Focus Shifts From FX Regime to Fuel Subsidy

Summary:

- *In the aftermath of the RMB policy change on 21 July, and Bank Negara lifting its currency peg, the ringgit appreciated 1.35% to touch 3.7490/00. Since then, however, the extent has significantly moderated, with the currency pair back at 3.7720, amounting to only 0.7% appreciation.*
- *Market is increasingly concerned about Malaysia's growth prospects. There are also worries related to the stubbornly high global energy prices, in particular its impact on the govt's fiscal position as a result of the domestic fuel subsidy policy.*
- *Latest FX reserves figures indicated investors are reassessing their valuations of Malaysian assets, and various houses have also revised down their expectation of ringgit's appreciation over the next 12 months.*
- *However, with inflation is at its highest level since Feb 1999 and further fuel subsidy cuts in the pipeline, our view is that Bank Negara may not have much of a choice but to allow some sort of FX appreciation. After all, as compared to other currencies in the region, Malaysia can certainly afford some FX appreciation.*
- *We expect USD/MYR at 3.74 by year-end, and then 3.68 by mid-2006. Our previous projection was 3.65 by end 2005 and 3.55 by mid-2006.*

In the aftermath of the RMB policy change on 21 July, and Bank Negara lifting its currency peg, the ringgit appreciated 1.35% to touch 3.7490/00. Since then, however, the extent has significantly moderated, with the currency pair back at 3.7720, amounting to only 0.7% appreciation. Bank Negara moderating the adjustment process, to mitigate the impact on local corporates, partly explained the moves - as it forced tired longs to leave the system. More importantly, players are increasingly concerned about Malaysia's growth prospects, following the weaker than expected Q2-05 GDP and more recently exports figure for Jul. There are also worries related to the stubbornly high global energy prices, in particular its impact on the govt's fiscal position as a result of the domestic fuel subsidy policy. Latest FX reserves figures indicated investors are reassessing their valuations of Malaysian assets, and various houses have also revised down their expectation of ringgit's appreciation over the next 12 months. However, with inflation is at its highest level since Feb 1999 and further fuel subsidy cuts in the pipeline, our view is that Bank Negara may not have much of a choice but to allow some sort of FX appreciation. After all, as compared to other currencies in the region, Malaysia can certainly afford some FX appreciation.

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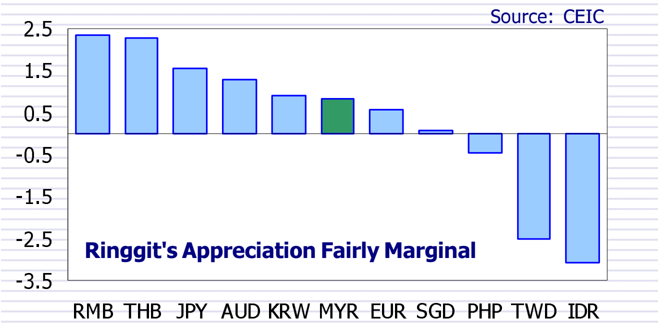
Exports & Economic Growth Momentum Moderating

Despite the largest net oil exporter in the region, Malaysian exports growth slowed to 2.9%y/y in Jul 2005 from 11.7%y/y rise in Jun. Market expectation was around 10%y/y growth. Crude oil exports were up 44.5%y/y in Jul, while electronics exports were up only 2.6%y/y. Even adjusted for the ringgit's appreciation, the headline figure was only 4+%y/y. Similarly, Malaysia's Q2-05 GDP growth underperformed, up only 4.1%y/y from 5.8%y/y in Q1-05, also slowest pace in 3 years. Market was expecting growth of around 4.6%y/y. Moderation in both manufacturing and services sectors, and higher domestic energy prices, continued to weigh on consumption. Headline figure slowed to 7.4%y/y from 10.4%y/y in Q1-05 and 10.2%y/y in the final quarter of 2004. Again, govt spending contracted, declining 2.4%y/y from 2.3%y/y in the previous quarter. The only outperformance was fixed capital formation, up 6.7% from 2-4%y/y growth since Q1-04. However, we doubt if this will sustain given the high global energy prices and further cuts in fuel subsidy, which are likely to weigh on domestic spending

