2015

MONETARY POLICY IN 2015

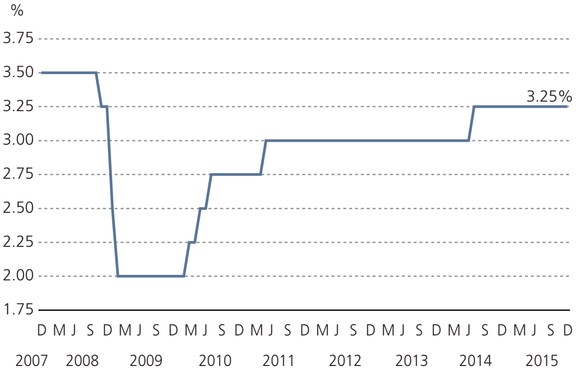
MONETARY POLICY

The Monetary Policy Committee (MPC) maintained the Overnight Policy Rate (OPR) at 3.25% in 2015, with the focus of ensuring that monetary conditions supported the sustainable growth of the Malaysian economy and price stability. The monetary policy stance was accommodative and supportive of economic activity. This was against a backdrop of increased uncertainties in the policy environment arising from a series of external and domestic developments that affected the outlook of the Malaysian economy and posed risks to overall macroeconomic stability. However, with the low interest rate environment, the MPC also maintained its vigilance against risks related to financial imbalances.

In 2015, the MPC focused on ensuring that monetary conditions supported the sustainable growth of the Malaysian economy and price stability, in an environment characterised by significant volatility and uncertainty

Chart 3.1

Overnight Policy Rate (OPR)



Source: Bank Negara Malaysia

The Malaysian economy was projected to grow at a steady pace of between 4.5% and 5.5% in 2015. This outlook was premised on the expectation that domestic demand would be the anchor of growth amid weak external demand, in line with the prospects of moderate global growth and lower prices for commodity exports. Growth in private consumption was expected to moderate compared to previous years given the higher costs faced by households, especially in the second half of the year, and a more uncertain economic environment. Nevertheless, it was assessed that household spending would continue to be supported by wage growth and stable employment conditions during the year. Similarly, investment activity was projected to remain resilient, with broad-based capital spending by both the private and public sectors cushioning the lower oil and gas investment activity. Investment activity was expected to be led by capital spending in the manufacturing and services sectors, as well as by infrastructure projects.

Headline inflation was forecasted to range between 2 - 3%. The expectation was for the lower global commodity prices and the generally lower global inflation to offset the increase in domestic cost factors given the implementation of the Goods and Services Tax (GST) and other domestic price adjustments, as well as the weaker ringgit exchange rate. From a trough in the first quarter of 2015, headline inflation was projected to trend higher, subsequently peaking in the first quarter of 2016, and moderating thereafter. Throughout the year, underlying inflation was assessed to remain relatively moderate amid the slower growth of domestic demand.

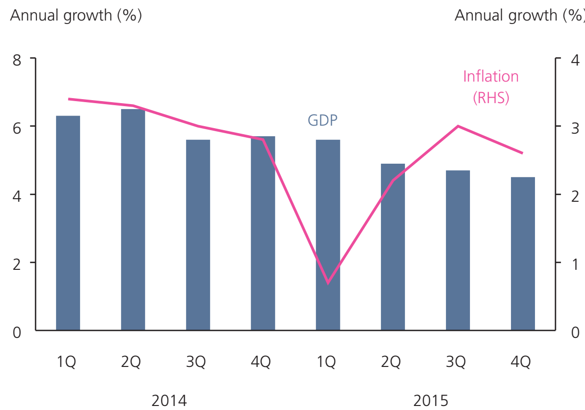
During the course of the year, this baseline outlook for domestic growth and inflation was subject to uncertainties arising from a series of external and domestic developments that affected the Malaysian economy. In the deliberations throughout the year, the MPC carefully monitored these developments and continuously assessed their potential risks to overall macroeconomic stability. In the beginning of the year, the main source of concern was the significantly changed and uncertain outlook for commodity prices and the risks it posed to the continued resilience of the Malaysian economy. In particular, the concerns were on the impact to the oil and gas sector and the spillovers to broader investment and export activity, as well as on the implications to the overall balance of payments and the Government's fiscal position. The MPC was also concerned about the misperception that the Malaysian economy was highly dependent on commodities. The reality was that Malaysia's economy was well-diversified, with the services and manufacturing sectors playing a key role. In its communications, the Bank sought to address this misperception. The MPC also paid close attention to the outcome of the GST introduction in April 2015. While beneficial to the economy over the longer term, the near-term impact on household and business behaviour could have economic consequences. The direct impact on inflation was deemed to be a lesser concern given the benign global and domestic inflation environment. However, there were concerns about possible profiteering and the pricing behaviour by firms, especially given that there were a number of other changes in domestic prices, such as the implementation of the managed-float pricing mechanism for domestic fuel products.

