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The US downgrade: Repercussions for the Malaysian economy

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In a nutshell

- Standard & Poor's (S&P) downgraded the United States (US) credit rating from 'AAA' to 'AA+' due to "the prolonged controversy over raising the statutory debt ceiling and the related fiscal policy debate among Washington policymakers." The downgrade was also done following the fiscal consolidation plan that Congress and the Administration agreed to last week which fell short of the amount that S&P believes is necessary to stabilise the general government debt burden by the middle of the decade.

- The downgrade is not unexpected, considering that the US government's gross debt-to-gross domestic product (GDP) ratio and budget deficits level will remain elevated in the next few years. Based on the forecast by the International Monetary Fund (IMF), the US gross debt-to-GDP ratio will climb to 112.7% by 2016 from 93.5% in 2010. The same goes for budget deficits which will likely be in the range of 7% to 10% in the next two years, according to the US Congressional Budget Office (CBO).

- The downgrade will not directly affect growth in the short term but will instead hurt financial market sentiment, which consequently may dent equity market performance and take a toll on private consumption in the medium term. What is more critical is the impact of the expenditure cut amounting to US$2.4 trillion that the US government is planning to implement which will likely be a drag on growth, leading to sub-par expansion rates. In view of the rising risk of a double-dip recession, US policymakers will likely consider introducing the third round of quantitative easing (QE3).

- We believe that the rating downgrade will have no material effect on Treasury yields in the short term in view of the significance of the US dollar (USD) which makes it difficult for asset managers to find viable alternatives. However, if, for any reason there should be a sustained reaction in US Treasury yields, the impact on US GDP growth will likely exert additional pressure on the already fragile economy. We are of the opinion that the US economy will only manage to expand by 1.5% to 2% in 2011 as the country's private consumption almost screeched to a halt in 2Q2011.

- We also believe that in the short term, because there will be few viable alternatives to the USD, demand for the greenback will not likely diminish dramatically, although a knee-jerk reaction has taken place against major currencies. In the longer term, however, we foresee that the trend of global central banks' diversifying their reserves away from the USD will continue and gradually diminish the status of the greenback as a global reserve currency.

- The impact on the ringgit and monetary policies with potential to be introduced by the monetary authority are among the factors that will affect the prospects of the Malaysian economy going forward. The current strength of the ringgit, while positive for consumer spending, will not likely lead to a jump in conspicuous consumption as sentiment is currently clouded by the slower prospects of economic growth and worries over the repercussions of external headwinds on the financial market, particularly the equity market.

- As Malaysia's economic growth moves in tandem with that of the US (as evidenced by the high correlation between the GDP growth rates of both nations), we think that a material slowdown in the US economy will temper Malaysia's growth performance. We are of the view that Malaysia's 2Q2011 growth may decelerate to around 4%. For the whole of 2011, we see a heightened probability of Malaysia's GDP growth rate moderating to between 4% and 5%.

- Expectations of upward pressures on the ringgit will be positive for capital inflows in the near term. Against this backdrop, we foresee the future moves of Bank Negara Malaysia (BNM) to be similar to those of regional central banks, i.e. not overly aggressive in hiking interest rates. We will not be surprised if macro-prudential measures are introduced by BNM in its valiant strife to balance growth and inflation. Some of the policies that have been adopted by other Asian countries to prevent excessive inflows of hot money may therefore be considered.

