Malaysia

30 April 2020

Don't Eat the Pill Yet

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Why Bank Negara may just hold rate unchanged on May 5

- The economic pain inflicted by the coronavirus is plain to see, and the painkiller in the form of policy rate cut stands ready to be used. So, why not do the obvious and take the medicine to in a bid to ease the agony?
- That is because the same pill may not work for everyone every time. In the case of Malaysia, the economic body is simply not ready to absorb the rate cut now, due to the 6-month loans moratorium. Since most borrowers do not need to service their loans at all, lower interest rates mean very little.
- Moreover, there are the potential side effects to consider. For a currency that remains inadvertently tied in investors' minds to oil's (mis)fortunes, Ringgit's trajectory might be impacted further by reduced yield differentials. To best ensure an eventual recovery, the continued health of the banking sector – which bears the brunt of the moratorium's costs – is crucial too.

Beyond Hari Raya?

Let's start by stating the obvious. The Malaysian economy – like so many others across the planet – is hurting.

It is feeling the pain from the first-order effect of the coronavirus outbreak, as consumers and businesses alike pull back from spending and investment due to the sheer uncertainty.

There is impact coming too from the necessary-but-costly imposition of restrictive measures to prevent exponential outbreaks of the virus. It has been 43 days since the MCO restriction order was enacted on March 18th and the government has extended it further to April 12th. Indeed, PM Muhyiddin Yassin has hinted that it may be prolonged even further, saying that Malaysians might not be able to go back to their hometowns for Hari Raya – which falls on May 24th this year.

Going by their calculations, the economy loses MYR2.4bn (USD550mn) in nominal terms for each day of business closures due to MCO. To us, if the MCO is indeed extended to beyond Hari Raya, with perhaps early June "re-opening" in mind, GDP growth may dip to -1.5% for 2020, compared to our earlier expectation for baseline growth of -0.5% yoy.

To some extent, a 'soft reopening' of segments of the economy should help to cushion the blow. To start with, Trade Minister Azmin Ali has said that the essential services that are allowed to operate during the MCO period will now be able to do so at 100% capacity. Depending on whether the number of cases can stay contained in the coming weeks, the government may heed the suggestion by the Malaysian Employers Federation as well on allowing the non-essential sectors to start operating too, albeit at reduced staffing and capacity rates initially.

Blame it on Oil

With or without some lifting of the restrictions, growth is bound to be suffering still and the need to bolster it in whichever way possible is evident. While the authorities have launched fiscal stimulus packages to help, and may yet do more if MCO becomes more prolonged, the space to do so is limited.

Given its continued dependence on oil revenues, fiscal deficit remains an inextricable function of global oil price. Even if we go with a more conservative sensitivity of revenue-to-oil price of the government, if the Tapis oil – which tracks Brent closely – averages $20 per barrel this year, deficit may strike 4.3% of GDP, instead of the 4.0% that the government targets with now-lofty $35-40 per barrel oil price in mind back then.

While reports suggest that the government may tap into Petronas, the state-owned oil-and-gas giant, again for a special dividend of MYR10bn, on top of its annual MYR24bn payment, doing so this soon after the MYR30bn extra dividend it had already paid last year will not be easy, particularly because Petronas' own operations are heavily impacted by the low oil price.

Oil helps here, at least

Compared to the limited space on the fiscal front, monetary policy does indeed have more capacity to support growth. To start with, the good side of low oil price is that it has kept current inflation low and the outlook on prices contained as well.

The March print showed CPI headline inflation at -0.2% yoy, driven mainly by a 8.9% dip in the transport category that serves as a good gauge for the helpful impact of lower fuel price. Indeed, for the whole of 2020, we expect inflation to be clocking at a subdued -1% yoy, driven by low prices at the pump and constrained demand.

Combine the tame inflation outlook which gives Bank Negara the room to cut, and the not-as-benign growth outlook which may push them to ease, there is the obvious conclusion that the central bank should adopt a more accommodative monetary policy stance. We see at least 50bps cut on the OPR this year on that account, on top of the 50bps of easing that BNM has adopted this year.

Give us cuts, but not yet

However, when it comes to the timing of the next cut, we are not fully convinced that the upcoming May 5th MPC meeting is a good time for it.

