Economy

AMB

MALAYSIA OPR UNCHANGED - CAPITAL FLOWS ON RADAR

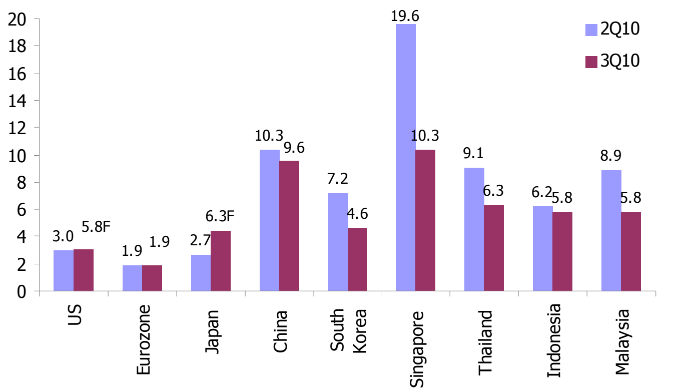
15 NOVEMBER 2010
2010/041

BNM MONETARY POLICY MEETINGS 2010

No.	Date	%
1st	26 January 2010 (Tuesday)	2.00
2nd	4 March 2010 (Thursday)	2.25
3rd	13 May 2010 (Thursday)	2.50
4th	8 July 2010 (Thursday)	2.75
5th	2 September 2010 (Thursday)	2.75
6th	12 November 2010 (Friday)	2.75

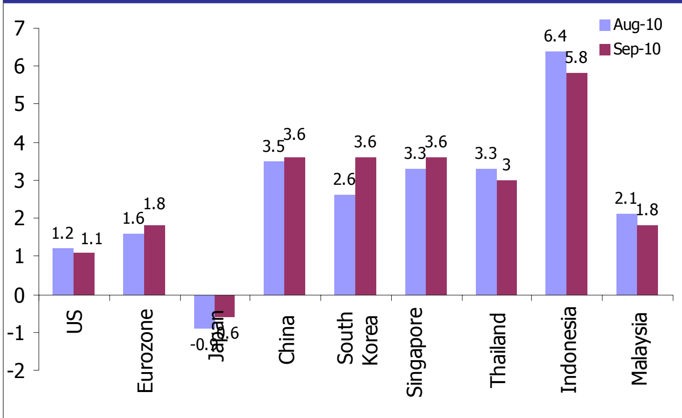
Source : BANK NEGARA MALAYSIA

REAL GDP FOR SELECTED COUNTRIES (% YOY)



Source : BLOOMBERG LP
F : RESEARCH DIVISION FORECAST

INFLATION FOR SELECTED COUNTRIES (% YOY)



Source : BLOOMBERG LP

- **In line with our and the consensus' view, Bank Negara Malaysia retained its benchmark OPR at 2.75%. The following is the MPC statement released on November 12:**

At the Monetary Policy Committee (MPC) meeting today, Bank Negara Malaysia decided to maintain the Overnight Policy Rate (OPR) at 2.75%.

Growth in the global economy has moderated in the third quarter, with a sustained divergence in the growth performance of the advanced and emerging economies. In the region, the recovery continues, although the pace of economic growth has moderated arising from a weakening of external demand. International financial market conditions have become more volatile with increased capital flows to emerging markets. This shift in global liquidity has brought with it risks to macroeconomic and financial stability in the emerging market economies.

In the Malaysian economy, recent indicators on exports and external-related sectors affirmed the earlier expectations for growth to moderate in the third quarter. Nevertheless, domestic demand has provided strong support to growth. Going forward, overall growth will continue to be well supported by domestic economic activity. Private consumption will benefit from the favourable employment conditions, firm commodity prices and accommodative financing environment, while the expansion in private investment is expected to be driven by increased capital spending in the domestic-oriented sectors.