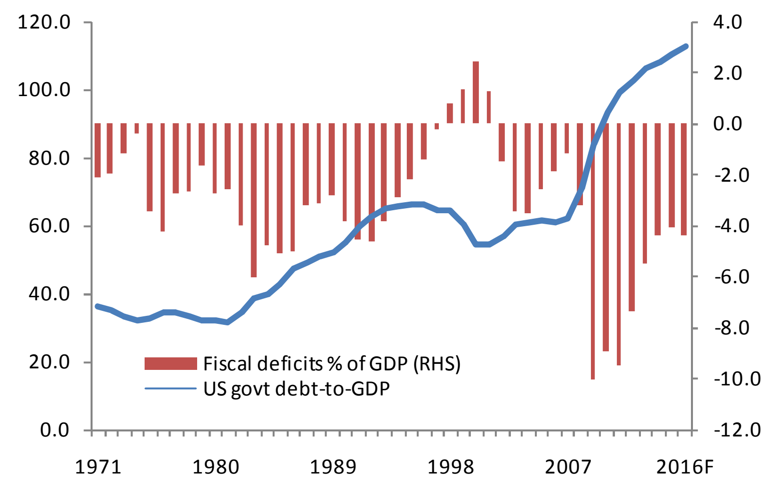
The first downgrade

The 'AAA' credit rating by S&P that the US has enjoyed since 1941 was slashed by one notch to 'AA+', the first downgrade in the country's history, on 5 August 2011. The credit rating was lowered as S&P believes that "the prolonged controversy over raising the statutory debt ceiling and the related fiscal policy debate indicate that further near-term progress containing the growth in public spending, especially on entitlements, or on reaching an agreement on raising revenues is less likely" than it previously assumed and "will remain a contentious and fitful process."

Moreover, the S&P mentioned that the fiscal consolidation plan that Congress and the Administration agreed to last week falls short of the amount that it believes is necessary to stabilise the general government debt burden by the middle of the decade. Indeed, the rating agency labeled the outlook on the long-term rating negative, adding that it could lower the long-term rating further to 'AA' within the next two years if it sees "less reduction in spending than agreed to, higher interest rates, or new fiscal pressures during the period" that will result in a higher general government debt trajectory than it currently assumes in its base case.

The downgrade is not unexpected, considering that the US government gross debt-to-GDP ratio and the deficits level will remain elevated in the next few years. The IMF, in its Article IV issued in July this year, expects the gross debt-to-GDP ratio to climb to 112.7% by 2016 from 93.5% in 2010. The same goes for budget deficits which will likely be in the range of 7% to 10% in the next two years, according to the CBO.

Chart 1: US fiscal deficits (% of GDP) and debt-to-GDP ratio



Sources: IMF& CBO, F= forecast

Impact on the US economy

Treasury yields and banking sector

The downgrade will not directly affect growth in the short term but will instead hurt financial market sentiment, which consequently may dent equity market performance and take a toll on private consumption in the medium term. Theoretically speaking, the downgrade will increase US borrowing cost, which will in turn raise the costs of mortgages, auto loans and other types of lending tied to the interest rates paid on US Treasuries. This will then detract a few percentage points from headline growth.

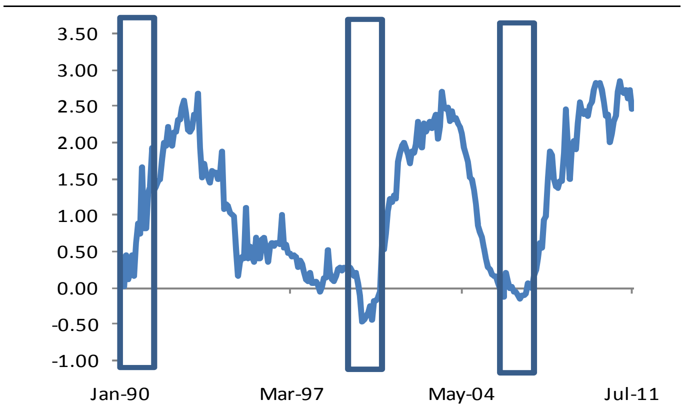
Our Fixed Income research team and banking analyst, however, are steadfast in their belief that the rating downgrade will have no material effect on Treasury yields in the short term in view of the significance of the USD which makes it difficult for asset managers to find viable alternatives. In other words, the demand for Treasuries will not substantially subside as foreign buyers will still have faith in the US debt instrument. This conclusion is supported by the fact that several officials from different countries have expressed their intentions to maintain their holdings of US Treasuries. Russia, for instance, stated that the one-step cut "can be ignored" and France echoed the US' questioning of S&P's reasoning for the downgrade, whilst South Korea issued a statement confirming its "faith" in US Treasuries.

