Economic Research

KDN No.: PP14787/11/2012(030811)

MALAYSIAN RATING CORPORATION BERHAD
(364803-V)

Economic Outlook 2012: Facing the chill wind of the Euro crisis

Vol.: ER/002/2012

Economics Team

Nor Zahidi Alias
Chief Economist
+603 2082 2200
zahidi@marc.com.my

Mohd Afzanizam Abd Rashid
Economist
+603 2082 2200
afzanizam@marc.com.my

Please read the disclaimer on the last page of this report

In a nutshell

- The global economic outlook remains murky amidst the debt debacle in the European economies. The International Monetary Fund (IMF) is projecting the world economy to grow at a 4.0% clip in both 2011 and 2012, down from June's estimates of 4.3% and 4.5% respectively. Accordingly, advanced economies are expected to register meager growth rates of 1.6% in 2011 and 1.9% in 2012 while emerging and developing economies are anticipated to expand by more than 6.0% over the same period.

- Despite being relatively robust, the risk for Asian economies has shifted downside with growth rates moderating even for economic powerhouses such as China and India. However, the fight against inflation in the past 18 months through upward adjustments in policy rates suggests that central bankers in Asia have some ammunition to counter cyclical downturns. As such, the direction of policy rates in 2012 is likely to be on the downside.

- As for the Malaysian economy, recent high frequency global data seems to suggest that forces from external headwinds cannot be underestimated and the events that are unfolding in the European economies have heightened risk aversion. This, in our view would continue to exert downward pressure on the real economy via weaker demand for exports and, more importantly, destabilising outflows of capital, especially portfolio investments. Offsetting this, however, is the US macroeconomy which has emitted more positive signals in recent months.

- Malaysia's external sector performance may not able to withstand the headwinds from weak global demand arising from the trouble brewing in the European continent. In addition, a persistent rise in risk aversion among investors may somewhat dampen their enthusiasm in 2012. As such, the pace of foreign direct investment (FDI) flows into the region – including in Malaysia – will likely soften from levels in 2011.

- Notwithstanding this, consumers will continue to support the economy, although the sentiment may slightly be dented by the weakness in the financial market and measures undertaken by the Bank Negara Malaysia (BNM) to cap Malaysia's household debt. After taking account critical factors that affect growth, we envisage that the economy will expand at a rate of 4.4% in 2012.

- As for inflation, we opine that the headline number has responded to both demand-pull and cost-push pressures in the past several months, causing the rate to remain above 3% for quite some time. Going forward, factors such as (1) a more cautious stance by consumers; (2) the high base effect; and (3) a general slowdown in economic growth will likely tame the headline inflation number for 2012. As such, we foresee the inflation rate to be circa 2.5% in 2012 from the 3.3% pace in 2011.

- With the economic momentum set to moderate in 2012, interest rate bias will likely be on the downside as the BNM shifts its focus to prevent growth from slipping too fast. At the same time, with inflationary pressure likely to remain benign following softer demand-pull and cost-push factors, lowering the interest rate will not likely bring any adverse repercussions to the general economy. As such, we think that a 25 to 50 basis-point cut in the Overnight Policy Rate (OPR) could be undertaken by the BNM in 2012, bringing the policy rate to 2.5% - 2.75%.

- We opine that the trend of increasing capital outflows will persist in the near future as international investors continue to move funds into US dollar-denominated assets. Of the forces that could influence Malaysia's foreign exchange, the possible outflows of portfolio investment is probably the most crucial in determining the trend of the ringgit in the near term. Judging by the growth outlook, inflation, interest rate expectations as well as the trend in capital flows, we anticipate the ringgit will still hover above the RM3.00 level against the US dollar and will have limited upside against the greenback in 2012.

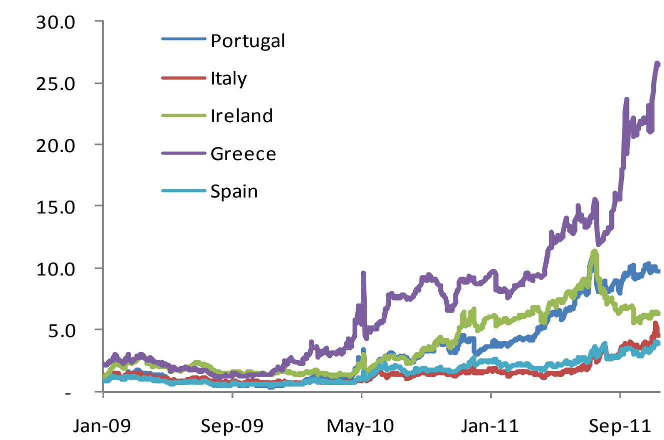
The year 2011 in retrospect

Advanced economies in limbo

The year 2011 has been an eventful year for the economy, with the most powerful earthquake recorded in Japan striking the country in March and causing massive disruptions in global supply chains, a move by international ratings agency Standard & Poor's (S&P) to downgrade the US' AAA sovereign rating which shocked the global financial market, and the debt crisis that erupted in Europe. As at the time of writing, concerns on the state of public finances in Europe are heightening as policymakers struggle to find means to maintain political stability while addressing critical macroeconomic problems.

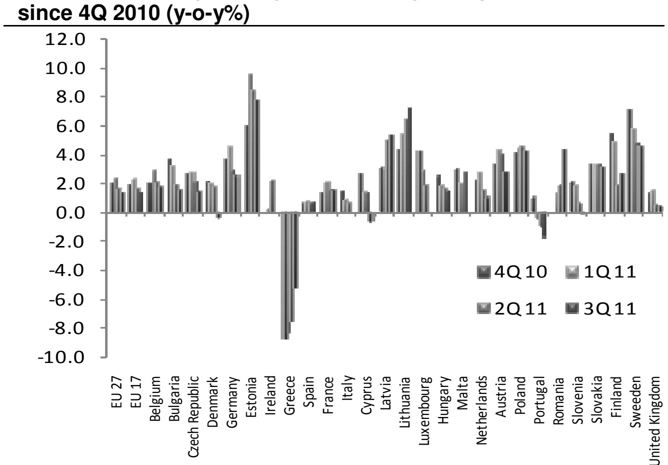
As events unfolded, market confidence slowly dissipated, leading to a steep rise in sovereign bond yields and causing difficulties for businesses to get access to funding via capital markets. This is reflected in the widening yield spread against German bunds for debt-stricken countries, with Greece and Spain seeing the widest spread among the euro zone economies. Additionally, risks of a sovereign rating downgrade of major euro zone economies could be a potential threat to the AAA rating accorded to the European Financial Stability Facility (EFSF), a special purpose vehicle that was created to expedite the disbursement of financial assistance. To make things worse, real economic activities are slowing sharply in some countries, raising concerns that they may fall into another recession in 2012.

