OCBC TREASURY RESEARCH

FX Viewpoint

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April 2020 MAS MPS Post-view – Stability is key

- In the April 2020 MAS MPS announced this morning, the MAS reduced slope of the SGD NEER policy band, adopting a **"zero percent per annum" rate of appreciation**. The policy band will now be "starting at the prevailing level of the SGD NEER", which "has depreciated to a level slightly below the mid-point of the policy band". **We interpret this as a slight re-centre lower in the policy band**. The width of the policy band is unchanged.

- In the statement, the MAS revealed that "between October 2019 and late January this year, the SGD NEER hovered near the upper bound of the policy band" and the "current level of the SGD NEER is slightly below the mid-point of the policy band". This description matches our estimated model of the SGD NEER, which fluctuated between +1.60% to +1.80% above parity in Q4 2019 to January 2020, and stood at approximately -0.40% to -0.50% below the parity prior to the statement itself.

- The prevailing level SGD NEER informed our caution in making an outright call for a re-centre to the scale of previous episodes (typically up to 2.00% lower, see FX Viewpoint: SGD NEER and March MAS MPS Preview, 23 March). We think this caution is justified through the deliberate omission of the term "re-centre" in the statement. **We think this is a calibrated decision to emphasize the limited extent of the re-centre, and to maintain a sense of stability in the monetary policy stance. Going forward, we will factor in a -0.50% reduction in the centre of the policy band in our estimated SGD NEER model, together with a neutral slope.** After accounting for the changes, we estimate the SGD NEER to be around parity to +0.50% above parity at the time of writing.

Growth and inflation outlook

- On the growth front, the MAS expects a "severe contraction" in economic activity, both on the supply and demand side. Individual sectors are expected to face challenges, and compounding across the sectors leaves us with a Singapore economy that "is expected to contract" this year. The official growth forecast for 2020 now stands at -4.0% to -1.0% yoy. **Our house view forecasts for -3.0% yoy.**

- **The MAS also noted that slack is expected to emerge in the domestic factor markets, and the negative output gap is expected to see "substantial widening".** This is within our expectations, as we sounded out previously that the short term output gap may grow to the largest since the Great Financial Crisis (GFC). Specifically, we expect the growth rate in the 1Q2020 to be almost 3.0% below trend, with slowdown widening to more than 6.0% below trend in 2Q2020, before closing in 2H2020.

- In this context, the labour market is also expected to be under stress, with the slack expected to be most acute around 2Q and 3Q 2020. Thus, resident unemployment rate is expected to rise, and wage growth ease, albeit the enhanced Jobs Support Scheme in the Resilience Budget may mitigate the downside risks for job losses.

- **In terms of inflation, disinflationary pressures cannot be avoided on both the internal and external fronts.** Internal price pressures are likely to be non-existent in the near term due to soft labour market conditions. Moreover, the government also announced it will freeze all government charges and fees for a year during the Resilience Budget. Similarly, external sources of inflation will be limited by the slump in crude oil prices, and the soft outlook in the crude oil complex.

- While the experience from both the GFC and Asian Financial Crisis (AFC) suggest food prices usually is muted during periods of economic slack, nevertheless the current COVID-19 pandemic with the accelerating lock downs and supply chain disruptions may imply an unexpected source of inflation. For instance, Malaysia's extension of the Movement Control Order till 14 April is tipped to contributed to some disruptions in vegetable supply. Still, given the heightened uncertainty over the severity and duration of the COVID-19 pandemic and the extent of this recession, MAS core inflation is still anticipated to remain below its historical average in the near and medium term. **Our headline and core inflation forecasts have been revised lower to -0.4% and -0.1% yoy respectively for 2020,** accounting for the above developments.

- **Overall, given the current context, the expected slope flattening appears justified and should provide the stimulatory impact for the economy.** The slight re-centre of the policy band, though theoretically also an easing measure, may have less significant impact compared to slope flattening. Note that the MAS has stressed that fiscal policy, namely the Unity and Resilience Budgets will do the heavy lifting of mitigating the economic ramifications of the COVID-19 pandemic, whereas monetary policy easing is a complementary measure. Overall, the short-term SIBOR and SOR rates are likely to go back to tracking the LIBOR and should ease somewhat post-month/quarter-end in line with LIBOR.

SGD NEER: Broader capitulation to lower bound of revised policy band not the base case.

- The policy actions this morning has opened up some more downside room for the SGD NEER to soften if the macroeconomic environment continues to deteriorate. Going forward, there might still be room for the SGD NEER to ease lower. **We put an initial floor at -1.00% below the revised parity level, and do not expect the SGD NEER to weaken all the way to the lower bound of the policy band. On the flipside, we find limited justification for the SGD NEER to sail higher towards the +1.00% above parity zone as well.**

- As mentioned in the previous FX Viewpoint, **we believe that the ability of the RMB complex to keep in-line (in either direction) with the broad USD is an anchor of stability for Asian currencies.** We think this should shield the SGD from excessive depreciation pressures against the USD and other G-10 currencies. The underperformance of the South Asian currencies amid unprecedented equity and bond outflows should also support the downside in the SGD NEER.