As for the banking sector, a statement by a group of US banking regulators, including the Fed and the Federal Deposit Insurance Corp (FDIC) indicated that the cut in the US credit rating won't affect the capital positions of the nation's banks as the risk weights for Treasury securities and other securities issued or guaranteed by the US government, government agencies and government- sponsored enterprises will not change. This simply means that access to credits will not be jeopardized by the downgrade and credit growth will likely resume its positive momentum after contracting for more than two years until March 2011. The Fed officials also said that S&P's decision would have no implications on its ability to influence interest rates through open-market operations. In fact, the central bank could buy more Treasury securities if the economy appeared in danger of stalling.

Economic growth

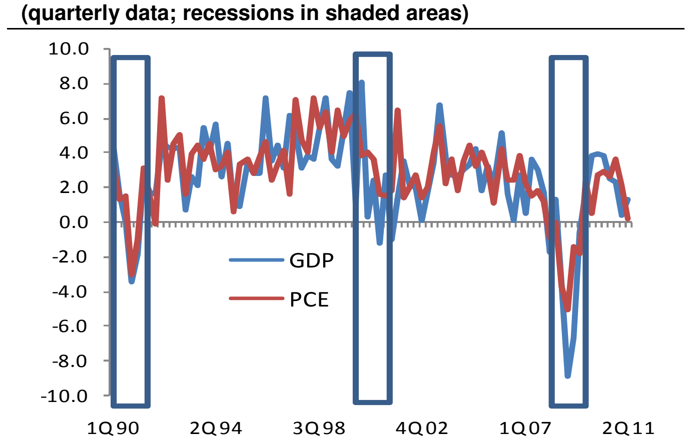
Notwithstanding this, if, for any reason, there should be a sustained reaction in US Treasury yields, the impact on US GDP growth will likely exert additional pressure on the already fragile economy. According to a study by the US Federal Reserve (the Fed), an increase of 50 basis points (bps) in the yields of US Treasuries will shave off approximately 0.4 percentage point from growth and raise the debt level by US$100 billion per annum. As the current growth projection is circa 2.5% to 2.7%, and the fact that 2Q2011 GDP growth has turned out weaker than expected, coupled with a substantial downgrade in 1Q2011 GDP to an annualised pace of 0.4%, we feel that the US economy will only manage to expand by 1.5% to 2% in 2011. Our estimation of a weaker US economic growth rate is also premised on the waning strength of the country's private consumption which almost screeched to a halt in 2Q2011 after a mediocre 2.1% expansion in the preceding quarter.

Chart 2: US bond yield: 10-2 (recessions in shaded areas)



Source: CEIC

Chart 3: GDP and private consumption annualised pace (quarterly data; recessions in shaded areas)



Source: US Bureau of Economic Analysis (BEA)

In the medium term, what is more critical is the impact of the expenditure cut amounting to US$2.4 trillion that the US government is planning to implement following the debt deal that was signed by President Obama. This massive expenditure cut, to come into effect when the economy remains fragile, could be a drag on growth in the medium term, leading to sub-par expansion rates. In view of the rising risk of a double-dip recession, US policymakers will likely consider introducing QE3.

Overall, we are of the opinion that while there is a need to manage the government's fiscal position to cap further gains in the debt level, a cut in expenditure without an accompanying rise in tax revenue will only weaken the economy doubly and in turn lower the prospects of generating revenue to pay down the country's mountainous debt.

Interest rates

Against the backdrop of weaker growth prospects, the US policy rate (the Federal Funds Rate, or FFR) will likely stay put at the current level as the Fed tries to ensure that growth will not falter in the short-term. In fact, there is a distinct possibility that the world's largest central bank will resume its bond purchase programme as suggested by Fed chief Ben S. Bernanke if the economy starts to show signs of stalling. The recent reading of the Institute for Supply Management (ISM) purchasing managers' index (PMI) for the manufacturing sector trended closer to the demarcation line of 50 (separating expansion from contraction), and data on the unemployment rate remaining above 9% both suggest an increasing probability of another round of QE by the Fed. In our view, we are not expecting the FFR to move until the end of 2012 at the earliest.

