MONETARY POLICY IN 2013

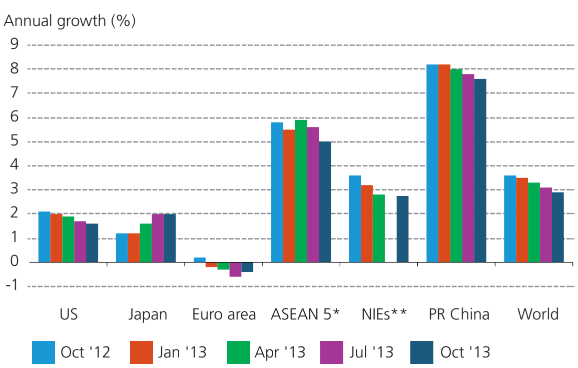
MONETARY POLICY

In 2013, against a backdrop of increased uncertainties on the balance of risks surrounding the outlook for domestic growth and inflation, the Monetary Policy Committee (MPC) maintained the Overnight Policy Rate (OPR) at 3.00%.

At the beginning of 2013, the Malaysian economy was projected to remain on a steady growth trajectory, with GDP growth expected to be in the range of 5%-6%. Domestic demand was to be the key driver of growth, with expectations for a gradual improvement in global growth. Private consumption was expected to remain supported by income growth and stable employment conditions. Investment activity would be sustained, led by capital spending in the domestic-oriented industries, the oil and gas sector and the ongoing implementation of infrastructure projects. Nevertheless, it was recognised that there were downside risks to the growth outlook, emanating mainly from the external environment. Constrained growth in the advanced economies arising from their fiscal consolidation efforts and weak labour market conditions could adversely affect the external sector of the Malaysian economy.

Chart 3.1

Outlook for Real GDP Growth in 2013

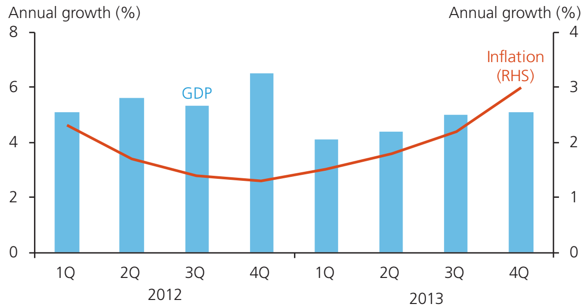


*Indonesia, Malaysia, Philippines, Thailand and Vietnam
**Newly Industrialised Asian Economies. July 2013 data for NIEs are not published.

Source: IMF, WEO October 2012, January, April, July and October 2013; Bank Negara Malaysia calculations

Chart 3.2

GDP and Inflation



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Inflation, as measured by the Consumer Price Index (CPI), was forecasted to be at 2%-3% in 2013, compared to the 1.6% outturn in 2012. The projected higher inflation was based on the expected higher domestic food prices arising from elevated global prices for key food commodities, higher costs arising from the implementation of the minimum wage policy and the possibility of adjustments to administered prices. However, demand pressures were not expected to be a significant factor behind price increases given the adequate productive capacity within the economy to generate new supply. Inflation risks were nevertheless on the upside as higher global commodity prices, a faster pace of subsidy rationalisation or stronger-than-projected demand pressures could all cause inflation to exceed the forecasted range.

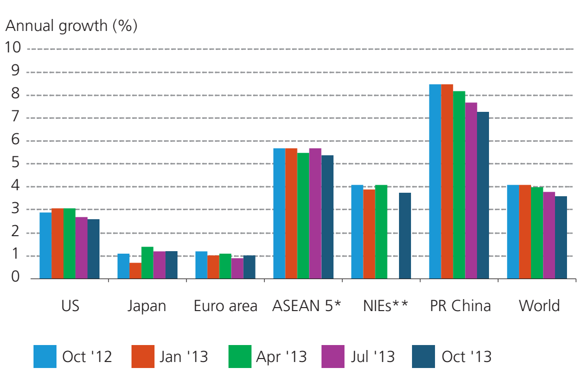
The MPC had assessed the risks to domestic growth and inflation as being broadly in balance. Domestic growth was expected to be resilient but faced significant downside risks emanating from the external environment. Inflation risks were tilted to the upside. Given this uncertainty regarding the balance of risks to the growth and inflation outlook, the MPC viewed that a change in the OPR was not warranted. The MPC also considered the merits of using the OPR to manage the formation of financial imbalances. Keeping an interest rate environment that is too low for too long risked financial imbalances forming, which could pose medium-term risks to macroeconomic and financial stability. The MPC decided that the level of the OPR was appropriate, and given that the risks of financial imbalances were confined to certain segments of the economy, other tools would be better suited to address these risks. Consequently, macroprudential measures were introduced in July to manage the risks of financial imbalances in a targeted manner (see Financial Stability and Payment Systems Report 2013).

