SASANA SYMPOSIUM 2025

STRUCTURAL REFORMS
BUILDING A RESILIENT MALAYSIA

Workshop 4

What's Behind The Consumer Price Index?

CPI INFLATION & MONETARY POLICY

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BNM's mandate is to promote monetary and financial stability conducive to sustainable growth



Monetary Stability

Monetary stability means keeping price movements in check so the economy can steadily grow over time

Financial Stability

Financial stability means that the financial system, including banks and markets, is working well and people have confidence in its ability to operate efficiently and reliably

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In pursuing monetary stability, BNM's goal of price stability is supported by DOSM's price data collection





Central Bank Act 2009 Section 22(1)

"In promoting monetary stability, the Bank shall pursue a monetary policy which serves the interests of the country with the ***primary objective of maintaining price stability*** *giving due regard to the developments in the economy."*

Statistics Act 1965 Section 2(2)

"The functions of the Department shall be to collect and interpret statistics for the purpose of furnishing information required in the formation or carrying out of Government policy..."

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What is price stability – conceptual definitions



Price stability is best thought of as ***an environment in which inflation is so low and stable over time that it does not materially enter into the decisions of households and firms****" – Alan Greenspan*



"A workable definition of "price stability" would seem to me to be a situation in which ***expectations of generally rising (or falling) prices over a considerable period are not a pervasive influence on economic and financial behaviour****" – Paul Volcker*



"Our economic system works best when producers and consumers, employers and employees, can proceed with full confidence that ***the average level of prices will behave in a known way in the future - preferably that it will be highly stable****" – Milton Friedman*

In practice, central banks typically consider *price stability* as an environment whereby **CPI inflation** is trending at a **low and stable** rate over the **medium-term horizon**

- CPI reflects the goods and services commonly purchased by an average Malaysian household – hence it tracks the purchasing power of Malaysian consumers
- Low positive inflation helps prevent deflation risks and improves labour market efficiency, while stable inflation ensures price changes are predictable and non-disruptive
- Monetary policy works with a lag, so it focuses on medium- to long-term stability -- and avoids overreacting to transitory short-term shocks like supply disruptions

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Price stability is a necessary condition for facilitating economic welfare to achieve sustainable growth



Reduces uncertainty & distortions — *Improves price signalling, reduces risk premia, & prevents arbitrary redistribution*

Enables efficiency & productivity — *Credible long-term commitment enables optimal planning and allocation of resources*

Facilitates economic welfare — *Higher living standards and sustainable growth amid monetary and financial stability*

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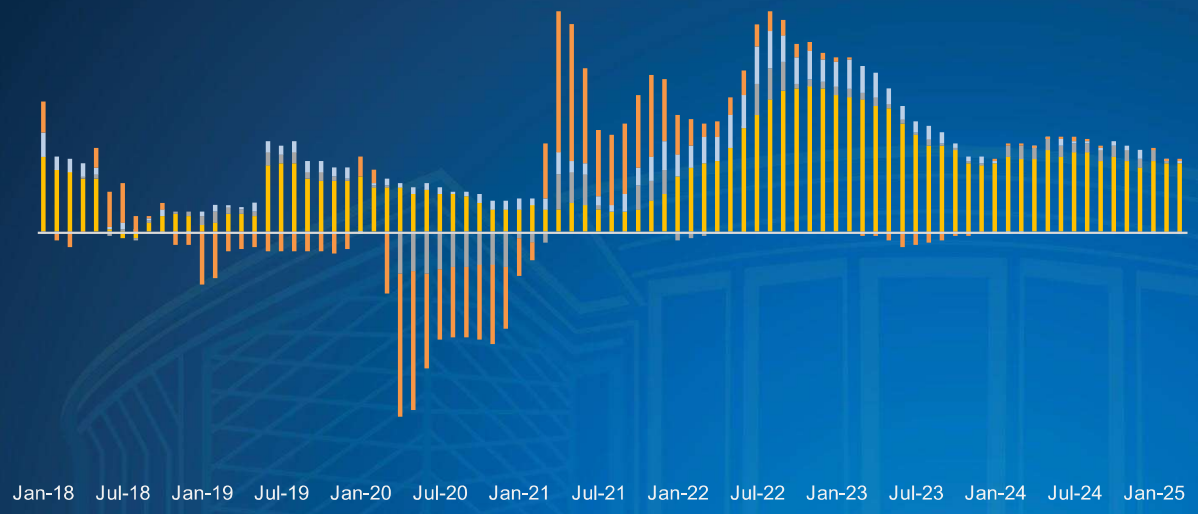
Zooming into the components of CPI inflation can reveal important information about price dynamics