For a while, especially during the heights of the market stress and massive cuts by the Federal Reserve in late March, we even thought that the BNM might well step in out-of-schedule to enact cuts. However, it opted to first cut the SRR on March 19th by 100bps to release MYR30bn of banking sector liquidity, and followed suit with a 6-month loans moratorium announcement on March 24th.

The last measure, especially, has prompted us to re-think our assessment of the likelihood of rate cut not only before the MPC but also for the scheduled MPC meeting itself next week.

The main reason is that, with the loans moratorium, households and SMEs – which make up more than 75% of the banking sector's loan book – are granted automatic reprieve from servicing their loans. For larger corporations, any reprieve can still be had, depending on their negotiations with the banks.

Since a vast majority of borrowers do not need to service their loans at all, lower interest rates during the period would carry very little oomph in terms of actual transmission and also bring only a subdued boost to sentiment. To be sure, since interests would still accrue on the loans amount during the period, a lower rate would bring lower total amount of loans outstanding, but the effect would be relatively minimal.

There is also the flipside of what an OPR cut would do to the banking sector's operations. Already facing the spectre of a potential pick-up in nonperforming loans, the moratorium also resulted in an absence of income streams coming in from the loans servicing during this period. A rate cut now may bring about a more compressed interest margin for the banks, adding another layer of challenges for the banks. For what it's worth, Fitch Ratings had revised its outlook for the Malaysian banking sector to negative on March 31st, on the back of these challenges.

Another factor to consider is the reduced yield differential that a rate cut would bring now, and its potential impact on the currency. Given the net oil exporter status of Malaysia, Ringgit has had a relatively high correlation with oil price – and that's not a good thing when oil has been trading in the doldrums. While it is not a major factor and would not have tipped the balance in and of its own, the challenges posed by low oil price on the currency – which may be heightened by lower yield differential – would likely be under consideration too.

What else can they do?

If Bank Negara indeed refrains from tweaking its policy rate for now, there are other measures that it might still adopt to help the economy more than it already has.

For one, another SRR cut to lower it from 2.0% now cannot be ruled out. While the central bank is usually at pains in stressing that SRR is an instrument to manage banking sector liquidity and not reflective of monetary policy stance, any easing there would nonetheless help the banking sector tide things over and improve sentiment.

Indeed, if recent policy mix by other central banks is any guide, things might get more interesting beyond the usual OPR and SRR focus, as well.

For one, Bank of England's Term Funding Scheme, announced on March 11th, can be an interesting starting point. By lending to UK's banks at or close to the BOE policy rate, the scheme allows more credit (at discounted rate) to flow to the economy. Moreover, BOE's provision whereby banks that increase lending to SMEs would be able to tap into larger amounts of such facility may be especially useful for Malaysia's case.

If things have been challenging for businesses overall, it may be especially so for SMEs, given the lower diversification of businesses and potentially higher cost base. Already, the SME Association of Malaysia said that as many as 300,000 SMEs may collapse over the coming year. Their survey noted that 70% of SMEs only have enough cash to last them through to end of April, and may be forced to cut as many as 2 million jobs.

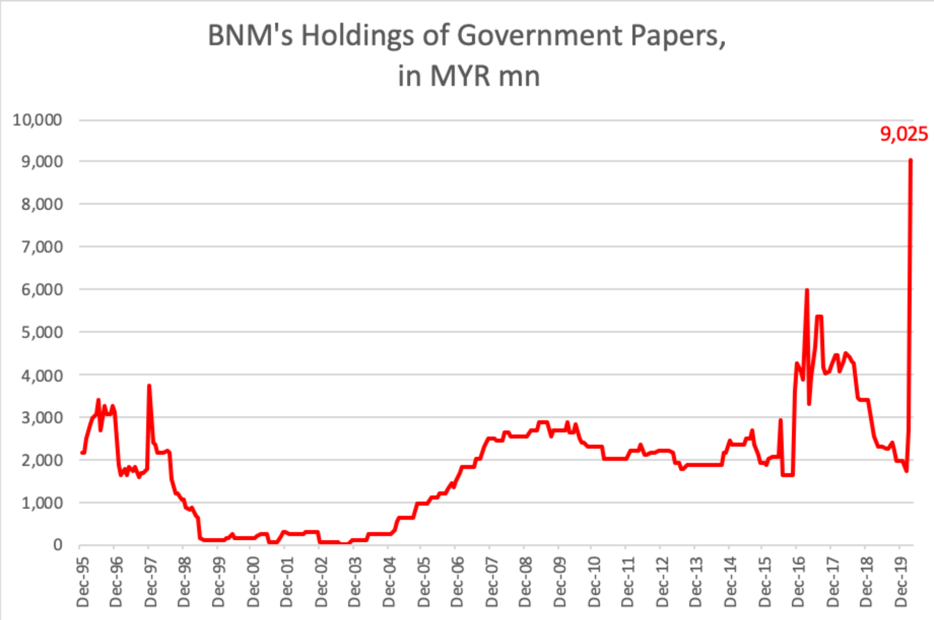
As it is, there is a sense that SMEs may have fallen through the cracks of current stimulus measures. For instance, the Danajamin guarantee fund from the government would only be for loans of more than MYR20mn – effectively shutting out most of the SMEs. The wage subsidy program has seen subdued take up by SMEs as well, because of the requirement to retain employees for at least 6 months.

