

Ringgit's strength expected to persist but at a gradual pace

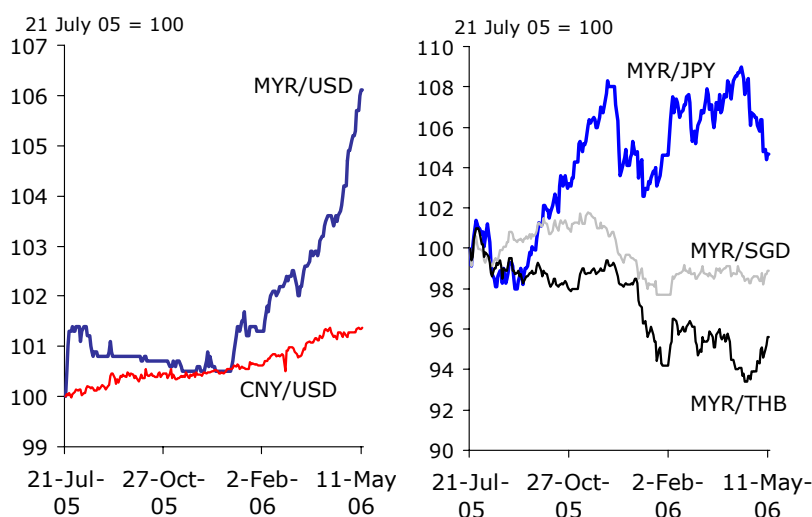
18 May 2006

The ringgit has strengthened considerably in recent months after a more measured pace of appreciation in the months after the currency moved from a pegged to a managed float exchange rate. Since the new regime was adopted on 21 July 2005, the ringgit has strengthened by 4.8% against the US dollar – a faster pace of appreciation than the Chinese yuan of 1.4%. It breached the USD/MYR3.60 level briefly, moving to USD/MYR3.59 on 8 May but has since been trading at around USD/MYR3.61 amidst a US dollar rally.

MYR takes off against USD but weakens against JPY

MYR and CNY against USD

SGD, THB, JPY against MYR



Source: Datastream

To some extent, the accelerated pace of ringgit appreciation reflects weakness in the US dollar. Against other major trading partner currencies, the ringgit's performance has been mixed. It weakened by about 2% against the Yen between March and mid-May 2006. Japan is Malaysia's top source of imports with the country being the main supplier of parts and components for its electronics/ semiconductor industry. The US and Singapore are Malaysia's top two export markets, with China in the top five.

The ringgit is expected to appreciate further, supported by a relatively healthy economic outlook, expectations of higher interest rates against a stronger inflation profile and USD weakness. Against the USD, the MYR is forecast to end the year at USD/MYR3.55 and USD/MYR3.50 by end-2007.

Against the AUD, the cross rate is expected to record a much stronger profile in favour of the ringgit, largely reflecting a forecast weakness in the AUD through to mid-2007. The AUD is forecast to weaken to AUD/MYR2.49 (currently AUD/MYR2.75) by end-2006 and AUD/MYR2.38 by end-2007.

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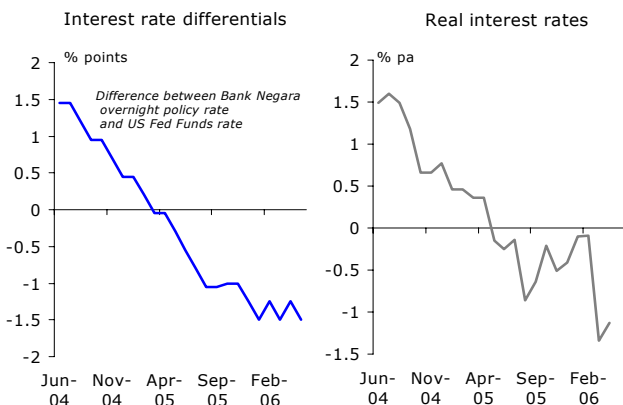
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Expectations of higher interest rates have assisted the ringgit

The central bank last raised the overnight policy rate on 26 April, by 25 bps to 3.5%. This was the third rate increase since November. We expect another quarter-point rate hike in the second half of the year reflecting inflation pressures.

