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MARKET DATELINE

RHB
RHB Research Institute Sdn Bhd
A member of the RHB Banking Group
Company No: 233327 -M

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Economic Outlook

Speed Bump In The Global Economy, Recovery Momentum Still Intact

Executive Summary

- Despite the slowing headline GDP growth, domestic demand has been resilient thus far and will likely pick up momentum in the 2H, underpinned by a sustained increase in consumer spending and as implementation of the ETP projects gathers speed.

- We believe the global economy will be able to weather the various challenges, from Europe's debt problem to scepticism over the sustainability of the US economic recovery and fear of China's hard landing, and emerge stronger in the 2H of the year. This will likely lift the country's exports and we expect real exports to inch up to 3.7% yoy in 2H 2011, from +3.0% estimated for the 1H.

- As a whole, we expect the economy to bounce back and expand at a faster pace of 5.5% yoy in 2H 2011, after moderating to 4.5% in the 1H. For the full-year, real GDP growth is projected to normalise to 5.0% in 2011, before picking up to 5.5% in 2012 and compared with +7.2% in 2010.

- Both fiscal and monetary policies will remain supportive of economic growth. On the fiscal front, although there was no price hike on RON95 petrol to reduce the fuel subsidy, we believe the budget deficit of 5.4% of GDP projected for 2011 is still achievable given that the Government also benefitted from higher oil revenue.

- A more moderate economic growth will likely lead to a larger current account surplus in the balance of payments for the country. This will continue to provide an underlying support to the ringgit at around RM3.00/US$. However, any substantial reversal of short-term capital could result in some temporary weakness of the ringgit, in our view.

- Inflation will likely pick up to an average of 3.8% yoy in 2H 2011, from +3.1% in the 1H. For the full-year, inflation will likely increase by an average of 3.5% in 2011, more than double +1.7% recorded in 2010. As a whole, we expect Bank Negara Malaysia to raise its overnight policy rate by 25-50 basis points in the 2H to bring it to a more neutral level of 3.25-3.50%.

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RHB

Speed Bump In The Global Economy, Recovery Momentum Still Intact

Despite the slowing headline GDP growth, domestic demand has been resilient thus far and will likely pick up momentum in the 2H, underpinned by a sustained increase in consumer spending and as implementation of the ETP projects gathers speed. We believe the global economy will be able to weather the various challenges and emerge stronger to lift the country's exports in 2H 2011. As a whole, we expect the economy to bounce back and expand at a faster pace of 5.5% yoy in 2H 2011, after moderating to 4.5% in the 1H. For the full-year, real GDP growth is projected to normalise to 5.0% in 2011, before picking up to 5.5% in 2012 and compared with +7.2% in 2010. A more moderate economic growth will likely lead to a larger current account surplus in the balance of payments for the country. This will continue to provide an underlying support to the ringgit at around RM3.00/US$. However, any substantial reversal of short-term capital could result in some temporary weakness of the ringgit, in our view. Inflation will likely pick up in 2H 2011 and we expect Bank Negara Malaysia to raise its overnight policy rate by 25-50 basis points during the period to bring it to a more neutral level of 3.25-3.50%.

Dark Cloud Gathering, But There Is Silver Lining

Despite the slowing headline GDP growth, domestic demand has been resilient thus far and will likely pick up momentum in the 2H, underpinned by a sustained increase in consumer spending and as implementation of projects under the Economic Transformation Programme (ETP) gathers speed. Whilst externally a dark cloud is gathering on the horizon, we believe the **global economy** will be able to weather the storms. As a result, the recovery would likely continue to build momentum in this new global economic growth cycle in 2H 2011, after hitting a soft patch in the 1H of the year. This will likely lift Malaysia's exports and boost business as well as consumer confidence in the 2H. As a whole, we expect **the Malaysian economy** to bounce back and **expand at a faster pace of 5.5% yoy in 2H 2011**, after moderating to +4.5% in the 1H. For the full-year, real GDP growth is projected to normalise to 5.0% in 2011, before picking up to 5.5% in 2012 and compared with +7.2% in 2010.

Dark cloud is gathering on the horizon, but we believe the global economy will be able to weather the various challenges

We expect the economy to bounce back and expand at a faster pace of 5.5% yoy in 2H 2011, from +4.5% in the 1H

Global Economy Faces Downside Risks ...

As it stands, the global economy is still struggling to grapple with **lingering concerns over the sovereign debt problems in the Eurozone and the weak recovery in the US economy**. Firstly, Eurozone's sovereign debt problem has resurfaced and is coming back to haunt the financial markets, one year after Greece was bailed out by the European Union (EU) and the International Monetary Fund (IMF). Greece is facing a risk of default and it threatens to spill over to other peripheral Eurozone countries, as increasingly the terms of Greece's rescue package put up in May 2010, which assumed that it will be able to tap the market for financing in 2012, is looking unlikely due to the exorbitant borrowing costs. Greece's 10-year bond yield rose to as high as 16.4% on 26 May, more than twice the level as at the time of the bailout (see Chart 1) and the country is due to sell €27bn of bonds in 2012 under the bailout programme. As a result, the EU is mulling over an idea to ask investors to reinvest in new debt when existing bonds mature and to consider providing Greece with additional aid to prevent a default.

The global economy is still struggling to grapple with lingering concerns over the sovereign debt problems in the Eurozone and the weak recovery in the US economy

Chart 1

Greece's 10-year Bond Yield Rising Sharply

Rising uncertainty on the US economic outlook

Secondly, there is also rising uncertainty on the US economic outlook after a string of disappointing economic data released in recent weeks and over what will likely happen to its economy after the end of quantitative easing (QE) 2 in June 2011. This, coupled with the inability of the US administration to raise the debt threshold after it hit a ceiling of US$14.3 trillion on 16 May, raises the downside risk to the US economy and revives the fear of a "double-dip" recession.

