MONETARY POLICY IN 2012

MONETARY POLICY

Monetary policy in 2012 was focused on managing the downside risks to growth amid moderating inflation. Although the Malaysian economy remained on a steady growth path and inflation was on a downward trend, the high degree of global economic and financial uncertainty remained a risk. In balancing the risks to inflation and growth of the economy, the Monetary Policy Committee (MPC) was unanimous in the decision to maintain the Overnight Policy Rate (OPR) at 3.00% throughout 2012.

Monetary policy in 2012 balanced between supporting growth and maintaining price stability

At the outset of 2012, the MPC assessed that the prospects for global growth had weakened compared to the previous year. The threat to global growth came predominantly from the economic and financial conditions in the advanced economies. The European sovereign debt crisis continued to affect the international financial markets. In the US and euro area, labour market conditions were still weak, fiscal consolidation was ongoing and policy uncertainties remained significant. Consequently, financial market volatility remained high and financial intermediation in these economies continued to be impaired. In the Asian region, while GDP growth was expected to be supported by domestic demand, the growth momentum was projected to moderate amid the weaker external environment. A distinguishing factor from the previous year was the additional uncertainty over the strength of economic activity in PR China and its ability to continue to support external demand in the region. In its January 2012 update of the World Economic Outlook (WEO), the International Monetary Fund (IMF) revised downwards its global growth forecast for 2012 from 4.0% to 3.3%. This meant that world growth in 2012 would be lower than the 3.9% recorded in 2011.

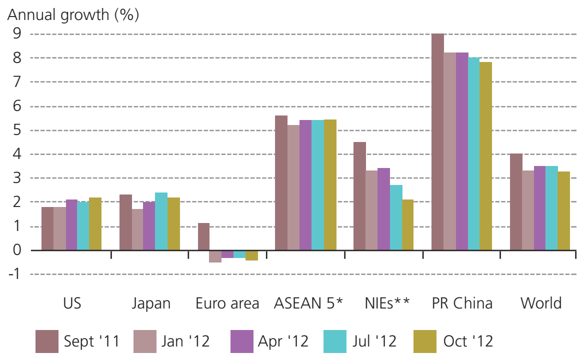
Given Malaysia's highly open economy, its growth would be affected by the moderation in global economic activity. Net exports was expected to contribute negatively to growth in 2012. Nevertheless, domestic demand was expected to support growth, driven by private sector activity and further reinforced by public sector spending. Private consumption would be supported by stable employment conditions, positive income growth and fiscal transfers to targeted households. Investment activity would be supported by capital spending in the domestic-oriented sectors, in the oil and gas industry and in projects related to the Economic Transformation Programme (ETP). With domestic demand supporting the Malaysian economy, GDP growth for 2012 was projected to be in the range of 4-5%.

In terms of inflation, the MPC assessed at the beginning of the year that the impact of domestic demand factors on inflation in 2012 would be contained. Despite the firm domestic demand, there was still excess capacity in the economy. Labour supply in the economy was adequate, and productivity would continue to improve. Cost-push inflation was expected to decline with the slowing global economic activity, alleviating the pressure on prices of key food and energy commodities. The subdued global inflation environment would also reduce imported inflation. Consequently, cost pressures were expected to be modest and firms were not expected to significantly raise retail prices. Headline inflation was therefore expected to moderate to a range of 2.5-3.0% in 2012, lower than the 3.2% recorded in 2011. Nevertheless, there were upside risks to inflation arising from potential global supply disruptions and the financialisation of commodities, which could result in higher commodity and food prices.