In the latter part of the year, concerns relating to the negative impact arising from the decline in commodity prices and possible disorderly adjustments to the GST waned. Nevertheless, a number of key global risks identified in the beginning of the year materialised. These included slower global growth arising from the weakening growth momentum in a number of major advanced and emerging economies, heightened volatility in global financial markets arising in part from policy uncertainty in the major economies, and the continued volatility in commodity prices. These external developments significantly affected the domestic financial markets and the ringgit exchange rate in the second half of the year. To a degree, domestic factors also worsened investor sentiments towards ringgit financial assets. Cumulatively, these developments led to the overall deterioration of economic sentiments among domestic households and businesses. By some measures, domestic economic sentiments reached levels last experienced during the crisis in the advanced economies in 2008-2009[1].

[1] For example, the Malaysian Institute of Economic Research (MIER) Consumer Sentiments Index reached a level lower than that experienced in 2008, while the MIER Business Conditions and Employment Indices were at the lowest since 2009 and 2008 respectively.

Chart 3.2

GDP and Inflation



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Despite these developments, the initial expectations on the outlook for domestic growth and inflation were not derailed. Malaysia's economy proved to be resilient. The well-diversified nature of the economy and its exports helped to sustain economic growth. The deep financial markets and well-capitalised financial institutions were able to withstand the large and volatile capital flows and continued to provide financing to support economic activity. Importantly, while global and domestic developments affected the ringgit exchange rate and domestic financial markets, overall domestic liquidity remained sufficient with financial institutions continuing to operate with strong capital and liquidity buffers.

Against this backdrop, the MPC assessed that the stance of monetary policy was appropriate and consistent with the achievement of price stability and sustainable economic growth. The policy stance, together with earlier macro- and microprudential measures, also continued to play a role in ensuring the sustainable growth of household debt and reducing the risks of financial imbalances. The MPC is vigilant to the heightened degree of uncertainty in the global and domestic economic environment, and has requested the Bank staff to undertake more intensive monitoring of these developments and their impact on the Malaysian economy. In its communications through the Monetary Policy Statements (MPS), the MPC has sought to provide greater clarity regarding its assessment of the economic and price outlook and the risks that it sees to this outlook.

Evolution of the Monetary Policy Committee of Bank Negara Malaysia: Key Milestones over the Years

Bank Negara Malaysia's Monetary Policy Committee (MPC) had its first meeting fourteen years ago. Since then, it has evolved and enhanced its effectiveness as the sole body responsible for the formulation of Malaysia's monetary policy and policies for the conduct of monetary policy operations. This box article summarises the key milestones in the evolution of the MPC from its formation.

