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15 May 2025

Real Interest Rate Rises to Post-COVID High – Time to Recalibrate?

BNM Holds Steady as Growth Momentum Eases

At its May 2025 meeting, Bank Negara Malaysia (BNM) maintained the Overnight Policy Rate (OPR) at 3.00%, citing continued global growth and trade, and sustained domestic demand. However, recent economic data suggests that Malaysia's growth momentum is beginning to moderate.

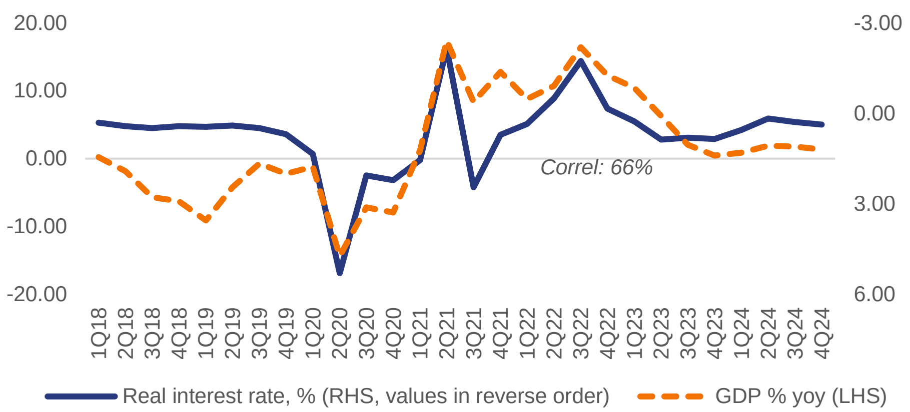
GDP growth slowed to 4.4% year-on-year in 1Q2025, down from 5.0% in the previous quarter, according to official estimates. While domestic demand remained a key driver, there are signs of softening in household consumption, with some spending indicators and loan growth moderating relative to Q4 2024.

While the current monetary policy stance remains broadly supportive, the window for pre-emptive recalibration may be narrowing. With inflation remained benign and global policy cycles turning more accommodative, timely adjustments could help **preserve growth resilience without undermining price stability**.

Real Policy Rate Is Creeping Higher

Malaysia's headline inflation has eased to 1.4%, while the core inflation sustained at 1.9% as of April 2025. With the OPR held at 3.00%, the real policy rate (OPR minus inflation) has now climbed to around 1.6% — one of the **highest levels seen in the post-COVID recovery phase**. Historically, real policy rates at this level have been associated with slower economic momentum, especially when external demand is soft. While the overall stance remains supportive, the recent uptick in real rates indicates that **monetary conditions are becoming less accommodative** — which could weigh on growth if external and domestic pressures persist.

Real interest rate vs Malaysia's GDP



Monthly real interest rate

Sources: CEIC, BMMB Economics

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A 25 bps OPR cut could lift 2025 GDP up to ~0.33 ppt, underscoring the potency of timely and proactive MP

