midf RESEARCH

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ECONOMIC VIEW

Greek crisis and its impact on Malaysia

- *Our baseline scenario assumes that Greece may not be allowed to leave the Eurozone – at least in the near-term as the big member countries are fully aware that this outcome will be more catastrophic. It may involve a revamp of the constitution governing the EU framework*
- *Under this assumption, we expect Ringgit would continue to face downward pressure as sentiments have yet to improve, until there is a clear sign of Grexit not going to happen.*
- *Nonetheless, the fundamentals of our financial system remain sound and most of the big European claims in the banking system are mostly by UK banks and European banks subsidiaries that are funded by local deposits.*
- *At the same time, our current account position and FX reserves is still sufficient to withstand any further outflows, which we expect would have slow down given the amount that had pulled out in recent months.*
- *The impact on the real economy may not be as significant given the size of Greece contribution against that of total by EU in terms of trade, portfolio flows as well as FDI flows, unless Grexit does happen.*

As in the past, any negative developments on the financial sectors of a big economy would first impact Malaysia via the financial markets. The Greece debt problem had not posed any real concern until the outcome of the referendum held over the weekend which showed 60% of Greek people oppose austerity measures (as bailout requirement) that raises the odds of Grexit. Greece may be a small economy but as it is a part of the Eurozone, its exit would trigger some instability within the currency bloc.

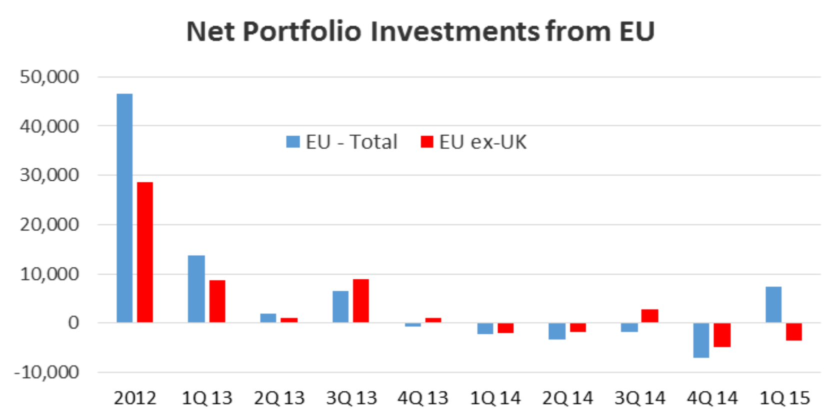
While the lingering concerns over Greece problems had already added on to the bearish sentiments on the Ringgit in the past few months, a Grexit would see much more negative implications on our financial markets. Flight to safety may see further outflows of funds from the financial markets. However, while the magnitude could expected to be as big as that seen when the US slipped into the financial crisis, most of the foreign funds had already left the country in the last few months and hence the size of outflows may not be that huge.

Our baseline scenario assumes that Greece may not be allowed to leave the Eurozone – at least in the near-term as the big member countries are fully aware that this outcome will be more catastrophic. It may involve a revamp of the constitution governing the EU framework - there are no provisions for departure, voluntary or forced, from the euro currency union.

Having said that, given that Ringgit is already at historic lows, any further outflows would drag Ringgit lower. Under this assumption, we expect Ringgit would continue to face downward pressure as sentiments have yet to improve, until there is a clear sign of Grexit not going to happen.

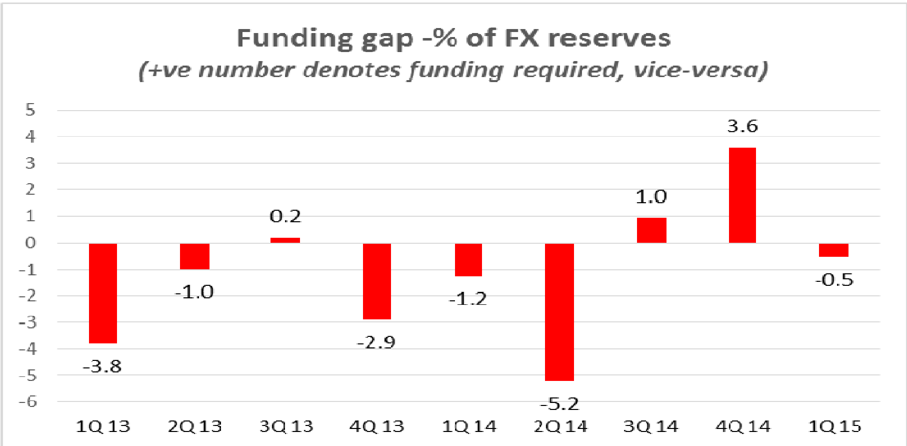
A report by a foreign broker put Malaysia as the most vulnerable may not be accurate. The report cited the fact that "the current account plus portfolio outflows defined as the funding gap accounts for about 4.1% of its foreign exchange reserves" and stated that even Indonesia and India are less vulnerable. This does not make sense as both countries are running current account deficits! Upon our checking on the data and the way they computed the funding gap, apparently they had put our current account balance which stood at RM9968 billion in the 1Q 15 as a deficit instead and this being added up to the portfolio outflows of RM7878 billion and set as a ratio against FX reserves.

