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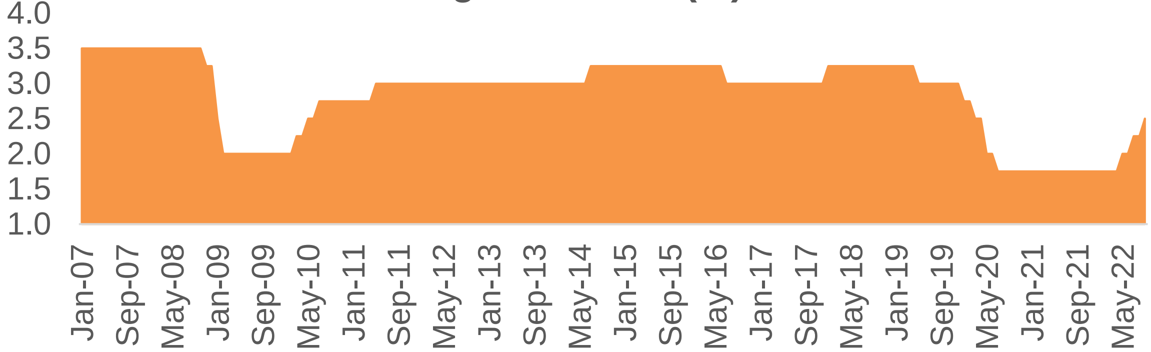
Bank Negara Malaysia (BNM) had thus far raised its key Overnight Policy Rate (OPR) by a total of 75bps YTD as at 8 September 2022. Despite that, the OPR at 2.50% remained below pre-pandemic level of 3.00% – *see Fig. 1*. We believe the current focus of BNM's monetary policy is to ensure sustainable recovery of Malaysia's economy. While the 25bps rate hike in September 2022 was largely anticipated, **we expect BNM to pause in November to allow the effects of higher OPR rates to filter through the economy. Nonetheless, there is a high possibility of another 25bps rate hike in November if upward inflationary pressures do not abate and economic recovery trend remains robust.**

Figure 1: OPR (%)



Malaysia's key economic indicators have thus far pointed towards a firm recovery. The economy expanded by 8.9% YoY in 2Q 2022, accelerating from 5% gain in the previous quarter thanks to pent up demand, base effect factors, normalising economic activities, tight labour market, supportive policy measures, and resilient external demand.

However, **downside risks to the recovery** continue to stem from a weaker-than-expected global growth, ongoing geopolitical conflicts, supply disruptions and climate change, among others. These risks along with improving demand are **putting upward pressure to prices of goods and services** which has forced central banks globally to start normalising their monetary policies in order to tame inflation and prevent the economy from overheating.

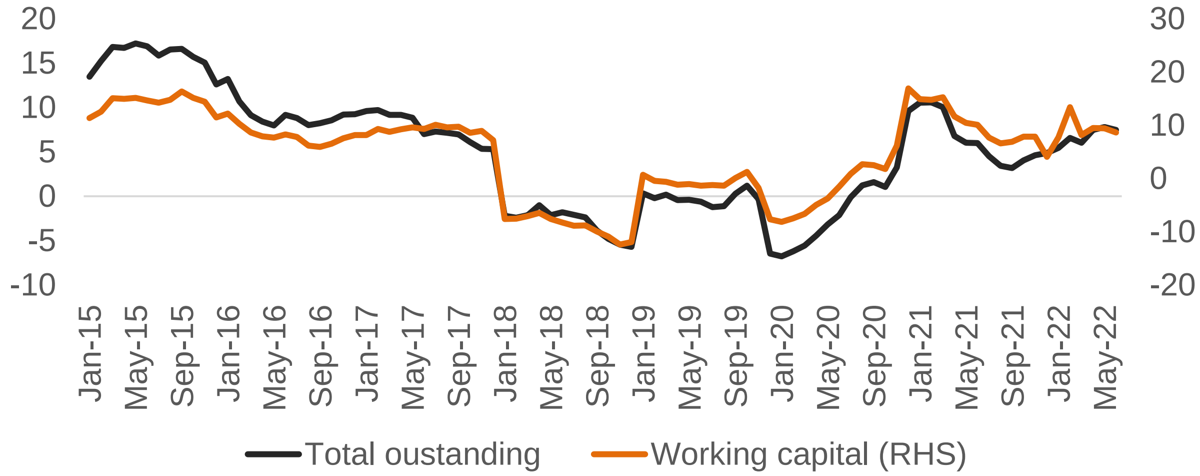
In Malaysia, rising prices of commodities and other raw materials are being cushioned by Government subsidies and price controls. For instance, retail price of RON95 and Diesel have been capped at RM2.05 and RM2.15 respectively. Similarly, ceiling price of standard whole chicken has been set at RM9.40/kg. Despite that, prices of some components especially food related items have been trending upward significantly. **Food inflation surged to 7% YoY in July 2022, compared to five-year pre-pandemic average of 3%.** Generally, when prices rise, there will be spill over effect to the entire economy via higher cost of living and cost of doing business especially for Micro, Small and Medium Enterprises (MSMEs).

The ringgit depreciated by 7.4% against the US Dollar (YTD until end-August 2022) to RM4.49/USD1, broadly in line with the movement of regional currencies. This reflects the continued strengthening of the USD following aggressive US monetary policy tightening and increased investors' risk aversion due to the weaker global growth outlook. Further narrowing of the spread between the US and Malaysia's interest rate differential could induce capital outflows from Malaysia and cause Ringgit to further depreciate. This could result in higher prices of raw materials and other inputs, adding another blow to businesses that are reliant on supplies from foreign countries.

As such, all these points towards **the need for BNM to step in** and utilise its monetary policy tool (i.e. OPR) to **ensure stability in the domestic economy with inflation remains under control and extreme volatility in the Ringgit is prevented.** As reaffirmed by BNM, the monetary normalisation process will be done in a "measured and gradual" manner by closely monitoring the economic developments so that it would not be detrimental to growth. As economy picks up speed, there is less of a need for super accommodative monetary policy to reign in the accumulation of excessive debt.

Despite higher borrowing costs, businesses are anticipated to continue demanding for financing to capitalise on the ongoing economic recovery. At the industry level, SMEs' outstanding loan/financing continued to grow by 7.5% YoY in Jun 2022 albeit inching downward from 7.8% YoY in the preceding month, due to a moderation in its largest component: working capital (8.6% YoY vs 9.4% in May) – *see Fig. 2*. Nevertheless, demand for working capital financing remained above pre-pandemic levels (2015-2019 average) of 4.2%.

Figure 2: SMEs' Oustanding Loan (% YoY)



Besides that, BNM in its latest Financial Stability Review for 2H 2021 showed that the **new rescheduling and restructuring (R&R) applications by SMEs have decelerated from its peak in July 2021, indicating that recovery is on track and SMEs have greater confidence and ability in servicing their debt**. The steady increase in earnings will lead to improvement in profitability over time, rebuilding business resilience.

While recent domestic economic data are showing an optimistic outlook, we remain cautious on the developments on the external front. The tighter global monetary policy environment, prolonged supply chain disruptions, geopolitical tensions, higher inflation, risk of recession and the emergence of contagious diseases could have spill over effects to the domestic economy and derail our recovery trajectory.

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