Monetary Policy in 2016

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MONETARY POLICY

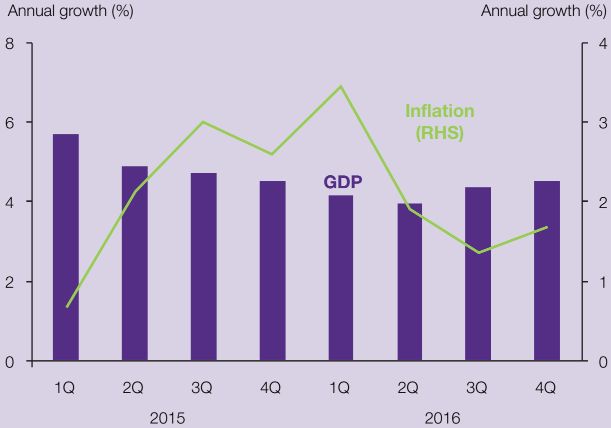
Monetary policy in 2016 was focused on ensuring the sustainability of Malaysia's growth prospects amid a challenging economic and financial environment

Monetary policy in 2016 was focused on ensuring monetary conditions remained supportive for sustainable growth of the domestic economy with price stability. This was against a challenging policy environment characterised by material shifts in the balance of risks to the domestic economic outlook and significant volatility in the financial markets. In particular, the risks to domestic growth increasingly shifted to the downside by mid-year, emanating from a confluence of external developments including the weaker-than-expected global growth momentum and policy uncertainties in the US and PR China. The challenging external environment was further exacerbated by the uncertainties surrounding the outcome of the UK's EU referendum (Brexit) and the increase in global geopolitical risks. Against this downside shift in the risks to growth, the Monetary Policy Committee (MPC) adjusted the degree of monetary accommodativeness by reducing the Overnight Policy Rate (OPR) by 25 basis points to 3.00% on 13 July 2016. The adjustment was a pre-emptive measure aimed at ensuring the Malaysian economy continued on a steady growth path. At the level of 3.00%, the OPR was considered to be consistent with the intended policy stance for the growth and inflation outlook, and was maintained for the rest of the year.

At the beginning of the year, the Malaysian economy was projected to expand at a more moderate pace in 2016, between 4.0% - 4.5% (2015: 5.0%). The growth prospects were expected to remain anchored by domestic demand, in line with the expectation of continued weak external demand. Private consumption and investment, however, were expected to moderate amid ongoing adjustments in the economy. Nevertheless, growth in private consumption was expected to be supported by sustained growth in incomes and employment, and measures to lift disposable income[1]. Investment activity was expected to be bolstered by ongoing infrastructure investments and capital expenditure in the manufacturing and services sectors. The external sector was anticipated to be constrained by the continued weakness in global demand and low prices for commodity exports.

Chart 3.1

GDP and Inflation



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

In early 2016, headline inflation was forecasted to range between 2.5% - 3.5% for the year (2015: 2.1%). The anticipated higher inflation was based on expectations of upward adjustments in administered prices and the weaker ringgit exchange rate. In terms of trajectory, inflation was expected to peak in the first quarter of the year due in part to the base effect of low oil prices in the first quarter of 2015. For the remainder of the year, inflation was projected to trend downwards due to the lapse of the impact of the Goods and Services Tax (GST) implementation, amidst an environment of

[1] This refers to both fiscal and non-fiscal measures that were announced by the Government.

continued low global energy and commodity prices and the generally subdued global inflation. Underlying inflation was projected to remain relatively moderate amid the slower expansion in domestic demand.

This outlook for domestic growth and inflation was inundated with significant downside risks from the external environment. These included spillovers from weaker global growth and ongoing policy uncertainties in the major economies, particularly surrounding monetary policy in the US and economic policies in PR China. The risk of continued volatility in the international financial and commodity markets and its spillovers to the domestic financial markets and the ringgit exchange rate also weighed on sentiments and outlook throughout the year.

Towards mid-year, the MPC assessed that the balance of risks to growth had shifted to the downside. There were increasing signs of moderating global growth momentum given the cyclical and structural economic weaknesses that continued to weigh on growth in the major economies, leading to more moderate growth in Asia amid persistent weakness in the external sector. The MPC was also concerned that global growth prospects had become more vulnerable to increased downside risks, in view of the potential repercussions of Brexit, renewed volatility in global oil prices, and rising geopolitical risks. On the domestic front, while the expectation was for growth in 2016 to remain within the earlier projection of 4.0% - 4.5%, the MPC recognised the need to ensure the sustainability of the growth momentum going forward. In particular, there were concerns that moderating economic sentiments of businesses and households could weigh on the strength of private consumption and investment. At the same time, the inflation trajectory saw a moderating trend after peaking in the first quarter, as anticipated. With the continued low global energy and commodity prices, the absence of the earlier projected adjustments to administered prices, and benign domestic inflationary environment, the inflation outlook was subsequently revised in July to be lower at 2.0% - 3.0% in 2016.

