

Malaysia: Latest FX Liberalization and Business Friendly Measures to Further Boost Investors' Confidence

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A fulfilling week for Malaysia's financial markets, with the govt announcing further relaxation of FX controls and then the lifting of capital gains tax on real estate purchases - both effective 01 Apr 2007. In response, the ringgit surged to 9-yr high of 3.4510, from 3.4950 at the start of last week. The KLCI was also up close to 4% over the past week (biggest weekly gains in 3 years). In all, the latest measures should enhance the liquidity of ringgit trading, and probably stronger ringgit over time. More importantly, it appears that BNM is now more willing to tolerate ringgit strength. All these mean more ringgit strength, which is also very much in part of the second leg of the broad USD correction that began in 2002.

In essence, the relaxation of FX controls can be divided in three broad areas: (1) Facilitating the development of domestic financial market; (2) Promoting Malaysia as an investment destination; (3) Enhancing business efficiency and facilitating the development of the domestic capital market.

Highlights of Recent Relaxation of FX Controls:

- Abolish the net open position limit of licensed onshore banks. Currently, such positions are capped at 20% of banks' capital base. Investment banks will be allowed to conduct FX business, although subjected to certain reviews by BNM.
- To promote Malaysia as an investment destination, the govt will remove a MYR200mn overdraft limit on non-resident stock brokerages and custodian banks. Licensed onshore banks can also appoint overseas branches to their banking group to settle MYR-related transactions.
- Unit trusts, insurances companies will be allowed to invest up to 50% of their net asset value in overseas assets, from 30% limit currently. Limited imposed on banks for FX accounts maintained by residents will also be abolished. Other measures to develop the local capital markets include local firms can use IPO proceeds on the main board to invest overseas.
- Limit on the number of residential or commercial property loans by foreigners will also be abolished. Currently, the limit is 3 loans.

Measures to Stimulate Local and Foreign Investments:

- To create a more conducive business environment, Malaysia will abolish real property gains tax (effective 1 Apr), PM Abdullah told an investment conference a day after the easing of FX controls. Malaysians are subjected to 30% property gains tax if the property is sold within 2 years. On a graduating scale, the tax level will drop to 5% in the 6th year and thereafter. Foreigners pay a flat rate of 30% if the property is sold within 5 years, after which the tax rate is 5%.
- A 10-yr corporate tax breaks for 6 industries to kick start the South Johor development region. These include health care, tourism, creative, financial services, logistics and education. Other incentives included freedom to tap on global funds and unrestricted hiring of foreign workers.

Positive Sentiment Working Through Assets Prices:

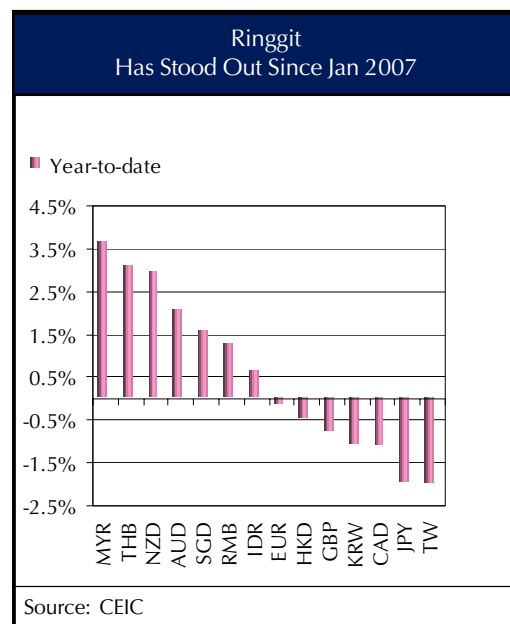
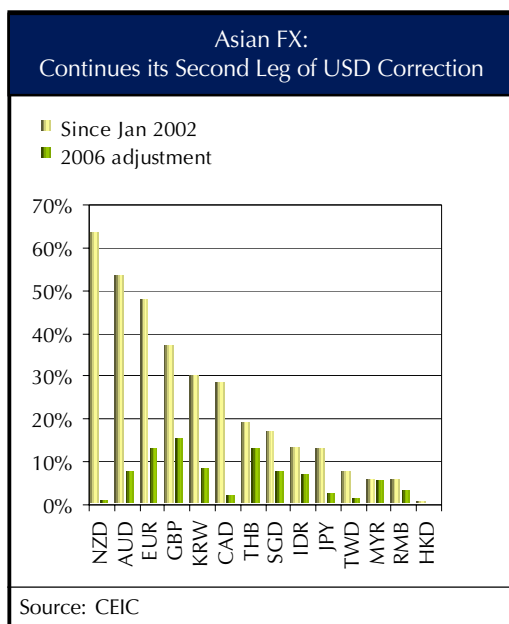
Endorsing the more open system, the ringgit appreciated 4 big figures over the past week, touching 9-yr high of 3.4510 on Monday. The rebound on the KLCI was equally impressive, surging also close to 4% over the past week - as property counters surge on the lifting of the capital gains tax. To begin with, enhancing the depth of ringgit trading also means more FX volatility, and there is naturally the

fear of a replay of the Asian crisis. However, we believe that Malaysia is now more equipped to cope with more volatility. Besides an arsenal of FX reserves of \$87.3bn, Malaysia is now sitting on stronger fundamentals. Key indicators such as NPLs of local banks, c/acct and fiscal balances have improved significantly. Further, there is one critical aspect that KL has yet to give in - offshore ringgit trading - which will limit offshore access to USD/MYR trading. While BNM governor Zeti did not rule out such a possibility, our view is that some sort of FX restrictions are not exactly a bad thing, as they help shield small emerging economies against the adverse effects of extended s-t capital flows, especially in a new environment of 'flush global liquidity'.

