Monetary Policy in 2017

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MONETARY POLICY

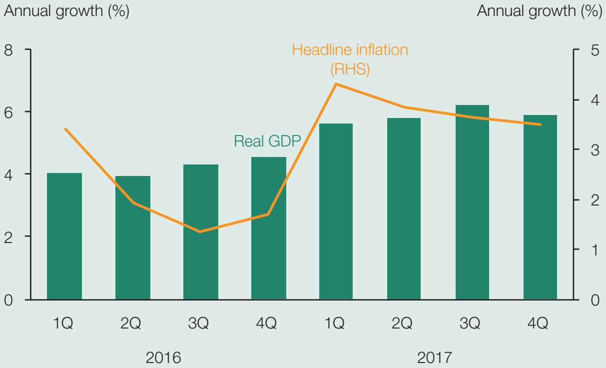
Monetary policy in 2017 focused on ensuring growth remained entrenched amid an environment of contained inflation

Monetary policy in 2017 focused on ensuring the growth of the Malaysian economy was firmly entrenched amid contained inflation. In the beginning of the year, downside risks to domestic growth arising from the external environment were prevalent. However, the upturn in global growth and trade during the course of the year resulted in a stronger growth momentum and a more favourable outlook. Inflation remained contained as the robust domestic demand was mitigated by some degree of spare capacity in the labour market and capital stock. Although the Overnight Policy Rate (OPR) was maintained at 3.00% in 2017, the Monetary Policy Committee (MPC) indicated in November that the degree of monetary accommodation could be reviewed, given the outlook of continued firm growth and contained inflation as the year progressed.

The Malaysian economy expanded by 5.9% in 2017 (2016: 4.2%), surpassing the initial projection of 4.3% - 4.8%. The expectation at the beginning of the year was for growth in 2017 to improve only slightly from 2016, amid pervasive downside risks from the external environment. During the course of the year, however, there was a strong upward shift in the growth trajectory and prospects. Global growth surprised on the upside and was stronger, more broad-based and synchronised. The continued robust global demand spurred global trade, which benefited Malaysia and other regional economies. Malaysia's gross exports growth persistently outperformed expectations, recording double-digit growth for the year. This had strong spillovers to the domestic economy through both the income and investment channels, as firms invested in productive capacity, raised wages and hired more workers. Consequently, this resulted in higher growth in private consumption and private investment. By the third quarter, growth for 2017 was expected to be significantly higher[1] than the initial forecast. More importantly, downside risks to the global environment receded, and upside potential became more apparent. However, downside risks remained, rooted in policy, political and geopolitical developments in the major economies.

Chart 3.1: GDP and Inflation

Entrenched economic growth amid contained inflation



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

The headline inflation forecast for the year was 3.0% - 4.0% (2016: 2.1%). In terms of the expected trajectory, inflation was to peak early in the year, breaching 4.0%, and to moderate gradually thereafter. This was premised on expectations for global cost factors to wane. As the year progressed, however, the combination of stronger-than-expected global oil demand amid production cuts, adverse weather conditions[2] and geopolitical concerns in the Middle East contributed to higher global oil prices, which resulted in higher domestic fuel prices. Global oil and domestic fuel prices were expected to remain elevated.

1 This was reflected in the growth projection for 2017 by the Ministry of Finance Malaysia of between 5.2% - 5.7% in the Economic Report 2017/2018 published in October 2017.

2 The occurrence of Hurricane Harvey at the end of August 2017 led to unexpected supply disruptions in the US.

Given the developments in oil prices, the MPC assessed that the average inflation for the year would reach the upper end of the forecast range. However, a stronger ringgit exchange rate since April 2017 helped to contain the increase in production costs. More importantly, the higher inflation in 2017 was expected to be transitory, and this trend was expected to moderate in 2018 as the assessment was that the effect from global cost factors would be smaller relative to the previous year.

While core inflation was sustained by the robust domestic demand, the overall trend of core inflation was expected to be contained. Some degree of spare capacity in the labour market and capital stock, and continued expansion in productive capacity, were expected to allow the economy to meet the higher demand without exerting excessive price pressures.

