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Bank Negara in tight spot

Aggressive rate hike may decelerate recovery

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Dr Geoffrey Williams

PETALING JAYA: The latest aggressive interest-rate hike in the United States will likely put Bank Negara in a dilemma, with the central bank having to choose between saving the economy or preempting an increased outflow of funds that could further weaken the ringgit.

It is typically expected that Bank Negara would follow the “footsteps” of the Federal Reserve (Fed) – the Bank Negara equivalent in the United States – in adjusting the benchmark interest rate.

This is to maintain a certain level of interest rate differential.

A differential that is too narrow could incentivise investors to cash out from Malaysia and park their monies in US assets.

Currently, the benchmark interest rate in Malaysia or the overnight policy rate (OPR) is 2%.

Meanwhile in the United States, the federal funds rate ranges between 1.5% and 1.75% – not far off from Bank Negara’s OPR.

On June 15, the Fed raised its rate by 75 basis points (bps), after hiking it by 50-bps in May.

The sharp rate hike came as the inflation in the United States hit a 40-year high in May 2022.

However, local economists opined that Bank Negara should avoid raising the OPR as aggressively as the Fed.

An aggressive hike in interest rates comes with a huge cost – deceleration in economic recovery.

Economist Manokaran Mottain told *StarBiz* that the inflation in Malaysia has not spiralled

out of control and that the inflation is more driven by higher costs, rather than demand.

“An aggressive OPR hike would not work in Malaysia.

“We can’t compare our situation to the United States. The US’ reopening of the economy was earlier than Malaysia, so domestic demand in the country has improved faster than us.

“The higher rate by the Fed would have factored in the demand-pull inflation, not just the cost-push inflation,” said Manokaran, who is also a director of Malaysia Venture Capital Management Bhd.

Malaysia University of Science and Technology economics professor Dr Geoffrey Williams said the mentality of “chasing the tail of the US” will put great pressure on Bank Negara’s Monetary Policy Committee.

“But they must resist it. Just because the United States is sneezing does not mean Malaysia has to catch a cold,” he said.

Williams argued that there is no real reason within Bank Negara’s mandate to raise interest rates at this stage.

“Price stability is normally taken as 2% to 3% inflation which we currently have.

“The economy is in the first stage of recovery but this is still tentative and must be sup-

ported. The financial system is very stable and this should not be put at risk,” he said.

According to him, higher interest rates will have no effect on the prices of oil, food or utilities, which are behind the inflation pressures at the moment.

After the 25-bps hike in May, Williams said there is no necessity for a further increase.

“But I expect that there will be (OPR hike). The only thing we can hope for is that they are small rises,” he added.

Manokaran, on the other hand, believes there is a 75% chance for the OPR to be hiked by 25-bps in September.

“I don’t agree on raising the OPR at the moment. But I won’t be surprised if Bank Negara wants to tighten its monetary policy in July by raising the OPR by 25-bps next month.

“It’s a 50%-50% chance,” he said, adding that the central bank may also raise interest rates by 25-bps in November.

Meanwhile, AmBank Group chief economist Anthony Dass said that central banks, including Bank Negara, need to catch up to their economies as they have been “behind the curve”.

Higher interest rates will hold back consumption and investment

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"They need to start to get interest rates above inflation effectively, or at least inflation expectations," he said.

He also pointed out that the underlying inflationary pressure is rising in Malaysia, due to cost pressures and improving demand-pull inflation.

"We expect Bank Negara to raise rates in July by 50-bps from the current 2% following a 25-bps hike in May.

"And we believe Bank Negara would raise rates by another 25-bps in September. We should be settling at 2.75% this year and 3.5% in 2023," said Dass.

According to him, the last time the differential between Malaysia's interest rates and the federal funds rate fell into the negative territory was back in 2005 to 2007.

"The US dollar-ringgit exchange rate was actually trading around 3.80 and appreciated to around 3.49 by the end of 2007," he said.

In general, while economists differ on how fast the OPR would be raised, they largely

concur that Bank Negara is highly unlikely to maintain its policy rate at 2%.

However, with higher rates and a tighter monetary policy, households and businesses would feel the brunt from higher loan payments.

If the monetary policy is tightened "too much", Manokaran said it would affect corporate earnings and the disposable income of Malaysians.

Echoing a similar stance, Williams said higher interest rates will hold back consumption, investment and economic growth.

"In March this year, Bank Negara stated that policy measures beyond its mandate would damage investor confidence and I fully support that view.

"That would also harm the exchange rate, so chasing the interest difference will be dangerous," he added.

Williams was asked whether the narrowing OPR-federal funds rate differential would be negative for the Malaysian bond market.

In response, he said the Malaysian

Government Securities and other government debt are largely held by Malaysians and local fund holders such as the Employees Provident Fund, which have already signalled their support for the Malaysian bond market.

"So that offers protection of a sort. "Foreign reserves are also quite strong and robust for the short term. So that will require monitoring but is not an urgent risk," he said.

Williams, who was critical of the Fed's move to aggressively raise rates, said it and the US government are showing extraordinary stupidity in economic policy.

"This will be damaging to Malaysia. "First because it has an effect on global economic activity and drags down trade, on which Malaysia is depending.

"Second because it raises the risk of global recession that has been warned by the International Monetary Fund, for example, and is becoming a self-fulfilling prophecy.

"Third because this policy approach is damaging the credibility of the Fed and central banks around the world that are follow-

ing it without thinking and that hits confidence hard," he added.

Despite the challenges ahead, exacerbated by the changing monetary policy landscape, AmBank's Dass expects Malaysia's economy to grow by about 5.6%, "with the downside at 4.8% and upside at 6%".

The economy, according to him, remains supported by external trade, firm commodity prices, domestic demand, foreign direct investments as well as wealth effects from a positive portfolio environment.

On the ringgit outlook, Dass expects the local currency to improve in the second half of 2022 to about RM4.20 to RM4.25 per US dollar.

He noted that Malaysia sits on healthy reserves, which can easily help stabilise the ringgit movement.

"The strong economic fundamentals, prudent ringgit management, capital inflows into equities and the pricing-in of the US rate hikes as well as new noises of potential economic slowdown in the United States would see the dollar exhibit some pullback," he said.