2010

MONETARY POLICY IN 2010

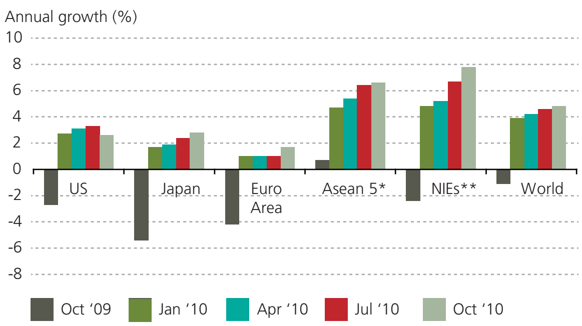
MONETARY POLICY

The Malaysian economy experienced a strong resumption of growth in 2010, driven by a robust expansion in private consumption and a rebound in private investment. In tandem with the improvement in the domestic economy, the focus of monetary policy in 2010 shifted away from the need to avert a fundamental economic downturn, and turned towards balancing the risks to inflation and growth, while ensuring that monetary conditions were appropriate to prevent the build-up of financial imbalances.

At the beginning of the year, economic indicators were signalling that the global recession was receding. Global growth was being led by a rebound in manufacturing and an upturn in the inventory cycle. Signs of improvement were evident from retail sales, consumer confidence, and the housing markets. World trade was also beginning to pick up. The change in outlook was reflected by the significant upward revision to the 2010 global growth forecast by the IMF in its January 2010 update of the World Economic Outlook (WEO). Meanwhile, economic performance of the emerging market economies, including Malaysia, was expected to improve more significantly than the advanced economies given the more resilient fundamentals relating to their economies and financial systems.

Chart 3.1

Outlook for Real GDP Growth in 2010



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

Source: IMF, WEO October 2009, January, April, July and October 2010

In the domestic economy, economic indicators suggested that the economy had started to grow again since the fourth quarter of 2009. Positive developments in manufacturing production, financing activity, external trade and labour market conditions reaffirmed the assessment that the economic recovery was gaining strength. The economy was expected to expand further during the course of 2010, with growth being supported by strengthening domestic demand, particularly private consumption, and further improvements in external demand.

> With the improvement in economic outlook, the need to normalise the extraordinary monetary stimulus became the focus of the MPC during the early part of the year

Meanwhile, inflation was expected to rise gradually but remain low throughout the year. Measures of core inflation and demand indicators suggested the potential emergence of demand induced inflation later in the year, in line with the recovery in demand conditions. Demand related pressures on inflation, however, were expected to remain relatively modest. The risk to inflation was more likely to originate from supply-side factors, namely the increase in global commodity prices as global demand improved and the expected adjustments to administered prices that were undertaken under the subsidy rationalisation programme. These supply-side factors, however, would not warrant tighter monetary conditions unless they led to signs of persistent and wide spread second-round effects.

Against this backdrop, the need to normalise the extraordinary monetary stimulus undertaken in 2009 became the focus of the Monetary Policy Committee (MPC) during the early part of the year. Leaving the Overnight Policy Rate (OPR) at such a low level could give rise to financial imbalances and create distorted incentives for economic agents, leading to the mispricing of risks, financial disintermediation and excessive credit growth *(See white box on 'Financial Imbalances and the Role of Monetary Policy')*. Ignoring such risks could lead to undesirable effects on the broader economy when such financial imbalances unravel in a disorderly manner. The policy focus, hence, was to assess the appropriate timing and pace for the process of monetary policy normalisation. With the economy still at a nascent stage of recovery, the challenge was in ensuring that raising interest rates would not disrupt the sustainability of private sector demand in driving economic growth.

