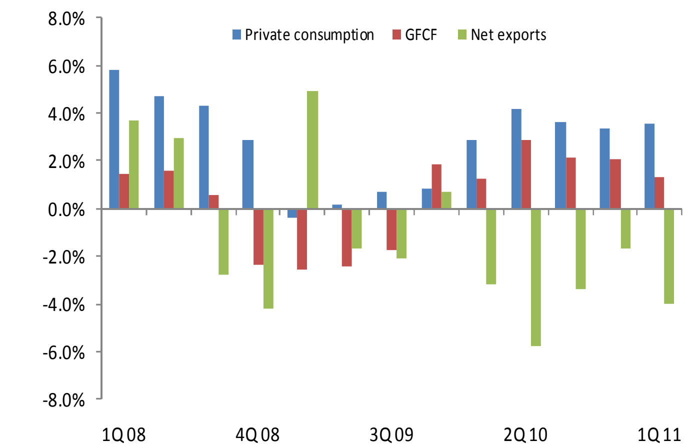
On the supply side, the services sector once again became the major contributor to growth in 1Q2011, expanding by 5.9%, albeit slower than in the preceding quarter's 6.1%. The manufacturing and construction sectors also moderated, expanding by 5.4% and 3.8% respectively from 4Q2010's 6.2% and 5.6% respectively.

Chart 1: Malaysia's total and household loan growth rates



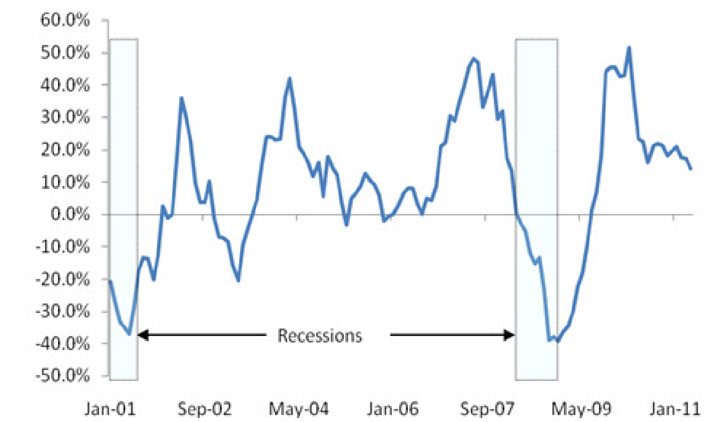
Sources: CEIC, MARC Economic Research

Chart 2: Contributions to growth by GDP component



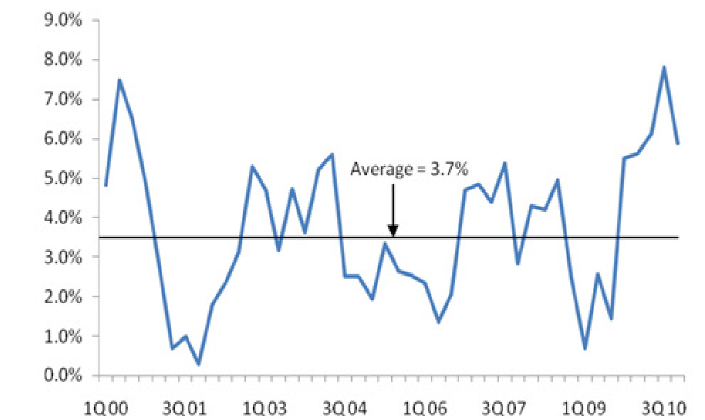
Sources: CEIC, MARC Economic Research

Chart 3: KLCI (year-on-year)



Source: CEIC

Chart 4: House Price Index (year-on-year)

