SUSTAINABLE GROWTH

Bank Negara policy rate hike is to tame inflation

WITH strong growth in the first quarter of this year, improving Industrial Production Index, and an optimistic outlook on exports and buoyant private sector-led initiatives, Bank Negara Malaysia, through its Monetary Policy Committee, made a bold decision in increasing the Overnight Policy Rate (OPR), the first in three years, by 25 basis points to 3.25 per cent.

This is done to ensure sustainability of the growth momentum in the future by managing inflationary pressure, and keeping economic and financial imbalances in check. There are positive and negative effects to the Malaysian economy as a result of the move.

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For growth to be sustainable and moving forward, inflation needs to be managed. The headline inflation rate in May stood at 3.4 per cent, thus making the real interest rate in the negative territory.

Some analysts have argued that increasing the interest rates at this time to tame inflation is misplaced as the inflation is more driven by cost-push rather than demand-pull. It is important to highlight that at 3.25 per cent, the monetary policy stance is still accommodative and far from initiating a contractionary monetary policy position. It is still in the process of "normalisation".

Perhaps the concern that underpinned this decision was the need to manage the build-up of economic and financial imbalances in the economy and the financial system, especially the household debt-to-gross domestic product (GDP) ratio, which is at 86.8 per cent, one of the highest ratios in the region.

To sustain the growth momentum in years ahead, the household debt situation needs to be addressed decisively. Although a slew of macro prudential measures have been put in place, such as trimming the tenures of personal loans and mortgages loans, plus measures to curb property prices, it seems that these were insufficient to manage the possible bubbles in sectors such as banking and housing.

It is also important to note that the trend in the household debt can be seen in the business sector and in the government. Malaysia's corporate debt-to-GDP ratio, which is now at 96 per cent, whereas debt accumulated by the government is now at 54.8 per cent of GDP, very close to the self-imposed ceiling of 55 per cent of GDP, which had been revised in July 2009.

The possible capital reversal caused by the move of the United States Federal Reserve to taper their bond buying programme, or the quantitative easing, is also on Bank Negara's radar and thus, the upward adjustments of the interest rates can be interpreted as a pre-emptive measure to calm the financial system, especially in the bond and exchange rate markets.

While there are legitimate concerns regarding the negative effects of the interest rates hike, it is crucial to appreciate the limitations of monetary policy in addressing the main problems the Malaysian economy faces right now, such as rising cost of living, which requires complementary structural reforms, and other measures to enhance the economic competitiveness to eventually getting the economy out of the middle-income trap.

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