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ECONOMIC UPDATE

BNM MPC - OPR at 3.25% remains appropriate

- *At its monetary policy committee (MPC) meeting held on July 8 – 9, 2015, BNM had decided to keep the Overnight Policy Rate (OPR) unchanged at 3.25%.*
- *BNM stepped up its concerns over the heightened risk on global growth performance which was further marred by the recent spike up in market volatility. Nonetheless, the central bank remains sanguine over domestic demand particularly on sustained investment expenditure despite the impact of GST.*
- *Weakening Ringgit has not caused disorderly functioning of financial system thus far.*

Heightened risk from the external front but domestic demand would still be able to offset. In its Monetary Policy Statement issued after the meeting, the central bank pointed out that recovery in most parts of the world is still modest but has become vulnerable to increased downside risks posed by the heightened volatility in the financial markets on the back of developments in Europe and continued policy uncertainties in several major advanced countries. On domestic front, growth is expected to have moderated in the 2Q 15 but still resilient. BNM cited the frontloading of consumption activity prior to the implementation of the Goods and Services Tax (GST) in the 1Q 15 as the main reason for the likely pullback in GDP growth in the 2Q period. Nonetheless, the central bank highlighted the fact that continued wage growth and stable labour market conditions would see consumer spending to remain sturdy going forward. It added on that with the sustained increase in capital spending in manufacturing, services and infrastructure projects, overall domestic demand would still be able to offset the drag in exports sector that was significantly affected by the weaker external demand and fall in commodity prices.

As such, growth is unlikely to deviate far from trend with inflation contained. Overall, the central bank continues to hold the view that Malaysian economy would remain on a steady growth path, with domestic demand being the key driver of growth. It expects inflation to edge higher from the last 2 moth's average of 2% as the impact of the GST and the recent adjustments to domestic fuel prices trickle through, before moderating in the 2H of 2016.

Weakening Ringgit has not caused disorderly functioning of financial system thus far BNM stated that liquidity in the domestic financial system remains ample and the financial and foreign exchange markets operations have not shown any sign of disorderly flows despite the persistently weak Ringgit. It attributed this fact to strong capital and liquidity buffers held at the domestic financial institutions which enable them to continue to execute financial intermediation role as reflected in the still healthy credit growth.

Given all those factors, the MPC believes that the overnight policy rate (OPR) at the current level remains appropriate. With growth slowing down but remains on its steady trajectory (which we infer as the long-term trend and potential output growth) and Ringgit weakness is still mainly due to the bandwagon effects from the negative market sentiments but not yet threatening financial stability, MPC deems the OPR at 3.25% remains appropriate for the economy at this juncture.

We expect BNM to continue to hold the OPR at current level until year-end. While there have been some in the market expecting a rate cut later this year, we still think that the OPR would remain unchanged until year-end. The impact of weaker Ringgit is rather mixed on the overall economy. At the same time, growth is set to slow but unlikely to be causing a negative output gap. In fact at slightly below 5% growth (our call: 4.7%), we are still recording the fastest growth in the region. In view of the current market volatility, it is best to ensure that Ringgit would not face further undue downward pressure.

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