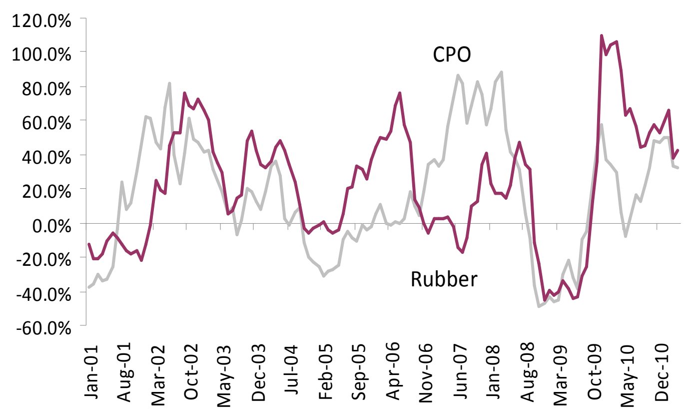


Sources: CEIC, MARC Economic Research

Investment, another component of GDP, has also played a part in supporting the economy, having expanded by 6.5% and contributing 1.3 percentage points to the growth achieved in 1Q2011. Although a breakdown of total investments was not provided, we opine that private investments have been a primary driver for total investments following high CAPU rates and the implementation of planned capital investment projects by the government. Going by the current momentum, the government will likely achieve a commendable growth performance, although this may fall short of the 12.8% annual growth target established in the 10th Malaysia Plan.

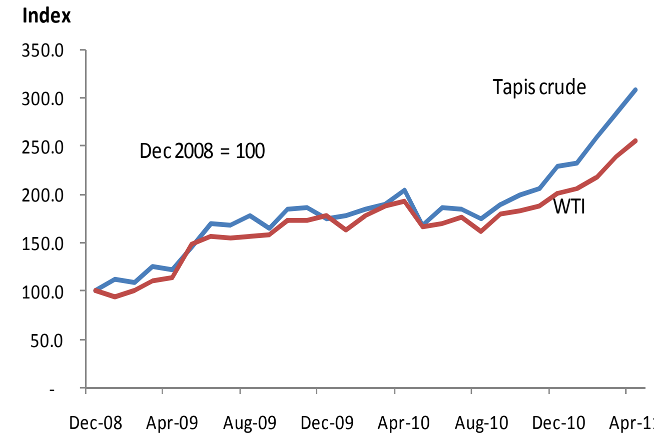
External-sector conditions have also improved, with the growth in real exports rebounding by 3.7%, up from 1.7% recorded in the preceding quarter. Robust commodity prices and an upward momentum in the growth of emerging economies as well as stable demand from major developed countries have helped propel Malaysian export growth in 1Q2011. Prices of crude palm oil and rubber have increased by 122% and 237% respectively since their lows in 4Q2008 despite moderating from their levels in the early part of 2010. A surge in global oil prices has also benefited Malaysia as the price of Tapis remained elevated in 1Q2011. Notwithstanding the improvement in export performance, net exports subtracted 4 percentage points from the headline growth due to a strong expansion in imports in 1Q2011.

Chart 5: Prices of crude palm oil and rubber (year-on-year)



Source: CEIC

Chart 6: Prices of Tapis and WTI (index)

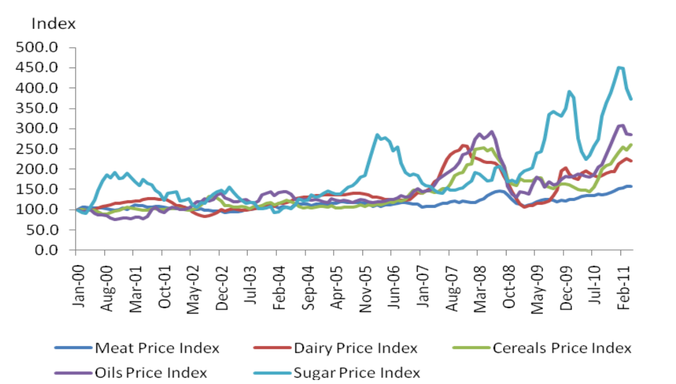


Sources: CEIC, MARC Economic Research

Inflation: demand- or cost-driven?

