Economic Research

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2H2014 Economic Outlook: External Positives Amidst Domestic Challenges

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In a nutshell

- The global economy received a respite following stronger manufacturing activities in advanced and emerging economies, as reflected by a pickup in manufacturing statistics in the United States (US) and China in recent months. The firmer growth of the Japanese economy in 1Q2014 also helped, but the increasing anxiety over weak consumer prices in the euro zone is keeping investors on their toes. Some Asian economies are facing domestic headwinds, with a steady build-up in inflationary pressure, rising asset bubbles and moderating growth, although the recent spate of good news in the form of China's latest effort to shore up its economy has prompted the financial market to reconsider the region's prospects.

- The US economic momentum continued on its upward trajectory despite some hiccups that were reflected in the recent 1Q2014 gross domestic product (GDP) growth numbers. What is comforting is that while the headline growth contracted, the underlying strength remained resilient, judging by the relatively strong 2.0% average growth in personal consumption in the past four quarters. Consumer credit also remained resilient in the 12 months to April 2014, although it was a tad slower than the average expansion one year prior to the Global Financial Crisis (GFC) in 2009. The upbeat momentum reflects the improved sentiment amidst rising household wealth and better labour market conditions, which can be seen from the latest increase in non-farm payrolls by 217,000 in May. Such an improvement, however, will not likely induce the US Federal Reserve (Fed) to speed up the cutbacks in bond purchases or push interest rates up in our view, as the central bank still considers the labour market to be relatively weak to withstand any increase in borrowing costs in the near term.

- The prospects of the euro zone economy now hinge on the success of the recently announced unconventional measures by the European Central Bank (ECB) to avert a deflationary spell in the region. While we view such measures as an important step to prevent consumer prices from slipping further, we think more measures akin to the Fed's Quantitative Easing (QE) will be introduced in the near term to solidify the region's economic recovery. Such a scenario, if it becomes a reality, implies another round of liquidity injection which may further bolster global financial markets and benefit emerging market (EM) economies, supporting their currencies, bond and equity markets in the near term. On balance, we think that the euro zone's growth prospects remain decent and the upward trend in the year-on-year (y-o-y) GDP expansion in many of its member countries will persist in the near term.

- In Asia, the new government that was recently elected in India has thus far received positive reviews from the global financial market while Indonesia's presidential candidates who are contesting for the top post in July have not disappointed investors. In China, the GDP growth trajectory continued to soften as policymakers made extra efforts to minimise economic imbalances by reining in excess credit. Although we foresee the war on over-lending, especially among non-bank institutions (shadow banking) will continue, recent moves by the government indicate that measures to support the headline growth above 7% per annum are gaining momentum. Government spending on infrastructure has picked up, supporting industrial production in recent months. This has led to a rebound in the momentum of manufacturing sector activities, as reflected by the official Purchasing Managers' Index (PMI) which climbed to the highest level in five months in May, after having weakened to the recent low in February 2014.

- In Malaysia, external demand is key to stronger headline growth in 2014, although domestic demand will lend support, albeit to a lesser degree than before due to the expected build-up in inflationary pressures in 2H2014. Gross export growth on a 3-month moving average (mma) accelerated to a double-digit pace in the five months ended April, pushing its average monthly trade balance to RM8.8 billion in 1Q2014 from barely RM2.7 billion in 2Q2013. The near-term prospects for the semiconductor sector also look more encouraging, judging by the improvement in the US book-to-bill (BTB) ratio which has climbed from its cyclical low in October 2012. Rising global chip sales, evidenced by double-digit growth rates since February 2014, will further benefit Malaysia's electronics and electrical sector (E&E) going forward. The trend in the US Institute for Supply Management (ISM)'s new orders index also suggests a more favourable outlook for global demand in the near term, although its pace has moderated from last year's average of 57.2 points.

- Domestically, Malaysia's private consumption remains one of the important pillars of the economy, expanding by 7.1% in 1Q2014, slightly slower than the 7.4% expansion in the preceding quarter. This is rather surprising considering that consumers are faced with multiple challenges arising from the government's ongoing subsidy rationalisation efforts (fuel price hike, abolishment of sugar subsidy, higher electricity tariff and price of natural gas), some of which commenced from 3Q2013. Going forward, although consumer spending will likely remain relatively resilient with our growth forecast of 6.8% in 2014, some moderation may take place due to the anticipation of stronger inflationary pressures in the economy in 2H2014. The 6% Goods and Services Tax (GST) slated to replace the sales and services tax in April 2015 would, in our view, affect consumer spending to some degree if the experiences of, for example, Australia and Singapore are anything to go by.

- Investment growth momentum in 1Q2014 remained healthy, led by private investment which contributed 2.4 percentage points to the headline GDP growth and expanded at a robust pace of 14.1% despite moderating from the preceding quarter (4Q2013: +16.6%). With drivers like the ongoing Economic Transformation Programme (ETP) in place, we believe that private investment will remain a strong growth engine this year. The ETP has made respectable progress since its implementation more than three years ago and remains exciting. We believe that with reasonable costs of borrowing, together with supportive government policies, private investment momentum will remain vibrant in the near term. We therefore have revised upward our estimate for private investment growth to 12% for 2014 from 11% initially.

- Inflation numbers will continue to hog the limelight for the rest of the year after rising as high as 3.5% y-o-y in February and March 2014. Increasing inflationary pressures have been primarily attributed to the ongoing subsidy rationalisation efforts by the government, starting from the fuel hike and abolishment of sugar subsidies in 2013. Higher electricity tariffs and the price of natural gas will likely continue to amplify the effects of increasing energy prices on consumer price index (CPI) growth in 2H2014. In addition, the impending introduction of GST in 2Q2015 is expected to exert additional pressure because of the anticipated initial strong demand prior to the implementation as households bring forward their consumption as well as the likelihood of profiteering activities that may take place even before its implementation.

- Going forward, we think inflationary issues will capture the attention of both the man on the street and the authorities as the latter maneuvers policies to deal with internal and external sources of inflation. Externally, developments in global food and commodity prices will have an important bearing on Malaysia's CPI trend. For instance, elevated global crude oil prices in the wake of rising geopolitical risks in Iraq may induce the government to further rationalise its petrol subsidies. In addition, the Food and Agriculture Organisation (FAO)'s Food Price Index, which leads Malaysia's inflation gauges, has rebounded since hitting its trough in December 2012, keeping Malaysia's food index and headline CPI growth higher than in the preceding year. Domestically, the possible pre-GST price rally will be among the key determinants of the degree of price increases in 2H2014.

- Notwithstanding this, we think the impact of GST on inflation will likely fade in the first two years after implementation, at least based on the experience of other countries, namely Singapore, Australia and China. Overall, we are of the view that the imposition of GST will push the headline CPI to above 4% temporarily, although inflation will likely normalise within two years. We anticipate the initial increase of CPI to above 4% simply because inflation has been on a rising trend to start with, amidst the government's ongoing subsidy rationalisation measures. On the whole, we foresee inflation to average around 3.5% in 2014 before edging up to 4.4% in 2015. MARC views the expected build-up in inflationary pressures to prompt Bank Negara Malaysia (BNM) to adjust its monetary accommodation stance to be 'ahead of the curve' and avert stronger-than-expected headline CPI numbers in the near term.

