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BNM Monetary Policy Committee meeting: What to Expect in the Near Term

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- Bank Negara Malaysia (BNM) decided to maintain its key policy rate, the Overnight Policy Rate (OPR), at 3% during its meeting yesterday (7 September, 2017). In its statement, BNM said that its current policy stance remains accommodative and it will continue to assess the balance of risks surrounding the outlook of domestic growth and inflation. In elaborating its decision, BNM reviewed both the global economy and Malaysia's economic performance, stressing the fact that stronger spillovers from the external sector will be positive for the domestic economy. At the same time, inflation is expected to moderate and core inflation is expected to be contained. BNM views that domestic demand will remain the key driver of economic growth in the near term.

- The decision was in line with market expectations. However, with headline growth having already improved significantly in 1H2017, speculation is now rife that a rate hike is on the cards in the near term. Real gross domestic product (GDP) growth which averaged 5.7% in 1H2017 was the strongest since 1H2014. With the United States' (US) economy continuing to register a decent growth and the European economy firming up significantly, expectations that demand-pull factors may emerge and push up the inflation rate in the near term have slowly resurfaced. Some of the wordings in the Monetary Policy Committee (MPC) statement support this argument. For instance, the global economy is described as "becoming more entrenched and synchronised" as opposed to just "more synchronised" as stated in the previous statement. Secondly, some of the elements of risks that were stated in the previous statement were removed, namely uncertainties with regards to "financial market developments and volatility of commodity prices". Thirdly, a statement that "overall (Malaysian economic) growth in 2017 will be stronger than earlier expected" also suggests the possibility of a more hawkish BNM sentiment, in our opinion.

- Notwithstanding this, MARC is of the view that BNM will not rush to push up rates due to several reasons unless the third quarter economic performance continues to beat expectations. First, inflation in 1H2017 has been largely driven by cost factor. In particular, the rise in petrol prices (RON95) explains the major increase in inflation in 1H2017. The price of RON95 bottomed out in March 2016 at RM1.60 per litre and has been on the rise since then. Not surprisingly, consumer price index (CPI) growth hit a peak of 5.1% in March 2017. On the other hand, demand-driven factors remain benign, judging by the trend of core CPI which remained stable at an average of 2.5% in the year-to-date. This suggests the lack of a widespread upward price pressure in the economy. Going forward, headline inflation rate is expected to moderate and will average circa 3.5% in 2017 according to our estimate.

- MARC take notes of the description of intensity of inflation in BNM's statement which has changed slightly. Prior to July 2017, inflation was described as "depending on global oil prices which are highly uncertain". In recent statements, however, the tone has softened. The trend is "expected to moderate, on expectations of a smaller effect of global cost factors," according to BNM. We believe that such a description provides an overall feeling that there is no urgent need for a policy intervention to diffuse higher inflation rate, unless growth continues to accelerate in the upcoming quarter.

- Second, according to our estimate, Malaysia's output gap has remained negative despite the recent surge in real GDP growth rates (actual output is below its potential output) in 1H2017. Also, private consumption – one of the key determinants in a rate hike decision – has not surpassed its trend growth in 1H2017 despite having recovered from its low in 3Q2015. In addition, Goods and Services Tax (GST) collection, while having improved in 2Q2017 (RM10.1 billion versus 1Q2017's RM9.2 billion), is anticipated to moderate to RM40.0 billion in 2017, down from RM41.2 billion in 2016. Consumers are still being adversely affected by the weaker ringgit (average of RM4.370 per USD in 1H2017), down by 7.2% from an average of RM4.056 per USD in 1H2016.

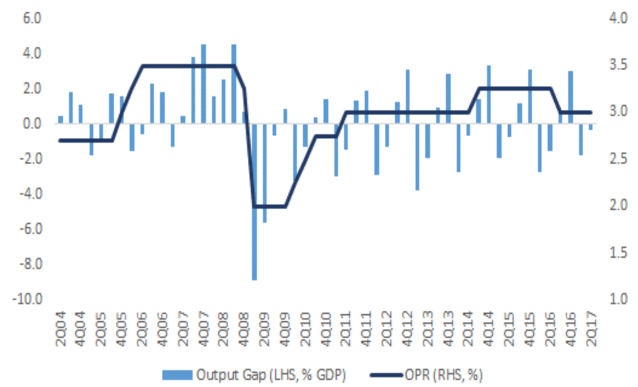
- Third, capital outflows have subsided by 2Q2017, compared to the period immediately after the November 2016 US election when huge outflows caused some speculation that the OPR would be raised to stem the flow. In fact, in the three months ended June 2017, the Malaysian bond market recorded an average foreign inflow of RM5.5 billion, compared with an average outflow of RM12.5 billion in 1Q2017. As the situation has improved quite significantly, there is now no urgency for a rate hike in the near term.