Monetary and financing conditions remained stable and supportive of economic activity throughout the year. The growth of financing to the private sector was sustained and total banking system liquidity remained sufficient. The ringgit strengthened over the year, supported by the better-than-expected GDP growth performance. The ringgit also experienced more balanced demand and supply following the financial market development measures introduced by the Financial Markets Committee (FMC). The risks of financial imbalances were also contained. The prevailing micro- and macroprudential measures, including more prudent lending standards, were effective in limiting any excessiveness in credit conditions and the degree of imbalances in the property sector.

During the year, the MPC actively assessed the stance of monetary policy to ensure it remained consistent with the evolving prospects of growth and inflation. While the monetary policy accommodativeness remained necessary to ensure the improved growth prospects were sustained, it was also important for its degree to be appropriate to prevent a build-up of risks that could arise from interest rates being too low for a prolonged period of time. As the year progressed, the MPC recognised that the balance of risks to the growth and inflation outlook had shifted considerably, with greater signs of the domestic growth being firmly entrenched. The MPC therefore began to consider whether the favourable macroeconomic conditions could warrant an adjustment in the degree of monetary accommodation. Furthermore, it became increasingly evident that economic conditions that warranted the previous OPR reduction in 2016 had vastly improved. Consequently, in November, the MPC communicated its consideration for a potential review of the degree of monetary accommodation in the Monetary Policy Statement. In the MPC's assessment, any potential adjustment would reflect a normalisation from the previous monetary accommodation in July 2016, rather than a tightening of monetary conditions.

Beyond the scope of monetary policy, the MPC also recognised the need to assess the broader distributional effects of economic growth in assessing the underlying strength of the Malaysian economy. The MPC was mindful that issues such as income inequality, low productivity and quality job creation are more structural in nature. Remedial solutions would necessitate collaboration with other policymakers and targeted policies that lie beyond the capacity of monetary policy, which is a blunt macroeconomic instrument.

MONETARY OPERATIONS

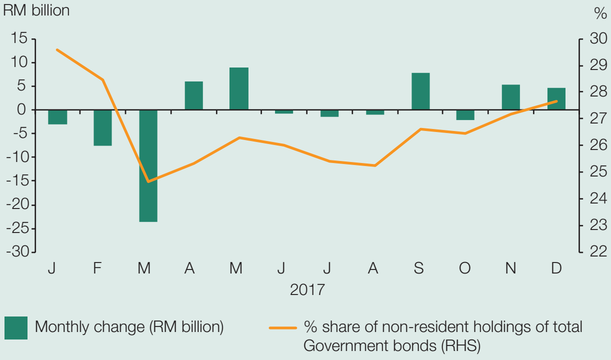
Monetary operations remained focused on ensuring smooth financial intermediation within the domestic banking system

In 2017, the Bank's monetary operations remained focused on ensuring smooth financial intermediation within the domestic banking system despite volatile movements in capital flows. Overall liquidity in the domestic banking system thus remained sufficient, with aggregate outstanding ringgit liquidity placed with the Bank increasing from RM184.8 billion in 2016 to RM189.1 billion in 2017.

Domestic financial markets were affected by periodic shifts in capital flows during the course of the year. In the first quarter, there were outflows from the unwinding of short-term speculative positions held by non-resident financial institutions and short-term asset managers following measures introduced by the FMC in December 2016, particularly from the Malaysian Government Securities (MGS) market. Nevertheless, there were capital inflows from the second quarter onwards, supported by positive investor sentiments arising from the recovery in global demand, improved global economic outlook and Malaysia's strong economic performance. The announcement of further initiatives to develop the onshore financial market by the FMC in April 2017 also led to renewed non-resident investor interest in Malaysian financial assets.