Concerns are also rising on the pace of deceleration in the Chinese economy, given that it needs to tighten its policies further

In addition, the Chinese economy is showing signs of further easing, following several rounds of aggressive credit and monetary policy tightening by the Chinese authorities to bring its asset prices and inflation under control. However, **concerns are rising over the pace of deceleration in the Chinese economy**, given the need for the Chinese authorities to tighten its policies further as prices remain sticky downward and could easily rear its ugly head again. As it stands, two surveys, done by HSBC and China Federation of Logistics and Purchasing, suggest that the growth in its manufacturing industry is slowing rapidly (see Chart 2). As inventory of finished goods in China's factories are rising, new orders have slowed down of late (see Chart 3). These created fears of a potential hard landing in the China's economy that will have a significant impact on the rest of Asia.

Chart 2

China : Manufacturing Activities Slowing Rapidly

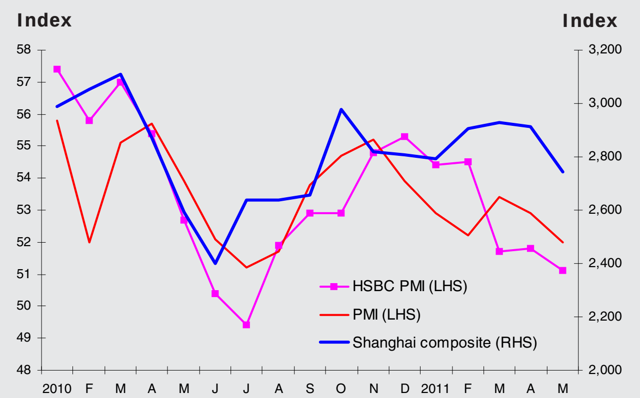
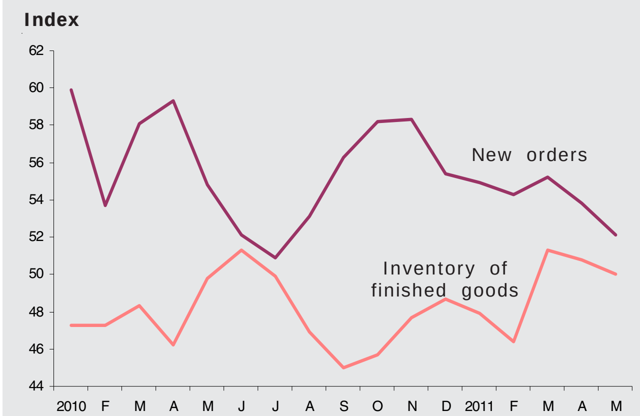


Chart 3

China : Manufacturing New Orders Heading South

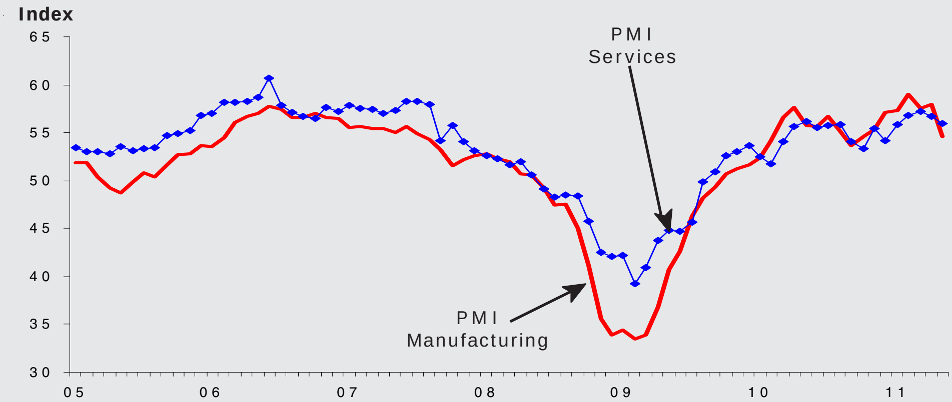


... But Will Unlikely Be Derailed

Nevertheless, whilst Europe is still grappling with Greece's debt restructuring and the potential debt default, the EU and IMF have approved the fifth disbursement of the €110bn bailout fund on 3 June. In addition, the European Central Bank gave its first signal endorsing measures to **encourage Greek bondholders to roll over the debt**, **increasing the odd of the debt problem being contained**. Besides, Germany and France will likely continue to power the region's economic growth, as indicated by continuing expansion in manufacturing and services activities in May, albeit at a slower pace (see Chart 4).

The ECB's inclination towards a rollover of Greek bonds increased the odd of the debt problem being contained

Chart 4
Eurozone : Manufacturing And Services Expanding, Albeit At A Slower Pace



For the US, the end of QE2 may mean that its economy is strong enough to sustain the recovery without additional QE measures rather than being perceived negatively. Also, the Fed said that it would maintain its balance sheet stable for another few months after June by continuing to reinvest the proceeds from maturing securities, suggesting that the unwinding process will likely be gradual to ensure no major disruption to the financial markets. This, coupled with a strong likelihood that an agreement will be reached for the Congress to raise the debt ceiling by 2 August, to continue with the current year's fiscal expenditure, will lead to an improving outlook for the US economy. We believe it is in the interest of all parties in the US for that to eventuate despite the strong undercurrent at this juncture. Also, **the softness in the US economy will likely be temporary** given that a surge in commodity and gasoline prices that affected consumer spending has since eased off. Although non-farm private payrolls grew at the slowest pace in 11 months in May and jobs created came in below expectations, it was still the 15th consecutive month of increase (see Chart 5), suggesting that the job recovery is more entrenched. In addition, consumer spending has begun to stabilise somewhat in April with personal consumption expenditure expanding by an annualised rate of 2.2% during the month, the same pace as in the previous month (see Chart 6). Furthermore, history shows that it takes time for an economy to recover from a severe financial crisis, like the one that hit the US in 2008.