- Fourth, regionally, interest rates have been on the downtrend. For instance, Indonesia has been lowering its policy rate in order to shore up its growth. The policy rate (7-day Reverse Repo Rate) was reduced from a peak of 6.3% in late 2015 to 4.5% recently. Its economic growth, although it was driven by consumer spending, is expected to soften as growth momentum is dragged down by moderating oil prices. Similarly, Thailand has maintained its policy rate at 1.5%, the lowest since mid-2010, while Vietnam's policy rate has been reduced to 4.25% in July 2017, the lowest since November 2005. The accommodative stance adopted by the Association of Southeast Asian Nations' (ASEAN) central banks has been due to uneven recovery of the global economy. With other countries maintaining an accommodative monetary stance, a rate hike in the OPR would likely induce capital inflows into Malaysian shores and complicate the management of liquidity and inflation in the economy.

- Another factor - Malaysia's high household debt - is a major concern when it comes to a rate hike decision. At close to 90% of nominal GDP, Malaysia's household debt is one of the highest in Asia - Thailand (2016: 79.8%) and Singapore (2016: 75.3%). BNM has been managing household debt cautiously in order to not affect the economy especially private consumption. As such, it may not likely want to risk raising the OPR too soon as it can affect consumers' debt service capacity.

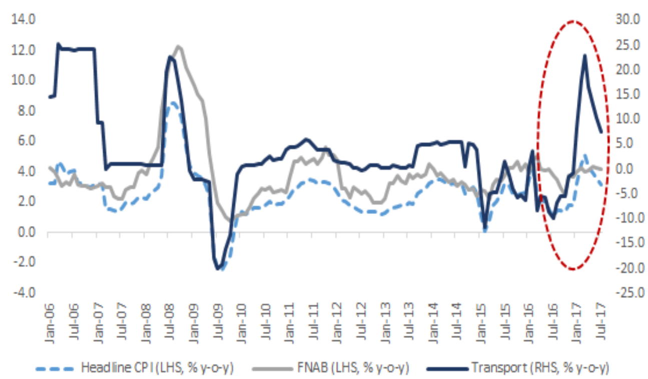
- All in all, MARC feels that the third quarter economic performance will be key to BNM's future rate hike decision. If the economy's performance continues to beat expectations in the rest of the year, the chances of a rate hike will be higher. However, we believe BNM will also take into account rising geopolitical risks before making its decision.

Chart 1: Output gap versus OPR



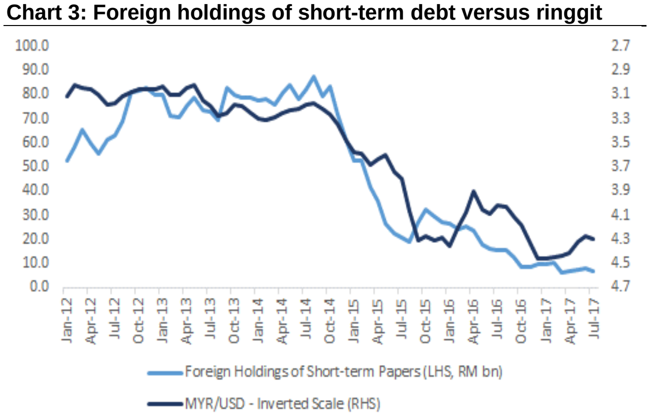
Source: CEIC, MARC Economic Research

Chart 2: Headline CPI, FNAB and transport prices



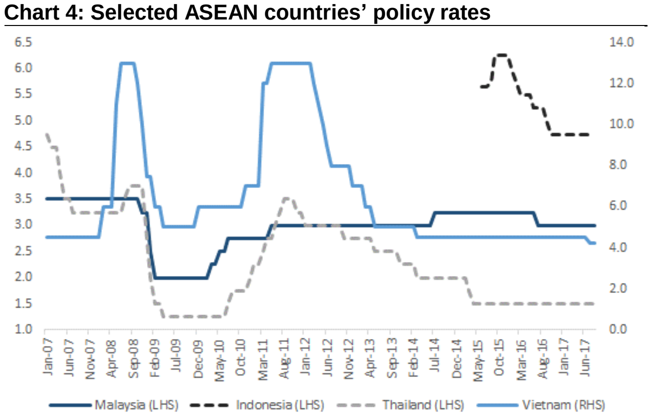
Source: CEIC, MARC Economic Research

Chart 3: Foreign holdings of short-term debt versus ringgit



Source: CEIC, MARC Economic Research

Chart 4: Selected ASEAN countries' policy rates



Source: CEIC, MARC Economic Research

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