By the middle of the year, however, the dynamics of both domestic growth and inflation had changed, and these increased the uncertainties surrounding the balance of risks. The release of the first quarter GDP growth data for the advanced economies showed that growth turned out to be below earlier expectations, weighed down by policy uncertainties. As a result, the growth forecasts for 2013 and 2014 for several advanced economies were revised downwards. Similar weaknesses were observed in the first quarter GDP growth data for several Asian economies which were mainly attributable to spillovers from prolonged weaknesses in external demand. In PR China, growth moderated more than initial expectations as the government showed firm commitment towards economic rebalancing. Consequently, the growth forecasts for several Asian economies were also revised downwards, factoring in the slower growth momentum in the advanced economies and PR China.

For the domestic economy, the growth of 4.3% in the first half of the year was lower than earlier

Chart 3.3

Outlook for Real GDP Growth in 2014



*Indonesia, Malaysia, Philippines, Thailand and Vietnam
**Newly Industrialised Asian Economies. July 2013 data for NIEs are not published.

Source: IMF, WEO October 2012, January, April, July and October 2013; Bank Negara Malaysia calculations

estimated. Net export growth was weak as export growth was affected by the prolonged slow growth in the US and weak economic activity in most of the European economies. Import growth expanded further following sustained growth in domestic investment and consumption. Consequently, the GDP forecast for the year was revised downwards in August to 4.5%-5.0%. While the annual growth was revised downwards given the slower expansion in economic activity in the first half of the year, the growth momentum was expected to improve in the second half of the year and into 2014. This was in line with the expectations for an improvement in global trade amid a recovery in the growth momentum of the advanced economies from the second half of 2013. However, uncertainty with regard to the domestic growth outlook for 2014 remained, especially on the strength of the global recovery. There was also uncertainty over the extent to which domestic factors such as the continued fiscal consolidation, rationalisation of subsidies and targeted measures to reduce the risks from vulnerabilities in the household sector, would affect domestic demand.

Inflation was expected to be within the lower end of the forecast range, as the key drivers of inflation identified at the beginning of the year did not materialise to the extent expected. Changes to administered prices had not occurred, while the projections for global food prices were revised downwards in line with the observed increase in global production. The extended deadline for the implementation of the minimum wage policy further eased pressure on costs. From September onwards, however, the inflation dynamics shifted and inflation was expected to increase for the remainder of the year and into 2014. This change was driven primarily by the upward adjustments in the prices of retail petroleum products and sugar in September and October, respectively; higher excise duties on tobacco products in the later part of the year; and the announced adjustment to electricity tariffs effective January 2014. A key risk the MPC had to consider was whether these price adjustments had the potential to set off a more sustained increase in prices across the economy. The subdued external price pressures and moderate domestic demand conditions were key mitigating factors to the prospect of broad-based price increases. The risks of second-round effects to inflation were also assessed to be limited, as the increase in inflation expectations remained confined to the prices of food and transportation.

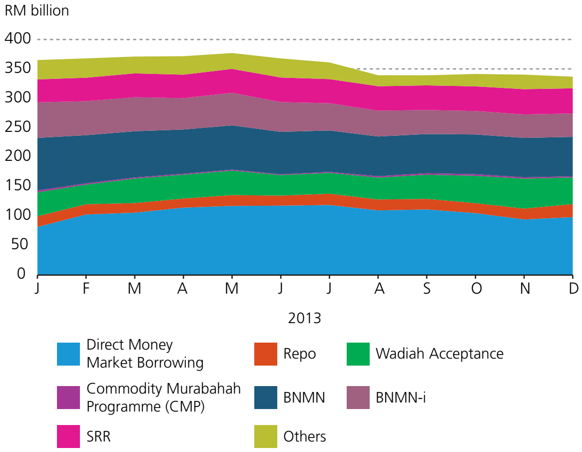
Wage pressures were moderate, with wage growth expected to be in line with the historical average. After careful consideration of these factors, the MPC assessed the risks of generalised price inflation to be limited.