- On interest rates, we think the primary reasons for BNM's hawkish tone during the latest Monetary Policy Committee (MPC) meeting in May, other than rising inflationary pressures, are the persistently elevated level of household indebtedness and the stronger-than-expected headline growth in 1Q2014. Similarly, on the supply side, the relatively elevated level of capacity utilisation (CAPU) in the manufacturing sector suggests a resilient economic momentum on the back of a sustained recovery in global demand. Against this backdrop, MARC maintains its view that the Overnight Policy Rate (OPR) will likely be nudged up by 25 basis points (bps) in 2014. While the possibility of another 25-bp increase cannot be ruled out, it may not take place this year as policymakers continue to monitor and assess the country's growth profile in 2H2014 as well as consumers' reaction to higher prices in the run-up to the GST's implementation in 2015.

- On balance, MARC is of the view that Malaysia's economic growth will pick up from 4.7% in 2013 to 5.3% in 2014, following a rebound in external trade performance and a sustained growth in private investments as well as private consumption, although the latter is expected to moderate due to stronger inflationary pressures. We also expect investments in mega projects related to the ETP that continue to flow into the economy to shore up economic growth in the near term. Its trickle-down effect will be supportive of business conditions, helping to improve their bottom lines. In the financial market, we also foresee lending growth to remain relatively strong, averaging 9%-11% in 2014 as demand for mortgage loans continues to lure borrowers despite the drop in loans for personal purposes.

- The wildcards to our outlook, however, are: (1) the degree of consumers' reaction to the changes in Malaysia's inflationary landscape and to the lower access to financing, following more stringent lending practices among financial institutions; (2) repercussions of the possible hike in the policy rate and other measures which are likely to be imposed to address the issues of stronger inflationary pressures and high household indebtedness; (3) developments in the global crude oil market which may affect domestic petroleum prices if the authorities decide to further intensify subsidy rationalisation efforts; and (4) unexpected weakness in the external sector which could hinder the economy from achieving the high end of BNM's 2014 headline growth forecast of 4.5%-5.5%.

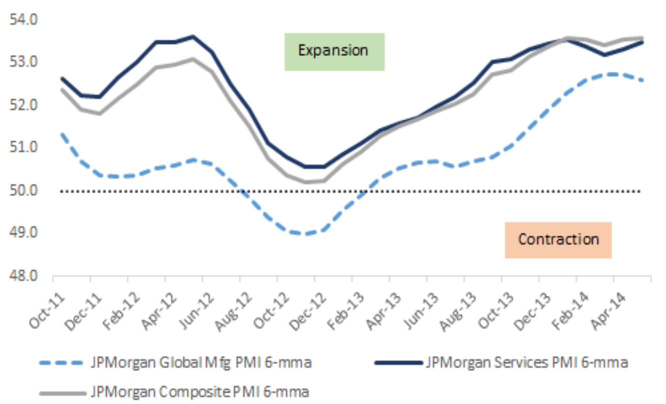
Global Economy

Renewed optimism amidst headwinds in EM economies

- The global economy received a respite following stronger momentum in manufacturing activities in advanced and emerging economies, as reflected by a pickup in manufacturing statistics in the US and China in recent months. The firmer growth of the Japanese economy in 1Q2014 also helped, but the increasing anxiety over weak consumer prices in euro zone is keeping investors on their toes. Notwithstanding this, the raft of unconventional measures unveiled by the ECB recently is the first convincing step to prevent a deflationary spell, although we think more measures akin to the QE implemented by the US Fed will be introduced in the near term to solidify the region's economic fundamentals. In Asia, the new government that was recently elected in India has thus far received positive reviews from the global financial market while Indonesia's presidential candidates who are contesting for the top post in July have not disappointed investors.

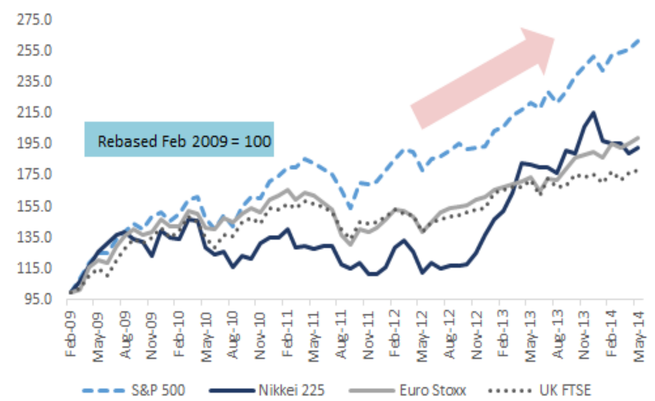
- The financial market performance in advanced economies have been generally positive as more encouraging developments emerged in Group of 7 (G7) economies. Reflecting stronger confidence over the general state of the US economy, the S&P 500 and Dow Jones indices broke new highs during the third week of June after the US Fed decided to continue trimming its asset purchases further while pledging to keep interest rates low for a considerable period. Both S&P and Dow indices have so far climbed by 7.1% and 3.1% respectively since the beginning of the year, reflecting increasing confidence about macroeconomic prospects in the near term. Similarly, despite worries on the prospects of deflation, the euro zone's financial market accelerated during the same period with the Stoxx Europe 600 index jumping to the highest level since 2008. The sentiment in the EM has also improved slightly despite the overall weaker trend when compared with the advanced markets. A significant drop in the volatility of MSCI's World Index (Ex-EM) to pre-GFC levels is also a positive sign for the financial market going forward.

Chart 1: Global manufacturing and services PMIs (6-mma)



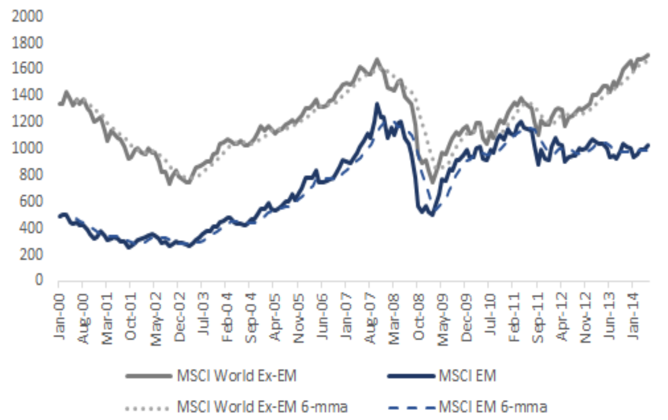
Source: Bloomberg, MARC Economic Research.