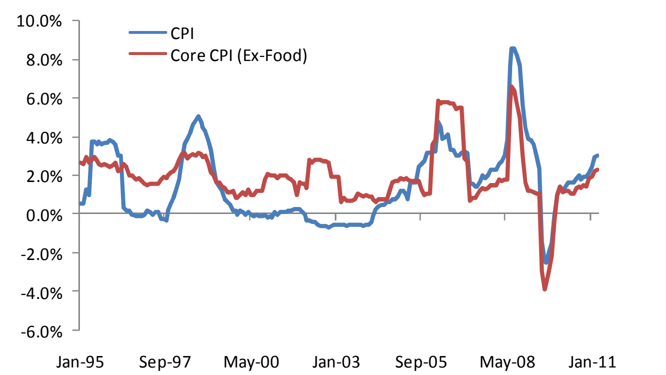
There is no doubt that the country's inflation rate is creeping up. CPI growth finally hit 3.2% in April 2011 as a result of significant increases in food and petrol-related products. Sugar prices were raised again by 20 sen on May 19 to RM2.30 per kg, while the price of RON97 was upped by another 20 sen to RM2.90 per litre. Indeed, rising food prices is a global phenomenon, as reflected in the surge of the Food and Agriculture Organization (FAO) food price index by 48% in April 2011 since 2009. As the government is determined to rationalise subsidies in the near term, the CPI will likely continue on its upward trend to average at around 3.3% in 2011. It is worth noting that while the CPI has increased by 2.8% in 1Q2011 - 80 bps higher than in the preceding quarter - another inflation gauge, the GDP deflator, suggests that prices have increased by an average of 6.1%, compared with the 4.3% recorded in 4Q2010. The GDP deflator, taking into consideration actual spending with no specific basket, has remained above the CPI since 1Q2010 (see Chart 10).

