

Our Role

Bank Negara Malaysia is Malaysia's central bank. Our principal objective is to promote monetary stability and financial stability conducive to the sustainable growth of the Malaysian economy. The Bank derives its mandate and powers from the Central Bank of Malaysia Act 2009 and other laws that it administers¹.

In our role to promote monetary stability, the Bank formulates and conducts monetary policy to keep inflation low and stable, while ensuring that it is supportive of sustainable economic growth. We are also mandated to promote an exchange rate regime consistent with the fundamentals of the economy.

To promote financial stability, the Bank regulates and supervises financial institutions to promote their safety and soundness. We oversee money and foreign exchange markets to promote their integrity and orderly functioning. We also exercise oversight over payment systems to foster safe, efficient and reliable payment systems and payment instruments. In addition, we regulate the conduct of financial institutions and intermediaries in order to provide appropriate protection to financial consumers.

The Bank plays a key role in promoting a progressive and inclusive financial system. This takes into account the changing needs of the Malaysian economy and its people, and the central role of finance in the nation's economic and social progress.

Our pursuit to develop and deepen both the conventional and Islamic financial system also recognises that a well-developed financial system is one that can help absorb shocks, and therefore contributes to the country's resilience.

The Bank carries out a number of other important functions. These include issuing currency, and holding and managing the country's foreign reserves. The Bank is also the financial adviser, banker and financial agent of the Government. Together with other government and law enforcement agencies, we play a role in helping to prevent the criminal abuse of financial services. Additionally, the Bank has been responding to climate risk, firstly through appropriate regulation and supervision of financial institutions, to support an orderly transition to a low-carbon economy; and secondly by embedding sustainable practices in our own operations.

In all the Bank does, it does in the best interest of the nation.

¹ Other key legislation includes the Financial Services Act 2013; Islamic Financial Services Act 2013; Development Financial Institutions Act 2002; Anti-Money Laundering, Anti-Terrorism Financing and Proceeds of Unlawful Activities Act 2001; Money Services Business Act 2011; and the Currency Act 2020.

Promoting Monetary Stability

The Bank's Monetary Policy Committee (MPC) formulates monetary policy autonomously to achieve price stability while giving due regard to economic developments. The MPC does this by setting the Overnight Policy Rate (OPR) based on its assessment of the outlook for inflation and economic growth in Malaysia.

Monetary Policy in 2022

In early 2022, the global economy was heavily affected by COVID-19 policy responses amid the emergence of new variants of concern. Countries had to employ strong measures to curb the spread of the disease, which in turn weighed on economic activity. However, by the first half of 2022, more effective pandemic management¹ enabled some economies to lift restrictions and reopen international borders. This led to improved labour market conditions and a rebound in economic activity and demand.

Notwithstanding these positive developments, the global recovery was hampered by several other factors during the year. These included rising global commodity cost pressures, the military conflict in Ukraine, and strict COVID-19 containment measures in China.² In particular, rising inflationary pressures emerged as a significant concern for many economies due to increased costs and stronger demand following economic reopening.

¹ These include progress in vaccination coverage, advancements in vaccine efficacy, and the availability of anti-viral treatments.

² Of note, the military conflict in Ukraine led to a spike in commodity prices and temporary disruptions in the supply chain, which was also partly worsened by lockdowns in China.

To manage high inflation, many central banks resorted to aggressive tightening of their monetary policy, with some increasing their policy rates quickly and by large magnitudes. As a result, global financial conditions tightened. Of significance, fast and large adjustments in the US interest rates and expectations of future hikes contributed to a strong US dollar. This appreciation of the US dollar subsequently affected other major and emerging market currencies, including the ringgit.

Even in the face of global challenges, Malaysia's economy continued to post a strong recovery. Domestic GDP grew by 8.7% in 2022 (2021: 3.1%). As COVID-19 restrictions were lifted, economic activities resumed. Labour market conditions and investment activities improved, further supporting domestic growth. The reopening of international borders³ helped revive tourism activity. Continued policy support, such as the minimum wage increase⁴ and cash transfers, provided an additional lift to the economy.

While the growth of the global economy was slower, exports activity remained resilient during the year. This was supported by strong demand for electrical and electronic (E&E) products and commodities. Despite tighter global financial conditions and higher volatility in the foreign exchange markets, Malaysia's strong external position⁵ and sound financial institutions ensured continued smooth financial intermediation to support the economy.

Overall, Malaysia's economic recovery in 2022 was largely driven by stronger domestic demand as economic activity normalised. However, the pace of recovery varied across different economic sectors. While economic activity in export-oriented industries thrived, some sectors such as that of the leisure-

³ Since 1 April 2022.

⁴ The monthly minimum wage was increased from RM1,200 to RM1,500 for companies with five or more employees effective 1 May 2022.

⁵ Malaysia's foreign currency assets were higher than the foreign currency liabilities.

related services remained below pre-pandemic levels. This was mostly due to tourist arrivals recovering only at a gradual pace during the year.

Headline inflation averaged higher in 2022 at 3.3% (2021: 2.5%). Underlying inflation, as measured by core inflation,⁶ also rose, averaging at 3.0% (2021: 0.7%). The surge in global commodity prices and prolonged supply-related disruptions were key factors that resulted in cost-push inflationary pressures. The continued US dollar strength against the ringgit also led to higher import prices, which added to the cost pressures. While inflation was largely driven by these cost factors, the strengthened domestic demand following the economic reopening also contributed to the increasing inflationary pressures. However, upward pressures on prices were partly contained by domestic price controls, subsidies, and prevailing spare capacity in the economy.

As the Malaysian economy was on a firmer footing, the MPC⁷ deemed that it was the right time to begin withdrawing excess monetary policy support. The MPC gradually increased the OPR through four 25 basis point adjustments at the May, July, September and November meetings. This resulted in a total increase of 100 basis points, bringing the OPR to 2.75% from a historical low of 1.75% in 2020.

In early 2022, domestic inflation was mainly driven by costs. However, as the year progressed and the economy recovered, the MPC observed some signs of demand-driven inflation. As such, the OPR increases were also aimed at pre-emptively mitigating the potential risk of excessive demand pushing up prices further. This was necessary to avoid excessive broad-based price pressures and unanchored inflation

expectations.⁸ Such a situation of high inflation is harmful to the economy. It erodes people's purchasing power and savings, especially affecting those in the lower-income group. High inflation is also detrimental for businesses as they face increased costs to produce goods and services, or lower sales due to reduced demand. These would then lead to slower economic activity and growth. If the MPC waited until high inflation became out of control before taking action, the OPR might need to be raised faster and by a larger amount. At the same time, the negative effects of high inflation would already be felt by all, particularly the lower income group. Together, these would be far more damaging to the economy. Overall, monetary policy remained accommodative and supportive of economic growth in 2022.

Following the OPR adjustments, interest rates in the wholesale and retail markets trended higher. In the retail market, returns to depositors and lending rates increased, broadly in line with the OPR increases. Throughout this period, the Bank's monetary operations focused on ensuring sufficient liquidity in the banking system,⁹ including after the expiry of the Statutory Reserve Ratio (SRR) flexibility on 31 December 2022.¹⁰ This enabled the orderly functioning of domestic financial markets and financial intermediation in the economy.

