Disinflationary pattern strengthens further rate cut odds

BY **SUPRIYA SURENDRAN**

Bank Negara Malaysia pulled off a hat-trick of rate cuts this year, slashing the overnight policy rate (OPR) three times in a row by a total of 100 basis points (bps) to 2% at its monetary policy committee (MPC) meetings.

Some quarters believe the central bank still has room to stretch this feat a little further, given the disinflationary pattern seen in the first four months of 2020. After a muted growth of 1.6% year on year in January and 1.3% y-o-y in February, Malaysia's inflation rate — measured by the Consumer Price Index (CPI) — contracted 0.2% y-o-y in March.

Last Wednesday, the Department of Statistics Malaysia (DOSM) announced that the CPI declined 2.9% in April, marking its largest drop since 1968 when it fell more than 3%.

In a note to clients last week, DBS Group Research senior economist Irvin Seah and strategist Duncan Tan say although they had initially expected Bank Negara to keep the OPR at 2% for the rest of the year, the present inflation dynamics suggest otherwise.

"Another 25bps cut by Bank Negara could be on the cards in July to better align the risks in both inflation and growth," they say.

ING economist for Asia Prakash Sakpal concurs, saying deep negative inflation in Malaysia has driven the real interest rate to 5%, making it one of the highest in Asia. For clarity, the real interest rate is a country's nominal interest rate that is adjusted for inflation.

"Malaysia's central bank doesn't particularly target inflation in setting monetary policy. But the economy, staring at a deep downturn ahead, is demanding more policy accommodation.

"Cutting interest rates remains an important option at the central bank's disposal, while there is space to do so," he adds in his note.

Prakash is forecasting another 50bps cut from Bank Negara at its July MPC meeting.

"With -3% inflation pushing the real interest rate much higher at 5%, it (Malaysia's real interest rate) is the highest among Asian countries [and] we don't see any reason why Bank Negara's policy rate couldn't fall further.

"We now add another 50bps cut to our Bank Negara policy forecast, driving the OPR to an all-time low of 1% by the end of 2020," he says.

The main culprit for the CPI's decline is low oil prices — the average price of RON95 petrol in April was RM1.27 per litre, almost half of its price of RM2.08 per litre last year.

With Brent crude oil futures showing a slight recovery, trading at US$36 per barrel at press time compared with US$20 per barrel last month, could this help to boost headline inflation? Not quite, says Sunway University Business School Economics Professor Dr Yeah Kim Leng.

He is of the view that the current retracement in world oil price is expected to be gradual for the rest of the year, but unlikely to reach the average price of US$65 per barrel seen last year.

