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Managing excess liquidity

YEAR 2003 HAS NOT BEEN AN AUSPICIOUS year for the greenback and we do not foresee a reversal in the downtrend of the dollar soon. The fundamentals of the dollar remain unfavourable and the dollar could slide for the third consecutive year

The US Federal Government deficit hit US$385 billion in the fiscal year ended September - 3.5% of nominal GDP. The Congressional Budget Office expects the deficit to rise to US$480 billion in calendar year 2004, with a return to surplus budgeted for only 2012. The Bush government has already squandered the surpluses accumulated during the previous government.

On a cumulative four-quarter basis, the US current account deficit will reach US$541.7 billion in 3Q04. For 2003, the US current account deficit is estimated to be equivalent to 5.0% of its nominal GDP, the highest on record.

Technically, the US dollar has strong support at 100 yen. We do not expect the dollar to weaken below 100 yen. The dollar is trading at steep discounts relative to the moving averages and the gap tends to close. It has also just completed a `head and shoulder' pattern, and further bearishness is rather unlikely. We believe the previous congestion area provides a support at slightly above 100 yen.

THE DOLLAR IS NOT IN CRISIS.

International liquidity has not forsaken the greenback as a currency of denomination. According to the Federal Reserve, total holding of US financial assets by non-US residents rose US$394 billion in 2Q03, despite the Iraq war and a lacklustre Wall Street. This represents a 5.5% q-o-q increase, the highest percentage surge since 4Q98. (The numbers for 3Q03 should be out soon).

In any case, the US economy is not in such a bad shape. GDP growth of 8.3% (annualised) in 3Q03 was driven by final demand and not inventory accumulation. Excluding inventory, GDP grew at the same pace, 8.2%. Private consumption rose 6.9% from 3.3% in 2Q03 while capital formation rose 15.7%. The aforementioned notwithstanding, sentiment towards the dollar is expected to stay weak throughout 1H04 as the dollar loses ground.

RINGGIT PEG TO REMAIN STEADFAST

We do not expect the ringgit to be repegged, barring any move by China to revalue the yuan. The authorities do not appear to be convinced that exchange rate reflects/influence trade, and vice-versa. In the words of Tan Sri Dr Zeti Akhtar Aziz, Bank Negara Governor, changes in the exchange rate do not reflect trade flows, but financial flows.

However, should China revalue the yuan, Malaysia may follow suit based on earlier indications by former Prime Minister Tun Dr Mahathir Mohamad. Two-way trade with China is expected to account for 7% of total trade this year, up from 6.6% last year, in favour of China.

One way to gauge the fair value of the ringgit is by benchmarking it against movements in regional currencies. This, however, depends on the starting reference. Compared with August 1998 (prior to the imposition of capital controls), regional currencies (excluding yuan and HK$, which are fixed) had, by December 2003, moved on a trade-weighted average of 4.9%.

As the ringgit was trading at RM4.20 against the dollar, the 4.9% gain translates into a fair value of RM4.00. However, between December 2003 and

December 2002, regional currencies had moved by 2.5%. Therefore, if the ringgit was trading at RM3.80, the 2.5% gain would have translated to a fair value of 3.71.

GROWING EXCESS LIQUIDITY: NOT A CAUSE FOR SLEEPLESS NIGHTS

Excess liquidity in the system, defined as banking sector depositing less statutory reserve with Bank Negara Malaysia, reached an estimated all-time high of RM87 billion at end 2003, 62% higher than what it was at the beginning of the year. We doubt the policymakers are overly perturbed by the rise, caused mainly by net inflow of external funds into the system. The central bank should be able to absorb the costs associated with the mopping-up operations.

BOND YIELDS TO CONTINUE TO BE INFLUENCED BY INTERNATIONAL RATES

In the bond market, liquidity has not been a main determinant for local bond yields, which continue to be influenced by international rates. Yield to maturity of 10-year Malaysian Government Securities has been on an uptrend this year, despite a surge in liquidity. We argued in the 4Q03 Outlook report, that the shape of the local yield curve has mimicked that of the US since Sept 11. The same was observed in 4Q03.

Although the US Federal Reserve does not foresee interest rates going up for a `considerable' amount of time, the market consensus is that the Federal Reserve Fund will be 0.5-1.0 percentage point higher by 4Q04. Globally, rates are trending up. The Reserve Bank of Australia and Bank of England have increased their benchmark rates by 25 basis point each. The odds are heavily stacked in favour of a rate increment.

LENDING RATES EXPECTED TO FOLLOW THE GLOBAL TREND

There is currently little pressure on lending rates to climb. The system is awash with liquidity, and the interest margin is healthy in view of improving asset quality. However, pressure on the intervention rate to be revised would be strong should there be an aggressive rate hike in the US and Europe. Recall that Bank Negara reduced the intervention rate by 50 basis points each in May 2003 and September 2001; the former as part of the stimulus package, while the latter was more in concert with global response after Sept 11.

Loans to SMEs rose 9.0% in 2003, an indication demand for loanable funds is on the rise. A move by Bank Negara to raise the intervention rate would be a strong signal that the cost of credit will not stay depressed, and this could prod reluctant borrowers into action, potentially triggering a virtuous cycle of loan demand.

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