Chart 2: Equity market performances in advanced countries



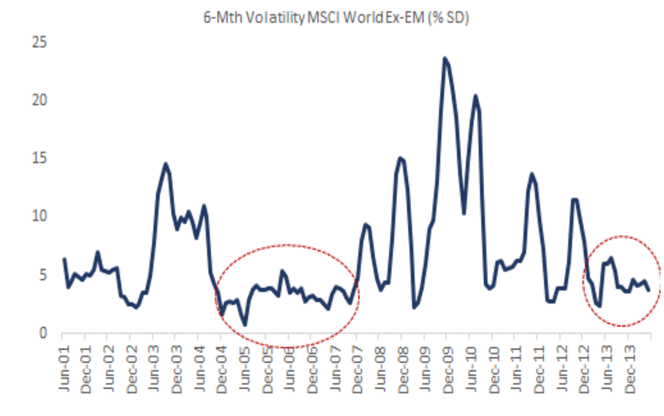
Source: Bloomberg, MARC Economic Research.

Chart 3: MSCI World Ex-EM Index and MSCI EM Index



Source: Bloomberg, MARC Economic Research.

Chart 4: Volatility in MSCI World Ex-EM index (SD; 6-month rolling)

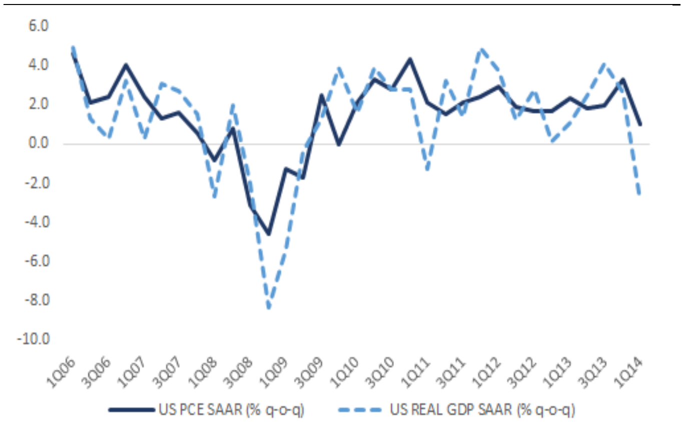


Source: Bloomberg, MARC Economic Research.

- The US economic momentum continued on its upward trajectory despite some hiccups that were reflected in the recent 1Q2014 growth numbers. We view the recent contraction in GDP in 1Q2014 (-2.9% quarter-on-quarter annual pace) as a blip which was mainly attributed to weak production due to several months of unfavourable weather conditions. What is comforting is that while the headline growth contracted, the underlying strength remained resilient, judging by the relatively strong 2.0% average growth in personal consumption in the past four quarters. Even the weakest spot of the economy, the labour market has continued to beat forecasts, increasing by 217,000 in May, the fourth consecutive monthly reading above 200,000.

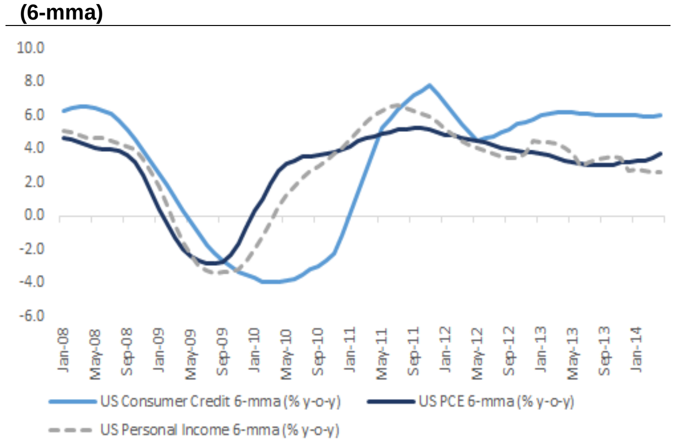
- Consumer credit has also remained resilient with growth averaging circa 6.0% y-o-y on a 6-mma basis in the 12 months to April 2014, a tad slower than the 6.6% average expansion one year prior to the GFC. The upbeat momentum reflects the improved sentiment amidst rising household wealth and better labour market conditions, although the latter is still generally considered by the US Fed as relatively weak to withstand any rate hike in the near term. Growth in personal consumption expenditures, while remaining below the pre-GFC level, has rebounded to 3.7% y-o-y on a 6-mma basis in April 2014 from the recent low of 3% in 3Q2013. Such an encouraging development suggests that consumer spending momentum will likely be sustainable in the near term, giving an extra boost to the headline growth in 2014. Going forward, the economy is envisaged to register a stronger headline GDP growth of between 2.5%-3.0% in 2014 and 2015.

Chart 5: US real GDP and PCE growth



Source: CEIC, MARC Economic Research.

Chart 6: US consumer credit, personal income and PCE growth (6-mma)

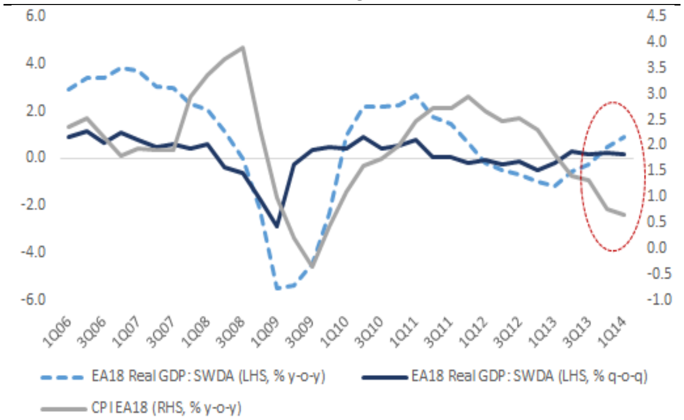


Source: Bloomberg, MARC Economic Research.

- The euro zone's high unemployment rate and the threat of deflation remain the primary concerns despite the general improvement in the growth trajectory. The jobless rate that remained stubbornly elevated at 11.7% in April is a major hurdle in sustaining private consumption that supports the headline growth in many countries in the region going forward. Weak consumer prices amplify the situation, holding back consumer spending. CPI growth has dropped to less than 1% since October 2013 and hit a low of 0.5% in May, sparking fears of a deflation that may dampen business sentiment in the near term.

