2011

MONETARY POLICY IN 2011

MONETARY POLICY

Monetary policy in 2011 focused on sustaining economic growth, containing the risks to inflation and preventing the build-up of financial imbalances. Maintaining the momentum from 2010, the Malaysian economy experienced sustained growth in the first half of 2011. Inflation was expected to be higher compared to the previous year, driven mainly by supply factors and to a lesser extent, domestic demand pressures. Monetary policy in the first half of the year was therefore focused on the need to further normalise interest rates and on the need to pre-emptively respond to the risks to macroeconomic stability arising from volatile and large portfolio flows. In the second half of the year, however, the downside risks to domestic economic growth increased significantly due to deteriorating global economic and financial conditions, whereas the upside risks to inflation had begun to moderate. Given the balance of risks, the Monetary Policy Committee (MPC) considered the prevailing Overnight Policy Rate (OPR) level to be appropriate and kept the policy rate unchanged for the remainder of the year.

Monetary policy in 2011 remained supportive of growth, while managing inflationary pressures

At the beginning of the year, economic indicators suggested that the recovery of the global economy was continuing, although the growth performance differed markedly across regions. The advanced economies were expected to grow at a relatively slower pace compared to the regional economies. The European sovereign debt crisis continued to cause ongoing financial market uncertainty while structural weaknesses in several advanced economies continued to restrain economic activity. Growth in the regional economies was, however, expected to remain robust, supported by strong domestic demand. In its January 2011 update of the World Economic Outlook (WEO), the IMF forecast growth in the US, euro area and Japan to be at 3.0%, 1.5% and 1.6% respectively in 2011, whereas growth in PR China, the Newly Industrialised Asian Economies[1] and the ASEAN-5[2] economies would be higher at 9.6%, 4.7% and 5.5% respectively.

Domestically, there were positive signs that the economy was on a steady growth path, underpinned by the firm expansion in domestic demand. At this juncture, the assessment was that private consumption would continue to be supported by income growth, given positive labour market conditions and high commodity prices; positive consumer sentiments and continued access to financing. Private investment would be sustained by capital expenditure in the domestic-oriented sectors. Public investment would contribute to economic activity, partly driven by capital spending by the non-financial public enterprises (NFPEs). GDP growth for 2011 was expected to remain robust at 5-6%.

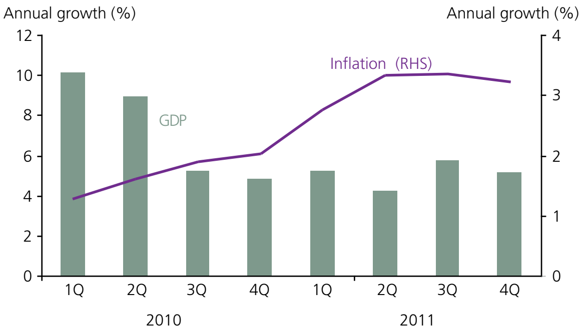
Inflation in 2011 was expected to be higher compared to 2010. Supply factors would be the main source of inflation during the year. The adjustments to the administered prices of petroleum products in December 2010 would inevitably raise headline inflation. Rising global energy and food prices were expected to exert upward pressure on firms' costs of production. Coupled with the expected strong domestic demand, the knock-on effects were expected to be larger and cause more generalised price increases across the economy. Domestic demand forces were also beginning to exert direct upward pressures on inflation. Core inflation had begun to increase and was expected to trend upwards during the year due to strong private consumption, which was supported by firm wage growth amid stable employment conditions. Core inflation had been on an uptrend from the third quarter of 2010, increasing from 1.3% in September 2010 to 1.6% in December 2010. There was also indication that inflation was becoming more pervasive. The share of CPI items

[1] Comprises Hong Kong SAR, Singapore, South Korea and Chinese Taipei

[2] Comprises Indonesia, Malaysia, Philippines, Thailand and Vietnam

Chart 3.1

GDP and Inflation



Source: Department of Statistics and Bank Negara Malaysia

experiencing price increases of more than 2% had risen over the course of the previous year, and this trend was expected to continue into 2011. Given these demand pressures, second-round inflationary effects could occur should inflation expectations become dislodged and wage increases respond to the higher inflation.