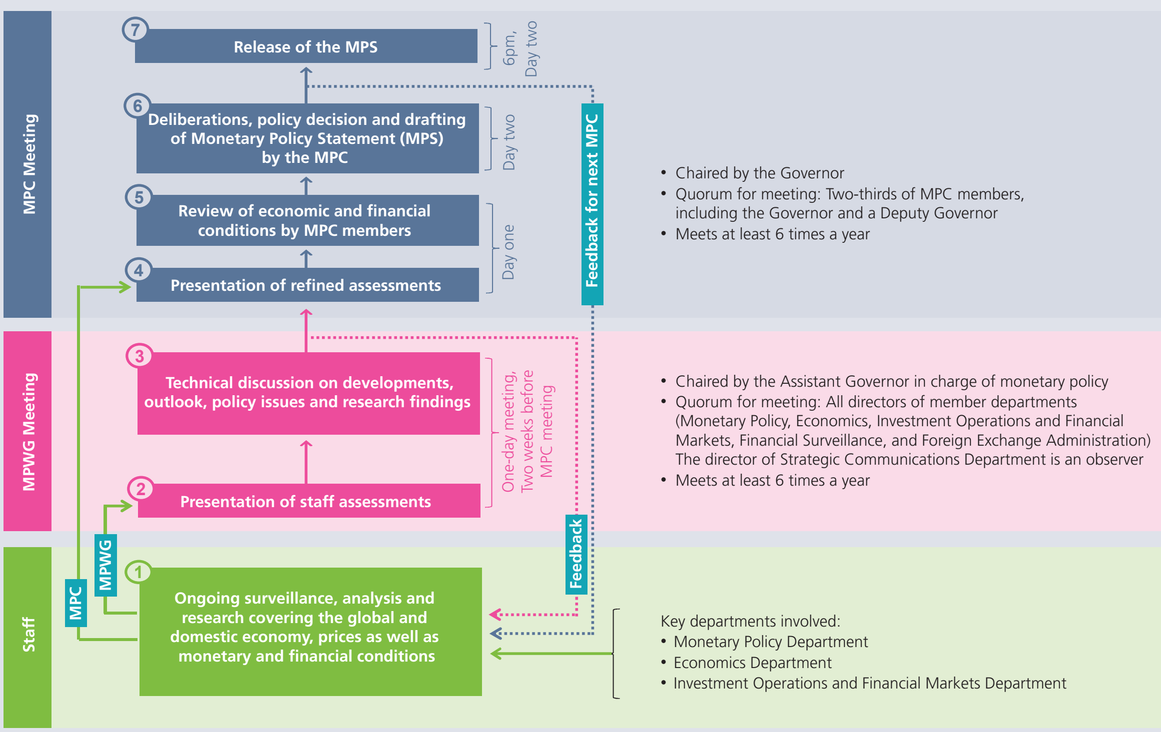
2002 to 2008: Laying the Foundations

The MPC was formed in 2002. In its initial form, it was an advisory committee comprising of the senior management of Bank Negara Malaysia (the Bank) that supported the Governor, who was the single decision-maker on monetary policy. The MPC meetings typically took place for a day, starting with staff presentations, followed by discussions among the committee members and ending with a decision by the Governor on the stance of monetary policy. The MPC met at regular intervals, to consistently assess the state of the economy and ensure that the monetary policy stance was appropriate given the changes to the outlook for growth and inflation.

An integral part of the monetary policy decision-making process is the internal processes leading up to the MPC meeting. In this regard, the Monetary Policy Working Group (MPWG) plays an essential role. The MPWG was established in 2002 as an internal forum to discuss staff assessments on the latest economic, monetary and financial market developments and outlook, policy issues and research findings before the presentations are prepared for the MPC. Apart from its quality control function, the MPWG also ensures that the views of all relevant parts of the Bank are taken into account and considered carefully. The MPWG is chaired by the Assistant Governor in charge of monetary policy

Diagram 1

Monetary Policy Process at Bank Negara Malaysia



Note: Numbering reflects the sequencing of the monetary policy process
Source: Bank Negara Malaysia

and the members are the directors of departments covering the areas of monetary policy, economics, investment operations and financial markets, financial surveillance, and foreign exchange administration. Initially, the MPWG met at least once a month, but this was subsequently changed to eight times a year in 2005 and six times a year in 2010, corresponding to the frequency of the MPC meetings.

An important component in the conduct of monetary policy is the communication of the policy decision to the public and the financial markets. For the MPC, the main policy communication tool is the Monetary Policy Statement (MPS). The first MPS was issued in August 2003, and was initially scheduled for release four times a year, coinciding with the release of Malaysia's quarterly GDP performance. The release dates were subsequently changed to coincide with the MPC meeting dates beginning in December 2005, which also saw for the first time the release of an advance calendar of the MPC meetings for the year ahead. The MPS is a forward-looking statement, outlining the monetary policy stance and the rationale for the policy decision.

2009: Autonomy and Institutionalisation

The year 2009 marked a very important milestone in the evolution of the MPC, with the enactment of the Central Bank of Malaysia Act 2009[1] (the Act). The Act stipulates that monetary policy shall be autonomously formulated and implemented by the Bank and legally recognises the MPC as the body responsible for formulating monetary policy and the policies for the conduct of monetary policy operations in the country. The Act also institutionalised and provided greater clarity to some established aspects of the conduct of monetary policy by the Bank. These include, for example, the objective of monetary policy, namely maintaining price stability while giving due regard to developments in the economy, and the formal requirement to publish an MPS following each meeting.