Chart 7: Breakdown of the FAO food price index



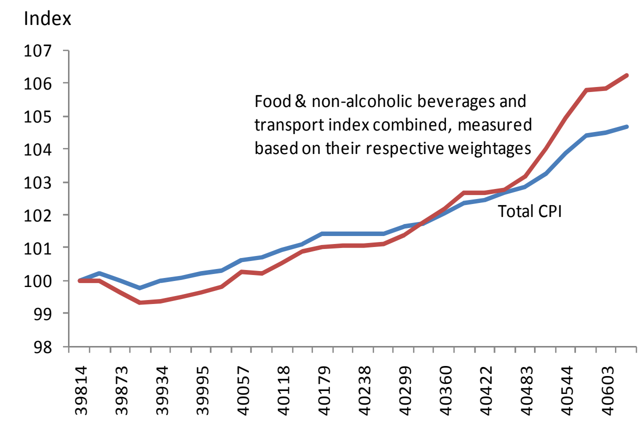
Sources: FAO, World Health Organization

Chart 8: Malaysia's headline and core CPI



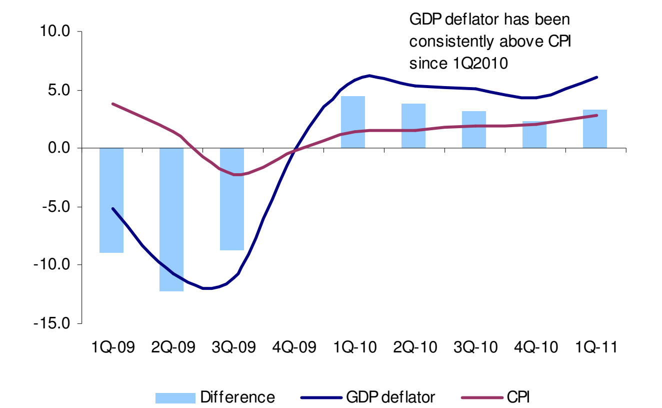
Sources: CEIC, MARC Economic Research

Chart 9: Malaysia's food and transport indices, rebased



Sources: CEIC, MARC Economic Research

Chart 10: Malaysia's CPI versus GDP deflator

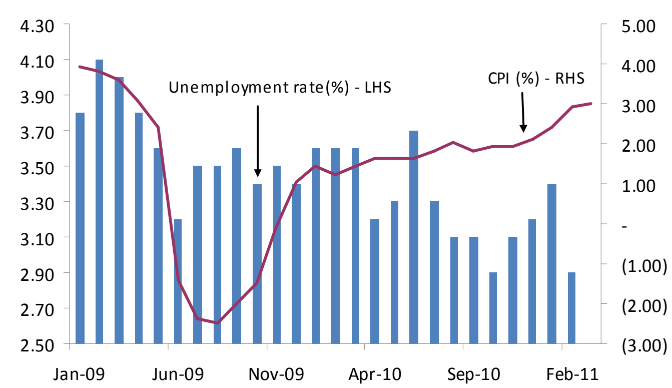


Sources: DoS, MARC Economic Research

The question on people's minds now is how BNM will respond to this upward inflationary pressure. While food prices are one of the major drivers of the CPI, the central bank recently pushed up the OPR by 25 bps to 3%. Given the persistent uptrend in the CPI, we are of the view that another 25-bps hike in the OPR is already on the cards. Indeed, the resilient headline growth (albeit lower than in the past few quarters), the continued acceleration in loan growth, resilient private spending as well as the rising CAPU rate in the manufacturing sector are among the factors that will likely drive BNM to keep pursuing a tighter monetary stance. This is in spite of the fact that the current inflation is likely attributed to the cost factor rather than demand factors. Strong growth in asset prices, as reflected in the increases in equity and home prices by 78% and 12% respectively since their recent lows, will also become important considerations for the central bank in pushing the rate higher.

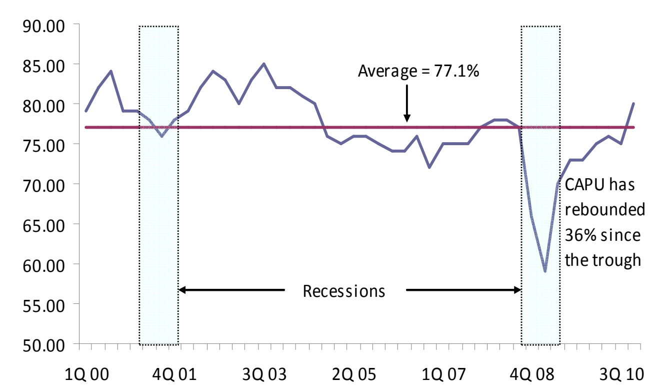
Notwithstanding this, we are of the view that for the OPR to reach 3.5% - the highest level since it was introduced in 2004 - the economy has to sail without much turbulence, locally or globally – something which is not the case at this juncture. Indeed, the dust has yet to settle in the euro region despite the strength exhibited by the region's two dominant economies of Germany and France, both of which have significantly outperformed their peers in the bloc. As for the emerging economies, while their growth continued to outpace that of other regions, their efforts to overcome the problem of economic overheating (i.e. surging prices of assets like property and stocks) will likely lead to more moderate growth rates in the near future.