Chart 1: Sovereign yield spread against German bund (basis points)



Source: Bloomberg

Chart 2: Quarterly GDP growth among European economies since 4Q 2010 (y-o-y%)



Source: Eurostat

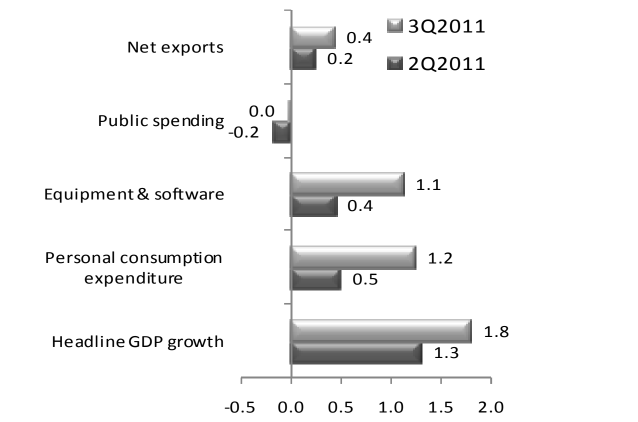
The collective 17 economies under the euro zone grew at a much slower pace of 1.4% y-o-y in 3Q2011 from 2.4% and 1.7% registered in 1Q2011 and 2Q2011 respectively. Even relatively strong economies such as Germany and France posted smaller growth rates in 3Q2011 while countries such as Spain, Ireland and Italy stagnated. Greece and Portugal were already in recession. In terms of labour market conditions, Spain and Greece were in the worst state, with their jobless rates soaring to 22.8% and 18.3% in October 2011 respectively from 20.4% and 14.0% in November 2010. Economic prospects look increasingly challenging for both countries as austerity measures continue to put a brake on their growth in the near term.

Notwithstanding this, consolation comes from US, the world's largest economy, where high-frequency data continues to emit positive signals despite political gridlock over how to address the country's budgetary problems. The latest economic releases from officials confirmed that the unemployment rate has finally come down from the 9.0% level in November while the ISM new orders spiked to above 50 points. At the same time, there has been a notable improvement in access to credit, as evidenced by the 2.4% y-o-y growth in consumer credit. All these suggest that the economy is slowly regaining its footing.

The 3Q2011 GDP statistics also suggest that domestic demand is on the mend with significant contributions coming from personal consumption expenditure (PCE) and fixed investment, particularly in the equipment and software (E&S) sector. The PCE and E&S sectors contributed about 1.24 (2Q2011: 0.49 percentage points) and 1.12 (2Q2011: 0.44 percentage points) percentage points to the 1.8%

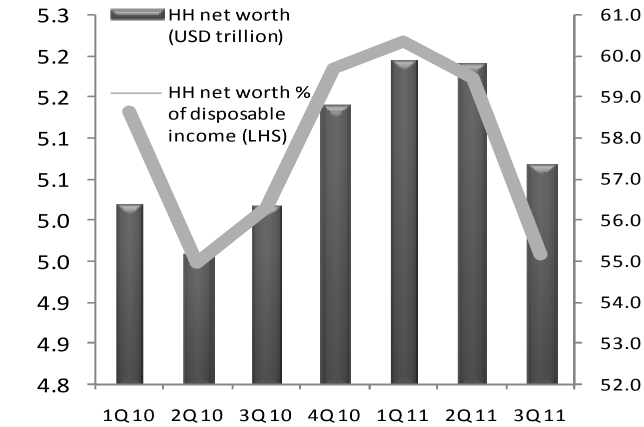
headline growth in 3Q2011. Notwithstanding these positive developments, we remain slightly cautious on the US economy as the recovery process is still fragile based on the statistics on household net worth which fell to US$57.4 trillion in 3Q2011 from a cyclical high of US$60.0 trillion in 1Q2011. Therefore, consumers will likely stay cautious as the labour market has yet to fully recover.

Chart 3: Contributions to US GDP growth during 3Q2011 and 2Q2011 (percentage points)



Source: US Bureau of Economic Analysis (BEA)

Chart 4: US household (HH) net worth in US$ trillion and as percentage of disposable income



Source: Flow of Funds Account, US Fed

Apart from the US, Japan is making good progress after being severely impacted by the Great East Japan Earthquake in March. The policy response was quite forthcoming as the Japanese authority worked on their first and second supplementary budgets for the fiscal year 2011 after being approved on July 29. Subsequently, business supply chains have steadily recovered judging by the growth numbers in 3Q2011 where the GDP rebounded strongly by 5.6% annualized rate after contractions of 2.0% and 6.6% in 2Q2011 and 1Q2011 respectively.

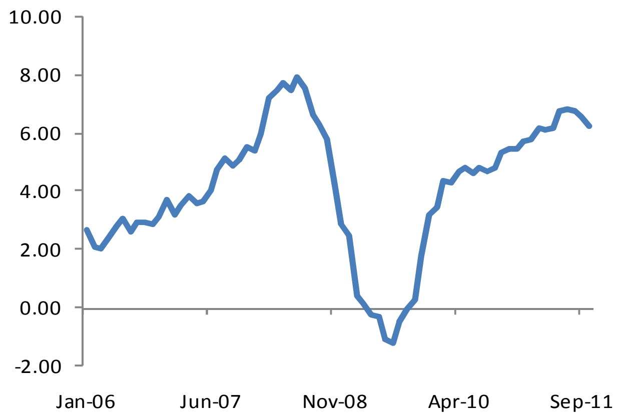
Going forward, however, we foresee that the Japanese economy will continue to face further challenges as its currency, the yen, appreciated sharply by 4.8% on a year-to-date basis and is weighing on exporters' revenue. To this end, the government has come up with comprehensive plans to deal with the rising yen which include measures to promote mergers and acquisitions (M&A) and procurement of natural resources by increasing the lending facility between the Foreign Exchange Financing Special Account and the Japan International Cooperation Bank (JBIC) from 8 trillion yen to 10 trillion yen.

Asia: Growth concerns are heightening

The sovereign debt problem in the advanced economies is no doubt a primary concern among Asian economies. For instance, despite still growing at a reasonable pace, China's economy is slowly feeling the pinch from weak external demand as evidenced by sluggish export growth in recent months. As a result, the Chinese authorities are considering implementing policy responses to counter the effects of weak global demand. Nonetheless, policy maneuvering is somewhat tricky in Asia compared with the developed economies given that inflationary pressures, although moderating, are still causing sleepless nights among policymakers. Additionally, credit growth is still somewhat robust despite registering modest increases in recent months. As such, should there be a sudden shift in capital inflows (outflows), domestic economies will be devastated.