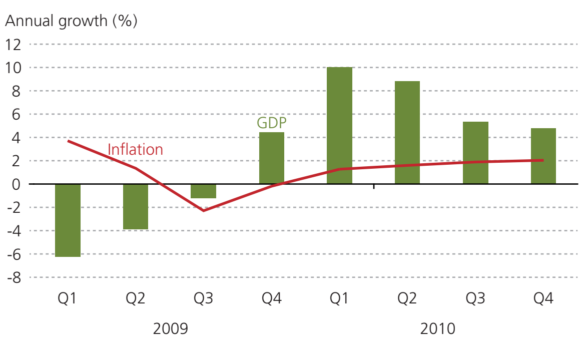
Incipient signs of the economic recovery being firmly entrenched allayed this concern. Compared to 2009, it was clear that the extraordinary conditions under which interest rates were reduced no longer prevailed. Forward looking indicators suggested stronger economic recovery ahead, while engagements with key industry players revealed more confident sentiments toward the economy. This assessment was affirmed in February 2010 when the numbers for 4Q 2009 showed a stronger growth performance of 4.4%.

The MPC was mindful that if interest rates continued to be held at very low levels for a sustained period, they could lead to financial imbalances. This was a key lesson from the experience of the industrial countries at the heart of the recent global financial crisis. A prolonged period of low interest rates discouraged savings, led to excessive borrowing, overinvestment in housing, and when combined with unchecked financial innovation, led to large investments in risky financial products. In essence, the following are the main considerations with regard to the normalisation of monetary policy. First, monetary policy must be adjusted pre-emptively to avoid the build-up of financial imbalances. Raising interest rates when financial imbalances have already permeated into the economy would not be effective. Second, the monetary policy stance needed to be recalibrated given that the threat of a fundamental recession was no longer present. The extraordinary amount of monetary stimulus provided in 2009 was no longer warranted as indicators showed growth becoming more entrenched led by the strong growth of private sector demand. Notwithstanding this need to normalise interest rates, it was recognised that monetary policy needed to remain accommodative to support the ongoing economic recovery. Policy adjustments would also be gradual to facilitate an orderly transition by financial institutions and market participants. Taking into account these considerations, the MPC normalised the OPR gradually by 25 basis points at each of the MPC meetings on 4 March, 13 May and 8 July 2010. The money market responded to the OPR increases in an orderly manner, with adjustments to money market rates, which were then transmitted to the retail lending rates.

Retail lending rates adjusted quickly, with all banks raising their base lending rates (BLR) within 6 days of the announcement of each OPR increase. Nevertheless, with borrowing

Chart 3.2

GDP and Inflation



Source: Bank Negara Malaysia

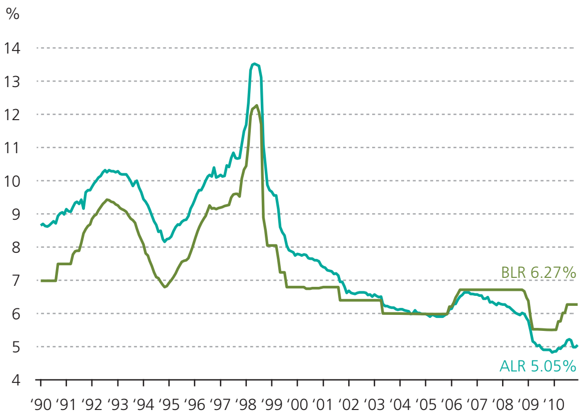
Table 3.1

MPC Meeting Dates and OPR Decisions

MPS Publication Dates	OPR
26 Jan 2010	2.00
4 Mar 2010	2.25 (+ 25 bps)
13 May 2010	2.50 (+ 25 bps)
8 Jul 2010	2.75 (+ 25 bps)
2 Sep 2010	2.75
12 Nov 2010	2.75