- **Headline inflation is made up of various components – underlying inflation (which aims to reflect general price level) and non-core components, which are driven primarily by supply or idiosyncratic factors.**

Breakdown of headline inflation by CPI components
(ppt contribution)



Underlying inflation – weight: 76.6%
- Core inflation by exclusion method (as published by DOSM)
- Excludes administered and volatile items

Price administered – weight: 10.4%
- Prices of certain goods controlled and subsidised by the Government

Price volatile – weight: 7.2%
- Fresh meat, vegetables, fruits etc.
- Price movements may be driven by weather disruptions or seasonal demand

Fuel – weight: 5.7%
- RON 95, RON 97, diesel

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Underlying inflation reflects the persistent trend in price changes which is crucial focal point for monetary policy

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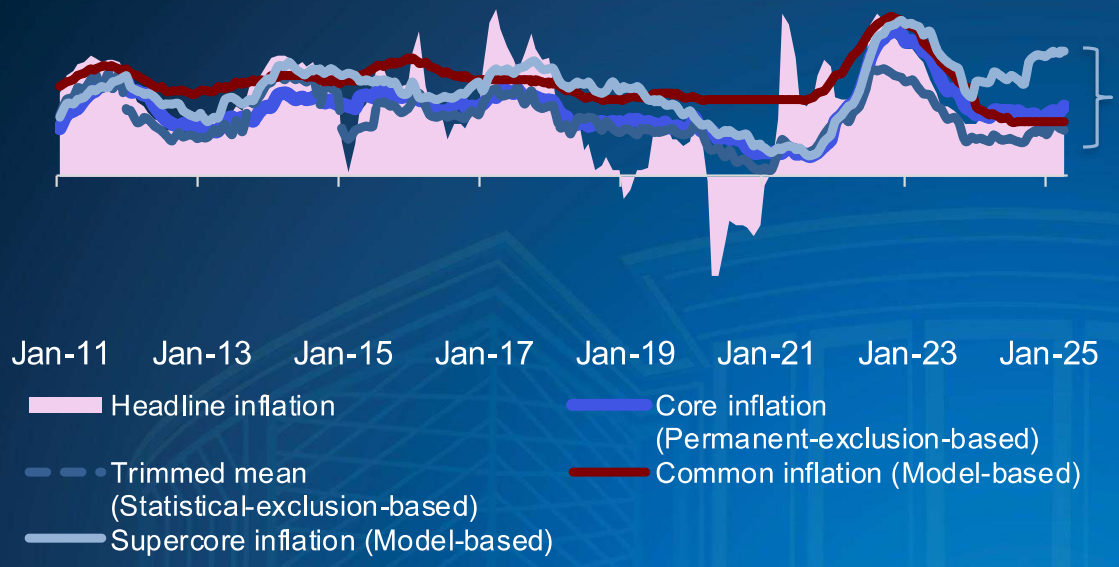
- **Measures of underlying inflation are more reflective of the medium-term path of the general price level, and it matters for price stability as it gives policymakers a clearer view about the path of inflation**



Stabilisation in underlying inflation following broad disinflation since 2023

Headline is more volatile, reflecting item-specific and idiosyncratic factors such as oil price shocks

Permanent-exclusion-based
- Core inflation (*as published by DOSM*)

Statistical-exclusion-based
- Trimmed mean
- Weighted median
- Double weighted

Model-based
- Common inflation
- Supercore inflation

For more details, please refer to BNM EMR 2023 box article "Underlying Inflation at its Core"

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High inflation weakens purchasing power and disrupts the economy



Erodes purchasing power
Same amount of money buys less over time, hurting consumers, especially those on fixed incomes.

Reduces value of savings
Real value of savings declines, discouraging saving behaviour.

Lower real income
When wages grow at a slower pace than inflation, people effectively earn less in terms of what their income can buy.

Uneven distributional impact
Disproportionately affects lower-income households who spend a larger share of income on consumption.

Distorts economic decision-making
Uncertainty about future prices discourages long-term planning and investment.