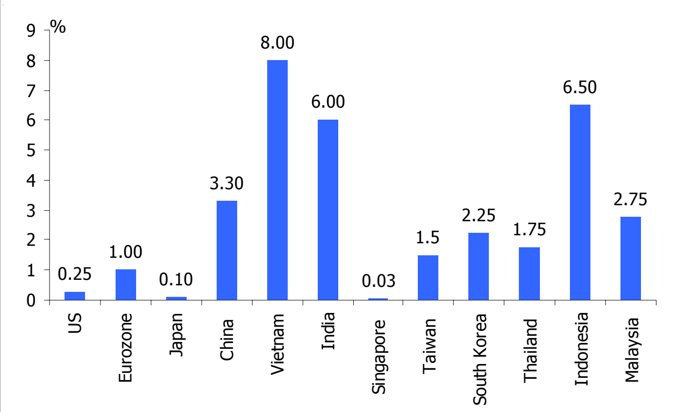
Domestic headline inflation moderated in September to 1.8%. Prices are expected to rise at a modest pace in the coming months in view of the rising global commodity and food prices. Inflation is however expected to remain moderate going into 2011.

The MPC considers the current level of OPR as appropriate and consistent with the latest assessment of the economic growth and inflation prospects. The stance of monetary policy continues to remain accommodative and supportive of economic growth. While domestic financial conditions remain orderly, greater vigilance will be accorded to the potential risks arising from large and volatile capital flows.

Comments:

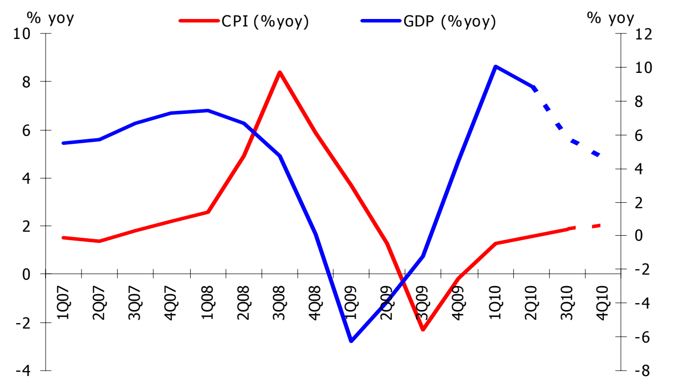
- In its MPC statement, Bank Negara reaffirmed its view on the slowing pace of the global growth, judging from the moderation in the 3Q10 GDP for the US and European economies. Meanwhile, GDP growth in China fell to single-digit while the expansion in Singapore and South Korea were eased sharply due to slowing export growth.

GLOBAL INTEREST RATES (%)



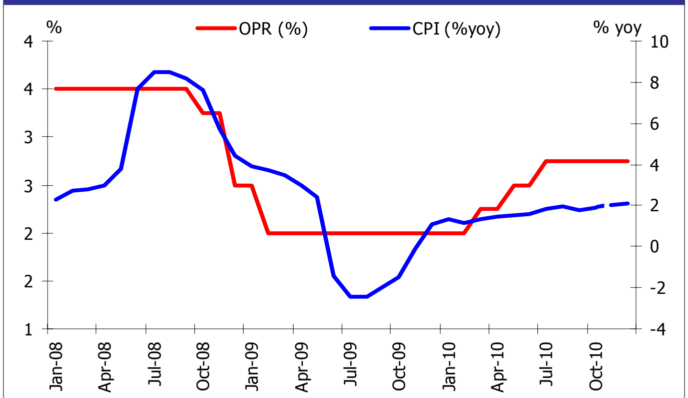
Source : BLOOMBERG LP

MALAYSIAN GDP VS CPI (% YOY)



Source : BANK NEGARA MALAYSIA,
Dotted Lines: RESEARCH DIVISION FORECAST

MALAYSIAN CPI (% YOY) VS OPR (%)



Source : BANK NEGARA MALAYSIA,
Dotted Lines: RESEARCH DIVISION FORECAST

- The statement also highlighted the volatility in the international financial market resulting from the increase in capital flows into emerging markets. This was not mentioned in previous MPC meetings, suggesting a further threat on the economic stability of the emerging economies which could adversely affect the global economy. While stressing on the potential risks arising from large and volatile capital flows, we expect Bank Negara to closely monitor the situation and react if an adverse impact on domestic activities is expected.