The MPC assessed that the risks to domestic growth and inflation were broadly in balance. Domestic growth was expected to be resilient but external developments created strong downside

Chart 3.1

Outlook for Real GDP Growth in 2012

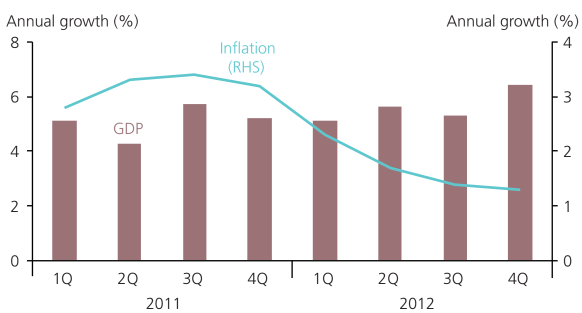


*Indonesia, Malaysia, Philippines, Thailand and Vietnam
**Newly Industrialised Economies

Source: IMF, WEO September 2011, January, April, July and October 2012

Chart 3.2

GDP and Inflation



Source: Department of Statistics and Bank Negara Malaysia

risks to the economic outlook. At the same time, while inflation was projected to moderate, potential disruptions to global supply and volatile commodity prices created upside risks to the inflation outlook. The OPR was therefore left unchanged at 3.00% in the first half of the year.

As the year progressed, there were tentative signs of improvements in the global economic and financial conditions. The recovery in the US economy showed signs of improvement, underpinned by positive credit growth, sluggish but improving labour market conditions and stabilisation of the housing market. Stress in the international financial markets was also partially alleviated by the introduction of measures to address the European sovereign debt crisis and further monetary easing by the advanced economies. Nevertheless, the underlying economic and financial conditions in the advanced economies remained vulnerable and uncertain. Concerns over fiscal sustainability in the US and euro area persisted. In the euro area, austerity measures and tight credit conditions continued to constrain growth. In the US, concerns increased over the possible discontinuation of a sizeable portion of the US fiscal support, which would have a significant impact on growth in the US. The reality was that the growth prospects of the advanced economies, and therefore for the global economy, remained fragile and subject to considerable downside risks.

By September, there was growing evidence that the global growth momentum had in fact moderated. Key indicators in the advanced economies still pointed towards weak economic activity, thus dampening prospects for the global economy for the remainder of 2012 and into 2013. At the same time, domestic demand in the Asian economies, including PR China, was showing signs of moderation. After having revised upwards the 2012 world GDP growth outlook to 3.5% in its April 2012 update of the WEO, the IMF subsequently revised its forecast downwards to 3.3% in October 2012. Similarly, the forecast for world GDP growth in 2013 was revised downwards from 4.1% to 3.6%.

While the domestic economy was affected by the weakness in the external environment, it became clearer as the year unfolded that the sustained expansion in domestic activity would be able to partially offset these external developments, as domestic consumption and investment recorded stronger-than-expected growth. Indicators and surveys of business conditions throughout the year pointed to the continued expansion of private consumption and business spending.
In assessing the outlook for 2013, private consumption was expected to receive additional support from sustained positive consumer sentiments, income growth, the access to credit from the banking system, and the various fiscal transfers to households by the Government. In addition, the growth in private investment in the domestic-oriented sectors was likely to be high. Public investment would also be robust, with high capital spending by the public enterprises and continued growth in the Federal Government development expenditure. GDP growth in 2013 is expected to remain firm in the region of the level in 2012, with domestic demand continuing to have a significant role.

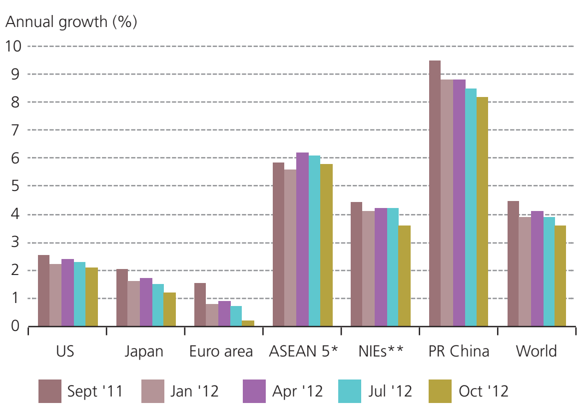
With regard to prices, headline inflation turned out to be below the Bank's initial forecast due to lower food prices amid better-than-expected domestic food supply conditions. The lower inflation was also due to the subdued global price pressures arising from slower global growth and the base effect following sharp and large increases in inflation in the previous year. The sustained domestic demand did not lead to significant increases in prices, as cost pressures were notably subdued during the year and there were efficiency gains from a stronger increase in productivity relative to income growth. In addition, the assessment was that while inflation might be higher in 2013 compared to 2012, it would remain moderate, as global energy and commodity prices were likely to be contained given the ongoing weak global conditions. Nevertheless, the upside risks to inflation emanating from possible global supply disruptions continued to be a source of vulnerability.