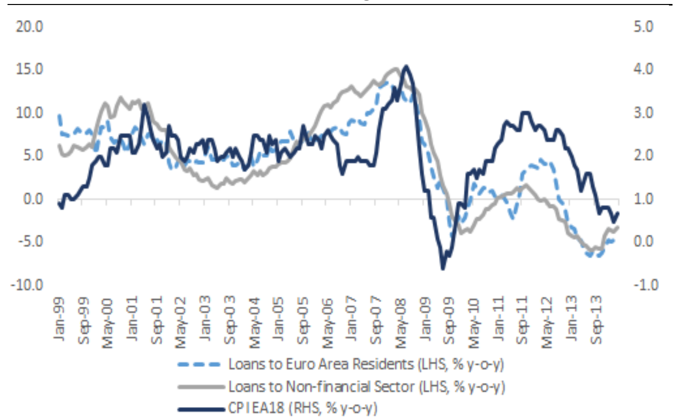
- The weak labour market and uninspired business conditions have also affected lending to consumers and businesses, evidenced by its growth which has fallen into negative territory since 4Q2012, even longer than during the euro crisis and the GFC. Notwithstanding this, the recent policy mix of conventional and unconventional measures unveiled by the ECB, which include (1) a lower policy rate of 0.15%; (2) negative deposit rates for banks that park their money with the ECB; and (3) 400 billion euro of conditional lending to banks, is the first convincing step to prevent a deflationary spell, although we think more measures akin to the QE implemented by the US Fed will be introduced in the near term to solidify the region's economic fundamentals. Such a scenario, if it becomes a reality, implies another round of liquidity injection which may further bolster global financial markets and benefit EM economies, supporting their currencies, bond and equity markets in the near term. Asian economies – Malaysia included – which have relatively better growth prospects will likely benefit from such developments. On balance, we think that the euro zone's growth prospects remain decent and the upward trend in the y-o-y GDP expansion in many of its member countries will persist in the near term.

Chart 7: Euro area GDP and CPI growth



Source: CEIC, MARC Economic Research.

Chart 8: Euro area loans and CPI growth

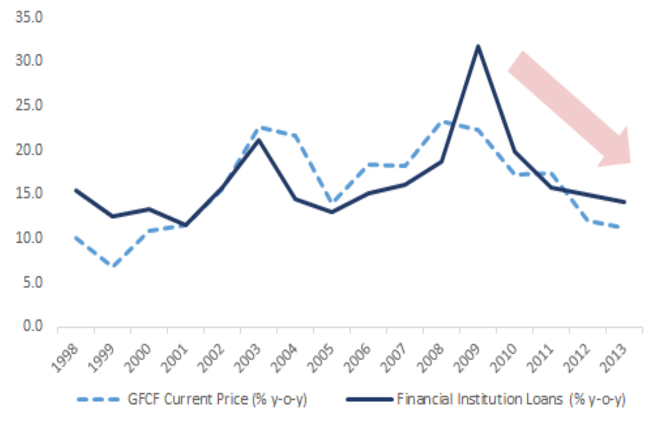


Source: CEIC, MARC Economic Research.

- In Asia, China's economic growth trajectory continued to soften as policymakers made extra effort to minimise economic imbalances by reining in excess credit. Such efforts have not come without a cost. As lending measures are tightened, businesses are squeezed, causing financial difficulties. This is evidenced by the first corporate default that happened in March 2014. Notwithstanding this, we foresee the war on over-lending, especially among non-bank institutions (shadow banking) to continue, albeit at a slower pace in the foreseeable future as policymakers are determined not to let financial imbalances pose severe consequences to the economy.

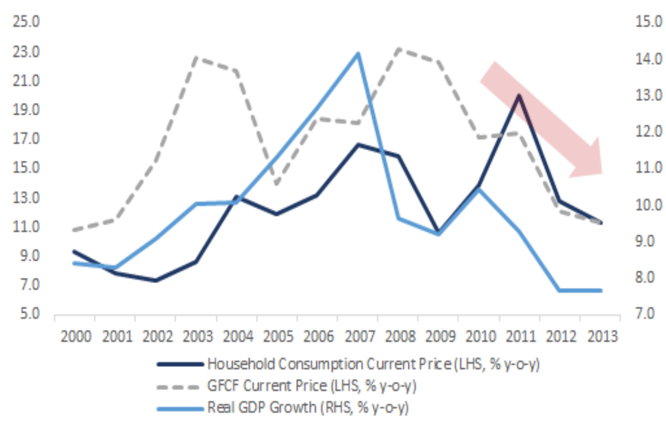
- While the efforts to rebalance the economy continue, the government has also implemented measures to support the headline growth above 7% p.a. This is despite the general tone of letting the growth moderate in order to contain financial imbalances in the economy. Government spending on infrastructures has picked up, supporting industrial production in recent months. This has subsequently led to a rebound in the manufacturing sector's momentum as reflected by the official PMI which climbed to the highest level in five months in May, after weakening to the recent low in February 2014. Taking account all these developments, we maintain our earlier forecast of GDP growth between 7%-7.5% in 2014 for China.

Chart 9: China's financial institution loans and investment growth



Source: CEIC, MARC Economic Research.

Chart 10: China's real GDP, household consumption and investment growth



Source: CEIC, MARC Economic Research.

- On balance, we view that global developments are getting more positive for a trade-dependent country like Malaysia. Decent headline growth in US and China will be supportive of Malaysia's GDP profile in 2014. The US ISM new orders which normally lead Malaysia's exports by approximately five months suggest that Malaysia's trade performance will continue to be stronger than expected, contributing to the headline growth.

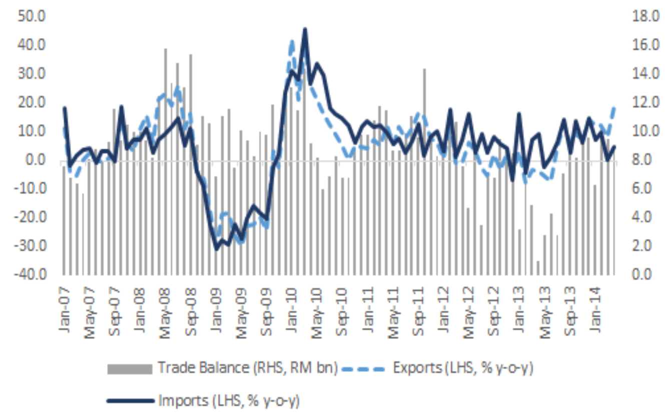
Malaysian Economy

External sector is key but domestic factors will further strengthen headline growth

- External demand is key to Malaysia's stronger headline growth in 2014, although domestic demand will lend support, albeit to a lesser degree than before due to the expected build-up in inflationary pressure in the 2H2014. In 1Q2014 alone, real exports rebounded 7.9% as global demand improved following the recoveries in advanced economies, namely the US, the euro zone and Japan. Net trade added 1.3 percentage points to growth in 1Q2014. Gross export growth on a 3-mma basis accelerated to a double-digit pace in the five months ended April (average 11.7% p.a.), signaling a swift rebound of the external sector which will likely be sustained in 2H2014. The monthly trade balance has also improved markedly from an average of RM2.7 billion in 2Q2013 to RM8.8 billion in 1Q2014, adding to the headline growth.