These considerations led to the MPC's decision that an OPR reduction at the July meeting was warranted as a pre-emptive adjustment to the degree of monetary accommodativeness. This adjustment was consistent with the policy stance to ensure that the domestic economy continued on its steady growth path. In addition, the timing was assessed to be appropriate given that inflation had trended lower and the risks of destabilising financial imbalances had receded. With regards to financial imbalances, the MPC recognised that macro- and micro-prudential measures as well as supervisory oversight had resulted in more prudent lending standards and contained speculative activities in the property market. In retrospect, the MPC recognised that the policy environment had become increasingly challenging following the more pronounced global financial market volatility towards year-end. These developments underscored the importance of a timely policy decision and having the policy flexibility to take advantage of the window of opportunity as it manifested.

Following the OPR reduction in July, there was an immediate and complete pass-through to interbank rates, with the 3-month KLIBOR declining by 25 basis points the next day. This consequently led to lower lending rates. The weighted average Base Rate (BR) of commercial banks declined by 22 basis points by end-August. Correspondingly, the weighted average lending rate (ALR) on outstanding loans was lower by 15 basis points in the same period.

Since the adjustment in July, the MPC assessed that the monetary policy stance has remained consistent with the macroeconomic outlook and kept the policy rate unchanged for the rest of the year. The domestic economy remained on track to expand as projected for 2016 and 2017. While the baseline estimate was for a slight improvement in global growth in 2017, the downside risks remained elevated following uncertainties over the growth momentum, policy shifts in major economies, unresolved issues post-Brexit and policy uncertainties arising from the outcome of the US presidential election in November. Global financial markets remained susceptible to heightened volatility amid setbacks and shifts in investor sentiments. Nevertheless, the MPC acknowledged that there were signs of positive developments, notably the prospects of a shift towards fiscal support for growth in the advanced economies.

During the course of the year, the MPC was also vigilant to the heightened degree of volatility in the domestic financial markets and the ringgit exchange rate given shifts in global liquidity and investor sentiments. In its communication through the Monetary Policy Statement (MPS), the MPC emphasised that Bank Negara Malaysia would continue to provide liquidity to ensure the orderly functioning of the domestic financial markets, such that overall domestic liquidity remains sufficient for healthy financial intermediation.

MONETARY OPERATIONS

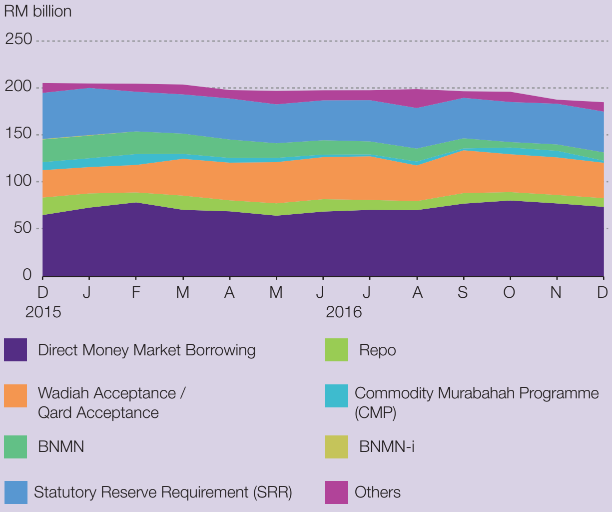
Monetary operations ensured orderly adjustments in banking system liquidity

Monetary operations in 2016 focused on ensuring the domestic money market continued to effectively intermediate short-term funds in a more challenging operating environment of heightened global financial market uncertainties. Several key external events, namely the outcomes of Brexit and the US presidential election, and the US interest rate normalisation in December, have resulted in capital outflows and volatility in the money market rates. The Bank, through its monetary operations, ensured that the adjustments in the banking system liquidity, particularly towards the fourth quarter of 2016, continued in an orderly manner. The aggregate surplus liquidity placed with the Bank remained ample at RM185 billion as at end-2016 (2015: RM205 billion), which provided the necessary buffer amid capital outflows.

Throughout 2016, the Bank's conduct of monetary operations resulted in stable money market rates, as evidenced by the close tracking of the average overnight interbank rate (AOIR) against the OPR.

