Frequently Asked Questions (FAQ) on Monetary Policy

Summary of Questions

Monetary policy explained

1. What is monetary policy and what is the OPR?

- Monetary policy is the action that Bank Negara Malaysia (BNM) takes to influence interest rates in the economy. As the central bank of Malaysia, BNM's role is to promote monetary and financial stability. This is aimed at providing the conditions suitable for sustainable growth of the Malaysian economy. To achieve monetary stability, our Monetary Policy Committee (MPC) sets monetary policy to keep inflation low and stable while supporting economic growth.

- The MPC sets monetary policy by changing the Overnight Policy Rate (OPR). The OPR is BNM's policy interest rate that influences, among others, banks' lending and financing rates, as well as deposit rates. These rates tell you how much the cost of loan is, or how much the returns are for deposits. They are applicable for both conventional and Islamic finance products. To keep things simple, we refer to these as 'interest rates' for this FAQ.

2. What happens when we change the OPR?

- Changes in the OPR affect economic activity and overall price level changes, typically by influencing interest rates in the economy.
- When we increase the OPR, higher interest rates on savings and loans will influence people to save more and spend less. For example, when the demand for goods and services in the economy is more than the supply available, prices will keep rising. People will pay more to buy what they want. The higher OPR will help to slow demand down. This brings demand more in line with supply and prices would increase more slowly.
- The reverse happens when we reduce the OPR. Lower interest rates on loans and savings will get people to save less and spend more. This spurs economic activity and avoids a situation of falling price levels due to weak demand, which will hurt the economy.

3. What is inflation?

- Inflation is a measure of how much the overall level of prices of goods and services in the economy has changed over a period of time. One way to do this is by comparing the cost of things today against how much they were a year ago.
- Every month, the Department of Statistics Malaysia (DOSM) collects the prices of a basket of over 500 items from around 21,800 retail outlets across

the country. They use this basket to compute the Consumer Price Index (CPI). Inflation is measured by comparing the change in CPI over time.

- The CPI basket is made up of goods and services which reflect the average spending patterns of Malaysian households. The items include food, fuel, clothing, restaurant meals, and leisure activities, among others. To develop the basket, DOSM conducts the Household Expenditure Survey periodically, typically every two to three years, to understand households' spending patterns. For example, on average, 29.5% of households' spending is on food and non-alcoholic beverages compared to 3.2% on clothing and footwear. This means that food and non-alcoholic beverages have a higher weight in the CPI, and so any change in food prices would have a larger impact on inflation.
- The monthly CPI releases are published on DOSM's website: https://www.dosm.gov.my/v1/index.php

4. Why is it important to have low and stable inflation?

- When inflation is low and stable, it means that changes in the overall level of prices are stable and predictable. This is important because if prices keep changing and are hard to predict, it is difficult for households and businesses to plan how much they can spend, save or invest. This will then affect economic activity and growth.
- When price increases go out of control, it hurts your purchasing power. High and volatile inflation affects everyone, but it hurts lower-income households the most. Compared to the higher-income group, a larger share of their spending is on essential purchases like food and housing.
- High inflation also makes it harder for businesses, which may face higher costs to produce goods and services, or lower sales if the high prices affect consumers' demand. This can then affect business sales and profits. When prices keep changing, businesses also find it difficult to plan and invest for the future.
- For savers and retirees, high inflation also eats into your savings. Rapid increases in prices will quickly erode the purchasing power of your savings.

- Having a long period where overall prices are falling is not good for the economy either. This is known as deflation, which is bad when it is due to a collapse in demand. When this happens, many people lose their jobs and there is more uncertainty and financial stress. As a result, there would be lower investment and spending. Businesses would have to cut prices to attract consumers, but people would not spend as their finances are uncertain and they wait for prices to come down more. Like high inflation, deflation is also harmful to the economy.

