The pivot to monetary easing

CAPITAL CONTOURS
BY RAY CHOY

On July 9, Bank Negara Malaysia lowered the overnight policy rate (OPR) by 25 basis points from 3% to 2.75%, framed as a precautionary easing amid the ongoing trade war. As Malaysia's first rate cut in five years, a turning point has been marked in the interest rate cycle — the beginning of the last interest rate downcycle was in May 2019, six years ago, heightening the significance of this monetary easing. There appears to be sufficient traction for further rate cuts in Malaysia, as the OPR has ranged from a historic low of 1.75% in April 2022 to a peak of 3.5% in October 2008, placing the current interest rate level close to the long-term midpoint. This suggests there is further room for rate cuts as economic growth will be affected by declining global trade due to rising trade protectionism and a period of adjustment to supply chain reconfigurations. Meanwhile, subdued inflation readings in Malaysia affords significant policy flexibility.

Challenging external conditions and geoeconomic positioning have often been blamed as the causes of slowing global growth. Indeed, global growth in merchandise trade is expected to decline to 1.5%-2.5% per annum in 2025-2026 from the 20-year average of 5.7%. In the very long term of 50 years, the historical average was 7.5%. These trends suggest that global trade is on the decline, and it had been happening for quite some time before the Trump administration accelerated the idea of nationalistic geoeconomic positioning.

In Malaysia's case, exports growth can be highly variable, with an elasticity to global trade of greater than 1, due to commodities exports and the semiconductor cycle. Generally, a good long-term average benchmark for exports growth in Malaysia has been 4%-5%, although periods with double-digit growth rates are not unusual. The variability of such trade is not necessarily negative, but a natural consequence of being a trade-driven economy — in 2023, Malaysia's trade openness ratio was 154% of gross domestic product (GDP) compared to the global average of 43.9%. Trade is supportive when a persistent trade surplus is achieved, as in Malaysia's case, with exports consistently exceeding imports, underpinning a current account surplus sustained since the deficit episode of 1997 during the Asian financial crisis.

Nonetheless, this benefit must not be taken for granted. The headwinds from the external sector are increasingly posing a threat to Malaysia's surplus position. As such, while exports can continue to support surpluses, the question is when and how much imports for infrastructure and industrialisation will generate economic returns. Trade-offs are fundamental in economics, and in an environment of slowing global demand, the maintenance of a trade surplus becomes increasingly difficult; particularly amid rising capital-goods imports and weakening commodity prices as global growth decelerates.

The global backdrop for rate cuts has grown clearer, as the US economy shows signs of deceleration, with unemployment trending upward above 4% and wage growth losing momentum, pointing to softer inflationary pressure. In fact, the evidence for a US rate cut had been long-standing, ever since the unemployment rate rose from 3.4% in April 2023 to 4.2% in July 2025, which weakens the argument of sticky inflation requiring elevated interest rates. Over the last three months, US non-farm payrolls collapsed to a monthly average of 35,000 from an average of 128,000 over the last 12 months, a massive 73% decline in job creation. Even so, US inflation has not been unreasonably high as the 12-month trimmed mean personal consumption expenditure (PCE) inflation was 2.7%, while global supply chain and commodity price disruptions make the 2% inflation target popularised in the early 1990s arbitrary, obsolete and outdated. Furthermore, it is well recognised that interest rate setting cannot responsibly rely on a univariate model alone. Consequently, markets are now pricing in cumulative rate cuts of 75 to 100 basis points over the next 12 months.

Should the US interest rate fall faster and steeper than Malaysia's interest rate, the pressure for ringgit appreciation is high. An excessively strong ringgit is unfavourable should the country wish to pursue a trade surplus, unless the demand for its goods is highly inelastic, where strong demand leads to limited reaction should prices increase. For now, this is unlikely as the strength of the ringgit is a function of the sovereign risk premium, comprising multiple factors, alongside interest rate differentials. Therefore, a key question lies in the question of trade durability. Given the complexity of external geoeconomic relations, the more prudent course is to concentrate on measures within the country's own control. As such, advancing up the value chain, a key goal of Malaysia's industrial plans, is crucial to retain product differentiation or high value-add which adds to robustness in product demand. While semiconductors are a key export, it is necessary for the entire nation to embrace the concept of value-add and economic complexity through the development of specialised skills to export uncommon, sophisticated products.