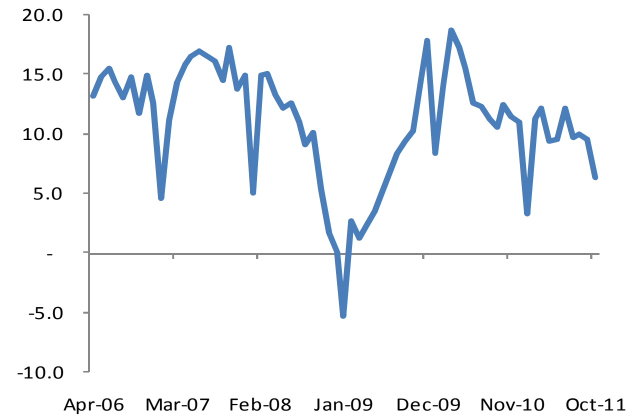
Rising international reserve assets, although positive for liquidity conditions in many Asian countries, have led to stronger asset price inflation. What is more worrying is the fact that much of the inflow has been through capital accounts and is short term in nature. Foreign purchases of domestic bonds have increased dramatically in the past one year as investors shunned advanced economies in favour of the relatively high-growth economies in Asia. As such, foreign holdings of domestic bonds have escalated, increasing the risk of sudden outflows of capital that can disrupt real economies.

Chart 5: Aggregated consumer price index (CPI) of selected Asian countries (%)



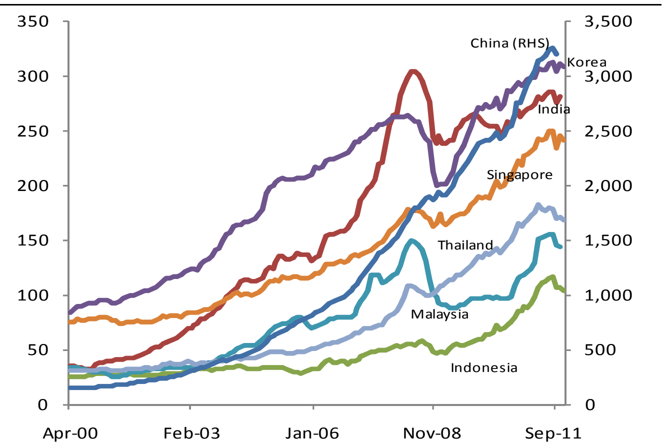
Source: CEIC, MARC Economic Research

Chart 6: Aggregated industrial production index (IPI) of selected Asian countries (%)



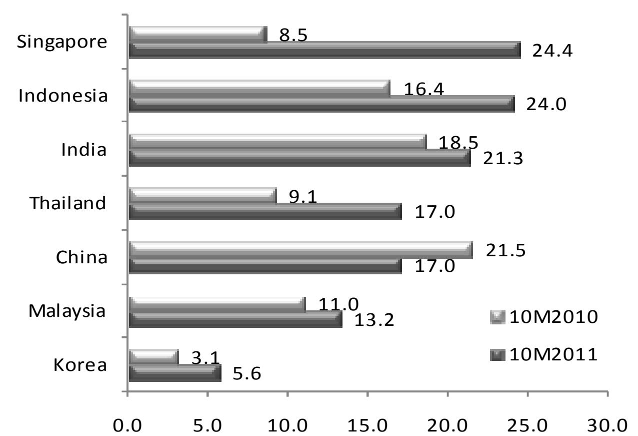
Source: CEIC, MARC Economic Research

Chart 7: International reserve assets in US$ billion



Source: CEIC

Chart 8: Average loan growth in the past 10 months (%)



Source: CEIC

Against this backdrop, central banks in the Asian region have engaged macro prudential measures to address the imbalances in the financial market. For instance, on August 29, the People's Bank of China (PBOC) expanded the deposit coverage for the purpose of computing its reserve requirement that includes margin deposits, letters of guarantee and letters of credit. In Indonesia, on 30 September, the Bank of Indonesia (BI) imposed a requirement to exporters to transfer their proceeds from offshore banks into domestic banks within a period of three months. Thus far, the BI and Bank of Thailand (BOT) have reduced their policy rates while the PBOC resorted to a reduction in the reserve requirement ratio.

On the growth front, China's economic momentum has moderated with GDP growth slipping to 9.1% in 3Q2011, below its average growth of 9.5% since 1Q2009. Similarly, in other economies such as Indonesia, Korea, Malaysia and Thailand, growth rates have moderated in 3Q2011 compared with the preceding quarters as external demand took a toll on their economic activities. On the inflation front, the aggregate consumer price index (CPI) of selected Asian economies showed that the inflation rate softened to 6.25% in October 2011 from 6.83% in July.

Table1: Quarterly GDP growth (y-o-y%)

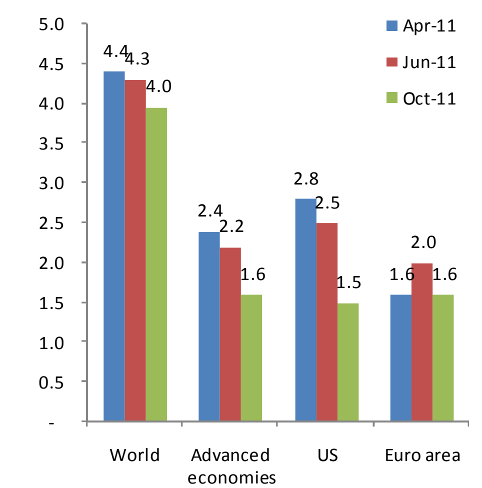
	1Q 10	2Q 10	3Q 10	4Q 10	1Q 11	2Q 11	3Q 11
China	11.9	10.3	9.6	9.8	9.7	9.5	9.1
India	9.4	8.8	8.4	8.3	7.8	7.7	6.9
Indonesia	5.6	6.1	5.8	6.9	6.5	6.5	6.5
Korea	8.4	7.3	4.4	4.7	3.9	3.4	3.5
Malaysia	10.1	9.0	5.3	4.8	5.2	4.3	5.8
Singapore	16.4	19.4	10.5	12.0	9.4	1.0	6.1
Thailand	11.8	9.1	6.5	4.0	3.0	2.8	3.5

Sources: CEIC & Bloomberg

Prospects for advanced and Asian economies

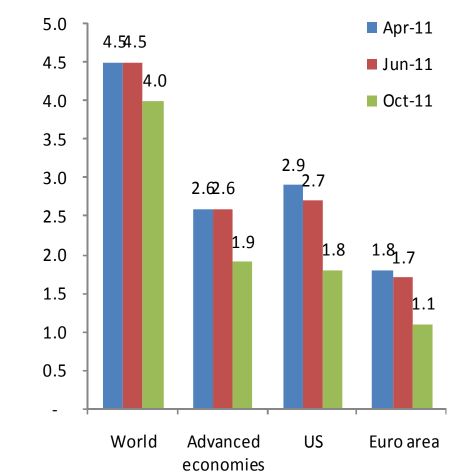
The World Economic Outlook issued by the IMF in October stated that the world economy is in a dangerous phase with uneven activities and rising downside risks. The global economy is projected to grow at a 4.0% clip in both 2011 and 2012, down from June's estimates of 4.3% and 4.5% respectively. Accordingly, advanced economies are expected to register meager growth rates of 1.6% in 2011 and 1.9% in 2012 while emerging and developing economies are anticipated to expand by more than 6.0% over the same period. The negative output gap will likely persist in 2012 for the Organization for Economic Cooperation and Development (OECD) countries, suggesting that monetary policies will continue to be accommodative.