Based on its assessment of the possible downside risks to growth and upside risks to inflation, the MPC viewed that holding the OPR steady would provide the best outcome for the intended monetary policy objectives. The level of interest rates was regarded as supportive to the economy. Given the reasons behind the increase in inflation and its sustainability, a monetary response was not considered as necessary.

A key development in the second half of the year was the capital flow reversal from the emerging economies due to the anticipated scale-back in the asset purchase programme of the Federal Reserve (Fed). Despite the increase in the size and volatility of capital outflows since May 2013, adjustments in the domestic currency and financial markets were orderly. The managed float exchange rate system accorded flexibility for the ringgit exchange rate to facilitate adjustments. The depth of the financial system also ensured that these volatile flows were intermediated without causing undue disruptions to economic activity. The growing demand from domestic institutional investors provided underlying support to the bond market and contained the increase in borrowing costs that were benchmarked off bond yields. There were consequently minimal spillovers to the real economy.

Chart 3.4

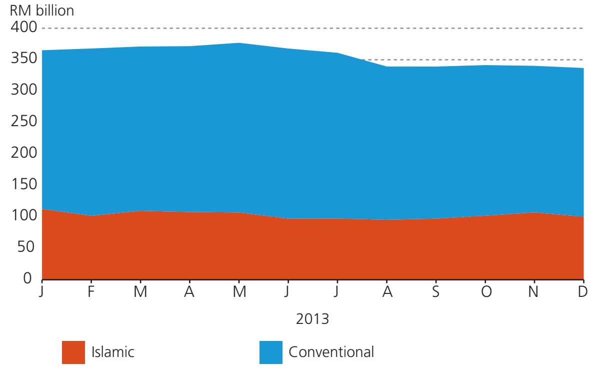
Outstanding Liquidity Placed with Bank Negara Malaysia



Source: Bank Negara Malaysia

Chart 3.5

Outstanding Liquidity Placed with Bank Negara Malaysia (Conventional-Islamic)



Source: Bank Negara Malaysia

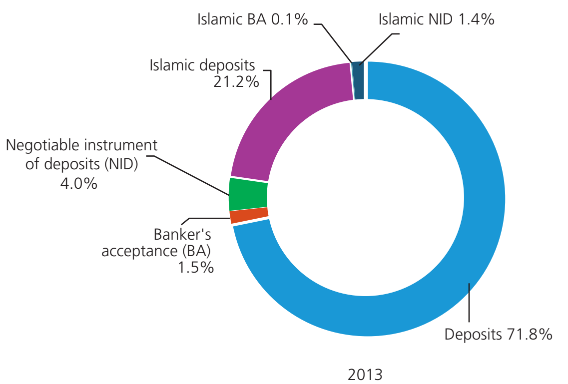
MONETARY OPERATIONS

Liquidity in the banking system remained stable throughout 2013, despite heightened volatility in global markets and larger swings in capital flows following the growing uncertainties surrounding the scale-back in the asset purchase programme by the Fed. Ringgit money market conditions were stable and continued to operate under a surplus liquidity environment, with participants placing their net surplus liquidity with the Bank throughout the year. Aggregate surplus liquidity for the year rose from RM370.8 billion as at end-2012 to a high of RM376.9 billion in May 2013, before declining to RM336.8 billion at the end of the year, consistent with the trend of capital flows.

During the year, total 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, recorded a volume of RM3.1 trillion, lower by 11.2% compared to 2012. Conventional deposits, which were unsecured borrowing and lending, became the main instrument of trading as it took up 71.8% of the total volume. However, this trading of deposits was lower in 2013 and amounted to RM2.2 trillion compared to RM2.6 trillion in 2012. The lower trading volumes for 2013 were due to the lower volumes from the month of June onwards

Chart 3.6

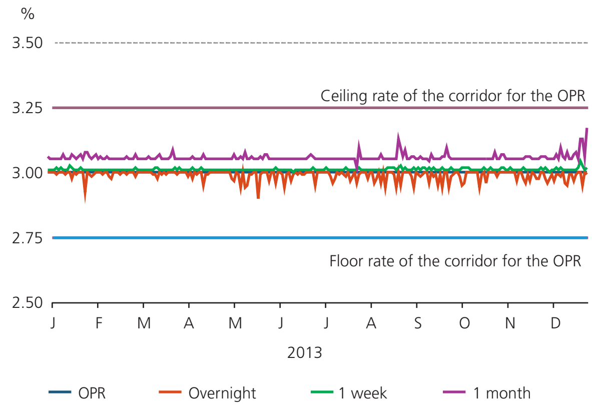
Breakdown of Interbank Money Market Transactions