Against this backdrop of sustained economic activity and demand-induced pressures on inflation, the policy focus of the MPC from the beginning of the year was on the need to further normalise monetary policy to avoid keeping interest rates too low for too long. A prolonged period of low interest rates amid ample liquidity would not only lend support to demand-driven inflation, but would also lead to financial imbalances as it creates incentives for excessive leveraging and risk-taking in the search for higher yields that could fuel asset prices while dampening the incentives to save. The pace and extent of interest rate normalisation would, however, require proper calibration so as not to impinge excessively on economic growth. The economy was still recovering and uncertainties with respect to the strength of private consumption and investment remained.

By May 2011, there had been an accumulation of economic indicators that supported the economy being on a sustained growth path. Figures released in February showed GDP growth in the fourth quarter of 2010 was sustained at 4.8%. Forward-looking indicators and measures of consumer sentiment pointed to a continued positive outlook for private consumption. Feedback from the Bank's industrial engagements suggested sustained growth of employment and wages, which would be further supported by the firm commodity prices in the first half of the year. The expansion in external demand in the first quarter of the year was also higher than had been anticipated and early estimates pointed to GDP growth remaining firm in the first quarter of 2011. The upside risks to inflation remained elevated, emanating from possible adjustments to fuel and food subsidies and electricity tariffs, and the increasing production costs due to the rising cost of inputs. Consequently, the MPC raised the OPR by 25 basis points on 5 May 2011 to 3.00%. The Statutory Reserve Requirement (SRR) was also increased by 1 percentage point each time in March, May and July to 4.00% to reduce the size of the excess liquidity in the banking system.

The transmission of the OPR increase to retail rates was rapid and sizeable. Banking institutions raised base lending rates (BLR) within 8 days of the announcement of the OPR increase, and the BLR was raised by 27 basis points to 6.54% as at end-May.

Table 3.1

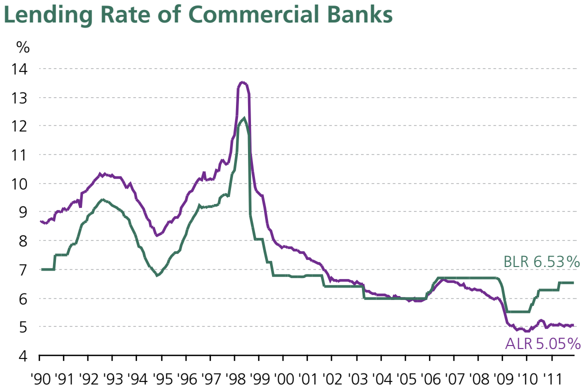
MPC Decision Dates and OPR Changes

MPC Decision Dates	OPR	
	Change	Level (%)
27 Jan 2011	-	2.75
11 Mar 2011	-	2.75
5 May 2011	+ 25 basis points	3.00
7 Jul 2011	-	3.00
8 Sep 2011	-	3.00
11 Nov 2011	-	3.00

Source: Bank Negara Malaysia

Chart 3.2

Base Lending Rate and Average Lending Rate of Commercial Banks



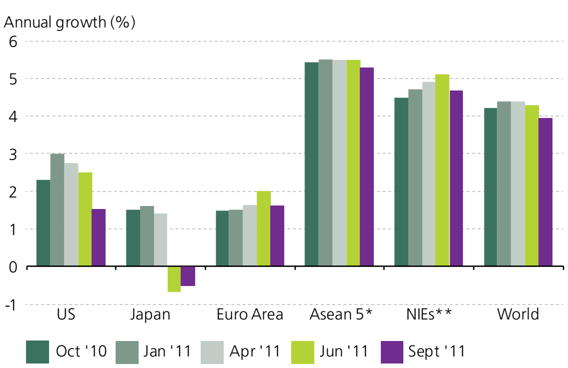
Source: Bank Negara Malaysia

The increase in the BLR was 2 basis points over the OPR increase, after imputing the higher cost of intermediation from the increases in the SRR.

