Inflation and labour markets in the wake of the pandemic

Inflation and labour market dynamics after the pandemic

Headline and core inflation

Headline and core inflation trended higher in 2022, driven by improvements in demand conditions and higher input costs amid elevated global commodity prices and supply-related disruptions. The extent of cost pass-through to consumer price index (CPI) inflation was partly mitigated by price control measures.

Headline inflation increased to 3.3% during the year, with the increase predominantly driven by food-related services and goods (Graph 1). Underlying inflation, as measured by core inflation, also trended higher to 3.0% amid demand and cost pressures.

Strengthening demand conditions following the reopening of the economy accelerated the normalisation of core inflation, after a period of subdued demand and reduced profit margins during the pandemic, and contributed to a greater pass-through of cost pressures to CPI inflation.

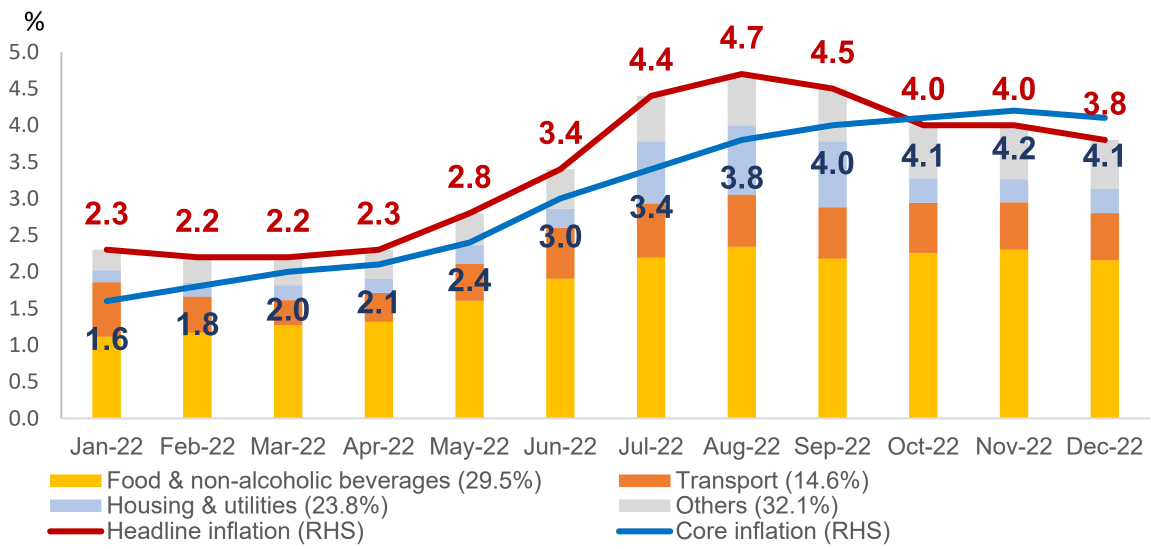
The confluence of the conflict in Ukraine and pandemic-related exogenous factors[1] led to a surge in global commodity prices and prolonged supply-related disruptions, which continued to drive higher input costs during the year. This was exacerbated by adverse weather conditions, export restrictions in key commodity-exporting countries and higher import prices, following sustained US dollar strength against the ringgit.

Nevertheless, the extent of cost pass-through to CPI inflation remained partly mitigated by government policies, which include price control measures such as retail fuel subsidies and price controls on selected fresh food items.

While headline inflation has gradually eased since its peak of 4.7% in August 2022, it is expected to remain elevated and above its long-term average (2011–19 average was 2.2%), albeit on a moderating trend, given the persistence of core inflation.

[1] Including disruptions in factories and shipping ports due to resurgences of Covid-19 and higher operating costs due to pandemic-containment measures.

Inflation by components Graph 1



Source: Bank Negara Malaysia estimate based on Department of Statistics Malaysia.

Labour market conditions

Slack prevails despite the strong recovery in labour market conditions. While wages improved in 2022, this largely reflected strengthening demand conditions upon the full lifting of restrictions, beginning in the second quarter of 2022. Thus far, wage growth is not assessed to be excessive in the context of the broader economic recovery.

