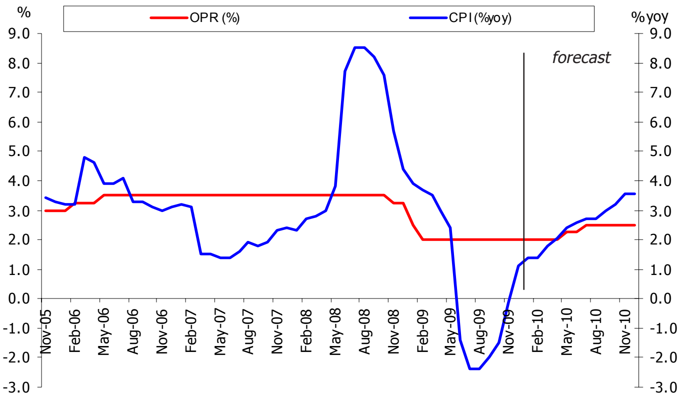
MALAYSIA: The monetary policy dilemma

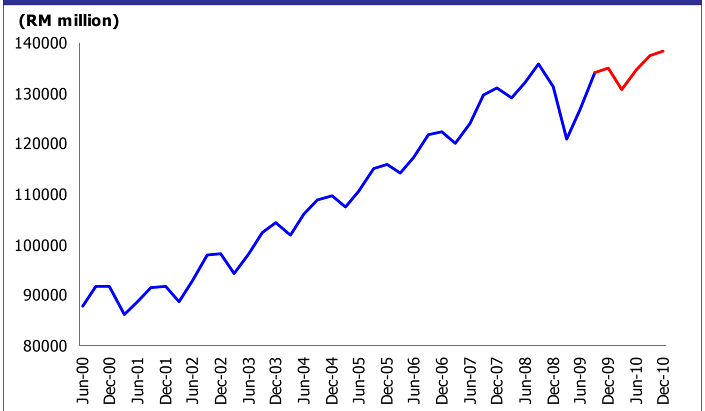
10 FEBRUARY 2010
2010/005

OPR (%) vs CPI (%YOY)



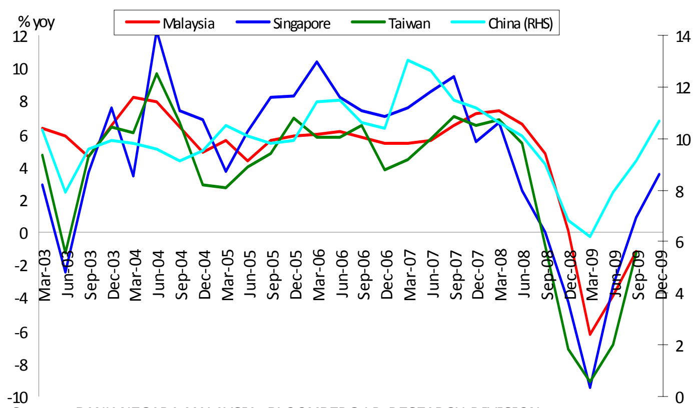
Source : BANK NEGARA MALAYSIA, BLOOMBERG LP, RESEARCH DIVISION

MALAYSIA REAL GDP (RM MILLION)



Source : BANK NEGARA MALAYSIA, BLOOMBERG LP, RESEARCH DIVISION

GDP (%YOY) - SELECTED COUNTRIES



Source : BANK NEGARA MALAYSIA, BLOOMBERG LP, RESEARCH DIVISION

- Of late, the slight change of tone in Bank Negara Malaysia (BNM) monetary policy statement and then the strong remark by BNM's Governor (on the need for Malaysia to normalise its interest rates from the current unprecedented low levels) left market participants pondering if there will be any sooner than expected increase in the Overnight Policy Rate (OPR).

- Following these statements, more than 50% of economists polled by Bloomberg LP which previously were expecting BNM to raise rates in the 2H10 now believe the benchmark rate will be increased in the 1H10, as early as BNM's March meeting by 25 to 50 basis points.

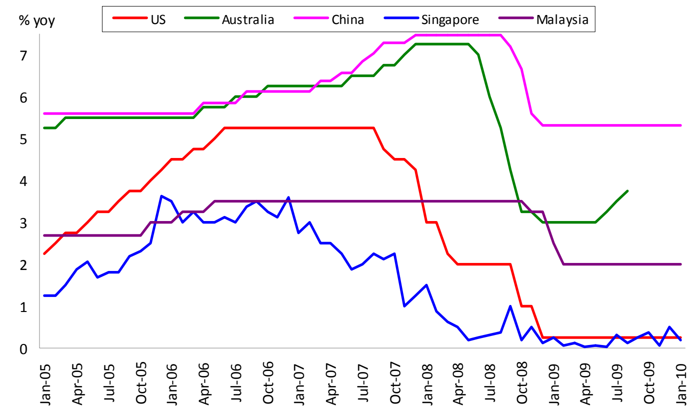
- The central bank, according to its Governor, was concerned that any prolonged low-interest-rate environment could turn investors away from the conventional banking system in search of other instruments to enhance their returns on savings and that could possibly involve them taking excessive risks without realising it i.e. the risk of financial imbalances.

