Economic Research

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

MALAYSIAN RATING CORPORATION BERHAD
(364803-V)

Vol.: ER/009/2018

Capital Flows, Renminbi & the Ringgit Trend

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In a nutshell

- With several Emerging Market (EM) currencies – the Turkish lira, Indian rupee, Indonesian rupiah and Chinese renminbi (RMB) – falling to cyclical and new lows, there is now increasing concern over the possibility of a contagion across other EM currencies. A sudden turnaround in the global macro backdrop, underpinned by escalating trade wars, rising geopolitical risks, increasing interest rates in the US and greater uncertainties over the prospects of China's economy is slowly changing the trend of capital flows across the globe.

- The ringgit is also affected by the current negative sentiment and a net capital outflow of RM16.9 billion from the Malaysian bond market in the first seven months of 2018 has not helped matters. This is despite the positive net inflow recorded in July, its first in the past four months. MARC believes that the capital outflows occurred predominantly because of external factors, namely the strengthening of the USD against global currencies as the USD index strengthened by 6% during the period. In fact, Malaysia's real effective exchange rate– the exchange rate against trading partners adjusted to inflation – barely changed.

- History shows that in the past 10 years, there were three episodes of significant capital outflows from the Malaysian bond market: (a) the Global Financial Crisis in 2008-2009; (b) the "Taper Tantrum" in May 2013; and (c) post the US election in 2016 ("Trump Rhetoric"). During these periods, foreign investors' holdings of Malaysian bonds - both government and corporate bonds - declined between RM25 billion and RM84 billion. Capital outflows had also led to a weaker ringgit against the greenback during these periods by 6% to 13%.

- History also shows that the ringgit tends to move in tandem with the RMB-USD exchange rate with a strong correlation over the period between 2013 and 1H2018. In the past two years, statistics show that a 1% drop in the RMB against the greenback is associated with a roughly 1.3% decline in the MYR-USD exchange rate.

- Assuming the relationship between capital outflows from the Malaysian bond market and the MYR-USD exchange rate holds and the correlation between the MYR-USD exchange rate and the RMB-USD exchange rate remains strong, a further decline in net foreign holdings of Malaysian bonds and a continuing weakness in the RMB-USD exchange rate could exert some downward pressure on MYR.

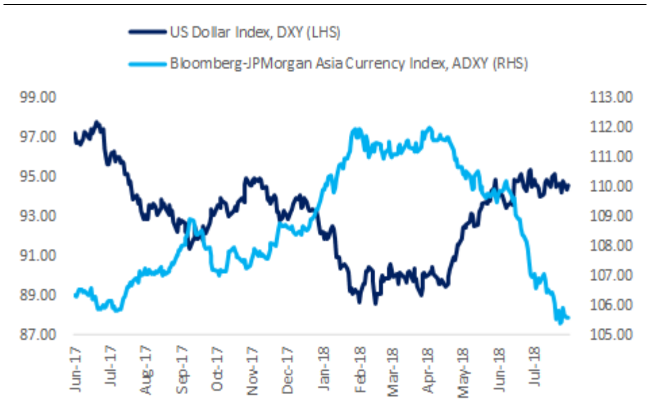
- In the medium term, however, MARC views that the downside of the ringgit would be capped by strong economic fundamentals. We also believe that, aside from external factors, internal factors that determine the ringgit's trajectory against the greenback would include the government's medium-term deficit, debt reduction plans and economic growth trajectory.

Capital outflows and ringgit

- With the Turkish lira plunging to new lows, the Chinese renminbi continuing to trend downwards and the Indonesian rupiah falling to an almost three-year low against the USD, there is now increasing concern over the possibility of a contagion across EM currencies. A sudden turnaround in the global macro backdrop, underpinned by escalating trade wars, rising geopolitical risks, increasing interest rates in the US and greater uncertainties over the prospects of China's economy is slowly changing the trend of capital flows across the globe, denting the performance of financial markets in EM economies.