The softness in the US economy will likely be temporary given that a surge in commodity and gasoline prices that affected consumer spending has since eased off

Chart 5
US : Non-farm Private Sector Still Creating Jobs

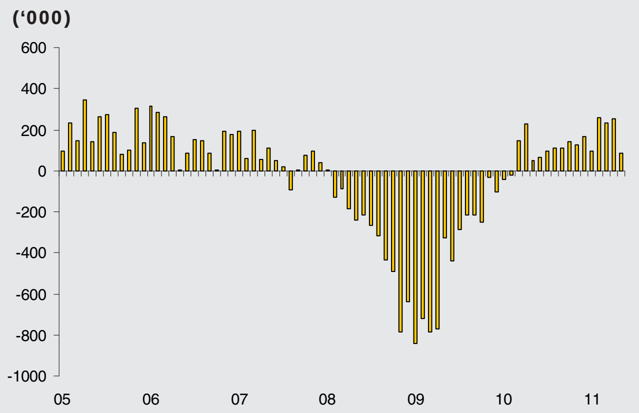
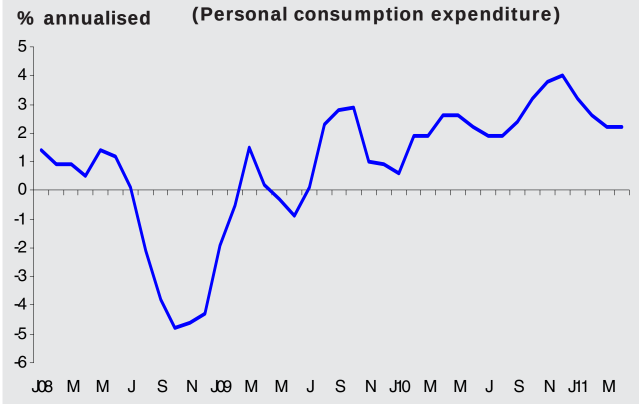


Chart 6
US : Consumer Spending Is Showing Signs Of Stabilising



At the same time, we believe China has enough policy ammunitions to steer its economy to an even keel situation. As it stands, asset prices in the major cities, such as Beijing and Shanghai, are trending down after a series of aggressive policy tightening (see Chart 7). While inflation is still a major concern for policymakers (see Chart 8), the situation could also improve gradually as weather conditions normalise and food prices ease in the 2H. In addition, the authorities were reported to have plans to shift RMB2-3 trn of debt off local governments in a preemptive move to reduce risk of a possible wave of defaults that would threaten the stability of the economy. As a whole, **China**, in our view, **will likely avoid a hard landing** for its economy.

China's preemptive moves in addressing risks in the economy suggest that it will likely avoid a hard landing for its economy

Chart 7
China : Home Prices In Major Cities Cooling Off After Policy Tightening

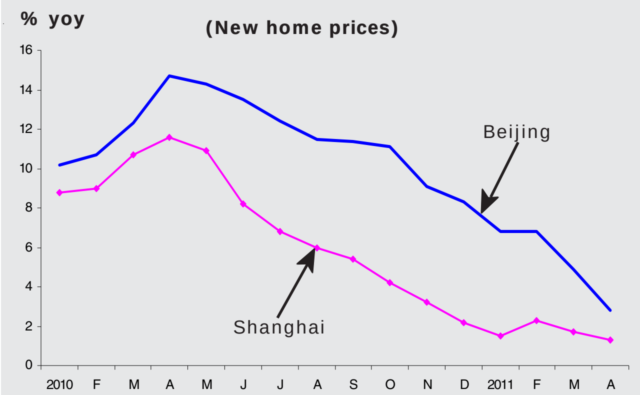
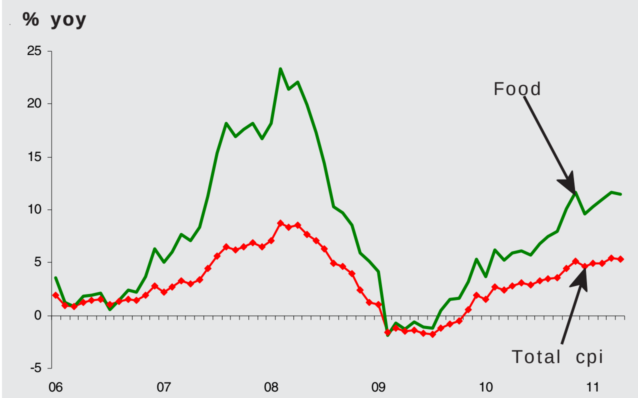


Chart 8
China : Inflation Remains A Concern



Meanwhile, although **Japan** will likely suffer another quarter of contraction in the economy in the 2Q, after falling by a larger annualised rate of 3.5% in the 1Q, the economy is **showing signs of recovering from a slump**, as companies are pushing forward plans to fix disruptions to the supply chain and consumers appeared less cautious about spending than they were immediately after the quake. This will likely be aided by reconstruction spending that could spur corporate spending and housing-related investment in the months ahead.

The Japanese economy is showing signs of recovering from a slump

Other headwinds that dragged down global economies thus far will also likely subside for the economy to bounce back in the 2H. These include : (i) Improving political situation in the Middle East and North Africa (MENA) region and oil price normalises; and (ii) Receding threat of accelerated inflation for Emerging Asia as weather conditions improve and food prices ease further.

Other headwinds that dragged down the global economy thus far will also likely subside for the economy to bounce back in the 2H

E&E Exports Will Likely Build Momentum To Recover In The 2H

In tandem with a recovery in the global economy, we expect demand for **electrical & electronic** (E&E) products, which account for about 42% of Malaysia's total exports in 2010, and other non-E&E manufactured goods to gradually improve in 2H 2011. The pick-up in E&E exports will also coincide with an uptrend in the global electronic cycle. As a result, we expect **real exports to inch up to 3.7% yoy in 2H 2011**, from +3.0% estimated for the 1H. For the full-year, we expect the country's real exports to slow down to 3.4% in 2011, after a rebound to +9.9% in 2010.

We expect real exports to inch up to 3.7% yoy in 2H 2011, from +3.0% estimated for the 1H

Resilient Consumer Spending And Implementation Of ETP Projects To Support Domestic Demand

On the local front, we expect domestic demand to pick up momentum gradually in 2H 2011, after remaining resilient in the 1H of the year, underpinned by a sustained increase in consumer spending and as implementation of the ETP projects gathers speed. Consequently, we expect **domestic demand to grow at a faster pace of 6.1% yoy in 2H 2011**, compared with +5.9% estimated for the 1H, bringing the full-year growth to 6.0% in 2011, softer than +6.4% recorded in 2010 (see Table 1). This will be underpinned by **consumer spending**, which is envisaged to inch up to 5.8% yoy in the 2H, from +5.7% estimated for the 1H. The sustained increase in consumer spending is supported by high savings and rising consumerism as well as rising wages. Rural household spending will also be strong, on account of high commodity prices that would boost rural household incomes. Furthermore, job markets will likely improve as economic growth bounces back during the period. For the full-year, consumer spending, however, will likely expand at a more moderate pace of +5.8% in 2011, compared with +6.5% recorded in 2010.

