Economic, Monetary and Financial Developments in 2023

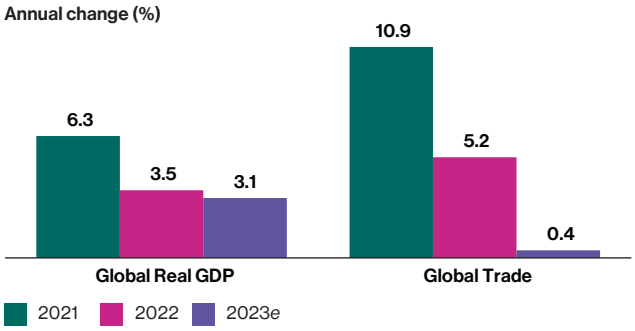
2023: MODERATE GROWTH UNDERPINNED BY DOMESTIC DEMAND AMID ELEVATED GLOBAL UNCERTAINTIES

Global growth slowed amid a challenging economic environment

In 2023, global growth slowed as tight monetary policy and elevated inflation weighed on economic activity (Chart 1.1). This was partially offset by strong wage growth and support from ample excess savings. In line with tepid demand, global trade weakened alongside other trade headwinds such as the rotation from goods to services, the global technology downcycle and higher trade restrictions. Meanwhile, China's growth rebounded following its post-COVID-19 reopening, but the optimism and momentum of the recovery were short-lived. Although headline inflation began softening, the moderation in core inflation was more modest than expected. This prompted central banks to keep interest rates at elevated levels.

In the advanced economies, strong wage growth and ample excess savings provided crucial support to consumer spending. These partially mitigated the effect of high interest rates and elevated inflation. Fiscal spending, particularly in the areas of defence, green transition and energy subsidy, also supported domestic demand. The US registered higher growth in 2023, as strong wage growth amid tight labour market conditions lifted consumer spending. The euro area saw a moderation in growth as high gas prices and inflation weighed on manufacturing activities and household spending amid weak real income growth. In particular, Germany observed weaker manufacturing activity, weighed by high gas prices and weakness in external demand.

Chart 1.1: Global Real GDP and Trade Growth



e Estimate

Note: Global real GDP is the aggregate global growth weighted by the purchasing power parity (PPP) exchange rate, the rate at which the currency of one country would have to be converted into that of another country to buy the same amount of goods and services in each country.

Source: International Monetary Fund (IMF) January 2024 World Economic Outlook (WEO) and Bank Negara Malaysia estimates

In March 2023, banking stress in the US and Europe induced concerns of broader contagion risks to the global financial system and potentially could derail growth. The episode was triggered by the collapse of Silicon Valley Bank in the US, which spilled over into Europe with the absorption of Credit Suisse into UBS in Switzerland. Central banks and banking supervision authorities swiftly responded by providing an immediate liquidity backstop to vulnerable banks. This contained the spillover to the global banking system and the broader economy.

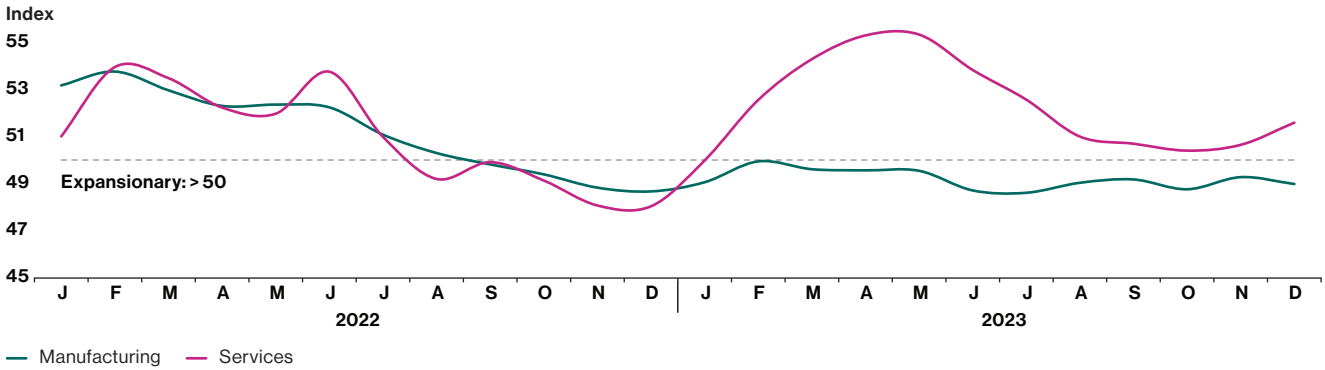
Despite initial optimism following the lifting of the zero-COVID-19 policy in China, the economy was weighed by softer external demand and weaknesses in the property sector. Households remained cautious in spending and continued to build savings. This was partly attributed to negative wealth effects from protracted price declines in the housing sector and the stock market. Home sales and housing starts declined due to poor sentiments among buyers and a liquidity crunch among developers. Spillovers from further corrections in the property market to China's financial stability were contained, given ample capital buffers of financial institutions and

various measures by authorities to stem further declines.[1] Nevertheless, consumer confidence was negatively affected by the property market downturn, which contributed to the slower-than-expected growth in China.

Global trade decelerated in 2023, in line with weaker demand conditions amid tight monetary policy and elevated inflation. Trade in goods was further weighed down by the continued spending rotation from goods to services (Chart 1.2), the global technology downcycle,[2] slower-than-expected domestic demand in China and higher trade restrictions.[3] Nevertheless, softening demand alongside the reopening of economies provided space for supply chain conditions to normalise. Delivery times and freight rates returned to pre-pandemic levels. The moderation in goods trade was partially offset by the recovery of global tourism activities, supported by strong pent-up demand, especially in the first half of 2023, and improved flight capacity. Global tourist arrivals recovered to 88% of pre-pandemic levels in 2023 with further room for recovery for Asia Pacific (65% of pre-pandemic levels), as some countries in the region reopened later and more cautiously than others.[4]

Global headline inflation moderated but remained elevated by historical standards, driven by lower commodity prices and normalisation of supply chain conditions. Nevertheless, there were intermittent upward price pressures from spikes in commodity prices due to geopolitical factors and extreme weather events, particularly in the second half of 2023. Oil prices were affected by production cuts announced by OPEC+ and the onset of the conflicts in the Middle East in October 2023. However, these were alleviated by strong oil production from non-OPEC countries. Overall, global crude oil prices remained below their June 2022 peak throughout 2023. Despite the moderation in headline inflation, underlying inflation (as measured by core inflation) remained elevated and persistent, prompting central banks to continue tightening monetary policy, albeit at a slower pace and lower quantum compared to 2022. The persistence in core inflation was accounted by services inflation, as resilient domestic demand, stronger-than-expected wage growth and continued spending rotation from goods to services put upward pressures on prices, especially in advanced economies. Meanwhile, inflation among emerging market economies reached its long-term average sooner than advanced economies, as inflationary pressures in the former were less severe to begin with (Chart 1.3). This was attributable to lower demand pressures and less tight labour markets in emerging market economies compared to advanced economies post-COVID-19. Lower inflation in China was another contributing factor to the more modest inflationary pressures in emerging market economies. Domestic factors such as moderate domestic demand, adequate food supply, suppressed rental rates and a price war among electric vehicle automakers led to lower consumer prices in China.

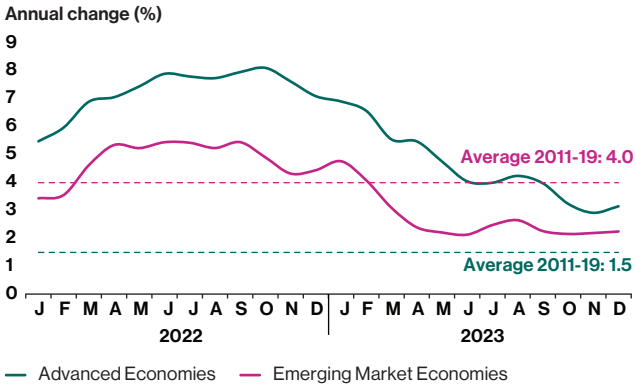
Chart 1.2: Global Purchasing Managers Index (PMI)



Source: S&P Global

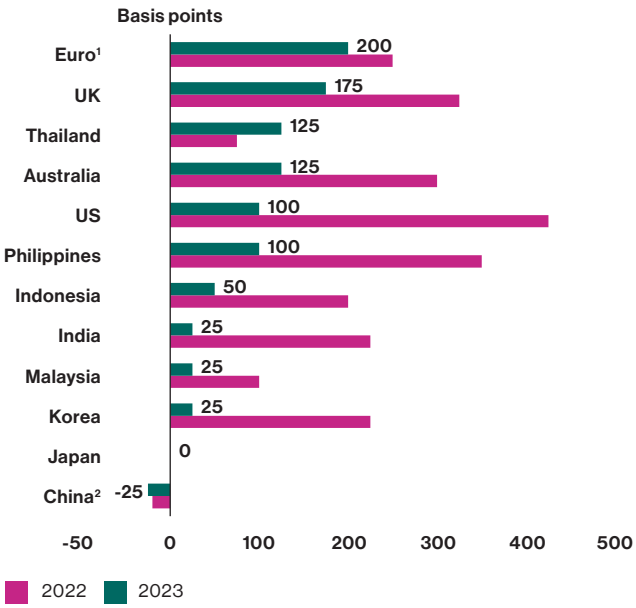
[1] These included reducing interest rates on outstanding mortgages and providing liquidity for developers to complete existing projects.
[2] The global technology downcycle was attributable to a global inventory correction and weakness in new orders as spending on technology was frontloaded during the pandemic.
[3] These referred to export restrictions by the US on advanced semiconductor chips to China and retaliations by China via export controls on metals needed for semiconductor production in the US.
[4] Source: United Nations World Tourism Organisation Barometer (January 2024)

Chart 1.3: Global Headline Inflation



Source: National authorities and Bank Negara Malaysia estimates

Chart 1.4: Change in Policy Rate of Selected Economies



¹ Refers to the European Central Bank's Deposit Facility Rate.
² Refers to the People's Bank of China's 1-year Medium-term Lending Facility Rate.

Source:Bloomberg

Global financial conditions were highly driven by evolving expectations of policy rate paths for the major economies amid diverging growth and inflation outlook

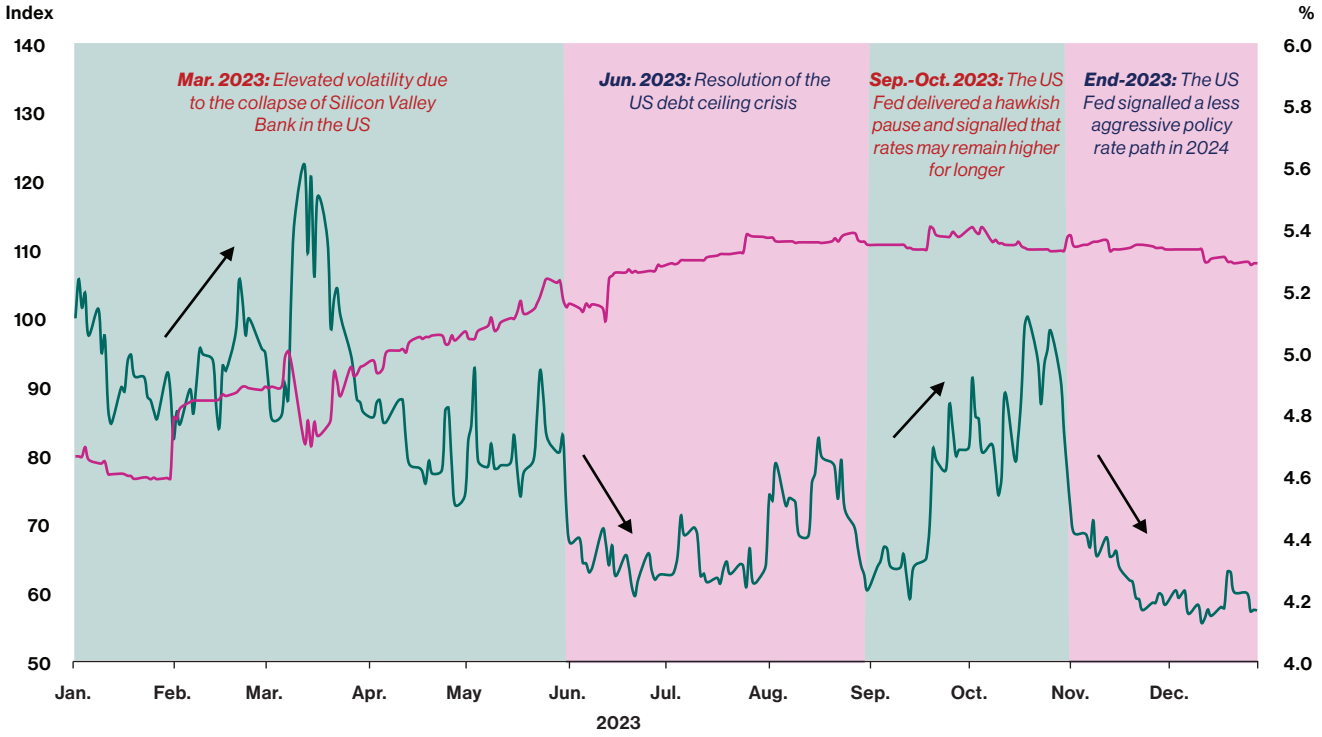
In 2023, financial markets continued to be shaped by the trajectory of tighter monetary policy globally. Central banks in most advanced economies raised interest rates further to tackle persistently high inflation (Chart 1.4). Of significance, the divergence between the market's expectations and monetary authorities over the pace and degree of tightening was a key source of volatility across asset classes, as evolving expectations led to rapid adjustments in asset prices and abrupt shifts in capital flows (Chart 1.5 & Chart 1.6).

Financial markets began the year fuelled by optimism surrounding China's economic reopening and growing sentiment that the global hiking cycle was nearing its end. However, investor sentiments took a turn with the emergence of banking sector stress stemming from the collapse of Silicon Valley Bank in the US and Credit Suisse in Switzerland. This led to recessionary concerns and a sharp correction in stock markets worldwide. Market participants initially priced in more imminent policy rate cuts but reversed course as the turmoil was contained.

The outlook on global interest rates path was further complicated by diverging economic and inflation prospects, particularly between advanced and emerging market economies. As the year progressed, expectations of positive spillovers from China's reopening dissipated. Signs of economic weakness emerged, prompting the People's Bank of China to loosen monetary policy. Conversely, central banks in advanced economies including the US Federal Reserve (the US Fed) signalled that interest rates may have to remain at restrictive levels for a longer period to steer inflation back to target. As a result, global bond yields surged between September and October 2023 as markets priced in the significant likelihood of higher-for-longer, with the 10-year US Treasuries rising to its highest level of 5% since the 2007–08 Global Financial Crisis. Financial conditions tightened and sustained US dollar strength led to exchange rate pressures in most emerging market currencies (Chart 1.7).

Towards the end of 2023, renewed geopolitical tensions in the Middle East introduced new uncertainties and concerns of disruptions in commodity markets. Nevertheless, with incoming data pointing to softer US inflation, financial conditions eased as market participants revised downwards their expectations of the future policy rate path. This was further supported by signalling from the US Fed that the current tightening cycle was likely nearing its peak. According to projections released at the final Federal Open Market Committee (FOMC) meeting of 2023, rate cuts were expected to begin in 2024, albeit uncertainties surrounding the timing of easing cycle remained.

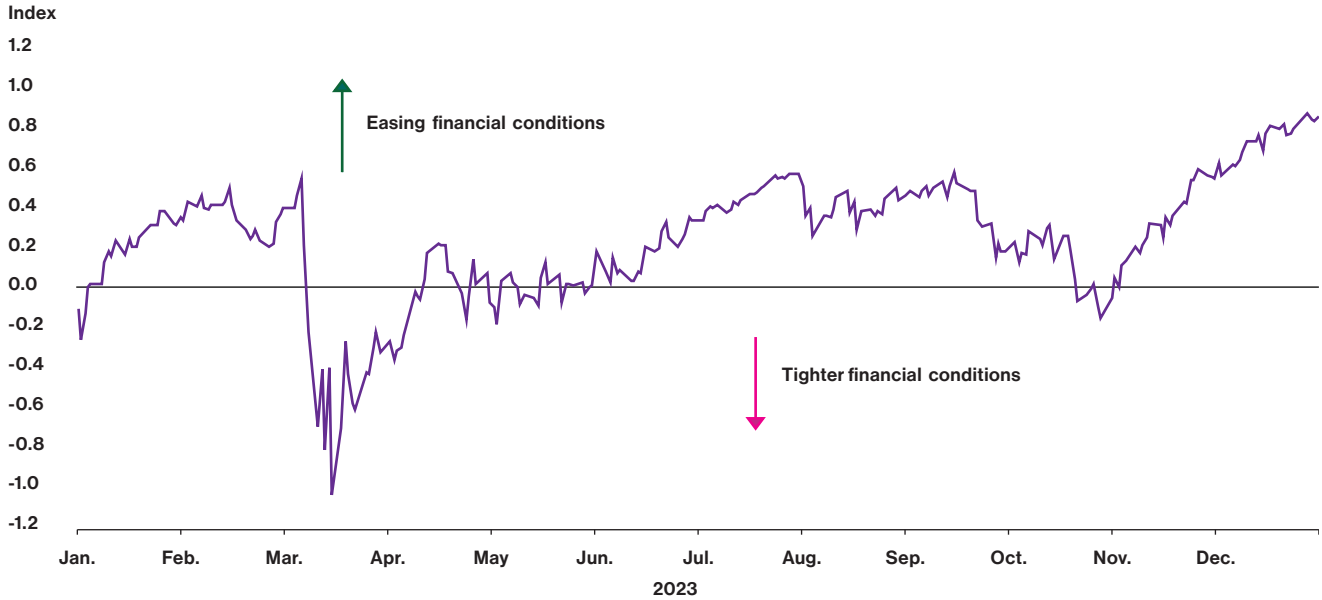
Chart 1.5: Financial Market Volatility Indicator (CBOE VIX) against Federal Funds Futures Implied Policy Rate Expectations



[1] Refers to expectations of FFR for the next FOMC meeting as implied by the Federal Funds Futures market.

Source: Bloomberg

Chart 1.6: Bloomberg US Financial Conditions Index



Note: The Bloomberg US Financial Conditions Index tracks the overall level of financial stress in the US money, bond, and equity markets to help assess the availability and cost of credit. A positive value indicates accommodative financial conditions, while a negative value indicates tighter financial conditions relative to pre-crisis norms.

Source: Bloomberg

Chart 1.7: 10-Year US Treasury (10Y UST) and US Dollar Index (DXY)

Note: The US dollar Index (DXY) is an index of the value of the US dollar against a basket of foreign currencies, namely EUR (57.6%), JPY (13.6%), GBP (11.9%), CAD (9.1%), SEK (4.2%), and CHF (3.6%).

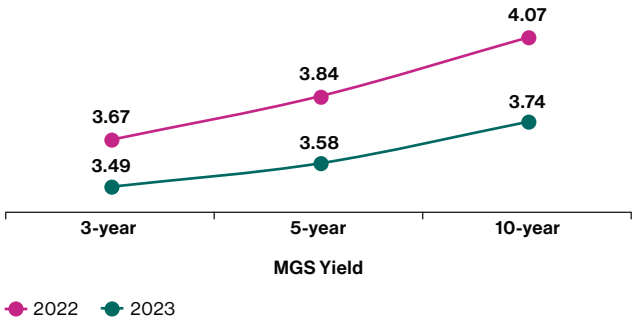
Source: Bloomberg

Domestic financial markets were affected by external headwinds, but spillovers to financial intermediation and wider economy were contained

The Malaysian financial markets were largely influenced by shifts in investor sentiment as external developments unfolded. Adjustments in global financial markets led to volatility in portfolio flows which spilled over to domestic financial conditions primarily through exchange rate fluctuation. Nevertheless, the impact was partly offset by positive domestic factors. These included improved macroeconomic prospects amid ongoing structural reforms aimed at attracting investments and enhancing long-term growth potential, which lent support to investors' confidence.

