

Executive Summary

Economic and Financial Developments in 2022

In 2022, global economic and trade activity moderated: Economic and trade growth moderated to 3.4% and 5.4%, respectively (2021: 6.2% and 10.4%, respectively). Growth was weighed down by, amongst others, the COVID-19 pandemic, domestic issues in China, military conflict in Ukraine, elevated inflation and tighter monetary policy. Pent-up demand supported global economic and trade activities as many countries lifted containment measures and shifted towards endemicity. Global inflation rose on account of both supply and demand factors. Commodity prices rose rapidly, primarily caused by supply chain disruptions due to the Ukraine conflict and China's zero-COVID policy. The environment of stronger demand, tight labour markets and elevated commodity prices caused inflation to rise to historical highs particularly in advanced economies (AEs). Central banks raised interest rates – some aggressively – resulting in a broad tightening in financial conditions and higher risk aversion. Inflation in Asian regional economies edged higher but remained relatively lower compared to the AEs and other parts of the world. This was partly attributable to existing price controls and subsidies on energy in some economies, as well as lower inflation on staple food in Asia.

Domestic financial markets were affected by external conditions but were supported by positive domestic factors: Narrowing interest rate differentials between Malaysia and AEs, rising global bond yields and the strength of the US dollar were some of the major external developments that affected the domestic financial markets. Nonetheless, strong domestic growth momentum during the year partly supported the domestic equity market. Spillovers to financial intermediation were contained, underpinned by the resilience of the domestic banking system. Of importance, the

flexibility in the ringgit exchange rate also played a role in cushioning the impact of adverse global shocks to the domestic economy.

In 2022, the domestic economy grew strongly and exceeded its pre-pandemic level: The Malaysian economy expanded by 8.7% in 2022 (2021: 3.1%) despite the challenges faced throughout the year. This was contributed by the full upliftment of containment measures, resilient growth in exports, particularly commodity exports, revival of tourism activity and continued policy support. However, the pace of recovery was uneven across sectors. Leisure-related services, mining and quarrying, agriculture and construction sectors remained below pre-pandemic levels. Activities in these sectors were constrained by the more gradual recovery in tourist arrivals, oil and gas facility closures for maintenance purposes, labour shortages and higher input prices, respectively. Growth in 2022 was largely driven by domestic demand, mainly from firm private sector expenditure. Improvements in labour market conditions and wage growth led to an increase in household spending. This was supported by the realisation of pent-up demand and continued policy support. In line with the reopening of the economy, public and private investment improved significantly. The improvement was contributed by public infrastructure projects, resumption of construction activity, as well as continued investments by firms to automate and digitalise their operations. Furthermore, external demand remained resilient and provided support to the economic growth in 2022.

Headline and underlying inflation trended higher in 2022: Headline inflation increased in 2022 to 3.3% (2021: 2.5%), mostly contributed by higher prices of food-related goods and services. In addition, prices for other CPI services including rental, and restaurants and hotels rose too. Upward price pressures arose from a combination of cost and

demand factors. The cost factors included high global commodity prices, prolonged supply-related disruptions, sustained US dollar strength against the ringgit, domestic food supply shortages and seasonal factors. Meanwhile, demand conditions improved following the reopening of the Malaysian economy. These factors resulted in higher cost pass-through to consumer prices. The full impact was, however, contained by existing price controls, subsidies, and the remaining spare capacity in the economy. Underlying inflation, as measured by core inflation, was also elevated at 3.0% (2021: 0.7%) due to strengthening demand conditions following the reopening of the economy. Price pressures also became more broad-based during the year, albeit with some moderation in the inflation pervasiveness from September 2022 onwards.

Monetary policy was recalibrated amid firmer domestic economic recovery: The Overnight Policy Rate (OPR) was gradually raised to 2.75% from a historical low of 1.75% through four consecutive adjustments beginning in May 2022. The recalibration of the OPR was warranted as the unprecedented conditions experienced during the height of the pandemic had abated. Nevertheless, such adjustments were undertaken in a gradual and measured manner to ensure sustainable growth over the longer term while enabling the Bank to pre-emptively manage the potential risk of excessive demand on price pressures. Overall, credit conditions remained supportive of the financing needs of households and businesses as the economy fully reopened. Targeted support also remained available, particularly for viable borrowers and those in the most affected segments that may take longer to recover.

Outlook and Policy for 2023

A challenging and uncertain global economic environment: Growth is expected to remain soft in major economies in 2023. Against this outlook, the PPP-weighted global growth and Malaysia's export-weighted global growth are projected to moderate. The resilient labour markets, easing of supply chain disruptions, China's reopening and continued recovery in global tourism activity are expected to facilitate global economic growth. The positive impact from reopening of economies and pent-up

demand will continue to wane in most economies. Additionally, tighter monetary policy amid elevated inflation in major economies, and projected subdued global trade activity will add to these challenges.