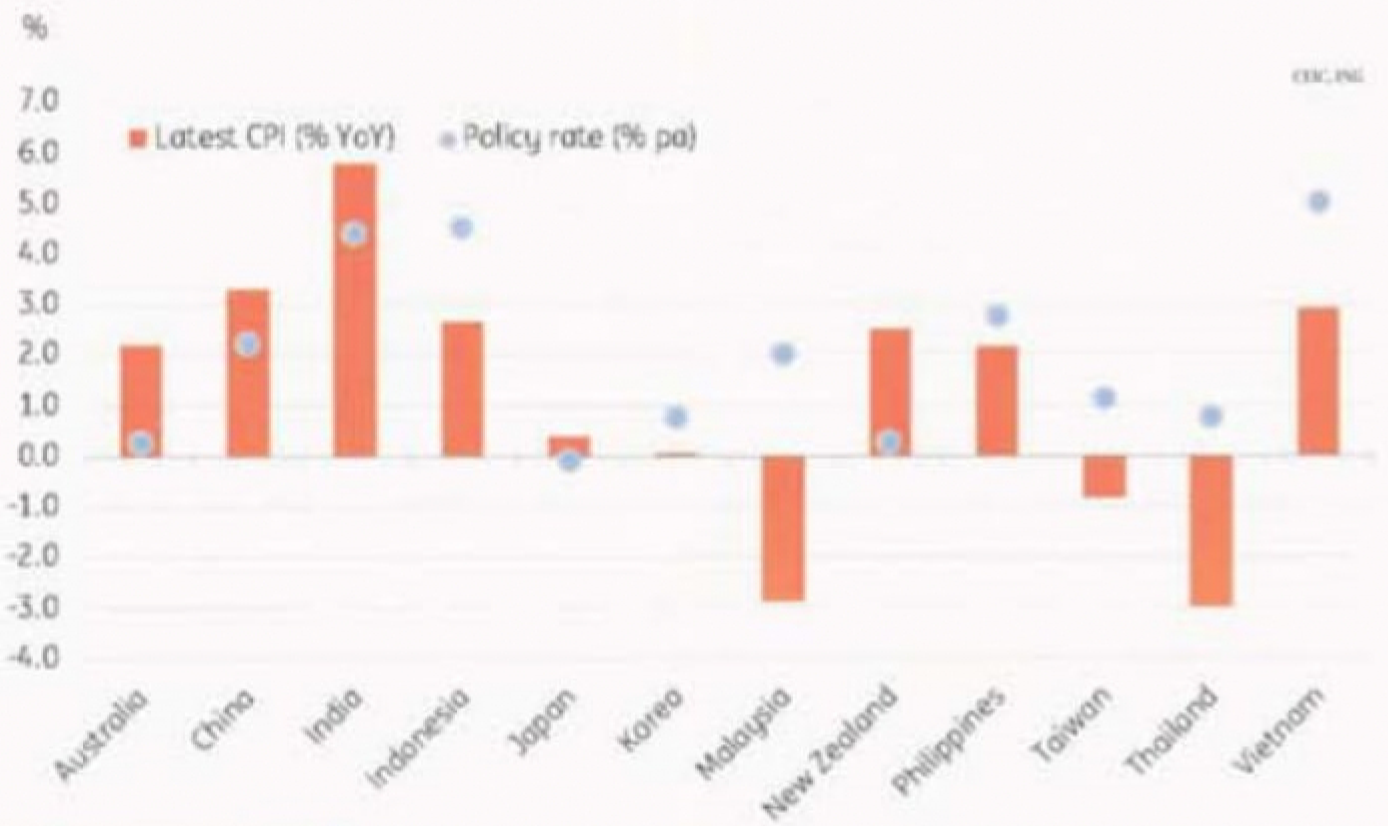
"On the demand side, the plunge in demand caused by the ongoing Covid-19 pandemic was staggering. A slow and tentative global recovery is anticipated as lockdowns are lifted and travel restrictions eased in varying degrees across countries of the world.

"The 'new normal' environment that will persist until the virus threat is removed entails substantially curtailed travel and transportation needs, thereby reducing substantially crude oil demand. On the supply side, excess inventories and oversupply despite production cuts by the oil-producing countries will keep prices down unless there are supply disruptions arising from geopolitical conflicts and natural disasters," he says.

REUTERS

According to DOSM, the main reason for the increase in food prices was that vegetable prices went up 3.5%

Inflation and central bank policy rates in Asia



A rise in food prices?

Fuel prices, or rather transport costs, made up 14.6% of the CPI basket in April, while food and non-alcoholic beverages made up 29.5%. While fuel prices went south, food prices did just the opposite and saw an increase of 1.2%.

According to DOSM, the main reason for the increase in food prices was that vegetable prices went up 3.5%. The prices of onions and garlic, in particular, rose 28% to 36% in April from a year ago.

And this is reflective — though some may argue to a lesser extent — of the actual retail prices of food items. Professor Datuk Dr M Nasir Shamsudin, an academic at Universiti Putra Malaysia's Faculty of Agriculture, believes in general there is no disconnect between the prices reflected in the CPI basket and the actual market prices.

"The food items and weightage in the CPI basket are reviewed regularly after every household consumption survey.

"However, there are instances in which the supply chain is affected by changes in production and inefficiency in the distribution and we may feel that the actual price is not reflected in the food CPI. But over the months, on average, the actual prices are reflected in the CPI basket," he says.