5. Why is it important to have sustainable growth?

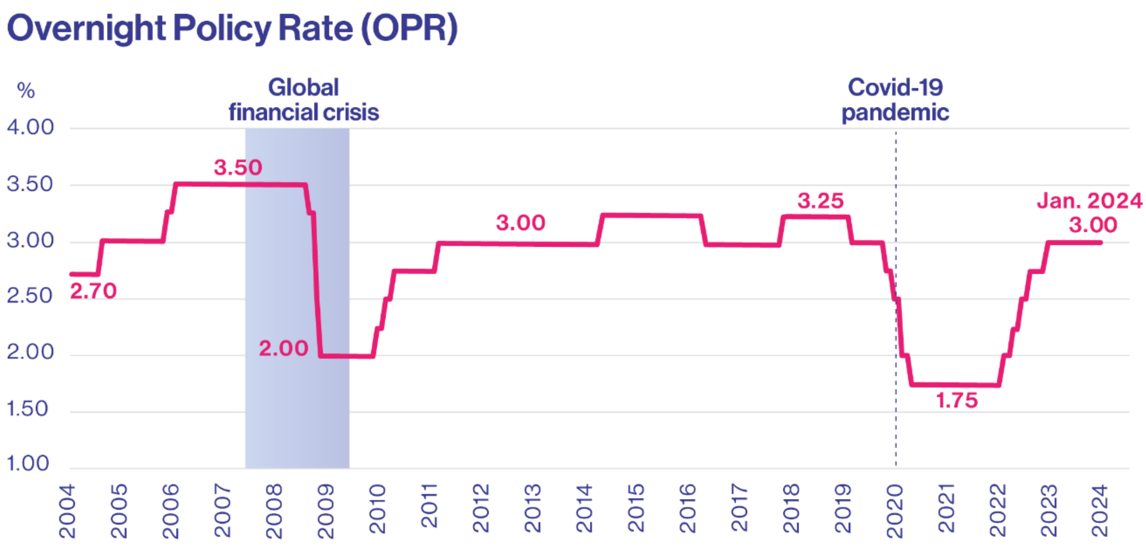
- Economic growth happens when the size of the economy increases over time. The size of an economy is usually measured by the total production of goods and services in the economy. This is also known as the gross domestic product (GDP).
- Sustainable growth is the rate at which the economy can keep growing at a steady pace over a long period. For some, it may appear to be a good idea to raise economic growth today, beyond the sustainable pace. This is like sprinting too hard in a marathon. You may pull ahead for a short while, but you will also quickly lose steam and might not even finish the race.
- So, it is more important to have growth that can be maintained without causing other problems. We have seen how growth that is too high or driven by cheap credit can damage the economy badly, such as in countries which faced extremely high inflation. When this happens, it is the people, including future generations, who will pay the costs and be left poorer. Having sustainable growth helps to temper such a boom and bust cycle.
- So, we balance both short and long-term aims in our policies to make sure growth is sustainable. Sometimes, this means being careful to avoid policies that could deliver high growth today but can cause growth to crash in the future.

6. How does the MPC set the OPR?

- The MPC's aim is to maintain low and stable inflation while promoting sustainable growth. Thus, when deciding on the OPR, we look at risks to both inflation and growth in Malaysia.
- We always look ahead when we set monetary policy because the effects of OPR changes on economic activity and inflation do not happen right away. According to some estimates, it usually takes about one year for monetary policy to have the most effect on the economy. This is because it takes time for households and businesses to change their behaviours.
- The MPC meets at least six times a year to set monetary policy. We announce our decisions on monetary policy after each MPC meeting through the Monetary Policy Statement (MPS).
  - Click here to find out more about the OPR and the MPC process.
  - Click here to read our MPS.

7. How has the OPR changed over time?

- We set the OPR to influence the pace of economic activity and inflation. Since the OPR was introduced in 2004, we have adjusted the OPR many times, both upwards and downwards, based on what the economy needs.
- The OPR was the highest at 3.50% in April 2006. During that time, the economy was growing steadily, CPI inflation was at 4.6% and a higher OPR was needed to manage the risk of higher prices.
- The OPR was the lowest at 1.75% from July 2020 until May 2022 to support the economy during the COVID-19 pandemic. In tough times, low interest rates make borrowing cheaper and lowers the returns on savings. This spurs spending, boosts investments and protects jobs and income in times of crisis.



- You can look at our OPR decisions over time, including the reasons for the decisions here.

