

Why should Malaysia's central bank be cutting rates again?

The end of Covid-19 lockdown may have provided some traction to Malaysia's economy. Still, a deeper recession in decades and prospect of a prolonged slump ahead are strong reasons why Bank Negara Malaysia should slash rates again next week



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1.50%

ING forecast

After 50bp cut next week

We're in the 50bp rate cut camp

Malaysia's central bank meets on Monday, 6 July and the decision is expected on Tuesday at 3 pm local time.

The central bank doubled up easing at the last meeting in early May, cutting the overnight policy

rate by 50 basis points instead of the conventional 25bp move. This pushed the OPR down to the 2% low reached during the 2009 global financial crisis, after a cumulative 100bp easing thus far in 2020. The central bank also announced MYR 16 billion (about 1% of GDP) of liquidity-boosting measures at the same time.

The consensus for the upcoming meeting is split between more rate cuts staying on-hold outcome, and there is a further split within the rate-cut camp on a 25bp or a 50bp cut.

We believe another 50bp cut is on the table this time.

Our rationale for aggressive BNM easing

The nationwide Covid-19 movement control order (MCO) started in mid-March and has lasted for nearly three months, throwing the economy into the worst recession in decades.

Malaysia's GDP shrank in 1Q20 by 2% quarter-on-quarter (seasonally adjusted). Indeed, with near-standstill activity, it would be a far bigger fall in 2Q and we estimate -7.7% QoQ, pushing the yearly growth down to -8.3% - the worst since the 1998 Asian crisis (2Q GDP data won't be available until mid-August).

The relaxation of MCO since early May (Conditional MCO) may have helped sentiment but not real economic activity as such. The accelerated export decline to more than 25% YoY in May will have dragged manufacturing further down after the 32% YoY plunge in output in April (also look out for May industrial production data next week, 10 July).

Talking about sentiment, the improvement is seen from a rise in the manufacturing PMI above the 50 threshold for expansion in June (51.0 vs. 45.6 in May), which is probably why some forecasters expect no rate cuts next week. However, it only underscores some recovery from the dramatic manufacturing declines in the preceding months. In fact, barring occasional spikes above 50, the PMI has hovered below this level in recent years. With the key driver exports missing in action it's hard to imagine the PMI staying in the expansionary territory in the months ahead. Persistent weak manufacturing means GDP growth should stay negative throughout the second half of the year.

We anticipate some recovery in 2021 though that's probably going to be very anaemic too.

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The negative CPI inflation (-2.9% YoY in April and May), has left the real rate as one of the highest in Asia, offering scope for further cuts in the nominal rate. A timely dose of easing, while there is room for it, will go some way in shoring up domestic demand, though the overall recovery will still hinge on external factors, given the economy's reliance on exports and tourism.

The ongoing fiscal constraint is another reason why the monetary policy needs to do some heavy lifting. Although the government has unveiled about 19% of GDP stimulus so far, we estimate it equates to just 5.6% of real-spending GDP. And, scepticism about that actually flowing through to

the economy is ample given the lingering political uncertainty.

Therefore, we see no reason why the central bank should take a pause next week. On the contrary, we believe its easing cycle has more room to run with our forecast of a total 100bp of rate cuts this quarter, including an additional 50bp cut we have pencilled in for the subsequent meeting in September.

What this means for markets?

The markets don't seem to be pricing any more rate cuts. Both short-term interbank rates as well as long-term bond yields are firm at the levels since the last central bank policy move – 3M Klibor at 2.3% and 10-year MGS yield at 2.8% currently. Likewise the FX market, with USD/MYR firm in a narrow trading range of 4.25-4.30 since early June, though that's partly a broader emerging market strength recently.

Yet, we are convinced about our view of the central bank delivering a 50bp rate cut next week. If true, this will pull the floor under the bond yields and pressure the USD/MYR higher. We view the risk to our 31.30 USD/MYR forecast for end-3Q20 as tilted towards the upside (spot 4.29).

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