Domestic demand will likely pick up momentum gradually in 2H 2011, underpinned by a sustained increase in consumer spending and as implementation of the ETP projects gathers speed

Table 1

GDP By Demand Aggregate (2000=100)

	2008	2009	2010	2010				2011	2011(f)	2012(f)
				1Q	2Q	3Q	4Q	1Q		
	% Growth in Real Terms									
GDP	**4.8**	**-1.6**	**7.2**	**10.1**	**9.0**	**5.3**	**4.8**	**4.6**	**5.0**	**5.5**
Consumption:										
Private	8.7	0.7	6.5	5.2	7.9	6.7	6.4	6.7	5.8	6.5
Public	9.9	3.9	0.5	6.7	7.3	-9.8	0.1	6.1	6.3	3.0
Total investment	1.1	-5.6	9.8	5.8	12.9	10.1	10.0	6.5	6.4	8.6
Private	0.2	-17.0	17.7	n.a	n.a	n.a	n.a	n.a	7.8	13.0
Public	2.2	7.5	2.8	n.a	n.a	n.a	n.a	n.a	4.9	4.0
Goods & services:										
Exports	1.7	-10.5	9.9	19.1	14.0	6.8	1.7	3.7	3.4	7.8
Imports	2.1	-12.2	15.1	27.8	22.6	11.2	3.5	8.4	2.9	10.0
Agg.domestic demand	6.9	-0.4	6.4	5.5	9.4	5.0	6.2	6.6	6.0	6.5

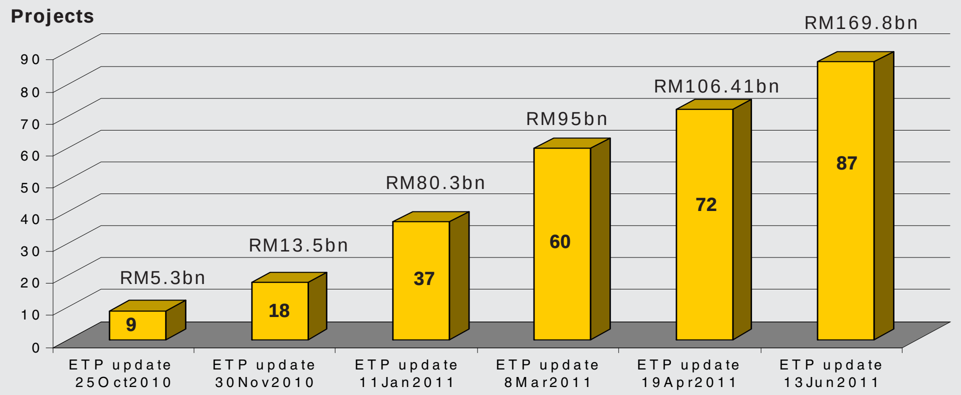
f RHBRI's forecasts

Similarly, **business spending** is likely to grow at a faster pace of around 8.5% yoy in the 2H, after easing to an estimate of +6.9% in the 1H, as businesses gain confidence, on the back of an improving economic outlook and as the implementation of the ETP projects gathers pace. As it stands, total approved manufacturing investment rose by 133.9% yoy in the 1Q, after a gain of +44.6% in 2010 and a rebound from -48.0% in 2009, indicating that private investment will likely sustain its growth in the months ahead. Similarly, the imports of capital goods held stable at 9.4% yoy in the 1Q, the same rate of increase as in the 4Q and compared with +21.1% in the 3Q, suggesting that private investment will likely be sustained. In addition, private investment will likely be supported by the implementation of the ETP projects. As of June 2011, the Government announced that 50% or 65 of its 131 entry point projects (EPPs), represented by 87 initiatives, with a total investment value of RM169.8bn (see Chart 9) are in the process of implementation and are beginning to get off the ground). Given the private-public partnership in the programme, **public investment** is projected to be sustained in the 2H of the year. As a whole, we expect **fixed capital formation** to pick up to 6.7% yoy in 2H 2011, from +6.0% estimated for the 1H, bringing the full-year growth to 6.4% during the year, compared with +9.8% in 2010. Public consumption, on the other hand, will likely expand at a faster pace of 6.7% yoy in the 2H of the year, compared with an estimate of +6.3% in the 1H, due partly to the low base effect.

Business spending is likely to grow at a faster pace in the 2H, as businesses gain confidence, on the back of an improving economic outlook and as the implementation of ETP projects picks up

We expect fixed capital formation to strengthen in 2H 2011, driven by private investment

Chart 9
Malaysia : 87 Initiatives Under The 65 EPP Projects Have Been Announced



On Track To Achieve An Improvement In The Budget Deficit

Although the crude oil price rose by 24.3% to an average of US$98.86/barrel, from an average of US$79.51/barrel in 2010, the Government had decided to keep RON95 petrol price unchanged at the current level on 25 May, implying that the fuel price is likely to stay at the current level until the next review in December. Under the ETP, the Government is supposed to reduce its subsidies gradually once every six months. The Government last raised the fuel prices by 2.7-2.9% on 4 December. By keeping fuel price stable, the Government would have to dip deeper into its coffer to fund the subsidy expenditure, on the back of a surge in commodity and crude oil prices. Earlier, the Government indicated that the subsidy bill will increase substantially to about RM21bn in 2011, if nothing is being done to address it, compared with RM10.3bn incurred in 2010. Of the total amount, about RM18bn will be used to foot the bill of fuel subsidy, up from RM10.3bn estimated previously based on an average crude oil price of US$85/barrel, and compared with RM8bn recorded in 2010. Despite the increase in subsidy expenditure, we believe the move would not strain the Government's fiscal position and **the budget deficit of 5.4% of GDP** or RM45.5bn **projected for 2011 is still achievable** (see Table 2), an improvement from a deficit of 5.6% of GDP or RM43.3bn recorded in 2010. We understand that as long as crude oil price stays at around US$105/barrel, it would not dent the Government