8. Why do we use the OPR instead of the exchange rate to manage inflation?

- Most central banks globally, including Malaysia, use interest rates as their monetary policy tool. However, some countries like Singapore and Hong Kong use the exchange rate as their monetary policy tool. The choice of monetary policy tool would depend on the economic characteristics of the country, for example, how much a country imports and the degree of openness to capital flows.
- In our case, imports account for a relatively small share of what Malaysian households spend on and invest in, so an exchange rate appreciation may not effectively mitigate inflation shocks. Managing inflation requires a tool that can directly influence domestic demand, which is why the MPC uses the OPR to set monetary policy. Read more about how the change in OPR influences demand which in turn affects inflation under FAQ number 2: What happens when we change the OPR?
- This policy also allows us to manage the domestic interest rate along with free capital movement and a flexible exchange rate. Click here to read more.

9. How do ringgit movements affect consumer prices?

- Consumer prices change due to many reasons, not just due to movements in the ringgit. Changes in global commodity prices (e.g., crude oil, wheat, natural gas), labour costs, and demand and supply conditions can also affect consumer prices.
- Movements in the ringgit can affect consumer prices either directly or indirectly. For example, ringgit movements can influence domestic inflation via changes in import prices through:
  - Prices of finished goods imported into Malaysia (e.g., beef and dairy products); and
  - Cost of imported materials used for domestic production. For example, grains are imported and used as chicken feed. So, changes in the price of grains imported from abroad can affect the cost of our chicken feed, and subsequently the price of chickens in Malaysia.
- However, the effect of ringgit movements on CPI inflation is not one-to-one. For example, if the ringgit depreciates against the US dollar by 5%, inflation will not necessarily increase by the same amount. In addition to the changes in import prices as described above, there are also other factors at play. Businesses who are affected may choose not to increase their prices to keep their customers. Often, when importers face higher prices of the products they import, they may also source cheaper alternatives. To some extent, measures implemented by the Government would further contain excessive price increases (e.g., price controls for some essential goods).
- You can find out more about the ringgit here.
- Click here to read how the exchange rate affects inflation.

What is happening currently?

10. Why are prices getting higher?

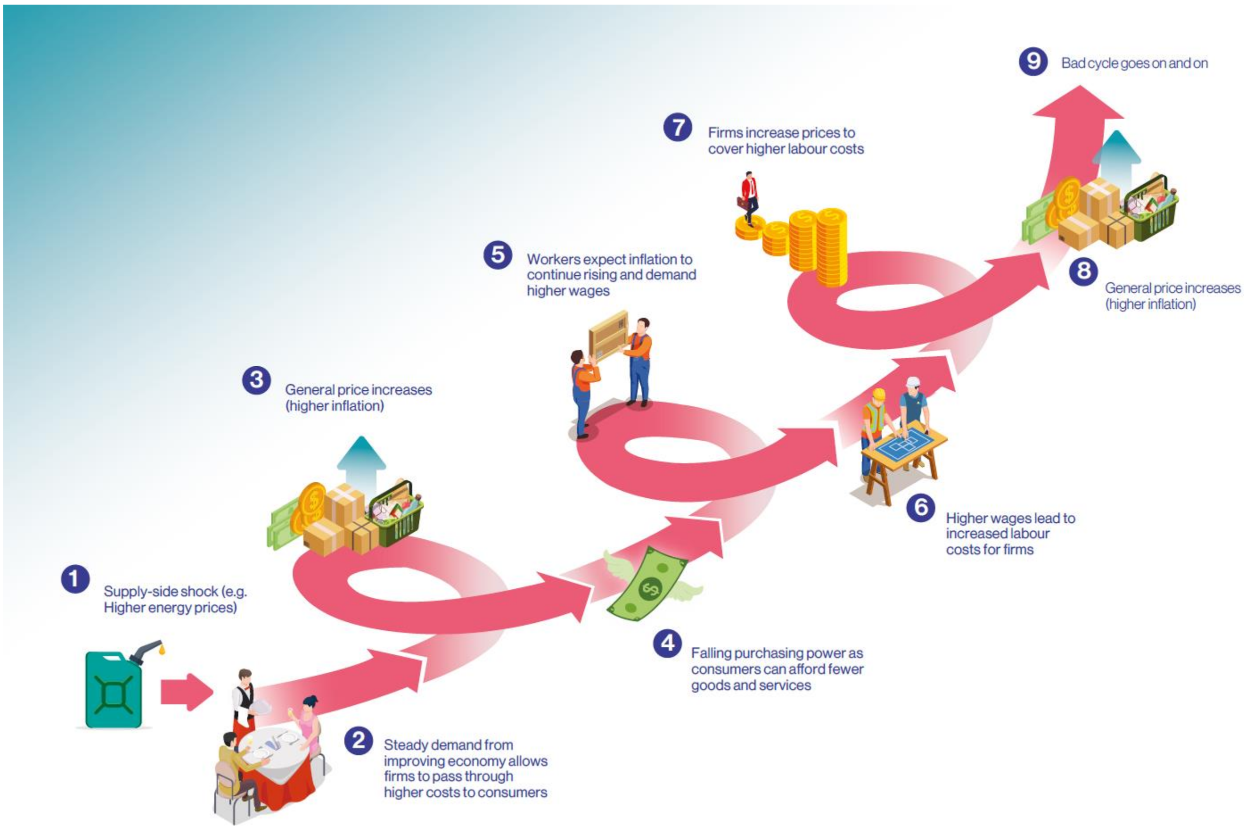
- The higher prices we see today are a global issue. Higher production costs were one of the main reasons inflation increased. Costs went up in 2022 for several reasons, including supply disruptions that affected the normal flow of production and the military conflict in Ukraine, which contributed to higher global energy and food prices. Together with the stronger demand after the economy reopened, prices started to increase faster and for more items.