Chart 9: IMF forecasts for 2011 (%)



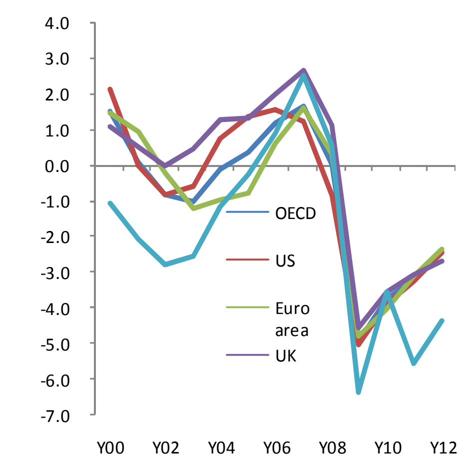
Source: IMF

Chart 10: IMF forecasts for 2012 (%)



Source: IMF

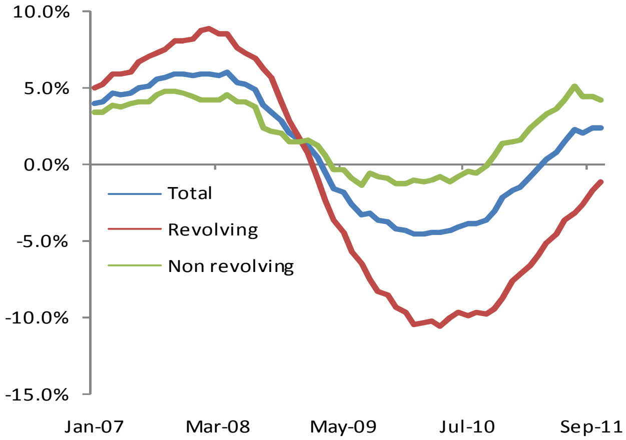
Chart 11: Output gap (%)



Source: OECD

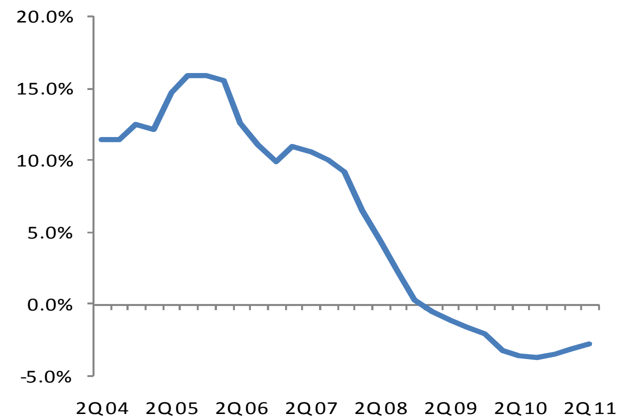
The prospects of further quantitative easing in the US have dimmed at this juncture as access to credit continues to improve. This is premised on rising consumer credit growth which has persisted in the past seven months after contracting since March 2009. In addition, the drop in mortgage debt outstanding has been reduced with the latest number in 2Q2011 showed a decline of 2.8% y-o-y compared with a 3.7% contraction in 3Q2010. The "Operation Twist" announced by the Fed has managed to reduce the long-term rates, although the effect has been quite minimal. Thus far, the 30-year US Treasury yields have fallen by 11 bps since the inception of the program while yields for the 3-year bonds were practically unchanged.

Chart 12: US consumer credit growth (y-o-y%)



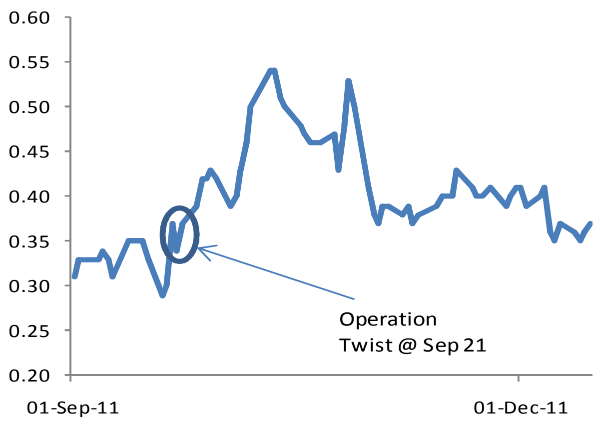
Source: CEIC

Chart 13: US mortgage debt outstanding growth (y-o-y%)



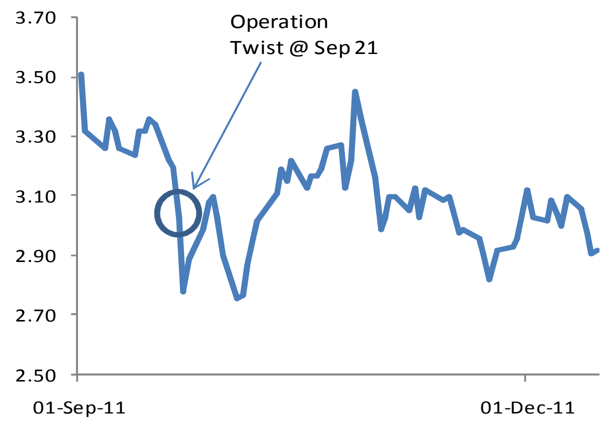
Source: CEIC

Chart 14: US Treasury bond 3-yr yield (%)



Source: CEIC

Chart 15: US Treasury bond 30-yr yield (%)



Source: CEIC

What is more pressing in the US is the political gridlock that could potentially undermine the recovery process. Although the payroll tax cut extension has been temporarily approved for another two months, the issue will likely continue to dominate the US political debate in 2012. This could potentially have an impact on consumer sentiment, a pivotal part of the economy.

In the euro zone, the fiscal compact agreed on December 9 by most of the member states suggests that the region is pushing for stronger economic cooperation in addressing the current crisis. The governments in European countries are determined to improve the state of public finances by forcing member states to incorporate procedures to contain excessive deficits in their constitutions. Despite this, market confidence has yet to recover judging by yields of debt-stricken economies which remain on relatively elevated levels. We expect such dynamics to continue well into 2012.

The risk for Asian economies has shifted downside. The fight against inflation in the past 18 months through upward adjustments in policy rates suggests that central bankers in Asia have some ammunition to counter cyclical downturns. As such, the direction of policy rates in 2012 will likely to be on the downside. Already, the Reserve Bank of India (RBI) – the most aggressive central banker in hiking up rates – has refrained from raising the repo rate in December's meeting.