Beyond that, the Act introduced important governance procedures that would serve to provide the framework to improve the robustness of not only the monetary policy decision-making environment, but would also allow the MPC to further evolve in the future. The governance of the monetary policy process is also guided by the MPC by-laws, which amongst others, provide a set of practices for efficient and robust policy decision-making; define the roles, responsibilities and accountability of MPC members; and define the monetary policy decision-making cycle. The by-laws include provisions such as the need for an optimal mix of representation of constituencies in the composition of the MPC to mitigate biasness, the approach to decision-making and the structure of the MPC meetings.

The MPC developed into a collegial decision-making committee in which decisions are made by consensus, with the Governor, as the Chair, having the role in leading the discussions and deliberations, as well as building a consensus among the MPC members. The membership criteria of the MPC also became more clearly defined in the Act. The overarching consideration to being nominated to the MPC is having the expertise and experience relevant to the responsibilities and functions of the MPC; and being a person of probity, competence and sound judgement. The Governor and the Deputy Governors remain as members of the MPC for so long as they hold office. The other members are appointed by the Bank's Board of Directors from amongst senior officers at the Bank with relevant expertise, on the recommendation of the Board Governance Committee of the Bank[2]. The Board Governance Committee may recommend external members to the Minister of Finance for their appointment to the MPC.

The duration of each MPC meeting was also extended to two days. This was to allow sufficient time for in-depth presentations by staff and for the MPC members to appraise and discuss the implications

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1 For a detailed account, refer to ``White Box: Monetary Policy Process under the Central Bank of Malaysia Act 2009´´, in Chapter 3 of Bank Negara Malaysia's Annual Report 2009.

2 The Board Governance Committee assists the Board of Directors in its oversight role, whose members are non-executive directors. The Board Governance Committee is responsible for recommending the persons to be appointed to the MPC and other Committees of the Bank, among other responsibilities. For further details refer to ``White Box: The Central Bank of Malaysia Act 2009´´, in Chapter 5 of Bank Negara Malaysia's Annual Report 2009.

of new developments. The additional time also enabled the evolvement of a consensus view of the policy direction, and finally the drafting of the MPS. The Act also specified that the MPC should meet six times a year, with the flexibility to convene additional meetings should it become necessary.

2010 to 2015: Enhancing Robustness of the Decision-making Framework

In the years after the global recession, the policy environment of the Bank continued to be challenging, arising in large part from the significant developments and uncertainties in the global economic and financial market environment. During this period, the Bank made a number of efforts to further strengthen its policy decision-making framework. The Bank established the Joint Policy Committee in 2010, a high-level policy committee that consists of members from both the MPC and the Financial Stability Committee of the Bank[3]. This is in recognition of the fact that monetary and financial stability policies are highly interdependent, such that effective coordination of these policies is critical for preserving macroeconomic and financial stability. The Joint Policy Committee facilitates broader surveillance and a more comprehensive risk assessment of issues by combining macroeconomic

Diagram 2

Evolution of the Monetary Policy Committee of Bank Negara Malaysia

Laying the Foundations (2002 - 2008)

2002
Formation of the Monetary Policy Committee (MPC) and Monetary Policy Working Group (MPWG).

MPC was an advisory committee that supported the Governor as the single decision-maker on monetary policy. Meetings lasted one day.

MPWG provided a forum to discuss staff assessments before being presented to the MPC.

2003
The MPC started meeting eight times per year, and the MPWG met at least once a month.

2003
Bank Negara Malaysia issued its first Monetary Policy Statement (MPS).

The MPS was scheduled for release four times a year, coinciding with the release of Malaysia's quarterly GDP numbers.

2005
First release of advance calendar for the MPC meetings.

2005
The frequency of MPWG meetings reduced to at least eight times a year.

2006
The release dates for the MPS were changed to coincide with the MPC meeting dates, thus eight MPS were released per year.

Autonomy and Institutionalisation (2009)

2009
The Central Bank of Malaysia Act 2009 (the Act) was enacted, which legally recognised the MPC as the body responsible for formulating monetary policy and the policies for the conduct of monetary policy operations.

The governance of the monetary policy process was also guided by the MPC by-laws.

Enhancing Robustness of the Decision-making Framework (2010 - 2015)

2010
With the enactment of the Act, the MPC developed into a collegial decision-making committee.

Duration of each MPC meeting was extended over two days.

Number of MPC and MPWG meetings reduced to six per year.

2010
Bank Negara Malaysia established the Joint Policy Committee, in recognition that monetary and financial stability policies are highly interdependent.