| Malaysia: Improving Fundamentals Since the Asian Crisis | | | |
|---|----------------|---|-----------------|
| Fiscal Balance (% of GDP) | | Current Acct Position (% of GDP) | |
| <u>1993/96</u> | <u>2005</u> | <u>1993/96</u> | <u>2005</u> |
| 6.2 | 8.4 | -4.2 | 12.8 |
| NPLs (%) | | FX Reserves (USDbn) | |
| <u>1998/99</u> | <u>2005(e)</u> | <u>End-96</u> | <u>End-2006</u> |
| 13.2 | 9.5 | 26.2 | 82.5 |
| Source: IMF, Moody's, S&P | | | |

Ringgit: Finally, Catching with the Other Asian Currencies

In terms of FX direction, our view remains for more ringgit strength. Not only the result of the latest liberalization but very much in part of the second leg of USD correction that began in Jan 2002. Certainly, Asian currencies have much to catch up, in particular the ringgit. This is also reflected on MYR NEER, which is lagging most regional currencies. While the USD/MYR has weakened about 9.1% since Jan 2002, MYR NEER has actually depreciated some 6%, while SGD NEER and THB NEER have appreciated some 4% and 14%, respectively. Adding in a still positive growth outlook, and increasingly bullish sentiment on KLCI, our view is that MYR will continue to edge higher -- albeit on gradual path.



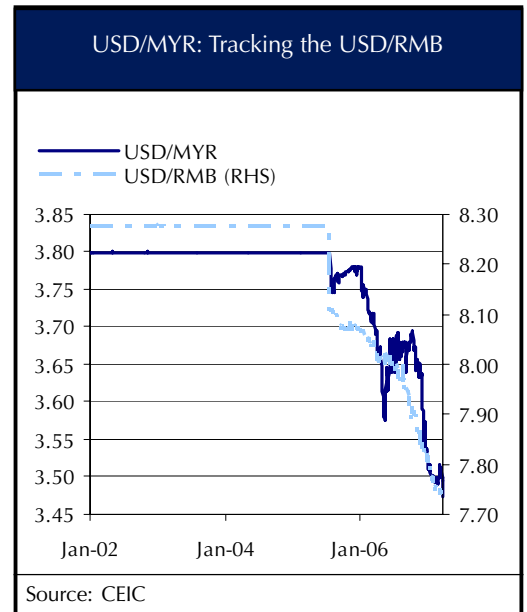
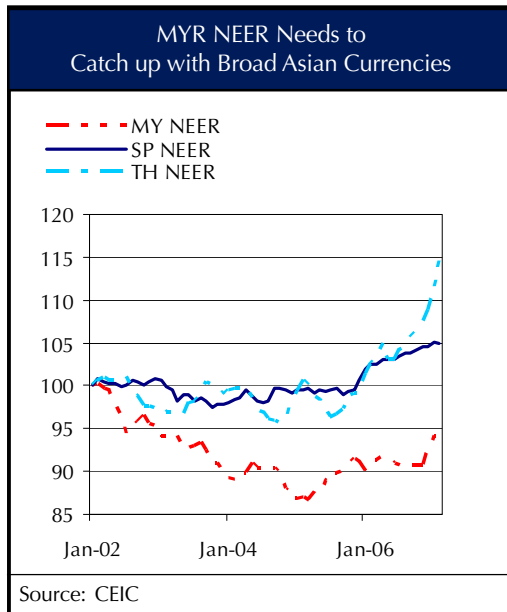
Equity: Finally, Some Excitement

After the last few years of doldrums, there are now more interests on Malaysian assets, as reflected on KLCI breaking the 1,000-level in Nov-2006, and then surging more than 25% to 1,272.87 on 23 Feb 2007, before the recent sharp global correction. Besides a still positive outlook (probably 6% GDP growth this year), the latest slew of business and financial markets friendly measures should help propel the KLCI, thereby the ringgit, forward. There is now even talk of an election before year-end or early 2008, given the current "elections friendly" environment. While declined to rule out an early

elections, PM Abdullah said the current "feel-good" factor is not strong enough to go to the polls. Malaysia's next election is only due in 2009.

Nonetheless, Watch the RMB

Since the start of the year, appreciation of MYR has been rather extensive, up 2.1%. In fact, our year-end target of 3.45 on USD/MYR was met last week. However, it is important to note that RMB appreciation has been gradual, about 1.06% appreciation - in line with market consensus of 3-5% appreciation annually. While most calculations indicate that more catch up needs to be done on the MYR, our view is that BNM would prefer a more gradual pace of ringgit appreciation, especially with global growth widely expected to moderate in the coming months. Indeed, we believe that bulk of the MYR appreciation for the year may have been delivered. In all, we expect USD/RMB at 7.45 by end-2007, and USD/MYR probably towards 3.40 (possibly 3.38) end-2007.



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