For borrowers, the impact of OPR increases on loan repayments depends on the type of loan. Existing fixed-rate loans (e.g., most car loans), which account for about 50% of the total number of household loan accounts,¹¹ were unaffected, while borrowers with floating-rate loans (mainly housing loans) faced higher monthly instalments. Interest rates for new loans also increased in line with the OPR adjustments.

⁶ Core inflation is computed by excluding price-volatile items (e.g., fresh meat, vegetables and eggs) and price-administered items (e.g., electricity, road tolls and sugar).

⁷ The MPC meets six times a year to decide on monetary policy. More information on Malaysia's monetary policy and the MPC can be found in the 'Governance' section of this report and in the 'Monetary Stability' section of the Bank's website (<https://www.bnm.gov.my/monetary-stability>).

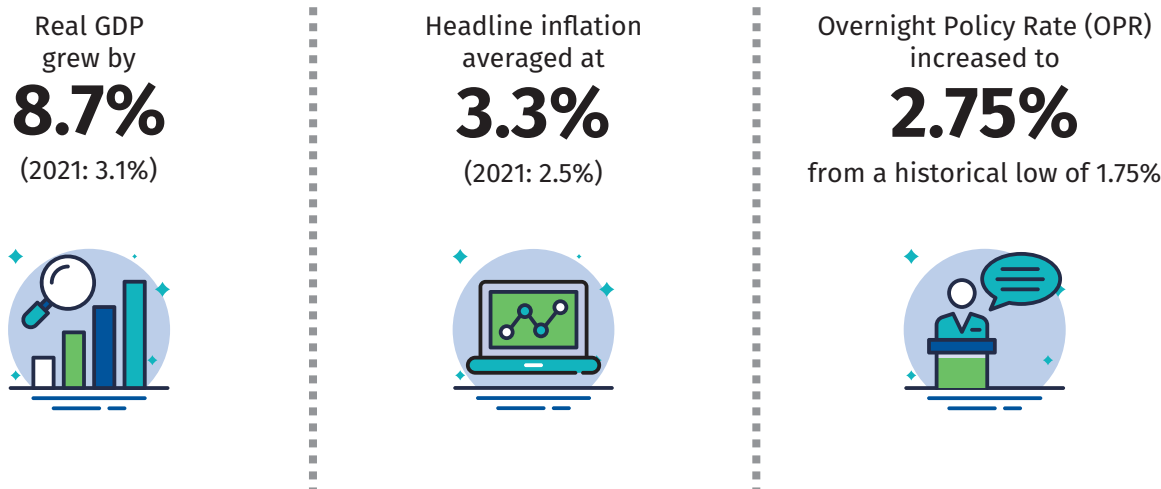
⁸ Inflation expectations can influence price- and wage-setting behaviours which could affect actual inflation outcomes. For example, when expectations are unanchored in a high inflation environment, firms would expect prices to keep rising, thus leading them to increase the prices of goods and services at a faster rate. At the same time, workers may demand higher wages due to their expected loss of purchasing power. As a result, these behaviours can further contribute to higher actual inflation, making it more challenging for the central bank to manage the inflationary pressures.

⁹ The Bank conducts monetary operations using a range of instruments. More information on the various instruments used can be found in the 'Monetary Operations' section of the Bank's website (<https://www.bnm.gov.my/web/guest/overview>).

¹⁰ Banking institutions were granted the flexibility to use the Malaysian Government Securities (MGS) and Malaysian Government Investment Issues (MGI) to fully meet SRR compliance from 16 May 2020 to 31 December 2022. This was to provide sustained liquidity support at the onset of the pandemic and during the economic recovery.

¹¹ As at end-December 2022.

Diagram 1: 2022 Key Domestic Figures at a Glance



Source: Bank Negara Malaysia and Department of Statistics, Malaysia

The Ringgit Exchange Rate

Like most currencies, the ringgit depreciated against the US dollar in 2022. The aggressive policy rate hikes in the US¹² and concerns over a weakening global growth outlook led to investors preferring US dollar-denominated assets. However, the ringgit was relatively stable compared against the currencies of Malaysia's major trade partners, as assessed using the nominal effective exchange rate (NEER). The NEER recorded a marginal appreciation of 0.05% for 2022. This helped preserve our competitiveness.

Malaysia adopts a flexible exchange rate regime. This flexibility is critical to help the Malaysian economy adjust to global economic and financial shocks. Movements in the ringgit exchange rate, whether it is an appreciation or depreciation, will guide businesses and households to adjust their consumption and investment decisions optimally.¹³ This ultimately benefits the economy in the long run.

While the value of the ringgit is determined by the market, the Bank's role is to ensure the orderly functioning of the ringgit exchange rate market.¹⁴ In other words, we carry out foreign exchange operations so that there are no sudden or excessive swings in the ringgit exchange rate that could disrupt economic activity (such as exports and investments). We do so by stepping into the market to buy and sell ringgit. This ensures sufficient two-way liquidity in the ringgit exchange rate market during periods of market stress – for example, during bouts of financial market volatility when the US Federal Reserve increased the pace of its monetary policy tightening in 2022. The Bank also continues to deepen the foreign exchange market, which promotes access to hedging instruments for businesses to better manage their foreign exchange risks.¹⁵

Analysis and Research

Throughout the year, our policy research and analytical work focused on assessing the resilience of the economic recovery and the rising inflationary pressures. On economic resilience, we updated our assessments on domestic labour market

¹² Amid higher inflationary pressures, the US Federal Reserve had sharply raised the federal funds rate cumulatively by 425 basis points, to its highest level in 15 years of between 4.25% to 4.50% by the end of 2022.

¹³ For example, when the exchange rate depreciates, domestic goods sold abroad (exports) become cheaper relative to goods from abroad (imports). This will incentivise an increase in exports relative to imports, thereby improving the trade balance. Consequently, these will lead to an increase in consumption, investment and inflation in the domestic economy. The opposite applies for an appreciation in the exchange rate.

¹⁴ More information on the ringgit can be found in the 'Ringgit Exchange Rate Policy' section of the Bank's website (<https://www.bnm.gov.my/monetary-stability/ringgit>).

¹⁵ More information on financial market development initiatives can be found in the 'Market Development Initiatives' section of the Bank's website (<https://www.bnm.gov.my/committees/fmc#devt>).

recovery and the strength of private consumption. This included analysing the extent of slack (unmet demand for employment), determinants of labour productivity and the impact of policy support on consumption.¹⁶ Additionally, we analysed how external factors could affect Malaysia's highly open economy, conducting scenario analyses to measure the potential impact on financial conditions, inflation and GDP. Our assessment also included a thorough examination of the channels through which changes in global commodity prices could potentially influence domestic inflation and the potential risks of unanchored inflation expectations in Malaysia.¹⁷ The impact of the exchange rate on the economy and inflation was given special emphasis in our policy surveillance and research.¹⁸ We also considered the impact of the global financial market volatility on domestic financial intermediation and the resilience of the banking system.

Amid the OPR increases, the Bank regularly evaluated the transmission of higher interest rates to domestic financial markets, the banking system, the economy and inflation. This comprehensive evaluation encompassed the effects on credit and financing, as well as consumption and investment activities.