In the second half of the year, however, global growth prospects began to deteriorate following the adverse developments in the advanced economies. The European sovereign debt crisis continued to intensify as the year progressed while policy uncertainties in the advanced economies, particularly in the US and euro area, only served to heighten financial market volatility and worsen confidence. Weaknesses in labour markets in the advanced economies also remained. In the US, the housing market continued to be weak and household balance sheets remained impaired. Overall, growth in the advanced economies in 2011 was expected to be slower than was forecasted at the beginning of the year, with the exception of the euro area where the core economies continued to experience strong growth. Growth in PR China was also expected to moderate, due to the weaker external environment and the effects of earlier tightening measures. Despite sustained domestic demand in the regional economies, growth also moderated. This change in the global growth outlook was reflected in the significant downward revisions to the 2011 and 2012 world growth forecasts by the IMF between its June 2011 and September 2011 updates of the WEO. The world GDP growth outlook was revised downward from 4.3% to 4.0% for 2011, and from 4.5% to 4.0% for 2012. These revisions indicated a renewed fragility of global economic growth and its vulnerability to shocks.

Chart 3.3

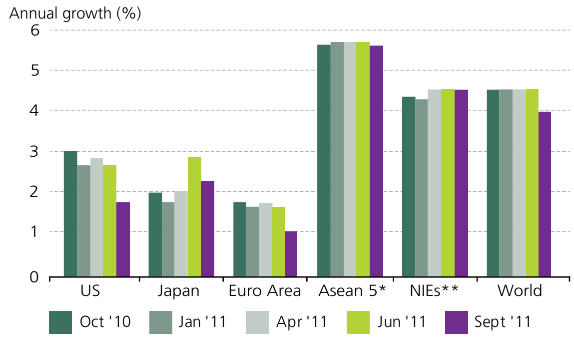
Outlook for Real GDP Growth in 2011



*Indonesia, Malaysia, Philippines, Thailand and Vietnam
**Newly Industrialised Economies
Source: IMF, WEO October 2010, January, April, June and September 2011

Chart 3.4

Outlook for Real GDP Growth in 2012



*Indonesia, Malaysia, Philippines, Thailand and Vietnam
**Newly Industrialised Economies
Source: IMF, WEO October 2010, January, April, June and September 2011

For the Malaysian economy, concerns about slowing external demand arising from the weaker global economic environment also began to emerge in the second half of the year. The more challenging external environment had thus increased the downside risks to the economy. Consequently, GDP growth was expected to come in at the lower end of the 5-6% range forecasted earlier. Overall growth prospects continued to remain positive, underpinned by the expansion in private consumption and investment, and public consumption. Employment conditions remained favourable amid sustained business and consumer confidence. The MPC, however, was mindful of the potential for lower commodity prices to affect domestic demand, particularly for rural households with reduced incomes.

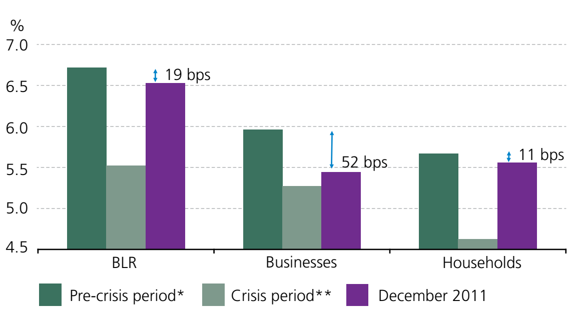
With regard to inflation, price pressures were expected to remain elevated but more stable for the rest of the year and to moderate in 2012. The contribution from supply factors to inflation was expected to decline. The slower global growth, and the expected more stable supply of commodities, would reduce the pressure on global commodity prices. At the same time, anticipated adjustments to administered prices were not expected to materialise. The influence of domestic demand factors on inflation would be less than what was projected earlier in the year, as the increased uncertainties over growth prospects restrained demand pressures. Inflation was therefore assessed to have peaked. Food price inflation, however, remained a concern, largely due to domestic supply disruptions. This assessment proved to be correct as inflation moderated from 3.5% in June to 3.0% in December. For the year as a whole, inflation averaged at 3.2%, which was within the Bank's forecast range of 2.5 – 3.5%.