Chart 1: Most EU investors have pared down portfolio holdings gradually in the past few quarters



Source: BNM

Chart 2: Our funding gap can be volatile but still manageable



Note: Funding gap is defines as total current account deficit plus portfolio outflows
Source: BNM, MIDFR estimates

Having said that, that does not rule out the fact that Malaysia is vulnerable to persistent or heightened volatility in the financial markets. The high foreign ownership of our local currency bonds and the reportedly high exposure to European bank claims estimated at 17.7% of GDP or 40% of total foreign banks' claims indicate that in the event of pull out of funds due to flight to safety or European banks deleveraging, Malaysia is at risk of financial instability.

Nonetheless, we still expect that the impact could still be mitigated due to these key factors:

- **Most European banks have pared down significantly their exposure to Greece**, hence the risk of huge pull out of funds from European banks or any European banks outside Greece having trouble is minimal.
- **Top EU countries for our portfolio investors have started paring down their holdings in the past 1-2 years**. At the peak of our recorded net portfolio inflows in 2012, top Eu investors were Belgium, Luxembourg, France and Netherlands. Luxembourg and France recorded big funds pullout in the 1Q 15 while Belgium and Netherlands put in tiny inflows during the quarter. Hence, we do not expect any further sharp pullout even in the event of Grexit.
- **According to the IMF analysis, the European bank claims include credit extended by the European bank subsidiaries that are funded by local depositors**, hence ruling out liquidity issue in the event of European banks pulling out their funds.

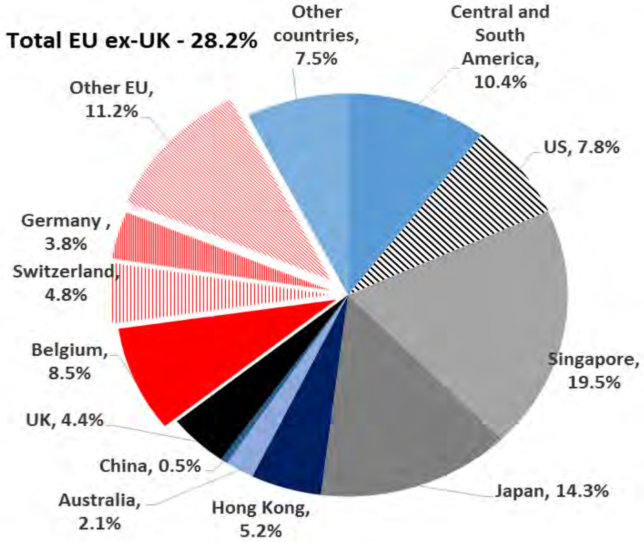
- **Also, most of the claims are by British banks** which have more than sufficient capacity to offset the euro area bank withdrawals
- **Our FX reserves is much bigger, at 2.2 times** the size of all European banks' claims

The impact on the real economy would then depend on our dependence on that respective country in terms of trade and investment. We are in view that any negative impact on our real economy is also likely to be muted. EU as a region excluding the UK accounts for about 30.95 of our total exports in 2014. Our trade balance with the region has been rather volatile – we turned net exporter in 2014 after 2 years of running deficits with the region. The latest data showed we continued to run surplus – albeit modest level- with the region. Greece accounts for a small percentage of our export market i.e. 0.5% and we have been running surplus with that country most of the time. That is considering the fact that Greece has been in an economic downturn for the last 5-6 years.

The latest trend on trade with EU suggests that we are benefitting from the improved terms of trade as Euro weakened. However, the trend could be different with Germany. The weak Euro has helped the country to boost its exports, including to Malaysia as the weak Euro makes exports of luxury items or high technological products from that country very competitive. We have always been a net importer of German exports. In the worst case scenario of a Grexit, we expect our terms of trade with the region would actually improve and boosts our net trade position. However, in the long run, that gains may be eroded as weaker economic growth would lead to less imports from the region and our trade position with them may deteriorate.

EU is our biggest FDI source but prospects of FDI involves medium to long-term factors that may not be related to exchange rate movements at all. As at 1Q 15, the EU ex-UK accounts for about 28.2% of the FDI stock. We may not see any near-term effects on the FDI numbers coming from Europe, even if the Euro staying weak at current level as long as the Ringgit also remains weak vis-à-vis other Asian currencies. Having said that, the prospects of FDI involves medium to long-term factors that may not be related to exchange rate movements at all. As such, we could only see any negative changes in the next 2-3 years provided that the current development causes long-lasting impact on European companies and other factors that matter for FDI such as labour and technology skills factors remain unchanged.

Chart 3: EU accounts for a big exports market and FDI source but Greece contribution is small



Source: BNM, MIDFR estimates

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