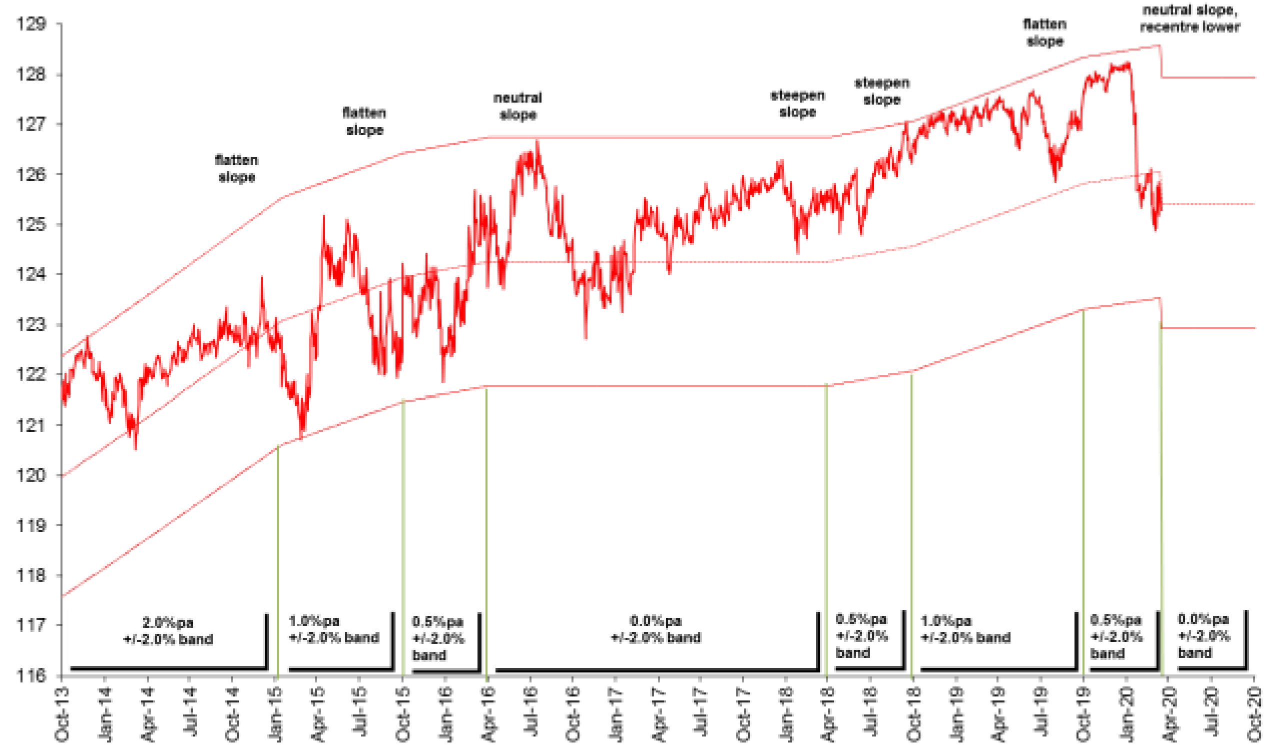
- Furthermore, we note that the MAS used “stable” (or “stability”) in relation to monetary policy thrice in the statement. In line with the expectation that fiscal policy will be the main thrust to support the economy and that monetary policy will just “complement” fiscal efforts, **we think the MAS may not be inclined to see the SGD NEER sink towards the lower bound of the policy band.**

- Overall, we think there may be slight market disappointment that the language surrounding the re-centre is not as more explicit and forceful. Coupled with some recent USD weakness, this may translate to some downside pressure in the USD-SGD in the coming sessions. Expect the 1.4200 to be potentially in play.

Conclusion: Fast forward to October 2020

- Looking ahead into October 2020, the slope reduction of the policy band has reached the limit of its movement, and a steepening is unlikely at this stage of the economic cycle. A widening of the policy band may also have a high bar, especially if “stability” in monetary policy is still emphasized. Thus, we are left to consider if there is a possibility of further downward re-centre of the policy band.

- The key question is whether the COVID-19 driven growth challenges and disinflationary pressures can persist into the next year. While it may be too early to say, it appears unlikely at this stage. If this assumption holds, **we do not hold another re-centre in October 2020 as our base case**. Much pessimism has already been factored in, and we may need another significant hit before further action may be contemplated. In any case, if further action is required, we expect the fiscal side to be the first-mover, and not monetary policy.



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