Prospects for Malaysian Economy in 2012

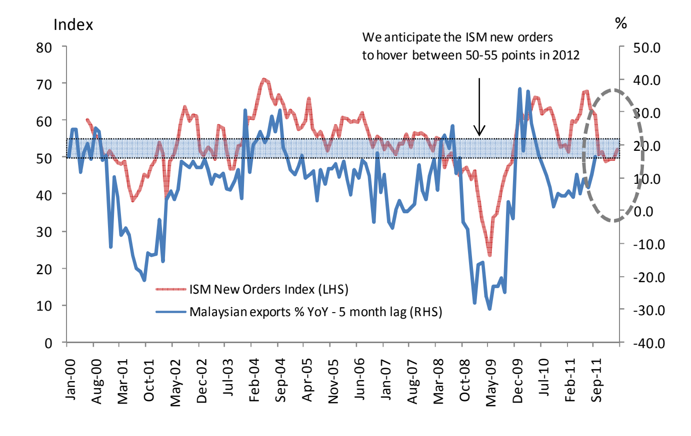
Growth – downward bias due to external headwinds

Recent high-frequency global data suggest that forces from external headwinds cannot be underestimated. Events unfolding in the European economies have heightened risk aversion, exerting downward pressure on the real economies of Asia through weaker demand for Asian exports and, more importantly, destabilising outflows of capital (portfolio investment). As a consequence, business sentiment will erode while the external sector's sluggishness will reverberate across regional economies.

Offsetting this, however, is the US' macroeconomy, which has emitted more positive signals in recent months. Although growth has been revised to a subpar 1.8% (from 2.0%) in 3Q2011, manufacturing activity has improved, as evidenced by a steady rise in the Institute of Supply Management (ISM) new orders component. New jobless claims have also continued to slide despite the relatively loose labour market, with an unemployment rate of 8.6%. Investments are also gaining momentum, judging by the double-digit expansion in the equipment and software sector in recent quarters.

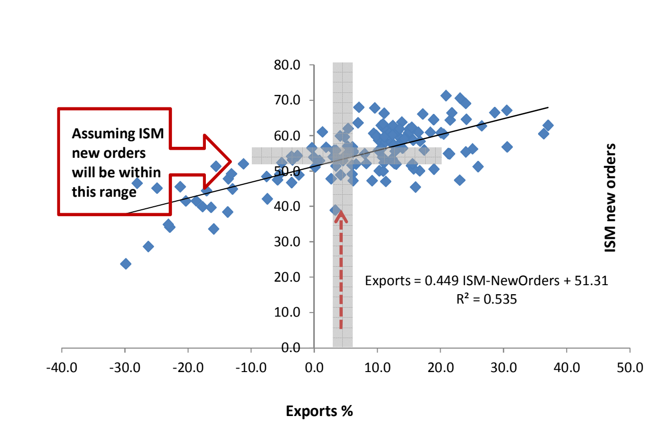
In our base-case scenario, we expect the ISM new orders gauge to hover at around 50 to 55 points in 2012. With such a moderate outlook, we opine that our gross exports will expand at a slower pace of 3% and 6% (Chart 17). Given this scenario, we anticipate industrial production to grow by between 1.5% and 3.5%. An examination of manufacturing sale statistics also suggests that the expected increase in sales by 6% to 8% in 2012 will lead to a likely growth in Malaysian industrial production that is within our projected range of 1.5% and 3.5%.

Chart 16: ISM new orders and Malaysia's exports (5-mth lag) (%)



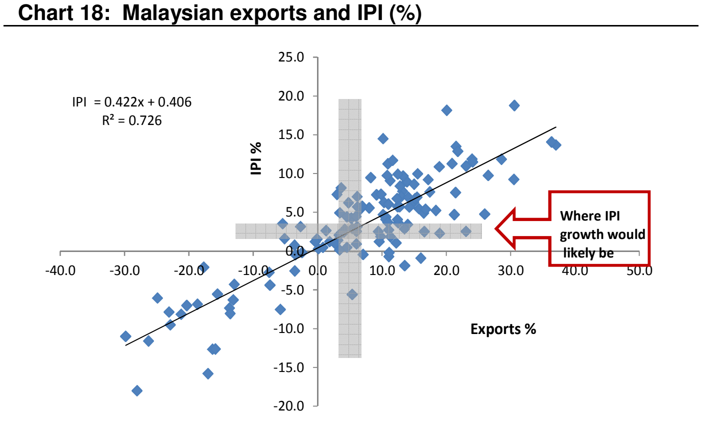
Source: CEIC and MARC Economic Research

Chart 17: ISM new orders and Malaysia's exports (5-mth lag) - scatter (%)



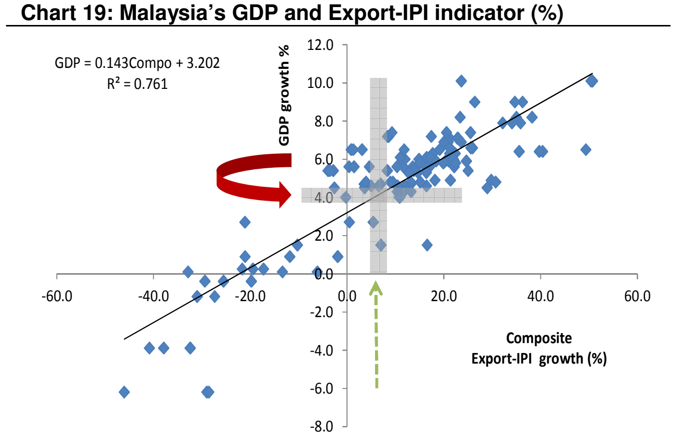
Source: CEIC and MARC Economic Research

Chart 18: Malaysian exports and IPI (%)



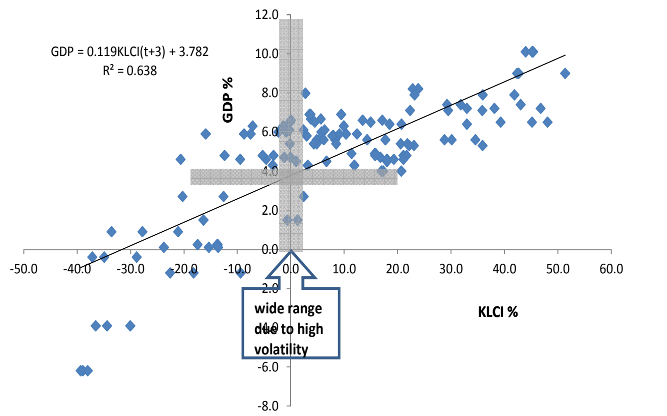
Source: CEIC and MARC Economic Research

Chart 19: Malaysia's GDP and Export-IPI indicator (%)