- Presently, the second Quantitative Easing (QE2) implemented by the US Federal Reserve has many Asian economies on guard for inflows of "hot money" into Asian economies including that of China and Thailand. The "short-term" capital is expected to cause property bubbles amongst others in emerging economies. In the 1997 financial meltdown, hot money inflows were a major contributor for the predicament of Asian economies such as Malaysia, Thailand and Indonesia.

- Bank Negara, however, appeared to be more optimistic on the domestic economy, stating that 'strong domestic demand', amidst slowing exports, will continue to support the Malaysian GDP during the 3Q10. While private consumption may show an encouraging growth, we expect that private investment would grow at a more moderate pace due to slowing manufacturing activities.

- Inflation continued to become less of a concern for Bank Negara in determining the OPR. The modest inflation rate charted in September this year gave the central bank the option to maintain the OPR for second consecutive meeting after raising it for a cumulative 75 basis points in March –July this year. Following its MPC statement, Bank Negara has a benign view on inflation for 2011, but we do expect a faster than expected increase in CPI growth on rising demand and supply pressures during the second half of next year that could finally lead to a hike in the OPR.

- While there is no hint on the future direction of interest rates, we expect that the current OPR will stay at the current level during the first half (1H) of next year. This is based on several factors:

- Firstly, the increase in the OPR would serve to attract speculative money into the country, which seems to affect the financial stability of the economy. Other regional countries such as Indonesia recently maintained its borrowing costs to avoid attracting capital inflows resulting from the low interest rates in the US and Japan. Furthermore, the so-called quantitative easing by the US, aiming to spur economic growth, would probably depress the dollar against its trading partners' currencies such as China's as well as Malaysia's and induce more capital flight into emerging market where the interest rates are higher. Given there are no signs of an increase in the US interest rate (expected to be realized only by the final quarter of 2011), we believe the OPR would likely be maintained at the current level, at least, till the end of 1H11.

- Secondly, global economic growth, expected to remain weak into next year, would continue to weigh down the local economy. Exports are expected to continue to trend lower on a further weakening in global demand following the high unemployment rate in developed economies that could suppress global spending activities. Though domestic demand is expected to support overall GDP growth for next year, concerns over the slowing exports would continue to weigh on domestic growth since exports are still an important driver of the local economy (as it constitute approximately 107% of total GDP).

- To a certain extent, we do not expect any changes in the OPR in the short to medium term as this would attract more capital inflows into the country, causing a further appreciation of the Ringgit against the US dollar. The Ringgit has appreciated as much as 11% against the USD this year, which could affect the competitiveness of Malaysian exports, and thus adversely affecting future economic growth.

- Thirdly, the high leverage among Malaysians as measured in terms of household debt together with the prevailing uncertainty in the world's markets might result in the maintenance of the current accommodative interest rate level at least during the first part of the year. As indicated by the Malaysian Institute of Economic Research (MIER), household debt has increased to 77% of GDP in 2009 – the highest in Asia- from 63.9% in 2008.

- Fourthly, Bank Negara may revert to other monetary tools to combat price increases. Presently, total outstanding loans are stable, except for the slight build up in the property segments. This has prompted Bank Negara to impose a maximum lending limit on the loan-to-value (LTV) ratio by 70% -effective Nov 3- for buyers taking out third mortgages to buy homes to prevent speculation activities in the urban areas.

- Finally, inflation is expected to remain subdued during the first half period due to the absence in demand-pull inflation. Even though there is a probability consumer prices will rise faster due to the second round of subsidy reforms anticipated early next year, this may only have a muted impact on the OPR. Previous experiences suggest that increases in inflation induced by supply-side factors did not grant any changes in the OPR.

- Presently, we expect that any shift in the interest rate policy would only happen during the 2H11. Improvements in the global condition, firmer domestic spending followed by an increase in demand- pull inflationary pressure and further effort to prevent any financial imbalances that may arise from interest rates being too low for a prolonged period of time and prompt Bank Negara to resume its interest rate hike, probably by 25-50 bps during the 2H of next year.