In the bond market, movements in the Malaysian Government Securities (MGS) yields broadly tracked global trends but fluctuations were more moderate. In line with the surge in global bond yields between September and October, MGS yields rose to a lesser extent before declining towards the year end following the easing of market expectations on the US Fed's policy rate path. Overall, the 3-year, 5-year and 10-year MGS yields decreased by 18, 26 and 33 basis points respectively (Chart 1.8). Despite the widening interest rate differential against advanced economies, the domestic bond market recorded non-resident inflows of RM4 billion (2022: -RM38.1 billion) in 2023. This reflected investors' confidence in Malaysia's sovereign credit quality on the back of fiscal reforms and favourable domestic macroeconomic prospects as well as attractive currency-hedged returns.[5]

Chart 1.8: Malaysian Government Securities (MGS) Yield Curve (%)



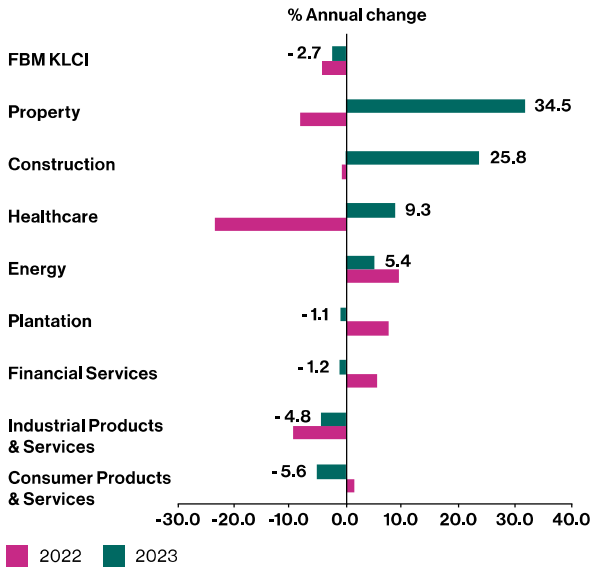
Source: Bank Negara Malaysia

[5] Refers to the returns from holding a foreign currency-denominated bond (e.g. MGS) in which the currency risk is hedged back to the home currency of the investor (e.g. USD). For illustration, in 2023, the approximated currency-hedged yields from holding a 3-year MGS that was hedged using 3-month USD/MYR foreign exchange (FX) forward contracts can range up to 6% on annualised basis.

The domestic equity market was affected by external factors as the global interest rate environment dampened appetite for risky assets. The ripple effects stemming from fears of a banking crisis in March 2023 were quickly felt across stock markets globally including Malaysia, as investors moved to safe haven assets such as the US Treasuries. Overall, the FTSE Bursa Malaysia Kuala Lumpur Composite Index (FBM KLCI) declined by 2.7% (2022: -4.6%) to close at 1,454.7 points (Chart 1.9). Nevertheless, the domestic equity market was partly supported by positive domestic factors. In particular, improved political stability following the conclusion of state elections as well as expected positive spillovers from the announcement of national master plans and special economic zones lifted the outlook.[6] Foreign interest partially recovered in the second half of 2023, with the equity market recording non-resident inflows of RM2.5 billion (2022: RM18 billion) for the year.

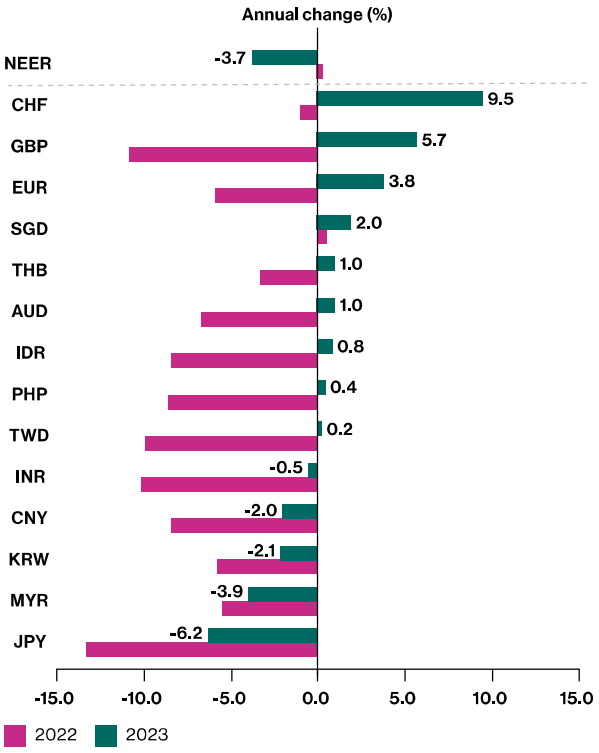
In the foreign exchange (FX) market, the ringgit exchange rate depreciated by 3.9% against the US dollar and by 3.7% against major trade partners in nominal effective terms (Chart 1.10). This was mainly due to more aggressive policy rate hikes by other central banks throughout 2023. Furthermore, expectations of weaker-than-expected growth in China also partly weighed on sentiments given Malaysia's close trade linkages with China. There was considerable variation in the ringgit's performance over the course of 2023. Strong portfolio inflows into the domestic equity and bond markets in July provided support and contributed to the ringgit's appreciation. However, in line with most emerging market currencies, the ringgit depreciated against the US dollar between September and October as market participants adjusted their expectations for a higher-for-longer environment upon hawkish signalling by the US Fed. Market expectations shifted subsequently when the US Fed signalled that rate cuts may commence in 2024 amid lower-than-expected US inflation data, with the ringgit retracing to RM4.5915 at end-2023.

Chart 1.9: Performance of FBM KLCI and Sectoral Stock Indices



Source: Bursa Malaysia

Chart 1.10: Performance of Major and Regional Currencies against the US Dollar and Ringgit Nominal Effective Exchange Rate (NEER)



Note: (+) indicates an appreciation of currencies against the US dollar. NEER shows the value of the ringgit against a trade-weighted basket of Malaysia's major trading partners' currencies.

Source: Bank Negara Malaysia

Despite the effects of external developments, financial markets remained orderly and financial intermediation continued without disruptions. This was attributed to the relatively deep and liquid financial markets[7] and sound banking system which served as buffers against external

[6] These included the New Industrial Master Plan 2030 (NIMP 2030) and the National Energy Transition Roadmap (NETR), Johor-Singapore Special Economic Zone as well as key infrastructure projects such as Bayan Lepas Light Rail Transit.

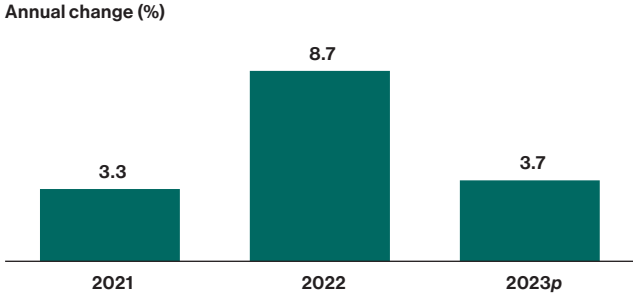
[7] Daily onshore FX trading volume remained healthy, averaging at USD15.6 billion in 2023 (2022: USD13.7 billion).

shocks. Financing conditions remained supportive of the domestic economy, with sustained fund-raising activity in the capital market and continued flow of bank credit. Existing prudential requirements on external borrowing by Bank Negara Malaysia (BNM) minimised the adverse impact of the ringgit's depreciation on Malaysia's external debt, alongside favourable maturity and currency profiles. Almost a third of Malaysia's external debt (33.1%; 2022: 33.1%) was denominated in ringgit and therefore not affected by fluctuations in the exchange rate. The remainder of foreign currency-denominated external debt were mainly held by banks and corporates which generally adopted prudent FX risk management practices, with most of it hedged either naturally or financially. Meanwhile, the effect of the ringgit's depreciation to inflation remained manageable. This is due partly to the presence of administered price controls and subsidies on key necessities which helped to stabilise cost pressures. Furthermore, BNM's liquidity and FX operations also provided necessary support to smoothen excessive volatility and ensure orderly market conditions.

The Malaysian economy continued to expand in 2023 despite external headwinds

Despite the challenging external environment, the Malaysian economy grew by 3.7%, supported by resilient domestic demand and further recovery in tourism activities (Chart 1.11). During the year, the economy faced multiple challenges from weak external demand, disruptions in commodity production and higher cost of living, which weighed on household spending. The more moderate growth also reflected normalising conditions from the high base in 2022, which was supported by the reopening of the economy and sizeable policy measures. The confluence of these factors led growth to reach its trough in the second quarter of 2023 (Chart 1.12).

Chart 1.11: Malaysia's Real GDP Growth



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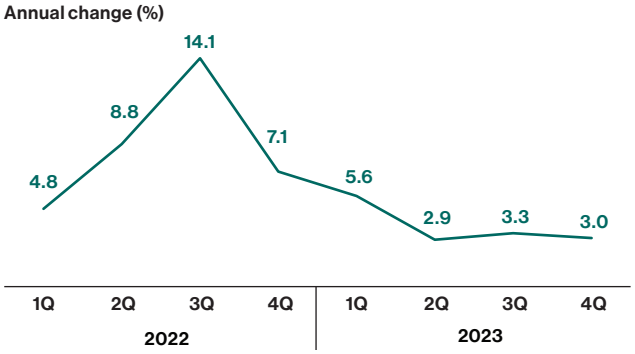
Source: Department of Statistics, Malaysia

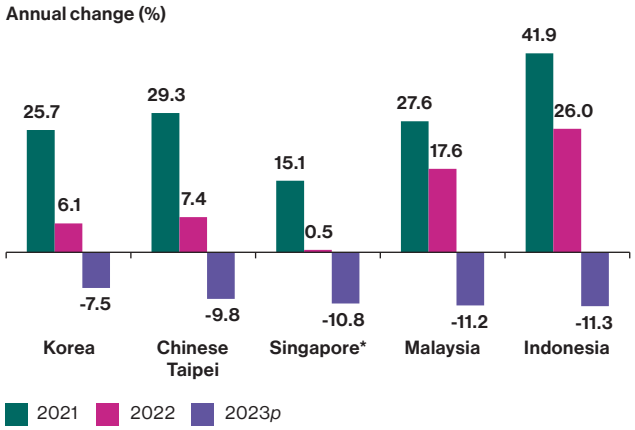
Chart 1.12: Malaysia's Quarterly Real GDP Growth



Source: Department of Statistics, Malaysia

On the external front, headwinds from more moderate global growth and weak trade activity were partly offset by improving tourism activities. Exports declined in 2023 due to moderating external demand conditions, lower commodity prices, continued spending rotation from goods to services, global technology downcycle and high base effects from strong global demand for goods in the previous year. In line with the export performance of regional economies, Malaysia's gross exports recorded a contraction (Chart 1.13). Gross imports also declined due to weaker demand for intermediate goods and softening domestic demand. Nevertheless, the ongoing recovery of inbound tourist arrivals and expenditure cushioned the impact of weak exports of goods. The reopening of China's international borders provided further impetus to tourism activities. The current account of the balance of payments continued to record a surplus, albeit narrower compared to 2022 due to weaker external demand conditions which was partially offset by improving travel receipts.

Chart 1.13: Gross Exports (USD)



* Refers to non-oil domestic exports

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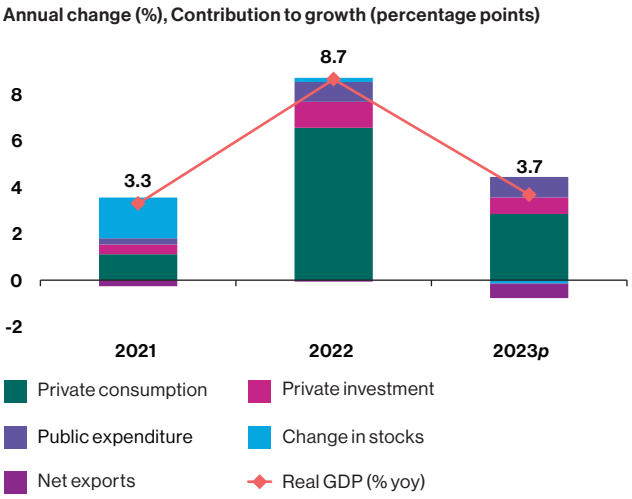
Source: National authorities

Despite these challenges, the Malaysian economy continued to expand in 2023, driven mainly by domestic demand (Chart 1.14). Labour market conditions improved as the unemployment rate declined to its pre-pandemic level. Employment growth exceeded its long-term trend and the labour force participation rate reached a historical high. Employment grew despite weaker external demand as firms preferred to retain workers due to concerns over difficulties and high cost of rehiring when external demand recovered.[8] Improving labour market conditions underpinned household spending on both necessities and discretionary items. Supportive policy measures such as targeted cash transfers were also in place to assist vulnerable households affected by higher cost of living. Gross fixed capital formation growth (2023: 5.5%; 2022: 6.8%) was driven by private sector capital spending across various industries such as information and communications technology (ICT), and electrical and electronics (E&E). These included investments in data centres and cloud computing as well as capacity expansion by firms. Meanwhile, higher public spending on infrastructure projects further supported investment activity.

In tandem with external trade performance, growth in export-oriented industries moderated sharply after two years of strong growth. While the Malaysian economy had fully recovered to its pre-pandemic level in the first quarter of 2022, selected sectors such as the food and beverages and accommodation sub-sectors, as well as the mining and quarrying, and construction sectors remained below their pre-pandemic levels.[9] This was due to the partial recovery of tourist arrivals, maturing oil and gas fields and facility closures, as well as limited replenishment of new mega projects respectively. It is noteworthy that all sectors continued to expand in 2023 (Chart 1.15).

Chart 1.14: Real GDP by Expenditure



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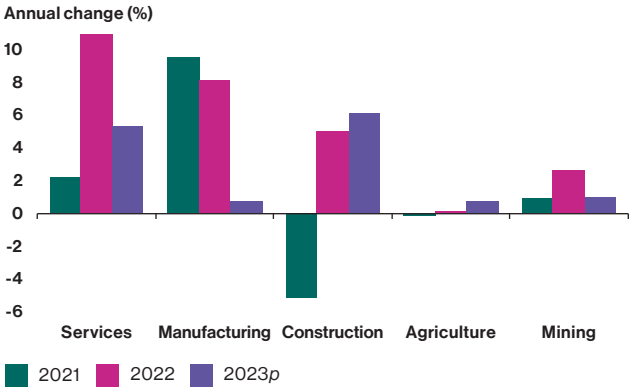
Source: Department of Statistics, Malaysia

Chart 1.15: Real GDP by Economic Sectors



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Source: Department of Statistics, Malaysia

[8] These insights were gathered from BNM's industrial engagements.

[9] These industries account for a combined 12.8% share of the economy.

Table 1.1

Malaysia - Key Economic Indicators

	2021	2022	2023*p*	2024*f*
Population (million persons)	32.6	32.7	33.4	33.7
Employment (million persons)	15.3	15.8	16.2	16.5
Unemployment (as % of labour force)	4.7	3.8	3.4	3.3
Per Capita Income (RM)	46,253	52,968	52,955	55,295
(USD)	11,163	12,035	11,598	11,696[4]
NATIONAL PRODUCT (% change)				
Real GDP at constant 2015 prices	3.3	8.7	3.7	4.0-5.0
(RM billion)	1,390.6	1,510.9	1,566.5	1,637.1
Agriculture	-0.1	0.1	0.7	-0.5
Mining and quarrying	0.9	2.6	1.0	3.5
Manufacturing	9.5	8.1	0.7	3.5
Construction	-5.1	5.0	6.1	6.7
Services	2.2	10.9	5.3	5.5
Nominal GNI	8.4	14.9	2.1	5.5
(RM billion)	1,506.7	1,731.9	1,767.6	1,864.3
Real GNI	2.8	7.9	4.1	4.1
(RM billion)	1,369.8	1,478.4	1,539.4	1,602.1
Real aggregate domestic demand[1]	1.9	9.2	4.8	5.4
Private expenditure	2.0	10.3	4.7	5.8
Consumption	1.9	11.2	4.7	5.7
Investment	2.7	7.2	4.6	6.1
Public expenditure	1.5	4.7	5.1	4.0
Consumption	6.4	4.5	3.9	3.2
Investment	-11.1	5.3	8.6	6.2
Gross national savings (as % of GNI)	26.7	27.5	24.5	23.7
BALANCE OF PAYMENTS (RM billion)				
Goods balance	177.6	186.0	132.9	163.8
Exports	1,005.8	1,238.2	1,052.7	1,133.6
Imports	828.2	1,052.2	919.8	969.8
Services balance	-65.7	-56.4	-41.9	-40.9
Primary income, net	-42.2	-59.4	-55.1	-68.3
Secondary income, net	-9.6	-15.1	-13.2	-13.2
Current account balance	60.2	55.1	22.8	41.5
(as % of GDP)	3.9	3.1	1.2	1.8-2.8
Bank Negara Malaysia international reserves, net[2]	486.8	503.3	520.8	-
(in months of imports of goods and services)[3]	5.9	4.8	5.4	-
(in months of retained imports)	7.7	6.3	7.0	-
PRICES (% change)				
Consumer Price Index (2010=100)	2.5	3.3	2.5	2.0-3.5
Producer Price Index (2010=100)	9.5	7.8	-1.9	-

[1] Exclude stocks.
[2] All assets and liabilities in foreign currencies have been revalued into ringgit at rates of exchange ruling on the balance sheet date and the gain/loss has been reflected accordingly in the Bank Negara Malaysia's audited accounts.
[3] For further details, please refer to "Expansion of the Measure on Reserves Coverage of Imports – from Retained Imports to Imports of Goods and Services" article in BNM's Quarterly Bulletin for the Fourth Quarter of 2021.
[4] Based on average USD exchange rate for the period of January-February 2024.

p Preliminary
f Forecast

Note: Figures may not necessarily add up due to rounding.