With the Hari Raya festivities around the corner, recent reports have emerged on the escalating prices of certain food items such as chicken, which, according to the Consumers Association of Penang (CAP), has increased from about RM7 per kg to as high as RM8.50 per kg in a week.

CAP also did surveys in several wet markets on the island such as those at Bayan Baru, Tun Sardon, Jelutong, Batu Lanchang and Chowrasta, where the price of Thailand-imported *daun ketumbar* (coriander leaves) was found to have risen five times to RM5 per 100g from RM1 per 100g and that of *daun sup* had increased to RM1 per 100g from 40 sen per 100g.

GDP and Inflation growth y-o-y (2010 to 2019)

"Interviews with some households indicate that festival budgets in many households have increased 40% in the last year. Residents say every year, the festival is an expensive affair," CAP research officer Ganesan Sivalingam tells *The Edge*.

In response, the Ministry of Domestic Trade and Consumer Affairs has enforced the Maximum Price Control Scheme, which will run from May 20 to June 3, throughout the Hari Raya Aidilfitri, Pesta Kaamatan and Hari Gawai festivities.

"Due to the Movement Control Order, demand might not increase as much during these festivals as compared to before, but the vertical transmission in the [food] supply side [chain] will be affected. Thus, we would still expect food prices to increase," says UPM's Nasir.

The increase in food prices, however, will not present a strong enough case to push up the inflation rate.

According to Sunway's Yeah, food price inflation will not persist as long as input costs remain stable and farm production and deliveries to major population centres are not disrupted.

"Prices of individual items fluctuate according to seasonal supply and demand, which also vary by location, accessibility and competition intensity.

"As long as substitutes are available, consumers can mitigate the effects of price changes on the individual household CPI," he says.

Core inflation stable at 1.3%

Yeah notes that despite Malaysia's headline inflation falling 2.9% y-o-y in April and 0.1% y-o-y in the first four months of this year, core inflation remains stable at 1.3%, suggesting that the economy is disinflating rather than confronting a feared deflation.

For clarity, core inflation excludes volatile items such as energy and food prices.

"Given subdued demand amid uncertain commodity price and currency movements, the headline CPI inflation this year is projected to range between -1% and 1%," he says.

ING's Prakash has cut his full-year inflation forecast for Malaysia to -1%, from -0.2% previously. "Indeed, it would take a significant demand recovery for inflation pressure to return — something that's unlikely to happen at least throughout the rest of this year, with the lingering impact of the disease and persistently weak economic outlook.

"We anticipate a deeper fall in prices ahead, as much as 4%, leading to a further downgrade to our annual inflation forecast, to -2.5%," he says.

UOB Malaysia senior economist Julia Goh and economist Loke Siew Ting are maintaining their CPI projection at -0.5% for 2020, with volatile global oil prices being a wildcard. Nevertheless, UOB expects Bank Negara to keep policy rates unchanged at 2%.

"We think that further rate cuts would be premised on steeper downward adjustments to the growth outlook, potential flare-up of [Covid-19] infections that warrants a tightening of measures and weak resumption of activity.

"We expect policy rates to stay unchanged at 2% for the rest of the year based on expectations of a modest recovery in the second half. This comes on the back of a progressive pickup in economic activity with the support of prior interest rate cuts and effective implementation of the RM260 billion fiscal stimulus package," they say.

Affin Hwang Capital also expects Bank Negara to stand pat on the OPR for now, but does not discount the possibility of another rate cut in the fourth quarter of the year if economic activity continues to soften sharply in the second half, especially from the external environment.

Should there be another rate cut, a pertinent question to ask is whether banks — which could deal with asset-quality issues once the six-month loan moratorium is over — can afford a further squeeze on their net interest margins that an OPR cut would entail.

While economists may have differing views on the probability of a rate cut, it will without a doubt be an uphill task for the central bank to make a decision that is not just data dependent, but that manages the expectations of various stakeholder groups and at the same time sets the country on the path to economic recovery. E