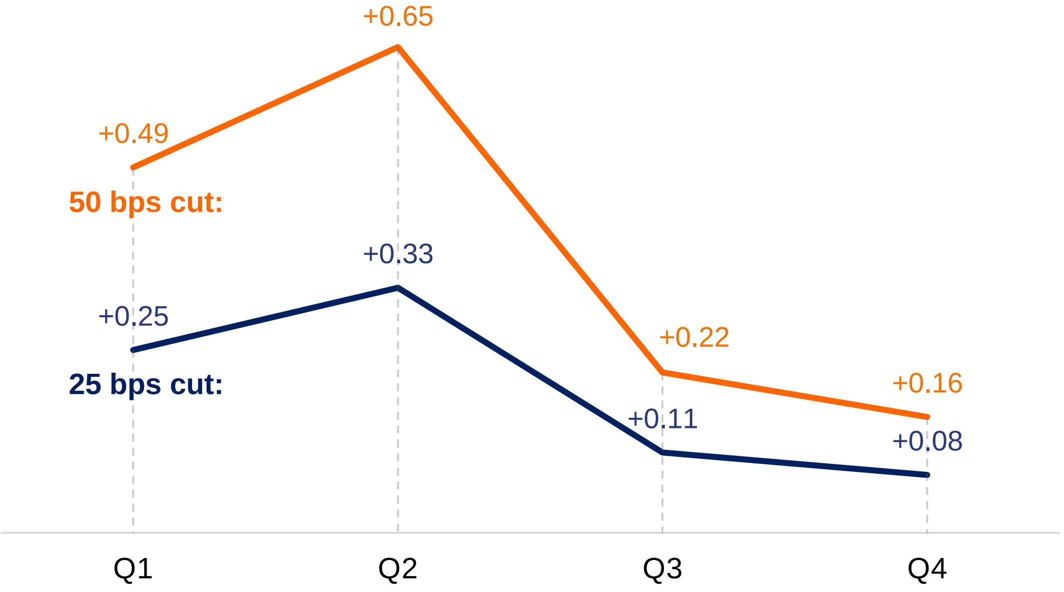
Policy Effectiveness – Findings from VAR Model

To assess the effectiveness of monetary policy in supporting growth, we estimated the impact of OPR changes on Malaysia's GDP using a structural VAR framework. The model isolates the OPR–GDP relationship, holding other variables constant to better identify the transmission effects.

Key Findings:

- A 25-basis point (bps) cut in the OPR is estimated to lift GDP growth by **~0.33 percentage points in 2Q**, with measurable effects already emerging in the first quarter post-cut (+0.25 ppt).
- The effect **peaks in the 2Q**, underscoring the importance of timely and proactive easing to support the economy when momentum is softening.
- While the impact tapers in subsequent quarters, the cumulative boost to GDP remains positive, suggesting that **even modest easing can provide meaningful support**.
- For illustrative purposes, we also simulate a 50-bps cut (assuming linear effects), which could yield up to +0.65 ppt GDP gain at its peak. However, in practice, larger cuts may have diminishing or nonlinear effects — especially nearer to the lower bound.

Estimated Impact of OPR Cuts on GDP Growth: 25 bps vs 50 bps Scenarios



Monetary easing is **effective at stimulating GDP**, with timely and statistically robust **effects observed within the first 2 quarters, especially when policy space is used proactively.**

Source: CEIC; BMMB Economics calculations

Technical footnote: Estimates may appear smaller in broader models due to tight controls and overlapping transmission channels. This exercise uses a streamlined specification to highlight the policy-growth linkage more clearly.

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SRR cut immediately spurs lending by +1.6%, but transmission contingent on bank and borrower behavior

Following BNM's recent reduction in the Statutory Reserve Requirement (SRR), liquidity conditions in the banking system is estimated to improve. Our model estimates that the SRR cut could lead to a **+1.64% increase in loan disbursements** within the first quarter post-cut, supporting a **modest rise in GDP of +0.20 ppt**. While the effect on lending is immediate, the **transmission to GDP is more gradual and subdued**, with the impact declining to just +0.08 ppt by the fourth quarter. This underscores the importance of bank and borrower behavior in determining the effectiveness of SRR-based stimulus.

