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Balancing the OPR and the ringgit

In the run-up to Bank Negara Malaysia's (BNM) monetary policy statement next week many are speculating whether the depreciation of the ringgit will force a hike in the overnight policy rate (OPR). The short answer is no.

The position of BNM and the government is clear, the exchange rate is determined by the market and acts as an automatic stabiliser. A depreciation helps Malaysian exporters even if imports become more expensive.

Malaysia is a small open economy and does not have the economic size to affect global exchange rate markets. Any attempt to defend the ringgit will fail because international currency reserves are too low to intervene for long and raising the OPR could damage the economy and weaken the ringgit further.

This means no intervention, no pegging, no exchange rate targets and no to the use of the OPR to interfere in the exchange markets.

The weaker ringgit is nothing to do with the Malaysian government or BNM. Along with many other regional currencies the ringgit is weakening because of international developments outside of the control of domestic policymakers. These include higher US interest rates and geopolitical uncertainty making investors seek a safe haven in dollar assets.

In domestic markets BNM has a clear mandate to maintain price stability and financial sector stability to support sustainable economic growth. This broad mandate reflects the realities of the Malaysian economy and the OPR is the most suitable tool influencing all three aspects.

This is different to Singapore and Hong Kong where price stability is focused on managing the exchange rate which has a much stronger influence on inflation and growth than the interest rate.

Although falling exchange rates raise the price of imports, less than 10% of Malaysia's imports are consumer goods and these are only around 26% of items that would affect the CPI. So the exchange rate pass-through to inflation is very muted.

According to BNM a 5% depreciation in the exchange rate would raise core inflation by only 0.2% after one year. In most cases depreciations are followed by appreciations and so overall short-term volatility will cancel out. Only long-term changes will be structurally impactful.

The OPR cannot influence short-term exchange rates systematically and the recent increases in the OPR by 1.25% since March 2022 have not held up the ringgit for long because international factors are having a bigger effect than interest rate differentials.

To match the increase in the US Federal Funds Rate the OPR would have had to rise 500 basis points since March 2022 and would be 6.75% rather than 3%, crushing Malaysian borrowers across the board, risking recession and collapsing the ringgit. This is why the OPR is not used to chase the dollar.

Instead BNM uses the OPR to manage inflation through multiple channels that influence demand and expectations. Raising the OPR makes credit more expensive and makes saving more attractive. People borrow less and save more and the combined effect moderates demand and helps slow down price increases.

Changing the OPR today will not begin to affect inflation for at least two years and the impact is not one-to-one. The first 0.25% increase in the OPR in May 2022 did not immediately reduce inflation by 0.25% and will only begin to have an effect early in 2024.

So it is important to take pre-emptive action now to moderate inflation and expected price increases in the future. With the OPR at normal levels and inflation falling as we have predicted all year, Malaysia is in much better shape than most countries and despite the ringgit volatility another pause in the OPR would be advisable.