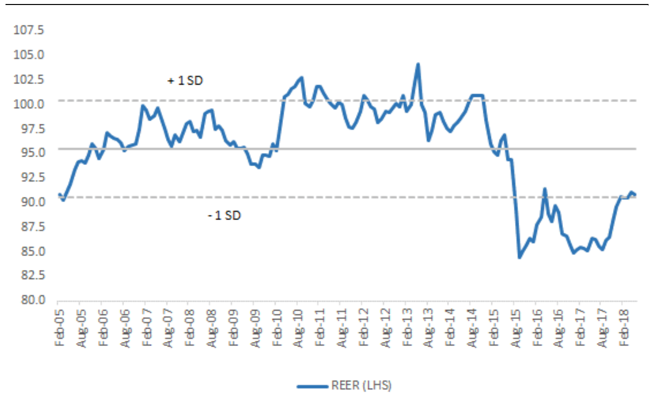
- The Malaysian bond market also experienced net capital outflows of RM16.9 billion in the first seven months of 2018. This is despite the positive net inflow recorded in July, its first in the past four months. The outflows had evidently led to a slide in the MYR-USD exchange rate over the period. MARC believes that capital outflows occurred predominantly because of external factors, namely the strengthening of the USD against global currencies. The strength of the greenback was mainly supported by factors that include: (a) expectation of a faster-than-expected interest rate hike in the US; and (b) global economic uncertainty due to trade wars between the US and its trading partners, especially China. The USD index (against major currencies) strengthened by 6% during the period while Malaysia's real effective exchange rate (REER) – the exchange rate against trading partners adjusted to inflation – barely changed.

Chart 1: USD index against six major currencies and against Asian currencies



Source: Bloomberg, MARC Economic Research

Chart 2: Malaysia's real effective exchange rate

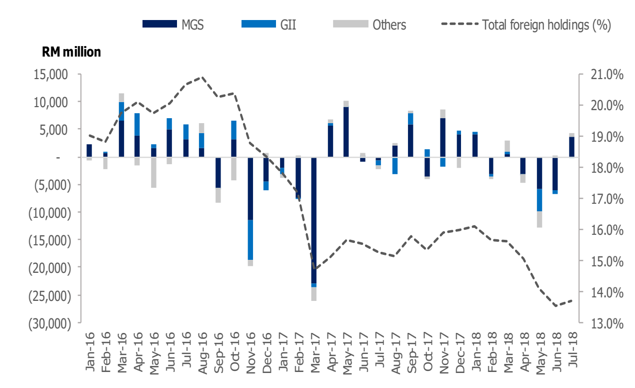


Source: BIS, CEIC, MARC Economic Research

- Against this backdrop, the Malaysian ringgit has depreciated since hitting a high of RM3.86 per USD in February 2018. Its recent low of RM4.08 against the greenback represents a 5% depreciation from its 2018 high. The ringgit has also weakened in tandem with the value of the RMB against the USD.

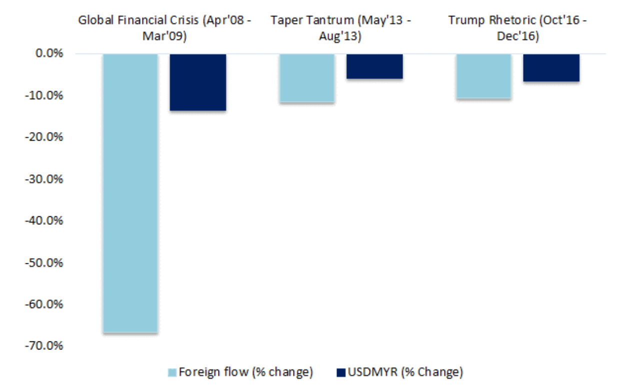
- History shows that in the past 10 years, there were three episodes of significant capital outflows from the Malaysian bond market: (a) the Global Financial Crisis in 2008-2009; (b) the Taper Tantrum in May 2013; and (c) post the US election in 2016 (Trump Rhetoric). During these periods, the share of foreign holdings of Malaysian bonds to their total bond outstanding amount fell between two to 14 percentage points from their peaks to troughs. In terms of value, the decline in foreign investors' holdings of Malaysian bonds - both government and corporate bonds - ranged from RM25 billion to RM84 billion. Capital outflows had also led to a weaker ringgit against the greenback during these periods *(refer to chart 3).*