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Table 1.2

Malaysia - Financial and Monetary Indicators

FEDERAL GOVERNMENT FINANCE (RM billion)	2021	2022	2023
Revenue	233.8	294.4	315.0
Operating expenditure	231.5	292.7	311.3
Net development expenditure	63.3	70.2	95.1
COVID-19 Fund	37.7	31.0	-
Overall balance	-98.7	-99.5	-91.4
Overall balance (% of GDP)	-6.4	-5.6	-5.0
Public sector net development expenditure	125.7	148.6	190.6
Public sector overall balance (% of GDP)	-8.3	-6.7	-7.5
EXTERNAL DEBT			
Total debt (RM billion)	1,080.4	1,144.7	1,242.5
Medium- and long-term debt	676.2	663.0	724.1
Short-term debt	404.2	481.6	518.4
Debt service ratio[1] (% of exports of goods and services)			
Total debt	10.8	11.4	13.1
Medium- and long-term debt	10.6	11.1	12.1

		Change in 2021		Change in 2022		Change in 2023	
MONEY AND BANKING		**RM billion**	**%**	**RM billion**	**%**	**RM billion**	**%**
Money supply	M1	54.6	10.4	24.7	4.3	35.5	5.9
	M3	130.8	6.4	93.9	4.3	136.4	6.0
Banking system deposits		132.4	6.3	132.0	5.9	132.1	5.6
Banking system loans[2]		80.6	4.4	108.9	5.7	107.2	5.3
Loan to fund ratio (%, end of year)[3,4]		81.2		82.5		81.8	
Loan to fund and equity ratio (%, end of year)[3,4,5]		70.8		71.9		71.6	

INTEREST RATES (%, AS AT END-YEAR)		2021	2022	2023
Overnight Policy Rate (OPR)		1.75	2.75	3.00
Interbank rates (1-month)		1.83	2.95	3.34
Commercial banks				
Fixed deposit	3-month	1.57	2.55	2.72
	12-month	1.71	2.65	2.83
Savings deposit		0.56	0.85	0.94
Weighted average base rate (BR)		2.43	3.42	3.67
Base lending rate (BLR)		5.49	6.42	6.68
Treasury Bill (3-month)[6]		1.79	2.93	3.18
Malaysian Government Securities (1-year)[6]		1.85	3.25	3.30
Malaysian Government Securities (5-year)[6]		3.15	3.86	3.57

EXCHANGE RATES (AS AT END-YEAR)	2021	2022	2023
Movement of Ringgit (%)			
Change against SDR	-1.4	-0.4	-5.0
Change against USD	-3.9	-5.4	-3.9

1 Includes prepayment of medium- and long-term debt
2 Includes loans sold to Cagamas with recourse. Data from 2021 onwards are based on the new set of loan data reflecting the latest requirements and cannot be directly compared to previous years' data.
3 Loans exclude loans sold to Cagamas and loans extended to banking institutions. Beginning July 2015, loans exclude financing funded by Islamic Investment accounts.
4 Funds comprise deposits (excluding deposits accepted from banking institutions and Bank Negara Malaysia) and all debt instruments (including subordinated debt, debt certificates/sukuk issued, commercial paper and structured notes).
5 Equities comprise ordinary and preferred shares, share premium and retained earnings.
6 Refers to data from Fully Automated System for Issuing/Tendering (FAST), Bank Negara Malaysia.

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

Domestic demand was the anchor for growth in 2023 as exports declined

In the aftermath of the pandemic crisis and recovery in the past two years, the Malaysian economy grew at a moderate pace of 3.7% in 2023, following the robust rebound in 2022 (8.7%). The growth performance was driven by resilient domestic demand, particularly by private sector expenditure. Household spending continued to expand with improvements in labour market conditions. The unemployment rate declined to pre-pandemic levels while labour force participation rate reached an all-time high of 70% by end-2023 (2019: 68.7%). Meanwhile, investment activity benefitted from continued progress of multi-year projects and capacity expansion by firms. Public expenditure increased on account of higher fixed asset spending by the Government and continued expansion in capital spending by public corporations. On the external front, net exports contracted as exports declined amid weaker external demand and global technology downcycle. This was partly cushioned by improving tourism activities, as tourist arrivals recovered to 77% of pre-pandemic levels in 2023.

Table 1

Real GDP by Expenditure (2015=100)

	2023*p*	2022	2023*p*	2022	2023*p*
	% of GDP	Annual change (%)		Contribution to growth (percentage point)	
Domestic Demand[1]	**94.1**	**9.2**	**4.8**	**8.5**	**4.4**
Private sector expenditure	76.2	10.3	4.7	7.7	3.6
Consumption	60.8	11.2	4.7	6.6	2.8
Investment	15.5	7.2	4.6	1.1	0.7
Public sector expenditure	17.8	4.7	5.1	0.9	0.9
Consumption	13.3	4.5	3.9	0.6	0.5
Investment	4.6	5.3	8.6	0.2	0.4
Gross Fixed Capital Formation	20.1	6.8	5.5	1.4	1.1
Change in stocks	**1.2**			**0.2**	**-0.1**
Net Exports of Goods and Services	**4.7**	**-1.0**	**-11.3**	**-0.1**	**-0.6**
Exports	66.3	14.5	-7.9	10.3	-5.9
Imports	61.6	15.9	-7.6	10.3	-5.3
Real Gross Domestic Product (GDP)	**100.0**	**8.7**	**3.7**	**8.7**	**3.7**

[1] Excluding stocks
p Preliminary

Note: Figures may not necessarily add up due to rounding.

Source: Department of Statistics, Malaysia

Private consumption moderated to 4.7% in 2023, after a strong recovery in 2022 (11.2%), following the lapse of effects from various Government policy measures in 2021 and 2022. Private consumption was supported by continued improvement in employment and income levels. Overall employment registered a growth of 2.8% while aggregate nominal wages expanded by 3.7% in the private sector and 6.1% for the public sector. Necessities expenditure recorded a growth of 6.7% largely driven by transport, utilities and food and beverage spending, while discretionary expenditure expanded by 5% led by restaurant and hotel spending. Some policy support to households remained in place throughout the year. This includes cash transfers and income support from the implementation of a higher minimum wage and revision of the income eligibility for overtime payments.

Gross fixed capital formation (GFCF) registered a growth of 5.5% (2022: 6.8%). By types of assets, growth was supported by higher investments in structures (6.2%; 2022: 4.7%), and continued purchase of machinery and equipment (M&E) (5.2%; 2022: 10.2%), as well as investment in other assets (2.8%; 2022: 2.3%).

Private investment expanded by 4.6% in 2023 (2022: 7.2%). Growth was driven by the implementation of new and ongoing multi-year projects. These were mainly in the services and manufacturing sectors including information and

communications technology (ICT), electrical and electronics (E&E) and chemicals and chemical products industries. Investment activity also benefitted from the gradual recovery in labour supply and easing cost pressures. This is reflected in the strong growth in construction work undertaken by the private sector (2023: 9.2%; 2022: 17.6%). Firms also continued to expand their capacity through acquisition of new machinery and equipment (M&E), as indicated by robust growth in capital imports (2023: 7.2%; 2022: 15.8%). Furthermore, the adoption of automation and digitalisation, as well as gradual green transition among firms lent further support to investment growth.

Public investment spending increased by 8.6% in 2023 (2022: 5.3%). This was driven by higher fixed asset spending by the Government. Growth was also supported by continued expansion by public corporations, mainly in the oil and gas (O&G) and transportation industry.

Public consumption expanded by 3.9% (2022: 4.5%), supported by Federal Government's spending on both emoluments and supplies and services. In particular, emoluments spending was higher driven by the Special Additional Salary Increment for civil servants and the absorption of contract workers to permanent positions.

Expansion in all economic sectors

Economic activity in 2023 was mainly driven by the *services* and *construction* sectors. Weaker external demand and tech cycle downturn had weighed on manufacturing activity. Meanwhile, temporary domestic supply disruptions had constrained growth in the *agriculture* and *mining* sectors.

Table 2

Real GDP by Kind of Economic Activity (2015 = 100)

	2023	2022	2023*p*	2022	2023*p*
	% of GDP	Annual change (%)		Contribution to growth (ppt)[1]	
Services	59.2	10.9	5.3	6.2	3.1
Manufacturing	23.4	8.1	0.7	2.0	0.2
Agriculture	6.4	0.1	0.7	0.0	0.0
Mining and quarrying	6.2	2.6	1.0	0.2	0.1
Construction	3.6	5.0	6.1	0.2	0.2
Real Gross Domestic Product (GDP)	**100.0**[1]	**8.7**	**3.7**	**8.7**	**3.7**

[1] Figures may not necessarily add up due to rounding and exclusion of import duties component
p Preliminary

Source: Department of Statistics, Malaysia

The *services* sector expanded by 5.3% (2022: 10.9%). Growth was driven mainly by consumer-related (wholesale and retail trade, food and beverages, and accommodation) and transport and storage subsectors which benefitted from improved tourism-related spending, with the reopening of China's international borders providing further impetus to tourism activities. Real estate and business services subsectors continued to grow in line with the expansion in construction activities, albeit at a moderate pace amid weak external demand. Meanwhile, the finance and insurance subsector was weighed down mainly by the increase in medical claims amid higher cost and frequency of claims for medical treatment post-COVID-19 pandemic.

The *manufacturing* sector growth slowed to 0.7% (2022: 8.1%). Weakness in the production of export-oriented clusters was partly cushioned by resilience in the domestic-oriented clusters. Reflecting Malaysia's deep integration in the global value chain, the E&E industry was impacted by the slowdown in global semiconductor sales as firms experienced subdued external demand and elevated inventory levels. Output in the primary-related cluster was affected by upstream

supply disruptions and maintenance of refineries. Nevertheless, strong demand for motor vehicles and continued recovery in tourism activities supported growth of the consumer-related cluster. Meanwhile, the construction-related cluster benefitted from the pickup in infrastructure activities.

The *agriculture* sector continued to expand by 0.7% (2022: 0.1%), mainly attributable to higher oil palm production. Oil palm yields were supported by a normalisation of labour conditions following the larger scale arrival of foreign workers, notwithstanding temporary hot weather in second quarter that led to forced ripening of fruit and lowering of yields. Meanwhile, output from the food crops and paddy subsectors benefitted from improving fertiliser supply as global shocks to the supply chain eased. In aggregate, these had offset the weaker output in the rubber, forestry and fisheries subsectors.

The *mining* sector expanded by 1% (2022: 2.6%) in 2023. Growth was mainly driven by an increase in oil production in existing fields as well as support from the operationalisation of new fields in Sarawak and Peninsular Malaysia. However, oil and gas production was lower in the second and third quarter due to plant maintenances, which have since been completed.

The *construction* sector registered a growth of 6.1% (2022: 5%) with continued expansion across most subsectors. This was supported by better labour supply conditions and easing of building material costs during the year. The growth was driven by the faster progress of multi-year civil engineering projects, particularly in the transport and utilities segments. Activities in the special trade subsector also provided further support to growth. This includes the ongoing early- and end-stage works as well as continued implementation of small-scale projects. Meanwhile, growth in the residential subsector rebounded as housing demand improved further amid better income and employment conditions.

Improving labour market conditions in 2023

In 2023, the labour market continued to improve. Employment grew by 2.8% (+439,200 persons; 2022: 3.1%, +472,400 persons). Of significance, the labour force participation rate reached a historic high of 70% (2022: 69.3%). The unemployment rate continued to decline towards pre-pandemic rates (2023: 3.4%; 2019: 3.3%).

The growth in employment in 2023 was mainly driven by semi-skilled workers, who continued to account for the largest employment share at 59.1% (2022: 59.6%). By status of employment, own-account workers[10] contributed more significantly to total employment growth compared to pre-pandemic years.[11] This was likely due to the rise of gig workers, as both displaced workers and new entrants into the labour force joined the gig economy amid trends such as the strong demand for food delivery. Despite weaker external demand during the year, employment was broadly sustained as most workers are employed in domestic-oriented economic sectors. BNM's industrial engagements also found that firms indicated intentions to retain workers due to concerns over difficulties and high cost of rehiring when external demand recovered. On the other hand, improved tourism activities led to increased hiring of workers in select high-touch services subsectors. In particular, the food and beverages and accommodation, and wholesale and retail trade subsectors were major drivers of overall employment growth during the year. Meanwhile, employment in the *construction* sector rebounded. This was supported by faster progress of multi-year investment projects amid continuing easing of labour supply constraints throughout the year.

Jobless claims reported by the Social Security Organisation's (SOCSO) Employment Insurance System (EIS)[12] rose during the year (2023: 49,982; 2022: 34,388), which accounted for about 0.3% of the total labour force. These claims were mainly contributed by the *manufacturing* sector and wholesale and retail trade subsector. For comparison, jobless claims stood at a high of 107,024 during the height of COVID-19 in 2020.

[10] Refers to individuals who operates their own farm, business or trade on a full-time basis, without employing any paid workers (Source: Department of Statistics, Malaysia).
[11] Refers to 2016–19 period.
[12] For more information, please refer to the Weekly EIS Reports on eiscentre.perkeso.gov.my.

Labour force participation rate reached a historic high of 70.2% in December 2023. This was due to a significant increase in participation rate for men during the year (82.8%; 2022: 81.9%). Increased opportunity in gig work, through which workers could easily enter the workforce contributed to this development. Female labour force participation also rose (56.2%; 2022: 55.8%), particularly among those with tertiary education (67.9%; 2022: 66.9%). Higher tertiary education enrolment among women in recent years could be a factor behind this (Female tertiary gross enrolment ratio[13] in 2020: 48.2%; 2017: 47%).

Aggregate nominal wages in the private sector[14] increased at a moderated pace of 3.7% (2022: 6.7%). In the *services* sector, wages grew by 3.8% (2022: 7.5%), driven primarily by the wholesale and retail trade, and transportation and storage subsectors. While employment in the *manufacturing* sector remained relatively strong, its wages registered a lower growth of 3.5% (2022: 5.2%). The moderation was broad-based across most subsectors, but particularly evident in the export-oriented industries (2023: 2.7%, 2022: 5.4%). This mainly reflected the moderating external demand conditions and global technology downcycle. Meanwhile, wages in the public sector edged higher during the year (6.1%; 2022: 5%).

Labour productivity growth, in terms of real value-added per hour worked, moderated in 2023 (0.2%; 2022: 1.8%). The *manufacturing* sector recorded the largest decline in productivity growth as production in the E&E subsector slowed while employment remained relatively strong.

Table 3

Selected Labour Market Indicators

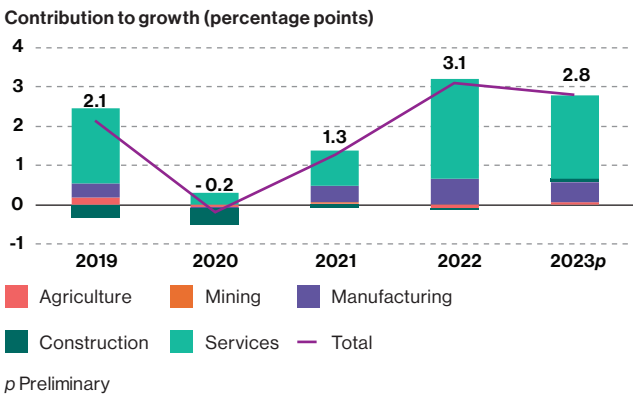
	2018	2019	2020	2021	2022	2023*p*
Employment ('000 persons)	14,810	15,126	15,096	15,290	15,762	16,201
Annual change (%)	2.4	2.1	-0.2	1.3	3.1	2.8
Unemployment rate (% of labour force)	3.3	3.3	4.5	4.7	3.8	3.4
Labour force participation rate (% of working age population)	68.4	68.9	68.5	68.5	69.3	70.0
Jobless claims (persons)	23,697	40,084	107,024	61,360	34,388	49,982
Non-Malaysian citizens employment ('000 persons)	2,239	2,254	2,214	2,149	2,136	2,200

p Preliminary

Note:
1. The employment, unemployment, labour force participation rates and non-Malaysian citizens employment are estimated based on quarterly averages from the Labour Force Survey.
2. Jobless claims refers to claims by insured person who had lost his employment and does not include voluntary resignations and retrenchment due to misconduct.

Source: Department of Statistics, Malaysia, Social Security Organisation (SOCSO) and Bank Negara Malaysia estimates

Chart 1: Employment Growth by Sector, 2019-23



p Preliminary

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

[13] Refers to ratio of total enrolment, regardless of age, to the population of the age group that officially corresponds to tertiary education. Source: World Bank.
[14] Private sector wages are derived from the salaries and wages data published in the Monthly Manufacturing Statistics and Quarterly Services Statistics by the Department of Statistics, Malaysia.

External sector remained resilient in 2023

Malaysia's external position remained resilient despite the challenging global landscape in 2023. The current account registered a smaller surplus of RM22.8 billion or 1.2% of GDP (2022: RM55.1 billion or 3.1% of GDP). Goods surplus moderated due to the lower exports but partially mitigated by narrowing deficits in income and services account. From a savings – investment (S–I) gap perspective, the smaller gap was driven by lower national savings, reflecting lower earnings from exports.

Table 4

Balance of Payments[1]

Item (Net)	2021	2022	2023*p*
	RM billion		
Current account	**60.2**	**55.1**	**22.8**
Goods[2]	177.6	186.0	132.9
Services	-65.7	-56.4	-41.9
Primary income	-42.2	-59.4	-55.1
Secondary income	-9.6	-15.1	-13.2
Capital account	**-0.5**	**-0.5**	**-0.2**
Financial account	**16.2**	**12.4**	**-18.9**
Direct investment	31.1	15.9	4.6
Portfolio investment	18.8	-50.6	-45.7
Financial derivatives	-2.3	-2.2	-3.9
Other investment	-31.4	49.2	26.0
Net errors and omissions (E&O)[3]	**-30.3**	**-13.6**	**-24.2**
Overall balance	**45.7**	**53.4**	**-20.6**

[1] In accordance with the Balance of Payments and International Investment Position Manual, Sixth Edition (BPM6) by the International Monetary Fund (IMF)
[2] Adjusted for valuation and coverage of goods for processing, storage and distribution
[3] The net E&O excludes reserves revaluation changes.

p Preliminary

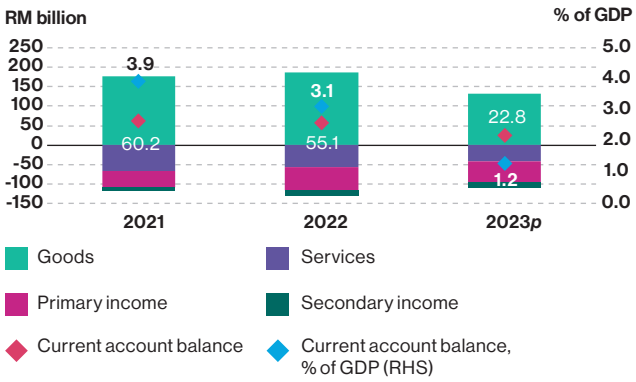
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

In the goods account, exports declined at a faster rate relative to imports. This resulted in a lower goods surplus of RM132.9 billion (2022: RM186 billion). The decline in exports was due mainly to sluggish global demand for goods from major trading partners, global technology downcycle and lower commodity prices. The services account recorded a smaller deficit of RM41.9 billion in 2023 (2022: -RM56.4 billion), reflecting the strong recovery in the travel receipts to RM67.5 billion (2022: RM28.4 billion). This was supported by higher number of regional tourist, with the revival of China's outbound travel following the lifting of its COVID-19 restrictions providing additional boost to inbound tourism.

In the income account, the primary income deficit narrowed to RM55.1 billion (2022: -RM59.4 billion). This was accounted mainly by lower investment income accrued to foreign investors in Malaysia following lower exports earnings. The secondary income account recorded a smaller deficit of RM13.2 billion (2022: -RM15.1 billion). This was supported by higher inward remittances from Malaysians working abroad, which partly offset continued increase in outward remittances by foreign workers.

In 2023, the financial account turned around to record a net outflow of RM18.9 billion (2022: +RM12.4 billion). This was due mainly to large outflows in portfolio investment, which more than offset the inflows from other investment and direct investment accounts.

