They Ate the Pill

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Bank Negara cut rates by 50bps to ease the pain

- Malaysia cut rates by 50bps, as consensus has it. We had expected it to remain on hold, as the 6-month loans moratorium has effectively rendered the monetary policy transmission mechanism in suspended animation.
- It appears that the prerogative to boost growth has vastly outweighed any other concern. With its projection that inflation may dip into negative territory this year, it has set itself up for some space for further cuts.
- The MPC statement appears to be fairly constrained however, expecting growth damage to be primarily a first-half issue for now. While further rate cuts cannot be ruled out, that does not appear to be in its baseline for now.

It's worth it

In our April 30th report, "*Don't Eat the Pill Yet*", we argued that although the need to ease the pain of economic impact is high, Bank Negara might not want to prescribe the painkiller of interest rate cut just yet due to potential side effects.

Alas, BNM opted for a rather heavy dose of 50bps rate cut today, in line with consensus expectations. As it turns out, in its judgement, the economic pain is simply too great. Even if the effect of the rate cuts might be more muted than usual due to the loans moratorium – in which 75% of loans do not have to be serviced for 6 months – it is better to 'pop the pills' than opt for alternative treatments at this stage.

Not surprisingly, the MPC statement sounded a sombre tone, stating that "Global economic conditions have weakened significantly," and recent indicators are in fact showing that "the global economy is already contracting". On the brighter side, it did add that "substantial policy stimuli" and "gradual easing of containment measures globally" would help to cushion the blow. For good measure, it added that "Growth prospects should improve in 2021" given the "expected containment of the pandemic."

On the domestic side, a similar things-are-bad-now-but-we-will-be-okay-eventually tone prevails. The MCO, the statement acknowledges that, while it has been "necessary to contain the spread of the virus", it has nonetheless "constrained production capacity and spending." It points also to the expectation that labour market conditions would "weaken considerably" and that "Economic conditions would be particularly challenging" in H1 this year.

Crucially, even as the statement tries to chime in with some higher notes, offering that, with the lifting of some MCO restrictions, "economic activity is projected to gradually improve", the outlook "continues to be subject to a high degree of uncertainty, particularly with respect to developments surrounding the pandemics." At the risk of sounding like we are putting words in their mouth, it appears that BNM may be alluding to the possibility that restriction orders might just make a comeback across the world if there is any resurgence in virus outbreaks later this year, putting economic recovery at risk.

Against the backdrop of highly uncertain growth, it is helpful that the statement hinted at further space to cut rate if necessary. For one, inflation is expected to remain tame in 2020, due to low oil prices. Indeed, BNM expects average headline inflation to be negative this year, in line with the -1.0% that we have in mind. Moreover, apart from the stock sentence near the end of the statement of how "The MPC will continue to monitor the outlook for domestic growth and inflation," it has also added that "The Bank will utilize its policy levers as appropriate to create enabling conditions for a sustainable economic recovery."

While it did not detail just what these policy levers may be in the MPC statement, we did not have to wait long to find out what some of these may be. Soon after the rates decision, BNM also announced that, effective May 16th, banks can now fully meet their Statutory Reserve Requirement, with existing ratio of 2.0%, by holding government bonds such as MGS and MGII. The measure is said to last until end May 2021.

To us, the move kills a few birds with one stone. To begin with, it provides a liquidity boost to the banking system, as banks do not have to hold 'extra' liquidity beyond their holdings of government bonds just to fulfil the SRR ratio requirement. Indeed, BNM estimates it to release MYR16bn worth of liquidity.

Secondly, by doing so, it has inadvertently helped to ease the burden on banks. As alluded to earlier (and detailed in our April 30th report), banks are bearing the brunt of the loans moratorium through deferred loans payment, and face the spectre of rising NPL due to poor growth outlook. With the rate cut today, their NIMs will be further compressed as well. Hence, the move might well be seen as somewhat of a consolation prize to the banks.

Thirdly, the measure would also boost the end-demand for government bonds. At a time of potential increase in issuance due to fiscal deficit needs, finding new demand for the bonds cannot hurt. In this case, banks are incentivized to be the net new marginal buyers, in a move similar in end effect from Bank Indonesia's recent cut-RRR-but-hike-MLB measure announced on April 14th, although the route taken by Bank Negara is a lot more straightforward.

Furthermore, in terms of providing support to the government bond market, Bank Negara has also noted that it has undertaken outright purchase of government securities in its MPC statement today. While it did not provide further details, it did say that such actions – together with SRR cut (of March 19th) and reverse repos – have added about MYR42 billion of liquidity into the domestic market. As mentioned in our previous report beforehand, data indicates that BNM has ramped up its purchase of government bonds lately. While figures from second half of April is yet to be available, its holding of bonds had gone up from MYR2.7bn in end-March to MYR9bn on April 15th. Today's acknowledgement of the purchases may portend more to come.

Overall, having cut its OPR by 100bps in aggregate this year already to the historic level of 2.0% last seen in the GFC days, the threshold to trim further is obviously harder to cross now.

Still, as BNM stated today, the outlook ahead remains ridden with high degree of uncertainties. Hence, it might well cut further again if the pace of recovery – in domestic economy, but also, relatedly given Malaysia's export-oriented sectors, the global one – falters even after various lockdowns are lifted.

Our baseline expectation is to see growth bottoming out in the next month or so, such that we can more concretely say there is going to be a significant uptick in Q3. In this scenario, BNM will be comfortable enough with what it has done thus far to hold rate unchanged in its next MPC meeting in July. For the sake of us all, let's hope that indeed turn out to be the case.

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