- This could be the case especially when the domestic inflation rate rises above the current OPR rate and resulting in a negative real interest rate. Currently, we foresee the inflation rate to increase above 2.0% by April and higher in later months, but on average inflation for the whole 2010 would not exceed 2.5%. Thus, should the OPR be maintained at the current level, we could have a negative real interest rate of between 0.1% to 0.5% for the rest of 2010.

- The domestic economy had experienced negative real interest rate environment in the past. In early 2006, for seven months the rate of inflation had edged upward above the OPR. Beginning May 2008, when the national petrol pump prices were increased due to the global crude oil price shock, real interest rate was again negative as inflation surged. In 2006, BNM responded by hiking the OPR by 50 basis points in two consecutive meetings. In 2008 however, the central bank decided to keep the OPR unchanged as the inflationary pressure was principally supply driven rather than demand and, at the same time, the threat of the global financial crisis on the domestic economy was mounting.

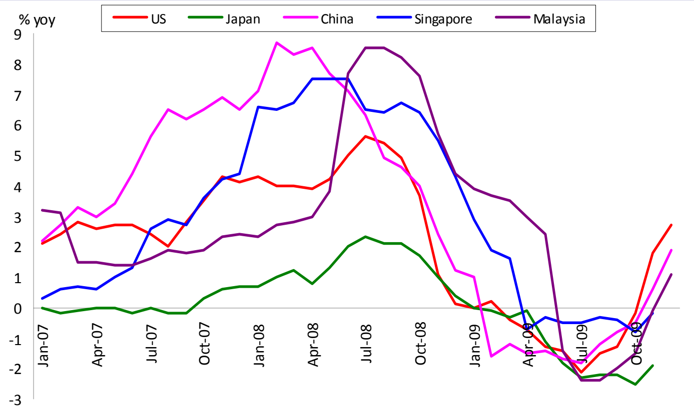
- At this juncture, the economic environment resembles more of the situation in 2008 and not 2006. Inflationary pressure in 2010, while not expected to rise to the level of 2008 (see chart 1), it will again be mostly supply-side induced or cost-pushed as a result of subsidy adjustments on major consumer goods such as sugar and petrol. Economic growth, although had shown a good degree of stabilisation, still faces the uncertainties of a sustained recovery in the developed countries which is crucial to the revival of Malaysia's export-led economy.

BENCHMARK RATES (%) - SELECTED COUNTRIES



Source : BANK NEGARA MALAYSIA, BLOOMBERG LP, RESEARCH DIVISION

CPI (%YOY) - SELECTED COUNTRIES



Source : BANK NEGARA MALAYSIA, BLOOMBERG LP, RESEARCH DIVISION

- A few countries, such as Australia, Norway and Vietnam had already raised their benchmark interest rates. On the other hand, others such as China, India, South Korea and Taiwan undertook non interest rate tightening measures to stave off rising inflation and rampant bank lending.

- In comparison to Malaysia, inflation rates in the above mentioned economies have increased sharply faster and have on an average passed 4.0%. In the case of China, money lending and money supply growth had also surged to historical highs of more than 30%. On the other hand, Malaysia's total bank lending and money supply growth remained below 10% as at December 2009.

- Furthermore, most of these countries are maintaining accommodative fiscal while Malaysia, in its effort to lower the fiscal deficit, had already announced a smaller budget for this year. This offers the flexibility for the other countries to tighten monetary policy while their domestic demand continues to be supported by fiscal stimulus.

- The domestic economic conditions are seen to have improved considerably and the economy has moved out of the recession based on the recent data on the supply and demand sides. Exports in 4Q09 grew by 5.1% after declining 22.4% in 3Q09, while imports, an indicator of domestic consumption, rose by 6.7% in 4Q09 after contracting by 18.4% previously. Industrial production on reversed to chart a positive growth of 3.2% yoy in 4Q09, the first gain since 4Q08, from -6.5% in 2Q09. These positive numbers, together with other important indicators of the local economy suggest that 4Q09 GDP could record a positive growth of 3.0% to 3.5%, following three straight quarters of decline.

- However, despite the positive developments, domestic production, investments and trade are still below the pre-crisis levels. Malaysia's total real GDP value for instance, is about 1.2% from its peak in 3Q08, while other activities such as exports and industrial production remained well below their pre-crisis trend. On the same note, the high unemployment rates in the developed countries together with their mounting debt levels could disrupt recovery and risks the prospects of global economy.

- Admittedly, Malaysia must finally exit the easy monetary policy and BNM has to normalise the benchmark interest rate as a pre-emptive measure to tackle financial imbalances. However, it is important to consider the timing and magnitude of the interest rate hike to help ensure a sustained recovery for the domestic economy. In this regard, it is crucial to closely monitor and asses the development in the 1Q10 before the monetary authority embarks on any policy review.

- Based on the aforementioned, we expect BNM to maintain the current OPR rate until its 13 May monetary policy committee (MPC) meeting. By then, there could be sufficient economic data to help in the better assessment of the local economy, including growth and inflation. The magnitude of increase could also be relatively small by 50 basis points to be undertaken in two meetings to 2.50% by 2H10. As we expect growth in 2010 to remain below potential of between 4.0% to 4.5%, chances are that the interest rate level will be maintained at 2.50% until the end of the year.