Chart 3.2: Monthly Change in Non-resident Holdings of Government Bonds*

Inflows from the second quarter, supported by positive investor sentiments

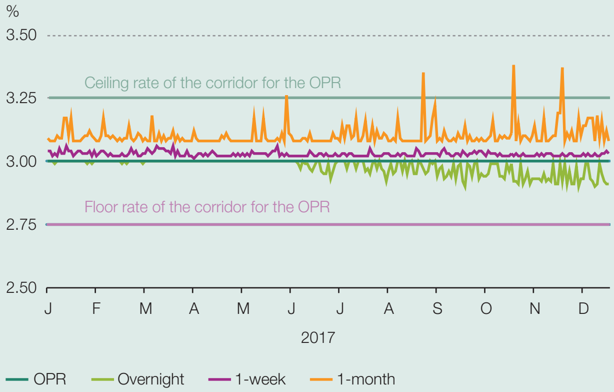


* Refers to Malaysian Government Securities (MGS), Malaysian Government Investment Issues (MGII) and Sukuk Perumahan Kerajaan (SPK)

Source: Bank Negara Malaysia

Chart 3.3: OPR and Interbank Rates

Interbank rates remained stable



Source: Bank Negara Malaysia

While there were shifts in capital flows, interbank money market rates remained stable across tenures and traded within fairly narrow spreads against the OPR. In particular, the average overnight interbank rate (AOIR) tracked the OPR closely, ranging between 2.90% and 3.00%. Kuala Lumpur Interbank Offered Rate (KLIBOR) rates were also stable throughout the year. Corporate deposit rates, which in the past several years faced upward pressure towards the end of the year[3], remained stable in 2017. In December 2017, the 3-month corporate deposit rate was unchanged at 4.00%, compared to the increase of 40 basis points to 4.20% in the previous year. Of note, rates on interest rate swaps (IRS), however, shifted upwards in November 2017, in part reflecting market expectations for an increase in the OPR subsequent to the release of the November Monetary Policy Statement.

In ensuring effective monetary policy operations and smooth financial intermediation, the Bank optimised the use of both liquidity absorption and injection instruments. For liquidity absorptions, the Bank utilised a wide range of both conventional and Islamic liquidity instruments. Direct money market borrowing and *Qard* acceptance were the main instruments for conventional and Islamic financial institutions, respectively. Demand for repo, which were longer-term in tenure, declined from 5.0% in 2016 to 0.5% in 2017 of total outstanding ringgit liquidity absorbed through monetary operations, reflecting greater demand by financial institutions for shorter-term placements to meet the short-term liquidity needs of their investors. The increase in *Qard* acceptance from 20.3% in 2016 to 26.1% in 2017 of total outstanding ringgit liquidity absorbed through monetary operations was mainly due to the increase in the share of Islamic surplus liquidity, which consequently increased the demand for Islamic liquidity instruments.

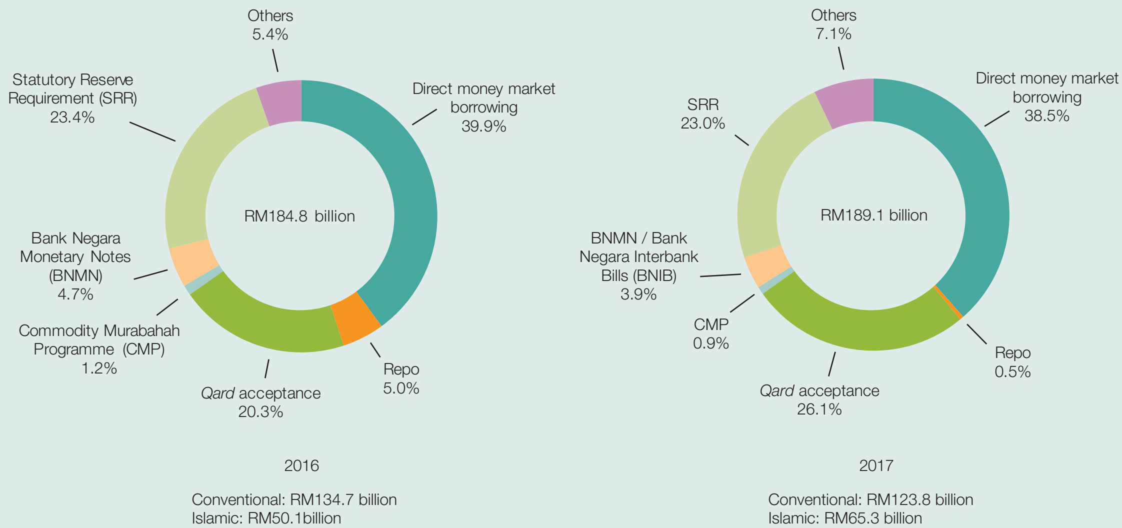
The Bank's liquidity injection operations also provided support to domestic liquidity conditions amid capital outflows during the first quarter of the year. This was done mainly through reverse repos and foreign exchange swap facilities. However, these liquidity injection operations declined following the resumption of capital inflows from the second quarter onwards.