US dollar

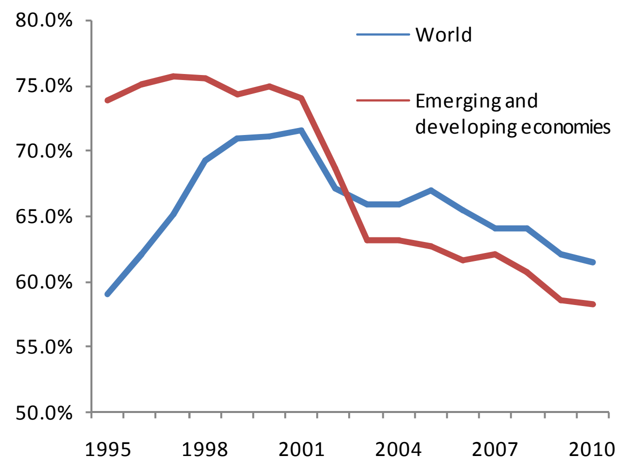
The knee-jerk reaction that occurred in the currency market was expected as investors re-evaluated their options to diversify away from USD-denominated assets for fear of a sustained depreciation of the greenback against other major currencies. The US dollar index, representing average exchange rates with six major world currencies, has declined by 26% as investors shied away from the greenback in expectation of an eventual downgrade of the US credit rating. The USD has also weakened against currencies like the Swiss Franc (CHF) and Japanese Yen (JPY) by 17% and 6.5% respectively since the beginning of the year.

Against the CHF, the USD has declined from its high of 1.8309 CHF/USD in October 2000 and smashed the 100% Fibonacci support level in June 2010. It broke through the recent support of 0.9642 in October 2010 and is now heading for the 161.8% Fibonacci support level. Against the Yen, the USD has fallen from the recent high of ¥124.13/USD in June 2007 and tested the 161.8% Fibonacci retracement for the first time in December 2008 but has rebounded temporarily. It re-tested and broke through the Fibonacci support in June 2007 and is now trading at ¥77/USD.

Against Asian currencies, the USD has also weakened in the past two to three months. On a year-to-date basis, the greenback has depreciated against the Singapore dollar (SGD), Indonesian rupiah (IDR), ringgit and Thai baht (THB) by 5.9%, 5.5%, 2.1% and 1.1% respectively, suggesting that investors' appetite for Asian currencies vis-à-vis the USD has strengthened in the wake of the troubles brewing in the world's largest economy in the past several months which have increased substantially the risk of holding USD-denominated assets.

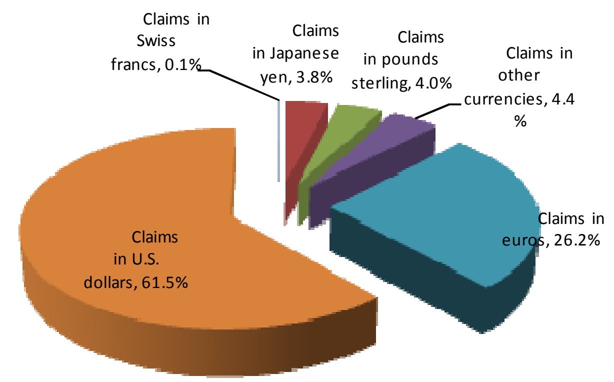
We believe that in the short term, because there will be few viable alternatives to the USD, demand for the greenback will not likely diminish dramatically, although the knee-jerk reaction has taken place against major currencies like the Great Britain pound (GBP), CHF, JPY. This was only to be expected. In the longer term, however, we foresee the trend of global central banks' diversifying their reserves away from the USD will continue and will slowly affect the status of the greenback as a global currency (see Charts 4 and 5).