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However, deflation can also cause unfavourable consequences to the economy

- **Lower prices may appear desirable, but persistent deflation (i.e. negative inflation over an extended period) can generate a vicious cycle of stagnation**



Job losses and lower wages
When prices fall, shrinking business profits often lead to cost-cutting measures such as downsizing to reduce labour costs

Reduced consumer spending
Consumers delay purchases in anticipation of lower prices, which weakens demand

Erosion of consumer confidence
As persistent deflation becomes entrenched into expectations, pessimistic sentiments can cause cautious consumer/financial behaviour

Downward economic spiral
Confluence of lower employment and income, weaker demand and poor sentiments weaken economic activity – causing prices to fall further and perpetuating the feedback loop

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Monetary policy helps keep prices stable by making sure a symmetric reversion of inflation to trend

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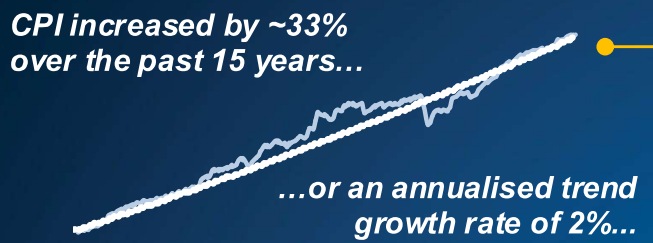
- **Keeping CPI inflation moderate and predictable (not too high nor too low) enables households and businesses to plan ahead as they factor price expectations into spending, investment, and wage decisions.**

Headline CPI Index (2010 = 100)
(2010-2024)



Headline CPI (year-on-year growth, %)
(2010-2024)



Monetary policy aims to ensure <u>timely reversion to trend</u> by making sure:

1. Interest rates are adjusted such that domestic demand conditions are not excessive, which can cause uptrend in underlying inflation
2. Long-term expectations are well-anchored (i.e. expect gradual price increases) given that economic planning is guided by general price changes rather than short-term price fluctuations
3. Inflation converges to long-term underlying rate, as transitory price shocks eventually dissipate on their own

Do you know?

Cyclical supply and demand shocks cause inflation to fluctuate, while underlying ***trend inflation*** is more persistent and is driven by longer-term factors, such as:

- Monetary policy stance
- Structural factors
- Global megatrends

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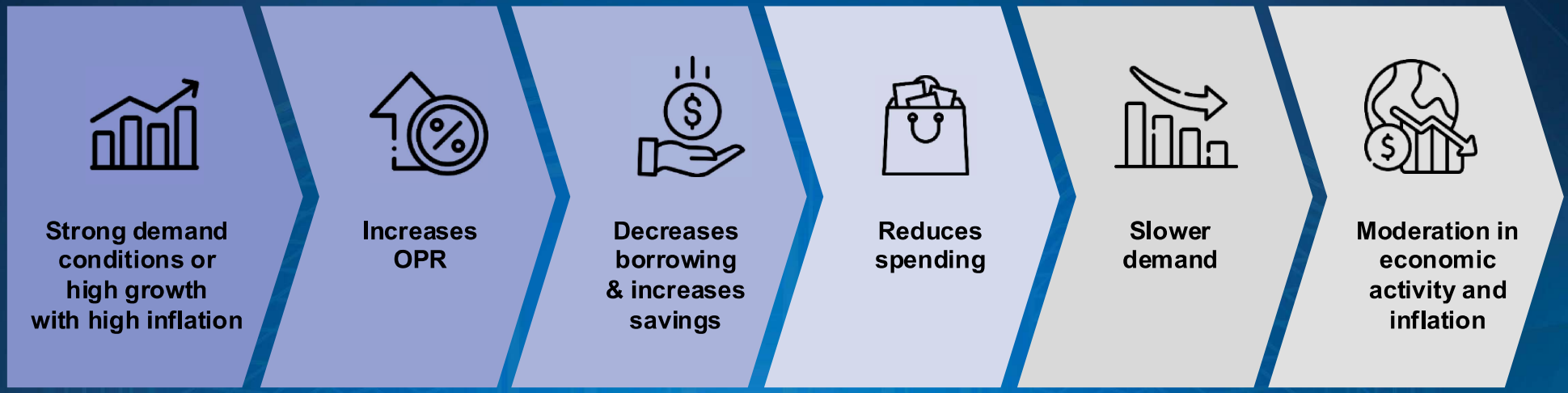
How does BNM conduct monetary policy and influence the direction of the economy by influencing the "price of money"

- **Price stability occurs when inflation (the rate of increase in the general price level of goods and services) is kept low and stable over an extended period of time.**