The Bank contributed to a number of Government policy groups, focusing on critical economic priorities, such as inflation, investment, labour, and social safety nets. For instance, we provided insights and policy advice on various cost of living initiatives from the macroeconomic perspective. In addition, the Bank contributed to the formulation of the Fiscal Responsibility Act, which ultimately serves towards ensuring the nation's overall fiscal soundness. We also provided technical assistance in COVID-19 vaccine effectiveness research to support the Government's vaccination and epidemic policies. As a result, this contributed towards a smooth endemic transition and a sustained economic recovery.

Our research on reinvigorating investment in Malaysia culminated in the launch of the New Investment Policy (NIP) based on the National

Investment Aspirations.¹⁹ The NIP serves as a forward-looking framework for Malaysia to adapt to changes in the global economic landscape and drive investment in future growth sectors. Our policy advocacy work also prioritised the green agenda. This includes providing recommendations for the National Energy Policy and forging strategic partnerships to promote co-innovation and investment in clean technology.²⁰ These align with our broader goal of creating new growth opportunities for the economy while mitigating the transition risks of climate change.

The Bank also contributed to enhancing Malaysia's social protection landscape.²¹ Our efforts included proposing improvements to the social safety nets (SSN) framework,²² advocating for better access to insurance options (e.g., Perlindungan Tenang), and policy interventions aimed at rebuilding retirement savings.²³ To improve job opportunities and income prospects, we proposed viable models for personalised training programmes. We also advocated for upward mobility and lifelong learning for all working-age adults, including by better connecting social assistance and insurance programmes with active labour market policies (ALMPs).²⁴ These recommendations are geared towards building a more comprehensive and inclusive social protection system for all Malaysians.

Communication and Outreach

In 2022, the Bank stepped up efforts to enhance our monetary policy communications. We endeavoured to provide the public with deeper insights into our monetary policy decisions and widened our engagement channels with different stakeholders using targeted forms of content. This involved making information more accessible and increasing

¹⁶ Further discussion on assessing slack and tightness in the labour market can be found in the BNM Economic and Monetary Review 2022 Box Article titled 'Analytical Approaches to Assessing Labour Market Conditions and Implications to Monetary Policy'.

¹⁷ More information can be found in the BNM 3Q 2022 Quarterly Bulletin Box Article titled 'Global Commodity Price Trends, Inflation Dynamics, and Policy Responses: The Case of Malaysia'.

¹⁸ Further discussion on the ringgit exchange rate can be found in the Box Article titled 'The Exchange Rate and the Malaysian Economy' in this report.

¹⁹ The NIP was launched on 6 October 2022.

²⁰ Clean technology refers to areas such as electric vehicles, agritech, hydrogen, as well as carbon capture, utilisation and storage (CCUS).

²¹ Social protection serves as an important macroeconomic stabilisation tool, particularly by providing support to vulnerable groups.

²² Enhancements to the SSN framework include consolidating overlapping assistances and strengthening the targeting mechanism (e.g., to identify recipients for targeted assistance). Together, these would greatly enhance the ability of SSN policies to uplift and reinforce economic security for vulnerable groups.

²³ More information can be found in the BNM Economic and Monetary Review 2022 Box Article titled 'Rebuilding Retirement Savings and Financial Safety Nets in Malaysia'.

²⁴ Examples of ALMPs include training, upskilling, apprenticeship opportunities and job placement services.

interactions with the public, analysts, media and Government representatives.²⁵

A key initiative was the introduction of the Monetary Policy Statement (MPS) Snapshot to accompany the statement itself. The MPS Snapshot is a summary of the MPS aimed at improving public outreach by cutting through technical terms, and describing OPR decisions more simply and intuitively. A list of frequently asked questions (FAQs) on monetary policy was also made available on the Bank's website.²⁶ These initiatives align with our long-term goal of improving monetary policy education and outreach. At the same time, they also helped to address public concerns surrounding OPR decisions during the year.

This year also marked the third edition of the Tun Ismail Ali Chair (TIAC) Monetary Policy Challenge.²⁷ In this challenge, undergraduate students from universities in Malaysia were given the unique opportunity to simulate the role of the MPC. Participants were tasked to formulate monetary

policy for a given economy based on their assessment of economic and financial market conditions. To further engage with university students, we also conducted the inaugural TIAC Talks webinar, which centred on sharing valuable insights on monetary and financial economics issues. This year's focus was on inflation and cost of living concerns.

The Bank continued to collaborate with academia through the Visiting Research Fellowship (VRF) Programme.²⁸ This programme allowed us to expand our research on monetary and financial economics by producing joint publications, with the first working paper published in October 2022.²⁹ Through initiatives such as the VRF programme, we aim to promote a better understanding of the complex issues that underpin monetary policy decisions. Collaboration with experts from academia also allowed us to tap into a broader range of perspectives and insights. Ultimately, this enhances our ability to make informed decisions that benefit the wider economy.



These three undergraduates from the University of Nottingham Malaysia emerged as champions of the third TIAC Monetary Policy Challenge in 2022.

²⁵ More information on the Bank's public engagements throughout the year can be found in the 'Engaging Malaysians' chapter of this report.

²⁶ <https://www.bnm.gov.my/monetary-stability>.

²⁷ The Tun Ismail Ali Chair was established by the Bank on 28 August 2000 to encourage and stimulate research, commentary, and public interaction on issues regarding monetary and financial policies that affect Malaysia and the rest of the world. The TIAC Challenge aims to promote interest in monetary and public policies among university students. More information on the TIAC can be found in its website (<https://tunismailchair.my/>).

²⁸ The programme was launched in October 2020.

²⁹ The joint research publication titled 'Fiscal multiplier in Malaysia: Concept, empirical assessment and policy implication' is available on the Bank's website (https://www.bnm.gov.my/documents/20124/826852/lau_maryam_fahrulradzi_helmi_2022.pdf).



Assistant Governor Fraziali Ismail, Professor Dr. Yeah Kim Leng (Professor of Economics, Sunway University) and Shakira Teh Sharifuddin (Senior Economist Malaysia, World Bank) evaluating the students' presentations for the finals of the TIAC Monetary Policy Challenge in 2022.

Monetary Policy Statement (MPS) Snapshot: March 2023



What did we decide?

We kept the OPR at 2.75%

- At this level, the OPR remains accommodative and supportive of economic growth

What's happening in the economy?

The economy will continue to expand this year at a moderate pace

- Since the economy reopened, households have spent more, and there have been more investments
- Even more tourists have visited, which supports local businesses
- Big projects are progressing well
- But global growth is weaker



Inflation remains elevated due to demand and cost factors



How do we see the economy in the future?

The Malaysian economy will continue to grow. Inflation will moderate but remain elevated

- We will continue to assess the impact of the past OPR adjustments on the economy
- Global developments can affect input costs, and our inflation
- Any changes to the OPR depend on how strong the economy and prices grow

Our goal is to keep inflation low and stable while supporting growth



The MPS Snapshot summarising the March 2023 MPC decision.

