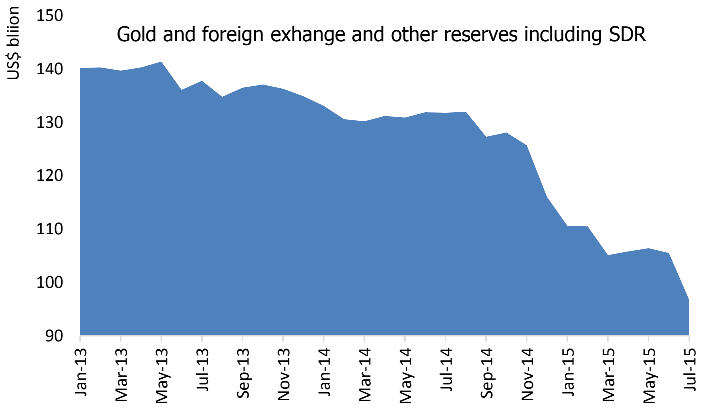
Economic Insight

2015/79 | 11 August 2015

Amanah Mutual Berhad

Malaysia: Volatility and dollar strength drive down reserves

CHART 1: INTERNATIONAL RESERVES OF BNM AS AT 31 JULY 2015



Source: Bank Negara Malaysia

CHART 2: MONTHLY CHANGE IN RESERVES (RM BILLION)

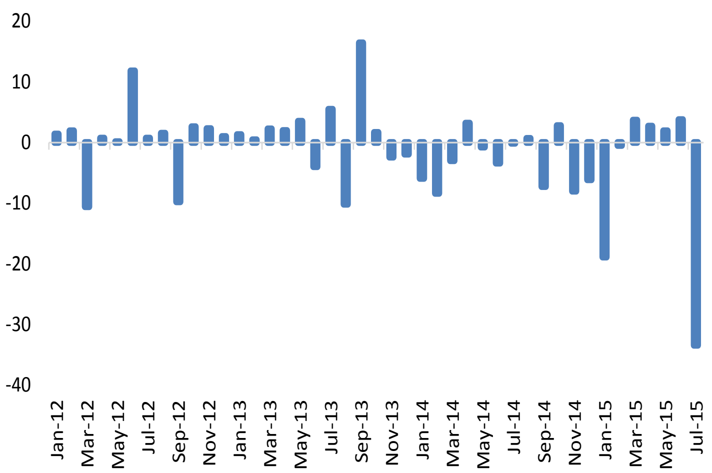
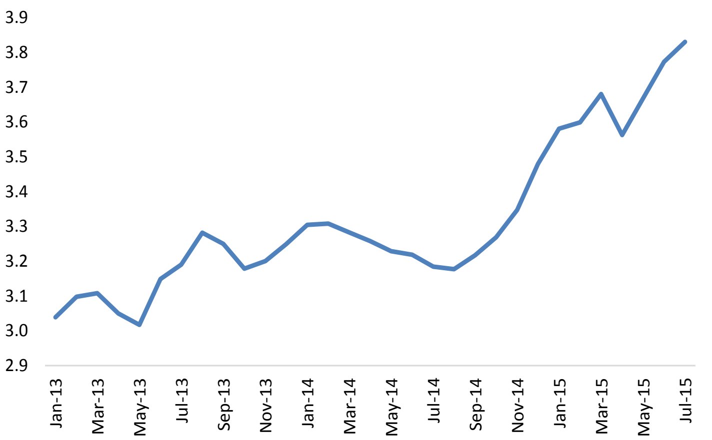


CHART 3: RM PER UNIT OF U.S. DOLLAR (END PERIOD)



Sources: Bloomberg, Bank Negara Malaysia

- As the world watched with bated breath as to whether Greece would exit the eurozone after it defaulted on a payment to the IMF and as Greeks said "no" to more austerity measures from its creditors in a referendum, global financial markets roiled in July. Likewise, on-going speculations as to when the Federal Reserve would raise rates and by how much had also similar volatile effects during the month. The slowing China economy did not help either which would further soften demand for commodities going forward. This had resulted in many emerging market currencies weakening further against the greenback as capital flowed out of emerging markets back into the U.S. Both ringgit and rupiah were the worst performers against the dollar among the ASEAN economies.

- On the domestic front, the noises from 1MDB and political contestations are thought to have contributed to the domestic equity market volatility. However, its extent is uncertain. Nevertheless, we are inclined to think that the U.S. monetary policy rate decision and developments in the eurozone had played a larger impact in explaining capital outflows than domestic uncertainty. This will continue this year on market anticipation of a first rate hike since the federal funds rate have largely been kept at 0%-0.25% range for a considerable time since the 2008/2009 sub-prime crisis.

- At the end of July, the ringgit had weakened to RM3.8310 against the dollar, representing a decline of 16.8% yoy and 1.5% mom. As at year to date (ending 31 July), the ringgit had declined by 8.7% against the dollar. If we compared yesterday's close of RM3.9285 against the dollar versus the 2014's year-end close, the ringgit would have depreciated by 11%.

- Given the global financial market volatility, Malaysia's gross international reserves recorded a decline of 13.9% yoy at the end of July, the most this year and since August 2009 when it dropped by 17.8% yoy. July's drop had brought international reserves to RM364.7 billion from RM398.1 billion at the end of June 2015, but is still significantly higher than RM329.1 billion at the end of August 2009.

- In dollar terms, international reserves trended down to $96.7 billion from $105.5 billion at the end of June, representing a drop of $8.8 billion from the previous month and an annual fall of 26.6%. The annual percent drop was the most since August 2009. However, this large drop was also related to the sharp change in value of the dollar against the ringgit and other currencies.

- On a mom basis, the fall was equivalent to 8.3%, the most since October 2008. International reserves level at below the $100 billion mark was last seen in August 2010, registering $95.2 billion. In fact when it had been at that level from Jan-August 2010, there was no hue or cry then. However, since that time, reserves had been on an upward trend, reaching its highest level of $140.3 billion in May 2013.

- Hence, both in ringgit and dollar terms, July's declines have been larger than usual due to the higher than average volatility seen in July.

- We have to be mindful that reserves are for intervention and Bank Negara Malaysia (BNM) need not adhere to keeping reserves at any psychological mark, though we are aware that the market is paying attention to this level.

- More importantly, reverses should be seen in light of months in terms of retained imports and IMF recommends that it be between 3-4 of months. As at the end of July, the reserves levels stood at 7.6 months of retained imports, still above IMF's recommended level. In terms of short-term debt it is 1.1 times.

- It is essential to note that in addition to intervention by the central bank, the change in the level of reserves is also influenced by changes from the current account, capital account, and financial account. For example, the reversal of non-resident portfolio investment from the equity market (foreigners became net sellers by RM2.8 billion in July and RM11.8 billion throughout Jan-July 2015) impacted the level of reserves. Other factors could be direct investment abroad by Malaysian companies, acquisition of foreign portfolio assets by resident investors and to a much smaller extent, Malaysians travelling abroad.

- Given that volatility is the new normal, we think that BNM would need to sustain its reserves amount to intervene and smoothen the domestic currency market movement since too rapid a decline or depreciation does not augur well with a healthy business environment, especially small and medium sized enterprises. A cheap currency is not a long-term strategy for export competitiveness, although in the intermediate term it could prove feasible.

- We are hopeful that once the U.S. starts to raise interest rates, there would be less volatility in global financial markets and the equity market accepts that the low oil price is the new structure for the commodity. Hence, the less intervention needed to sustain an orderly exchange rate movement going forward.