

BNM may front-load more OPR hikes in 2023 to tackle core inflation, say economists

KUALA LUMPUR (Nov 3): Malaysia's cost of borrowing increased for the fourth time this year as Bank Negara Malaysia (BNM) hiked the Overnight Rate Policy (OPR) by another 25 basis points to 2.75% at the sixth and final Monetary Policy Meeting (MPC) for 2022.

Though the hike was widely anticipated by the market, the central bank is far from done and remains keen to rein in inflation by continuing to increase OPR next year until it reaches a neutral rate of 3.25%-5%.

According to economists and fund managers, although BNM may not be emulating the hawkish stance the US Federal Reserve took by raising policy rates by a big quantum of 75 basis point to battle inflation, the central bank may have a much more calculated approach.

Nevertheless, Bank Negara is concerned about the core inflation rate which increased to 4% year-on-year at the end of Sept, 2022, which is a sharp contrast to the 1.6% recorded by the **Department of Statistics Malaysia (DOSM)** in January, 2022. In Aug 2022 core inflation reached 3.8%. goal, says Sunway University Business School professor of economics Dr Yeah Kim Leng.

"The increase will help to moderate demand pressures, so that inflation expectations can be managed without resulting in higher inflation.

"However, given that the interest rate is still below the neutral rate, we expect the central bank to continue its normalisation given that the pre-pandemic interest rate ranged between 3.25% and 5%. We may see the central bank continue to push towards raising the interest rate to the neutral rate. Of course, the quantum and the pace will be based on prevailing inflation as well as growth momentum," said Dr Yeah when contacted by The Edge CEO Morning Brief.

He added that inflation is not a problem exclusive to Malaysia, as the magnitude of the inflation rate surge has caught many central banks across the world by surprise.

"Although the central bank does not have an inflation target, a comfortable inflation level will be around 2.5%-3.5%. But we also note that inflation will remain elevated in the post pandemic environment as well as supply chain disruption caused by the Russia-Ukraine war," said Sunway's Dr Yeah.

BNM in a statement on Nov 3 said that countries around the world continue to embark on contractionary monetary policies to manage inflationary pressure particularly driven by strong demand and tight labour market.

The central bank also highlighted global growth to face challenges from tightening monetary policy in many economies, elevated inflationary pressure in developed markets and domestic challenges in China.

"We view the decision to raise OPR by another 25bps is timely, taking advantage of the stronger-than-expected macroeconomic performances," said MIDF Research in an economic review note on Nov 3.

MIDF added that although BNM views inflation to be manageable in the first nine months of 2022, BNM sees headline and core inflation to stay elevated amid both demand and cost pressures, and possible changes in domestic policy measures in 2023.

“We are in tune with BNM, especially the stance of the post-GE15 (15th general election) government on fuel subsidy policy will determine the direction of Malaysia’s inflation outlook for next year,” said the research firm.

MIDF, however, said the OPR increase is also done at a measured pace as the central bank hinted at a strong and robust third quarter gross domestic product (GDP) growth underpinned by improvements in labour market conditions and income prospects.

Malaysia GDP expanded by 8.9% in 2Q 2022 amid improving domestic demand.

“With the rising core inflation trend and stronger-than-expected domestic demand, we expect the central bank to front-load its monetary bullets to pre-pandemic levels at 3% by Jan 2023.

“However, the decision will be subject to the stability of economic growth, the pace of price increases and further improvement in macroeconomic conditions, particularly continued recovery in the labour market and growing domestic demand,” said MIDF.

From a medium-term perspective, the research outfit said that policy rate normalisation is necessary to avoid risks that could destabilise the future economic outlook such as persistently high inflation and a further rise in household debt.

Ringgit under pressure on Fed’s 75 bps rate hike

On Nov 2, the Fed chair Jerome Powell, as widely expected, lifted the policy Fed Funds Target rate (FFTR) by a fourth consecutive 75bps hike to 3.75%-4%.

The jumbo interest rate hike may further accelerate the rate of exodus of capital from Asian economies that are still suffering from the consequences of a strong dollar.

According to Fortress Capital Asset Management Sdn Bhd CEO Thomas, the ringgit is likely to continue to weaken against the US dollar if the interest rate differential between US dollar and ringgit continues to widen.

“Having said that, the strength or weakness of the ringgit is likely to move in line with regional currencies given the strong trade relations regionally,” he told The Edge CEO Morning Brief.

He added: “The US dollar strengthening has been universally observed against all currencies, rather than just the ringgit. At some point, concerns of a runaway US dollar exchange rate will subside and real transactional demand should then set the rate of exchange.”

The ringgit continued to fall against the US dollar on Thursday following the Fed’s rate hike due to weak sentiment amid the strengthening greenback.

At 6pm on Nov 3, the local note fell to 4.7425/7460 versus the US dollar from 4.7360/7400 at Wednesday's close.

To date the ringgit has declined 13.72% against the US dollar year to date.

The Fed also signalled that it will continue to do a few rounds of hikes, which will further exacerbate pressure on the local unit.

“With the Fed signalling a more hawkish rate hike path, we maintain our expectation for the ringgit to depreciate further towards the end of the year and average USD/RM4.44 (YTD: USD/RM 4.38),” said RHB Research in a note.

Widened interest rate differential between US dollar and ringgit risks money outflow
Sunway University’s Dr Yeah added the widening of interest rate differentials against the US interest rate is expected to result in further outflow of foreign funds.

“The US dollar is also known as a safe haven, so we’ll see more funds fleeing there. However it will also be determined by the higher returns there that investors can receive from investing in the US market,” he said.

The foreign demand for Malaysian Government Securities (MGS) and Government Investment Securities (GII) weakened in September, with net outflows of RM2.5 billion in light of the US Federal Reserve's continued aggressive stance in raising interest rates.

The 10-year US Treasury (UST) yield jumped 68 basis points (bps) month-on-month to 3.83% as of end-September, outpacing the 10-year MGS yield which rose 45.7 bps to 4.44% as of the same date, according to RAM Rating Services Bhd (RAM Ratings) in a report released on Oct 18.

“This is inevitable. But the comfort for Malaysia is we do have sufficient domestic liquidity to offset expected foreign capital outflow. So that will help to maintain the stability in the financial market,” Dr Yeah.

Fortress’ Yong believes that although the weaker ringgit added pessimism to the financial market, the businesses, particularly exporters with cost structure denominated in ringgit, are likely to continue to enjoy the strong US dollar environment.

“However, with global growth expected to slow down ahead, demand might be affected. Sectors such as automobile, airlines, media and pharmaceuticals would likely be affected by the weak ringgit if they cannot pass through the higher costs to the consumers. Generally, those companies with high costs denominated in US dollars would suffer,” he added.

<https://www.theedgemarkets.com/article/bnm-may-frontload-more-opr-hikes-2023-tackle-core-inflation-say-economists>