2012
The Framework for the Appointment of External Members for the Monetary Policy Committee and the Monetary Policy Committee Code of Ethics and Conflict of Interests were put in place.

2015
Two external members were appointed to the MPC. Prior to this, MPC members comprised only internal members, that is, senior officers of Bank Negara Malaysia.

Source: Bank Negara Malaysia

[3] Further discussion on the Joint Policy Committee can be found in "Box Article: Bank Negara Malaysia's Joint Policy Committee", in Chapter 3 of Bank Negara Malaysia's Annual Report 2012.

surveillance with micro-level analysis of the financial sector. This allows the Bank to deliberate on cross-cutting issues and to ensure the effective coordination of policies that may have an impact on both the financial system and the broader economy.

In 2012, the process further evolved when the Monetary Policy Committee Code of Ethics and Conflict of Interests (Code) was put in place. The Code established guidelines to preserve the integrity of decision-making by the MPC by seeking to minimise and manage any conflict of interest. In addition, an internal Framework for the Appointment of External Members for the Monetary Policy Committee (Framework) was developed in 2012. The Framework provides guiding principles, based on the criteria set out in the Act and the MPC by-laws, to facilitate the Bank's Board Governance Committee in assessing the suitability of the external candidates to be recommended as members of the MPC. The Framework strengthens safeguards already in place, such as specifying that in recommending any person to be a member of the MPC, the Board Governance Committee should be satisfied that the person will strengthen the diversity of expertise and experience available within the MPC, and requiring external members to include disclaimers in views expressed in members' professional capacity elsewhere so as to distinguish these views from those of the MPC.

Two external members were appointed to the MPC in April 2015. The inclusion of external members is a significant milestone. It reflects the ongoing progress of the MPC as a decision-making committee, with the external members bringing additional diversity of views and relevant expertise to the monetary policy decision-making process.

Conclusion

The foundations put in place over the last fourteen years of its existence, in particular the governance framework and established processes, provide the MPC with a solid platform to effectively discharge its responsibility of formulating monetary policy and policies for the conduct of monetary policy operations in Malaysia.

MONETARY OPERATIONS

The heightened uncertainties in global financial markets led to capital outflows during the year. The capital outflows were mainly from short-term money market instruments and to some extent, equity investments. The domestic sovereign bond market, however, recorded net inflows of RM25.7 billion for 2015. The net outflows from the money market led to a reduction in the aggregate surplus liquidity placed with the Bank from RM269.9 billion as at end-2014 to RM205.1 billion at the end of the year. The monetary operations of the Bank were thus focused on managing this reduction in excess liquidity by ensuring that the financial intermediation process continued to function smoothly with orderly financial market conditions.

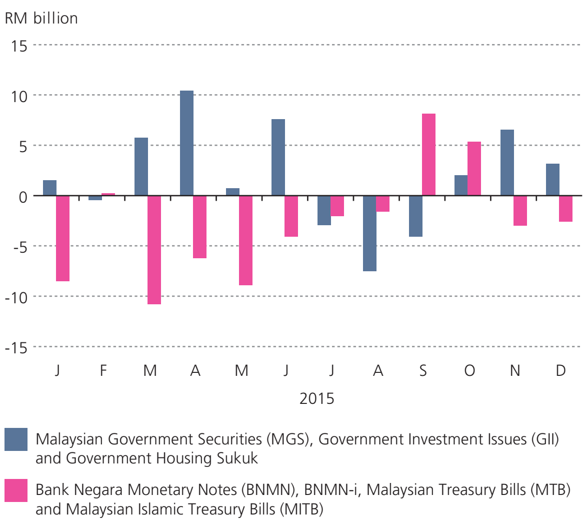
In the first half of 2015, the Bank significantly reduced the issuance of Bank Negara Monetary Notes (BNMNs), partly in response to the reduction in liquidity caused by the outflows. Only in the latter half of 2015 did the Bank start to re-issue BNMNs to long-term investors[2] when capital flows began to stabilise in late August 2015. Outstanding BNMNs thus fell from RM107.1 billion as at end-2014 to RM24.5 billion at the end of the year, of which 97% were held by long-term investors.