Source: Bank Negara Malaysia

Chart 3.8

OPR and Interbank Rates



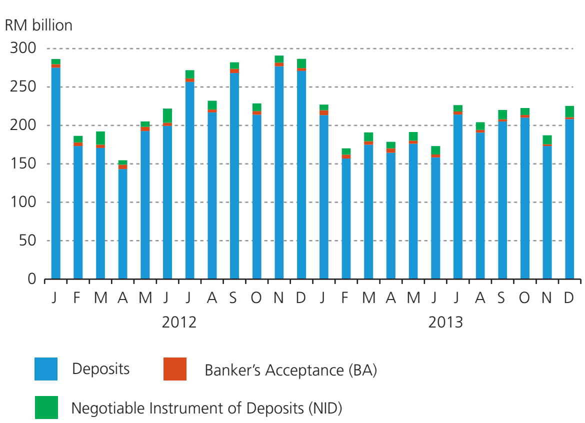
Source: Bank Negara Malaysia

to the end of the year when compared to the same period the previous year. This coincided with the reduction in overall liquidity in the system following the outflows arising from uncertainties in global financial markets over the Fed's asset purchase programme. Banks exercised caution in managing their surplus liquidity, and were more measured in interbank lending to preserve liquidity as a precaution to address any potential outflows. Despite this, expectations for domestic interest rates were well anchored, with no changes expected for the OPR. The average overnight interbank rate (AOIR), which tracked the OPR closely, ranged between 2.88% and 3.00%, with an average deviation (AOIR minus OPR) of 1 basis point. Interbank rates across all tenures traded within fairly narrow ranges, and transactions were concentrated in maturities of up to 1 month.

As ringgit money market liquidity and trading adjusted to the outflows which were taking place across the emerging economies from May to August, the Bank shifted the profile of monetary operations in favour of shorter-term instruments. Instead of the typical weekly operations, the Range Maturity Auction (RMA) was used more frequently over the period to provide more flexibility to financial institutions in managing their excess liquidity. In 2013, short-term borrowings, which comprised of conventional money market borrowings, Wadiah Acceptance and Commodity Murabahah Programme, increased from 32% in 2012 to 43% of total monetary operations. At the same time, the use of securities-based transactions had gradually declined, partly reflecting reduced demand for securities during the period of outflows.

Chart 3.7

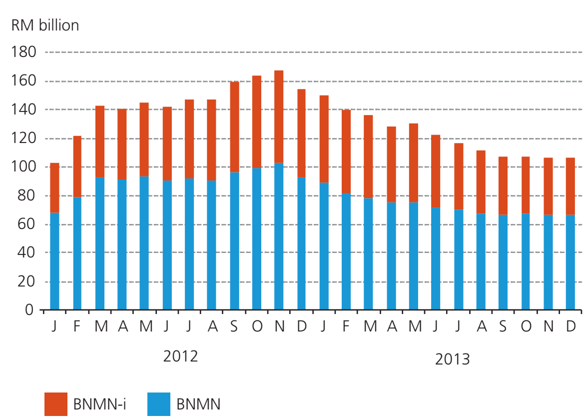
Conventional Interbank Money Market Transactions