- Malaysia is also affected by this. Higher commodity prices are a key reason behind the increases in prices we are seeing. Food-related items were most affected. The higher prices also reflect the improving demand after the reopening of the economy. Demand and inflation were weak during the pandemic, but they are now returning to previous levels. Imagine that you are a restaurant owner – you may find it easier to adjust prices to keep up with higher production costs now that more people are dining in.
- Compared to other countries, the rising prices have been less extreme in Malaysia. We have fuel subsidies and price controls that keep inflation lower. However, such measures could come at a large cost to the country. This is because the Government will have to keep spending a large amount to keep prices low. This reduces how much the Government can allocate for productive spending or other forms of support, especially for those who need it most.

11. Why does Bank Negara Malaysia increase interest rates even when cost of living is rising?

- We cut the OPR from 3.00% to the lowest level in history, at 1.75%, during the COVID-19 crisis in 2020. The lower interest rates made loans cheaper to spur spending. We did this to cushion the impact of the pandemic when the economy was not healthy and in recession.
- It is important to have the right policy at the right time. If we keep the OPR too low for too long when the economy is steadily recovering for example, it could cause too much spending and borrowing, which pushes prices up.
- Today, the economy is no longer in crisis and our economy has been steadily improving. So, we have been adjusting the OPR gradually.
- We also want to avoid the case where prices keep rising at a fast pace for many items. This is worse when higher prices lead to higher wages, which then lead to higher prices again. If you are a business owner, for example,

your workers will start to ask for higher wages when prices are increasing everywhere and are expected to keep going up. You then need to raise their wages and pass the extra costs down through higher prices. If this does not come with improvements in productivity, increases in wages will be offset by higher prices, and purchasing power could be eroded further. This bad cycle can go on, causing extreme inflation which harms the economy.