Chart 4: Claims in USD (% of total allocated reserves)



Source: IMF

Chart 5: Official reserve assets profile in 2010 (% of total allocated reserves)



Source: IMF

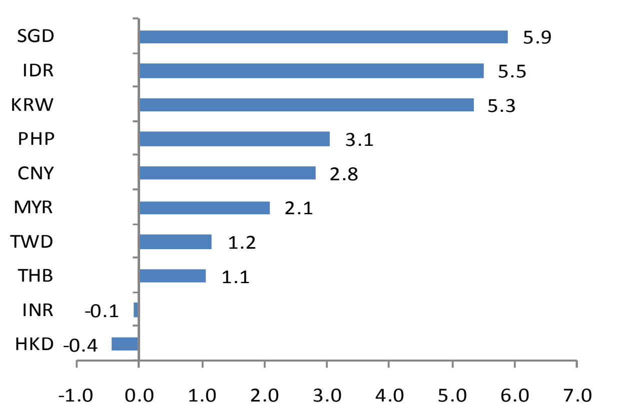
Impact on the Malaysian Economy

Impact on the ringgit

The impact on the ringgit and monetary policies to be potentially introduced by the monetary authority are among the factors that will affect the prospects of the Malaysian economy going forward. Against the USD, the ringgit has re-pierced through the RM3.00/USD resistance level for the third time in the third week of July and has been hovering between RM2.95 and RM3.00 per USD. With increasing upward pressures on the ringgit following lacklustre prospects of the greenback, we believe that BNM will closely monitor its gyrations against the USD so as to prevent any excessive impact on the financial market.

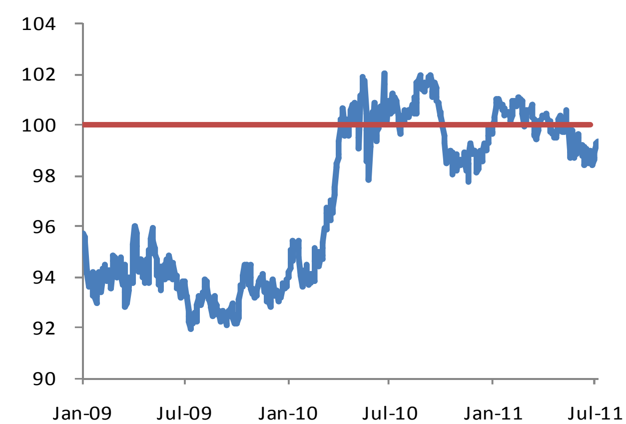
Notwithstanding this, major technical indicators such as Stochastics, Moving Average Convergence-Divergence (MACD) and Relative Strength Index (RSI) seem to indicate that the ringgit's bullishness will probably lose momentum in the medium term. This is likely due to the fact that Malaysia's economic growth is expected to decelerate in response to the slowdown in global demand for the country's major exports. As such, we foresee the ringgit to move within the range of RM2.95-RM3.05 in the short term.

Chart 6: Year-to-date performances of currencies (%)



Source: Bloomberg

Chart 7: Malaysia's Nominal Effective Exchange Rate (NEER)



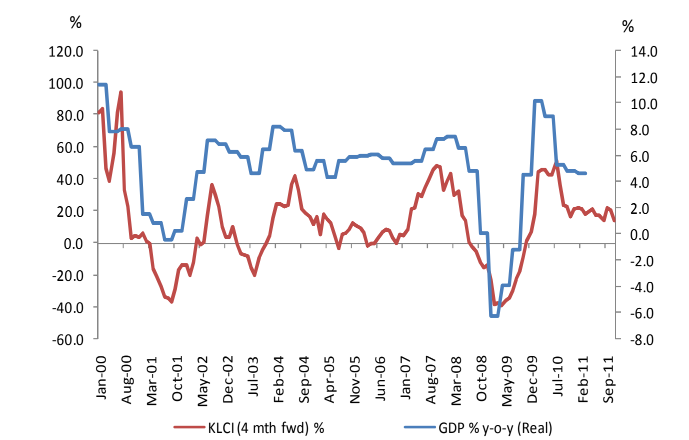
Source: MARC Economic Research

On the nominal effective exchange rate (NEER) basis, the ringgit has remained below 100 for four months, suggesting a slight undervaluation against its major trading partners, although the degree of undervaluation is diminishing. As Malaysia is highly exposed to global trade and will therefore likely be affected by a slowdown in global demand following heightened concerns over the debt problems in Europe and the US' significant economic slowdown, we opine that the NEER will have limited upside in the near future.