Chart 3.3

Base Lending Rate and Average Lending Rate of Commercial Banks

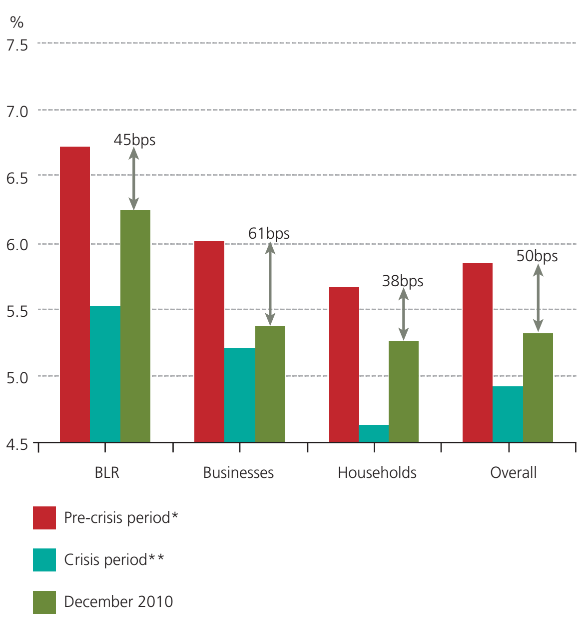


Source: Bank Negara Malaysia

costs still below pre-crisis levels, financing conditions remained supportive of economic activity. Specifically, as at end-December 2010, nominal retail lending rates on new loans to businesses remained on average 61 basis points below pre-crisis levels[1]. Lending rates to households were 38 basis points lower than pre-crisis levels over the same period.

Chart 3.4

Average Nominal Lending Rates on New Loans for Various Periods



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

Source: Bank Negara Malaysia

> With the borrowing costs still below pre-crisis levels, financing conditions remained supportive of economic activity

Reflecting the reasonable borrowing cost and ample liquidity in the financial system, private sector financing remained robust throughout 2010. Loans extended to businesses during the year improved as retail sales and investment activity improved. Household loans also expanded in line with the strong growth in consumption expenditure following stable labour market conditions and positive sentiments. Notwithstanding the strong trends in financing, credit growth was judged to be in line with fundamentals and the overall level of household indebtedness remained at a prudent level.

Following the cumulative increase of 75 basis points, the MPC considered the OPR level of 2.75% to be appropriate and consistent with its assessment of the medium-term economic growth and inflation prospects. In the second half of the year, the Malaysian economy continued to expand in spite of the slower performance in the external sector. Domestic economic growth continued to be supported by domestic demand following favourable labour market conditions, positive sentiments, low inflation and conducive credit conditions. There were, nevertheless, downside risks to global growth arising from several factors. The escalation of the sovereign debt crisis in the euro area as well as the announcements of impending fiscal austerity measures in several advanced economies raised uncertainties on the sustainability of the global economic recovery. In addition, growth in the advanced economies slowed as the temporary boost to economic activity from the build-up of inventories and the earlier policy stimulus had begun to fade. Furthermore, the policy-induced slowdown in

[1] Over the period January 2008 to October 2008 when the OPR was still at 3.5%, the lending rates on new loans for businesses and households were on average 6.01% and 5.67% respectively.

PR China to achieve a more sustainable growth over the medium term could affect intra-regional trade.

With regard to inflation, the consumer price index (CPI) edged higher during the second half of the year. This increase was moderate despite the series of adjustments to administered prices, and was mainly on account of supply factors. At the same time, the lower imported inflation from more modest growth in the advanced economies and the stronger ringgit helped to mitigate some of the pressures on inflation. For the year as a whole, inflation remained low at an average of 1.7%.

The risk of a build-up of financial imbalances continued to be evaluated throughout the year. Assessments showed that growth in asset prices and credit were generally not excessive and continued to be in line with the improvements in the economy. First, there were limited evidence of overvaluation in the equity market. The magnitude of the KLCI increase did not deviate too far from its underlying trend. Moreover, even though equities posted healthy gains, equity purchases funded through borrowings were low. Second, evidence of excessive credit growth was also limited. The ratio of loan to GDP relative to its trend was neither excessive nor persistently above trend. Third, property price inflation at the national level remained modest with an annual increase of 1.5% in 2009, compared to the 2000-2008 average of 3.6%[2]. However, there were concerns of speculative activity in the property market in selected locations in the urban areas. The number of transactions and house prices in these locations experienced faster growth. There was also a rise in financing provided to individuals for multiple unit purchases. In this instance, targeted macro-prudential measures were judged to be more appropriate to address such concerns. The policy intent was to reduce speculative activity in the property market. To this end, the Bank in November 2010 announced the implementation of a maximum loan-to-value (LTV) ratio of 70% applicable to the third and subsequent house financing facilities taken out by a borrower.