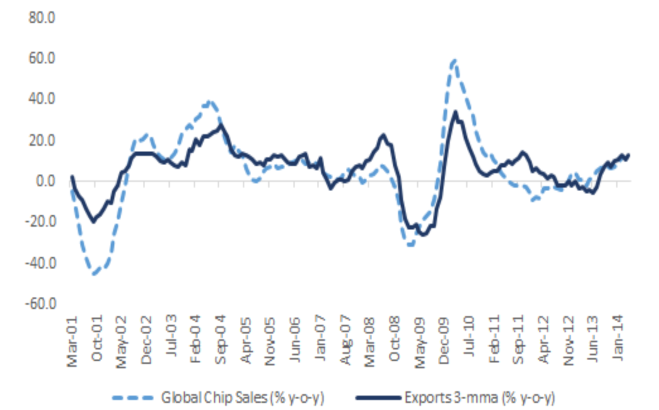
- The E&E exports which accounted for roughly 37% of total exports are also gaining strength, evidenced by its double-digit growth on a 3-mma basis since November 2013, after contracting almost every month in 2011 and 2012. The improvement in the US BTB ratio from its cyclical low of 0.75 in October 2012 will likely continue throughout the year judging by its upward momentum that pushed the reading to above the unitary level since October 2013. Similarly, global chip sales are also gaining momentum with growth rates reaching a double-digit pace since February 2014, the first time since February 2011. The trend in the US ISM new orders index also suggests a more favourable outlook for global demand in the near term, although its pace has moderated from last year's average of 57.2 points. Going forward, we foresee the ISM new orders index which leads Malaysia's export growth by approximately five months to average around 55 points in 2014.

Chart 11: Malaysia's trade performance



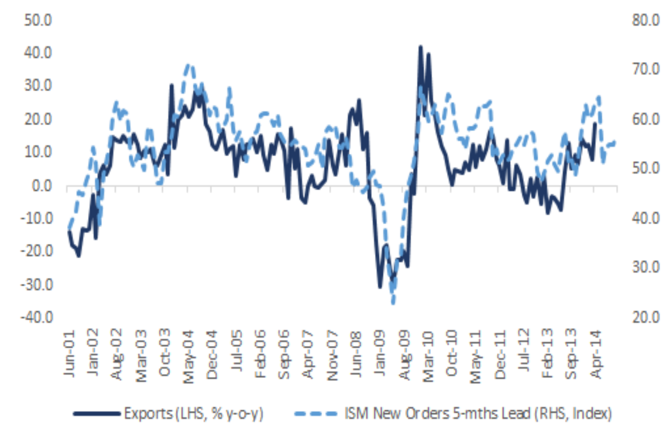
Source: CEIC, MARC Economic Research.

Chart 12: Malaysia's exports (3-mma) and global chip sales



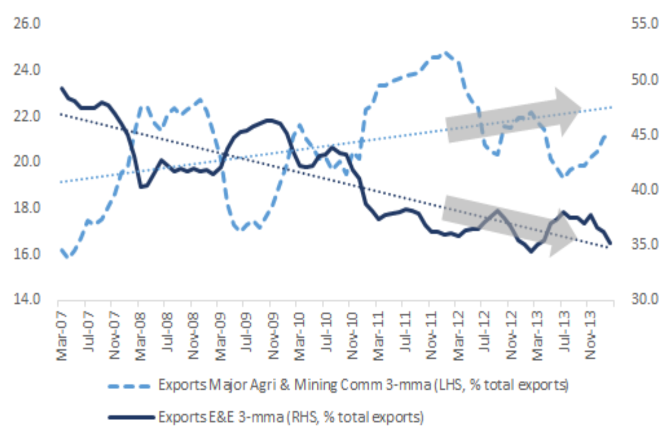
Source: CEIC, SIA, MARC Economic Research.

Chart 13: Malaysian exports and US ISM new orders (5-mth lead)



Source: CEIC, ISM, MARC Economic Research.

Chart 14: Shares of E&E and commodities to total exports

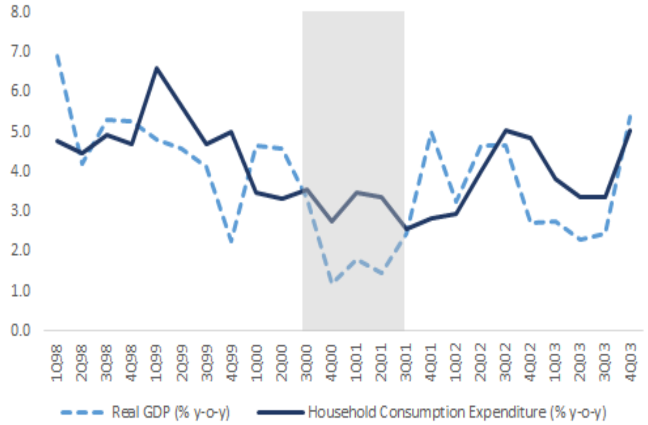


Source: CEIC, BNM, MARC Economic Research.

- While external demand is key, domestic demand has an important supporting role. In particular, private consumption, which in 1Q2014 made up roughly 52% of GDP, remained a strong pillar of the domestic economy, expanding by 7.1% y-o-y and contributing a significant 3.7 percentage points towards GDP growth in 1Q2014. This is rather surprising considering that consumers faced with multiple challenges arising from the government's ongoing subsidy rationalisation efforts (fuel price hike, abolishment of sugar subsidy, higher electricity tariff and price of natural gas), some of which commenced from 3Q2013. The strong headline consumption number also defies the trend in consumer sentiment which normally leads actual spending. According to Malaysian Institute of Economic Research's (MIER) 1Q2014 Consumer Sentiments Survey report, its Consumer Sentiments Index (CSI) remained below the threshold of 100 points after hitting the lowest reading in almost five years in 4Q2013.

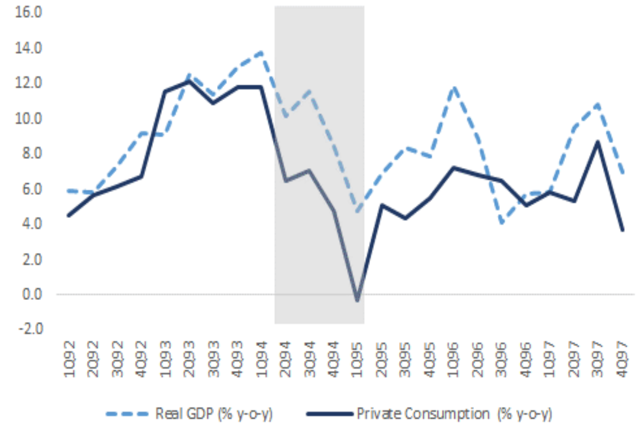
- The impact of the 6% GST slated to replace the 5%-10% and 6% sales and services tax on April 1, 2015 should not be taken for granted. Although it is possible that private consumption expenditure may spike initially prior to the introduction of GST as households bring forward their consumption, private consumption could slip following the implementation of GST if the experiences of, for example, Australia and Singapore are anything to go by. In Australia for instance, while the average headline GDP growth remained unchanged at 3.9% four quarters post GST in the year 2000, private consumption actually slipped by one percentage point to an average of 3.1% in the four quarters post GST from 4.1% growth pre-GST period. In Singapore, both private consumption and GDP growth declined post GST implementation period in 1994. Similarly, the average GDP growth in the four quarters post GST period weakened to 8.8% from a blistering 12.7% pre-GST while private consumption averaged 5.6% in the four quarters post-GST, six percentage points lower than its average prior to the imposition of GST. As for Malaysia, although consumer spending will likely remain relatively resilient with our growth forecast of 6.8% in 2014, some moderation may take place due to the anticipation of stronger inflationary pressures in the economy in 2H2014.

