

Executive Summary

Economic and Financial Developments in 2021

The global economy rebounded in 2021 from the pandemic-induced recession in 2020 with an uneven recovery: The global economy and trade rebounded by 5.8% and 9.3%, respectively. However, this recovery was uneven, especially between Advanced Economies (AEs) and Emerging Market Economies (EMEs). While new COVID-19 variants affected most economies, more advanced vaccination progress in AEs allowed for a quicker lifting of containment measures and thus, a faster rebound in economic activity. Together with stronger demand, labour shortages in several AEs and supply chain disruptions raised logistics and input prices, resulting in higher inflationary pressures in the second half of 2021. Amid this backdrop of higher inflation, some central banks began to normalise monetary policy. Inflation in Asian EMEs, however, remained muted, resulting in continued monetary accommodativeness in the region.

While domestic financial conditions were tighter, the spillovers to financial intermediation were contained: The domestic financial market movements were influenced by both external and domestic factors, which contributed to intermittent volatility in portfolio flows, elevated pressure on Malaysian Government Securities (MGS) yields, subdued equity prices, and ringgit volatility. Nonetheless, market adjustments were orderly, underpinned by Malaysia's deep and liquid financial markets and supported by the Bank's liquidity and foreign exchange operations. In addition, the strength and resilience of Malaysia's banking system anchored the effective intermediation of funds in the economy. The flexibility in the ringgit exchange rate also facilitated the appropriate adjustments in the external sector.

The Malaysian economy improved in 2021, registering a growth of 3.1%: The recovery momentum in the early part of the year was affected by the reimposition of nationwide containment measures from June to September 2021, following a rapid resurgence of cases due to the Delta variant. However, unlike the movement restrictions in the second quarter of 2020, more essential economic sectors were allowed to operate, while businesses and households were better adapted to the containment measures and standard operating procedures (SOPs). Notwithstanding this, some sectors, such as high-touch services, tourism-related industries and construction, were slower to recover due to continued restrictions on movement and operating capacity. As these restrictions were eventually lifted in October 2021 amid rapid progress in domestic vaccinations, economic activities picked up and labour market conditions improved. The expansion in employment and subsequent increase in private sector wages contributed towards increased household spending. Private investment growth was supported by expansion in productive capacity, especially in the *manufacturing* sector, alongside higher capital spending by firms on automation and digitalisation. In addition, external demand also provided additional support to our economic growth in 2021.

Headline inflation turned positive in 2021 while core inflation remained subdued: Headline inflation in 2021 increased to 2.5% (2020: -1.2%), reflecting mainly higher fuel inflation. Global supply-side disruptions also led to some upward price pressures, though the impact on consumer prices was relatively contained, as firms absorbed the higher cost. Underlying inflation, as measured by core inflation, remained relatively subdued at 0.7% in 2021 (2020: 1.1%), reflecting the spare capacity in the economy amid a moderate recovery in the labour market.

In 2021, accommodative monetary policy provided continuous broad-based support for economic recovery: The Overnight Policy Rate (OPR) was maintained at the historical low of 1.75% throughout the year. The thrust of monetary policy in 2021 was to ensure sustainable economic growth in an environment of manageable price pressures. Additionally, the extension of the Statutory Reserve Requirement (SRR) flexibility from 31 May 2021 to 31 December 2022 provided sustained liquidity support for financial intermediation throughout the year. Financial measures, such as credit guarantees and the Bank's various financing facilities, also provided targeted support for affected segments that were facing a more uneven recovery. Overall, financing remained supportive of the economic recovery, with continued flow of bank credit to households and businesses.

Outlook and Policy for 2022

Continued recovery in the global economy as countries gradually transition towards normalcy, albeit at varying degrees: In 2022, PPP-weighted global growth and Malaysia's export-weighted global growth are projected to expand between 3.8% and 4.3%, and between 4.0% and 4.5%, respectively. The improvement in labour market conditions amid the progressive reopening of economies over the past year is expected to facilitate recovery in private sector activity in 2022. The impact of resurgences of COVID-19 remains a key risk but is expected to be smaller in 2022 than in 2020 and 2021 due to factors such as continued good progress in vaccinations, among others. Nevertheless, the ongoing military conflict in Ukraine is expected to weigh on global growth. Spillovers would stem mainly from disruptions in commodity supply, leading to higher commodity prices and inflation which could raise cost pressures on firms and lower real income for households.

Global inflation is projected to rise and remain elevated in 2022: This is driven by higher energy and commodity prices and ongoing disruptions in the global supply chain in an environment of sustained demand recovery. Amid continued strength in inflationary pressures globally, a further normalisation of monetary policy is anticipated in 2022 for most central banks in both AEs and EMEs. Nonetheless, the pace and magnitude of monetary policy normalisation remain uncertain, as they depend largely on the persistence of inflationary pressures and the strength of the recovery in the economy and labour market.

Balance of risks to global growth remains tilted to the downside, amid heightened geopolitical tensions and continued uncertainties surrounding COVID-19: The main risk to growth arises from a potential reimposition of strict containment measures in the event of a COVID-19 resurgence due to severe and vaccine-resistant Variants of Concern (VOCs). This could result in higher and more persistent inflation, which extreme weather conditions and disruptions in the production of commodities could exacerbate. Downside risks also arise from slower-than-expected recovery in China and worsening geopolitical conflicts, particularly if the conflict in Ukraine continues to escalate further and is prolonged, or if trade and financial sanctions are intensified. Moreover, tighter global financial conditions risk sharp capital outflows, which could lead to disorderly exchange rate adjustments and the unwinding of prevailing financial sector imbalances. Nevertheless, there are upside risks to global growth, arising from a faster and wider rollout of COVID-19 vaccines, new treatment options for COVID-19 infections, and additional fiscal support particularly in AEs.