Global FX Performance Since 21 Jul 2005



Malaysian GDP Growth: Consumer Spending Losing Momentum

	Mar 04	Jun 04	Sep 04	Dec 04	Mar 05	Jun 05
GDP	7.8	8.4	6.7	5.8	5.8	4.1
Total Consump't Exp	9.5	11.3	8.7	8.6	7.6	5.1
Pte Consump't	8.9	11.9	11.2	10.2	10.1	7.4
Govt Consump't	11.8	9.5	1.1	4.2	-2.3	-2.4
GFCF	3.5	3.5	3.2	2.3	2.0	6.7
Exports of G&S	16.4	20.4	19.0	10.2	9.5	7.9
Imports of G&S	21.0	25.8	24.3	12.9	7.6	7.0

Source: CEIC

(accounting for 56% of GDP). Overall, Malaysia's full-yr GDP growth should show up at the lower end of govt's 5-6% target range. Indeed, ADB in its recent publication has cut Malaysia's growth outlook to 5.1%y/y from 5.7% forecasted in Apr, citing slower global electronics demand and slack in construction activities.

Fuel Subsidy - A Thorny Issue

Despite benefiting from its net oil exporter position, Malaysia is feeling the strain subsidising domestic fuel prices. While petrol and diesel prices have been hiked three times since Oct 2004, with petrol and diesel prices up 14% and 50%, they have failed to catch up with the rise in global crude oil prices. It took 8 months for crude oil to rise from $50/bbl to $60/bbl, but less than one month to rise from $60/bbl to $70/bbl. To appease the public, the govt has promised not to raise fuel prices till the end of the year. Further, it has agreed to cut road tax for all commercial vehicles by 25%, and halved road tax for private cars with 1.0-1.6 litre engine capacity. While this should bring some cheer to consumers, it also means more burden on the govt. Fuel subsidy could cost up to MYR16.8bn this year, up 40% from MYR12bn in 2004 and a meager MYR6.6bn in 2003. This amounts to 14% of total govt's expenses. More importantly, it spells bad news for the govt fiscal position, which has stayed above 4% of GDP over the last few years. In fact, international credit rating agency has warned on several occasions that further fiscal loosening could jeopardise Malaysia's credit standing.

Comparison of Fuel Prices Within Asia

Country	RON97 (per/Litre)	Last chg (RM/Litre)	Date	DIESEL (RM/Litre)
Singapore	$1.00 (S$1.65)	Mkt adj	Aug 01	$0.65 (S$1.1)
Thailand	$0.60 (THB24)	Mkt adj	Jul 31	$0.47 (THB19.4)
Malaysia	$0.43 (MYR1.62)	14.1%	July 31	$0.34 (MYR1.28)
Indonesia	$0.45(IDR4,500)	+126%	Oct 01	$0.43 (IDR4,300)

Source: UOB

Note: Thailand has let its gasoline prices float with the market since October 2004. The govt announced an end to diesel subsidies in July 2005.

Malaysia - Fuel Price Hikes

	Petrol sen/litre (MYR)	% chg	Diesel sen/litre (MYR)	% chg
Oct-00	120		60.1	
Oct-01	130	8.3	70.1	16.6
May-02	132	1.5	72.1	2.9
Nov-02	133	0.8	74.1	2.8
Mar-03	135	1.5	76.1	2.7
May-04	137	1.5	78.1	2.6
Oct-04	142	3.6	83.1	6.4
Mar-05	142	0.0	88.1	6.0
May-05	152	7.0	108.1	22.7
Jul-05	162	14.1	128.1	18.5

Source: UOB

Malaysia: Fuel Subsidies & Tax Exemption (MYR mn)