Another development that posed challenges to the conduct of monetary policy during the year was the larger and more volatile international financial flows. Sustained divergence in growth prospects between developed and emerging economies led to continuous financial inflows into the emerging market economies and created upward pressure on their currencies. This was further compounded by further monetary easing in advanced economies. Differences on currency policy among the G20 nations also heightened tensions in the foreign exchange market. In response, several emerging market economies responded by imposing measures to better manage the significant increase in capital flows. Different countries, however, had different threshold levels to capital flows and exchange rate appreciation and varying capacity to manage them. The inflows into Malaysia have so far been manageable and with no discernible signs of the inflows creating imbalances in the domestic economy and financial system. Amidst the large capital inflows, the ringgit exchange rate movements remained orderly, while sterilisation operations ensured that the impact of the excess liquidity on domestic monetary conditions was contained. Having a broad range of instruments for monetary operations helped increase the efficiency of domestic liquidity management. The depth and resilience of the financial system together with the healthy level of international reserves also served to mitigate the risks arising from reversal of these flows.

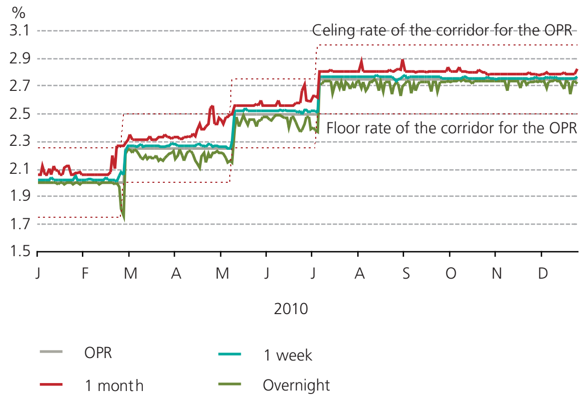
MONETARY OPERATIONS

Overall conditions in the domestic money market were stable in 2010. Focus was accorded to ensuring that the normalisation of monetary policy was being transmitted to the money market rates in an efficient and orderly manner. Money market conditions remained orderly as financial institutions adjusted their interest rates to the increases in the OPR in March, May and July 2010. The Bank maintained the average overnight interbank rate (AOIR) within the corridor of ± 25 basis points of the OPR. During the period 2 – 4 March 2010, the AOIR traded lower, close to the floor rate of the corridor. This reflected market participants' exceptional interest for overnight placements with the Bank ahead of the March MPC meeting. Subsequent to this episode, the AOIR traded within a wider range up until the third quarter in line with market expectations for further increases in the OPR.

[2] Source: National Property Information Centre (NAPIC)