Going Forward

While Malaysia's economic growth had exceeded its pre-pandemic level in 2022, the economy is expected to face headwinds in the coming year, particularly from global developments. Conditions will continue to evolve and uncertainties remain surrounding global growth and global financial markets amid monetary policy tightening in major economies and the recent banking sector issues, geopolitical conflicts and supply chain disruptions. Amid these challenges, the Bank remains committed to ensuring price stability in support of sustainable domestic economic growth. Further normalisation to the degree of monetary policy accommodation would be informed by the evolving conditions and their implications to the domestic inflation and growth outlook. Monetary operations will continue

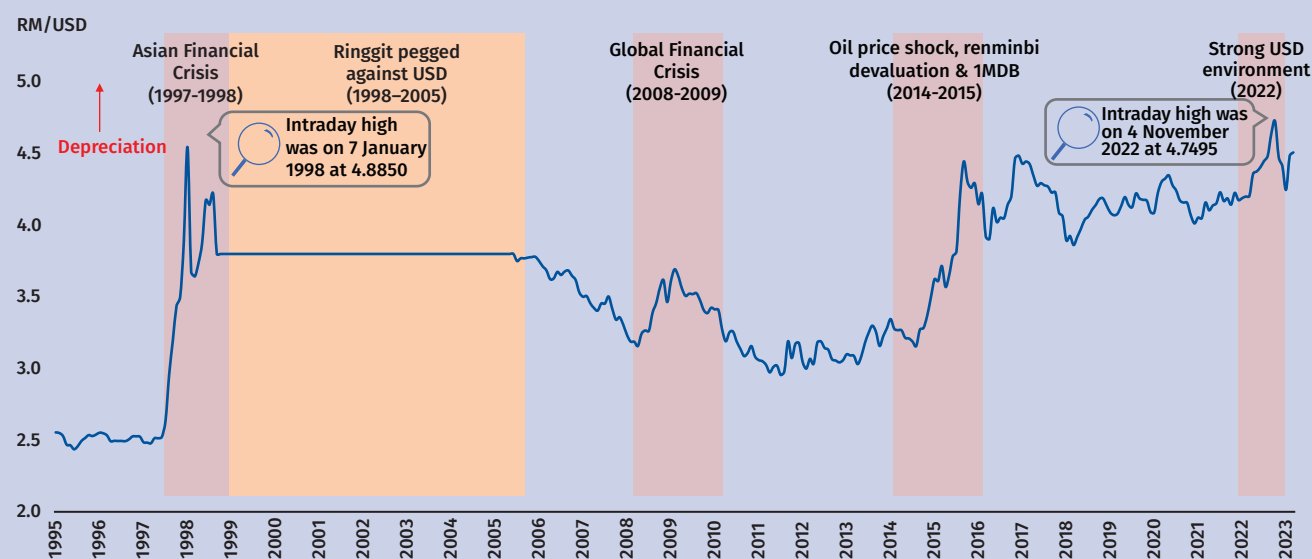
to ensure sufficient liquidity in the foreign exchange, money and Government bond markets. They will also complement our other policies to ensure the smooth functioning of domestic financial markets and financial intermediation.

Now that the worst of the pandemic crisis is behind us, we must focus on restoring our economic strength and foundation to prepare for any future shocks. This would entail rebuilding policy space, and the depleted buffers of households and businesses through future-proofing our social protection coverage, encouraging savings, and strengthening the agility and innovation of businesses. The Bank will continue to work with our stakeholders on relevant policy measures, particularly structural reforms, to strengthen Malaysia's overall economic resilience for the future.

The Exchange Rate and the Malaysian Economy

In 2022, the ringgit exchange rate experienced a period of sustained depreciation against the US dollar. While small movements in the ringgit exchange rate are common, large fluctuations in the level can create lasting impact for businesses, households and the economy. As the ringgit against the US dollar hovered close to levels last experienced during the Asian Financial Crisis (AFC) (Figure 1), this became a concern. There were even some calls for the ringgit to be pegged to prevent it from falling further.

Figure 1: Performance of the Ringgit against the US Dollar



Note:

1. RM/USD is as at end-month, up to 20 March 2023.
2. The RM/USD exchange rate used here is the average of buying and selling rates at noon in the Kuala Lumpur Interbank Foreign Exchange Market.

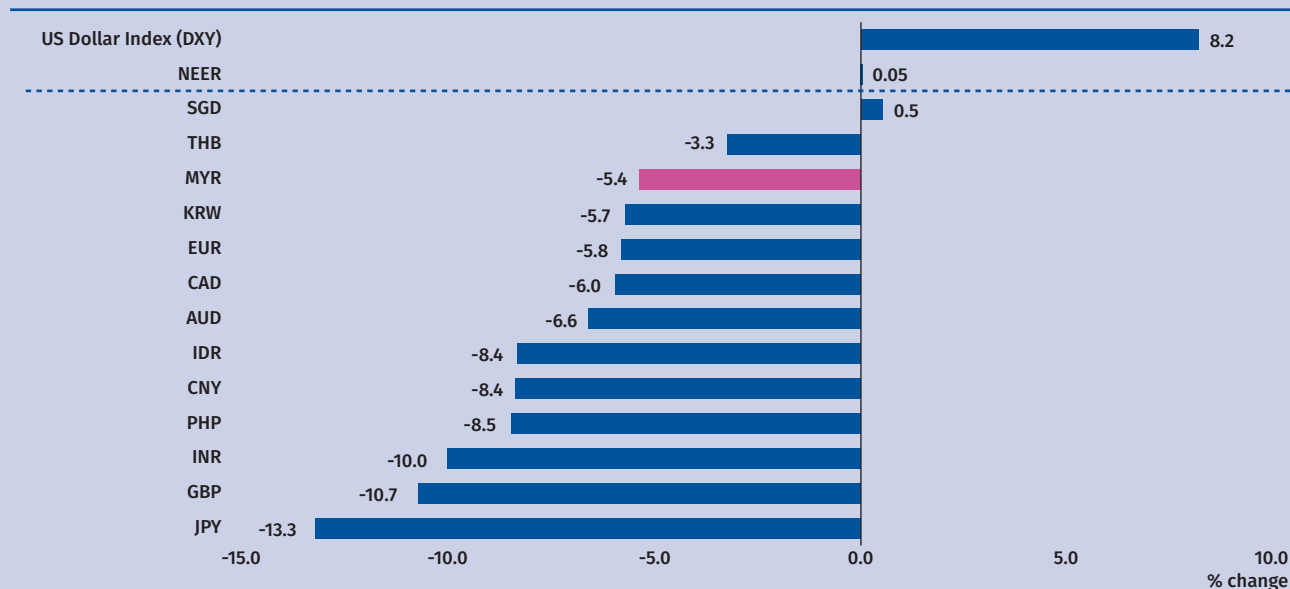
Source: Bank Negara Malaysia and Bloomberg

To understand the role of the exchange rate in the Malaysian economy, it is worth noting that movements in the exchange rate will influence households' and businesses' decisions, and thus in aggregate, will impact economic activity. For a country with a flexible exchange rate like Malaysia, the ringgit can periodically appreciate and depreciate. Over the longer term, the exchange rate should be determined by our economic fundamentals relative to key trading partners. In a financially integrated world, short-term movements in the exchange rate are also strongly influenced by cross-border financial flows and investor risk sentiments, which are often affected by global developments and are not necessarily reflective of our country's economic fundamentals.

This was certainly the case in 2022 when the US Federal Reserve raised its policy interest rate aggressively by 425 basis points to a target range of 4.25-4.50% to address inflation.¹ The higher returns on US financial assets raised demand for these assets and led to a period of sustained US dollar appreciation. Consequently, other currencies including major currencies and the ringgit, depreciated against the US dollar during the year (Figure 2). This depreciation was a global trend and not generally indicative of any fundamental weaknesses in the affected economies within the region and globally.