Given the heightened downside risks to domestic growth and lower upside risks to inflation, the MPC considered the OPR level at 3.00% to be appropriate and kept the OPR unchanged for the remainder of the year. The outlook for the Malaysian economy remained positive, as the economy was expected to continue to expand, albeit at a more moderate pace. In the prevailing uncertain global economic environment with its consequent spillover effects onto the domestic economy, access to financing and business opportunities were the most important factors in determining the sustainability of growth.

Monetary conditions remained supportive of economic activity. Borrowing costs, especially in real terms, continued to be highly favourable. Lending rates remained below the levels prevailing before the 2008 financial crisis in the advanced economies. The cumulative 100 basis points increase in the OPR in 2010 and 2011 was only two-thirds the 150 basis points reduction undertaken in 2008 and 2009 to mitigate the impact of the financial crisis in the advanced economies. At end-December 2011, average nominal lending rates on new loans to businesses remained 52 basis points below pre-crisis levels and 11 basis points lower for households. Private sector financing was sustained in 2011. Net financing raised by the private sector through the banking system and

Chart 3.5

Average Nominal Lending Rates on New Loans for Various Periods



* January 2008 - October 2008
** March 2009 - February 2010

Source: Bank Negara Malaysia

the capital market expanded at a faster annual pace of 12.5% in 2011 (2010: 10.9%).

A key challenge to the conduct of monetary policy during the year was the significant and volatile portfolio inflows. Emerging economies continued to receive large net portfolio inflows particularly in the first half of 2011 due to the sustained divergence in growth prospects and interest rates between the advanced and emerging economies amidst the substantial injections of liquidity by central banks in the advanced economies. The portfolio inflows and the consequent build-up of liquidity in the domestic financial system, if not managed, could lead to financial imbalances and create risks for macroeconomic and financial stability, particularly in terms of exchange rate overshooting and excessive growth in asset prices and credit. A sudden reversal in portfolio flows could also lead to economic and financial instability.

To manage the risks from excess liquidity, the MPC decided to raise the SRR by 1 percentage point each time in March, May and July to 4.00%. The staggered increases facilitated orderly adjustment by financial institutions. An important distinction was made that the SRR was not used as a signal on the stance of monetary policy, but used as an instrument to manage liquidity. It was highlighted that the SRR was one of the monetary instruments being used to manage liquidity in the banking system. The Bank also uses other monetary instruments such as uncollateralised borrowing and the issuance of Bank Negara Monetary Notes (BNMNs).

The Bank also instituted pre-emptive macro-prudential measures to ensure prudent debt management and address the possible risks arising from credit expansion. New measures were introduced on credit cards to promote prudential financial and debt management. New guidelines were also issued to financial institutions to promote prudent, responsible and transparent retail financing practices (*See Financial Stability and Payment Systems Report 2011 for further details*).

The year 2012 will undoubtedly present new challenges for monetary policy. The MPC will continue to assess carefully the evolving developments surrounding inflation, economic growth and financial conditions, and adjust monetary conditions accordingly to ensure the sustainability of growth of the Malaysian economy in an environment of price stability.