Chart 11: Unemployment rate and CPI



Source: CEIC

Chart 12: Capacity utilisation rate



Sources: CEIC, MARC Economic Research

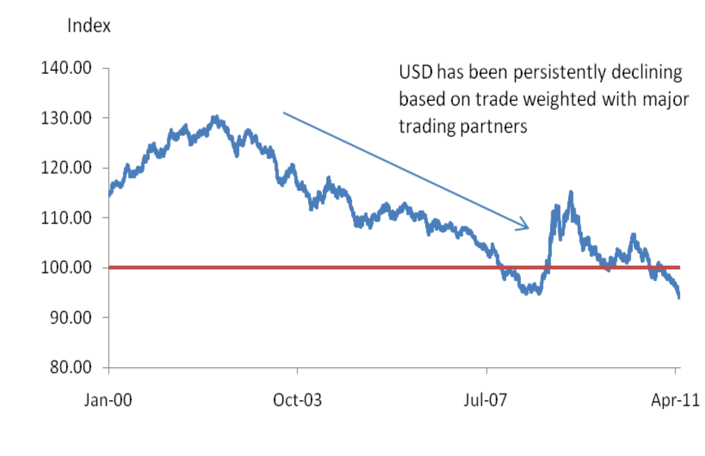
The ringgit and the US dollar

Malaysia's decision on the policy rate will also be dependent on the trend in capital flows. While aggressive interest-rate hikes were implemented in other countries to quell inflationary pressures, this move may also induce greater inflows of hot money, complicating liquidity management. As such, we are of the view that Malaysian policymakers have to walk the tightrope between tightening monetary policy and preventing massive inflows of hot money.

Thus far, the ringgit has remained strong and has benefited tremendously from expectations of a persistent weakness in the greenback following the US' ultra-accommodative policy stance. Copious amounts of capital have hitherto flowed into the equity and bond markets of high-growth emerging economies such as Malaysia. While there is no compelling reason for international investors to withdraw their funds from the region in a big way, the leakage may commence with the emergence of beliefs that regional policymakers are facing difficulties in cooling off their economies, or if the risk-return ratio flips in favour of holding USD-denominated assets (this can happen if the US economy starts to show convincing signs of recovery while Asian economies are struggling to contain macro imbalances). While a slow and steady leakage of portfolio capital is not detrimental to the economy, a significant and sudden outflow will dampen the sentiment of the financial market and affect macroeconomic performance in the short term.

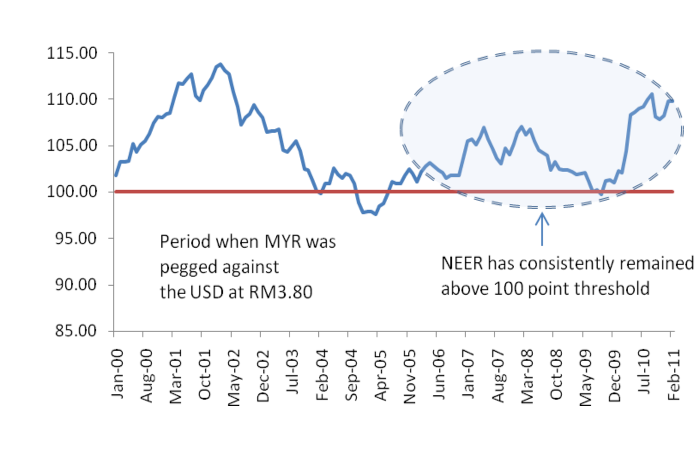
With the prospects of the USD being clouded by issues such as the US' debt limit, budget deficits and sovereign rating and the fact that Malaysia's OPR is likely to continue trending upward to alleviate inflationary pressure in the economy, the ringgit is expected to remain relatively strong in the near future. Its strength, however, is largely predicated on the less-than-sanguine outlook of the greenback, as reflected by an across-the-board decline in the US trade-weighted index. As long as the rhetoric from the Fed suggests that an ultra-accommodative stance will continue in the near future, the ringgit will likely remain within the trading range of RM2.95-RM3.05/USD. However, once the greenback starts to get investors' attention due to factors like rising speculation on rate hikes in the US, lower risk-adjusted returns in emerging economies or increasing risk aversion, the appreciation of Asian currencies, including the ringgit, will likely taper off. In addition, BNM's liberalisation measures on direct investment abroad to encourage two-way capital flows will promote stability of the ringgit's movement and prevent the currency from experiencing a sharp appreciation. We now foresee a strong resistance at RM3.07/USD and a support at RM2.95/USD.

Chart 13: US dollar trade-weighted index



Source: Bloomberg

Chart 14: Malaysia's NEER



Source: Bloomberg

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