The central bank is expected to continue with monetary policy normalisation. Inflation ticked up to 4.8%YOY in March and 4.6% YOY in April, largely reflecting the impact of fuel price hikes which took effect on 28 February – the government’s fifth and largest increase since May 2004. The likelihood that electricity prices will be allowed to be lifted some time this year will also keep inflation pressures elevated, but some reprieve is expected when the impact of the fuel price hike implemented in August 2005 wears off. We have lifted our forecast for average inflation for 2006 to around 4% from 3.5% previously – the highest level since 1998. In its latest Annual Report, Bank Negara projected real GDP growth of 6% for 2006. We have projected real GDP growth of around 5.3% pa for 2006 and 2007, which is broadly in line with consensus. Real credit growth remains in double-digits although it has slowed to around 16% YOY in February 2006 compared with close to 26% YOY in June 2005.

Interest rate trends



Sources: Bloomberg, Datastream

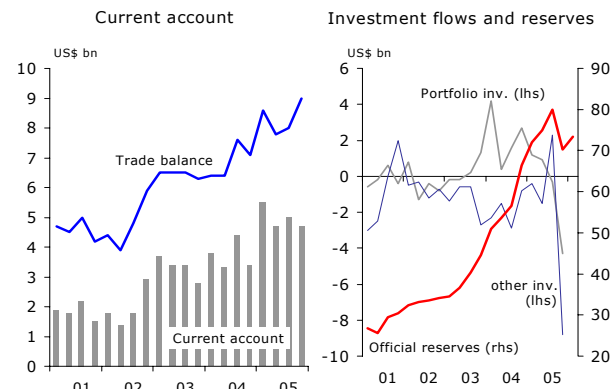
Real interest rates have been negative since May 2005. The outlook, nonetheless, is for an improvement in the second half of the year when we expect inflation to ease as the effects of one-off fuel price hikes wear off. In terms of interest rate differentials with the US, Malaysian interest rates are now below the US and differentials have widened in favour of the US. The spread is likely to stay in negative territory although some narrowing is expected with the US Fed funds rate likely to have peaked while we expect Bank Negara to hike rates one more time.

While real interest rates and interest rate differentials do not support currency strength, expectations of higher interest rates amidst a stronger inflation profile and relatively healthy economic growth are expected to underpin gains in the ringgit.

External balances support ringgit

Trade trends so far this year have also underpinned currency strength and are likely to continue to do so, with exports recording healthy growth. The trade surplus for January-March 2006 was 3.3% higher than the same period in 2005. A rise in international reserves in 2006 after sharp investment outflows in Q4 2005, in search of better returns, also reflect support for the currency.

Balance of Payments



Source: Datastream

Currency outlook

Over the outlook period, the expectation of higher domestic interest rates and a general appreciation of regional currencies are likely to support a further strengthening of the ringgit over 2006 and 2007. In addition, a more flexible Yuan exchange rate will support an accelerated pace of appreciation in the ringgit though history has shown that this is not a necessary condition.

We have forecast the ringgit to strengthen further through 2006 and 2007. The exchange rate is projected to reach USD/MYR3.55 by end-2006 (USD/MYR3.61 currently) and USD/MYR3.50 by end-2007. Against the AUD, the divergence in profile against the USD, with the AUD forecast to weaken further, is expected to produce a much stronger ringgit against the AUD. The AUD/MYR is forecast to end the year at AUD/MYR2.49 (AUD/MYR2.75 currently) and AUD/MYR2.38 by end-2007.

Figure 1: Forecast Table

	2004	2005	2006f	2007f
Real GDP growth (%)	7.1	5.3	5.3	5.1
Inflation (year avg, %)	1.5	2.9	4.0	3.0
Exchange rate (eop)				
USD/MYR	3.80	3.78	3.55	3.50
AUD/MYR	2.96	2.78	2.49	2.38
Interest rate (OPR, % pa), eop	2.7	3.0	3.75	3.25

Source: Economics@ANZ

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