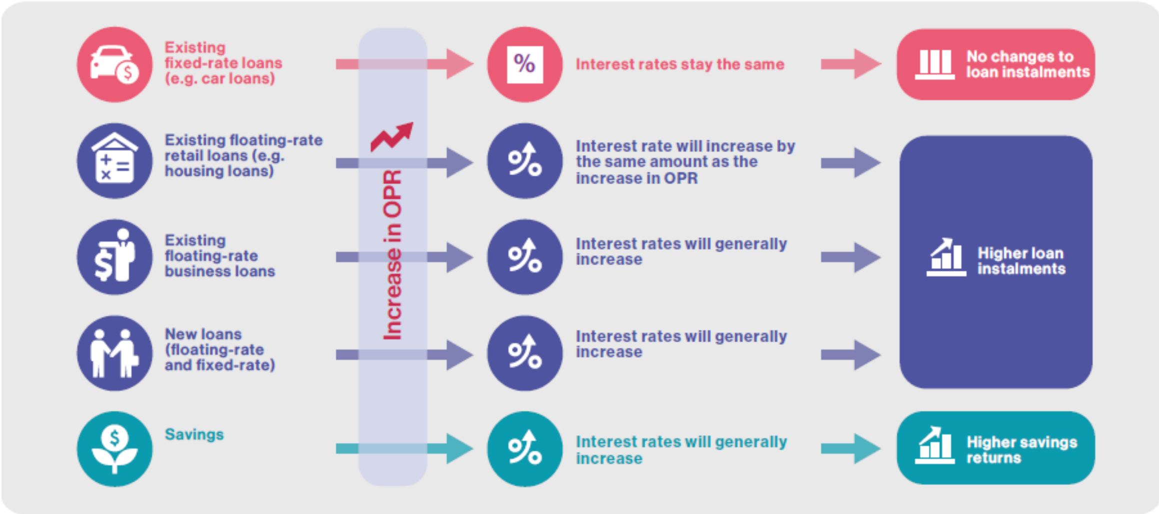


- Higher interest rates help to break this cycle. If we wait until high inflation becomes out of control before we act, it will lead to worse outcomes. By then, we would need to increase the OPR faster and by much more. This would harm households and businesses more, especially when it goes hand in hand with high inflation that would hurt everyone’s purchasing power and plunge the economy into a recession. So, it is important for monetary policy to act early to prevent this from happening in the future.

12. How will the higher interest rates affect me?

- Higher interest rates are intended to encourage people to borrow less and save more.
- If you have a loan, the effect depends on the type of loan that you have.
  - Fixed-rate loans will be unaffected. The amount you pay to your bank will remain exactly the same. Typically, this applies to car loans.
  - If you have a floating-rate loan, your borrowing costs will increase. This means your monthly instalment will be higher. Typically, this will affect housing loans and some personal loans. For individual borrowers, the interest rate on your loan will increase by the exact same rate as the increase in the OPR. For example, if the OPR is increased by 25 basis points, the interest rate on your housing loan, if previously at 3.50%, will also increase to 3.75%. Your loan instalment will increase with the higher interest rate.
- Your bank must inform you accordingly on changes to your loan repayments. You will receive a notification from your bank spelling out how your repayment amount will change (either via mail, email, SMS or applications). This will clearly outline your latest interest rate, new repayment amount and when it will take effect, so that you can prepare accordingly. **The notice may not reach you immediately after a change in OPR but banks are required to ensure it reaches you at least seven calendar days before the new instalment amount is due for payment.**
  - Read more about this in the Reference Rate Framework policy document and Consumer Guide on Reference Rate Framework.
- If you are planning on taking out a new loan, borrowings could also become more expensive for you if interest rates are higher.
- It is important to understand how a change in interest rates could affect your ability to pay. You can use a home loan calculator that is available online to work out your new monthly instalments, such as this.
- Aside from loans, higher interest rates also affect your savings. If you deposit your money in a bank account that pays interest, you will get higher returns on your savings too. Higher returns will benefit savers of all ages,

young and old. These include retired persons and other individuals who rely on interest income to cover their day-to-day living expenses.



13. Can I be excluded from the higher interest rates? What if I can't afford the increases to my loan?

- Generally, monetary policy is intended to affect the economy as a whole. This is what makes it effective to keep the economy healthy.
- Borrowers should be aware that repayments for floating-rate loans will change if the OPR changes and consider whether they can afford the loan if the interest rates were to increase.
- Having said that, if you are an existing borrower with fixed-rate loans, you will not face higher interest rates for the loans you currently have.
- We understand that the increase in interest rates may be more difficult to handle for some. Help is available. If you are having trouble repaying your monthly loan instalments, the best thing you can do is get in touch with your banks or the Credit Counselling and Debt Management Agency (Agensi Kaunseling & Pengurusan Kredit, AKPK) as soon as you can to learn about the support options available.
  - https://www.akpk.org.my/
- You can also ask your bank for repayment options that suit your current financial situation (e.g. to retain the same instalment amount temporarily). Your banks will explain the implications of the repayment options to you.