¹ Since the start of 2023, the US Federal Reserve has continued to increase its policy interest rate by another 50 basis points to a target range of 4.75-5.00% (as at end-March 2023).

Figure 2: Performance of Major and Regional Currencies against the US Dollar in 2022



Note:

1. The RM/USD exchange rate used for calculation here is the average of buying and selling rates at noon in the Kuala Lumpur Interbank Foreign Exchange Market.
2. NEER refers to the ringgit nominal effective exchange rate. It is an index measuring ringgit's performance against currencies of Malaysia's major trading partners.

Source: Bank Negara Malaysia and Bloomberg

With this in mind, the effects of the exchange rate on the Malaysian economy are not only determined by developments in the bilateral exchange rate against the US dollar. As a trading nation that also has key investment relationships with many countries, assessments should consider ringgit movements against our major trading partners. This would provide insights on whether Malaysia's relative competitiveness has been affected by movements in the exchange rate.² A common gauge for this is the nominal effective exchange rate (NEER).³ In 2022, despite the ringgit's sharp depreciation against the US dollar, Malaysia's NEER was relatively stable (Figure 2). As the currencies of key trading partners were similarly affected as the ringgit, Malaysia's relative competitiveness remained unchanged.

Whether the exchange rate appreciates or depreciates, there will always be winners and losers in the domestic economy. A depreciation in the ringgit hurts those who consume imported goods and services, and if sustained, can lead to a rise in the overall cost of living. At the same time, a weak ringgit could increase exporters' earnings. On the other hand, when the ringgit appreciates, it benefits those who import goods, services, and travel abroad, but hurts exporters and the domestic tourism industry. When these exchange rate movements occur, it is important for the adjustments to be orderly to ensure that economic activity can continue. The focus of the country's exchange rate regime should not be on picking sectoral winners or losers. Instead, the goal is to ensure long-term benefits for the overall economy.

Malaysia's exchange rate regime and financial system have evolved over the years to serve the growing needs of an increasingly market-oriented domestic economy. In this regard, the current flexible exchange rate regime has brought benefits to Malaysian businesses and households. As an external price, the exchange rate conveys an important signal to businesses to guide them towards sustainable investment opportunities and to allocate their resources optimally. Similarly, for households, the exchange rate helps to inform them of their consumption choices such as purchasing more or less imported goods, as well as travelling abroad or locally.

² The exchange rate is just one of many other factors that can affect Malaysia's relative competitiveness. This includes structural factors such as position within the global supply chain, as well as the domestic business and investment climate.

³ NEER refers to the ringgit nominal effective exchange rate. It is an index measuring the ringgit's performance against currencies of Malaysia's major trading partners.

Crucially, the flexible exchange rate regime provides Malaysia with the flexibility to naturally adjust to international economic and financial shocks. For instance, a ringgit depreciation can help to cushion the domestic economy from external shocks such as a sudden decline in global commodity prices. An example would be Malaysia's experience during the oil price shock in 2015. Brent crude oil prices declined by 68% from USD115 per barrel on 19 June 2014 to USD37 per barrel on 22 December 2015. Given Malaysia's position as a net oil exporter, the domestic oil and gas sector was hit hard by this situation, leading to restructuring exercises within the industry. In fact, the oil and gas sector went through considerable structural changes, involving the rightsizing of many industry players. Nevertheless, the diversified structure of the Malaysian economy helped to limit the negative spillovers to the rest of the economy. Specifically, the ringgit's depreciation also supported our non-commodity sectors' competitive standing. These sectors provided support to employment and overall economic growth during that period.

In 2022, the flexible exchange rate regime similarly helped the Malaysian economy to adjust to shifting external conditions without disrupting our economic recovery. Despite a major external shock in the form of fast and sizeable adjustments of interest rates in the US which led to the rapid appreciation of the US dollar against most currencies, Malaysia's competitiveness was relatively unaffected. The domestic economy remained on its recovery path, registering a growth rate of 8.7% for the year.

It is recognised that the depreciation in the exchange rate did lead to higher import costs. The pass-through to domestic inflation was most pronounced for directly imported fresh food items, such as beef and selected vegetables. As food items tend to make up a larger share of the consumption basket among vulnerable groups, this led to cost-of-living concerns. To some extent, domestic price controls and subsidies on fuel prices, have helped to contain the broader impact of an exchange rate depreciation on inflation.

Nevertheless, a highly volatile exchange rate can itself be a source of vulnerability for the domestic economy. Large swings in the exchange rate within a very short time can exacerbate uncertainties and cause individuals and firms to delay their decisions to consume and invest. If this is prolonged, it could pose risks to the longer-term domestic economic outlook. To mitigate such risks, Bank Negara Malaysia (the Bank) undertakes foreign exchange operations⁴ to stem excessive volatility and maintain orderly market conditions.

The flexible exchange rate has also contributed to making domestic markets more open and attractive to global investors. With greater financial openness, this also means that domestic markets are now more susceptible to global financial developments. Spillovers, however, have been contained due to two main factors. First, is the presence of a large domestic institutional investor base comprising among others, banks, pension funds and insurance institutions, to facilitate foreign investment flows. Over the years, this has mitigated outsized adjustments in domestic asset prices. In turn, this has helped to preserve and support returns on household savings managed by these institutions. Secondly, the domestic hedging market has also grown over the years to insulate firms from unanticipated moves in the exchange rate, leading to lower external vulnerabilities.

The rapid and sizeable depreciation of the ringgit against the US dollar in 2022 led to some calls for the ringgit to be re-pegged to the US dollar, similar to the policy undertaken during the AFC. Would this have been the right policy move? Using a medical analogy, it is important to properly diagnose the problem before prescribing the treatment. Just as the right type and dosage of medication must be chosen to address an identified ailment, it is important to pinpoint the root cause of an economic issue before determining a solution. Even if two patients present the same symptoms, the underlying cause may not be the same; thus, the course of treatment can differ. Furthermore, a good physician must ensure that the treatment does not worsen the patient's condition.

During the AFC, the Malaysian economy and financial system ran into deep problems when the balance sheets of banks, firms, and households were severely affected by the rapid depreciation of the ringgit and valuation losses in the domestic equity market. As part of the immediate policy measures, the ringgit was pegged to the US dollar at RM3.8000 alongside the introduction of selective exchange controls. These measures worked to

⁴ Foreign exchange operations by the central bank is the act of maintaining orderly market conditions in the domestic foreign exchange (FX) market by managing liquidity via buying or selling foreign and domestic currency with counterparties such as commercial banks.

provide banks and businesses with a stable external environment and space to strengthen their balance sheets. However, things are different today (Table 1). Reforms and policy measures have since been implemented to reduce Malaysia's external vulnerabilities. Businesses' and banks' balance sheets are much more resilient now than they were back then. Domestic financial markets are also much more developed and capable of withstanding external financial shocks without affecting banks' capacity to support economic activity.