Chart 2: Current Account Balance



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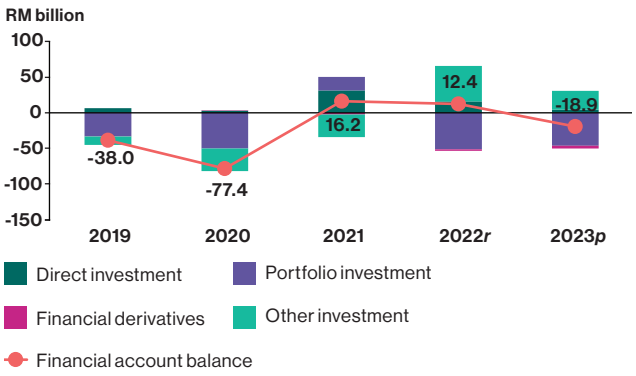
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 3: Financial Account Flows by Key Components



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Source: Department of Statistics, Malaysia and Bank Negara Malaysia

The direct investment account registered a net inflow of RM4.6 billion (2022: +RM15.9 billion). Of note, net FDI recorded an inflow of RM39.5 billion (2.2% of GDP; 2022: +RM74.6 billion, 4.2% of GDP). This reflected the sustained interests by foreign investors to expand their production capacity in Malaysia. In particular, FDI inflows for the year originated mainly from Singapore (55.7% of net FDI), Hong Kong SAR (39.2%) and Japan (12.0%).[15] However, the more moderate external demand affected investor sentiments and led to slower FDI inflows during the year. From a sectoral perspective, foreign investments were mainly channelled into the *services* sector. This included finance and insurance services (2023: +RM14.4 billion; 2022: +RM29.6 billion) as well as information and communication services (2023: +RM9.3 billion; 2022: +RM3.0 billion). Malaysia continues to benefit from the ongoing technological megatrends. This is particularly evident with the rising FDI into activities related to data centres and cloud services. Meanwhile, the *manufacturing* sector recorded a smaller inflow of RM2.6 billion (2022: +RM31.6 billion). This can be attributed to the slowdown in global trade activities.

DIA outflows were also lower at RM34.9 billion (-1.9% of GDP; 2022: -RM58.6 billion, -3.3% of GDP). These investments abroad were mainly channelled into the *services* sector, especially finance and insurance and utility subsectors, as well as the *mining* sector. Singapore (37.2% of net DIA), Indonesia (18.7%) and the United States (9.4%) were the major recipients of DIA in 2023.

The portfolio investment account recorded a net outflow of RM45.7 billion (2022: -RM50.6 billion). This owed mostly to the acquisition of debt and equity securities abroad by resident investors. These outflows were partly offset by the turnaround in non-resident investments in Malaysia (+RM6.5 billion; 2022: -RM20.1 billion). This was supported mainly by the acquisition of domestic debt securities.

The other investment account continued to register a net inflow of RM26.0 billion (2022: +RM49.2 billion). This was mainly on account of the non-resident deposit placements into resident banks. Net errors and omissions (E&O) amounted to -RM24.2 billion or -0.9% of total trade during the year (2022: -RM13.6 billion, or -0.5% of total trade).

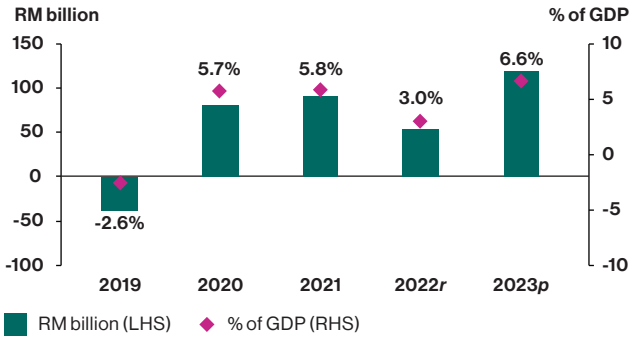
[15] This was partly offset by outflows of FDI mainly in the Netherlands (-RM11.3 billion; -28.5% of net FDI) and the United States (-RM5.0 billion; -12.7%).

Malaysia's international investment position remained favourable

As at end-2023, Malaysia's net international investment position (IIP) recorded a higher net external asset position of RM119.4 billion, equivalent to 6.6% of GDP (end-2022: RM54.2 billion or 3% of GDP). The improvement mainly reflected the increase in external assets by RM180.6 billion in 2023, primarily in portfolio and direct investments. The higher external assets also in part reflected exchange rate valuation effects, particularly due to the weaker ringgit against the USD. This more than offset the increases in external liabilities amounting to RM115.5 billion, mainly reflecting net inflows of FDI and other investments.

The net foreign currency (FCY) external asset position[16] stood at RM1.3 trillion, or 70.4% of GDP (2022: RM1.2 trillion, or 64.5% of GDP). With this position, the ringgit exchange rate depreciation translated to a larger increase in FCY external assets compared to FCY external liabilities.

Chart 4: Net International Investment Position (IIP)



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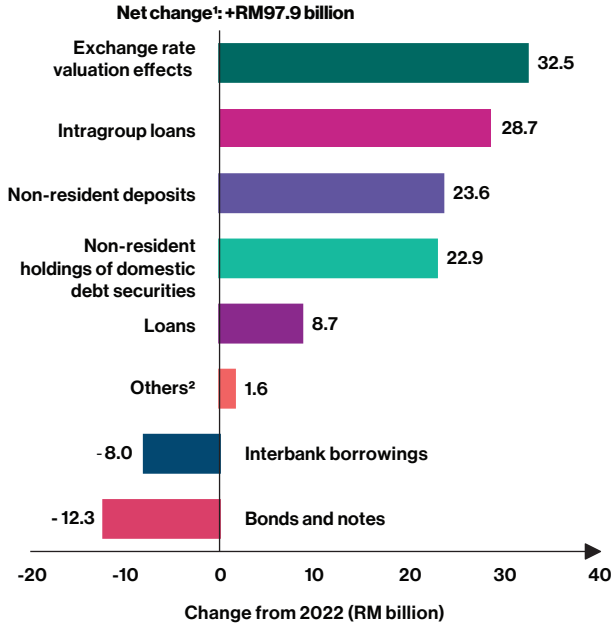
Source: Department of Statistics, Malaysia

Chart 5: Changes in External Debt



[1] Changes in individual debt instruments exclude exchange rate valuation effects. Positive indicates net borrowing or issuance of debt securities.
[2] Comprises trade credits, IMF allocation of SDRs and other debt liabilities.

Note: Figures may not add up due to rounding.

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

[16] As measured by external assets in FCY less external liabilities in FCY.

Malaysia's external debt amounted to RM1,242.5 billion as at end-2023, or 68.2% of GDP (2022: RM1,144.7 billion; 63.9% of GDP). The higher external debt was driven mainly by exchange rate valuation effects following the weakening of ringgit, particularly against the US dollar. The increase in external debt was also attributed to larger intragroup loans and higher non-resident deposits. These were partially offset by net repayment of international bonds and notes, largely by corporates.

Risks surrounding Malaysia's external debt were well-contained given the favourable maturity and currency profiles. Coupled with BNM's prudential and hedging requirements[17] on corporates and banks, external debt remained manageable. As at end-2023, the external debt-at-risk for corporates[18] and banks[19] amounted RM9.2 billion and RM90.9 billion respectively (2022: RM9.8 billion and RM85.9 billion). Cumulatively, these amounted to 8.1% of Malaysia's total external debt and 19.2% of international reserves (2022: 8.4% and 19% respectively).

About a third of external debt was denominated in ringgit (33.1%; 2022: 33.1%), and therefore not affected by fluctuations in the ringgit exchange rate (Chart 6b). Out of this ringgit-denominated external debt, 65.5% were in the form of non-resident holdings of domestic debt securities and 16.8% in non-resident deposits.[20] Meanwhile, the remainder of external debt dominated in FCY was largely subject to prudential requirements on liquidity and funding risk management.[21] Moreover, intragroup borrowings[22] accounted for 43% of FCY external debt, which were generally more stable and on concessionary terms.

BNM's international reserves amounted to USD113.5 billion (or RM520.9 billion) as at end-2023 (2022: USD 114.7 billion). This was sufficient to finance 5.4 months of imports of goods and services and was 1.0 time the short-term external debt.[23] Notwithstanding this, other means of meeting external obligations remain available, and continue to be strengthened. In particular, the accumulation of FCY external assets by banks and corporates over the years. These assets, particularly the liquid portion amounting to RM873.9 billion,[24] can be drawn upon to meet their short-term external debt obligations of RM518.4 billion without creating a claim on international reserves (Chart 7).

[17] For more details on Malaysia's external debt management, please refer to 'Malaysia's Resilience in Managing External Debt Obligations and the Adequacy of International Reserves' box article in BNM's Annual Report 2018 on external debt.
[18] Based on offshore loans raised and bonds issued by high-risk corporate borrowers.
[19] Refers to the portion of banks' external debt that were more susceptible to sudden withdrawal shocks. These include interbank borrowings (RM63.9 billion), financial institutions' deposits (RM20.7 billion) and other short-term debt (RM6.2 billion) from unrelated counterparties.
[20] Other components of ringgit-denominated external debt include intercompany loan, other debt liabilities, trade credits, loans, interbank borrowings as well as bonds and notes.
[21] Including requirements imposed on banks under local banking regulations.
[22] Comprises intragroup loans and interbank borrowings.
[23] For more details on BNM's international reserves, please refer to 'Building Buffers: Roles and Functions of BNM's International Reserves' box article in BNM's Annual Report 2020.
[24] Corporate and banks' liquid external assets.

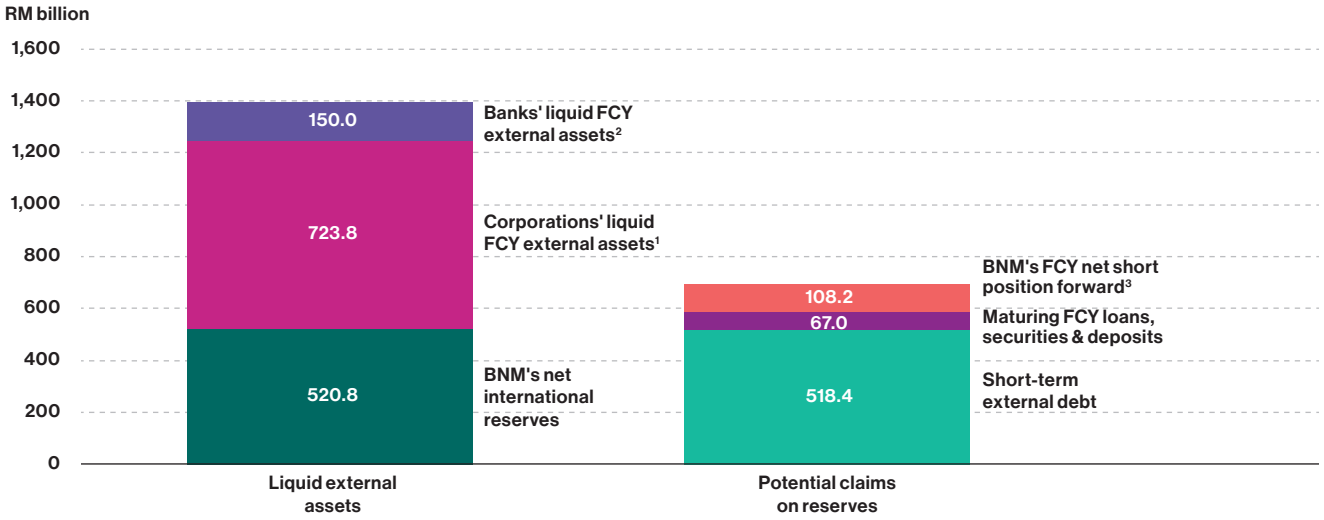
Chart 6: Profile of Malaysia's External Debt (% share)

[1] Comprises trade credits and other debt liabilities, such as insurance claims yet to be disbursed and interest payables on bonds and notes.

Note: Figures may not necessarily add up due to rounding.

Source: Bank Negara Malaysia

Chart 7: Liquid External Assets and Potential Claims on International Reserves



¹ Consist of portfolio investments and currency and deposits.
² Consist of deposits and interbank placements, bonds and notes and money market instruments.
³ Including the forward leg of currency swaps.

Note: BNM refers to Bank Negara Malaysia.

Source: Bank Negara Malaysia

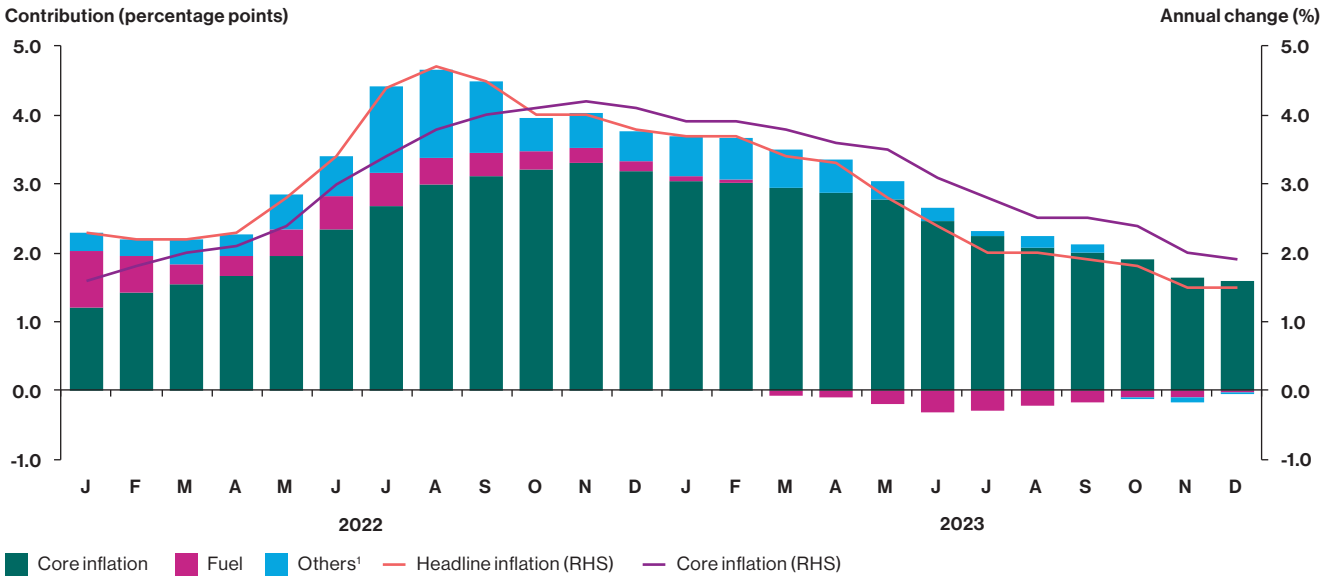
Headline and core inflation moderated in 2023

In line with the easing cost environment and stabilising demand conditions, headline inflation moderated in 2023 after reaching its peak in 2022, averaging at 2.5% for 2023 (2022: 3.3%). The moderation was driven by broad-based easing in both core and non-core inflation. In particular, lower inflation for fuel (2023: -1.6%; 2022: 5.1%) as well as food and non-alcoholic beverages (2023: 4.8%; 2022: 5.8%) were among the main drivers contributing to softer headline inflation (Chart 1.16).
In 2023, the government began introducing several subsidy rationalisation measures including the revision of electricity tariff for households with higher electricity usage[25] and the removal of chicken subsidy and price controls.[26] However, the implementation of these domestic policies had a manageable impact on inflation. This was on account of the relatively smaller weight of electricity in the Consumer Price Index (CPI) basket (2.7%) and majority of households remained shielded from the impact of tariff adjustments. Meanwhile, the removal of price controls had minimal impact to prices of fresh chicken, which had already trended below the ceiling price prior to its removal amid stable supply conditions.

Despite the sustained US dollar strength against the ringgit, upward pressures on import prices were offset by the broader moderation in the global cost environment. As the effects from global supply chain disruptions and commodity price shocks abated, input costs were lower throughout 2023, as reflected by the Producer Price Index (PPI) which declined by 1.9% in 2023 (2022: +7.8%). The lower producer price inflation alleviated operating costs of firms, contributing to easing consumer prices. The extent of exchange rate pass-through to consumer prices was also partially mitigated by existing price controls and subsidies on key expenditure items such as retail fuel as well as the relatively stable firms' pricing behaviour in Malaysia.[27]

[25] Beginning July 2023, domestic consumers with electricity consumption exceeding 1,500 kWh will be subject to a surcharge of 10 sen/kWh in line with a more targeted approach on electricity subsidy. This is estimated to affect approximately 1% of domestic users.
[26] Subsidies and price controls on chicken were discontinued beginning 1 November 2023.
[27] It is estimated that on average, a 5% change in the RM/USD exchange rate is associated with approximately 0.1 percentage points change in core inflation in the next quarter (short run) and 0.2 percentage points over a year (long run). For further details, please refer to the box article 'Revisiting Exchange Rate Pass-through to Inflation in Malaysia' in BNM's Economic and Monetary Review 2022.

Chart 1.16: Contribution to Headline Inflation by Components



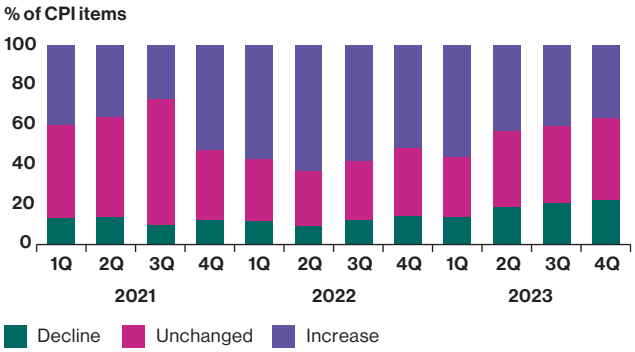
[1] Others include price-volatile items and other price-administered items (excluding fuel).

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

Underlying inflation, as measured by core inflation,[28] averaged at 3% for 2023 (2022: 3%). The pace of disinflation, however, was more gradual as core inflation remained elevated before trending closer to its long-term average (2011–19 average: 2%) in the second half of 2023. The slower core disinflation partly reflected lingering and persistent demand pressures in the economy particularly during the first half of 2023. This was evidenced by persistence in discretionary services such as food away from home (1H 2023: 8.3%; 2H 2023: 5.2%; 2022: 6.7%) and repair and maintenance of personal transport (1H 2023: 10.2%; 2H 2023: 5.7%; 2022: 10.5%). Notwithstanding this, the sustained improvement in labour market conditions did not translate into excessive demand pressures in the economy as wage growth remained outpaced by productivity growth.

Price pressures were broadly less pervasive during 2023, notwithstanding intermittent periods of higher pervasiveness which reflected seasonal factors. Overall, the share of CPI items recording monthly price increases trended lower for most of 2023, normalising closer to the long-term average trend (2023: 43.9%; 2022: 57.5%; 2011–19 average: 45.6%) (Chart 1.17).

Chart 1.17: Month-on-Month Price Changes of CPI Items*



* Based on the month-on-month inflation for 125 CPI items at the 4-digit level (average for the quarter).

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

[28] Core inflation is computed by excluding price-volatile and price-administered items.

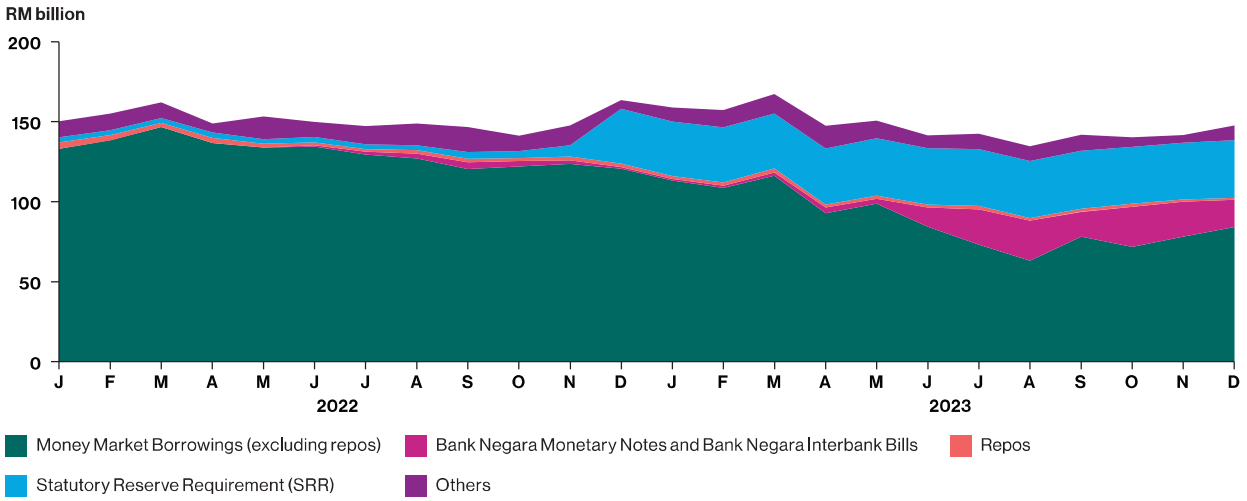
Further normalisation of monetary policy amid resilient domestic growth prospects

In 2023, the Overnight Policy Rate (OPR) was raised by 25 basis points to 3.00%. The adjustment marked the full withdrawal of the monetary stimulus intended to address the COVID-19 crisis in promoting economic recovery. Following successive hikes by a total of 100 basis points in 2022, the Monetary Policy Committee (MPC) judged that it was prudent to pause for the first two meetings in 2023 and take stock of the impact from the previous OPR adjustments. Recognising that monetary policy changes often have a lagged effect on the macroeconomy, it was important to assess the transmission of previous adjustments to economic conditions and closely monitor for any risk of over-tightening.