Chart 3: Capital flows from the Malaysian bond market



Source: BNM, MARC Economic Research

Chart 4: Episodes of significant capital outflows from the Malaysian bond market and movements of MYR

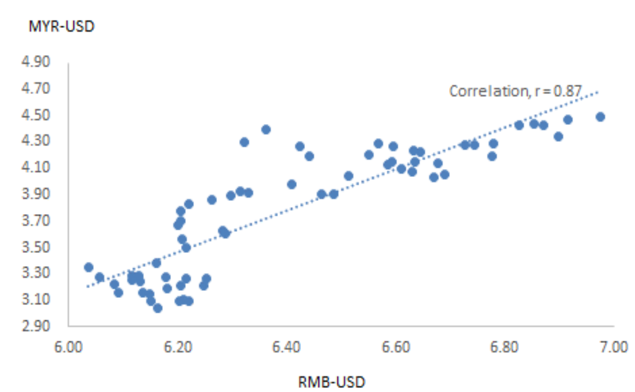


Source: BNM, MARC Economic Research

Renminbi-USD trend and the ringgit

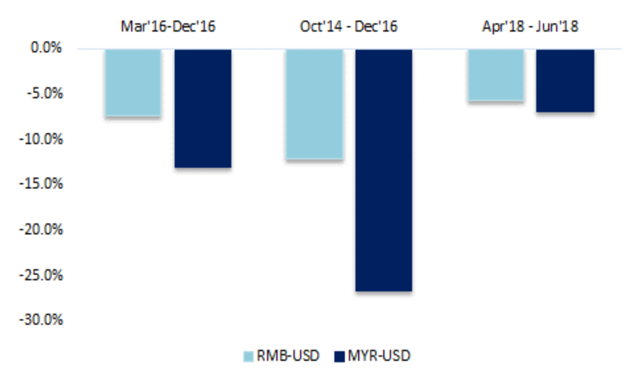
- History also shows that the ringgit tends to move in tandem with the RMB-USD exchange rate. A significant weakness in the latter has been normally accompanied by a depreciation of the ringgit against the greenback. This can be seen in three recent periods (a) October 2014-January 2016; (b) March 2016-December 2016; and (c) April 2018-July 2018. Over the period between 2013 and 1H2018, the ringgit had a strong correlation of 0.87 with the RMB-USD exchange rate *(refer to Chart 5)*.

Chart 5: MYR-USD and RMB-USD exchange rates between 2013 and 1H2018



Source: Bloomberg, MARC Economic Research

Chart 6: Episodes of significant depreciation of RMB in recent times



Source: BNM, MARC Economic Research

Near-term ringgit path

- Assuming the relationship between capital outflows from the Malaysian bond market and the MYR-USD exchange rate holds and the correlation between the MYR-USD exchange rate and the RMB-USD exchange rate remains strong, a further decline in net foreign holdings of Malaysian bonds and a continuing weakness in the RMB-USD exchange rate could exert some downward pressure on MYR. It is noteworthy that statistics in the past two years show that a 1% drop in the RMB against the greenback is associated with a roughly 1.3% decline in MYR-USD exchange rate.

- In the medium term, however, MARC views that the downside of the ringgit would be capped by strong economic fundamentals. The fact that the ringgit remains below one-standard deviation from its long-term mean also suggests that its downside could be limited. We believe that, aside from external factors, internal factors that determine the ringgit's trajectory against the greenback would include the government's medium-term deficit, debt reduction plans and economic growth trajectory.

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Published and Printed by:

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