Despite the adverse external environment, the performance of the domestic economy continued to surprise on the upside, with a better-than-expected performance. The strong performance of the economy and relatively muted inflationary conditions led the MPC to maintain its monetary policy stance throughout the second half of the year.

MPC members viewed that the strong loan demand throughout the year, while warranting close monitoring, was not a concern, as total loan growth was supported mainly by lending to businesses, particularly to those in the domestic-oriented industries and ETP-related projects. Nevertheless, there were concerns over the potential risk of excessive indebtedness in certain segments of the household sector. The MPC was therefore of the view that a change in the monetary policy stance was not appropriate. The Bank had already introduced macroprudential measures and the guidelines issued on responsible financing practices at the beginning of the year and these were gradually having the effects of slowing loan growth to the household sector. The growth of banking system loans to households moderated from 12.9% in December 2011 to 11.6% in December 2012. Nevertheless, developments in household credit continued to be closely monitored to ensure that the risk of household indebtedness becoming excessive remained contained.

Chart 3.3

Outlook for Real GDP Growth in 2013

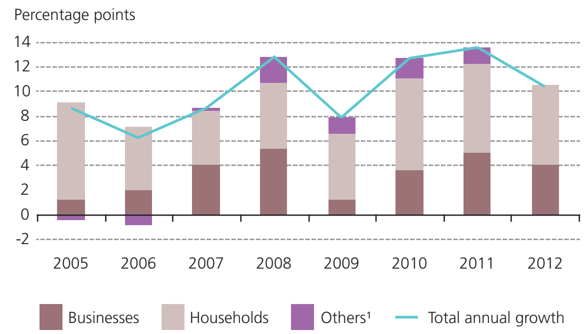


*Indonesia, Malaysia, Philippines, Thailand and Vietnam
**Newly Industrialised Economies

Source: IMF, WEO September 2011, January, April, July and October 2012

Chart 3.4

Contribution to Annual Growth in Total Loans Outstanding



[1] Others refers to government, financial institutions, foreign enterprises and other domestic entities

Source: Bank Negara Malaysia

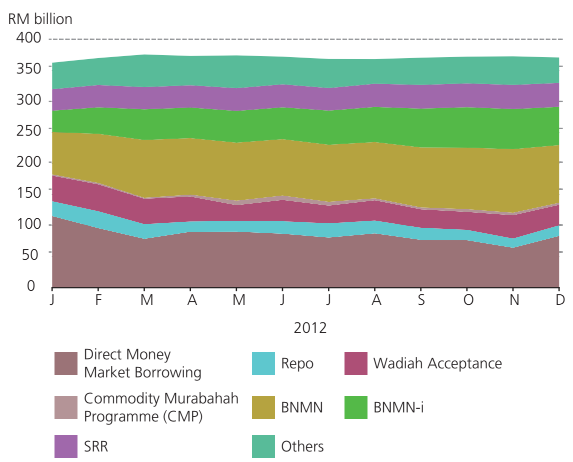
Monetary policy was also confronted with the challenge of sustained large and volatile capital flows throughout the year. The easy monetary policy and low interest rate environment in the advanced economies had created substantial global surplus liquidity that was in search of higher yields. Given the better yields and growth prospects of the emerging economies, including Malaysia, it attracted this surplus liquidity in the form of portfolio flows. Furthermore, developments in the advanced economies and changing sentiments in the global financial markets made these flows highly volatile. For the most part, the financial system was able to effectively intermediate these flows without generating substantial distortions in the financial markets. The deepening of the Malaysian financial system over this recent decade had increased the capacity of domestic financial intermediaries and markets to intermediate the inward and outward movements of portfolio flows. In addition, the more liberalised environment generated two-way flows that moderated the volatility of the flows.