Chart 3.5

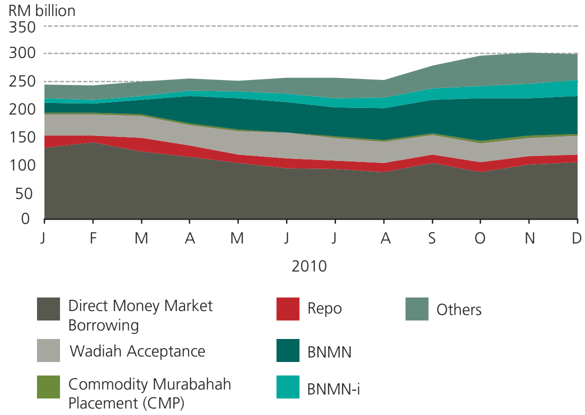
OPR and Interbank rates



Source: Bank Negara Malaysia

Chart 3.6

Outstanding Liquidity Placed with Bank Negara Malaysia



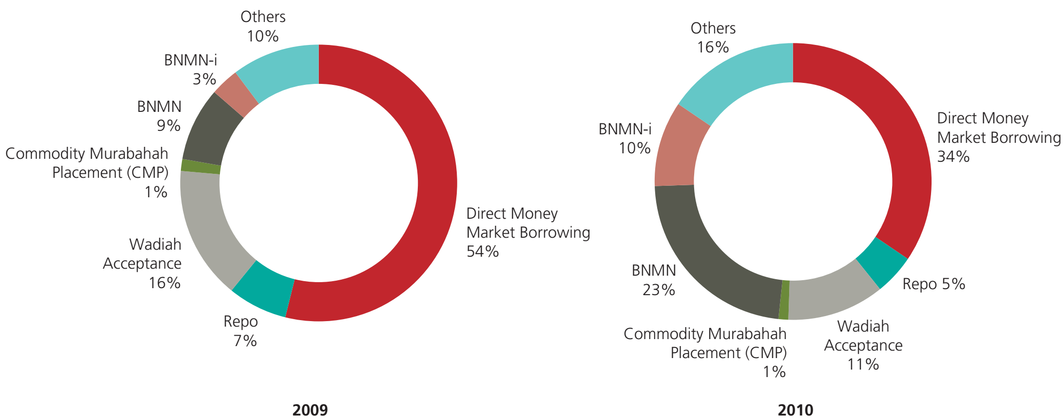
Source : Bank Negara Malaysia

With the resumption of portfolio inflows into the domestic financial markets, a key challenge for monetary operations was to manage the surplus liquidity in the interbank market. Malaysia, along with other emerging market economies, registered net portfolio inflows in 2010. For the year as a whole, aggregate surplus liquidity increased significantly to RM299.2 billion as at end-December 2010 (2009: RM251.8 billion).

The composition of monetary instruments became more diversified in 2010. Although uncollateralised borrowings remained the main instrument used (accounting for 62.7% of outstanding monetary policy instruments), there was a sizable increase towards securities-based monetary policy instruments (2010: 37.3%, 2009: 20.2%). Bank Negara Malaysia Monetary Notes (BNMN for conventional and BNMN-i for Islamic money markets) were increasingly used in 2010 as there had been strong demand for these securities by investors, particularly non-resident investors. Hence, the frequency of issuances for the BNMN and BNMN-i was increased from once a week in 2009 to twice a week in 2010. The share of Islamic monetary instruments was

Chart 3.7

Breakdown of Outstanding Monetary Policy Instruments



Source : Bank Negara Malaysia

23.9% of total monetary instruments as at end-2010. Liquidity absorbed through Islamic instruments increased in line with the growth of total liquidity in the system and stood at RM71.6 billion (2009: RM58.9 billion).

In terms of the maturity profile of monetary instruments, the average maturity was extended to 40 days in 2010 (2009: 27 days). This was a change in strategy compared to the last few years when the focus was on a shorter average maturity structure to ensure that liquidity can be swiftly unwound in the event of large and sudden outflows given the significantly more volatile environment in the financial markets. In a period of rising interest rates, extending the maturity of borrowings allows for more cost effective sterilisation operations as surplus liquidity is locked-in at a lower rate over a longer period.

During the year, the Bank introduced several changes to the features of monetary instruments to increase operational efficiency. One of the initiatives was the Range Maturity Auction (RMA), a variation to the money market term tender[3] which would allow flexibility in determining the maturity range for uncollateralised borrowings. The initiative made liquidity management more efficient by providing financial institutions the option to offer their excess ringgit funds according to their liabilities' profile. This would enhance the Bank's liquidity management by matching the Bank's liquidity forecast with the financial institution's liquidity requirements. Another enhancement of monetary operations was the automation of Commodity Murabahah Programme transactions in the Fully Automated System for Issuing/Tendering (FAST). This system caters for both auction/tender and bilateral transactions of the Commodity Murabahah. The system configuration of FAST enables the purchase and sale of commodities, auto generation of murabahah contracts and digital signature.

With respect to Islamic monetary instruments, the Bank will introduce new instruments that are structural variations of the BNMN-i issuances in 2011, namely the Bai Bithaman Ajil (deferred payment) and Istithmar (investment based on a combination of Murabahah and Ijarah). These new structures would appeal to a wider base of investors given the stricter compliance with Shariah requirements of different jurisdictions. In line with the vision of Malaysia being an Islamic Financial Centre, the Bank would continue to develop new and flexible Islamic monetary instruments that are widely acceptable amongst global investors.