Chart 15: Australia's real GDP and private consumption growth during, pre- and post-GST



Source: CEIC, MARC Economic Research.

Chart 16: Singapore's real GDP and private consumption growth during, pre- and post-GST



Source: CEIC, MARC Economic Research.

Table 1: Trend in GDP growth and private consumption during, pre – and post-GST in Australia and Singapore (%)

	Australia		Singapore	
	GDP Growth	Pvt Consumption	GDP Growth	Pvt Consumption
Pre-GST	3.9	4.1	12.7	11.7
During GST	1.9	3.3	8.8	4.5
Post-GST	3.9	3.1	8.8	5.6

Source: CEIC, MARC Economic Research.

- Investment growth momentum in 1Q2014 remained healthy, despite expanding at a slightly slower pace of 6.3% y-o-y (4Q2013: +6.5%). As in the past few years, private investment led the growth, contributing roughly 2.4 percentage points to the headline GDP in 1Q2014 and expanding at a robust pace of 14.1% despite moderating from the preceding quarter (4Q2013: +16.6%). With drivers like the ongoing ETP in place, we believe that private investment will remain a strong growth engine this year. The ETP has made respectable progress since its implementation more than three years ago and remains exciting. We believe that with reasonable costs of borrowing, together with supportive government policies, private investment momentum will remain vibrant in the near term. We therefore have revised upward our estimate for private investment growth to 12% for 2014 from 11% initially.

- On balance, MARC is of the view that Malaysia's economic growth will pick up from 4.7% in 2013 to 5.3% in 2014 following a significant rebound in external trade performance and a sustained growth in private investments as well as private consumption, although the latter is expected to moderate due to higher inflationary pressures. Despite this, strong equity market performance, a stable labour market and relatively resilient commodity prices will limit the downside in the growth of consumer spending. We also expect investments in mega projects related to the ETP that continue to flow into the economy to shore up economic growth in the near term. Its trickle-down effect will be supportive of business conditions, helping to improve their bottom lines. In the financial market, we also foresee lending growth to remain relatively strong, averaging 9%-11% in 2014 as demand for mortgage loans continue to lure borrowers despite the drop in loans for personal purposes.

- The wildcards to our outlook, however, are: (1) the degree of consumers' reaction to the changes in Malaysia's inflationary landscape and to the lower access to financing, following more stringent lending practices among financial institutions; (2) repercussions of the possible hike in the policy rate and other measures which are likely to be imposed to address the issues of stronger inflationary pressures and high household indebtedness; (3) developments in the global crude oil market which may affect domestic petroleum prices if the authorities decide to further intensify subsidy rationalisation efforts; and (4) unexpected weakness in the external sector which could hinder the economy from achieving the high end of BNM's 2014 headline growth forecast of 4.5%-5.5%.

Table 2: Real GDP growth – demand side (%)

Growth (%y-o-y)	2010	2011	2012	2013	MARC 2014F	BNM 2014F	MoF 2014F
GDP	7.4	5.1	5.6	4.7	5.3	4.5 - 5.5	5.0 - 5.5
Domestic Demand	7.7	7.9	10.6	7.6	6.6	6.9	5.9
Private Consumption	6.9	6.8	7.7	7.6	6.8	6.9	6.2
Public Consumption	3.4	15.8	5.1	6.3	3.8	3.0	3.3
Private Investment	18.4	10.5	21.9	13.6	12.0	12.6	12.7
Public Investment	4.9	1.0	17.1	0.7	1.0	2.9	-2.7
Real Exports	11.1	4.6	-0.1	-0.3	4.0	2.1	1.6
Real Imports	15.6	6.1	4.7	1.9	5.6	3.1	2.2

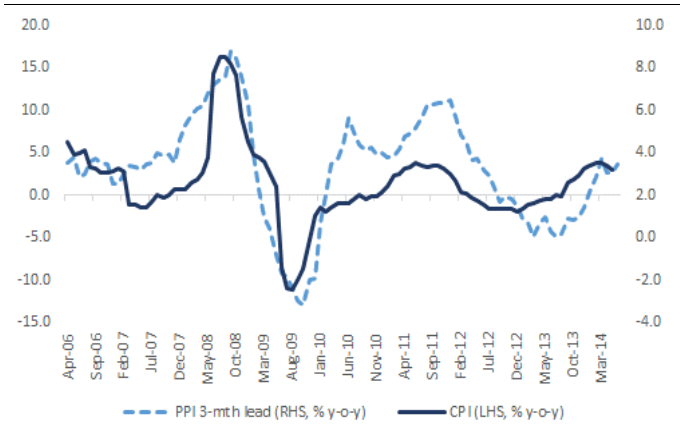
Source: CEIC, MoF, BNM, MARC Economic Research

Inflation will emerge as a thorny issue

- Inflation numbers have clearly stirred some excitement in 1H2014 and will continue to hog the limelight for the rest of the year after rising as high as 3.5% y-o-y in February and March 2014. Increasing inflationary pressures have been primarily attributed to the ongoing subsidy rationalisation efforts by the government, starting from the fuel hike and abolishment of sugar subsidies in 2013. Higher electricity tariffs and the price of natural gas will likely continue to amplify the effects of higher energy prices on CPI growth in 2H2014. In addition, the impending introduction of GST in 2Q2015 is expected to exert additional pressure because of the anticipated initial strong demand prior to the implementation as households bring forward their consumption as well as because of the likelihood of profiteering activities that may take place even before its implementation.

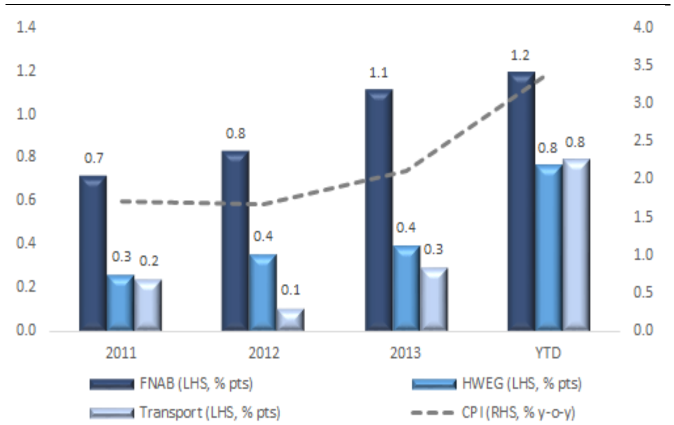
- Growth in the Producer Price Index (PPI), which leads the CPI by approximately three months, is now persistently on the uptrend as producers passed on most of their costs to end users. Such a development implies that CPI will likely follow the PPI's upward trend in the next few months. Thus far, higher headline CPI numbers have been attributed to stronger growth in prices of food and non-alcoholic beverages (FNAB), which contributed an average of 1.2 percentage points between January and May. Other drivers for inflation were housing, water, electricity, gas and other fuels (HWEG) as well as transport indices which climbed by 0.8 percentage points each within the period.