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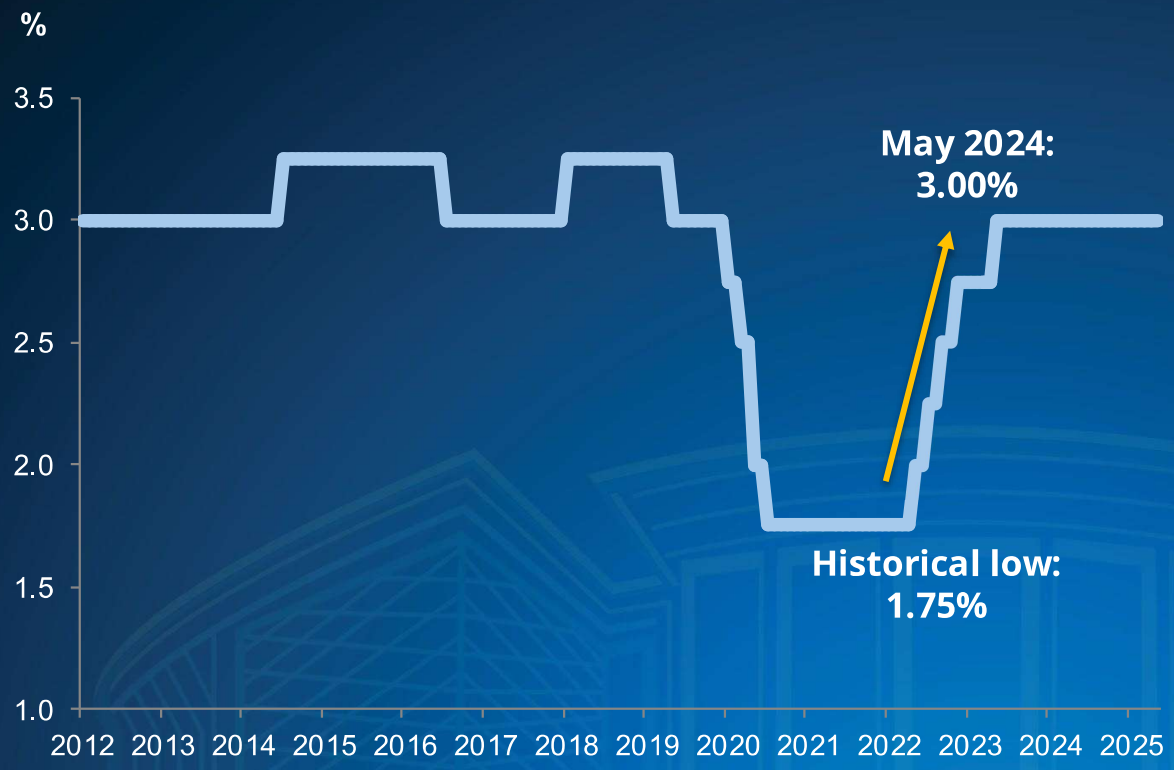
The OPR adjustments following the economic recovery in 2022 offer a real-life example of the MPC's considerations



Source: Bank Negara Malaysia

1. **2020: COVID-19 crisis**
   The MPC cut the OPR from 3.00% to a historic low of 1.75% to help the economy stay afloat
2. **2021: Stabilising economy**
   OPR was unchanged
3. **2022-23: Road to recovery**
   The OPR was gradually normalised as more material signs of recovery had appeared amid the lifting of lockdowns
4. **2024**
   OPR remained unchanged at 3.00%

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Inflation has moderated, but cost of living remains a challenge amid weak income growth