At the May 2023 meeting, the MPC decided to further normalise the degree of monetary accommodation with a 25 basis points increase in the OPR. The decision was made based on the outlook that domestic growth prospects remained resilient amid elevated core inflation. Although headline and core inflation were projected to moderate over the remaining course of the year, the balance of risks to the inflation outlook were tilted to the upside stemming from any changes to domestic policy including on subsidies and price controls, financial market developments as well as global commodity prices. As the year progressed, the timing of the Government's subsidy rationalisation exercise was also part of the MPC's considerations. Some of these measures were rolled out gradually in the second half of 2023 starting with electricity tariff adjustments for households with higher usage and removal of price controls and subsidies for chicken, but the impact to inflation was assessed to be manageable. Given the steady disinflation progress, the MPC decided to keep the OPR unchanged throughout subsequent meetings.

Domestic monetary and financing conditions remained conducive to financial intermediation. At the system level, liquidity remained sufficient, and the interbank market continued to function in an orderly manner. During the year, BNM increased its issuance of Bank Negara Interbank Bills (BNIB) as part of liquidity management operations to reduce the high overnight balances[29] which had built up in part due to increased preference for shorter-term placements by banking institutions amid the interest rate hike cycle. This was also aimed at enhancing efficiency and price discovery in the interbank market by encouraging more interbank trading activities. Following the adjustments to liquidity operations strategy, interbank trading volume as a proportion of banks' surplus overnight balances had increased by 8%.[30] As of end-December 2023, total banking system liquidity stood at RM147.7 billion (2022: RM163.4 billion) (Chart 1.18). At the institutional level, most banking institutions continued to maintain surplus liquidity positions with BNM.

Chart 1.18: Outstanding Ringgit Liquidity Placed with Bank Negara Malaysia (at end-period)



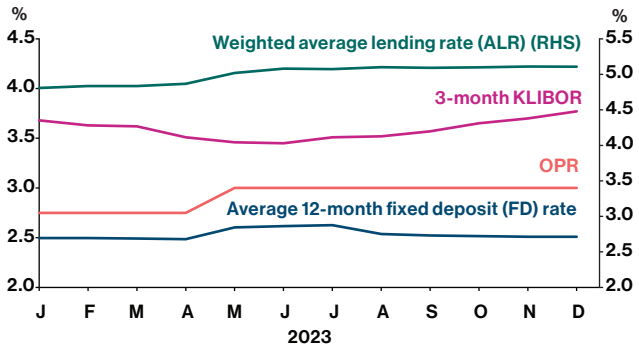
Source: Bank Negara Malaysia

[29] Prior to BNIB issuances, overnight surplus liquidity placed with BNM reached RM101 billion by the end of 2022 and had remained around RM70 billion to RM80 billion since then (2015–19 average: RM39 billion).
[30] Based on the period between August 2023 to January 2024.

Given that market participants had previously priced in expectations of further increase in OPR, interbank rates as reflected by the 3-month Kuala Lumpur Interbank Offered Rate (KLIBOR) gradually declined from elevated levels earlier in the year following the MPC's decision to pause. The moderation was also partly due to easing of tighter interbank market conditions arising from competition in the corporate deposit market in end-2022. Interbank rates continued to decline on waning market expectations of further OPR increases. Nonetheless, in light of seasonal year-end funding demand, KLIBOR began trending higher from September. This in part reflected actions by banks in taking pre-emptive measures to shore up their liquidity position in anticipation of intense year-end deposit competition.[31]

Notwithstanding the elevated interbank rates towards the end of 2023, spillovers to broader credit conditions were limited. Lending rates as indicated by the weighted average lending rate (ALR) on outstanding loans increased broadly in line with the adjustments in the OPR. Pass-through to average costs of funds had been strong amid ongoing repricing of deposits from previous OPR hikes and continued shift in savers' preference towards longer-term deposits. Nevertheless, translation to lending rates on new loans were more contained, particularly for household loans, owing to competition between banks.[32] In the retail deposit market, the rise in OPR in May resulted in an upward revision to fixed deposit rates. However, some moderation were observed in the second half of 2023 as part of bank's funding strategy to manage cost of funds (Chart 1.19).

Chart 1.19: Policy, Interbank, Fixed Deposit and Lending Rates (at end-period)

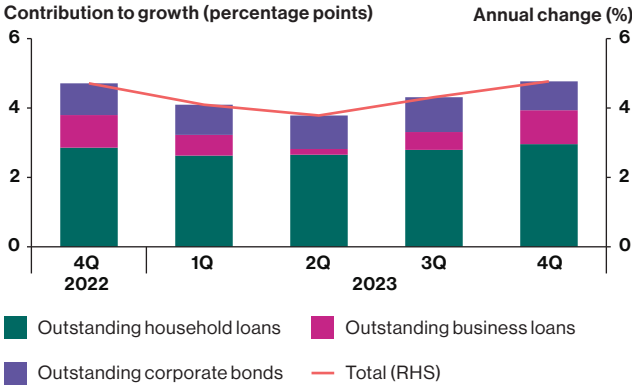


Source: Bank Negara Malaysia and Bloomberg

Continued flow of credit to the private non-financial sector

Financing activities remained broadly sustained in 2023, in line with the pace of domestic economic growth. The sustained growth in credit to the private non-financial sector (4.8%; 2022: 4.7%) was driven by higher growth in outstanding loans[33] (4.9%; 2022: 4.7%) while outstanding corporate bonds expanded at a more moderate pace (4.2%; 2022: 4.6%) (Chart 1.20). Despite some moderation in business loan growth in the first half of 2023, outstanding loan growth improved in subsequent quarters as business outlook gradually improved.

Chart 1.20: Credit to the Private Non-Financial Sector



Source: Bank Negara Malaysia

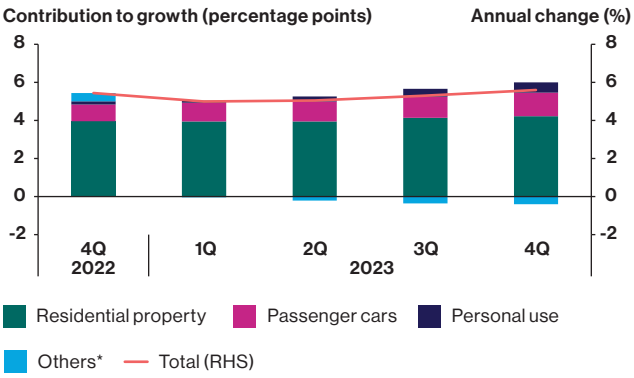
The household segment remained the key driver of loan growth, with outstanding household loans growing at 5.6% (2022: 5.4%) (Chart 1.21). Loan growth was sustained across key purposes, particularly for the purchases of houses and cars, as credit demand was supported by steady employment and wage growth. In addition, government incentives including the extension of stamp duty exemption for first time homebuyers under the Home Ownership Programme also continued to provide support for household loans. Even as the OPR had returned to its pre-pandemic level, the repayment capacity of households remained sound. This was reflected by the sustained growth in loan repayments (13.8%; 2022: 19%) in tandem with the pace of disbursements (13.7%; 2022: 22.1%).

[31] Beginning early 2024, 3-month KLIBOR had since eased to 3.56% as of 29 February 2024 (end-2023: 3.77%).

[32] Following the cumulative 125 bps increase in the OPR, average lending rates on new loans increased by 103 bps for households and 127 bps for businesses (data as at end-December 2023).

[33] For the purpose of the Economic and Monetary Review 2023 publication, the figure on outstanding loans reported here under credit to the private non-financial sector also includes loans to households extended by major non-bank financial institutions (NBFIs). This is in addition to the sum of outstanding business and household loans extended by banks and development financial institutions (DFIs).

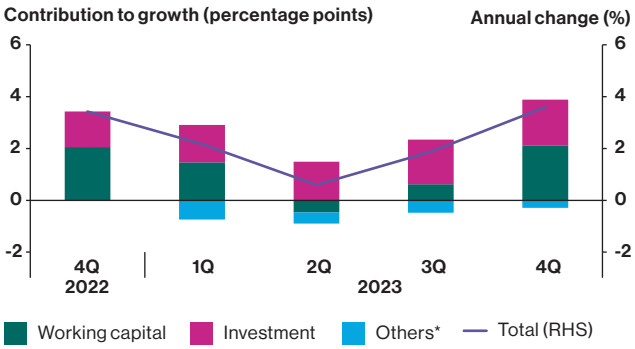
Chart 1.21: Households - Outstanding Loans by Purpose



* Includes purchase of non-residential property, securities, credit card and others.

Source: Bank Negara Malaysia

Chart 1.22: Businesses - Outstanding Loans by Purpose



* Includes purchase of securities, credit card and others.

Source: Bank Negara Malaysia

For businesses, outstanding loan growth moderated in the first half of 2023 before improving to 3.6% (2022: 3.4%) by end-2023 (Chart 1.22). The moderation was driven mainly by slower growth in working capital financing among non-SMEs. The slowing loan growth momentum was more pronounced for the export-oriented sector, in line with the decline in exports amid weaker external demand conditions. Nonetheless, loan growth in the small and medium enterprises (SMEs) segment and disbursements for investment-related loans remained forthcoming. Despite softer loan growth among non-SMEs, fund-raising activities in the corporate bond market remained broadly sustained with RM90 billion of issuances (2022: RM120 billion[34]) recorded throughout 2023 amid favourable conditions as reflected by narrowing bond spreads, in particular, for high quality issuers.

Overall, credit conditions remained supportive of the financing needs of households and businesses. This was underpinned by forthcoming credit supply with stable loan approval rates while banking institutions continued to adopt prudent lending standards. More broadly, financing support in the form of BNM's targeted funds for SMEs, credit guarantees, debt restructuring and advisory arrangements remained available to ensure continuous flow of credit to the economy.

[34] Excluding a single large issuance in the construction sector in December 2022, gross corporate bond issuances would have amounted to RM95 billion in 2022, comparable to RM90 billion in 2023.

Underlying Inflation at its Core

Introduction

Headline inflation may not always reflect the underlying path of prices in the domestic economy. This is because the CPI basket includes items which may experience temporary price volatility due to short-lived shocks such as supply chain disruptions or geopolitical events. This makes it difficult to discern the underlying 'signal' of inflationary pressures using headline inflation alone.

At the same time, it is crucial for central banks to be able to monitor this underlying trend of inflation to guide monetary policy, apart from other factors. Interest rates are a blunt tool that affects the economy as a whole and cannot meaningfully influence changes in individual relative prices,[1] which reflect demand and supply conditions for specific items. As such, monetary policy primarily focuses on managing broad-based risks which affect price stability over the medium-term horizon rather than reacting to temporary price movements which affect a small subset of items. This motivates the use of underlying inflation measures to identify the more persistent trend of inflation which matters for monetary policy considerations.

This article provides an update on underlying inflation measurements used by Bank Negara Malaysia (BNM), as previously detailed in the 2008 BNM Annual Report box article '*Core Inflation: Measurements and Evaluation*'. The article explains how underlying inflation plays a critical role in guiding monetary policy. It delves into how underlying inflation is disentangled from temporary price shocks by analysing various estimation methods, as well as the importance of having a nuanced reading of the data so that monetary policy is appropriately calibrated in line with medium-term price stability.

What is underlying inflation and how is it measured by central banks?

Conceptually, underlying inflation cannot be directly observed and must be estimated by filtering out the transitory and idiosyncratic elements from headline CPI inflation.

There are various methods of estimating underlying inflation, which can be grouped into three broad categories: permanent-exclusion-based measures, statistical-exclusion-based measures and model-based measures (Banbura et.al., 2023). Generally, all these measures aim to remove short-term volatile CPI components to reveal the underlying trend in the general price level, which corresponds to macroeconomic factors, such as excess demand or tightness in the labour market. Such factors can generate more widespread and persistent inflationary pressure (Banbura et.al., 2023). These are the price conditions that are most responsive to changes in interest rates.

[1] Relative price movements reflect the price changes of individual items or segments in the CPI basket, which may be driven by idiosyncratic factors rather than reflecting broader trends affecting the general price level.

Table 1: Definitions of Key Underlying Inflation Indicators Monitored by Bank Negara Malaysia

Estimation method	Measure	Definition
Permanent-exclusion-based measures	CPI excluding fresh food and energy; CPI excluding fresh food and price-administered items	Excludes items which are known to be more volatile in nature, or where price movements typically reflect temporary, item-specific factors.
Statistical-exclusion-based measures	Trimmed mean	Excludes items with the highest and lowest annual change each month (e.g. top and bottom 15% of the weighted distribution of annual CPI price changes).[1] The excluded items can change over time.
	Weighted median	Retains the item located at the mid-point of the weighted distribution[1] of annual CPI price changes each month.
	Double weighted	Assigns a lower weight to highly volatile CPI items and more weight to items that are less volatile.
Model-based measures	Common inflation	Captures the 'common' co-movement of the prices of goods and services across the CPI basket.
	Supercore inflation	Weighted aggregated index of CPI items with statistically significant relationship to economic slack,[2] as measured by the output gap.

[1] Under the trimmed mean method, 125 CPI items are arranged in ascending or descending order based on their weighted annual CPI change. The trimmed mean measure then excludes the items within the top or bottom 15% tails of this distribution. Similarly, the weighted median measure retains the item at the mid-point of this distribution.
[2] Refers to the amount of resources in the economy that are not being utilised, such as idle capital inputs or unemployed persons, due to insufficient demand relative to what the economy is capable of producing (Source: ECB).

Source: European Central Bank (ECB) Economic Bulletin Issue 4/2018 and Bank Negara Malaysia

In the official compilation by the Department of Statistics, Malaysia (DOSM), core inflation is measured as a permanent-exclusion-based measure of CPI. It permanently excludes specific CPI categories such as fresh food and price-administered items.[2] Similarly, for our published forecast of core inflation, BNM uses the permanent-exclusion-based measure.[3] Statistical authorities typically favour publishing permanent-exclusion-based measures of underlying inflation as they are relatively easy to compute and understandable by the public. However, it should be noted that there is no singular best measure of underlying inflation. Each method has its own set of strengths and weaknesses. Analysing the various measures holistically can reveal different features of the underlying price trends, allowing for a more nuanced picture of the inflationary environment at hand.

What can the various measures tell us about underlying inflation dynamics in Malaysia?

Permanent-exclusion-based measures exclude a certain fixed set of items where prices tend to be more volatile and idiosyncratic, such as energy or fresh food. By doing so, these measures are meant to capture the more persistent trend in inflation. However, as the choice of excluded items is fixed, it is still susceptible to idiosyncratic trends in the retained CPI items, particularly those with large weights. For example, food-related items[4] make up close to 30% of the core CPI basket. Their prices are influenced by factors such as global commodity prices and weather conditions. During times when the prices of these items diverge from broader core CPI prices, this could distort the signal of underlying inflation.

Additionally, while most countries compile some measure of core inflation based on permanent-exclusion-based methods, the exact choice of excluded items may differ across countries. This affects cross-country comparability.

[2] These include price-controlled food, alcoholic beverages and tobacco, utilities and energy, and transport services. In total, core CPI items have a weight of 73.7% of the overall CPI basket with the excluded components taking up a 26.3% weight. (Source: DOSM CPI Monthly Report, page 126). From January 2024, DOSM CPI data has been updated with new consumption weights based on Household Expenditure Survey (HES) 2022 and classifications based on Classification of Individual Consumption According to Purpose (COICOP) 2024. The analysis in this article are based on the previous conventions used from 2018-23.
[3] BNM's official economic forecasts are typically communicated during the release of its Economic and Monetary Report in March of each year, though the projections are periodically updated during the year.
[4] This includes food away from home, selected food at home, non-alcoholic beverages and expenditure in restaurants and cafes. Together, these categories make up a combined weight of 29.2% of the core CPI basket.

Table 2: Choice of Items Excluded from Headline CPI Basket to Form Core CPI Basket

Countries	Excluded items
US (Core CPI)	• Food – food at home, food away from home • Energy – energy commodities, energy services
UK (Core CPI)	• Food • Energy • Alcohol and tobacco
EU (Core HICP)	• Energy • Food • Alcohol and tobacco
Japan (Core CPI)	• Fresh food
Philippines (Core CPI)	• Food • Energy-related items
Malaysia (Core CPI)	• Fresh food • Price-administered items
Indonesia (Core CPI)	• Volatile food • Price-administered items
Singapore (Core CPI)	• Accommodation • Private road transport
Thailand (Core CPI)	• Fresh/raw food • Energy

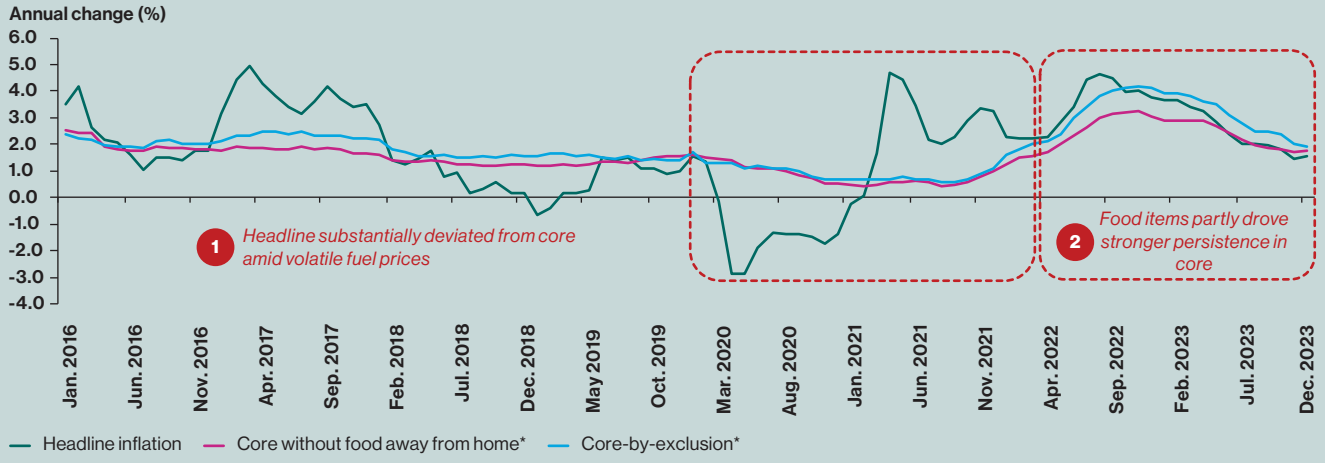
Source: Central bank websites and national statistical agencies

Case Study 1: Malaysia's experience through the COVID-19 pandemic (2020–23)

Permanent-exclusion-based measures (henceforth referred to as 'core-by-exclusion') are able to isolate items that are well known to be volatile outliers within the CPI basket. Fuel is a clear example of this.