At present and against this backdrop, a pragmatic goal is one in which the ringgit remains stable and gradually converges towards estimated fair value, rather than experiencing a strong appreciation. If Malaysia's key exports were to acquire characteristics rendering their demand less sensitive to global growth cycles (that is, lower elasticity), a more durable and sustained appreciation of the ringgit could then take hold. In contrast, depreciation remains an undesirable outcome in political-economy terms, in so far as it amplifies inflationary pressures and erodes perceived household wealth. Therefore, interest rate management amid global rate changes, the currency's value and internal agendas are a fine balancing act.

Fortunately, in Malaysia's case, the central bank has retained strategic options with interest rates as a potentially supportive economic policy tool. Regionally, Indonesia has faced sustained trade deficits that hamper interest rate cuts as it relies on portfolio inflows to fund its twin fiscal and current account deficits. Thailand had already cut interest rates since early 2025, with its policy rate now at 1.5%, prioritising growth over currency stability, limiting policy ammunition. Conversely, some economies possess greater monetary policy flexibility, but the essential lesson is that the effective use of interest rates as a policy instrument is not universally and always available; it must be earned through: (i) sustained fiscal consolidation to contain sovereign risk premiums; (ii) the maintenance of sophisticated capital markets conducive to global investors; (iii) the attraction of investments; (iv) the accumulation of foreign exchange reserves via durable trade surpluses; and (v) the effective pacing of monetary policy, among other factors. Although Malaysia has earned this policy flexibility over the decades, it must continue to safeguard and defend it, lest fiscal and external imbalances, or erosion of investor confidence undermine the very foundations upon which such autonomy rests.

In the short to medium term, Malaysia's economy would benefit from interest rate cuts, considering through-the-cycle data. While it is true that the consumer and retail sector in Malaysia is robust, as indicated by healthy services growth of slightly over 5.1% in 1H2025, this is a deceleration from the pre-pandemic average of 6.2%. The same can be said about manufacturing, which decelerated from the pre-pandemic average of 4.8% to 3.9% in 1H2025. The services and manufacturing sectors form almost two-thirds and a quarter of Malaysia's GDP, respectively. Meanwhile, although construction has made headlines with 13.2% growth in 1H2025 driven by ongoing infrastructure spending and data centres, it is challenging to maintain momentum from such spikes, due to the high base effect and mean reversion, and this sector is relatively minor as a proportion of overall GDP. Furthermore, there are limitations to rapid expansion in any given sector due to capacity constraints, such as energy supply and necessary reserve margins. In 2026, GDP growth may decelerate to 4%, although downside risks remain due to the uncertainties of global trade protectionism. While supply chains are being reconfigured towards improved resilience, the implementation lag will occur due to a period of adjustment — for example, feasibility studies on new investments and shifting geoeconomic realignments through new trade agreements within and across regions.

While easing interest rates are theoretically meant to spur demand, a caveat lies in the persistence of the decline of interest rates and, similarly, the length of time in which interest rates remain at a trough. This analysis is made more complex, considering that global liquidity flows and interest rate policy curves also feature in the overall weight of monetary accommodation. This point is important as empirical evidence suggests that a material portion of interest rate movements track economic cycles even though they are meant to be countercyclical, or supportive to growth when it heads south. A finer analysis suggests that for interest rate accommodation to be effective, U-shaped troughs are better than V-shaped trajectories, suggesting the need for some persistence of at least a year in interest rate accommodation after it declines, at a rate which is commensurate with inflation, growth and unemployment expectations. Logically, debt refinancing programmes, business plans and obtaining management buy-in for such strategic moves take time, particularly when seeking new avenues for trade amid policy disruptions which require a significant reshuffling of business plans. E

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