Arising from the increased volatility of capital flows during the year, the banking institutions' preference for managing their liquidity profile shifted in favour of shorter maturities to manage the uncertainty in liquidity requirements. Correspondingly, the Bank shortened the tenures of money market borrowings and repos, thereby reducing the overall average duration of liquidity absorption operations from 56 days as at end-2014 to 34 days as at end-2015. The Bank also provided liquidity to the banking system during the year, amounting to RM39.5 billion as at end-2015. The provision of liquidity was undertaken in part through the reverse repo facility introduced since March 2015, which allows eligible participants to obtain liquidity of tenures ranging from one month to six months by pledging high-quality collateral to the Bank.

The Bank adopted a similar strategy in managing Islamic liquidity, with an additional emphasis on the use of the competitively auctioned Commodity Murabahah Programme (CMP) to further promote profit rate transparency in the Islamic money market. Islamic banks have progressively switched their Wadiah placements with the Bank to

Chart 3.3

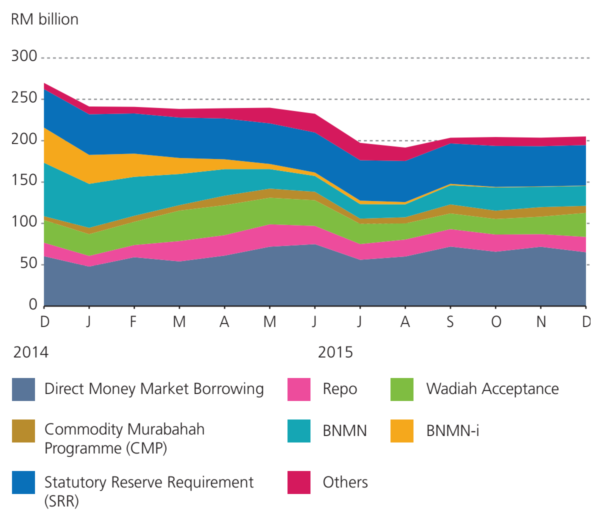
Monthly Change in Non-Resident Holdings of Ringgit Securities



Source: Bank Negara Malaysia

Chart 3.4

Outstanding Liquidity Placed with Bank Negara Malaysia

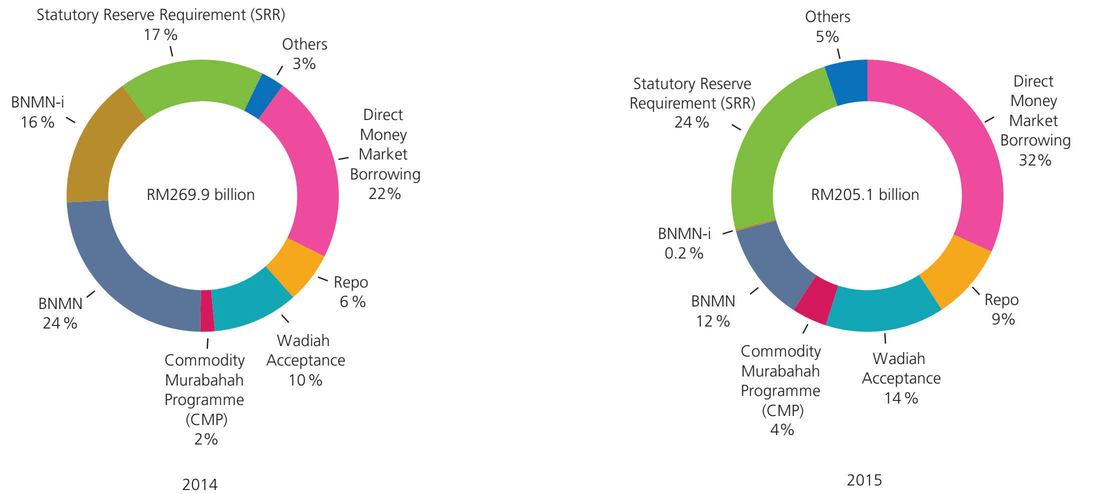


Source: Bank Negara Malaysia

[2] These long-term investors adopt buy-and-hold strategies and are committed to rolling over maturing BNMNs and Malaysian Government Securities (MGS) to maintain country exposure for investment mandates.