- From Chart 1, there was a large divergence between headline and core inflation when global oil prices fell sharply and subsequently recovered in 2021. While core-by-exclusion remained relatively stable, headline inflation surged largely due to fuel inflation. This was driven by short-term shocks to crude oil prices, which were highly volatile due to uncertainties arising from global movement restriction measures during the pandemic.

Chart 1: Headline and Core Inflation



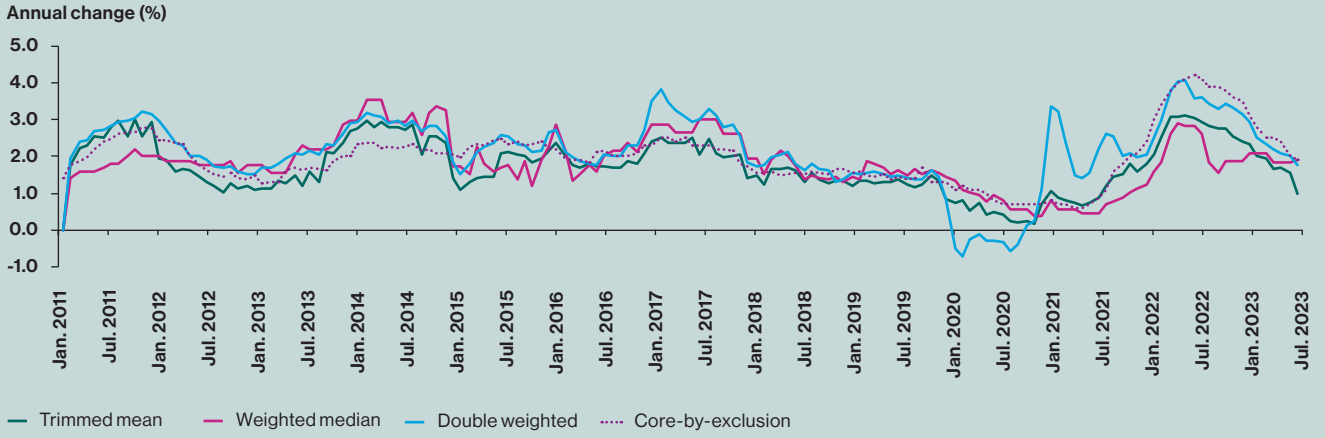
*Excludes the estimated direct impact of tax policy changes.

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

- However, core-by-exclusion remains heavily influenced by movements in individual CPI categories such as food[5] – which may in turn be largely driven by idiosyncratic supply factors. This may obscure the underlying price trend. When food away from home is filtered out, we can see that it contributed around 0.6ppt to 1ppt to core inflation from June 2022 to October 2023 (Chart 1: Core by exclusion vs Core without food away). This indicates that the outlook for core-by-exclusion is highly sensitive to movements in food prices (particularly food away from home), despite fresh food and administered food items being excluded. This also suggests that some idiosyncratic shocks which spur large movements in food prices would also distort core-by-exclusion. Going forward, the planned rationalisation of subsidies and price controls on food items could potentially exert material cost-push pressure to core CPI inflation.

Statistical-exclusion-based measures (Chart 2) remove price-volatile outliers on a time-varying basis. For example, trimmed mean inflation simply excludes the top and bottom 15% of price movements[6] in the CPI basket during a given period in its aggregation of inflation. This can be advantageous as it is agnostic on the exact components that are excluded every month, but consistent on the treatment of outliers (i.e. always the tails of distribution). Measures like trimmed mean and weighted median can offer more precise estimations of underlying inflation during periods with significant outliers. This is because they rely on rule-based criteria rather than discretion-based choices in the exclusion of CPI items.

Chart 2: Core Inflation (Permanent-Exclusion-Based Measure) and Statistical-Exclusion-Based Measures of Underlying Inflation



Note: All the measures exclude the estimated direct impact of tax policy changes.

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

Unlike permanent-exclusion-based measures, statistical-exclusion-based measures can identify and omit isolated price fluctuations in typically stable items. For example, motorcars are a typically stable component within the core CPI basket, but experienced a negative idiosyncratic price movement in June 2020 (month-on-month change: -1.5%) following the implementation of tax exemptions on motor vehicles. This was omitted in statistical-exclusion-based measures but not in permanent-exclusion-based core inflation.

However, to its disadvantage, it is difficult to effectively communicate trends in statistical-exclusion-based core inflation to the public. Namely, the changing set of excluded items from one period to another could pose interpretation challenges, as they may not provide a consistent explanation for the drivers of relative price movements.

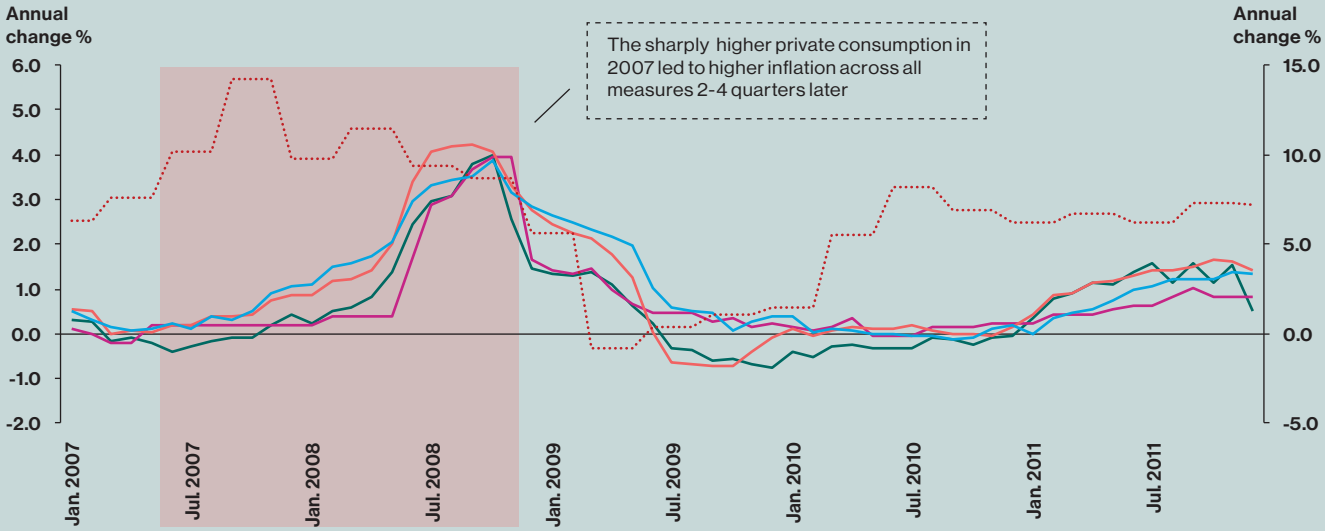
[5] Includes items such as food away from home, rice, bread and bakery products, milk and biscuits.
[6] Items at the tails are deemed to have higher volatility and are outliers as compared to the price movements of the majority of items.

Case study 2: Comparing Malaysia's experiences during the global financial crisis (2007–11) and COVID-19 (2019–23)

Comparing the three statistical-exclusion-based measures in the period around the global financial crisis (2007–11) and the COVID-19 period (2019–23), it can be observed that their movements typically show similar trends but at times deviate from permanent-exclusion-based core inflation. Contrasting these measures may provide us with a more nuanced understanding about the underlying inflation dynamics at play.

- For the global financial crisis (GFC) period (Chart 3), underlying inflation as measured by core-by-exclusion and all three statistical-exclusion-based measures showed similar trends. An increase in the first half of 2008 can be seen across all measures, following the strong demand pressures mainly from high real private consumption growth and exacerbated by the knock-on effects from fuel price shocks. This signals that demand pressures generated broad-based impetus to underlying inflation. Thereafter, all the measures declined in line with the sharp contraction in demand amid the global financial crisis, and to some extent, the reversal of the high energy prices. These dynamics reflect that the inflationary pressure was broad-based, and the underlying factor (i.e. excess demand coinciding with high costs) affected all CPI items, a trend captured by both statistical-exclusion-based and core-by-exclusion measures.

Chart 3: GFC period: Inflation Deviation from 5-year Average (2003–07)



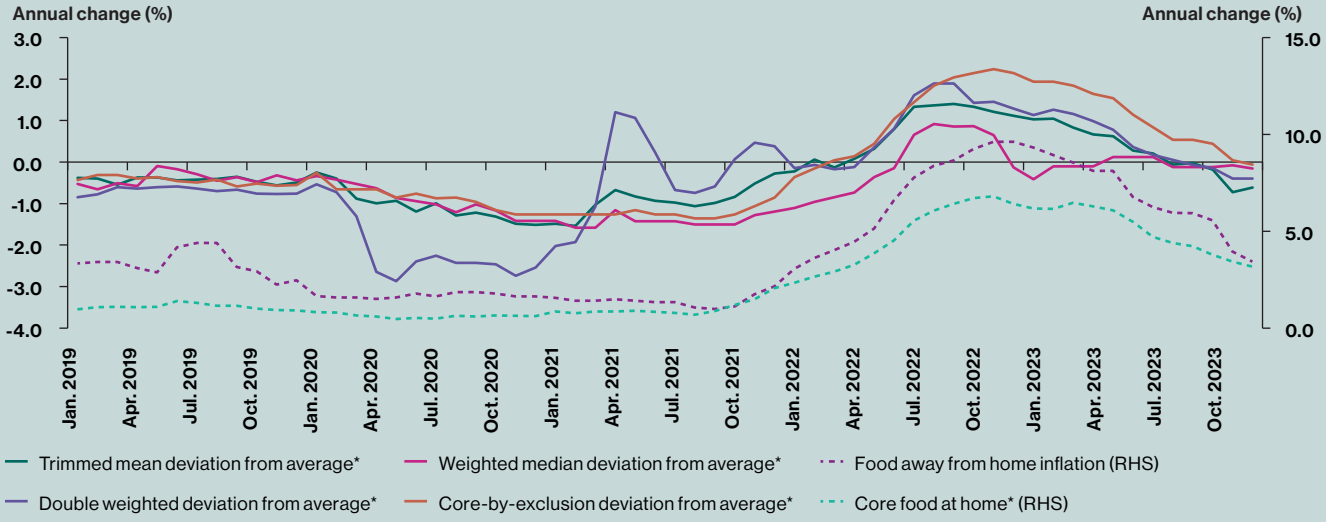
* Excludes the estimated direct impact of tax policy changes.

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

In contrast, in 2022–23 (Chart 4), core-by-exclusion and statistical-exclusion-based measures showed diverging trends. As explained earlier, the higher and more persistent trend of core-by-exclusion partly reflected the large weight of food-related items, which experienced more durable price pressure compared to the rest of the CPI basket. As some of these movements are outliers to the overall CPI basket, they are excluded by the three statistical-exclusion-based measures. As a result, the underlying inflation based on these statistical-exclusion-based measures returned to average levels more swiftly than the more conventional core-by-exclusion. This is in line with lower pervasiveness[7] of CPI inflation in 2023, which eased to long-term average levels in the first half of 2023 (Chart 5).

[7] Based on the month-on-month price changes for 125 CPI items at the 4-digit level.

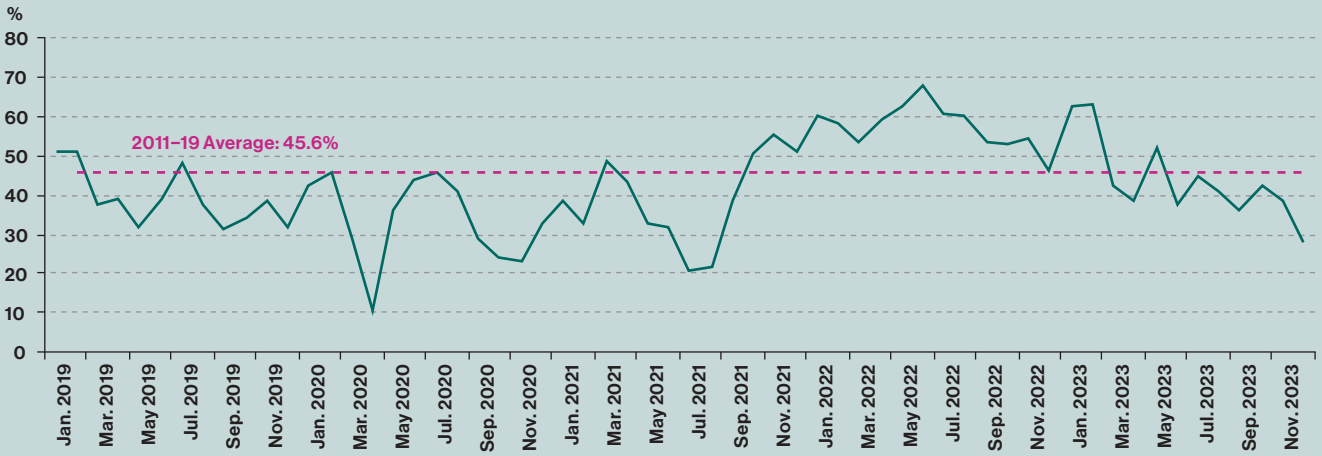
Chart 4: COVID-19 Period: Inflation Deviation from 5-year Average (2015–19)



* Excludes the estimated direct impact of tax policy changes.

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

Chart 5: Inflation Pervasiveness: Share of CPI Items Recording Monthly Price Increase



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

Model-based measures utilise relationships from economic theory to capture the persistent aspect of inflation more rigorously. These measures use empirical techniques to filter out the transitory component and isolate certain desired features of underlying inflation. In some cases, they aim to more precisely reflect the co-movement of prices or dynamics driven by business cycle developments.

Two notable model-based measures are common inflation and supercore inflation.

Common inflation uses a data-driven approach to isolate the shared trend that drives co-movement in CPI prices, while excluding the impact of sector-specific disturbances. Similar to the other measures, this is another way of capturing the broad price changes driven by macroeconomic factors, such as the strength of the economy or broad-based cost shocks[8]. This method effectively filters out an idiosyncratic component driven by item-specific outliers to the broader inflation trend and provides a clearer signal of the general trend in CPI inflation to inform monetary policy.

(For more details refer to the Second Quarter of 2023 BNM Quarterly Bulletin box article '*Understanding Inflation Drivers: Differentiating Common and Idiosyncratic Dynamics in Malaysia*').

- **Methodology**: A dynamic factor model[9] is used to estimate the common component from the individual inflation rates of 125 disaggregated CPI items.[10] Each inflation series is separated into a common and an idiosyncratic component, which is then aggregated, forming the common inflation[11] and idiosyncratic inflation series.

Case study 3: Malaysia's experience with common and idiosyncratic inflation (2011–23)

Observable increases in common inflation often coincide with periods of strong real economic growth and pronounced cost pressures, as seen in 2011 and 2022. This observation underscores the close relationship between common inflation and economy-wide factors, with the sensitivity of common inflation especially heightened during shifts in aggregate demand conditions. The recent rise in headline inflation following the recovery from the COVID-19 pandemic was primarily driven by the common component, which contrasted with historical instances where fluctuations in headline inflation were mainly fuelled by idiosyncratic shocks (Chart 6). In 2022, the increase was driven by the combination of global cost factors and the rebound in domestic demand, as the country eased containment measures. This affected a broader range of consumer prices, resulting in a swift uptick in common inflation.

Although common inflation captures broad-based price shocks, it is unable to isolate whether the shocks are driven by cost factors or cyclical demand conditions – given that it is constructed based on co-movements in CPI prices regardless of the source of price shocks.

Supercore inflation,[12] like the permanent-exclusion-based core inflation measures, excludes components where price movements have a lesser bearing on monetary policy. Notably, it draws an explicit link to macroeconomic conditions by constructing a narrower core-by-exclusion index which only retains CPI items which exhibit a significant relationship with economic slack. This allows the measure to more effectively gauge the strength of demand pressure on inflation.

- **Methodology**:[13] Based on a linear regression of disaggregated CPI items, we retain items that exhibit a statistically significant coefficient of the output gap, after controlling for other cost factors. Overall, around half of the core CPI basket, by weight, are sensitive to the output gap. These items are mainly services such as food away from home and rental.

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8 This differs from typical supply shocks which are transient and affect a smaller subset of prices. In particular, it refers to episodes whereby cost shocks induce higher input prices across a wide variety of consumer items. For example, the multiple cost shocks in 2022, arising from global value chain disruptions, higher commodity prices and exchange rate pressures affected a large proportion of items across the CPI basket.

9 Following Nir et al. (2021), a dynamic factor model is used to estimate the common component based on 125 monthly ex-tax inflation series from January 1991 to June 2023.

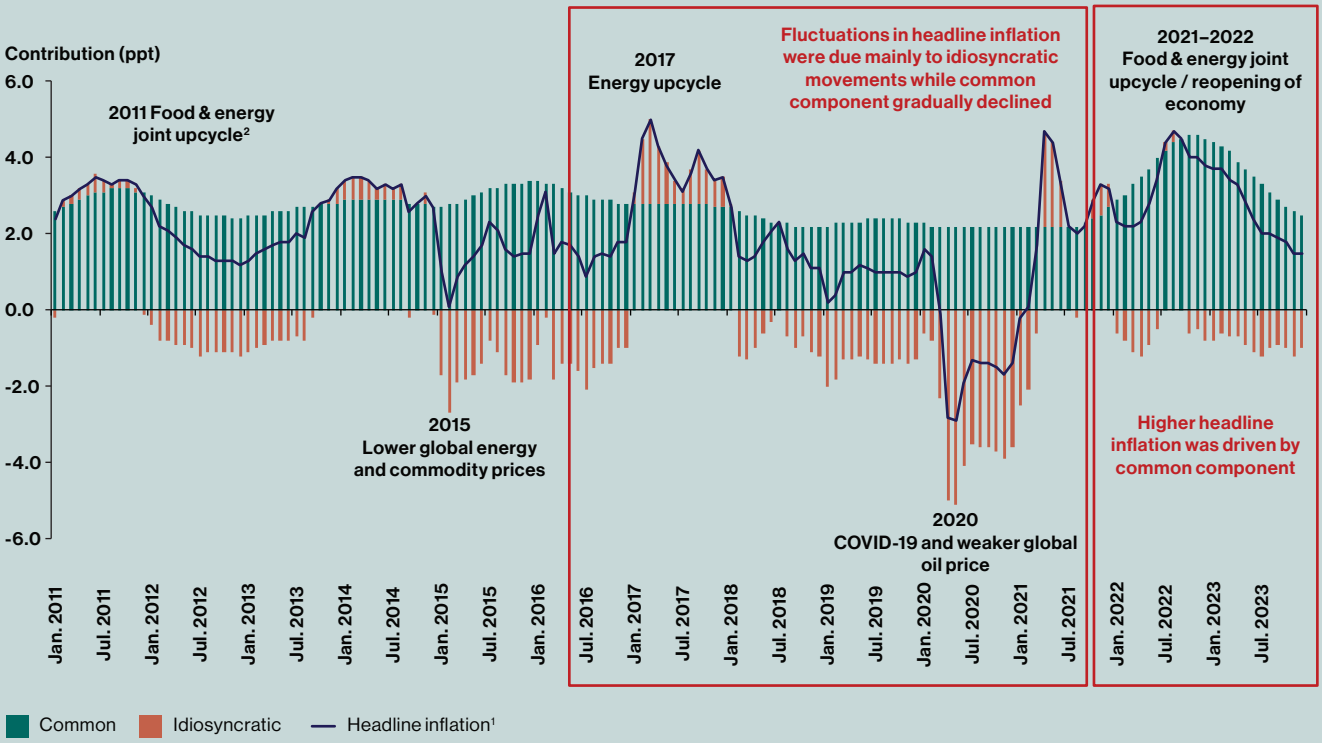
10 At the four-digit level of granularity, as published by Department of Statistics, Malaysia. The inflation of each individual item has been adjusted to exclude the direct impact of one-off changes in consumption tax policies (GST and SST) in 2015 and 2018.