The Malaysian economy is expected to improve further, with growth projected to be between 5.3% and 6.3% in 2022: The economic recovery is underpinned by the continued expansion in external demand, full upliftment of containment measures, reopening of international borders, and further improvement in labour market conditions. In addition, the implementation of investment projects and targeted policy measures will provide further support to economic activity and aggregate demand.

Stronger private sector recovery, supported by labour market improvements, to be the main driver of growth in 2022: As economic activity picks up, the unemployment rate is expected to decline further in 2022 to around 4% of the labour force. The recovery in the labour market will be further supported by targeted measures to boost labour demand, facilitate re-skilling and up-skilling and reduce labour market frictions. A sustained recovery in employment and income is expected to drive an improvement in household spending. Additionally, progress in vaccinations and upliftment of containment measures will lead to an improvement in consumer confidence and some materialisation of pent-up demand. As a result, private consumption is expected to grow by 9.0% (2021: 1.9%). Private investment is also expected to recover, growing by 5.3% (2021: 2.6%), supported by the continued expansion in global demand and the implementation of new and ongoing investment projects.

Targeted policy measures to remain in place to facilitate recovery momentum: With an emphasis on assisting vulnerable segments, various policy measures will play a key role in supporting a broader economic recovery. Government measures to provide some support to household spending include various cash transfers and tax reliefs. For businesses, the Wage Subsidy Programme and numerous targeted grants are extended to vulnerable sectors such as tourism-related industries and agriculture.

Overall, the risks to domestic growth are tilted to the downside: The potential reimposition of broad-based containment measures due to a resurgence in COVID-19 such as the emergence of severe and vaccine-resistant VOCs is a key downside risk. In addition, slower-than-expected rollout of public infrastructure projects, more persistent labour shortages and supply disruptions, and higher-than-expected inflation could also affect the recovery path. On the external front, worsening supply chain disruptions, heightened volatility leading to disorderly financial conditions, as well as prolonged and further escalation of geopolitical tensions could significantly affect Malaysia's growth and trade outlook. Nevertheless, higher-than-expected global growth and stronger-than-expected improvement in tourism-related sectors amid reopening of borders pose an upside risk to domestic growth.

Headline inflation to average between 2.2% and 3.2% in 2022 amid higher underlying inflation: Fuel inflation, which contributed to higher inflation in 2021, is expected to moderate in 2022. While high input costs are projected to exert some pressures on selected fresh food prices, these pressures will be partly mitigated by price controls. Meanwhile, core inflation is expected to average higher between 2.0% and 3.0% in 2022 due to stronger demand conditions amid lingering cost pressures. For most items in the core CPI basket, the price pressures in 2022 would largely reflect a normalisation in prices after a period of subdued demand and reduced profit margins during the pandemic. However, the extent of upward adjustments in core inflation will remain partly contained by the continued slack in the economy and labour market. The upside risks to the overall inflation outlook stem mainly from cost-push factors, such as a more persistent uptrend in input costs and prolonged global supply chain disruptions, which geopolitical tensions and lockdowns in China could exacerbate. Meanwhile, downside risks to the outlook mainly reflect factors that could precipitate a weaker

recovery in economic conditions, leading to more benign price pressures.

Domestic monetary and financial conditions to remain conducive to financial intermediation activities: The lending capacity of Malaysian banks remains intact, given their healthy capital and liquidity buffers. With the improving economic conditions, credit flows to the private sector are expected to pick up during the year amid banks' strong capacity and improved willingness to lend, coupled with higher demand for financing by households and businesses. There are, however, heightened uncertainty and risks emanating from external developments, such as monetary policy normalisation globally and escalating geopolitical tensions. Nevertheless, continuous efforts to strengthen external buffers and economic fundamentals over the years have improved the resilience of the domestic economy and financial system, which will facilitate orderly intermediation of portfolio flows. Moreover, the impact from exchange rate fluctuations on domestic financing conditions is mitigated by low reliance on foreign currency financing and the availability of hedging facilities. The flexibility of the exchange rate would also remain as a key shock absorber to facilitate necessary macroeconomic adjustments from external shocks. Meanwhile, the Bank's monetary policy operations will ensure sufficient domestic liquidity in the financial system to support financial intermediation and the orderly functioning of the financial markets.

Monetary policy in 2022 will continue to support a sustainable economic recovery while preserving price stability: Going forward, the MPC will focus on ensuring that the degree of monetary accommodativeness is consistent with the expected improvement in economic conditions amid moderate upward price pressures and well-anchored inflation expectations. Against a background of rapidly evolving conditions and heightened uncertainties, the MPC will continue to monitor the outlook for growth and inflation, and the possibility of materialisation of risks. Considerations for continued monetary policy support would need to be balanced against maintaining low interest rates for a prolonged period, which could lead to an emergence of financial imbalances. The MPC is also mindful of the potential upside risks to inflation, which continue to be subject to global commodity price developments. While monetary policy may not be

the best tool to react to these “first-round” effects, the MPC will assess whether such price pressures could become more persistent and pervasive, and whether they would be reinforced by stronger domestic demand. Therefore, future monetary policy decisions will continue to be data-driven and guided by the evolving balance of risks surrounding

the outlook for domestic inflation and growth. Any potential adjustments to the degree of monetary accommodation would be made in a measured and gradual manner. Given the lingering uncertainties and downside risks to growth, monetary policy will remain accommodative, while preserving price and financial stability.