Impact on economic growth

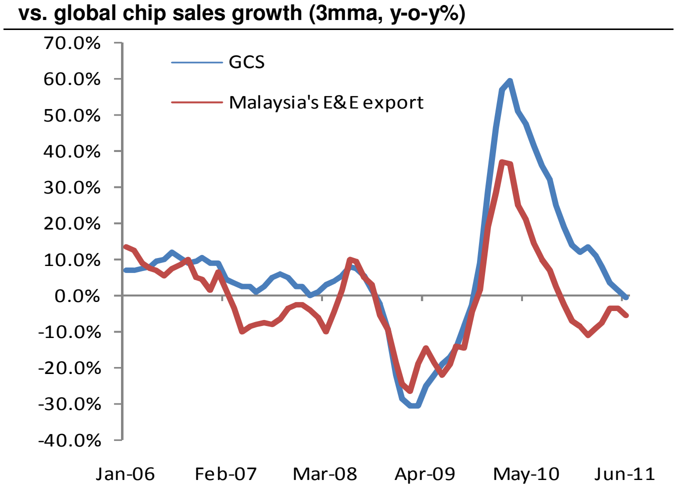
The current strength of the ringgit, while positive for consumer spending, will not likely lead to a jump in conspicuous consumption as sentiment is currently clouded by the slower prospects of economic growth and worries over the repercussions of external headwinds on the financial market, particularly the equity market. Secondly, the prevailing strength of the ringgit is also expected to complicate Malaysia's external trade performance which is already feeling the pinch from slower electrical and electronics (E&E) exports at this juncture.

Chart 8: Malaysia's equity market vs. GDP growth (%)



Source: CEIC

Chart 9: Malaysia's E&E export performance (3mma, y-o-y%) vs. global chip sales growth (3mma, y-o-y%)

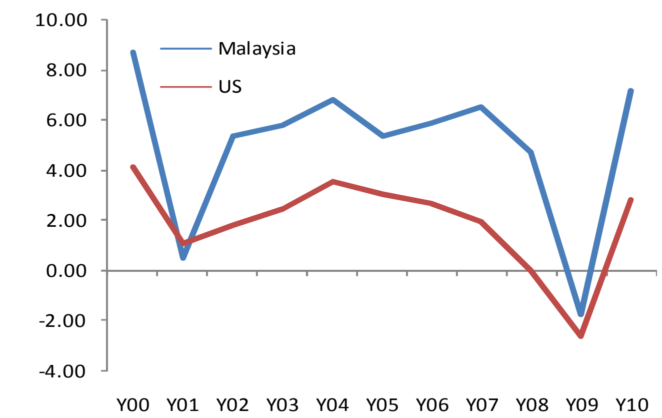


Sources: CEIC, Semiconductor Industry Association & MARC Economic Research
Note: 3mma = three months' moving average

A point of note is the fact that Malaysia's economic growth moves in tandem with that of the US, as evidenced by the high correlation between the GDP growth rates of both nations of 0.87 between 2001 and 2010. This phenomenon is largely attributed to the fact that Malaysia's exports, despite having diversified away from the US market in the past decade, are dependent on Asian countries who subsequently re-export to the Group of (G3) economies of the US, Japan and the euro area. The deceleration in demand from the G3 is reflected in Malaysia's considerably weak industrial production performance, with negative growth rates being recorded in the past two months (-5.1% in May and -1.7% in April).