Labour demand steadily increased and was met by forthcoming labour supply as labour force participation rebounded above pre-pandemic levels (69.8% of the working age population in November 2022 compared with 69.1% in the fourth quarter of 2019). Hence, slack remains in the domestic labour market, as reflected by the elevated unemployment rate relative to its pre-pandemic averages (3.6% of the labour force in November 2022 compared with a 2015–19 average of 3.3%).

Wages improved following strengthening demand and were partly supported by the 25% increase in the minimum wage to MYR 1,500 that became effective in May 2022 (8.0% private sector wage growth in the third quarter of 2022 compared with its recent trough in the third quarter of 2021). Nevertheless, the increase in wages remained significantly more moderate compared with the pickup in production activity (14.2% in the third quarter of 2022 compared with the third quarter of 2021).

A comparison of wage growth in the US relative to Malaysia provides further insights into the degree of wage excessiveness. In contrast to Malaysia, wage growth in the United States has been markedly stronger. Private sector wage per worker growth in the United States averaged 4.5% between the first and third quarters of

2022 (2013–19 average was 2.5%), while Malaysia recorded only 2.9% (2013–19 average was 3.6%) in the same period.

There were labour shortages but these were driven by frictions and concentrated in specific jobs and sectors. Hence, shortages have not contributed to broad-based increases in wages. This issue is expected to ease amid a gradual return of migrant workers and as demand normalises.

The Bank's engagements with industry players also suggests that firms deployed multiple strategies to mitigate these shortages, particularly through increasing productivity by arranging for workers to take on more tasks, and accelerating automation and digitalisation for more capital intensive sectors.

Historically, wage growth in the services sector is more highly correlated with the prices of core services (correlation: 0.8), but correlation is low between manufacturing wages and core goods (correlation: 0.4). This reflects that wages constitute a larger share of total costs for the services sector (22% of total costs), but a smaller share of the costs of manufacturing goods (9% of costs). This may warrant close monitoring given the potential persistence of services inflation which has remained high at this juncture, while goods inflation has begun to moderate.

While the increase in minimum wages in 2022 did contribute some additional cost pressure to domestic firms, the size of the impact was largely contained. In particular, the increase in minimum wages was estimated to directly affect less than 15% of the population in employment, and the cascading impact on the wages of other workers was assessed to be gradual.

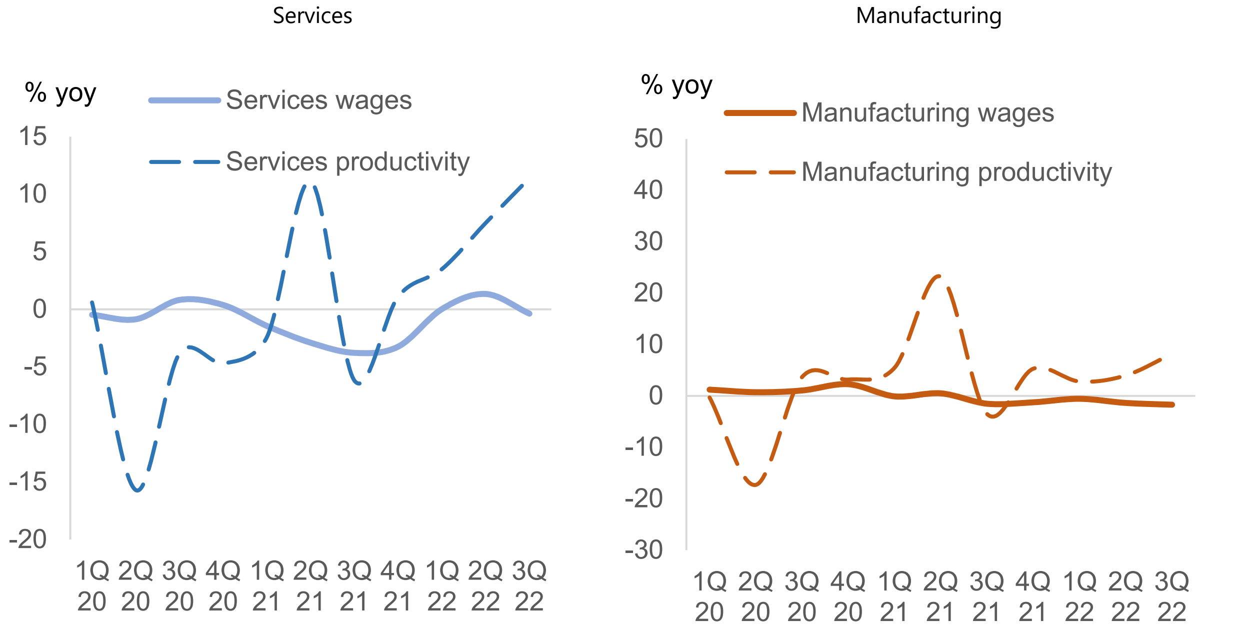
At this juncture, second-round effects are assessed to be limited while the risk of a wage-price spiral remains remote. Inflation expectations remain firmly anchored, while wage growth has not exceeded increases in prices, due in part to limited collective bargaining power and a lower prevalence of wage-indexation mechanisms in Malaysia.