To further enhance the efficiency and flexibility of liquidity management in the interbank market, the Bank introduced Bank Negara Interbank Bills (BNIB) in November 2017. The BNIB is only available and tradable between onshore banks and is recognised as Level 1 high-quality liquid assets (HQLA). As at end-2017, a total of RM5.0 billion of BNIB was issued via eight issuances. Moving forward, the BNIBs are expected to play a bigger role in complementing the direct borrowings of the Bank. Additionally, the Bank has also announced that the scope of eligible collateral for monetary operations will include banker's acceptance (BA) and negotiable instrument of deposits (NID) issued by AAA-rated financial institutions.

[3] Since 2014, corporate deposit rates have typically trended higher towards the end of the year due to competition for deposits among banks for window dressing purposes. This competition led to spillover effects on short-term money market rates.

Chart 3.4: Composition of Outstanding Ringgit Liquidity Placed with Bank Negara Malaysia (as at end-period)

Direct money market borrowing and *Qard* acceptance were the main liquidity absorption instruments



Note: Figures may not necessarily add up due to rounding

Source: Bank Negara Malaysia

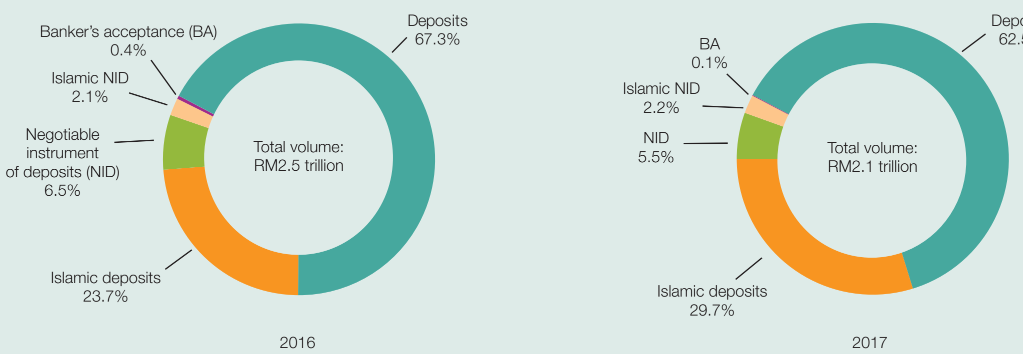
This will provide financial institutions with a wider range of securities that can be pledged to obtain liquidity under the Bank's Standing Facilities. This initiative is also expected to provide an impetus to the secondary trading and pricing of NID and BA.

In terms of money market transactions in the interbank market, both conventional and Islamic instruments, which comprised deposits, NID, and BA, recorded a lower volume of RM2.1 trillion (2016: RM2.5 trillion). Conventional money market deposits remained the major instrument of liquidity, representing 62.5% of the total volume traded, followed by Islamic deposits and NID (both conventional and Islamic).

In May 2017, the Bank issued the Code of Conduct for Malaysia Wholesale Financial Markets (CoC) as part of the initiative to enhance market professionalism and the integrity of market participants in both the money and foreign exchange markets. The new code supersedes the earlier version issued in 1994 and is consistent with the principles of the ACI Financial

Chart 3.5: Breakdown of Interbank Money Market Transactions

Interbank money market transactions mainly in conventional and Islamic deposits



Source: Bank Negara Malaysia

Markets Association (ACI) Model Code and Bank for International Settlements (BIS) FX Global Code. As part of continued efforts to foster market development, the Bank has extended the Regulated Short Selling (RSS) framework to Malaysian Government Investment Issues (MGII) held by both conventional and Islamic financial institutions based on the bilateral binding promise (*muwa'adah mulzimah*) concept. The revised framework will encourage repo activity and increase liquidity for MGII in the secondary market and tighten pricing gaps and yield differences between conventional and Islamic papers.