Chart 17: PPI 3-mth lead and CPI growth



Source: CEIC, MARC Economic Research.

Chart 18: Contribution to CPI growth



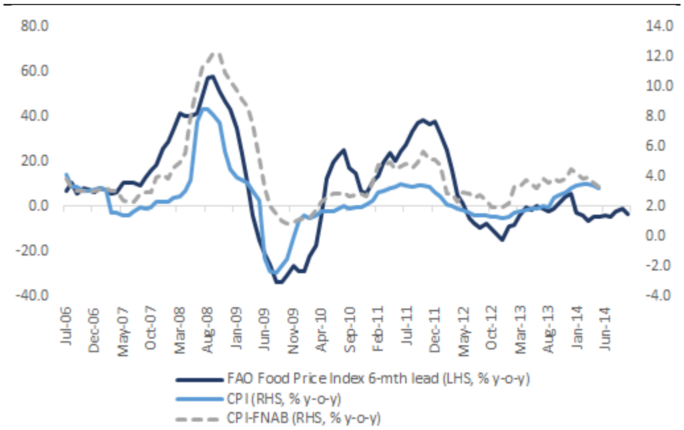
Source: CEIC, MARC Economic Research.

- Externally, the developments in global food and commodity prices will also have an important bearing on Malaysia's CPI trend. For instance, the elevated level of global crude oil prices in the wake of rising geopolitical risks in Iraq may induce the government to further rationalise its petrol subsidy. In addition, although the FAO Food Price Index, which tracks general food prices globally, has somewhat moderated in recent months, it has rebounded significantly since hitting its trough in December 2012. Based on the fact that the FAO Food Price Index normally leads Malaysia's headline CPI and FNAB indices by approximately six months, the trend in global food prices will likely exert an upward pressure in the near term, making it challenging for policymakers who are already searching for appropriate measures to diffuse domestic factors that have pushed up prices in the past six months or so.

- Domestically, the impending implementation of GST is critical in determining the strength of the upward pressure on Malaysia's inflation numbers in the next one year or so. Based on past experiences in other countries – namely Singapore, Australia and China – inflation normally spiked up during the period of implementation (or during the rate hike, in the case of Singapore) by an average 4 to 5 percentage points in Australia and Singapore and by 14 percentage points in China. This temporary increase in prices later moderated approximately two years after GST was imposed. In Australia, Singapore and China, the average CPI growth dropped to 2.9%, 2.3% and 12.7% respectively two years after the implementation (or the rate hike) from 6.0%, 5.4% and 24.2% in the four quarters during the implementation (or the rate hike). Notwithstanding this, prices remained double the rate in the period prior to implementation of GST.

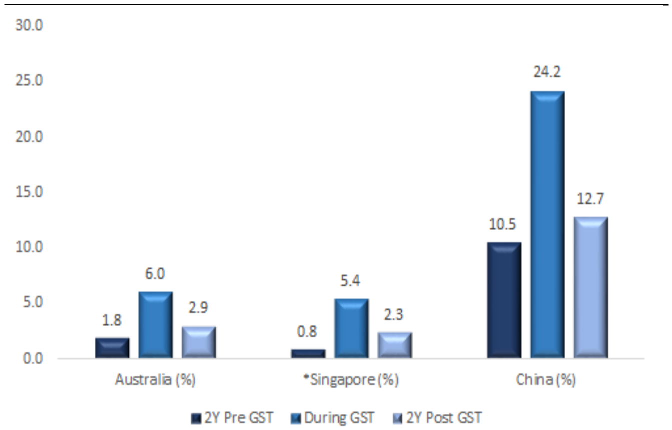
- In the case of Malaysia, the imposition of GST is expected to push the headline CPI to above 4% temporarily, although inflation will likely normalise within two years. This is because inflation has been on a rising trend to start with, amidst the government's ongoing subsidy rationalisation measures that have been undertaken (fuel price hike, abolishment of sugar subsidy, higher electricity tariff and price of natural gas) since 2013. On the whole, we foresee inflation to average around 3.5% in 2014 before edging up to 4.4% in 2015. MARC also views the expected build-up in inflationary pressures to prompt BNM to adjust its monetary accommodation stance to be 'ahead of the curve' and avert stronger-than-expected headline CPI numbers in the near term.

Chart 19: FAO Food Price Index 6-mth lead, headline CPI and FNAB



Source: CEIC, FAO, MARC Economic Research.

Chart 20: Inflation rates pre-, during and post-GST for selected countries



Source: CEIC, MARC Economic Research.
Note: 2 years before and after, 1 year during GST implementation
*: * = during GST rate hike to 7% from 5%*

Watch for developments in interest rates

- The strongest hint by the BNM on the possibility of an interest rate hike came during May's MPC meeting when the central bank highlighted its concern over financial imbalances that exist in the economy. Both rising inflation and high household indebtedness, although not elaborated on at length by the BNM, are worth monitoring in our view. As mentioned previously, we are of the view that the upward bias in inflation is due to (1) subsidy rationalisation measures undertaken by the government to ease the burden on its coffers; (2) reaction to the impending implementation of GST from both consumers and producers; and (3) higher global food prices due to unfavourable weather conditions. At the same time, rising household indebtedness which reached 86.8% of GDP, among the highest in the region, is another critical reason for the BNM to consider hiking up its policy rate soon.

- Analysing BNM's past statements (2010 and 2011) prior to interest rate hikes suggest that the recent rhetoric will likely mean that the level of OPR will be adjusted upward by 25 bps pretty soon. For instance, in January 2010, prior to the first 25-bp hike from the historical low of 2%, BNM stressed the need to "*prevent the build-up of financial imbalances that could arise from interest rates being too low for prolonged period of time*". In March 2011, prior to the last OPR hike to 3%, BNM stated that "*the degree of accommodation may be reviewed…"*. Thus, the latest statement that says "*the degree of monetary accommodation may need to be adjusted…*" is the clearest sign that the OPR will likely increase from the current level in our view.

Table 3: MPC statements on the period prior to rate hikes

Period	*MPC Statements*
Jan 2010: Prior to 25 bps hike in March 2010	*"MPC also recognizes* ***the need to ensure that the stance of monetary policy is appropriate to prevent the build-up of financial imbalances*** that could arise from interest rates ***being too low*** for a prolonged period of time"
March 2011: Prior to 25 bps hike in May 2011	*"Moving forward, while the stance of monetary policy is expected to remain supportive of growth,* ***the degree of monetary accommodation may be reviewed*** given the sustained grow th in the economy and risks to inflation. This is to ensure the sustainability of the grow th prospects of the Malaysian economy."
May 8, 2014	*"Going forward, the* ***degree of monetary accommodation may need to be adjusted*** to ensure that the risks arising from the accumulation of these imbalances w ould not undermine the grow th prospects of the Malaysian economy."