Why the Impact May Be Overstated

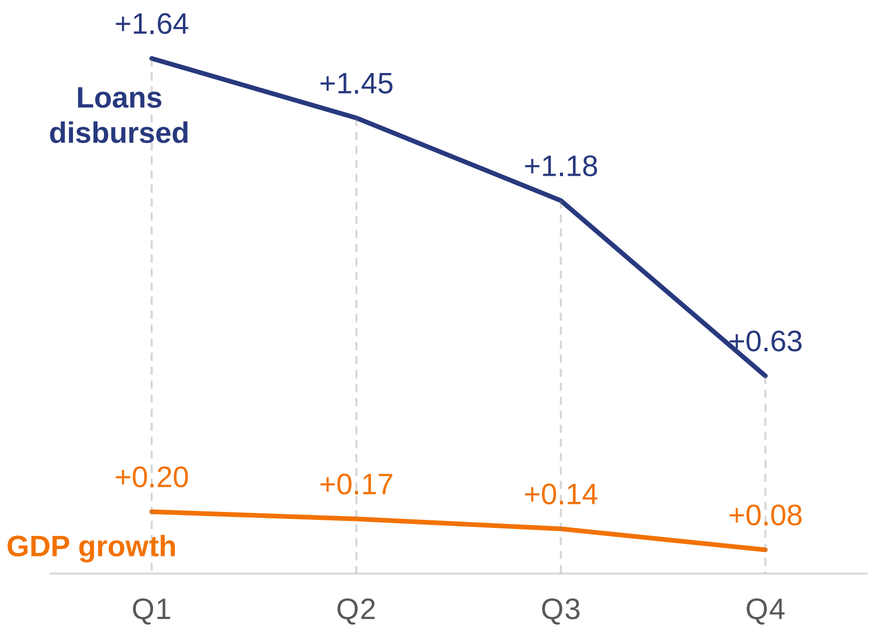
Although our model shows a positive trajectory, the actual effect may be more muted in practice due to three key factors:

Banks May Not Fully Lend Out the Released Liquidity
In periods of weak demand or heightened risk, banks may hold the liquidity as reserves or invest in low-risk assets.

Muted Credit Demand
Households and firms may remain cautious amid economic uncertainty, high indebtedness, or subdued income growth — limiting the pass-through into consumption and investment.

Regulatory Constraints
Loan-to-value caps, debt service ratio limits, and tighter capital requirements may counteract the loosening effect, especially in property and SME segments.

Estimated Impact of SRR Cuts on Loans disbursed and GDP Growth



The SRR is a liquidity tool, not a direct interest rate signal. Therefore, its **real impact depends on how banks respond**.