This may include changes to the total cost of borrowing, changes in the length of your loan tenure or additional interest amount you need to repay. You can revise your instalment amount upwards once your financial situation improves to reduce the overall cost of borrowing in the future.

14. Why aren't the interest rates on my loan or savings going up by the same amount as the OPR?

- When the OPR increases, banks pay higher interest rates on the funds that savers deposit in banks. Savers will benefit from the higher returns on savings. Similarly, banks will also charge higher interest to borrowers to reflect the higher cost of funds.
- The OPR influences interest rates on savings and borrowings, but other factors matter too.
  - For new loans, the interest rate charged by banks also depends on a borrower's ability to pay instalments, as well as banks' operating costs, market competition and other business considerations. For example, if you have a good repayment track record, you may enjoy a lower interest rate on your new borrowings, compared others.
  - If you have an existing floating-rate loan (e.g., a floating-rate housing loan), the interest rate on the loan will go up the same amount as the OPR. Whenever the OPR changes, your new loan instalment amount will take effect anytime within three months.
  - For savings, deposit rates also depend on factors such as competition among banks for funding, alternative sources of lower-cost funding available to banks, and other business considerations including lending strategies. These factors could see interest rates on savings changing more or less than changes in the OPR. Returns on deposits placed with banks also depend on the type of deposits, such as whether you are placing your money in a current and savings deposit account, or a fixed deposit account. Returns on current and savings deposit account are usually much lower and less sensitive to movements in the OPR. This is because the main purpose of these accounts is to allow you to make transactions and the money in these

accounts can be withdrawn at any time. In contrast, you will obtain a higher rate of return if you place your money in a fixed deposit account, where you have to commit to place the money for a pre-agreed period. Generally, the longer the pre-agreed period, the higher the interest rates you would receive on your savings.

15. Will interest rates continue to rise?

- Even though we have raised the OPR a few times, it is not the case that we will keep on raising it at each MPC meeting. At each meeting, we will continue to monitor how the economy is doing and decide whether we need to change the OPR. But we don't expect any drastic increases as seen in some countries. This means that changes to the OPR, if any, will be done gradually.
- Some other central banks have increased their policy interest rates faster and by larger amounts because that is what is needed for their economies. This does not mean that we need to do the same. When we decide on the OPR, we look mainly at our domestic economy to see what is most suitable for us. Global factors, like other central banks' policy rate changes, are considered only through how they affect risks on our own inflation and growth outlook.
- Today, the economy is no longer in crisis and our economy has been steadily improving. So, we have been adjusting the OPR gradually.

16. If the ringgit is weak, does this lead to higher inflation in Malaysia?

- Dollar (or any foreign currency) strength will raise the cost of imported goods, including food prices. However, imported inputs account for less than 20% of production cost. Although the exchange rate impact to inflation is not one to one, it partly contributes to the rising cost of living as higher commodity prices and supply disruptions affect domestic prices. Various measures are being implemented to lessen the impact of this increase in prices. These include social assistance, stabilisation of prices and access to discounted necessity goods.

17. Will a higher OPR strengthen the ringgit exchange rate?

- The OPR is calibrated to help foster the right conditions for sustainable economic growth with price stability. This in turn improves investors' sentiments on our economy and supports the ringgit exchange rate over time.
- There are many other factors that also influence the ringgit exchange rate. Of note, we are currently in a strong US dollar environment, due to a few reasons. These factors include the large rate hikes by the US Federal Reserve to contain US inflation, which have led to higher returns, and thus demand for US dollar assets among investors globally.
- Besides, we should not just compare the ringgit movements against the US dollar. Instead, we should take a broader view and compare it against other currencies. This is where the nominal effective exchange rate (NEER) comes into play. The NEER takes into account ringgit movements against the currencies of Malaysia's trade partners. This is often a better measure of general trends in the exchange rate rather than any one bilateral exchange rate (e.g., ringgit against the USD). For example, the ringgit could be depreciating against the US dollar but appreciating against other currencies.