The Government decided to keep RON95 petrol price unchanged at the current level on 25 May

fiscal position badly, as for every US$1/barrel increase in crude oil price, the Government's revenue is estimated to increase by RM300m. As it stands, the Government's revenue jumped by 38.5% yoy in 1Q 2011 (see Chart 10), indicating that it might have benefited from higher oil revenue, especially after it changed the Petroleum Income Tax to the current year assessment (pay-as-you-earn) from the assessment based on previous year income since 2010. The operating expenditure, on the other hand, increased by 21.3%, albeit slower than the increase in revenue during the quarter. Nevertheless, in a move to reduce the subsidy expenses, the Government had on 10 May raised the sugar price by 9.5% or 20 sen to RM2.30/kg, while the diesel subsidy for commercial vehicles, including deep sea fishing boats had been removed from 1 June. The moves are expected to save the Government RM117m and RM659m in subsidy, respectively. Also, the gas price provided by Petronas to power producers and industrial users had been raised on 1 June and will likely be reviewed every six months to enable the company to sustain its dividend payment to the Government and to invest for growth.

The move would not strain the Government's fiscal position and the budget deficit of 5.4% of GDP projected for 2011 is still achievable

Table 2

Federal Government Financial Position

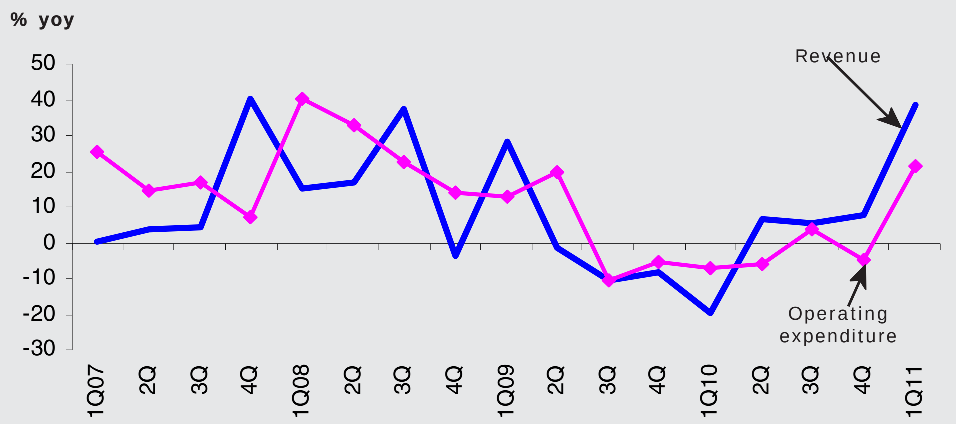
	2008	2009	2010[1](e)	2011[1](f)	2010(e)	2011f)
		(RM bil)			(%, change)	
Revenue	159.8	158.6	159.6	165.8	0.6	3.9
Operating Expenditure	153.5	157.1	151.6	162.8	-3.5	7.4
Current balance	6.3	1.5	8.0	3.0		
Gross development expenditure	42.8	49.5	52.8	49.2	6.5	-6.8
Less : Loan recoveries	1.0	0.6	1.5	0.7		
Net development expenditure	41.9	49.0	51.3	48.5	4.6	-5.5
Overall balance	**-35.6**	**-47.4**	**-43.3**	**-45.5**		
% to GDP	**-4.8**	**-7.0**	**-5.6**	**-5.4**		

[1] *Budget estimate, excluding 2011 tax measures*

e Estimates *f Forecasts*

Source : MOF's Economic Report 2010/2011

Chart 10
Malaysia : Government's Revenue Benefitted From Higher Oil Prices



The setback for keeping fuel price stable, however, is that Malaysia would not be able to channel the savings from subsidies into more productive spending and encourage the efficient use of energy.

Supply Side Activities Are Likely To Bounce Back

Activities on the supply side from manufacturing to services, construction, agriculture and mining sectors are likely to grow at a stronger pace in 2H 2011, in tandem with a pick-up in exports and domestic demand. Value added in the **manufacturing** sector is projected to pick up to 6.4% yoy in 2H 2011, after easing to an estimate of 5.0% in the 1H, as external demand for the country's exports gains pace and domestic demand grows at a faster rate. As it stands, output of the export-oriented industries slowed down to 4.6% yoy in 4Q 2010, from a high of +14.5% in the 1Q, before inching up to +4.8% in 1Q 2011, indicating that the sub-sector had begun to show signs of stabilisation just right before the Japan's disaster struck on 11 March. While Japan's disaster and slowing global growth will likely cause another quarter of setback for the export-oriented industries, we believe it will likely gradually improve towards the year end, on account of a pick-up in exports and Japan's reconstruction of areas affected by the earthquake. Similarly, output of domestic-oriented industries slowed down to 8.6% yoy in the 1Q, from +13.6% in the 4Q of last year. Despite the slowdown, growth remained reasonably strong and we believe it will likely bounce back in the 2H, underpinned by the implementation of projects under the ETP and resilient consumer spending. For the full-year, the manufacturing sector, however, is projected to soften to 5.7% in 2011, after picking up to +11.4% in 2010 (see Table 3).