Source: CEIC; BMMB Economics calculations

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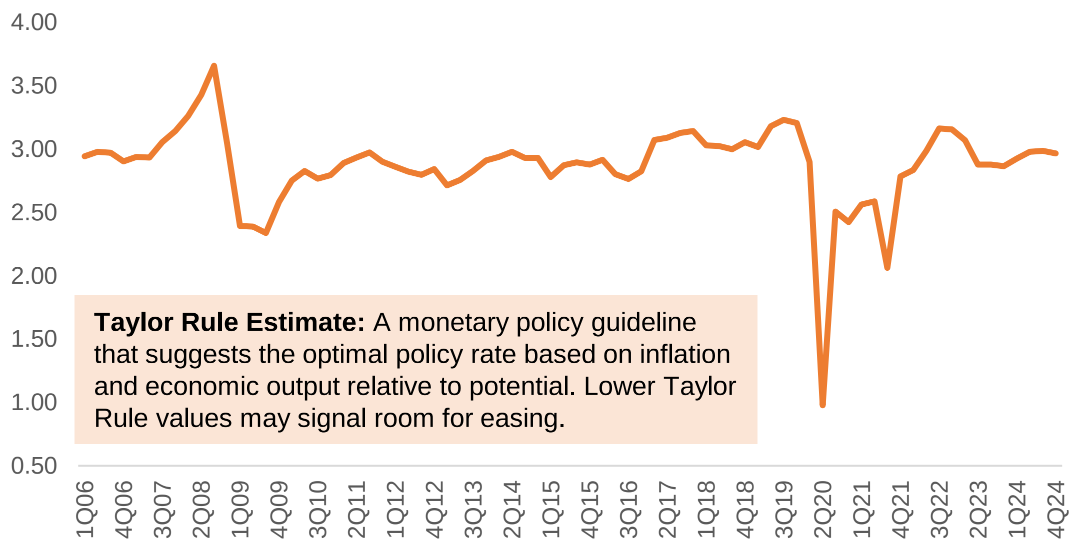
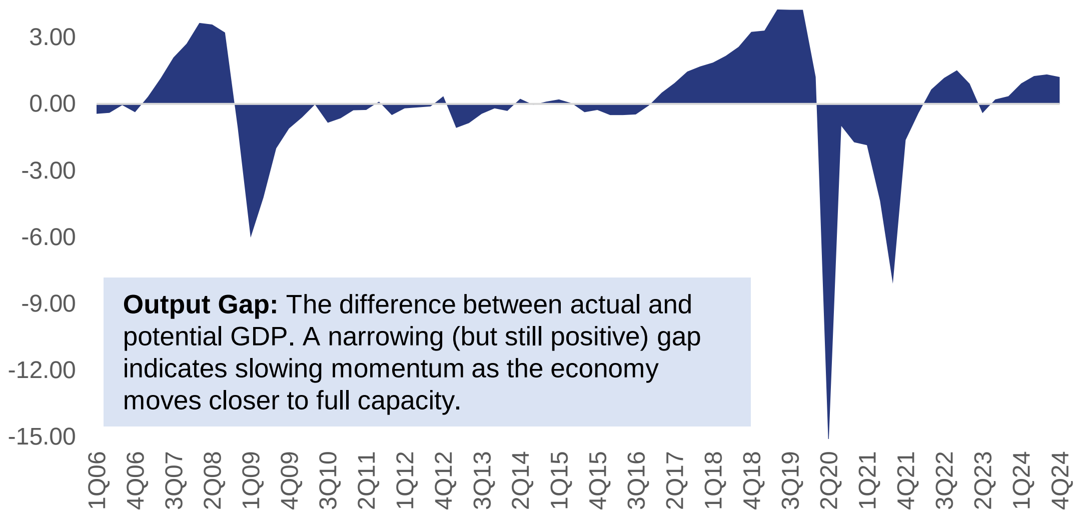
Policy Signals Turning More Supportive

Taylor Rule (%)



Output Gap (%)



Source: CEIC; BMMB Economics calculations

Malaysia's **output gap has narrowed in recent quarters**, indicating that while growth remains in positive territory, **underlying momentum is easing** as the economy approaches its potential. This is consistent with recent signs of softening domestic demand and more subdued credit growth. At the same time, the **Taylor Rule estimate has fallen below the current OPR**, suggesting that monetary conditions may now be **more restrictive than warranted** — particularly with inflation remaining below 2% and external risks, such as trade tensions, continuing to build. As such, we maintain our view that a rate cut remains appropriate this year, despite the recent SRR reduction. Looking ahead, we remain attentive to key developments — especially the **upcoming 1Q2025 GDP release** and potential shifts in US tariff policy — which will offer further clarity on the growth outlook. A timely rate adjustment could help reinforce recovery momentum and ensure that monetary policy remains responsive to evolving macroeconomic conditions.