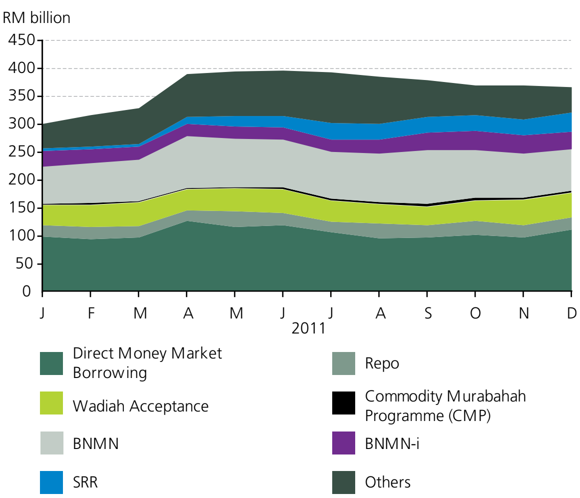
MONETARY OPERATIONS

During the year, the domestic money market and liquidity in the banking system were affected by developments in the international financial markets and volatile portfolio flows. Overall conditions in the domestic money market, however, remained resilient to the global financial turmoil. Interbank markets continued to operate under a surplus liquidity environment, with all participants remaining as net lenders throughout the year. Aggregate surplus liquidity rose from RM299.2 billion as at end-2010 to as high as RM397.5 billion as at June 2011, before declining in the second half of the year.

The earlier surge in domestic liquidity, which peaked in June 2011, corresponded with the portfolio inflows into emerging markets. To absorb the excess liquidity, the Bank increased the issuances of BNMNs. As a result of the significant amount of portfolio inflows, the 3-month and 6-month BNMN yields traded, on average, only 3 and 7 basis points above the OPR prior to the policy rate increase in May 2011 despite the widespread market expectations for monetary policy tightening. After the increase in the OPR, and during the second half of the year, BNMN yields traded below the OPR as a result of continued strong demand by non-residents. The Bank also absorbed liquidity via repo operations and direct money market borrowings. In addition,

Chart 3.6

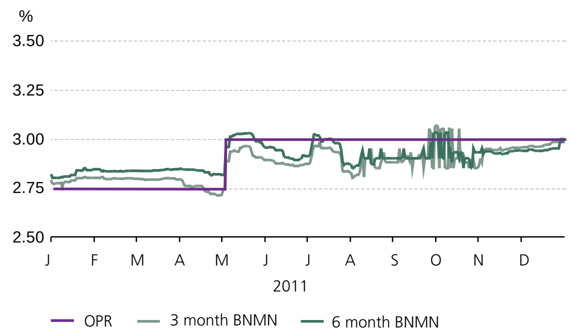
Outstanding Liquidity Placed with Bank Negara Malaysia



Source: Bank Negara Malaysia

Chart 3.7

BNMN Yields and OPR



Source: Bank Negara Malaysia

as part of managing this excess liquidity, the Bank revised the SRR, raising it in a staggered manner from 1.00% to 4.00%.

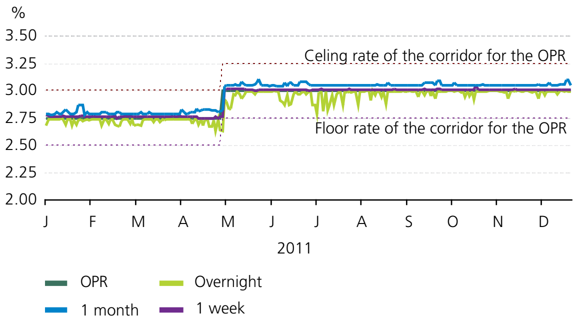
During the later part of the year, excess liquidity conditions in the domestic money market eased as a result of the reversal of portfolio flows. Nevertheless, overall liquidity remained in a surplus position. Bank Negara Malaysia responded to the changed conditions by reducing BNMN issuances and money market borrowings.

As a result of the monetary operation strategies adopted throughout the year, overall liquidity conditions in the domestic money market were stable. This was evidenced by the average overnight interbank rate (AOIR) in 2011, which was maintained within the range of +/- 25 basis points of the OPR. The AOIR adjusted to an average of 2.97% in the period after the 25 basis points increase in the OPR to 3.00% in May 2011, from an average of 2.72% previously. Throughout the year, the AOIR was relatively stable and tracked the OPR closely with an average deviation (AOIR minus OPR) of three basis points.