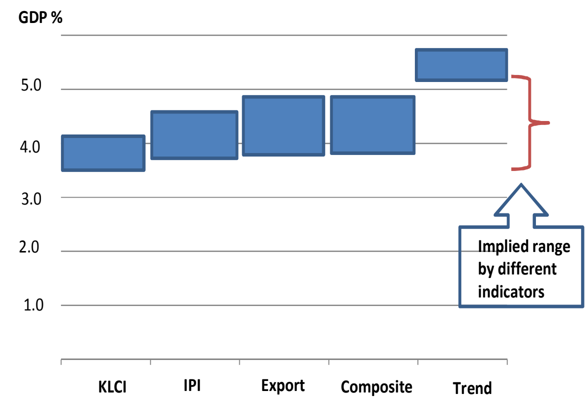
Source: CEIC and MARC Economic Research

Chart 20: Malaysia's FBM KLCI and GDP growth (4-mths lag) (%)



Source: CEIC and MARC Economic Research

Chart 21: Malaysia's GDP growth range (%)



Source: CEIC and MARC Economic Research

When another mapping exercise is done using the growth rates of the composite 'Export-IPI' indicator (which we define as a simple summation of export and IPI growth) and gross domestic product (GDP), we arrive at a possible GDP growth range of 4% to 4.8% for 2012. The expected performance of the equity market is also taken into consideration as the benchmark index, i.e. the FTSE Bursa Malaysia Kuala Lumpur Composite Index (FBM KLCI), provides a relatively good picture of future GDP growth trends. By examining the general outlook of the equity market for 2012 and coupling it with other macro indicators, we arrive at the possible range of GDP growth through proper weightages.

Based on these indicators, we envisage the economy to expand by between 3.8% and 5.0% in 2012. Taking the mid-point of the range, we pencil in our GDP projection of 4.4% for 2012.

Private consumption – still our greatest hope

Consumer spending will continue to support the economy, although sentiment may be slightly dented by weak financial market performance and measures undertaken by BNM to put a lid on domestic household debt. As such, we anticipate private consumption to grow by 6.4% in 2012 on account of (1) the relatively steady labour market despite the fragility of the manufacturing sector; (2) the feel-good factor brought about by the government's plan to upgrade the salary scale of civil servants in 2012; and (3) the still relatively easy access to credit through bank lending to the household sector.

The last factor is crucial in supporting consumer spending patterns, although BNM has recently tightened financial institutions' guidelines for lending (such as using net income to determine eligibility for loans, and imposing a cap on the amount of credit extended by credit cards for cardholders with income levels of less than RM3,000 per month). This is due to the fact that banks will continue to target households in their drive to expand loan growth and will therefore make extra effort to reach out to more eligible borrowers, while non-financial institutions like cooperatives will continue to entice civil servants to take up as much credit as they possibly can.

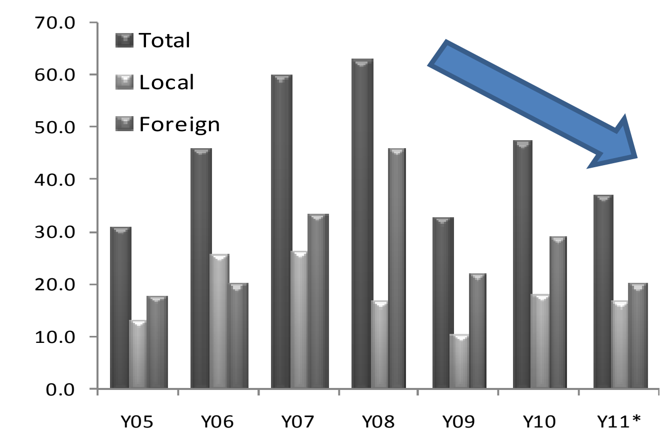
Private investment – not a short term remedy

While the government is banking on the momentum of private investment to invigorate the economy in 2012, a persistent rise in risk aversion among investors amidst shaky global economic prospects may somewhat dampen investor enthusiasm. As such, the pace of FDI flows into the region (including Malaysia) will likely soften from their levels in 2011. The weakening of global FDI flows will also affect cross-border M&As and acquisitions, leading to slower growth in private investment.

However, offsetting the above effects is the respectable momentum of the Economic Transformation Programme (ETP) projects which may have pushed private investments up by a double-digit pace in 2011, a phenomenon that we have rarely seen in the past decade. As of November 2011, about 53% of the 131 targeted entry point projects (EPP) have taken off. Of the total value of RM171 billion in committed investments, approximately RM10 billion has been realised and another RM5 billion is expected to be realised by the end of 2011. At the same time, of the RM51.2 billion worth of private investment generated in the first half of 2011, about RM10 billion came from EPPs' realised investments.

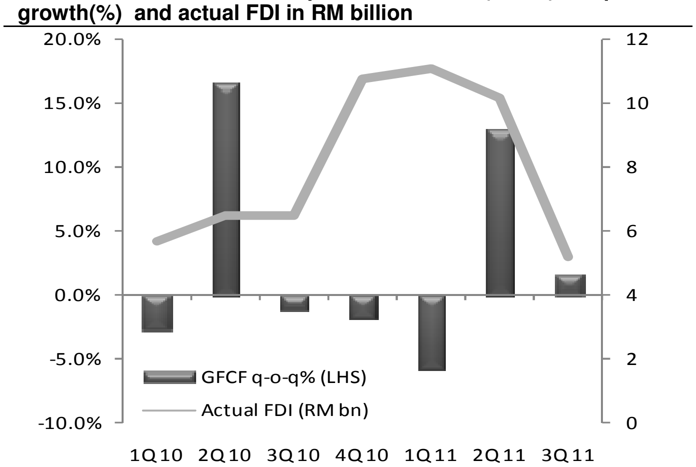
Notwithstanding the success of the ETP, private investment will not likely be able to carry the economy through the rather turbulent waters of 2012 due to its relatively small share of GDP (about 12% in 2010). While the spillover effect from private investments may trickle through the economy via a stronger construction sector (and hence services sector), the adverse effects from the external sector will likely overshadow such positive effects. As such, we foresee private investment to expand at a slower pace of 9.1% in 2012 compared with the government's forecast of 15.9% expansion.