The manufacturing sector is projected to pick up in 2H 2011, as external demand for the country's exports gains pace and domestic demand grows at a faster rate

Table 3

GDP By Industrial Origin (2000=100)

	2008	2009	2010	2010				2011	2011(f)	2012(f)
				1Q	2Q	3Q	4Q	1Q		
	% Growth in Real Terms									
GDP	**4.8**	**-1.6**	**7.2**	**10.1**	**9.0**	**5.3**	**4.8**	**4.6**	**5.0**	**5.5**
Agriculture	4.3	0.6	2.1	7.2	2.8	3.0	-3.9	-0.3	2.9	1.5
Mining	-2.4	-6.3	0.2	1.0	1.5	-0.7	-1.2	-3.0	0.7	2.0
Manufacturing	1.2	-9.3	11.4	17.1	16.0	7.6	6.2	5.4	5.7	7.8
Construction	4.2	5.9	5.1	8.6	4.1	2.8	5.6	3.8	4.8	5.3
Services	7.6	3.1	6.8	8.6	7.4	5.3	6.1	5.9	5.7	5.7

f RHBRI's forecasts

In the same vein, the broad **services sector** will likely grow at a faster pace of 5.9% yoy in 2H 2011, compared with +5.5% estimated for the 1H, underpinned by a pick-up in trade activities as well as higher business and consumer spending during the period. This will likely lift services activities in utilities; transport & storage; finance & insurance; and communications sub-sectors. Similarly, we expect activities in wholesale & retail trade, accommodation & restaurant and real estate & business sub-sectors to pick up. Also, government services will likely remain resilient during the period, in line with an increase in public consumption. The services sector, however, will likely expand at a more moderate pace of 5.7% in 2011, compared with +6.8% in 2010.

The services sector will likely grow at a faster pace in 2H 2011, underpinned by a pick-up in trade activities as well as higher business and consumer spending

Also, we expect **construction activities** to gain pace and grow by 5.0% yoy in the 2H of the year, compared with an estimate of +4.7% in the 1H, as the implementation of the ETP projects gathers momentum. This will likely be supported by activities in the construction of residential property during the period, while ongoing projects will likely drive construction activities in the non-residential property sub-sector. As it stands, housing approvals by the Ministry of Housing and Local Government held

We expect construction activities to gain pace in the 2H of the year, as the implementation of the ETP projects gathers momentum

relatively stable at 31.6% yoy in the 1Q, compared with +31.7% in the 4Q. Although the growth was off the high of +43.1% recorded in the 3Q of last year, it remained robust. Similarly, the renewal of permits for sales and advertising of houses picked up to 25.1% yoy in the 1Q, from +13.0% in the 4Q and a low of +8.6% in the 3Q of last year. For the full-year, growth in the construction sector is projected to ease to 4.8% in 2011, from +5.1% in 2010.

In the same vein, the **agriculture** output is projected to strengthen to 4.1% yoy in 2H 2011, after recovering to a growth of +1.5% estimated for the 1H of the year. This will be driven by a recovery in palm oil production during the period, as weather conditions normalise. As it stands, palm oil production contracted by a smaller magnitude of 1.4% yoy in January-April 2011, compared with -6.5% in 2H 2010. Similarly, the production of saw logs will likely improve, in line with higher prices and an improvement in weather conditions even though it suffered a larger contraction of 26.2% yoy in January-February 2011, compared with -17.7% in the 2H of 2010. Similarly, the production of rubber moderated to 2.1% yoy in the 1Q, from +3.4% in 2H 2010 but high rubber prices amid strong global demand will likely continue to encourage tapping activity. Meanwhile, the non-commodity sub-sector such as fisheries, livestock and crops will continue to record favourable growth, following the Government's efforts to invigorate the sector. As a whole, the agriculture sector's growth will likely pick up to 2.9% in 2011, from +2.1% in 2010.

The agriculture output is projected to strengthen in 2H 2011, driven mainly by a recovery in palm oil production during the period

Similarly, **mining** output is projected to bounce back and grow by 2.4% yoy in 2H 2011, after recording a smaller contraction of 0.8% estimated for the 1H. This will be driven mainly by a pick-up in the production of crude oil after the maintenance work, while liquefied natural gas (LNG) output will likely be higher due to stronger demand. As it stands, crude oil production fell by a larger magnitude of 6.8% yoy in January-April 2011, compared with -4.4% in 2H 2010, caused by the maintenance work. Similarly, LNG production softened to 0.2% yoy in January-April 2011, from +4.8% in 2H 2010. For the full-year, mining output is projected to grow at a faster pace of 0.7% in 2011, after turning around to record a positive growth of +0.2% in 2010, the first in three years.

Mining output is projected to bounce back in 2H 2011, on account of a pick-up in the production of crude oil and LNG

Resilient Monetary And Loan Growth

The growth of broad monetary aggregate, **M3**, **accelerated to 10.1% yoy in April**, following an expansion of +8.2% in March and from a low of +7.0% in December last year. This was the strongest growth in 28 months, reflecting resilient underlying economic activities and inflow of foreign portfolio funds driven by better returns in investing in Malaysian assets. As a result, external operations soared to a new high of 32.0% yoy during the month, from +19.3% in March and +15.8% in February, pointing to a substantial inflow of foreign portfolio funds. A sharper fall in government operations as well as a slowdown in the demand for funds by the private sector, however, offset part of the gain. The former points to a moderation in government development expenditure during the month, while the latter was mainly on account of a sharper decline in the issuance of securities which was mitigated by stronger demand for loans. Going forward, we expect M3 growth to moderate to around 6.8% in 2011, from +7.0% at end-2010, as a reversal of foreign portfolio funds is likely in 2H 2011, albeit gradually. Despite the moderation in money supply growth, **monetary policy will likely be accommodative to support the country's economic growth in 2H 2011**.

M3 growth accelerated in April, reflecting resilient underlying economic activities and inflow of foreign portfolio funds

Monetary policy will likely be accommodative to support the country's economic growth

Similarly, loan growth inched up to 13.5% yoy in April, after expanding by +13.2% in March and exceeded the recent high of +13.2% recorded in November. This was mainly on account of **a strengthening in corporate loans, which were offset partially by a slowdown in household loans** during the month. Our estimate showed that corporate loans rebounded to increase by 14.6% yoy in April, from +13.9% in March but off the high of +16.7% recorded in November. The stronger growth was due to a pick-up in loans extended to the agriculture, manufacturing, utilities and financing, insurance & business services sectors as well as a smaller decline in loans extended to the transport, storage & communication sector. Loans extended to the construction & real estate and wholesale & retail sectors, on the other hand, grew at the same pace in April and March. These were, however, offset partially by weaker growth in household loans, which moderated to 13.1% yoy in April, after strengthening to +13.2% in March and compared with a high of +14.0% recorded in November. This was primarily due to a moderation in the growth of credit card loans as well as loans extended to purchase passenger cars and houses. In the same vein, personal loan growth eased while loans extended for the purchase of consumer durable goods recorded a sharper decline during the month. Going forward, we expect the banking system's loans to **expand at a more moderate pace of 11-12% in 2011**, compared with +12.8% in 2010, in line with a slowdown in economic growth. The move by the Central Bank to raise interest rates and tighten credit conditions for housing and credit card loans are likely to have some impact as well. As it stands, the amount of loans approved by the banking system, which provides an indication of the amount of loans that may be disbursed in the months ahead, slowed to 24.0% yoy in April, after surging to a new high of +44.7% in March, suggesting that loan growth had probably peaked and will likely moderate in the coming months.