Table 1: Comparison of Economic Fundamentals

	AFC (1997-98)	2022
RM/USD (annual % change)	-47% ¹	-5.4%
Real GDP (annual % change)	-7.4% ²	8.7%
Net international investment position (IIP, end-year)	-RM 137.6 billion ³	RM 63.0 billion
International reserves (end-year)	USD 21.7 billion ⁴	USD 114.6 billion
International reserves coverage of short-term external debt ⁵	1.4 times ⁴	1.0 time
Current account (annual)	-RM 16.7 billion ⁴	RM 47.2 billion
Banking system gross impairment loans ratio (% of total loans)	18.6% ²	1.7%
Government foreign currency debt (% of total Government debt)	19.1% ⁵	2.7%

¹ From 10 July 1997 to 7 January 1998 ² 1998 ³ 2001 ⁴ 1997 ⁵ 2000 ⁶ In 2014, Malaysia's external debt was redefined. Specifically on short-term external debt, the new definition included 1) inter-bank foreign currency borrowing, 2) inter-company foreign currency borrowing, 3) other foreign currency loans which include non-related company borrowing, 4) trade credits, 5) non-resident holdings of domestic money market instruments, 6) currency and deposits and 7) other liabilities (IMF allocation of SDRs, and liabilities of pension funds and life insurance companies to non-residents). By comparison, the previous definition of short-term external debt only included items 1) to 3). For more information, please refer to 1Q 2014 Quarterly Bulletin Box Article on 'The Redefinition of External Debt'.

Note: The RM/USD exchange rate used here is the average of buying and selling rates at noon in the Kuala Lumpur Interbank Foreign Exchange Market.

Source: Bank Negara Malaysia, Ministry of Finance Malaysia and Department of Statistics, Malaysia

Introducing and maintaining a peg today in the same way that was done during the AFC would require implementation of capital controls on financial flows. Without capital controls, such an exchange rate regime would require the Overnight Policy Rate (OPR) to match the rise in interest rate of the country to which the ringgit is pegged. This being the US dollar, the OPR would need to be raised by 475 basis points (more than four times higher than the cumulative 100 basis points hike) to match the rise in the federal funds rate. This will constrain the economy much more due to significantly higher costs of borrowing. In addition, a significantly higher amount of international reserves would be needed to maintain the credibility of the peg as defence against speculators.⁵ Besides that, maintaining large foreign exchange reserves can incur higher opportunity costs as these assets are typically invested in highly liquid but lower yielding financial assets.

Selective exchange controls were needed and worked during the AFC due to the circumstances at the time.⁶ The implementation of selective exchange controls during the AFC was targeted at stabilising short-term capital flows and have since been liberalised. More importantly, the controls allowed us to implement the necessary reforms to strengthen the banking system and the corporate sector. Heeding to calls to re-peg every time the ringgit depreciates could mean switching capital controls on and off. This would create a highly unstable and unpredictable environment for investors and businesses. For international investors, this could deter them from choosing Malaysia as their preferred investment destination. In the long run, this could hinder investments, innovation as well as the growth potential of the domestic economy. Eventually, this would come at the expense of future economic productivity, and lead to significant welfare losses (Forbes, 2007; Gadanecz and Mehrotra, 2013).

⁵ If the stock of international reserves is assessed to be insufficient to maintain the exchange rate at the pegged level, it could force the central bank to devalue its currency during times of financial market stress. The sharp adjustments and its impact to sentiments could be more detrimental to the economy compared to orderly exchange rate adjustments under a flexible exchange rate regime.

⁶ The implementation of selective exchange controls was intended to eliminate access to currency speculators and stabilise short-term capital flow movements. As such, the controls required capital inflows to remain in the country for a minimum period of 12 months. Importantly, controls were not imposed on current account transactions, repatriation of income from portfolio investment and other forms of ringgit assets and foreign direct investment flows.

Given Malaysia's flexible exchange rate regime, fluctuations in the ringgit should be expected to occur from time to time. In fact, since reaching a peak of RM4.7477 on 4 November 2022, the ringgit did rebound to reach RM4.2435 on 30 January 2023.⁷ As challenges in the global economy continue to evolve, US dollar developments are likely to continue to be the main factor affecting the ringgit exchange rate. Our financial system has held up well throughout this period and continued to facilitate intermediation to support the broader economy. Reflecting on the events of the year, the Bank will continue to proactively monitor developments and ensure that our economy continues to be served by an exchange rate regime that supports our mandate to achieve monetary and financial stability conducive for sustainable growth of the Malaysia economy.

References

Forbes, K. J. (2007). The microeconomic evidence on capital controls: no free lunch. In *Capital Controls and Capital Flows in Emerging Economies: Policies, Practices, and Consequences* (pp. 171-202). University of Chicago Press.

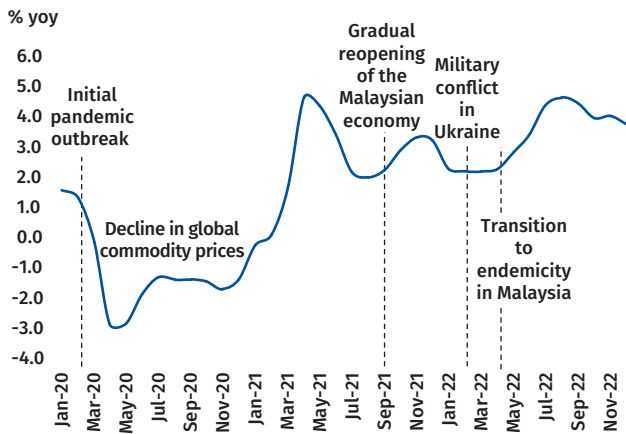
Gadanecz, B., & Mehrotra, A. N. (2013). The exchange rate, real economy and financial markets. *BIS paper*, (73b).

⁷ These RM/USD rates are as of end-day.