Chart 3.5

Composition of Outstanding Liquidity Placed with Bank Negara Malaysia



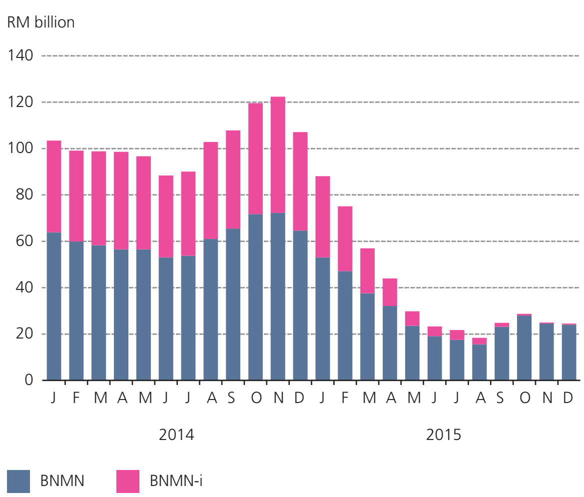
Source: Bank Negara Malaysia

CMP, with the share of CMP against total Islamic short-term acceptances increasing from 14.5% in 2014 to 22.7% in 2015. The Bank also introduced the Bank Negara Malaysia – Mudarabah Certificate (BNM M-Cert), a hybrid equity instrument, to add variety to the instruments available for liquidity management. The BNM M-Cert is structured based on a profit-sharing agreement between the Bank and sukuk holders, where the Bank undertakes the role of investment manager by investing funds in Shariah-compliant assets and distributing the profits according to the agreed profit-sharing ratio. The BNM M-Cert is recognised as Level 1 high-quality liquid assets (HQLA) and is tradable in the secondary market.

While short-term money market rates with tenures of one week or less remained stable, with the average overnight interbank rate (AOIR) tracking the OPR and trading within the range of 3.03% to 3.25%, the longer-term money market rates fluctuated and trended higher during the year. Longer-term interbank rates with tenures