MONETARY OPERATIONS

During the year, the domestic money market remained stable amid ample liquidity in the domestic banking system despite the uncertainties and volatility in the global markets. The interbank market continued to record healthy levels of activity and trading volumes under the surplus liquidity environment. All participants were net lenders to the Bank. Average aggregate surplus liquidity for the year amounted to RM370.9 billion, with liquidity reaching a high of RM375.7 billion in March 2012. Interbank money market transactions recorded a volume of RM1,138 billion, an increase of 35% compared to the previous year. The bulk of the interbank money market transactions were focused on short-term maturities (overnight and 1-week), which were preferred by interbank market players for short-term liquidity management.

Chart 3.5

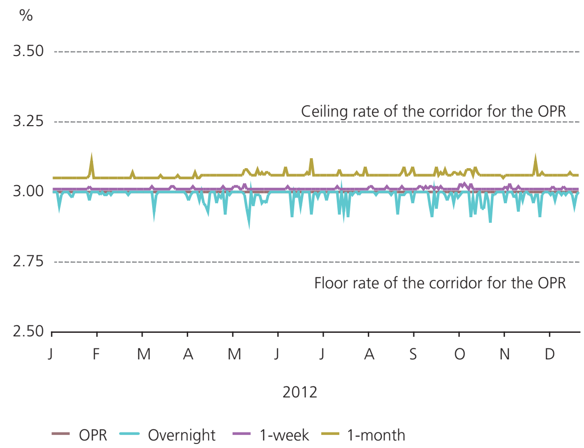
Outstanding Liquidity Placed with Bank Negara Malaysia



Source: Bank Negara Malaysia

Chart 3.6

OPR and Interbank Rates



Source: Bank Negara Malaysia

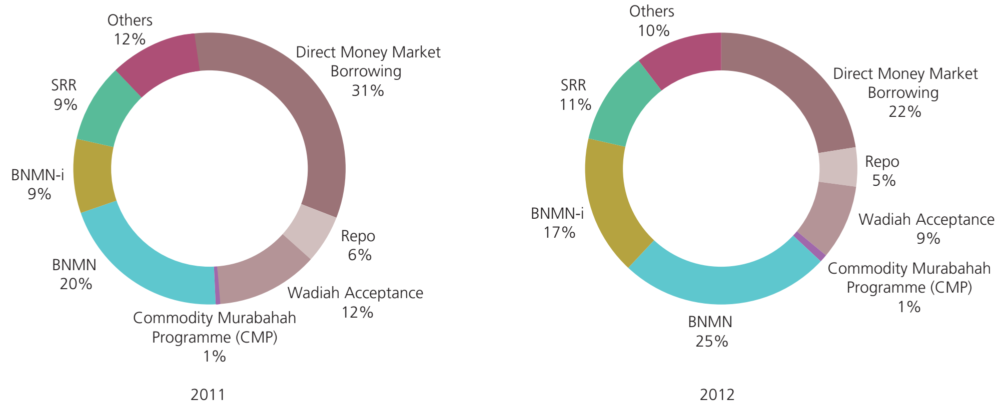
With the stable money market conditions, interbank rates across all tenures traded within fairly narrow spreads. The average overnight interbank rate (AOIR) tracked the OPR closely, ranging between 2.89% and 3.00%, with an average deviation (AOIR minus OPR) of 1 basis point.

In line with the recommendations outlined in the Financial Sector Blueprint 2011-2020 to promote an efficient and competitive money market with greater depth and liquidity, the Bank shifted the conduct of monetary operations to favour securities-based and collateralised transactions. During the year, the Bank gradually increased the issuance of conventional and Islamic Bank Negara Monetary Notes (BNMNs), thus reducing reliance on unsecured borrowings. Securities-based monetary operations increased from 36% to 48% of total operations in 2012.

The yields on BNMNs were below the OPR during the first quarter as market participants expected BNM to lower the OPR given the slower global growth outlook and its impact on the domestic economy. However, the yields normalised from the second quarter onwards as the financial markets settled on the view of an unchanged OPR at 3.00% throughout the year. The second half of the year also saw continued strong demand for BNMNs by banks and non-resident investors, which led to the yields trading closer to the OPR. The strong preference for BNMNs enabled the Bank to drain the surplus liquidity for a longer period and lengthen the maturity profile of its monetary instruments.