Inflation: Its evolution, two years after the pandemic

1 Over the past two years, consumer price developments shifted from being disinflationary to inflationary

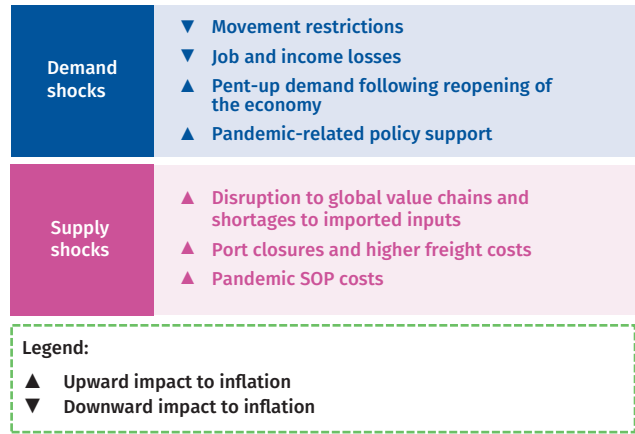
Chart 1: Headline Inflation



Source: Department of Statistics, Malaysia and Bank Negara Malaysia assessments

2 In particular, the COVID-19 pandemic led to changing demand and supply dynamics

Chart 2: Pandemic-related Economic Shocks



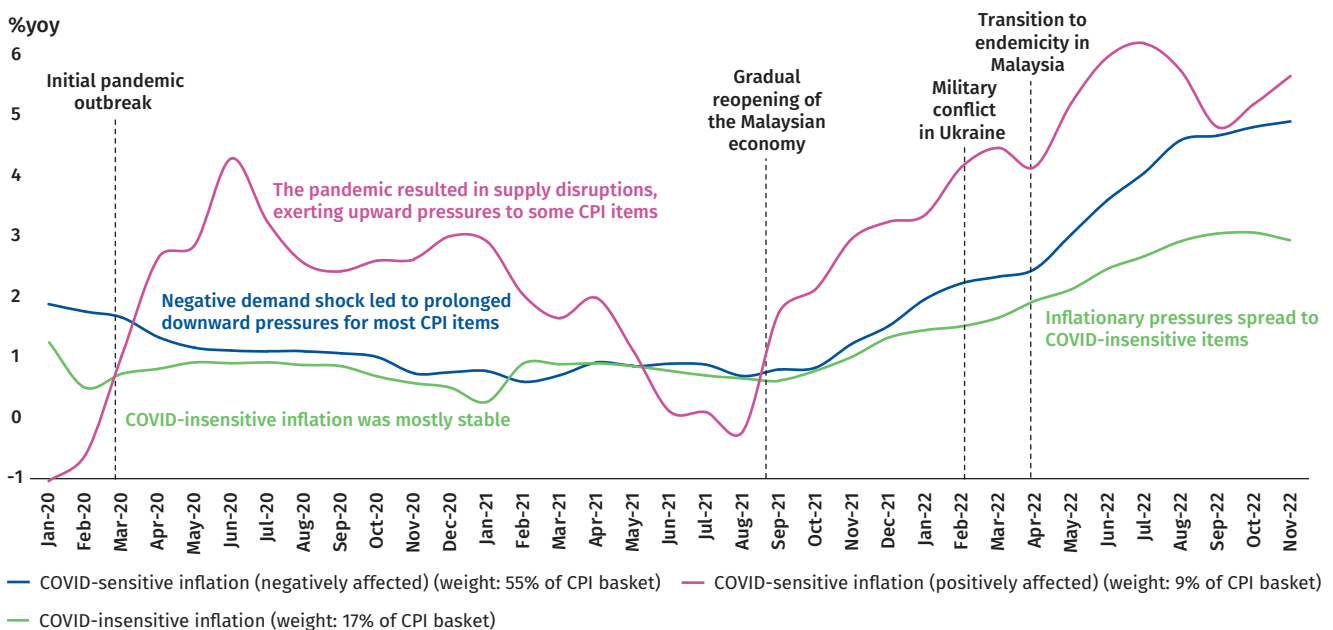
Source: Bank Negara Malaysia assessments

3 In 2020-2021, inflation dynamics were driven mostly by pandemic developments. In 2022, however, inflationary pressures began to be observed in most CPI items, suggesting that other factors beyond the pandemic were at play

Chart 3: Inflation by Pandemic Sensitivity

Recap on COVID-sensitive inflation methodology (for more details, refer to EMR 2021 Box Article: An Anatomy of Inflation: Effects from the Prolonged Pandemic):

1. CPI items are classified into two categories: Those that are statistically sensitive to pandemic shock (COVID-sensitive) and those that are not (COVID-insensitive)
2. Among COVID-sensitive items, some faced downward price pressures (negatively affected), while others faced upward pressures (positively affected)
3. To reflect the pandemic shocks only, this statistic excludes price-administered items, and items which had been affected by the severe monsoon season in 2021

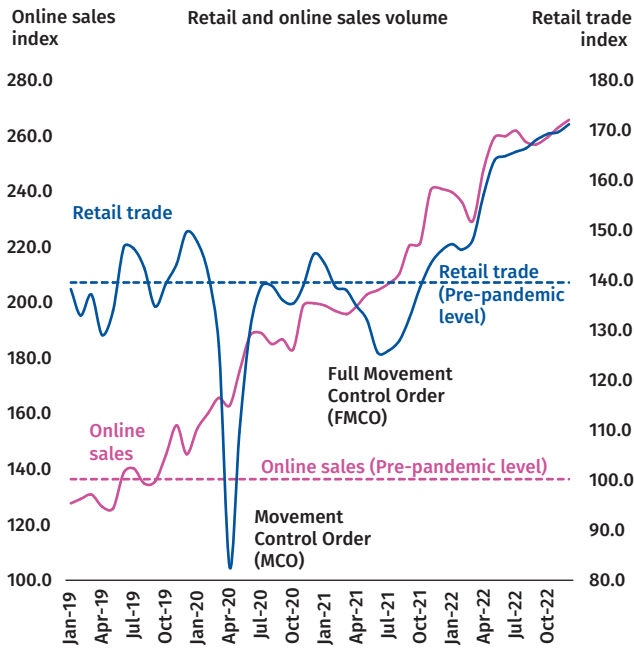


Source: Bank Negara Malaysia estimates

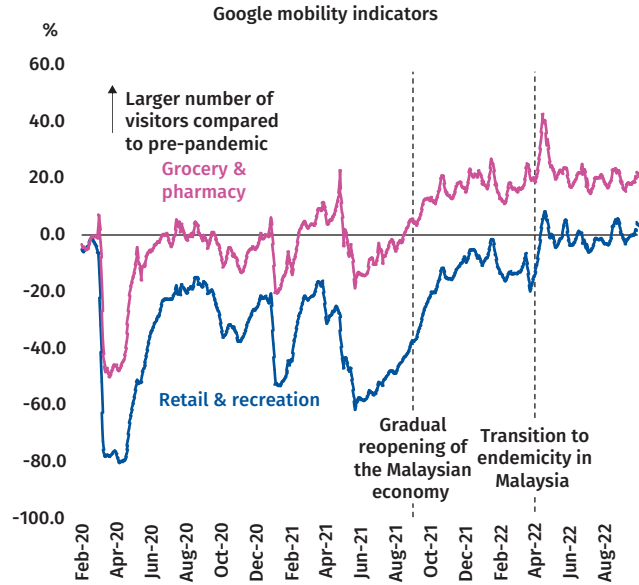
4 This turn of events reflected additional shocks, which coincided with pent-up demand following the reopening of the economy and the general rebound in economic activity

Chart 4 and 5: Indicators of Domestic Demand and Economic Activity

Additional shocks in 2022 included the military conflict in Ukraine, droughts in commodity-exporting countries; and domestically, from full relaxation of COVID containment measures and several policy measures, including the revision in minimum wage and EPF special withdrawals.



Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

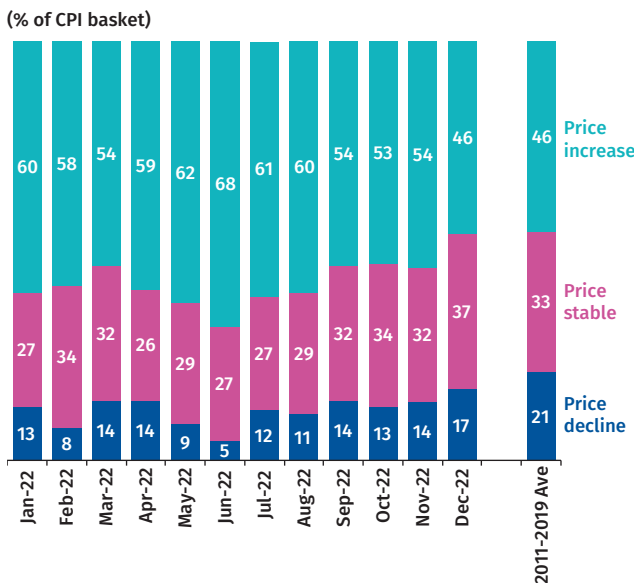


Note: The chart shows how the number of visitors (or time spent) in categorised places has changed compared to baseline days (the median value for the 5-week period between Jan -Feb 2020)