11 Common inflation is formally defined and calculated as the predicted series obtained from a simple linear regression of the monthly ex-tax headline inflation on an intercept and the common component derived from the dynamic factor model of CPI items.

12 The concept of supercore inflation originated from the ECB, as published in a box article in ECB Economic Bulletin 2018.

13 While similar in concept, BNM's measure of supercore inflation differs in methodology from the ECB, which included items based on comparing the forecast error in a model containing output gap against a univariate autoregressive model.

Chart 6: Decomposition of Headline Inflation[1] by Common and Idiosyncratic Factors



[1] Headline inflation is adjusted to remove the changes in consumption tax policies (GST and SST) in 2015 and 2018.
[2] Upcycle refers to periods when global food and/or energy commodities exhibited year-on-year movements higher than the standard deviation. Global food and energy commodities data are from World Bank Commodity Price Data (The Pink Sheet).

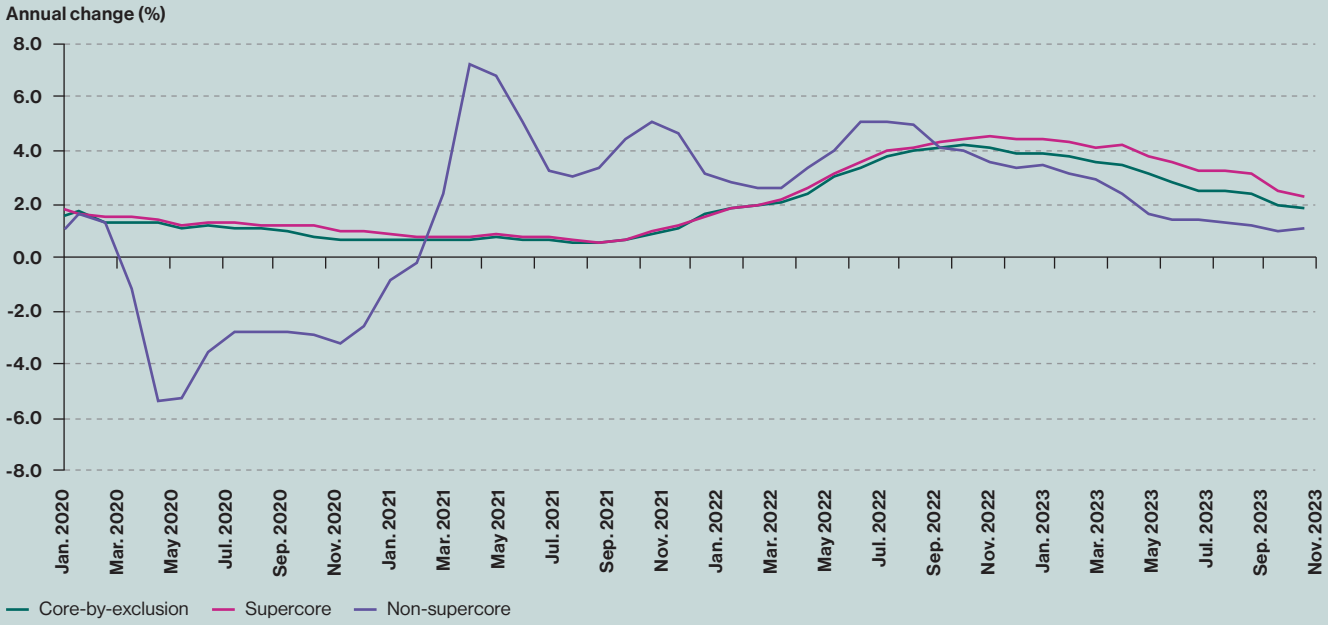
Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

Case study 4: Malaysia's experience following the post-pandemic reopening (2022–23)

Supercore inflation trended higher in 2021 driven by the rebound in demand pressures following the post-pandemic reopening of the economy.[14] Domestic spending was further lifted by Government stimulus measures and Employees Provident Fund (EPF) special withdrawals. After peaking in February 2023, supercore inflation then showed a slower moderation compared to core-by-exclusion which began to ease after its peak in November 2022 (Chart 7). This trend indicates that the persistence of underlying inflation was partly driven by continued demand pressures in the economy, despite the downward pressure from easing global cost conditions which is reflected to a greater degree in the core-by-exclusion measure.

[14] For more discussion on the rebound in demand pressures post-pandemic, please refer to the 2021 BNM Economic and Monetary Review box article 'An Anatomy of Inflation: Effects from the Prolonged Pandemic'.

Chart 7: Supercore and Core-by-Exclusion Inflation



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

How did monetary policy respond to the signals from various underlying inflation measures?

Combining insights from the various measures of underlying inflation, we can see that robust domestic demand conditions, together with higher costs, played a role in driving higher inflation between 2022 and the first half of 2023. In particular, an uptrend was seen across all of the underlying inflation measures, as presented above, following the post-pandemic reopening of the economy. Moreover, this trend was seen across the CPI basket, rather than affecting just a small subset of items. This dynamic partly reflected the considerations faced by the Monetary Policy Committee (MPC). As the Malaysian economy was on a firmer footing following the COVID-19 crisis, the MPC gradually increased the Overnight Policy Rate (OPR) through five 25-basis point adjustments since May 2022, bringing the OPR to 3.00% in May 2023 from a historical low of 1.75% in 2020. The higher OPR helped to pre-emptively contain the risk of more excessive demand-driven price pressures amid the firm domestic economic recovery.

Since the second half of 2023, the underlying inflation measures had steadily declined, partly reflecting the disinflationary forces at play in line with global experiences, as well as the effect of the OPR adjustments. At the prevailing OPR level, the monetary policy stance was assessed to be consistent with the objective of sustainable economic growth amid price stability.

Conclusion

Measures of underlying inflation offer richer and more diverse perspectives that contribute to a greater understanding of price dynamics in Malaysia. Although the measures may diverge, investigating the reasons for deviations can reveal additional insights into the nature of price dynamics at hand. Coupled with deeper evaluations of broader macroeconomic conditions, this approach allows for a clearer signal of underlying inflation.

It becomes especially crucial to monitor underlying inflation during periods marked by significant and temporary fluctuations in highly volatile components, such as energy and food prices. This helps to gauge the broad direction of inflation in the medium-term. For monetary policy, underlying inflation measures ensure that central banks respond to signals of sustained shifts in the general price level, rather than temporary supply shocks. This ensures that monetary policy is calibrated in an appropriate and timely manner such that price stability in the medium-term horizon is achieved without placing undue pressure on economic activity.

Moving forward, the phased rationalisation of subsidies and price controls by the Government would lead to higher relative prices for selected CPI items, such as energy and food. In view of its price stability objective, the Monetary Policy Committee (MPC) will continually assess the risks of the resulting price pressures becoming more persistent or broad-based. In doing so, continuous evaluation of underlying inflation, using the above methods, would help us to identify the extent of inflationary pressures across the broader CPI basket. This would aid in MPC's assessment of the medium-term outlook for inflation.

Importantly, the impact on domestic inflation will depend on the timing and magnitude of the subsidy rationalisation. This would also be influenced by the accompanying mitigating measures, such as the proposed targeted diesel subsidies to key business segments and disbursement of cash transfers, which are essential to alleviate the impact of higher cost of living to Malaysian households.

As the year progresses, the MPC will rigorously assess the inflation outlook and its implications to the appropriate stance of monetary policy to maintain price stability. In doing so, the various measures of underlying inflation, along with continuous on-the-ground surveillance, will serve as good aids in discerning the direction of general price dynamics going forward.

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Navigating Economic Cycles: Interactions between Monetary and Fiscal Policy

Introduction

The impact of the COVID-19 pandemic was unlike any of the economic shocks experienced before. Many countries imposed strict lockdowns in dealing with the pandemic, which directly impacted incomes and growth. In response, central banks and fiscal authorities swiftly adopted expansionary monetary and fiscal policies. In some countries, the scale of policy stimulus reached unprecedented levels. Central banks reduced policy rates, many to record lows, causing the global median to fall from 1.5% in 2019 to 0.1% in 2021. Governments embarked on massive spending and transfers programmes, widening fiscal deficits from a global median of -0.9% of GDP to -5.1% of GDP during the same period (BIS, 2023). These resulted in an increase in public debt[1] while monetary policy approached its effective lower bound. Some countries, particularly advanced economies, resorted to unconventional policy measures such as quantitative easing and funding-for-lending schemes to further support the economic recovery.

While the synchronised policy action cushioned the economic downturn and facilitated recovery, the subsequent policy normalisation amidst high inflation faced challenges against an environment of uneven economic recovery and public pushback of policy tightening. By end-2022, most central banks in emerging market economies had normalised their policy rates back to pre-crisis levels. However, economies facing higher and more persistent inflation resorted to more aggressive rate hikes.[2] Particularly for advanced economies, this was mostly attributed to the strong consumption activity due to the accumulation of excess savings during the pandemic, bolstered by sizeable fiscal support (BIS, 2023). [3] The task to unwind pandemic-related support also faced challenges from the simultaneous rise in global energy and food prices. For example, the high prices of global commodities warranted targeted support to vulnerable segments particularly those still severely affected by the aftermath of the pandemic crisis,[4] resulting in further increase to the already historically high public debt (IMF, 2022).

The interactions between monetary and fiscal policy are complex given its mutual influence and impact, particularly on inflation, debt and economic growth. The COVID-19 pandemic has shed light on the importance of policy coherence without compromising respective policy objectives and mandates. This article dissects the roles of cyclical macroeconomic policies, namely monetary and fiscal policy: their similarities and differences, synergies and risks in their interactions, as well as implications for structural and financial stability policies. It also draws on Malaysia's experience and concludes with key takeaways in navigating the interactions between the two policies moving forward.

The synergies from monetary and fiscal policy interactions

Policymakers adopt different policies to achieve various macroeconomic objectives such as structural[5] and macroeconomic policies. This article focuses solely on the latter, namely monetary and fiscal policy. While monetary policy has limited impact on long-run growth, the same cannot be said about fiscal policy, as tax and government expenditure can have impact on potential growth.[6] Nevertheless, these policies can be particularly effective at managing short-run macroeconomic fluctuations when deployed in a counter-cyclical manner (Diagram 1). Thus, it is critical to have a coherent conduct of monetary and fiscal policy to avoid the costly damages from sharp boom-bust cycles.

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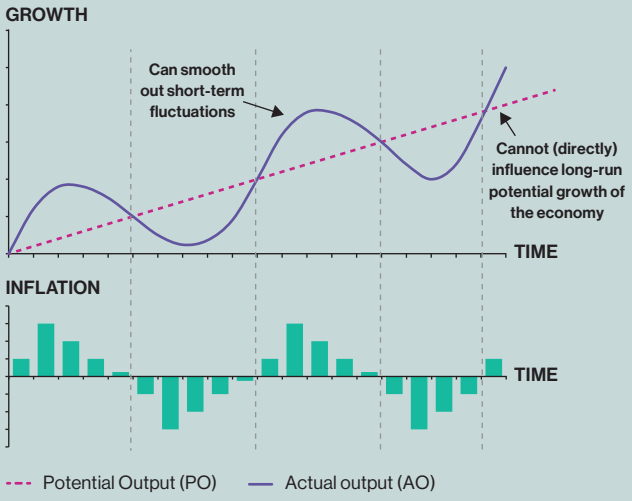
1 Global public debt has risen from 84.9% of GDP in 2019 to 92.4% of GDP in 2022 (IMF Global Debt Monitor 2023).
2 This includes advanced economies such as the US and EU, as well as emerging market economies in Latin America.
3 On top of excess demand, supply-related factors such as supply chain disruptions, logistical bottlenecks and labour shortages contributed to inflationary pressures. The conflict in Ukraine further worsened supply conditions by causing higher energy prices and affecting key industries such as utilities and transportation (WEF, 2022).
4 Over 700 measures were implemented related to revenue (e.g. reduction in excise rate) and expenditure (e.g. subsidies & cash transfers), below-the-line measures (e.g. loans or guarantees to state-owned energy companies) and non-fiscal measures (e.g. export bans) (IMF, 2022b).
5 Structural policies such as industrial, education, and labour policies are deployed to meet longer-term objectives such as increasing the potential output of the economy.
6 While tax and government spending measures can have long-term impact by incentivising or disincentivising certain activities or sectors, this article focuses solely on their short-term counter-cyclical application.

Diagram 1: Role of Monetary and Fiscal Policy



Source: Adapted from Erokhin et al. (2023)

- **Monetary policy:** Broadly, monetary policy tools can be categorised as either conventional or unconventional. Conventional tools such as changes in policy rates (e.g. the Overnight Policy Rate (OPR) in Malaysia) work by influencing the short-term interest rate, based on the outlook and balance of risks to growth and inflation. Beyond that, a set of unconventional tools such as large-scale asset purchase programmes (e.g. quantitative easing, QE) have also been adopted elsewhere. This is more prevalent in some advanced economies which have exhausted the space to deploy conventional tools and face issues surrounding the effective or zero lower bound[7] (BNM, 2021). This involves large-scale purchases of financial assets to lower yields on long-term government bonds and other interest rates (also known as 'flattening the yield curve'), thereby reducing borrowing costs for households and corporates (Bank of England, 2022).

- **Fiscal policy:** Plays a counter-cyclical role via 'automatic stabilisers' and 'discretionary spending'. Automatic stabiliser is a fiscal feature embedded in the design of taxation and expenditure policies. For example, governments would collect less tax (due to lower household and business incomes) and spend more (due to increase in social security claims) during economic downturns. Beyond automatic stabilisers, governments can also influence aggregate demand by using 'discretionary' spending, which can be either procyclical or counter-cyclical in orientation. In counter-cyclical use, government can increase discretionary spending during recessions or reduce them during economic booms (van den Noord, 2000). Examples include measures such as cash handouts, wage subsidies and tax incentives and reliefs to mitigate economic scarring during recession.

In performing their counter-cyclical roles, monetary and fiscal policies interact in two important ways, with various implications:

- **Transmission channels:** Fiscal policy actions can affect monetary policy transmission through government debt issuances to finance fiscal deficits. More specifically, excessive government bond issuances can create distortions in financial markets by driving up yields. This could cause mispricing of other financial assets due the higher returns on this 'risk-free' asset, potentially triggering capital reallocation away from riskier assets. Additionally, the higher yield environment would result in interest rates being higher than levels warranted by the prevailing economic condition. Alternatively, excessive government bond issuances could cause yields to rise on riskier assets, making it expensive for the private sector to seek financing. This is called the crowding-out effect.[8] Conversely, monetary policy could

[7] The effective lower bound is characterised by a point below which policy rate cuts would result in net negative effects to the economy, with commonly cited symptoms including a contraction in lending and economic activity (Brunnermeier and Koby, 2019).

[8] In certain circumstances, where there is a loss of confidence in the fiscal authorities, interest rates could spike up and trigger sell-offs in the financial markets leading to increased volatility.

have an impact on public finances in several ways. Changes in the central bank's policy rate affect yields on new government borrowing, impacting borrowing and debt servicing costs to fiscal authorities (BIS, 2023). Secondly, it can induce larger fiscal multiplier effects, when operating at the effective lower bound (ECB, 2021).[9] The two policies are further intertwined through interlocking balance sheets arising from normal central bank open market operations (namely the purchase of government bonds in the secondary market) and remittances of profits from the central bank's operations (BIS, 2023).

- **Growth and inflation outcomes:** Contingent upon underlying causes and initial conditions, impact to growth or inflation induced by one policy may require a recalibration of policy stance by the other. In a scenario of high inflation and low growth, excessive fiscal expansion could necessitate a more restrictive monetary policy response to curb inflation, potentially negating the intended impact of fiscal policy to growth. Conversely, higher inflation induced by loose monetary policy can positively affect fiscal balances by boosting tax revenue and enlarging fiscal policy space by reducing the value of government debt (Amaglobeli et al., 2023). In the broader experience of advanced economies, progressive government spending and redistributive policies can reverse the decline in the natural interest rate,[10] thereby increasing monetary policy space for central banks constrained by the effective lower bound.[11]

Table 1: Stylised Facts on Monetary and Fiscal Policy

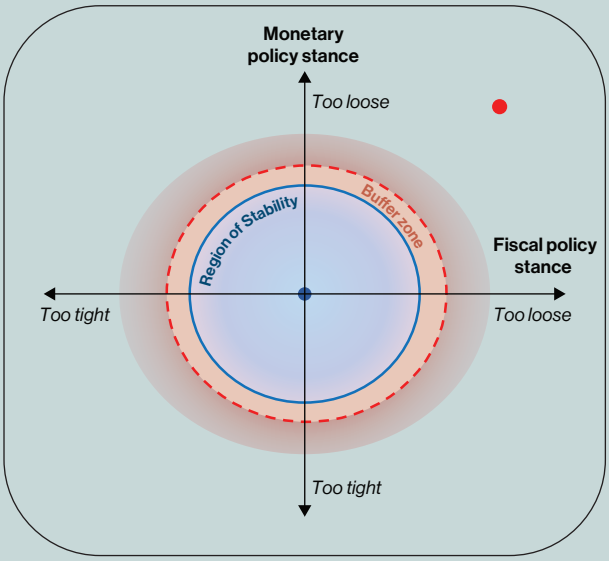
	MONETARY POLICY	DISCRETIONARY FISCAL POLICY[12]
Definition	Involves the use of policy instruments (e.g. interest rates, liquidity operations, etc) by central banks to manage inflation and support economic activity (e.g. growth or employment)	Refers to the use of government spending, taxation, and borrowing to influence the level of aggregate demand, promote growth, and meet various socioeconomic objectives
	SIMILARITIES	
Orientation	Counter-cyclical tools impacting aggregate demand	
Time-horizon	Focused on short-run impact with a timeframe of 12–36 months, although fiscal multiplier impact can persist much longer[13]	
Distributional effect	Pervasive distributional effect on income and wealth; Fiscal policy can transfer resources between sectors and segments while monetary policy can transfer resources between savers and borrowers	
	DIFFERENCES	
Objectives	To control inflation and/or growth by influencing aggregate demand	Influencing aggregate demand and ensuring stability in aggregate supply towards achieving macroeconomic goals (e.g. sustainable growth, employment and price stability)
Transmission mechanism	Occurs through channels of interest rates, asset prices, credit, exchange rate and expectations	Occurs through channels of consumption and investment
Impact	Generally, a blunt tool with broad-based impact	Can be both broad-based or targeted to specific sectors or segments

Source: Staff compilation from Dong, Wei et al (2021), Hopper (2018) & Kopcke et al (2006)

[9] At the lower bound, higher government spending increases expected inflation which subsequently lowers real interest rates. This boosts private spending thereby causing a larger multiplier effect (Christiano et al, 2011).
[10] Refers to the level of interest rate that neither stimulates nor restrains economic growth. The decline in the natural interest rate, attributed to global savings glut (Bernanke, 2005), suggests that policies aimed at reducing aggregate savings could unlock higher aggregate demand and, consequently, facilitate a rise in natural interest rates through inflationary pressures (Michau, 2020).
[11] This occurs via automatic stabilisers and progressive taxation which provide better protection against aggregate or idiosyncratic shocks to economic agents, thereby reducing the need for precautionary savings. Consequently, the fall in supply of total savings will increase the natural rate of interest (ECB, 2021).
[12] Of note, different types of fiscal policies can impact both aggregate demand and supply. However, macroeconomic stabilisation primarily relates to its influence on aggregate demand. Fiscal policies with objectives beyond short-run macroeconomic stabilisation are referred to as structural reforms.
[13] Fiscal multiplier impact can persist up to several years based on state-contingencies (e.g. economic cycle and liquidity constraints) and type of instruments (e.g. revenue and spending measures) (Office for Budget Responsibility, 2013).