Several developmental initiatives were implemented in 2011 to increase the operational efficiency of monetary operations and enhance the variety of money market instruments. The Range Maturity Auction (RMA) was fully operationalised during the year and became part of standard monetary operations. The RMA is a variation to the money market term tender, which allows greater flexibility in determining the maturity range for uncollateralised borrowings. With the RMA, the Bank offers a tender amount with a tenor of maturity ranging from 7 days up to 1 year, but provides flexibility to the

Chart 3.8

OPR and Interbank Rates



Source: Bank Negara Malaysia

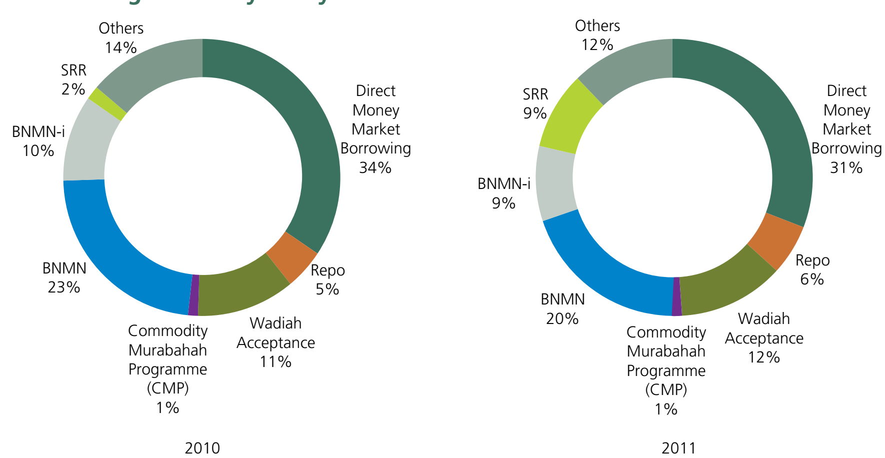
financial institutions to choose the maturity for the uncollateralised borrowings within the range offered by the Bank. RMA allows liquidity to be managed more precisely by providing financial institutions the option to lend their excess ringgit funds according to their liabilities profile. This has enhanced the Bank's liquidity management by matching the Bank's liquidity forecast with the financial institution's liquidity requirements.

For the Islamic money market, two new instruments were introduced in 2011 to enhance the variety of instruments for liquidity management in the Islamic money market. The first instrument is the Bank Negara Malaysia Monetary Notes-Istithmar (BNMN-Istithmar), which is based on the *Istithmar* (investment) concept that refers to portfolio investments that comprise of *Ijarah* (lease) and *Murabahah* (commodity cost-plus) transactions. This new monetary instrument is widely accepted by Islamic banks in Malaysia and is tradable in the secondary market. The second instrument is the Bank Negara Malaysia Monetary Notes-Bai Bithaman Ajil (BNMN-BBA), which is similar to the existing Murabahah-based BNMN-i, as both represent indebtedness arising from deferred payments on commodity *Murabahah* sale transactions between the issuer and investor. The BNMN-BBA, however, does not have secondary market tradability features, thus satisfying a different Shariah interpretation on the debt trading (*Bay Al Dayn*) prohibition.

As part of the effort to strengthen cross-border liquidity management, the Bank has embarked on initiatives to establish cross-border collateral arrangements (CBCA) with other central banks in the region. This would enable eligible Malaysian financial institutions operating in these countries to obtain liquidity from the respective central banks by pledging ringgit or ringgit-denominated sovereign and central bank securities. Similarly, eligible foreign financial institutions from these countries operating in Malaysia may obtain ringgit liquidity from Bank Negara Malaysia by pledging foreign currency or foreign currency-denominated sovereign and central bank securities with Bank Negara Malaysia. To date, the Bank has established CBCAs with the Monetary Authority of Singapore and the Bank of Thailand. With more countries in the region expected to participate in this initiative, this will reinforce financial and economic integration and support the expanding regional activity of financial institutions operating in the region.

Chart 3.9

Breakdown of Outstanding Monetary Policy Instruments



Source : Bank Negara Malaysia