Malaysia: On the verge of deflation?

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2009/0026

- Malaysia's headline inflation eased to 2.4% in May from 3.0% in April, the slowest in 17 months, although mom it increased by 0.2%.

- All components of the consumer price index (CPI) displayed slower growth during the month. Year to date inflation rate averaged at 3.3% as compared to 2.9% during the same period last year.

- The further fall in the inflation rate (disinflation) reflected the continued deterioration in domestic and external demand, and in line with the trend seen in many economies.

- Given the high base recorded in the previous year (above 7.0% in June to December 2008), it is very likely that the CPI will begin to register negative growth in the coming months as demand falters.

- If this materializes, it will be the first time that Malaysia enters a deflationary period, perhaps since the late 1960s. (Deflation is a decrease in the general price level of goods and services, and it occurs when the annual inflation rate falls below zero percent).

- Other countries had entered deflation mode earlier than Malaysia. China (-1.6% in February), the United States (-0.4% in March), Japan (-0.1% in April) and Singapore (-0.7% in May).

- The negative growth in Malaysia's producer price index (both for the domestic and import components of the PPI) that had emerged since November last year only suggest that the effects will be passed on to consumers in the second half of the current year. This trend in PPI will most likely persist for the remaining half of this year.

- This development will certainly provide additional room (not large though) for the monetary authority to further reduce interest rates given the continued uncertainty in the external demand performance.

- At this juncture, while the decline in production and sales data has somewhat stabilized, we have yet to see green shoots emerging on the local front.

- Nonetheless, we do not foresee that the interest rate level would be reduced to accommodate growth as it would not guarantee that recovery would take place anytime soon. In our opinion, it is best that the current level be maintained to avoid Malaysia going into liquidity trap (a situation where a country's nominal interest rate has been lowered nearly to or equal to zero to avoid a recession, but the liquidity in the market created by these low interest rates does not stimulate the economy to full employment).

- Additionally, the steady loan growth (circa 11.0% annualized) and healthy asset quality of the banking system (NPL at 2.2% of net loan) would render the reduction in interest rates unnecessary at this time. The stable ringgit against its major trading partners (3.47/ USD) similarly does not require any changes on the interest rate front.

- Deflation is bad for the economy (because as prices of goods fall, consumers have an incentive to delay purchases and consumption until prices fall further, which in turn discourages production – no incentive to profit, reduces overall economic activity and would contribute to the deflationary spiral).

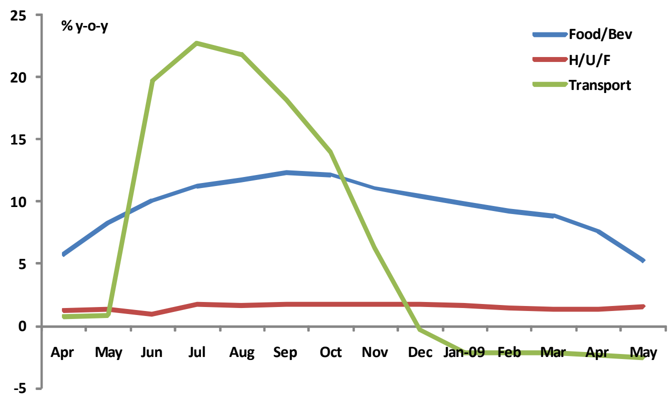
- We believe, however, that the deflationary phenomenon for Malaysia would be temporary (about six months, perhaps). If the projected recovery, mild at best, in domestic and external demand could be realized in the coming year (real GDP of 3.0% to 4.0%), consumer price level could also normalizes to 1.0% to 2.0% from 0.5% to 1.0% estimated for this year.

MALAYSIA: CPI % YOY

	CPI	F&B	Housing / Utilities /fuel	Transport
2005	3.0	5.7	1.2	6.3
2006	3.6	3.4	1.5	11.0
2007	2.0	3.0	1.3	2.3
2008	5.4	8.9	1.6	8.9
9-Feb	3.7	9.2	1.5	-2.1
9-Mar	3.5	8.8	1.4	-2.1
9-Apr	3.0	7.5	1.4	-2.3
9-May	2.4	5.2	1.6	-2.5
2Q-08	4.9	8.0	1.3	7.1
3Q-08	8.4	11.7	1.8	20.9
4Q-08	5.9	11.2	1.8	6.6
1Q-09	3.7	9.3	1.6	-2.1

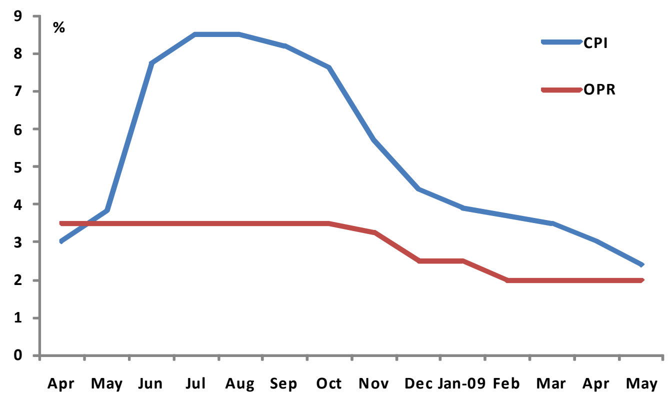
Source : Bank Negara Malaysia & Department of Statistics Malaysia

CPI BY COMPONENTS % YOY



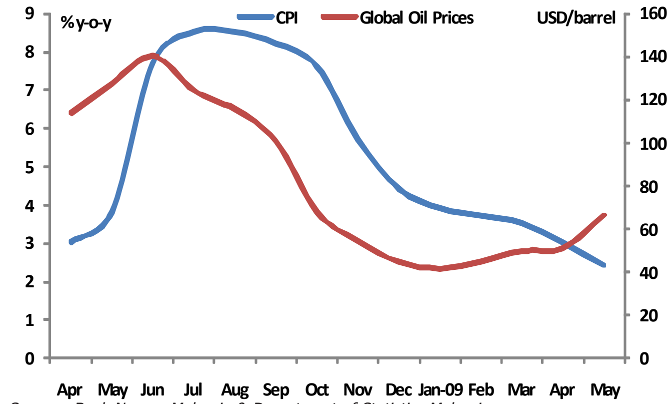
Source : Bank Negara Malaysia & Department of Statistics Malaysia

CPI ALL DIVISION vs BNM OVERNIGHT POLICY



Source : Bank Negara Malaysia & Department of Statistics Malaysia

CPI ALL DIVISION vs CRUDE OIL



Source : Bank Negara Malaysia & Department of Statistics Malaysia