Global inflation is expected to moderate but remain elevated for many countries: The moderation is driven by easing of supply chain disruptions, lower commodity prices and softening global demand. However, inflation may remain higher than its long-term average due to tight supply in commodities. Elevated inflationary pressure and further adjustments of monetary policy, especially by central banks in AEs, will continue to weigh on economic activity. The adjustments will be the main factor influencing global financial market conditions during the year. Against this backdrop, spillovers to emerging market economies (EMEs) would stem from tighter financial conditions and slower exports. However, such pressures are to be partially offset by slower pace of monetary policy tightening, though the extent of tightening hinges on the evolving inflation outlook and financial stability concerns following the recent banking sector stress in some AEs.

Risks to global growth are tilted to the downside: This could arise from an escalation of geopolitical tensions, which could disrupt global trade, supply chains and commodity markets, and the turmoil in the global banking sector. Tighter monetary policy may be required to tame inflation due to tighter labour markets and higher commodity prices. This could expose vulnerable EMEs to debt distress. On the other hand, there are possible upside risks to global growth, stemming mainly from stronger-than-expected pent-up demand, particularly in major economies.

The Malaysian economy is projected to grow between 4.0% and 5.0% in 2023, supported by firm domestic demand: The economy is expected to face challenges from slowing global growth. Additionally, continued concerns on the elevated cost of living and input costs, as well as their impact to households' and businesses' spending behaviour will add to these challenges. Nonetheless, further improvement in labour market conditions, continued implementation of multi-year investment projects and higher tourism activity – particularly with the resumption of China's outbound tourism – are expected to support private consumption and investment growth.

The risks to Malaysia's economic growth are fairly balanced: Weaker-than-expected global growth may adversely affect consumer and business sentiments as well as trade performance. Tighter monetary policy by major central banks will lead to higher risk aversion in global financial markets. Additionally, further escalation of geopolitical conflicts could have an adverse impact on the global economy and trade. Domestically, higher-than-expected inflation would weigh on households' purchasing power and affect firms' profits adversely, which could impact their spending and investment decisions, respectively. However, better-than-expected labour market conditions and tourism activity as well as implementation of multi-year projects, including as outlined in Budget 2023, would provide upside risks to the domestic outlook.

Both headline and core inflation are projected to average between 2.8% and 3.8% in 2023: Headline inflation is expected to be on a moderating trend throughout 2023. Global cost factors, which contributed to higher headline inflation in 2022, have started to moderate and is expected to prevail in 2023. The moderation will be driven by the expectation that prices of key commodities are averaging lower amid improving supply constraints and softening global demand. Additionally, price controls and subsidy measures will continue to contain inflationary pressures. However, despite the moderating trend, headline and core inflation will remain elevated for several months due to continued strength in domestic demand and the labour market. The outlook for inflation in 2023 is uncertain and remains tilted to the upside. The upside risks include higher global commodity prices due to worsening of geopolitical conflict, extreme weather conditions, stronger-than-expected demand from China, and higher input costs due to exchange rate developments. Furthermore, changes to domestic policy on subsidies and price controls would also pose as upside risks to inflation. Risk of a wage-price spiral is expected to be remote, as long-term inflation expectations remain well-anchored. Productivity growth will likely outpace any catch-up in wages. Meanwhile, downside risks to the outlook could emanate from more subdued global commodity prices amid weaker global growth and moderation of price pressures following faster dissipation of domestic pent-up demand.

Domestic monetary and financial conditions to remain supportive of financial intermediation activities: Demand for financing is expected to be sustained in 2023 due to continued expansion of economic activity and improvement in labour market conditions. Banks' lending capacity remains forthcoming due to their healthy capital and liquidity buffers. Meanwhile, progress on key reforms together with sound economic policies would provide impetus for sustained capital inflows and recovery in the domestic financial markets. There are, however, risks to domestic financial conditions arising from tighter monetary policy globally, concerns surrounding geopolitical conflicts and the impact from China's economy reopening. In addition, there has been increased global market volatility amid elevated stress in the global banking sector, albeit posing minimal impact to Malaysian financial assets. Despite these challenges, adjustments in domestic financial markets are expected to remain orderly. Any adverse impact of outflows and spillovers to financial intermediation will be contained by the presence of domestic institutional investors and strength of the domestic banking system. Macroeconomic adjustments due to external shocks, on the other hand, are facilitated by the flexibility of the exchange rate. Moreover, the Bank's liquidity and foreign exchange operations will mitigate excessive market volatility to ensure orderly functioning of the financial markets.

Monetary policy will remain supportive of sustainable economic growth while ensuring an environment of price stability: In 2023, the MPC's monetary policy considerations will continue to focus on managing inflation risks while supporting sustainable growth. The MPC will continue to assess the cumulative impact of past OPR hikes, as well as the evolving conditions and their implications to the domestic inflation and growth outlook. The MPC is also mindful of the potential upside risks to domestic inflation due to persistent inflationary pressures. However, the risks to growth are fairly balanced as better domestic outlook offsets the weak global growth. Given the lingering uncertainties, any potential adjustments to the degree of monetary accommodation will be guided by the impact of evolving developments on balance of risk to inflation and growth.