By adopting a measure similar to BOE's facility, BNM might be able to help this crucial sector through, while maintaining some income streams for the banking sector.

Closer to home, BNM would have noted that neighbouring central banks such as Bank Indonesia has embarked into uncharted territories by starting to participate in primary auctions to help raise money to plug the fiscal gap as well. While it remains a low-likelihood scenario at this stage, it may be an option on the table.

Already, judging from the official data, BNM might have stepped up its purchase of government papers in the secondary market. At the end of March, BNM held MYR2.7bn worth of government bonds. By April 15th, the holding went up to MYR9bn, for instance. To be sure, as a percentage of outstanding MGS, the holding remains small at just 2.25% of total even after the uptick in the first half of April compared to Bank Indonesia's 15%. Still, it marked a sizable pick-up that may portend more to come.

Elsewhere, BNM has also been busy loosening administrative measures on the foreign exchange policy front. Just today, it announced a host of liberalization moves that should improve the appetite for hedging activities in the real sector. Compared to having to ask for BNM's explicit approval before cancelling or unwinding FX hedging before, there is no need to do so anymore except for portfolio investors. There is also no more cap on cross-border financial guarantees, compared to MYR100mn outbound and MYR50mn inbound before, which should help MNC HQs to offer help to their subsidiaries.



Source, OCBC, BNM.

Viewed from another angle, the liberalization move can also be seen as one action to placate FTSE Russell which has dangled the potential of taking Malaysia's sovereign off its WGBI index for quite some time now, voicing its concern in particular about foreign exchange policy measures.

Malaysia's Foreign Exchange Policy Liberalization Measure on April 30, 2020

Areas	Previous	Effective Now	Impact of Change
Exports Proceeds	Resident exporters required to convert export proceeds below RM 200k per transaction into Ringgit.	Exempted from the requirement.	Lower administrative burdens, especially for SME exporters.
Hedging Tenor	Residents could hedge foreign currency loan obligations up to 12 months only.	Residents could hedge foreign currency loan obligations up to the tenor of the underlying loans.	Allow for better management of FX risk from loans, especially of longer tenor.
Unwinding of Hedges	Both residents and non-residents needed to seek BNM's approval to cancel or unwind their hedges. (Only those registerd under the corporate hedging framework could do so flexibly)	Now all entities - except portfolio investors - can cancel or unwind their positions without seeking BNM's approval. (Portfolio investors may register under the existing dynamic hedging framework to hedge their positions).	Lessen administrative burden, and also broaden the attractiveness of entering into hedges, now that they can be cancelled or unwound without BNM's approval.
Receipt of Financial Guarantees	Residents could only obtain financial guarantees up to a limit of RM100mn, in aggregate.	No limit anymore to the aggregate sum of the financial guarantees that residents can receive.	This would benefit Malaysian subsidiaries of foreign entities considerably, given no limit to the support they can get from HQs.
Offer of Financial Guarantees	Residents could only issue financial guarantees up to an aggregate limit of RM50mn.	No limit anymore to the aggregate sum of the financial guarantees that residents can offer.	This would help the overseas subsidiaries of Malaysian corporates, and improve their ability to support global operations.

Source, OCBC, BNM.

Overall, we see these measures – actual and potential – as indicative of the fact that, even without resorting to OPR cut on May 5th, the BNM has been and will remain proactive in supporting the economy at a difficult time. While the scale of the slowdown and the space that it has may yet compel it to cut rate immediately instead of waiting for the second half of the year, we think that on balance, it would opt to wait to help ensure sustained banking sector health.

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