Chart 3.6

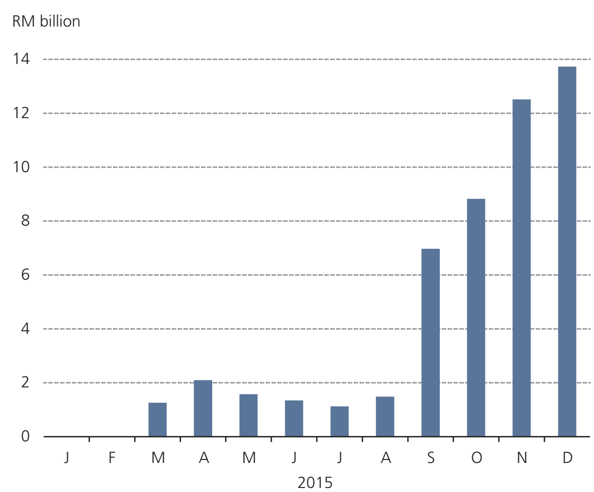
Outstanding Amount of BNMNs



Source: Bank Negara Malaysia

Chart 3.7

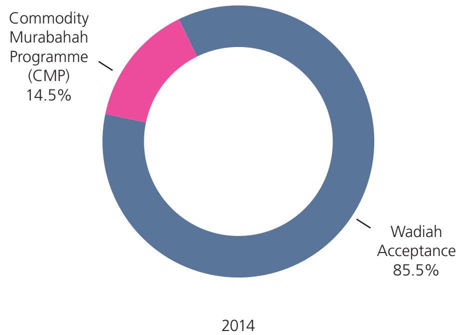
Outstanding Reverse Repos



Source: Bank Negara Malaysia

Chart 3.8

Outstanding Amount of Islamic Short-term Acceptances

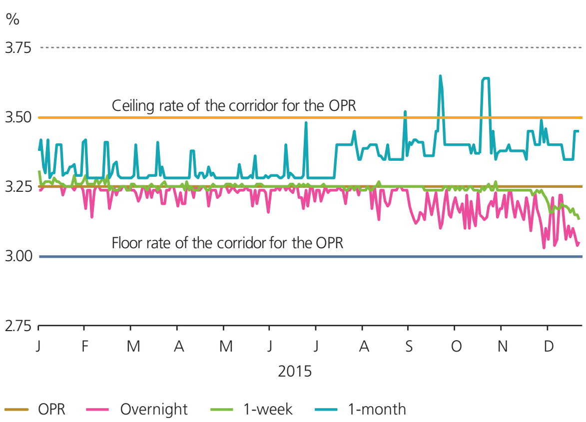


Source: Bank Negara Malaysia

of above one month were already at elevated levels in early 2015, following the rising trend in late 2014 which reflected an increase in the funding costs for banks, arising from greater competition for stable funding. The competition for stable funding was due to the slower growth in deposits because of net external outflows as well as banks preparing for the phasing-in of the Basel III Liquidity Coverage Ratio (LCR)[3] requirements, which became fully enforceable in June 2015. However, these interest rates gradually declined, with the 3-month Kuala Lumpur Interbank Offered Rate (KLIBOR) easing from a peak of 3.86% to 3.69% in the first half of the year, following the broadening of scope of recognition of HQLA to include the Statutory Reserve Requirement (SRR) and term deposits placed with Bank Negara Malaysia, as well as clarification by Bank Negara Malaysia on the treatment of banks' expected cash outflows. The reverse repo operations by the Bank also injected liquidity into the interbank market[4], alleviating the pressure on banks to seek long-term funding from the interbank market. In the second half of the year, interbank rates trended higher again with the 3-month KLIBOR reaching 3.84% at the end of the year, as banks again competed for stable funding to support their loan-to-deposit ratios in an environment of net external outflows.

Chart 3.9

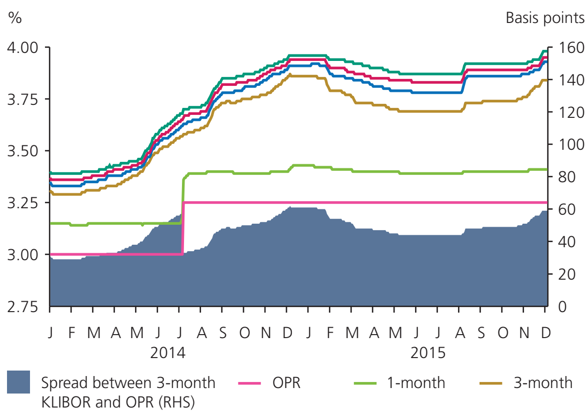
OPR and Interbank Rates



Source: Bank Negara Malaysia

Chart 3.10

KLIBOR Rates



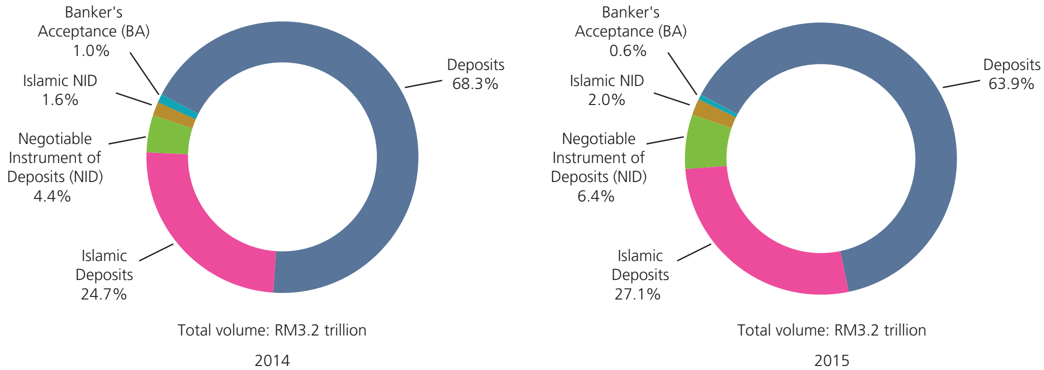
Source: Bloomberg and Bank Negara Malaysia

[3] The objective of the LCR is to promote the short-term resilience of the liquidity risk profile of banks. It does this by ensuring that banks have an adequate stock of unencumbered HQLA that can be converted easily and immediately in private markets into cash to meet their liquidity needs for a 30-calendar day liquidity stress scenario.

[4] Banks were able to pledge the securities which were gradually built up for the implementation of the LCR as collateral for the reverse repo, thereby allowing them to monetise their holdings of the HQLA.

Chart 3.11

Breakdown of Interbank Money Market Transactions



Source: Bank Negara Malaysia

Total interbank money market transactions, which comprised deposits and acceptances, banker's acceptance (BA), and negotiable instrument of deposits (NID) in both the conventional and Islamic money markets, were unchanged at RM3.2 trillion (2014: RM3.2 trillion). Although deposits (conventional unsecured borrowing and lending) remained the main instrument traded, there was an increase in NID transactions due to its recognition as HQLA under the LCR requirements.

Moving forward, it is expected that domestic liquidity conditions will continue to be affected by swings in capital flows. The Bank's monetary operations will continue to focus on ensuring that liquidity remains ample to support financial intermediation and the orderly functioning of the domestic financial markets.