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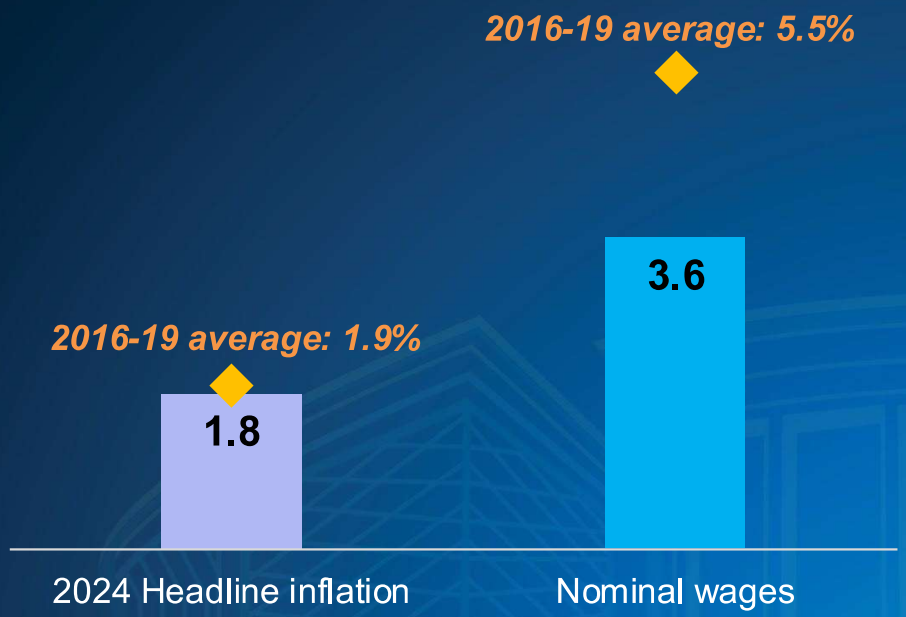
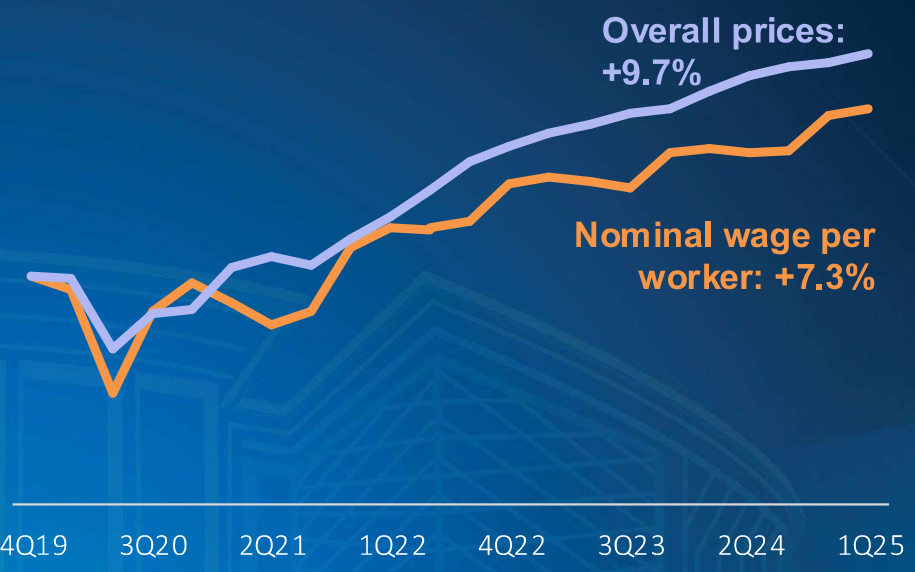
- **Cost of living is a function of both prices and income – higher wages are needed to restore purchasing power following bouts of high inflation**





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Integrating macroeconomic policies with deep structural reforms is crucial for a more impactful approach

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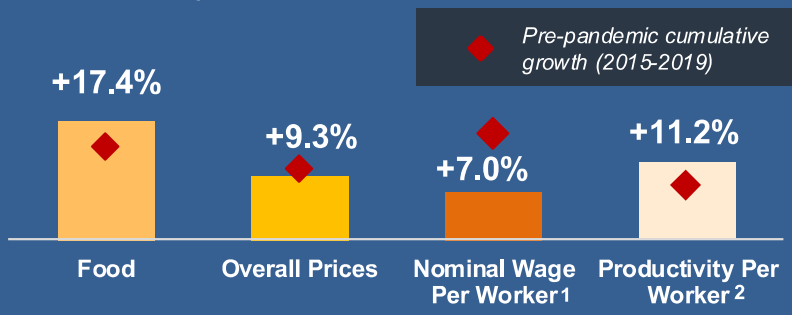
1 Cost of living concerns remain prominent

Consumer Prices and Wages

Cumulative growth between 4Q 2019-4Q 2024



1. Wage growth has not kept pace with price increases
2. Elevated price levels post-pandemic despite low inflation
3. Lower-income households are more vulnerable, as a higher proportion of income is spent on food

2 Aligning policies and structural reforms is crucial to address cost of living concerns effectively

Monetary Policy	Primary tool to manage inflation through its effects on overall demand
Fiscal Policy	Strategically targeted to assist specific groups; raises productive capacity
Structural Reforms	Boosts productivity; enhances competition and economic resilience
Labour Market and Social Protection Reforms	Meaningfully increases incomes; provides safety nets for vulnerable groups

1/ Refers to wages earned by workers in the manufacturing and services sectors.

2/ Productivity Per Worker growth (indexed 2020 = 100) is defined as change in real output per worker

Source: Department of Statistics, Malaysia

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THANK YOU!

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