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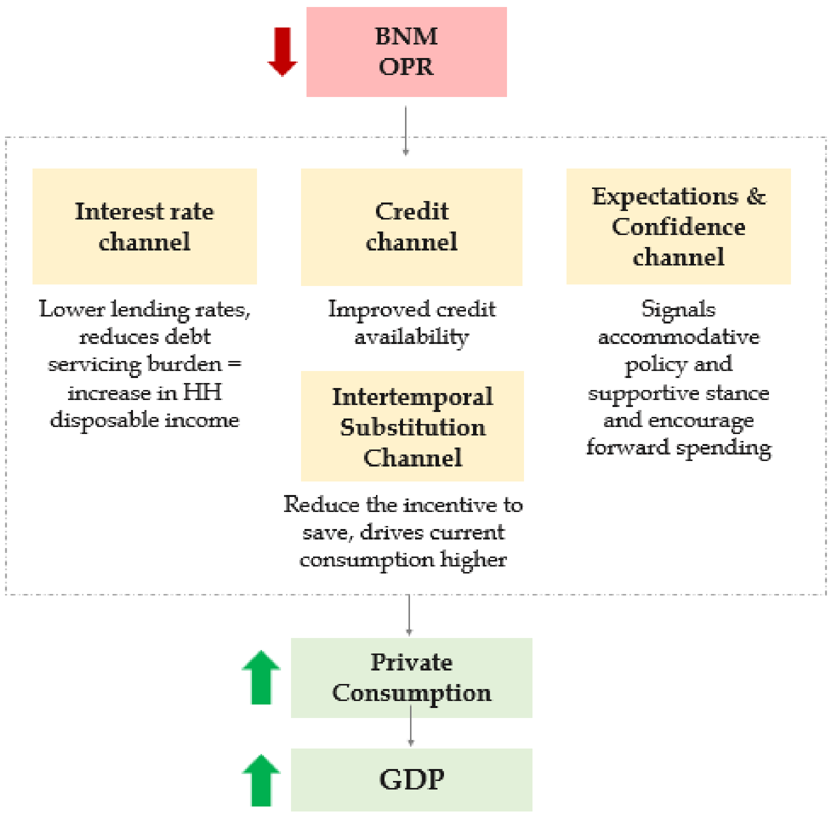
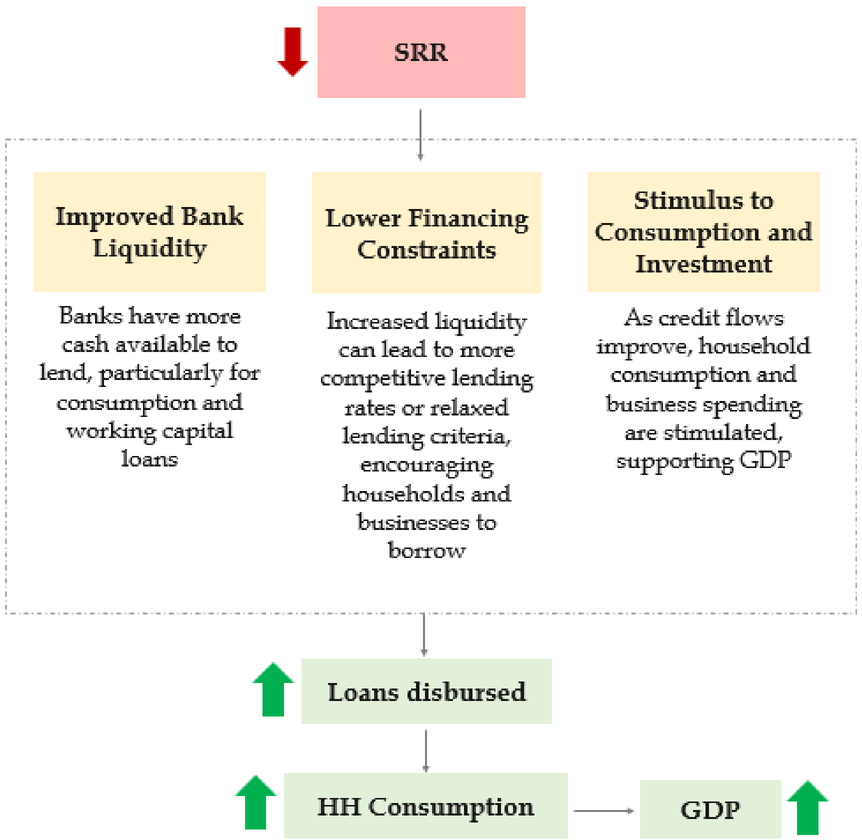
Appendix: Transmission channel

OPR Transmission to the Real Economy



SRR Transmission to the Real Economy



Note: The transmission channels illustrated above are key pathways and not exhaustive. Monetary policy may also influence economic activity through other mechanisms such as asset prices, exchange rates, and external sector dynamics.