Chart 3.2

Aggregate Surplus Liquidity Placed with Bank Negara Malaysia



Note: Wadiah acceptance includes Qard acceptance, which was introduced on 15 June 2015

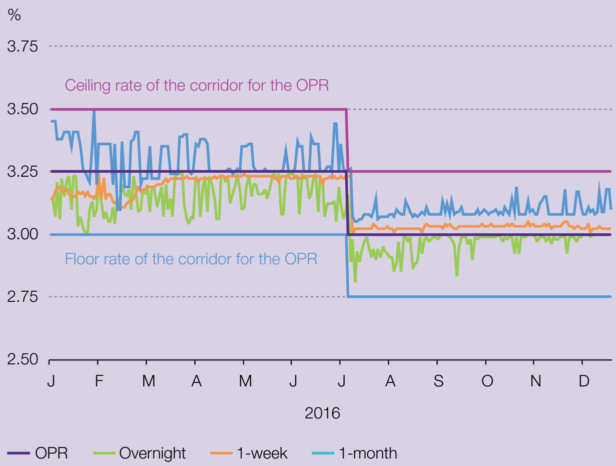
Source: Bank Negara Malaysia

Longer-term money market rates with tenures of one month and above were marginally higher in January and February due to the heightened global financial market volatility. These rates, however, gradually adjusted as volatility in the global financial markets subsided and following the reduction in the Statutory Reserve Requirement (SRR) ratio from 4.00% to 3.50%, which came into effect in February. The SRR reduction injected additional liquidity of RM6.5 billion into the banking system, easing the pressure on interbank borrowing costs. Consequently, the 3-month KLIBOR declined by 5 basis points. In July, interbank rates adjusted lower following the 25 basis points reduction in OPR from 3.25% to 3.00% and remained stable until the volatility triggered by the outcome of the US presidential election in November that pushed longer-term interbank rates marginally higher. Arising from the increased volatility in capital flows, the banking institutions' preference for managing their liquidity profile shifted towards shorter maturities to manage the uncertainty in liquidity requirements. Consequently, the Bank has shortened further the tenure of its liquidity operation through various instruments, which led to the reduction of the average duration of liquidity absorbed by the Bank. The average duration stood at 26 days as at end-2016, compared to 34 days as at end-2015.

Liquidity instruments available for the Bank's monetary operations are diverse and available to both the conventional and Islamic financial institutions. While money market borrowing remained the main instrument for conventional financial institutions, Qard acceptance