Chart 3.7

Breakdown of Outstanding Monetary Policy Instruments



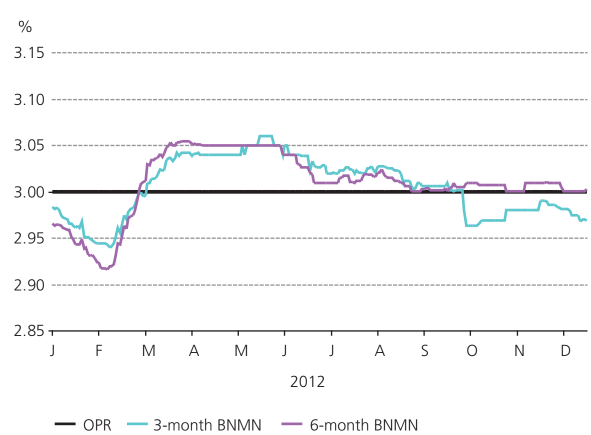
Source: Bank Negara Malaysia

The list of eligible collateral has been expanded to include non-ringgit securities issued by the Malaysian Government, securities issued by the governments and central banks of EMEAP-member economies in major and respective home currencies, as well as US Treasuries and UK Gilts

In May 2012, the Bank released a new guideline under the Standing Facility framework that expanded the list of eligible collateral to facilitate more robust liquidity management by financial market participants. The framework, which initially only accepted ringgit denominated securities, has been expanded to include non-ringgit securities issued by the Malaysian Government, securities issued by the governments and central banks of Executives' Meeting of East Asia Pacific Central Banks (EMEAP)-member economies in US dollars, pound sterling, euro, Japanese yen, and the respective home currencies, as well as US Treasuries and UK Gilts. In addition, the Bank will also accept home currency sovereign issues and the currencies of countries with which the Bank has signed cross-border collateral arrangements (CBCAs). Currently the Bank has such arrangements with Singapore and Thailand. The expanded framework is in line with efforts to strengthen cross-border liquidity management through the CBCAs, by allowing financial institutions operating in these countries to pledge foreign denominated securities and currencies to obtain liquidity from the respective central banks. This revision will also facilitate a greater regional orientation of financial institutions and increase cross-border activities within the region. In the revised guidelines, the Bank, in accepting securities issued in major currencies by multilateral development banks and multilateral financial institutions, will also recognise International Islamic Liquidity Management Corporation (IILM) securities as eligible collateral for the standing facility. IILM, an international institution established

Chart 3.8

BNMN Yields and OPR



Source: Bank Negara Malaysia

in October 2010 by central banks, monetary authorities and multilateral organisations, was set up to issue short-term Shariah-compliant financial instruments to facilitate effective cross-border Islamic liquidity management.

For Islamic money market operations, the Bank introduced Collateralised Murabahah in May 2012, as an alternative instrument for Islamic banks to obtain liquidity from the Bank under the standing facility. Collateralised Murabahah is essentially secured financing which combines the widely accepted Murabahah financing transaction with Sukuk to form the pledged collateral. The main objective of introducing Collateralised Murabahah is to offer a new low credit-risk financial instrument that promotes collateralised transactions in the Islamic money market in Malaysia. As an alternative to the existing sell buy back arrangement, the new instrument adds diversity to the repo-like liquidity management tool in the Islamic financial market. In future, it will also be expanded to facilitate daily Islamic money market operations (Islamic repos).

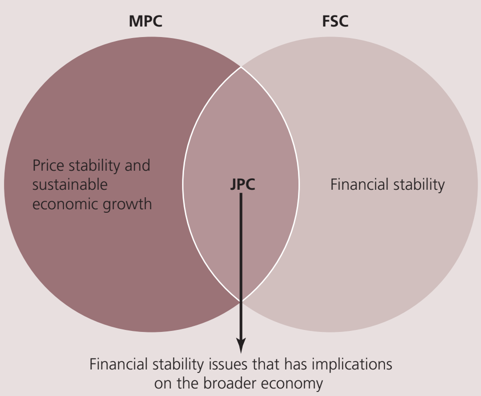
Bank Negara Malaysia's Joint Policy Committee