Real wage increases are not outpacing productivity – real wage growth between the first and third quarters of 2022 was 2.9%, while the productivity rate rose by 5.0% (Graph 2) and slack remains in the labour market. Inflation expectations remain firmly anchored. The latest indicators of long-term analyst expectations, including consensus expectations on inflation for the period 2028–32, continue to be broadly consistent with the long-term average (2028–32 consensus is 2.3%).[2] Over the shorter term, expectations for 2024 also suggest a moderation towards 2.2%.[3]

2 Asia Pacific Consensus Forecast, October 2022.

3 Bloomberg, accessed on 19 January 2023.

Real wages per worker vs productivity in the services and manufacturing sectors Graph 2



Source: Department of Statistics Malaysia, Bank Negara Malaysia estimate.

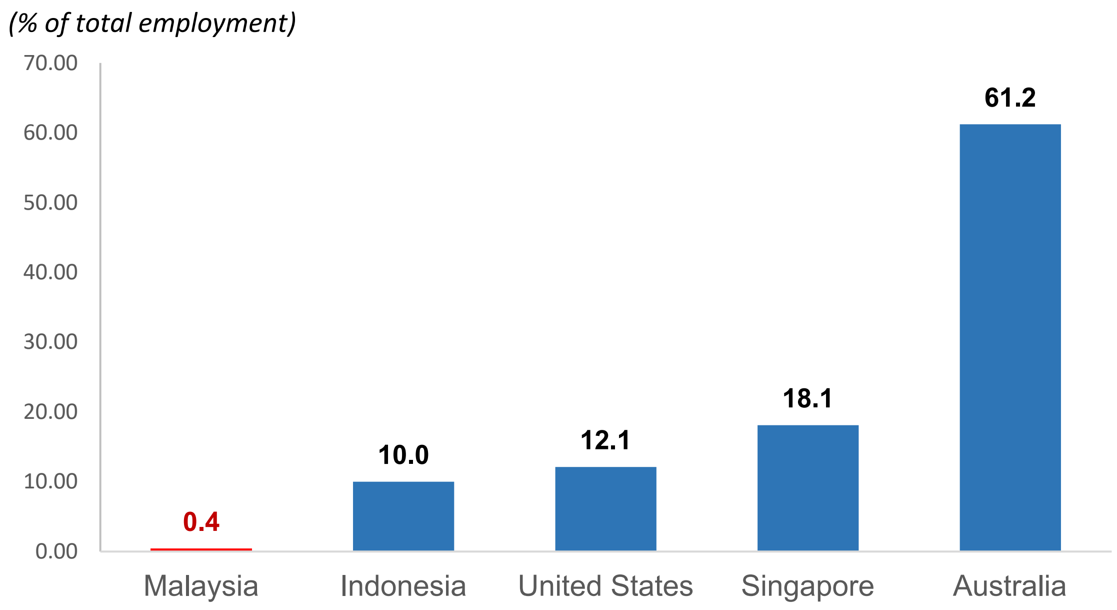
Structural features of the domestic labour market, including the low prevalence of collective wage agreements and wage-indexation practices, have partly mitigated the risk of second-round effects. Only a small fraction of wages in Malaysia are covered by collective wage agreements: 0.4% of total employment as of 2019. This is relatively low compared to other economies (Graph 3). Moreover, union membership in Malaysia across government, the private sector and statutory bodies comprises only around 6.3% of total employment, as of 2019. This is in contrast to 9.8% in the US, and other emerging market economies such as Indonesia (13.0% in 2019), India (19.8% in 2017) and Vietnam (49.6% in 2018).[4]