We expect the banking system's loans to expand at a more moderate pace in 2011, in line with a slowdown in economic growth

In terms of asset quality, the net impaired loan ratio of the banking system improved slightly to 2.1% of total loans in April, from 2.2% in March and after remaining relatively stable at 2.3% between December 2010 and February 2011. Going forward, we expect the banking system's **net impaired loan ratio to improve to 1.8% by end-2011**, from 2.3% at end-2010.

The banking system's net impaired loan ratio will likely improve in 2011

A Wider Current Account Surplus, Ringgit Fundamentally Strong

A slowdown in economic growth in 2011 will likely result in a sharper deceleration in the growth of imports relative to that of exports during the year. This will likely translate into an improvement in the country's external position. As a result, we expect the **current account surplus** of the balance of payments **to widen to RM98.6bn or 12.5% of GNI in 2011**, compared with a surplus of RM88.1bn or 11.9% of GNI in 2010 (see Table 4). This is on account a larger surplus in the merchandise trade account, as a slower economic growth will likely suck in lesser imports. At the same time, the services account is projected to record a slightly larger surplus due to the smaller net payment for transportation charges as imports slow down. A widening deficit in the income account, as dividends from profits to be repatriated by non-resident controlled companies are likely to remain large, while Malaysian corporations will probably bring back less profits into the country, however, will likely offset part of the gain. Also, repatriations of salaries and wages by foreign workers are likely to remain large during the year, given the country's reliance on foreign workers. Meanwhile, the pick-up in the current account surplus will likely contribute to a build-up in the country's foreign exchange reserves and fuel domestic liquidity in the financial system. As it stands, the excess liquidity (including repos) mopped up by the Central Bank from the banking system rose to RM286.3bn at end-May, from RM242.3bn at end-2010.

The current account surplus of the balance of payments is projected to widen in 2011, on account of a higher trade surplus

Table 4

Balance Of Payments

	2009	2010	2010	2011				2011 (f)	2012(f)
			1Q	2Q	3Q	4Q	1Q		
	(RMbn)								
Current account	**112.1**	**88.1**	**29.3**	**14.8**	**20.2**	**23.8**	**30.2**	**98.6**	**96.1**
(% of GNI)	**(16.8)**	**(11.9)**	**n.a**	**n.a**	**n.a**	**n.a**	**n.a**	**(12.5)**	**(11.3)**
Goods	141.7	134.7	44.4	30.0	28.0	32.3	42.4	143.5	142.3
Services	4.7	1.7	-0.0	-0.2	1.1	0.9	-1.3	1.0	1.3
Income	-14.6	-26.5	-9.8	-9.3	-3.5	-4.0	-5.7	-26.1	-27.4
Current transfers	-19.6	-21.8	-5.4	-5.7	-5.3	-5.5	-5.2	-19.8	-20.0
Capital account	-0.2	-0.2	-0.0	-0.0	-0.1	0.0	-0.0	0.0	0.0
Financial account	-80.2	-19.8	-17.6	-0.2	-3.3	1.2	-6.0	-19.0	-36.5
Errors & omissions*	-17.9	-70.7	-31.2	-16.6	-15.9	-7.0	-8.3	-28.0	-25.0
Overall balance	13.8	-2.6	-19.6	-1.9	1.0	17.9	15.9	51.6	34.6
Outstanding reserves^	331.4	328.7	311.8	309.8	310.8	328.6	344.5	380.3	414.9
(US$)^	96.7	106.5	95.3	94.8	105.8	106.4	113.8	124.1	135.6

f RHBRI's forecast ^ As at end-period

** Reflect mainly revaluation gains/losses from Ringgit depreciation/appreciation and statistical discrepancies*

The financial account deficit is projected to narrow further in 2011

Similarly, the **financial account deficit** is projected to **narrow further** in 2011. We believe the outward direct investment (Malaysians invest abroad) is likely to shrink, as investors turned more cautious in view of a slowing global economy, while inflow of foreign direct investment is likely to pick up, as indicated by a sustained growth in the approved foreign manufacturing investment. Similarly, we expect the outflow of other private investment (capital that are not classified as direct outward investment) to slow down and deficit in errors & omissions to narrow this year given prospects of a further strengthening in the ringgit. These, however, will likely be offset partially by a smaller inflow of foreign portfolio investment in 2011, after a strong pick-up in 2010, as economic growth in developed countries will likely improve and their markets becoming more attractive in relative terms. As a whole, we expect capital outflow to narrow to around RM19.0bn in 2011, from -RM19.8bn in 2010.

The overall balance of payments is projected to record a surplus in 2011

Consequently, the **overall balance of payments** is projected to record a surplus of around RM51.6bn in 2011, compared with a decline of RM2.6bn in 2010, after taking into account a smaller deficit in errors & omissions. This will boost the country’s foreign exchange reserves to US$124.1bn by end-2011, from US$106.5bn at end-2010.