Source: Google Mobility Report

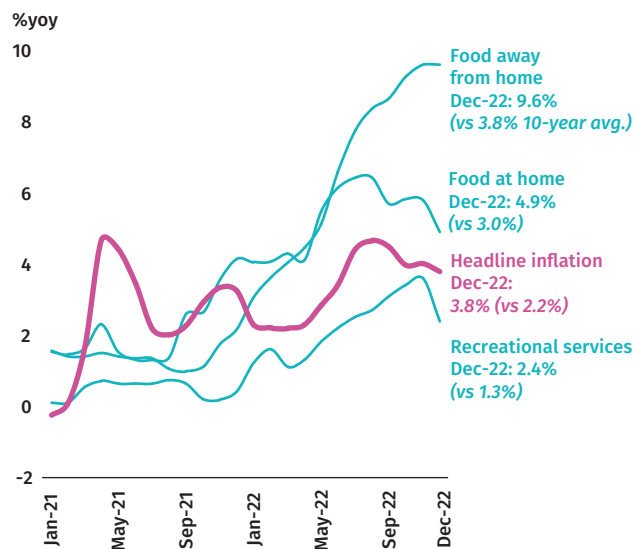
5 The resulting inflation was evident across most consumer items, most acutely for food. Nevertheless, there are signs of moderation in price pressures after a year of rising inflation

Chart 6: Monthly Price Changes of CPI Items



Source: Bank Negara Malaysia estimates based on Department of Statistics, Malaysia

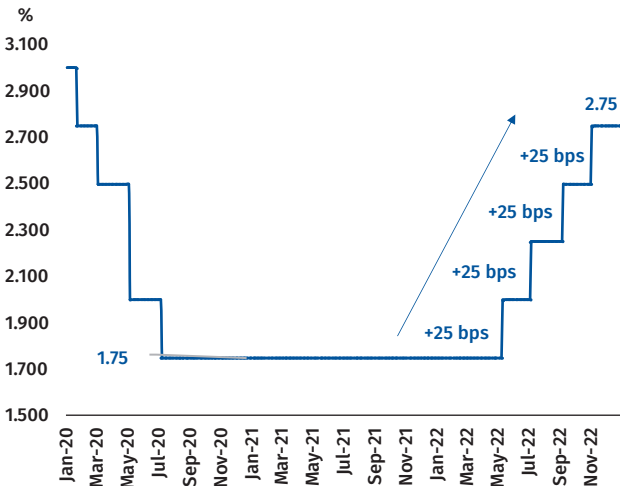
Chart 7: Inflation by Categories



Source: Bank Negara Malaysia estimates based on Department of Statistics, Malaysia

6 Monetary policy was gradually calibrated throughout 2022 given firmer economic recovery and amid signs of demand-driven inflation

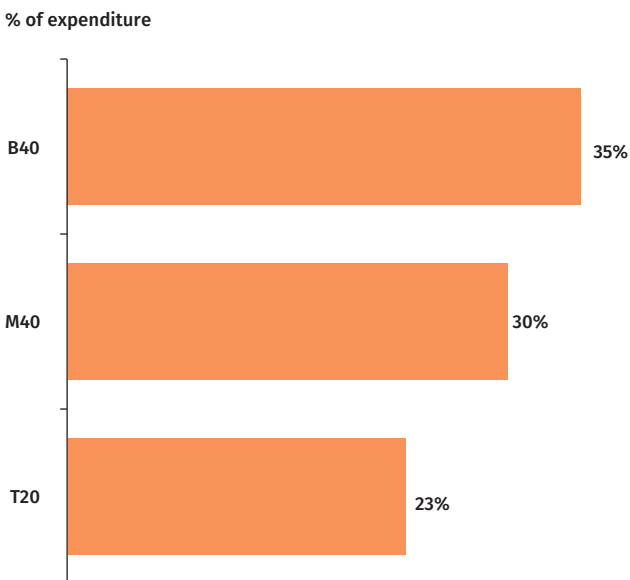
Chart 9: Overnight Policy Rate (OPR)



Source: Bank Negara Malaysia

8 Higher inflation in the past two years affected all Malaysians. Lower-income households were most impacted, given their higher spending on food

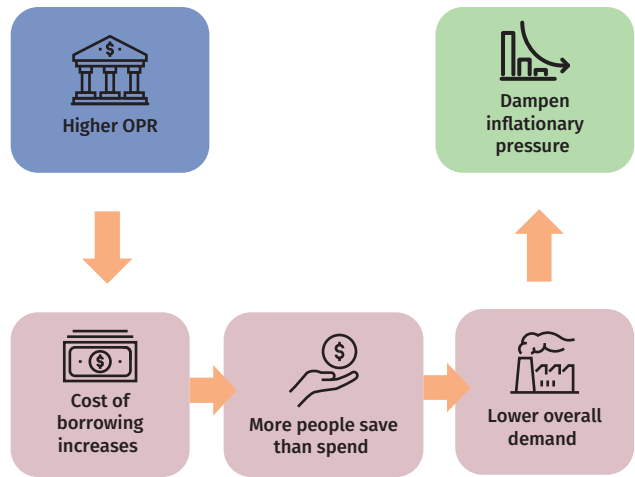
Chart 10: Spending on Food (Including Food Away from Home)



Source: Bank Negara Malaysia estimates based on 2019 Household Income and Expenditure Survey, Department of Statistics, Malaysia

7 The role of monetary policy is to maintain price stability that is conducive for sustainable growth. This, in turn, ensures that purchasing power is preserved

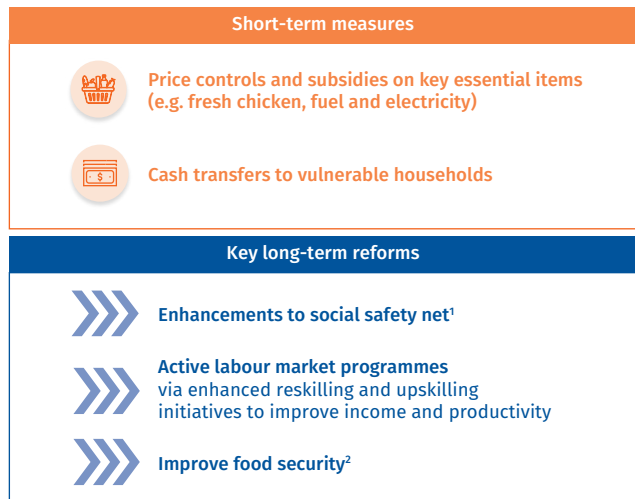
Chart 8: Stylised MP Transmission



Source: Bank Negara Malaysia assessments

9 Short-term measures have helped to partly alleviate the burden, but are not a substitute for structural reforms to create higher paying jobs and improve social protection

Chart 11: Policies to Address High Cost of Living



1/ For more details, refer to BNM EMR 2020 Box Article: A Vision for Social Protection in Malaysia

2/ For more details, refer to BNM Quarterly Bulletin 3Q 2021 Box Article: Closing the Food Gap: The Role of Structural Improvements in Agrofood Security

Source: Bank Negara Malaysia assessments