In answering the Bank's regional survey of domestic households and firms, respondents indicated a limited intention to react to the elevated cost of living by seeking or providing, respectively, higher wages. This suggests a limited risk of a wage-price spiral.

4 ILOStat, accessed in December 2022.

Share of wages covered by collective wage agreements

Graph 3



Source: ILOStat.

Policy implications

While the extent of wage-push inflation is assessed as being broadly contained, the Bank has calibrated its monetary policy stance to pre-emptively respond to incipient demand pressures in a gradual and measured manner. Although inflation expectations have remained anchored thus far, the Bank is mindful that the policy trade-off could become much larger if expectations become unhinged. In this situation, the Bank would need to increase interest rates more aggressively, which comes at a greater cost to the economy. For this reason, the Bank has taken a pre-emptive approach in mitigating the risk of excessive demand on price pressures and inflation expectations. Since May 2022, the overnight policy rate (OPR) has been raised by 100 basis points, bringing the stance of monetary policy to a level consistent with firmer growth prospects for the Malaysian economy.

Credibility is also important in mitigating the risks from unanchored inflation expectations, especially as pre-emptive interest rate hikes have been met with unanticipated public dissent as a result of concerns over the higher cost of living. In light of this, the Bank has taken steps to enhance monetary policy communications in managing public sentiments.

The Bank has widened its channels of engagement, supplemented with targeted forms of content. This includes sharing deeper insights with analysts, and more accessible materials and sessions with the media, public and even government representatives. To manage expectations of further interest rate hikes, communications have been geared towards providing greater assurance on the future policy path, which will be measured and gradual.

Monetary policy needs to be complemented by labour reallocation policies and structural reforms to manage short-term risks to inflation and safeguard long-term growth potential. While the structure of the labour market has led to rigidities in wage growth, greater frictions in the labour market since the Covid-19 pandemic have given rise to concerns over higher wage costs. Continued support for labour reallocation policies during the recovery remain important to facilitate an inclusive recovery and ease risks of escalating wages, however remote. These policies include:

- The JaminKerja initiative – an incentive for employers to hire Malaysians who remain underutilised and labour force segments that may need additional support (eg women, disabled workers and indigenous workers).
- Malaysia short-term employment programme (MySTEP) – a scheme providing employment opportunities in the public sector and government-linked companies, particularly for younger workers and new graduates.
- Various upskilling and reskilling programmes, including the "train and place" programme, a fully-funded apprenticeship programme that guarantees employment.

In addition, structural reforms are being undertaken to generate decent, well paying jobs, preserve economic competitiveness and ensure the sustainability of household incomes going forward. Such reforms aim to:

- attract high-quality investments;
- develop a dynamic and high-calibre workforce;
- accelerate the adoption of technology and digitalisation; and
- strengthen the social security system.

The viability of monetary policy transmission is increasingly dependent on complementary structural reforms. The role of structural reforms in ensuring long-term sustainable growth, and building resilience against shocks, is critical in addressing underlying rigidities and frictions such as persistently higher unemployment and skills mismatches.

Left unaddressed, these structural issues may inhibit efficient transmission of monetary policy actions through the ineffective allocation of resources and a disconnect between labour market outcomes and price-setting mechanisms.

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