We expect the ringgit to be well supported fundamentally at around RM3.00/US$

The build-up in foreign exchange reserves will continue to provide an underlying support to the ringgit. Nevertheless, a substantial reversal of capital flows may weaken the ringgit temporary when the Fed Reserve in the US and the European Central Bank (ECB) signal a change in its policy stance. Indeed, it might have begun given that the ringgit weakened by 1.6% to RM3.0085/US$ on 6 June, from RM2.9615 at end-April, after the Fed signalled that it would end the quantitative easing when it expires in June, while the ECB has begun raising its interest rates for the first time in almost three years in April. However, the Fed said that the monetary policy will remain stable after June and we believe the Fed will only start raising interest rate in the course of 2012. Similarly, the ECB signalled that the increase of its interest rates will be gradual due to the uneven economic recovery in the region. This suggests that, unlike 2008, a reversal of the foreign portfolio inflow will likely be gradual given that the interest rate differentials between Malaysia and the US, Eurozone and Japan will remain wide for a while. Indeed, the ringgit could gain some support when investors start to anticipate Bank Negara raising interest rates again, particularly in 2H 2011. As the outflow of foreign portfolio investment normalises, we **expect the ringgit to be well supported fundamentally at around RM3.00/US$** towards the end of the year. Further out, the ringgit will likely strengthen to RM2.80-2.90/US$ by end-2012, on the back of a sustained surplus in the country's current account of the balance of payments.

Inflation Trending Up In The 2H And Will Likely Stay Elevated In 2012

The headline inflation rate quickened to 3.2% yoy in April, the fifth consecutive month of increase, from +3.0% in March and a low of +2.4% in January (see Table 12). This was the fastest increase in 24 months, primarily attributed to faster increases in both the core inflation rate and food & non-alcoholic beverage prices during the month. The core inflation rate grew at a faster pace of 2.5% yoy in April, compared with +2.3% in March. This was driven by an increase in the costs of transportation and a rebound in the costs of communication during the month. The acceleration in the costs of transportation, which climbed to 5.3% yoy in April, after rising to +4.6% in March, reflected the reduction of fuel subsidies by the Government in December and the readjustment of the RON97 fuel prices due to the elevated level of crude oil prices. These were made worse by faster increases in the costs of education and recreational activities & culture as well as the prices of furnishings & household equipment and charges at restaurants & hotels. These were, however, mitigated by a sharper decline in the prices of clothing & footwear and a slowdown in the cost of healthcare during the month. The price of alcoholic beverages & tobacco and the cost of housing & utilities, on the other hand, held stable in April. Meanwhile, the price of food & non alcoholic beverages rose by 4.9% yoy in April, after holding stable at +4.7% in March and February.

The headline inflation rate quickened in April, attributed to faster increases in both the core inflation rate and food & non-alcoholic beverage prices

Going forward, although the price of RON95 petrol would be held stable for the time being, **inflation is still likely to trend up in the near term**, caused by the power tariff hike, increase in industrial gas price and international food as well as commodity prices in late 2010 and the early part of the year. Indeed, the removal of diesel subsidy for commercial vehicles, including deep sea fishing boats, from 1 June, has prompted members of the Pan-Malaysia Lorry Owners Association to raise transportation charges by 20-30%. Also, sugar price has been raised by 9.5% or 20 sen to RM2.30/kg on 10 May and traders are likely to take advantage of the situation to raise other retail product prices. In addition, anecdotal evidences suggest that inflationary expectation is building. This was reaffirmed by the Malaysian Institute of Economic Research's (MIER) survey, which indicated for the last two consecutive quarters that consumers are concerned about inflation. In fact, the Government's New Economic Model which intends to transform the country into a high income nation might have played a part as well. In the same vein, rising food prices might have begun to spill over into non-food prices given the resilient demand in the country, as domestic demand strengthened to 6.6% yoy in 1Q 2011, from +5.9% in the 4Q, underpinned by a pick-up in both private and public consumption spending, even though the overall real GDP growth softened to 4.6% in the 1Q, from +4.8% in 4Q 2010. As a whole, **inflation will likely pick up to an average of 3.8% yoy in 2H 2011**, from +3.1% in the 1H. For the full-year, the headline inflation will likely increase by an average of 3.5% in 2011, more than double +1.7% in 2010 and will be at the high end of the Central Bank's forecast of between 2.5-3.5% in 2011. Further out, inflation will likely stay elevated in 2012, given that subsidies for fuel and power tariff as well as industrial gas are likely to be reduced progressively according to the plan.

Inflation will likely pick up to an average of 3.8% yoy in 2H 2011, from +3.1% in the 1H

Further Policy Normalisation Is Envisaged In 2H 2011

In order to be ahead of the curve, rising inflationary pressure had prompted the Central Bank to raise the Overnight Policy Rate (OPR) by 25 basis points to 3.00% on 5 May, from 2.75%. This marked the first interest rate hike by the Central Bank since July 2010, after leaving it unchanged in four policy meetings in a row. The hike was predicated on the Central Bank's assessment that the Malaysian economy will remain firmly on a steady growth path. In addition, the Central Bank is concerned that **domestic demand factors could exert upward pressure on prices in 2H 2011**, due to elevated levels of commodity and fuel prices, and as economic growth gradually improves. The Central Bank also raised the Statutory Reserve Requirement (SRR) Ratio of the banks by 1.0 percentage point to 3.0% effective 16 May 2011 with the aim to manage the risks of a further build-up of liquidity that could cause macroeconomic and financial imbalances. Although the increase in the OPR and SRR ratio will likely have some impact on consumer spending and business activities, it will help to moderate the increase in prices, in our view.

The Central Bank is concerned that domestic demand factors could exert upward pressure on prices in 2H 2011

Going forward, the power tariff and industrial gas price hikes, coupled with the resilient consumption spending, have increased the odd of an interest rate hike by the Central Bank in its next policy meeting in July. Although the Government held the fuel prices stable on 25 May, the increase in power tariff and industrial gas prices will likely have a knock-on effect on other product and services prices. This suggests that an interest rate hike by the Central Bank in July cannot be ruled out altogether. As a whole, we believe **the Central Bank will likely raise the OPR by another 25-50 basis points in 2H 2011** to bring the OPR to a more neutral level of 3.25-3.50% by end-2011 and the OPR will likely be raised by another 25-50 basis points in 2012. Similarly, the **SRR ratio could also be raised by another 1.0 percentage point** to bring it to the pre-recession level of 4.0% by end-2011.

We believe the Central Bank will likely raise the OPR by another 25-50 basis points in 2H 2011 to bring the OPR to a more neutral level of 3.25-3.50%

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