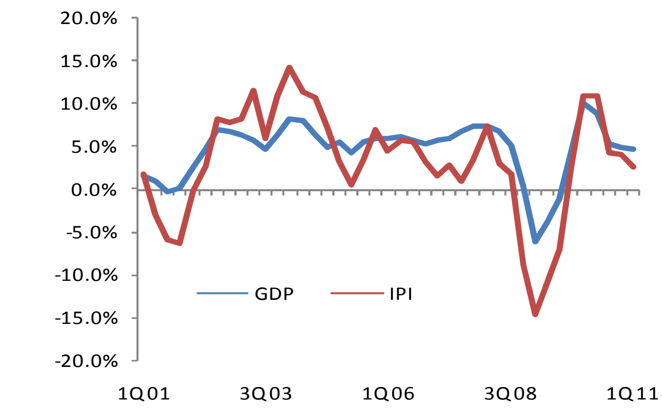
Against this backdrop, we opine that a material slowdown in the US economy will temper Malaysia's growth performance. Assuming that June's industrial production index (IPI) continues to register negative growth of circa 1%, Malaysia's 2Q2011 growth may decelerate to around 4%. Fortunately, however, Malaysia's private consumption is well supported by a strong labour market and easy access to credit, which, to some extent, buffer the economy against a precipitous decline in economic activity. As such, we see a heightened probability of Malaysia's GDP growth to moderate to between 4% and 5% this year, compared with our current forecast of a 5.3% growth.

Chart 10: Malaysia and US GDP growth (%)



Source: IMF

Chart 11: Malaysia's IPI and GDP (y-o-y%)



Source: CEIC

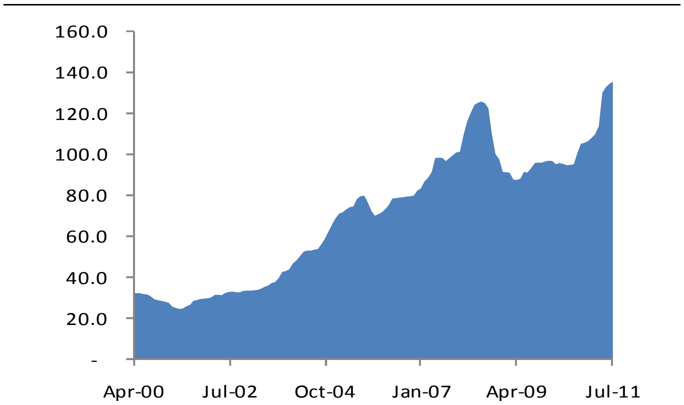
Impact on monetary policy

Expectations of upward pressures on the ringgit will be positive for capital inflows in the near term. Net inflows of portfolio investment into Malaysia have been positive for seven consecutive quarters with the latest figure of RM8.4 billion in 1Q2011, compared with net inflows of RM3.5 billion in 4Q2010. The deluge of hot money is also evidenced by growing foreign holdings of Malaysian Government Securities (MGS) to 33.5% of total MGS in June. Weak appetite for USD-denominated assets will likely raise the appeal of holding MGS from foreign investors' perspective, thereby increasing inflows of hot money into Malaysian shores.

Against this backdrop, we foresee BNM's future moves to be similar to those of regional central banks, i.e. not overly aggressive in hiking interest rates. Recent remarks by the BNM Governor suggest that the overnight policy rate (OPR) may not be the appropriate tool to address the problem of rising food prices, thus strengthening the argument that the central bank will not be in a hurry to raise interest rates when growth is on a moderating trend. It follows, then, that addressing the problem of low food sufficiency levels is preferred to monetary policy intervention.

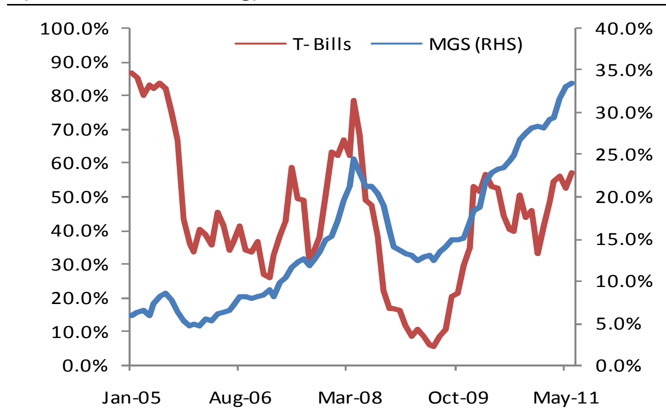
Going forward, we acknowledge that monetary policy conduct is increasingly challenging in the face of higher capital inflows: given the extremely low interest-rate environment in the advanced economies, raising the OPR will build in expectations of future rate hikes and further induce capital inflows. As such, we will not be surprised if macro-prudential measures are introduced by BNM in its valiant strife to balance growth and inflation. Some of the policies that have been adopted by other Asian countries to prevent excessive inflows of hot money may therefore be considered (see table in Appendix).