Chart 22: Manufacturing investment approvals (RM billion)



Source: CEIC
*first nine months of 2011

Chart 23: Gross fixed capital formation (GFCF) sequential growth(%) and actual FDI in RM billion



Source: CEIC

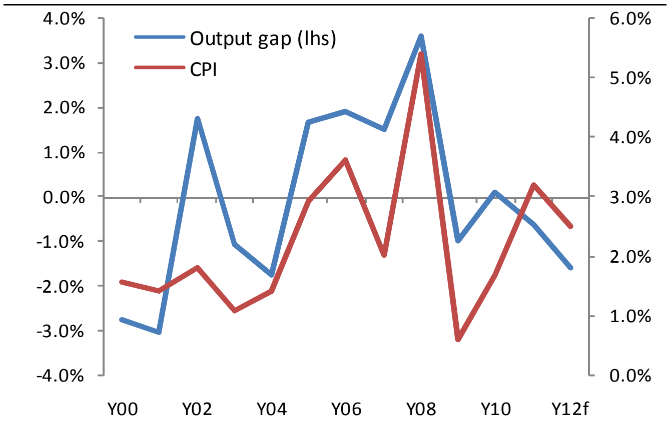
Headline inflation – not a major problem

Asian economies – including Malaysia – will likely see a more benign inflation environment in 2012, based on the rather dim growth scenario painted above. Even India, where inflationary pressure has been relatively stubborn in the past one year, has seen its Wholesale Price Index (WPI) dropping to 9.1% in November, from close to 10% in preceding months.

For Malaysia, we think that the headline number has responded to both demand-pull and cost-push pressures in the past few months, causing the rate to remain above 3% for some time. A vibrant consumer sector following stable labour-market conditions, coupled with the rising cost of raw materials, have led to persistent increments in food prices. Indeed, since July 2007, when civil servants last received a broad-based salary revision, food prices have escalated by 23.9% while the headline CPI rose by 12.3%.

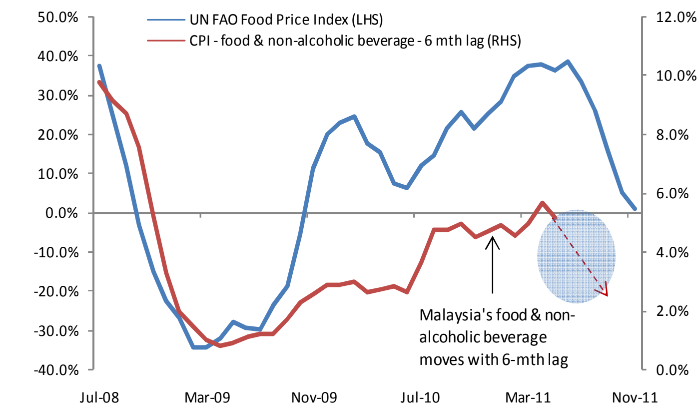
Going forward, we do not anticipate a significant increase in Malaysia's CPI although food prices will remain a thorny issue despite a possible moderation in the food and beverage index as indicated by a decline in the United Nations FAO food price index (Chart 25). The concern over food prices is due to (1) unfavourable supply factors as Malaysia remains a major importer of food; and (2) a trickle-down effect from continual subsidy-rationalisation efforts by the government. Notwithstanding this, opposing forces such as (1) a more cautious stance by consumers; (2) the high-base effect; and (3) a general slowdown in economic growth will likely tame the headline inflation number for 2012. Thus, we foresee CPI inflation to be circa 2.5% in 2012 following a 3.3% pace in 2011.

Chart 24: Output gap and CPI (%)



Sources: CEIC & MARC Economic Research

Chart 25: International food price index versus Malaysia's food and beverage index – 6-mth lag (%)

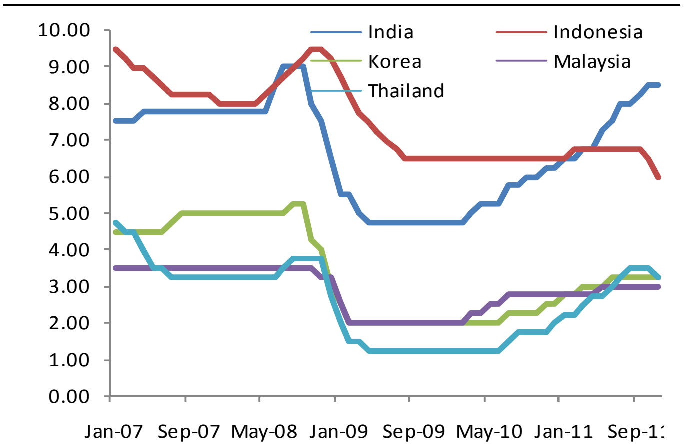


Sources: CEIC & UN

Interest rate – on downward trajectory, naturally

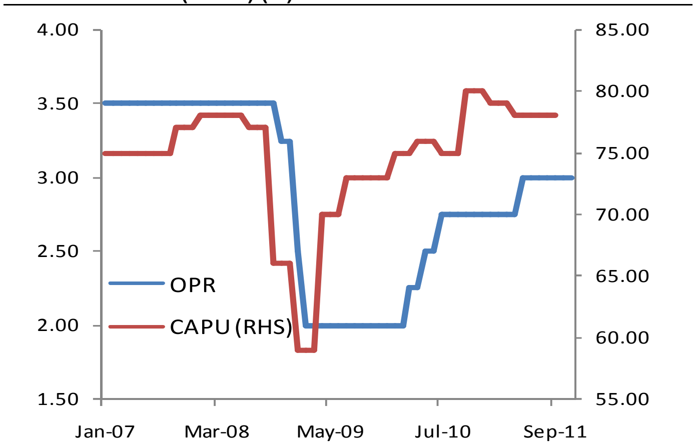
With economic growth set to moderate in 2012, the interest rate bias will likely be on the downside as BNM shifts its focus to prevent any sharp decline in economic activity. Such growth-bolstering measures have, to some extent, been undertaken by regional central banks. Indonesia's central bank, for instance, frontloaded its interest-rate cut by 75 basis points for fear of a sharp decline in its GDP growth. Similarly, China's central bank reduced domestic banks' reserve requirement ratio in mid-December — the first time in the last three years — and is expected to continue loosening its monetary policy, following signs of sluggish export growth in November, and a decline in the growth of money supply to the lowest level in a decade.

Chart 26: Regional policy rates (%)



Source: CEIC

Chart 27: Malaysia's overnight policy rates (OPR) and capacity utilization rates (CAPU) (%)



Source: CEIC

As for Malaysia, recent remarks by BNM suggest that policymakers are ready to implement measures to support growth, although there are limits to what monetary policy can do, and that fiscal measures are needed to provide more impetus to economic growth. Taking cognisance of the fact that the government's fiscal side is constrained by the need to keep budget deficits in check, we think that there is some likelihood for BNM to undertake mild accommodative measures to complement the government's measures to prevent a sharp deterioration in the economy in 2012. At the same time, with inflationary pressures likely to remain benign following softer demand-pull and cost-push factors, lowering interest rates will not likely bring about any adverse repercussions to the general economy. Hence, we think that a 25 to 50 basis-point cut in the OPR could be on the cards in 2012, bringing the policy rate down to the range of 2.5% to 2.75%.