Source: BNM

- We think the primary reasons for BNM's hawkish tone during the latest Monetary Policy Committee (MPC) meeting in May, other than rising inflationary pressures, are the persistently elevated level of household indebtedness and the stronger-than-expected headline growth in 1Q2014. Statistics have revealed that household indebtedness has continued to climb higher to 86.8% at the end of 2013 despite various macroprudential measures introduced by the central bank. The debt-service ratio (DSR) which stood at 43% implies the debt burden is relatively high especially for those with low income, although the ratio has moderated slightly below 40% for new loans. Households with income levels below RM3,000 per month constituted about one-third of the country's household debt valued at RM854 billion.

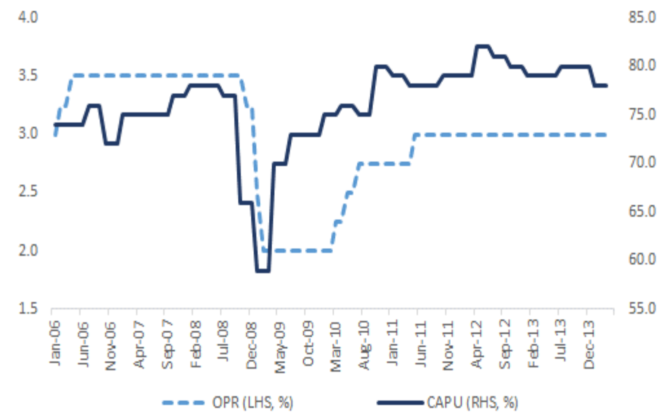
- The stronger-than-expected headline GDP growth also suggests that stronger measures are needed to avert further deterioration in the level of household indebtedness. In particular, the resilient 7.1% growth in private consumption in 1Q2014 (which contributed to about 3.7 percentage points to GDP growth) reflects a high degree of consumerism in the economy, partly aided by easy credit, which if left unattended, will eventually erode household balance sheets and asset quality of financial institutions, although the latter may not likely lead to a credit crunch due to strong capital buffers. At the same time, negative real interest rates (estimated using one-year fixed deposit rates adjusted to CPI growth) will not likely be a scenario which policymakers would allow to persist for too long as this may lead to further acceleration in asset prices.

- Similarly, on the supply side, the consistently elevated level of CAPU in the manufacturing sector suggests resilient economic momentum on the back of a recovery in the global demand. The manufacturing sector's CAPU has remained above the 78-point level since 4Q2011. On the whole, we view that the stronger-than-expected headline growth is another major trigger for the BNM's hawkish tone in its latest MPC statement.

- The financial market is already discounting higher OPR as reflected in its spreads against Malaysian Government Securities (MGS) and 3-month Kuala Lumpur Interbank Offered Rate (KLIBOR). In the past, the spreads normally widened prior to the rate hikes. For instance, three months prior to the first 25-bp hike in 2010, the OPR and 3-year MGS spread climbed by about 38% to an average of 128 bps from 93 bps in the three months preceding it. In the three months to May 2014, the spread also widened more than twofold, from an average of 19 bps in the last three months of 2013 to an average of 43 bps.

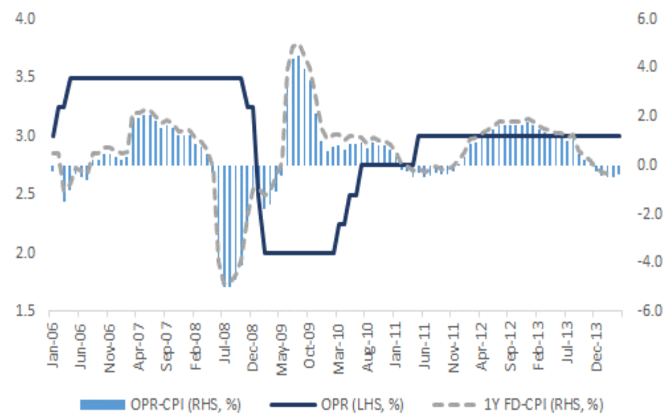
- With these recent developments, MARC maintains its view that the OPR will likely be nudged up by 25 bps in 2014. While the possibility of another 25-bp increase cannot be ruled out, it may not take place this year as policymakers continue to monitor the growth profile in 2H2014 and consumers' reaction to higher prices in the run up to GST implementation in 2015.

Chart 21: OPR and CAPU



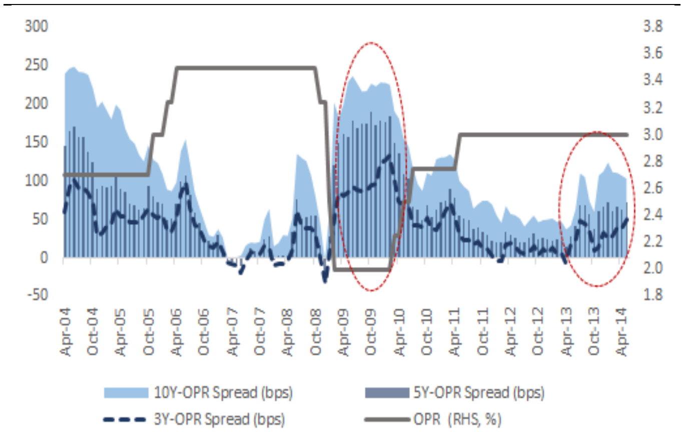
Source: CEIC, MARC Economic Research.

Chart 22: Spread between OPR and CPI and 1-yr FD



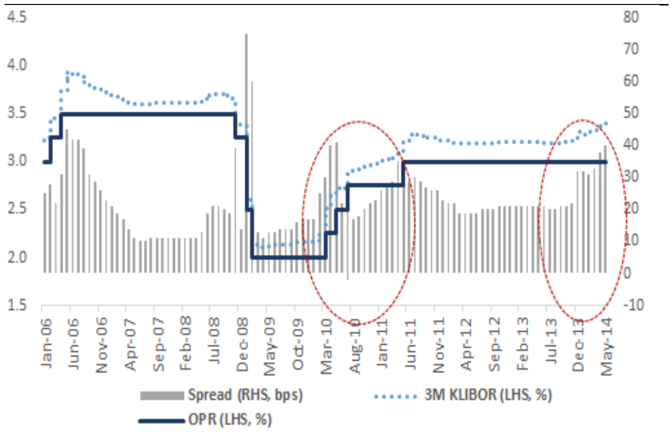
Source: CEIC, MARC Economic Research.

Chart 23: Spreads between OPR and 3Y/5Y/10Y yields



Source: CEIC, MARC Economic Research.

Chart 24: Spread between OPR and 3-mth KLIBOR



Source: CEIC, MARC Economic Research.

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