Chart 3.3

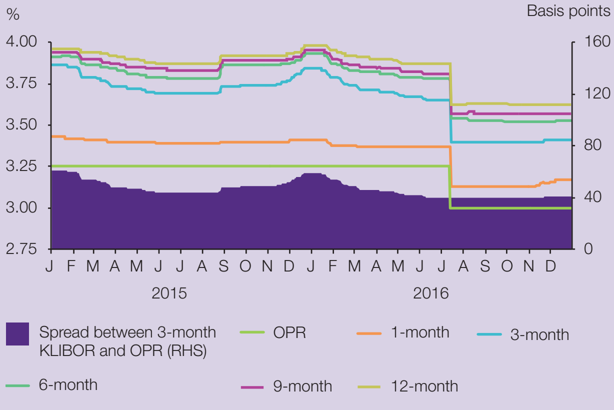
OPR and Interbank Rates



Source: Bank Negara Malaysia

Chart 3.4

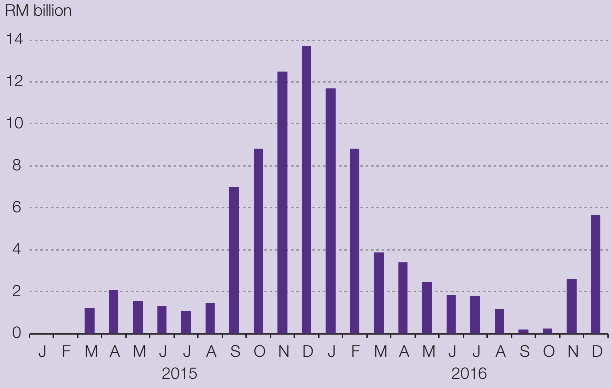
KLIBOR Rates



Source: Bloomberg and Bank Negara Malaysia

Chart 3.6

Outstanding Reverse Repos



Source: Bank Negara Malaysia

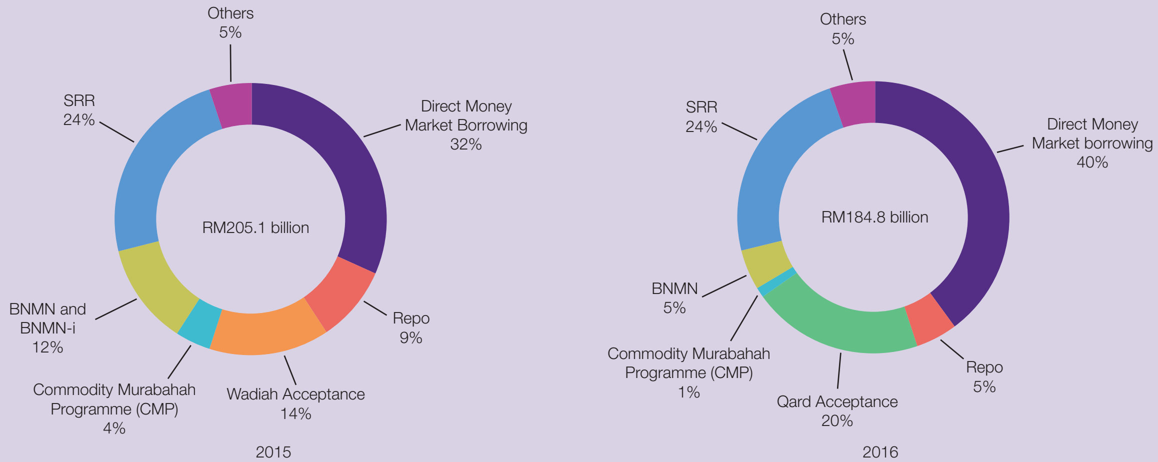
saw an increase in usage to 20% (2015: 14%[2]) of the overall liquidity instruments used by the Islamic financial institutions. Utilisation of the reverse repo facility moderated in early 2016, with the outstanding amount declining from RM13.7 billion in December 2015 to a low of RM196 million in September 2016. Demand for reverse repos increased to RM5.7 billion in December due to the capital outflows observed towards the end of the year.

The total volume of interbank money market transactions, which comprised deposits, banker's acceptance (BA), and negotiable instrument of deposits (NID) in both the conventional and Islamic money markets, amounted to RM2.5 trillion in 2016 (2015: RM3.2 trillion). Deposits under the conventional money market remained as the main instrument for liquidity, representing 67% of the total volume traded, followed by the Islamic deposits and NIDs (both conventional and Islamic).

During the year, the Bank has undertaken several initiatives to further expand its liquidity management operations. Given the growing importance of Development Financial Institutions (DFIs) in their role

Chart 3.5

Composition of Liquidity Instruments

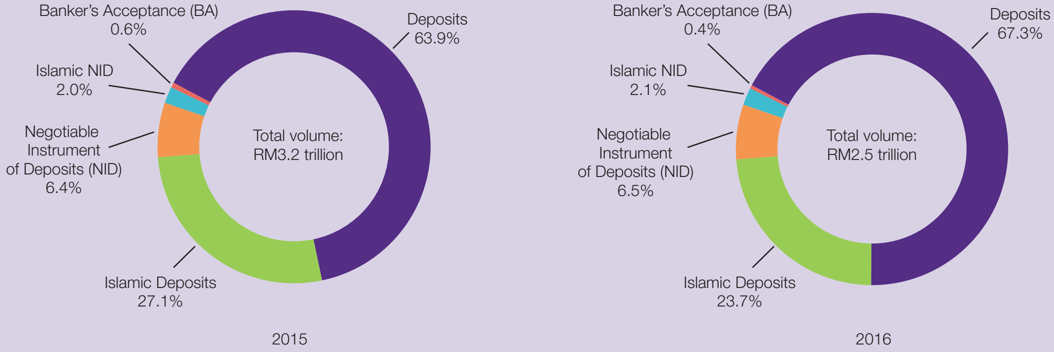


Source: Bank Negara Malaysia

[2] This refers the sum of the share of Wadiah and Qard acceptance placed with the Bank, as Qard acceptance was introduced on 15 June 2015.

Chart 3.7

Breakdown of Interbank Money Market Transactions



Source: Bank Negara Malaysia

as financial intermediaries, the Bank has extended the offering of Standing Facility to DFIs under its purview. The facility allows DFIs to obtain ringgit liquidity by pledging eligible securities with the Bank. Additionally, the Bank also established the Restricted Committed Liquidity Facility (RCLF), which is a facility that allows banking institutions to pledge eligible securities. The securities pledged under the RCLF will be recognised as a Level 2B high quality liquid asset (HQLA) for the purpose of the Liquidity Coverage Ratio (LCR) compliance. To participate in the RCLF, banking institutions are charged a monthly Facility Rate, which is currently at 75 basis points per annum.