	Direct Subsidies	Tax Exemption (Indirect Subsidies)	Total
2000	3,425	5,630	9,055
2001	2,398	5,084	7,482
2002	917	3,310	4,227
2003	1,824	4,763	6,587
2004	4,788	7,147	11,935
2005	NA	NA	16,800

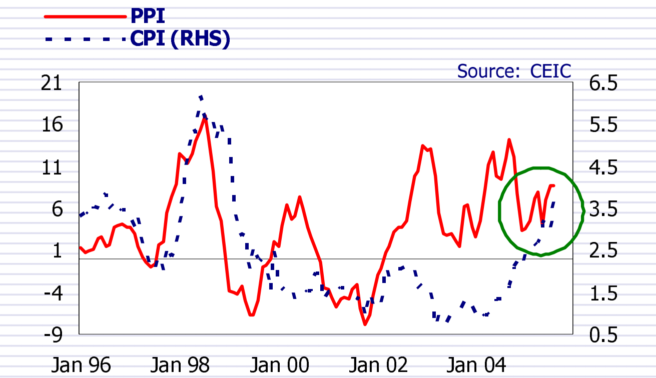
	Direct Subsiidies (% total govt expenditure)	Fiscal Deficits (% GDP)
2000	16.1	-5.7
2001	8.1	-5.5
2002	4.9	-5.6
2003	8.7	-5.3
2004	13.0	-4.3
2005	16.0	-4.0

Source: EPU

Inflation Creeping into Domestic System

CPI was up 3.7%y/y in Aug 2005, well above market forecast of 3.2-3.5%y/y rise and also the highest level since Feb 1999. Headline inflation for the first 8 months now stands at 2.8%y/y vs the govt full-yr's forecast of 2.5%. With global energy prices remaining high, and fuel subsidy a strain on the govt's fiscal position, it is a matter of time that fuel prices will have to increase further. Indeed, the govt has affirmed that inflation will stay above 3% till mid-2006. Overall, headline inflation is likely to average around 3% this year from 1.4% in 2004, and possibly 3.0-3.2% next year.

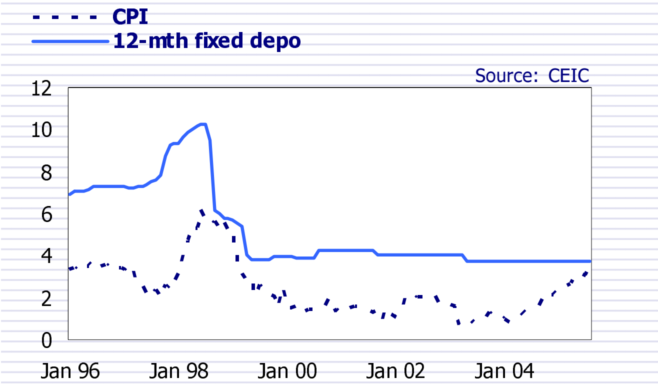
Malaysia: Higher Prices Creeping Into Domestic System



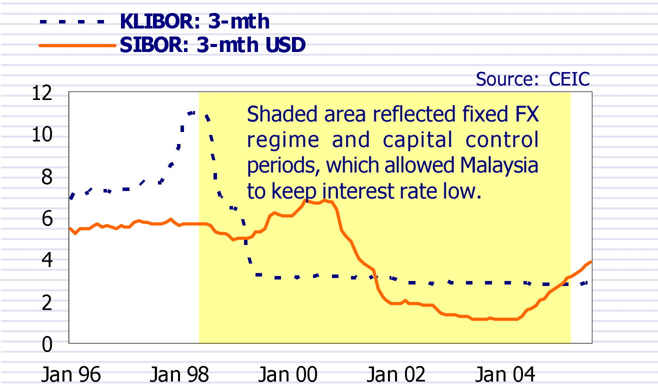
Interest Rate Hikes - Probably Sooner Than Later