Capital flows – something worth watching

Recent statistics on the balance of payments (BoP) raised some eyebrows due to a sizeable amount of net capital outflows in 3Q2011. On the whole, the BoP registered a much smaller surplus of RM10.9 billion, down from RM61.7 billion in the preceding quarter following net outflows of RM23.3 billion in the financial account which was largely attributed to equally massive RM23.4 billion net outflows in portfolio investment. This is hardly surprising, as global portfolio managers switched back to the greenback in search of safe-haven financial instruments amidst heightening risk aversion.

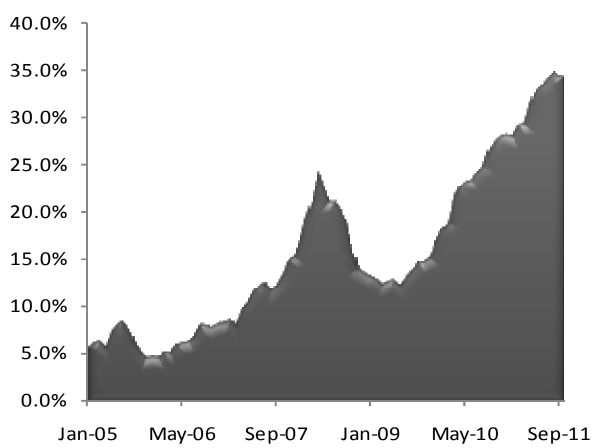
It is worth highlighting that we view that this trend in outflows will persist in the near future as international investors continue to move funds into US dollar-denominated assets. The reasons are as follows: (1) any jitters in the financial market will lure asset managers back to the greenback for safe-haven purposes; (2) further signs of a steady recovery in the US economy will make Asian economies less appealing on a relative basis, as the latter will continue to be confounded by the conflicting aims of containing asset-price inflation while supporting economic growth at the same time; and (3) massive amount of inflows into Malaysian Government Securities (MGS) in the past year will mean a higher probability of outflows when investors start to rebalance their portfolios in favour of the US market. Given this scenario, Asian currencies – including the ringgit – will likely be on a downward trajectory against the US dollar going forward.

Ringgit – to sail through a rough sea due to market volatility

Rising volatility in global exchange rates in recent years have indubitably complicated the task of evaluating the ringgit's movement. Out of all the forces that could influence the ringgit's movement, possible outflows of portfolio investment are probably the most crucial in determining the trend of the ringgit in the near term. This is based on the possible reversal in capital flows following a dramatic increase in the percentage of foreign holdings of MGS to total MGS outstanding to an all-time high of 35% in August 2011. Neighbouring Indonesia also experienced massive inflows into its government debt instruments.

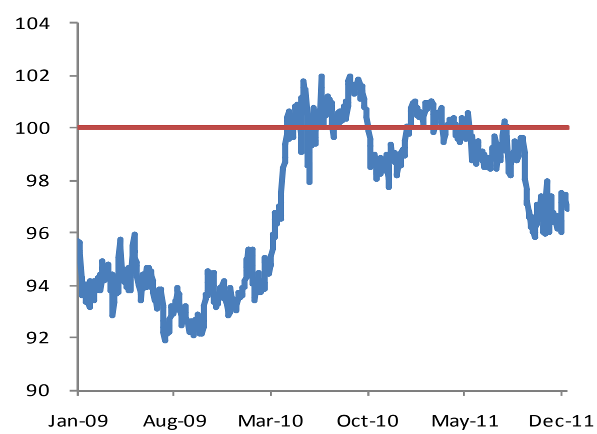
As for the ringgit, judging by the outlooks of growth and inflation, interest-rate expectations as well as the trend in capital flows, we expect the ringgit to continue hovering above the RM3.00 level against the US dollar in 2012. We generally believe that the ringgit will have limited upside against the US dollar due to: (1) rising flow of funds into US dollar-denominated assets as the US economy continues to emit positive signals; (2) lower growth prospects for the Malaysian economy and Asia in general following lag effects of the European economic turmoil; and (3) portfolio outflows from Malaysian shores as investors seek to rebalance their positions after being heavily invested in MGS in the past two years. Therefore, we opine that the ringgit will trade mostly in the range of RM3.10 to RM3.30 against the greenback in 2012.

Chart 28: Foreign holding of MGS as % of outstanding



Source: CEIC

Chart 29: Malaysia's nominal effective exchange rate (NEER)



Source: MARC Economic Research

Government financial condition – no qualm over the target

Although the government's budget deficit target for 2012 of 4.7% of the country's GDP may seem like a tall order, we think that this is achievable if GDP growth does not fall too drastically in 2012. This confidence is derived from the observation that the projected deficit target is based on relatively low growth in government revenue, which we think can be surpassed if the economy does not shrink dramatically in 2012.

Our view is also strengthened by the fact that Malaysia's tax-to-GDP ratio is one of the highest in the region. Barring any unforeseen need to aggressively expand fiscal policy to support growth, and with an increase in the efficiency of revenue collection as well as the government's cautious expenditure patterns, we are of the view that the 4.7% deficit target level is well within reach in 2012.

Table 2: GDP breakdown demand and supply sides

	2008	**2009**	**2010**	**2011E**	**2012F**
GDP	**4.8%**	**-1.6%**	**7.2%**	**5.0%**	**4.4%**
By expenditure					
Domestic demand	6.9%	-0.4%	6.3%	8.1%	6.1%
Consumption	9.0%	1.3%	5.2%	8.1%	5.8%
-Private	8.7%	0.7%	6.5%	6.8%	6.4%
-Public	9.9%	3.9%	0.5%	13.4%	3.7%
Investment	1.1%	-5.6%	9.8%	8.1%	7.0%
-Private	0.2%	-17.0%	17.7%	11.8%	9.1%
-Public	2.2%	7.5%	2.8%	4.4%	4.7%
Real exports	1.7%	-10.5%	9.9%	3.2%	2.6%
Real imports	2.1%	-12.2%	15.1%	6.5%	4.2%
By industry					
Agriculture	4.3%	0.6%	2.1%	5.4%	3.2%
Mining & quarrying	-2.4%	-6.3%	0.2%	-6.0%	-2.1%
Manufacturing	1.2%	-9.3%	11.4%	5.1%	3.9%
Construction	4.2%	5.9%	5.1%	3.8%	5.7%
Services	7.6%	3.1%	6.8%	6.8%	6.7%

Source: MARC Economic Research

THIS PAGE IS INTENTIONALLY LEFT BLANK

THIS PAGE IS INTENTIONALLY LEFT BLANK

-- Disclaimer --

Published and Printed by:

MALAYSIAN RATING CORPORATION BERHAD (Company No.: 364803-V)
5th Floor, Bangunan Malaysian Re, No. 17, Lorong Dungun, Damansara Heights, 50490 KUALA LUMPUR
Tel.: +603 2082 2200 Fax: +603 2094 9397 E-mail: marc@marc.com.my
Homepage: www.marc.com.my