

Forecast: Interest rates may go up
Malaysiakini.com
July 06, 2010

Malaysia's central bank may raise rates for the third time in five months after strong economic growth in the first half, but it could be a close call, with many analysts believing it will keep rates on hold due to fears of a global slowdown.

Nine out of sixteen analysts polled by Reuters expect a rate hike of 25 basis points (bps) to 2.75 percent at a policy review on Thursday, while the remaining seven expect a pause.

Most of the economists who expect a hike on Thursday do not see any more tightening for the rest of the year.

Of those who see no changes in rates this week, two said the central bank was already finished for the year, while three predicted it would bump up rates in September.

Malaysia last month raised its full-year economic growth forecast to 6 percent from 4.5 to 5.5 percent after gross domestic product (GDP) expanded by 10.1 percent in the first quarter from a year earlier, its fastest pace in 10 years.

Export growth in April and May, however, have moderated compared to first quarter numbers and this may impact second-quarter economic growth. The central bank has said that domestic factors would drive policy considerations.

Uncertainties over the euro zone recovery and fears the US economy may be losing steam may also influence the central bank's decision, with some economists saying that weak US economic data recently has lessened the chance of a domestic rate rise.

Late last month, Malaysia's central bank governor said inflation was not a concern.

July hike, last of the year?

After two, 25 bps rate hikes in March and May, Malaysia's central bank will decide if it should further nudge rates to a more "normal" setting.

Economists consider that 2.75 percent would be the normal rate for the central bank, while remaining accommodative to further growth, giving policymakers the opportunity to pause or the rest of the year to review the impact of the earlier tightening.

It cut rates by a total of 150 bps during the global financial crisis, from 3.5 to 2 percent.

Domestic demand may remain firm as imports of consumption goods have been strong. In contrast, export growth has moderated, but some easing had been expected going into the second half.

The central bank has also downplayed any fallout from the euro zone debt crisis, although investors will watch its references to the global economic situation for clues on whether rate rises have ended for now, or if they will continue.

Probability: More likely.

Market impact: Both the ringgit and bond markets stand to gain from another rate hike as foreign investors would continue buying into government bonds, betting on more ringgit gains.

In June alone, five-year government bond yields dropped 7 basis points while the ringgit appreciated by 1.2 percent. The ringgit has gained more than 6 percent year-to-date, making it the best performing Asian currency.

Rate pause in July, but to continue later?

Growing uncertainty about the global economic recovery may lead to more moderate economic growth, prompting the central bank to pause its tightening campaign at the current 2.5 percent before hiking rates once more in the fourth quarter.

Bond and forex traders say the sharply divided outlook for Thursday's decision is due to the markets' inability to gauge what the central bank considers to be an acceptable level.

The Overnight Policy Rate (OPR) has a relatively short history, making it difficult to determine what is considered a normal level. It was only introduced in 2004, with an initial setting of 2.7 percent.

Three-month KLIBOR was quoted at 2.73 percent on Tuesday. In the forward starting swaps space, the three-month rates swap on a contract starting after three months was quoted at 2.80 percent.

This implies the market is pricing in just 7 bps of rate tightening by October. The KLIBOR in recent weeks has increased 6 bps since the May rate hike, compared to a 37 bps gain before the May rate hike, implying that there is less anticipation for a hike on Thursday.

Probability: Less likely

Market impact: A pause would not be a big cause for concern as foreign investors are still buying ringgit and government bonds as Asian currencies track yuan gains after China abandoned its two-year currency peg to the dollar.

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