The need to maintain a decent real interest rate means that it is a matter of time that Malaysia will have to hike domestic cost of funds (currently at 2.7% on the 3-mth KIBOR). Further, the US Fed has hiked rates by 2.5% points since June 2004. If Malaysia does not respond soon, it risks capital outflow. Thailand has embarked on eight interest rate hikes since Aug 2004, with the latest a 50bps move on fear of contagion risks from the Indonesia's rupiah freefall. Indeed, most prognosis is that the recent rupiah's crisis was led by narrowing USD-IDR interest rate spread, which probably explained the $5bn fall in FX reserves over the last 3 months. Latest Malaysian FX reserves are already indicating tired longs unwinding their positions, after parking some $15bn in Malaysian assets over the last two years. Between 15-30 Aug, Malaysia's FX reserves fell $300mn to $80.1bn. As such, BNM will have to hike rates fairly soon, unless we see a rebound in FX reserves holdings. Overall, we expect BNM to hike rates by 25bps (possibly 50bps) before the year is over.

Spread Between Headline CPI & 12-mth MYR Fixed Depo Returns have Narrowed Significantly



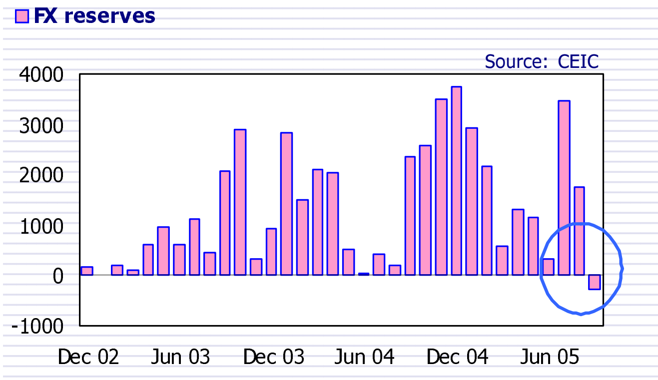
MYR-USD Interest Rate Spread has Fallen into Negative Territory



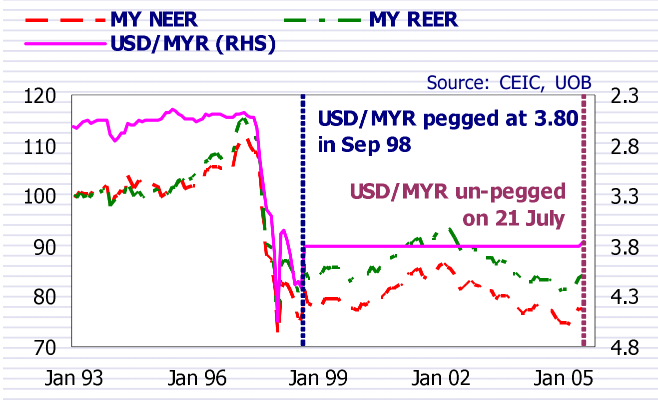
FX Valuation - Can Afford More Ringgit Upside

Current valuation is that the ringgit is still about 5-6% weaker than Sep 98, where BNM perceived the ringgit as fairly-valued. This is as compared to SGD REER and THB REER, which are about 2% and 4% weaker than Sep 98. Certainly, it means that BNM can afford more ringgit adjustment, especially with global oil prices forcing up domestic inflation. However, growth concerns imply that previous extent of appreciation may not materialise, as demand moderation should take off some heat from domestic price pressure. Overall, against earlier expectation of 3-5%, the extent of ringgit will probably be closer to the weaker end of that range. We expect USD/MYR at around 3.74 by year-end and probably only 3.68 mid-2006.

Malaysia: FX Reserves Fell $300mn 15-30 Aug 2005



MYR Valuation Since Sep 98: -5.0% (NEER) and -2.7% (REER)



Malaysia Can Afford Some Ringgit Adjustment vs its Neighbours (NEER Terms)