Malaysia Outlook

OCBC Bank

Deflation but still expect BNM to hold 1H 2019

Friday, March 22, 2019

Highlights

- **Headline CPI fell for the second straight month by 0.41% yoy but core CPI did edge upwards by 0.25% yoy.**
- **One off policy actions such as the replacement of GST with SST and the setting of fuel and broadband prices at lower levels were the main drivers of the deflation.**
- **Given that the deflation is transitory in nature, we don't expect that BNM (Bank Negara Malaysia) would react to it and they will probably still keep the benchmark rate on hold for at least 1H 2019.**

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Headline CPI for Malaysia fell for the second straight month by 0.41% yoy (Jan 2019: -0.66% yoy). The main driver of the deflation was the transport category which constitutes 14.6% of the total basket and fell by 6.8% yoy. This was possibly a result of lower oil prices where the government had fixed the RON95 prices at RM2.08 per liter compared to last year when it averaged about RM2.26 per liter for the same period. The communications (-1.23% yoy) and clothing and footwear (-3.2% yoy) categories also fell. The former was probably mainly driven by lower broadband prices whilst the latter could be due to the replacement of GST with SST. However, the fall in these categories were offset by price increases in the food and non-alcoholic beverages (0.99% yoy) and housing, water, electricity, gas & other fuels (2.02% yoy) categories.

We do though see the deflation is still transitory in nature and that it shouldn't be interpreted immediately as a sign of economic weakness. Many of the factors driving the decreases in the various categories can be viewed as one off policy changes that would gradually wear off. This was a similar story in January 2019. The setting of lower broadband prices and the replacement of GST with SST occurred in the second half of 2018 and hence, the effects from these factors should not carry on into the second half of this year. The government has said that it will cap RON95 fuel prices at RM2.08 for the entire 2019 but in budget 2019, they had also committed to eventually introduce a targeted subsidies scheme. Hence, potential adjustments in fuel policy should still be closely watched. Furthermore, core CPI continued to edge upwards for February 2019 at 0.25% yoy (Jan 2019: 0.17% yoy) indicating that the underlying trend is still positive. Going forward, we see that headline CPI would turn positive at 0.2% yoy for March 2019 but this means that overall, headline CPI will still average -0.3% yoy for the first quarter of 2019. We still keep our entire 2019 inflation forecast at 1.3% yoy.

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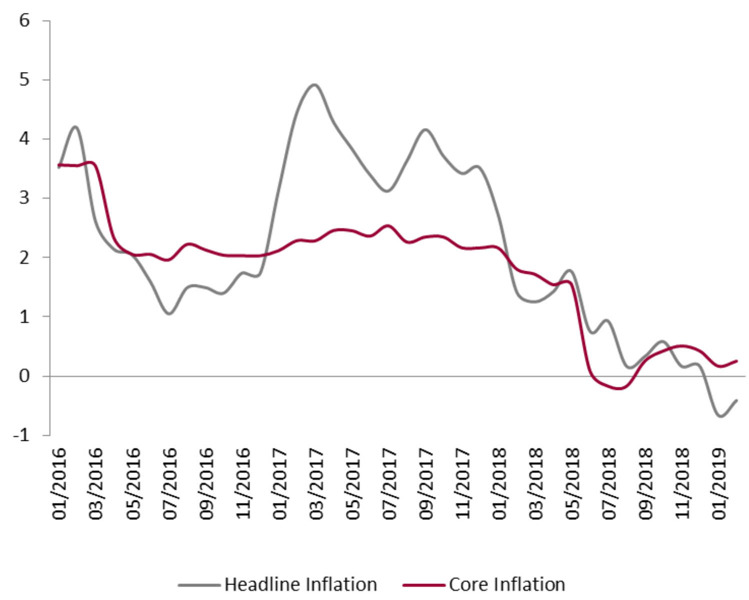
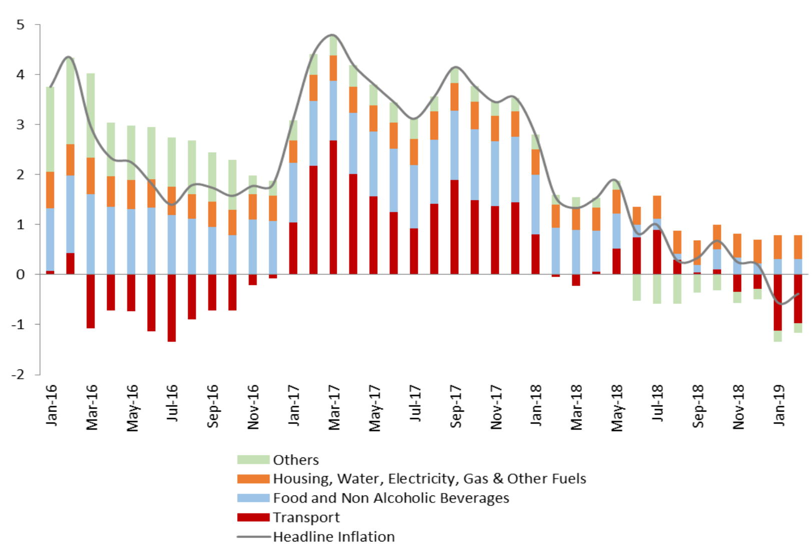
At this point, we are still calling for BNM to keep the benchmark rate on hold at 3.25% for at least the first half of 2019. We don't expect that BNM would react to this deflation number given that we have mentioned it is transitory in nature and does not exemplify economic weakness. Instead, we believe that BNM would be more vigilant of the risks in the external environment and the impact they would have on GDP growth. Currently, there remains uncertainty on the outcome of US – China trade talks but a positive conclusion from the negotiations would certainly provide the needed boost to Malaysia's small open economy. Hence, we see BNM would continue a "wait and see" approach to at least the end of 1H 2019 to observe the progress of these talks and also the global environment as a whole before acting.

Chart 1: Core and Headline Inflation, % yoy



Source: CEIC, Bloomberg and OCBC

Chart 2: Contributions to Headline Inflation, % yoy



Source: CEIC, Bloomberg and OCBC