Interest Rate Hike – A Little Too Soon?

The key function of a central bank is to balance the dual risks of escalating inflation and an economic downturn. After hitting a lull of 4.4 per cent in the preceding quarter, economic growth rose at a faster clip in the third quarter, expanding by an annualised 5.3 per cent. On the price front, consumer prices, after reaching a high of 3.7 per cent on an annual basis in August, stood at 3.3 per cent in October. Despite falling off a pace, the inflation risk was nonetheless officially judged to be sufficient enough to justify a rate hike.

Following the country's stronger economic performance, Bank Negara has adjusted its monetary policy, sending a very strong signal that the interest rate cycle has turned and the directive is skewed towards further possible tightening next year. The benchmark overnight policy rate was raised for the first time in seven years by 30 basis points to 3.0 per cent as the central bank, in its analysis of the economy, felt that the risk of slower economic growth has now diminished while the risk of higher inflation remains.

Inflationary pressure aside, the latest move is also seen by the market as a bid to stem the outflow of capital. Since peaking at USD80 billion at end September, Malaysia's foreign reserves have since fallen USD4.6 billion by mid-November as foreign investors continued unwinding their ringgit position in both the equity and bond markets, and repatriating their profits and dividends. The stock market has fallen 2.5 per cent while government bond yields have risen 10-40 basis points over the past two months as speculative funds, which came in earlier into the country in anticipation of a significant ringgit exchange rate revaluation after the up-pegging of the ringgit exchange rate with the US dollar, are now flowing out. A weak ringgit exchange rate, a widening differential between the US and Malaysia's real deposit rate, a lethargic stock market and negative real returns on domestic deposit rates have prompted the outflow. The ringgit exchange rate, which has appreciated to a high of 3.747 in early August since the de-pegging, has since weakened and is now hovering just above the 3.80 level against the US dollar.

Against tightening financial conditions globally, Bank Negara would surely need to raise rates at some point in the future, But the question, really, is whether the recent hike has come a little too soon. It is arguably so?

First, the recovery is still at a very early stage and its strength may be overstated. The 5.3 per cent growth has been achieved against an easier base comparison. In 2004, the economy expanded by a robust 7.8 per cent and 8.4 per cent in the first and second quarter, respectively, before easing off to 6.7 per cent in 3Q04. Also, the jump in consumer spending in the third quarter to 10.4 per cent (7.4% in 2Q04) may be a blip considering that, unlike last year where there were three Mega Sales Carnivals, the Mega Sales held in 3Q05 was the first this year. Although growth momentum may well be sustained in the fourth quarter due to the recently introduced Mega year-end sales, the year-end Christmas celebration and the bonus payments for civil servants, consumer spending could come under pressure next year. Going forward, a highly geared consumer sector could well suffer from the double whammy of higher costs of living (further reduction in subsidies, possible increases in water and electricity tariffs) and higher borrowing costs. Although there are some worries over the high gearing in the consumer's sector, the problem would have been more effectively dealt with more stringent regulations on credit card spending rather than a generalised hike in rates.

Second, interest rate policy, though effective in dealing with generalised demand driven inflation, is not equipped to deal with the damage from oil price increases. Indeed, much of the increase in consumer prices is policy induced, through reductions in fuel subsidies, the imposition of higher duties on cigarettes and liquor, and the increase in toll charges. In other words, there is far less pressure from demand-driven factors.

Third, external balance remained far too resilient despite the recent outflow. The savings-investment gap (current account surplus) is still in excess of 10 per cent of GDP. And foreign reserves, which stood at 8.4 months of retained imports after taking into account the outflow, are still excessively high when compared against the often-used benchmark of 3 months. Therefore, wouldn't it be more appropriate to adopt a symmetrical directive in monetary policy to induce more funds outflow, most of which are short-term speculative funds, so that the level of liquidity in the system would become more evenly balanced with the rate of economic growth?

Fourth, unless Bank Negara adopts a more flexible exchange rate regime, raising interest rates alone would not stop funds from flowing out. It is simple economic logic that rising interest rates would make financial assets less attractive. In fact, the stock market has unsurprisingly drifted even lower after the recent rate hike to below the psychological 900-point support level, though some of the weakness could be linked to poor quarterly corporate earnings results.

Fifth, despite better economic growth, corporate profits continued to disappoint due mainly to the squeeze in margins. And going forward, firms would have to deal with an additional problem of higher rates.

Finally, there is little evidence of increased pressure on productive resources (labour force and capacity utilisation) and wage inflation. After all, except for 2004, the economy has been expanding below its estimated potential level of about 6.5 per cent since 2001, suggesting there is still some slack in the economy which offers the scope for Bank Negara to keep its monetary policy unchanged, perhaps, for a little longer.

Perhaps, the only justification for the interest rate increase is that real interest rate has been negative due to relatively high inflation numbers. However, interest rates still remain negative in real terms even after the recent interest rate adjustment by commercial banks. Mercifully, the interest rate hike is small, but the negative impact it can have on private consumption, the main driver of growth in recent times, cannot be ignored.

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