The interactions between monetary and fiscal policy create challenges in navigating the policy landscape for both central banks and governments. In the context of policy analysis, the so-called 'Region of Stability (ROS)' provides a framework to understand how different macroeconomic policies affect one another and how the interplay between the two policies could pose risks to the economy (BIS, 2023). Of critical emphasis, ROS is defined by its boundaries, whereby macroeconomic stability is at risk should monetary and fiscal policy operate outside of it (Diagram 2). These boundaries evolve, influenced by factors such as structural changes to the economy (e.g. ageing population) which can shift those boundaries, and cumulative policy choices (e.g. persistently high fiscal deficits) which further stress them. Similarly, prolonged periods of low interest rates could also create financial imbalances and encourage excessive leverage in the economy. Hence, risks from policy interactions may arise, compromising the ability to achieve respective objectives and threatening overall macroeconomic stability. This underscores the need for vigilance in policymaking and a steadfast approach in building adequate policy buffers. Importantly, it emphasises that monetary and fiscal policy cannot be operated in a vacuum, necessitating effective management of the interactions to ensure optimal outcomes.

Diagram 2: Monetary-Fiscal Interactions and Implications Towards the Macroeconomy



● **Operating within the Region of Stability:** A mix of monetary and fiscal policy that is consistent with macroeconomic stability

● **Operating outside the Region of Stability:** Characterised by poorly calibrated policies against prevailing macroeconomic conditions resulting in adverse implications towards financial stability & structural reforms

▶ **Factors influencing the borders of the Region of Stability:**
- Macroeconomic fundamentals
- Structural reforms
- Sustainability of policy trajectory – where neither are excessively loose or tight

▶ **Buffer zone: 'Safety margins' preventing unraveling of macroeconomic stability**

Factors influencing the buffer zone:
- Macroprudential policies
- Confidence

Source: Adapted from BIS (2023)

Understanding and mitigating risks from monetary and fiscal policy interactions

The high degree of interaction between monetary and fiscal policy creates the risk of 'fiscal dominance', whereby monetary policy decisions are unduly subordinated by fiscal considerations (Agur et al., 2022), particularly via public debt vulnerabilities. Importantly, concerns of fiscal dominance can even occur subtly, without direct influence from fiscal authorities, as extremely high government debt levels pose challenges to central banks needing to raise interest rates

as it could create financial instability and harm the real economy. For instance, Heinemann and Kemper (2021) argue this to be the case with individual members of the ECB Governing Council, which includes governors of the euro area national central banks (NCB) and the ECB board members. They show that there exists a positive correlation between the dovishness[14] of each member and the indebtedness of the member states they are from.[15] Similar concerns were also raised about central banks in Japan and the United States during the pandemic due to considerations about liquidity and sovereign solvency amidst high government debt levels (Bordo and Levy, 2021).

Beyond fiscal dominance, direct interference and deficit financing by the central bank are more extreme circumstances which significantly impact the conduct of monetary policy. Direct interference entails direct political interference on monetary policy decisions, compromising central bank independence. For instance, political pressure on the Federal Reserve to maintain low interest rates throughout the mid-1960s is cited as a contributing factor of the Great Inflation (Meltzer, 2003).[16] On the other hand, direct financing of fiscal deficits by central banks can occur through direct lending to the government or direct purchases of government bonds by the central bank (i.e. debt monetisation) (Tobias et al., 2021). The outcome is a permanent and continued increase in the money supply, ultimately leading to risks of hyperinflation as observed in Zimbabwe in the early 21st century (Hooley et al, 2021).

Monetary and fiscal policy interactions can also exert implications towards financial stability. Given that monetary and fiscal policy interactions are linked via government debt issuances in financial markets, inconsistent behaviour on either policy can induce financial instability. This is highlighted by the 2022 gilt crisis in the United Kingdom. The unfunded nature of the fiscal package announced by the UK's Chancellor of the Exchequer raised concerns about rising government debt and potential inflation pressures. The subsequent market impact, particularly on UK pension funds, forced the Bank of England to temporarily reverse its balance sheet reduction programme by making temporary and targeted purchases of gilts to restore orderly financial market conditions (Leeper, 2023). This particular case illustrates the interconnectedness of different macroeconomic policies and highlights the importance of policy coherence.

Moreover, monetary and fiscal policy interactions can also affect the prospects for structural reforms. For instance, sound public finance will facilitate more effective reforms taking place as it provides budgetary room to finance mitigating measures and transition plans for those potentially disadvantaged by the reforms (IMF, 2004; Tompson, 2009). In a similar vein, combining reforms with fiscal incentives (e.g. tax cuts or credits) can facilitate or even expedite reforms by alleviating transition and social costs. However, this is conditional upon the fiscal support being targeted, time bound and tied to commitment towards other major reforms (Banerji et al, 2017).

In sum, understanding the risks arising from the interactions between monetary and fiscal policy is critical. Operating within the Region of Stability prevents over-burdening of any single policy in macro stabilisation, mitigates potential imbalances, and avoids hindering the effectiveness of either monetary or fiscal policy. The success in operating within the Region of Stability hinges on two critical factors:

- **Policy conduct:** Monetary policy must be focused on its price stability mandate in supporting other macroeconomic objectives of sustaining growth and financial stability. Fiscal policy should prioritise prudence, utilising fiscal space when needed and rebuilding buffers afterwards to ensure long-term debt sustainability. For both, the respective policy stance relative to the 'neutral' stance[17] is critical to guide its operation in effectively playing the counter-cyclical role.[18]

- **Institutional framework**: A well-defined legal framework safeguards institutional and operational independence while establishing institutional arrangements to facilitate engagement between central bank and fiscal authorities.

[14] Refers to the monetary policy preference for more accommodative or expansionary monetary policy alongside a greater tolerance of inflation, typically characterised by a general preference for lower interest rates. The findings from Heinemann & Kempel (2021) indicate that individuals from highly indebted member states tend to advocate for a more accommodative monetary policy stance.

[15] The Transmission Protection Instrument (TPI) introduced in July 2022 has been highlighted as a potential case of subtle fiscal dominance by Leeper (2023), as it allows the ECB to purchase additional sovereign bonds in response to 'unwarranted' yield increases, which could be viewed as an attempt to influence the bond yields of highly indebted euro countries. Despite never being activated, the TPI functioned as a deterrent against disorderly and unwarranted increases in sovereign spreads and ensured the effective monetary policy transmission throughout the eurozone (Schnabel, 2023).

[16] Refers to the period between 1965 and 1982 in the United States of America characterised by high inflation up to 15%.

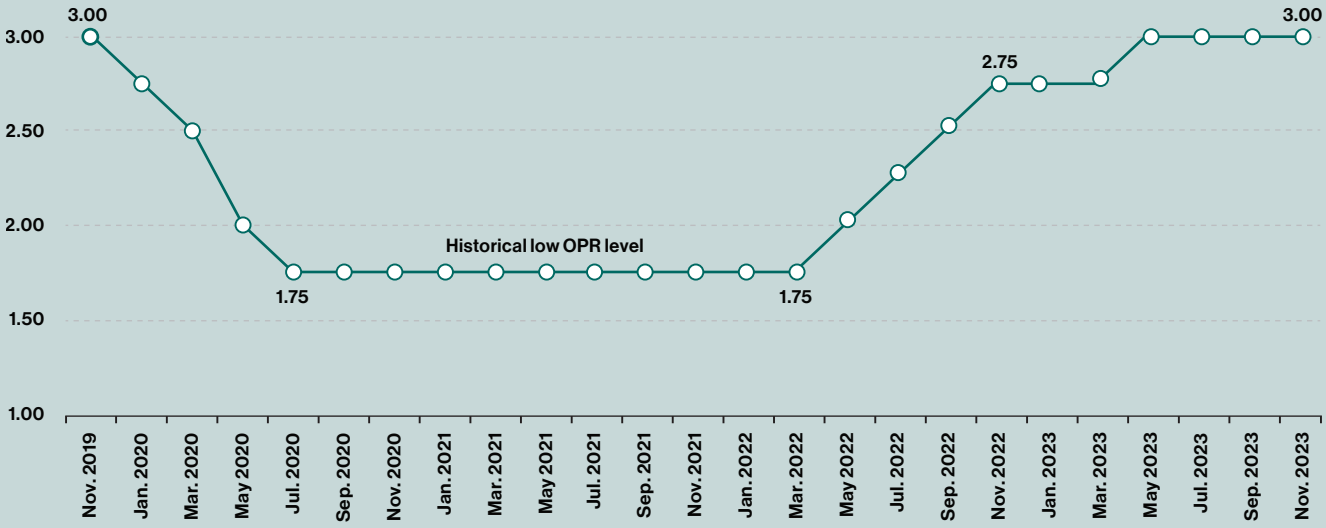
[17] Refers to a policy stance that is neither expansionary (i.e. supportive) and contractionary (i.e. dampening) to the economy.

[18] For fiscal policy, the cyclically-adjusted primary balance (i.e. fiscal balance minus cyclical components and interest payments, adjusted for the output gap) captures the use of 'discretionary' tax and spending in being expansionary or contractionary (Fedelino et al, 2009).

The Malaysian experience

The interaction between monetary and fiscal policy in Malaysia focuses primarily in the areas of macroeconomic stabilisation, debt management and economic development. The recent pandemic-induced recession presented a set of unique and unprecedented challenges to the country and provided us with a rich test case of the policy levers operating within the Region of Stability. Mirroring the global experience, Malaysia's pandemic response saw greater monetary and fiscal policy interventions, which increased the interactions between the two. At the onset, Bank Negara Malaysia (BNM) reduced the Overnight Policy Rate (OPR) by 125 basis points, from 3.00% to a historical low of 1.75% between January and July 2020 (Chart 1), to provide support for economic activity during the unprecedented economic slowdown due to the lockdown. This was supported by a suite of financial stability policies to inject liquidity, facilitate intermediation activities, and ease cash flow pressures among borrowers.[19] Likewise, the fiscal response was also sizeable and wide-ranging, encompassing eight stimulus and assistance packages totalling RM530 billion of both fiscal and non-fiscal measures.[20]

Chart 1: Overnight Policy Rate (OPR, %)



Source: Bank Negara Malaysia

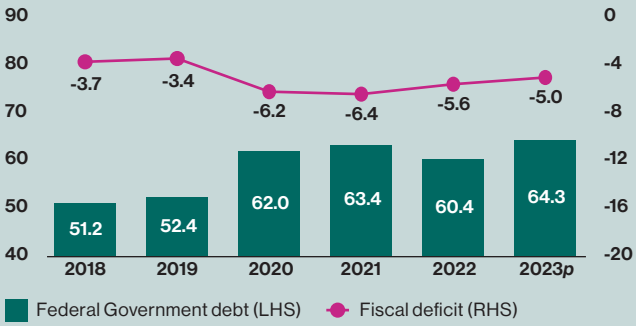
As the economy recovered, BNM's gradual and measured approach to monetary policy normalisation saw the OPR steadily raised from May 2022, returning to the pre-pandemic level of 3.00% by May 2023. Alongside that, financial stability measures shifted from broad-based towards targeted repayment assistance. In parallel, the sizeable increase in government debt from 52.4% of GDP in 2019 to 64.3% of GDP in 2023 necessitated fiscal policy to adopt a less expansionary stance. This is reflected in the gradual fiscal consolidation from -6.4% of GDP in 2021 to -5% of GDP in 2023 (Chart 2). The 2024 Medium-Term Fiscal Framework (MTFF) reinforces this commitment, with an average fiscal balance target of -3.5% of GDP between 2024 and 2026. Additionally, the recently approved Public Finance and Fiscal Responsibility Act (FRA)[21] imposes a maximum limit of federal government debt at 60% of GDP to ensure debt sustainability. Moving forward, a successful implementation of a more targeted approach to subsidies will further support fiscal consolidation efforts. These sets of policy actions proved to be coherent, as an over expansionary fiscal stance might necessitate a contractionary monetary policy stance to contain inflationary pressures, potentially negating the intended impact to growth. Importantly, this policy combination facilitated a strong economic recovery, culminating in a robust real GDP growth in 2022 and 2023 of 8.4% and 3.7% respectively, with inflation moderating from its peak of 4.7% in August 2022 to 1.5% by December 2023.

[19] These include allowing banks to temporarily operate below the minimum liquidity coverage ratio of 100%, reduction of the Statutory Reserve Requirement (SRR) from 3% to 2% and the 6-month automatic loan repayment moratorium. Additionally, financial institutions were temporarily allowed to utilise the Malaysian Government Securities (MGS) and Malaysian Government Investment Issues (MGII) for the SRR compliance.

[20] This was partly financed by the establishment of the COVID-19 Fund under the Temporary Measures for Government Financing (Coronavirus Disease 2019 (COVID-19)) Act 2020. Notable measures include withdrawals from EPF savings, cash transfers (e.g. Bantuan Prihatin Nasional and Bantuan Khas COVID-19), wage subsidy programme (WSP), and the implementation of small-scale projects (Ministry of Finance, 2022).

[21] The Act introduces four fiscal rules: A fiscal deficit ceiling at -3% of GDP; federal government debt limit at 60% of GDP; capping government guarantees at 25% of GDP, and a minimum annual development expenditure of 3% of GDP.

Chart 2: Federal Government Debt and Fiscal Deficit (% of GDP)



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Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

In playing its counter-cyclical role and managing risks of heightened interactions during the pandemic, two key elements guided BNM's approach namely clarity of mandates and a robust institutional framework. Firstly, the Central Bank Act of Malaysia Act (2009) establishes BNM's mandates and governs its relationship with the Government. Notably, the Act stipulates the principal object to promote monetary and financial stability conducive to sustainable growth of the Malaysian economy whilst providing advisory on economic and financial stability matters to the Government.[22] Secondly, in ensuring the effective delivery of this mandate, two key safeguards are stipulated within the Act among others. The Act[23] formally assures the independence of BNM in monetary policy conduct, which is vital in ensuring monetary stability.[24] The Act[25] also imposes strict limits on BNM's ability to provide financing to the Government, defined by specific parameters of duration, limits, and permitting circumstances.

Robust institutional arrangements facilitated engagement and policy alignment between BNM and the Government. As a member of national-level policy platforms such as the Economic Action Council (EAC) and the Fiscal Policy Committee (FPC), BNM plays a proactive role in providing policy advisory on various economic issues encompassing from macroeconomic management, structural challenges to fiscal reforms. This is further bolstered by participation at various dedicated working-level platforms. In particular, this allows BNM to consistently provide insights on the economic outlook and emerging risks in the global and domestic economy.

In general, the legislative and institutional setup in Malaysia facilitated coherent monetary and fiscal policy responses while mitigating risks of adverse or excessive monetary-fiscal interactions. Still, the risk that could arise in the interaction between these policies needs to be managed proactively. Case in point is the proactive fiscal consolidation efforts by the Government as unsustainable government debt levels may complicate monetary policy considerations in responding to rising inflationary pressures. These risks could subsequently result in financial market instability and inadvertently result in a subtle form of fiscal dominance, which impedes macroeconomic stability and sustainable growth in the long run. Hence, sustained vigilance and continued enhancements to policy tools remain paramount.

To further safeguard the efficacy of monetary and fiscal policy and its interaction, several measures could be considered, which include:

Monetary policy:

A deeper understanding of structural shifts in the economy: Efforts to deeply understand ongoing and future structural shifts, whether arising from the pandemic crisis or prevailing economic megatrends (e.g. ageing population, digitalisation and climate change), continue to be part of BNM's agenda. This will enable BNM to undertake monetary

[22] Refers to Section 5 and 70 of the Act.
[23] Refers to Section 22 of the Act.
[24] Arnone et al (2009) highlight the benefits of autonomous central banks empowered by a Central Bank Act on policy outcomes such as inflation.
[25] Refers to Section 71 of the Act.

policy effectively in ensuring price stability that is consistent with sustainable growth. Of paramount importance is the keen understanding of the evolution of inflation dynamics and monetary policy transmission mechanism in light of these structural shifts. Research will be focused on these areas.

Fiscal policy:

- **Alignment with economically sound indicators:** Commitment to enhanced fiscal policy conduct by targeting a fiscal deficit towards the Debt Stabilising Primary Balance (DSPB)[26] and the Cyclically Adjusted Primary Balance (CAPB) would preserve fiscal sustainability and boost its effectiveness as a counter-cyclical tool. The Public Finance and Fiscal Responsibility Act (FRA) lays the groundwork for this and would mitigate procyclical tendencies while also ensuring debt sustainability.

- **Steadfast fiscal policy reform:** In the short-term, the consolidation efforts should also be supported by revenue and expenditure reforms. These include measure to broaden and diversify revenue base and prioritising expenditure items with high multiplier impact.[27]

Lastly, structural reforms play a crucial role in mitigating risks arising from monetary-fiscal interactions. It expands the Region of Stability and thus facilitates macroeconomic strength and resilience. Key reform areas include increasing the economy's growth potential, ensuring the workforce is future-ready, transitioning towards a low-carbon economy, ensuring effectiveness of social protection as well as building fiscal resilience by broadening the revenue base and optimising expenditure with a focus on high multiplier spending. Such reforms expand the Region of Stability by boosting potential growth and minimising volatility, thereby reducing pressures on monetary and fiscal policy to support economic activity. Recent announcements of major national economic masterplans[28] and reforms to the social protection system[29] are steps in the right direction. The former is essential for securing sustainable growth engines by boosting innovation and productivity meanwhile the latter provides resilience against economic shocks. Thus, it is imperative that these masterplans and other structural reform measures are executed well and in earnest.

Summary and way forward

Increased interaction between monetary and fiscal policy is not inherently detrimental to the economy. However, imprudent policy conduct could complicate a country's overall ability to operate within the Region of Stability. Malaysia's recent experience during the pandemic pointed to both policies working well within the Region of Stability. Nevertheless, it is recognised the post-pandemic landscape presents possible future vulnerabilities in the form of elevated fiscal risks due to high debt levels as well as more permanent shifts in the structure of the economy.

Moving forward, proactively building monetary and fiscal policy buffers is therefore crucial to mitigate these potential risks. Monetary and fiscal authorities must also be vigilant in enhancing their surveillance toolkits to better understand the evolution of the economy. For monetary policy, the immediate task is to ensure that risks to price stability are contained. For fiscal policy, it is important that the risks arising from the vigorous fiscal exertions during the pandemic are steadily unwound. Adherence to the ongoing fiscal consolidation plan will be key and would support debt sustainability over time. Taken together, this ensures the readiness of both policies to effectively play a counter-cyclical role in a coherent manner and solidify macroeconomic stability in a sustainable manner.

[26] Refers to the primary balance (i.e. fiscal balance minus interest payment) at which government debt starts to moderate.
[27] Empirical estimates of fiscal multipliers indicate that expenditure on supplies and services and fixed assets exhibit the highest multiplier effects (Lau et al, 2022).
[28] Refers to the National Industrial Masterplan (NIMP) and the National Energy Transition Roadmap (NETR).
[29] Encompassing social safety nets, social insurance, and active labour market policies (ALMPs), these policies provide the social protection floor, mitigate life-cycle risks and enhance economic opportunities. This would be supported by overarching reforms such as a centralised database (i.e. Pangkalan Data Utama (PADU)).

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