Source: Bank Negara Malaysia

Chart 3.9

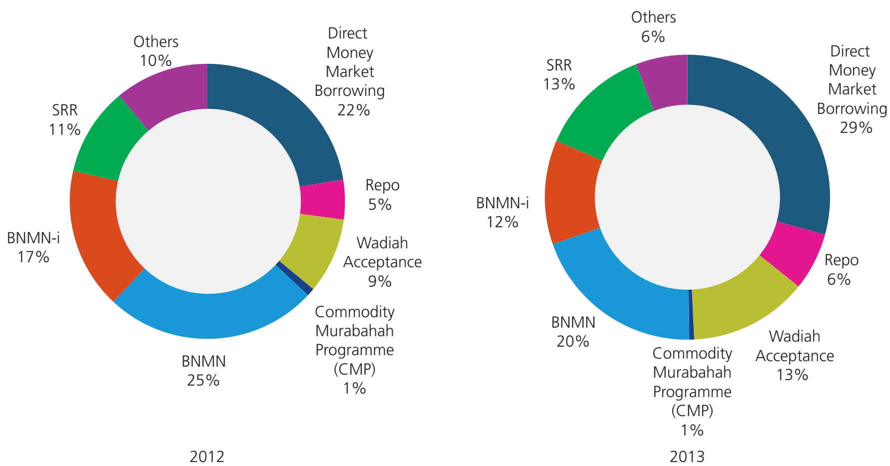
Outstanding Amount of BNMNs



Source: Bank Negara Malaysia

Chart 3.10

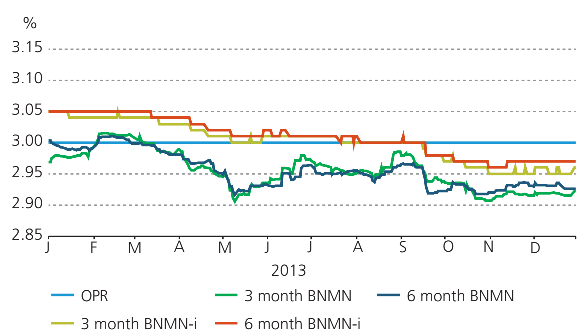
Breakdown of Outstanding Monetary Policy Instruments



Source: Bank Negara Malaysia

Chart 3.11

BNMN Yields and OPR



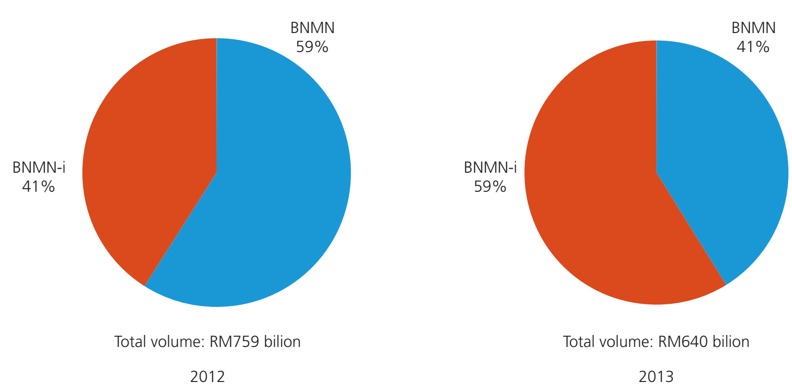
Source: Bank Negara Malaysia

The average duration for overall borrowing declined to 45.3 days in 2013 from 56.1 days in 2012.

The fluctuations in liquidity in the banking system led to the active management of the issuances of Bank Negara Monetary Notes (BNMNs). The Bank began reducing issuances of BNMNs from the first quarter of the year, having observed declining demand from non-resident investors. This strategy continued throughout the year following the global market volatility and outflows. As a result, total outstanding BNMNs declined from RM154.3 billion in early January 2013 to RM106.7 billion at the end of the year. Yields remained stable and averaged 6 basis points

Chart 3.12

Trading of Conventional and Islamic BNMNs



Source: Bank Negara Malaysia

below the OPR in 2013. This was despite higher yields observed from early February to March during a transition period after the Bank prescribed the use of onshore USD/MYR fixing for all domestic foreign exchange orders executed at the 11.00 am fixing. As for the trading of BNMNs, comprising conventional and Islamic BNMNs, the total volume amounted to RM640.0 billion in 2013, a decline of 15.7% compared to 2012. However, the share of Islamic BNMNs traded increased from 41% to 59%. The total trading of Islamic BNMNs increased by 21.0% to RM377.6 billion, catering to the demands of both conventional and Islamic investors for these securities and reflecting the growing acceptance of Islamic instruments by global investors.

The Bank continued with a number of initiatives to strengthen regional cooperation and facilitate more effective liquidity management by financial institutions in the domestic and regional markets. In 2013, the Bank established a cross-border collateral arrangement (CBCA) with the People's Bank of China, the third CBCA established after arrangements with the Monetary Authority of Singapore and Bank of Thailand in previous years. With this latest arrangement, financial institutions in Malaysia can now pledge Chinese government and central bank securities with the Bank to obtain ringgit liquidity. For the Islamic money market, the Bank introduced Islamic Range Maturity Auction (iRMA), an auction similar to the conventional RMA launched in 2011, to increase the operational efficiency of Islamic monetary operations. The iRMA provides flexibility for Islamic banks to choose the maturity tenure of placements with the Bank in the form of Wadiah Acceptance or Commodity Murabahah Programme.