Chart 12: International reserve assets (USD billion)



Source: CEIC

Chart 13: Foreign ownership of MGS and T-Bills (% of total outstanding)



Source: CEIC

Appendix

Policy Tool	Recent Country Examples	Motivation/Objective
Limits to direct and indirect FX exposure	**Korea** (June 2010): Capped FX forward positions of banks relative to their equity capital. Reduce corporate FX hedging limit from 125% to 100% of export receipts.	By limiting derivatives positions, the measure indirectly targets a reduction in external borrowing by the private sector, particularly the banking sector. This exposure was also associated with carry trades onshore, including through "over hedging" of dollar receivables by Korean exporters.
Increase restrictions on external borrowing	**India** (Dec. 2009): Re-instated interest rate cap on eligible external commercial borrowing that was eliminated during the crisis.	To limit access to foreign credit to best corporate credits and prevent high cost borrowing.
Minimum holding period on central bank bills	**Indonesia** (June 2010): One month holding period on central bank bills (SBIs) instated for both domestic and foreign investors	To limit volatility of flows. SBIs had been subject to sharp shifts in positions relative to global risk appetite, as they were used as a carry trade vehicle. Holding period limits the volatility of flows on exit from positions.
Limited foreign access to central bank instruments	**Indonesia** (June 2010- present): Phased out one- and three-month SBIs in favor of nine- and 12-months SBIs, and expanded supply of nontradeable term deposits up to six months tenor, which are only available to banks operating in Indonesia.	To reduce volatility of inflows, and address concerns that central bank sterilization was attracting further inflows. Short-term SBIs, largely used to sterilize FX intervention, were a favored vehicle for carry trades.
Other restrictions on foreign access	**Taiwan Province of China** (Nov. 2009): Financial Supervisory Commission (FSC) barred access to time deposit accounts for foreign investors.	To dampen speculative flows. Time deposits are one avenue for carry trades/ currency speculation.
	Taiwan Province of China (Nov. 2010) FSC extended existing investment of nonresident inbound remittances in domestic securities to 30 percent, to include government securities of remaining maturity greater than one year.	Reduced access of nonresidents to government bonds.
Measures to encourage outbound investment by residents	**Malaysia** (Oct. 2010): Announced that the overseas investment limit of the Employee Provident Fund would be raised from 7 percent to 20 percent.	
	Philippines (November 2010): Increased ceilings on residents' purchase of FX and foreign assets from authorized agent banks. Prepayment of private sector FX loans allowed.	
	Thailand (February, September 2010): Raised ceilings on residents' outward direct investment, lending abroad, and foreign currency holdings.	
Reserve requirements on foreign currency and nonresident accounts	**Taiwan Province of China** (Jan. 2011): Raised reserve requirement on local currency accounts held by non-residents to 90 percent on balances exceeding the outstanding balance on December 30, 2010. Balances below end-2010 levels subject to 25 percent reserve requirement. Require reserves for such accounts are no longer remunerated.	To effectively bar banks from offering interest-bearing accounts to nonresidents.
	Indonesia (March 2011): Raised reserve requirement on foreign currency accounts from 1 to 5 percent. A further increase to 8 percent is scheduled for June 2011.	To limit bank vulnerabilities to inflow volatility, and to reduce incentives for banks to intermediate short-term inflows.
Withholding tax on foreign holdings of government bonds	**Thailand** (Oct. 2010): Reimposed 15 percent withholding tax (withdrawn in 2005) for state bonds on foreign investors. **Korea** (Jan. 2011): Reintroduced 14 percent withholding tax on foreign holdings of government bonds and central bank securities. In both cases, the impact has been limited due to wide coverage of double taxation treaties.	To slow inflows into government bond markets.

Source: IMF

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