Bank Negara Malaysia has always recognised the interdependence of monetary policy and financial stability. The financial crisis in the advanced economies has amplified the importance of the relationship between these two types of policies. While the effective conduct of monetary policy presupposes a sound and stable financial system to provide an effective monetary transmission mechanism, continued financial stability, in turn, requires sound macroeconomic conditions, including an effective monetary policy. For example, given the pivotal role of the financial system in the intermediation process, a breakdown in financial stability can disrupt the monetary transmission mechanism by disrupting financial intermediation and the flow of credit to the economy, rendering monetary policy less effective. Similarly, a monetary policy stance that allows for prolonged low interest rates could lead to the build-up of financial imbalances, which in turn, increases the risks to financial stability.

As monetary and financial policies are highly interdependent, effective coordination of these policies is critical towards preserving sustainable macroeconomic conditions. In recognition of this, the Bank has established the Joint Policy Committee (JPC), a high-level internal policy committee, to deliberate on cross-cutting issues and to ensure the effective coordination of policies that may have an impact on the financial system and the broader economy. The joint forum framework facilitates broader surveillance and a more comprehensive risk assessment of issues by combining macroeconomic surveillance with micro-level analysis of the financial sector. This allows the Bank to act pre-emptively on emerging issues in a more coordinated and timely manner. The JPC is equipped with a broad range of powers and macroprudential instruments to undertake its mandates.

Chart 1

Demarcation of Responsibilities



The JPC is activated when either the Monetary Policy Committee (MPC) or Financial Stability Committee[1] (FSC) escalates an issue that has implications on both monetary and financial stability[2]. The Bank convened the inaugural JPC meeting on 7 September 2010. The current Committee consists of the Governor, Deputy Governors and Assistant Governors of the Bank.

Since its inception, several important issues have been brought to the attention of the JPC. Of significance, the JPC discussed the analysis of credit conditions from several perspectives. Given the downside risks to the domestic economy that were emanating from the weak global environment and the threat of higher inflation from rising global commodity prices in recent years, the JPC

[1] Refer to white box on 'Operationalisation of the Central Bank of Malaysia Act 2009', Annual Report 2010.
[2] As such, there is no fixed schedule or frequency for JPC meetings.

assessed the resilience of households to income shocks, with the evaluation being undertaken at both the aggregate level and at the disaggregated income levels. More recently, the JPC deliberated on the sustainability of household indebtedness, with detailed analysis of credit trends relative to the fundamentals of the economy and the health of household balance sheets across various income and age groups. This was supplemented by an assessment of the increasing role of non-bank financial institutions in the financing of the household sector. Another issue discussed was the developments in the property market and overall credit conditions in the residential and non-residential property sectors. The analysis on the property market was approached at both the national level, as well as by specific localities. The cumulative outcome of the JPC meetings was the implementation of several targeted macroprudential measures to ensure prudent levels of household debt and prevent excessive speculation in the property market.

Table 1

Outcome of the Joint Policy Committee (JPC) Meetings

Measure	Implementation		Rationale
Maximum loan-to-value (LTV) ratio for housing loans	Nov 2010	• Maximum LTV ratio of 70% applicable on the third and subsequent house financing facilities taken out by a borrower	• Mitigate excessive investment and speculative activity which was resulting in significant house price increases in certain locations
	Dec 2011	• Maximum LTV ratio of 60% for housing loans by non-individuals	
Guidelines on Responsible Financing	Jan 2012	• Financial institutions are required to make appropriate enquiries into a prospective borrower's income after statutory deductions for tax and retirement fund, and consider all debt obligations, in assessing the borrower's affordability • Maximum hire purchase financing of 9 years	• To promote prudent, responsible and transparent retail financing practices by financial institutions • To encourage sound borrowing by helping consumers to consider their ability to service all their debt obligations without recourse to further debt or substantial hardship
Propose for the increase of the real property gains tax (RPGT)	Jan 2012	• The Government increased the real property gains tax to 10% for sales of property within two years of purchase and to 5% for sales between 2 to 5 years	• To discourage speculative activity in the property market