[3] Money market term tender refers to uncollateralised borrowings with a predetermined maturity within 1 week to 2 months. Normal maturities for money market term tenders are 1 week, 2 weeks, 3 weeks and 1 month.

Financial Imbalances and the Role of Monetary Policy

In 2010, the OPR was raised by a total of 75 basis points. Although inflation remained benign and the economy was at an initial stage of recovery, the OPR was adjusted upwards to normalise monetary conditions to manage the risk of financial imbalances. In the Bank's assessment, if left unchecked, the subsequent unwinding of financial imbalances could undermine the sustainability of the economic recovery and have adverse consequences on price stability and economic growth.

Financial imbalances can manifest in the form of an unhealthy build-up of leverage, under-pricing of risks, excessive yield seeking activities, over investment in certain markets, asset prices that depart substantially from fundamentals and increased risks to the stability of the financial system. These distortions tend to surface when interest rates are expected to remain very low for a prolonged period. In this regard, the Bank is mindful of the need to ensure the stance of monetary policy is appropriately aligned to mitigate the risks to inflation and growth.

There has always been a close link between monetary policy and financial stability. First, extremely loose monetary policy for a prolonged period can be at the root of financial imbalances. Monetary policy affects the inter-temporal allocation of resources which underlie the incentives for economic agents to save and borrow. Interest rates that are kept too low for a prolonged period would create incentives for savers and borrowers that are detrimental to the economy over the medium term. For example, low or negative real returns on deposits could encourage shifts from low risk deposits towards speculative investments in riskier assets in a search of higher yields. Substantially low borrowing costs could also promote excessive leverage by households and businesses. Second, a well functioning and resilient financial system is necessary for the effective transmission of monetary policy. As the financial imbalances unravel, the balance sheets of financial institutions that are exposed to bad assets and delinquent borrowers would be impaired. In turn, these weak financial institutions will not be able to expand lending activity to support economic activity during downturns even under such an easy monetary policy environment. Third, financial imbalances have implications for macroeconomic stability, whereby a disorderly correction of imbalances may lead to a contraction in economic activity. For example, in the event that asset bubbles burst, asset values would deteriorate. Consumption and investment activities would be adversely affected as households and businesses face difficulties in securing financing due to deterioration in the value of collateral. Consequently, economic activity could slow or even contract.

The recent global financial crisis exemplifies clearly the close link between monetary policy and financial stability. The crisis was a culmination of financial imbalances accumulated over a prolonged period of very low interest rates. The unravelling of financial imbalances led to the collapse of financial institutions and market disruptions globally. Failures of the financial intermediation process and the contraction in private sector economic activity subsequently resulted in the worst global recession since the Great Depression. While monetary policies in the advanced economies at the centre of the crisis were substantially eased to support the economic activity, the dysfunctional financial institutions and markets were not able to transmit the unprecedentedly large monetary policy stimulus to the broader economy.

In formulating monetary policy, the Bank does not only focus narrowly on managing inflation and growth over the typical monetary policy horizon of 6 - 8 quarters. The Bank takes into consideration information on the developments in the credit and asset markets in its monetary policy decision making, with the view of ensuring macroeconomic stability over the medium term. Monetary policy takes into account the underlying cause of asset price inflation rather than the asset price inflation itself. This approach has resulted in policy action when monetary policy adjustment was made even in the absence of risks to inflation within the monetary policy horizon. The recent monetary policy normalisation is an example of this approach.

The use of interest rate policy to manage the risks of financial imbalances takes into account several important caveats. First, monetary policy must be pre-emptive in order to be effective. Raising interest rates when asset prices are already significantly overvalued would not be effective in deterring speculative activity as the expected gains from asset prices increases would have by then far exceeded the borrowing costs. Second, monetary policy on its own would not be effective in addressing such financial imbalances. To rely only on interest rates may in fact result in an over adjustment. Macroeconomic policies need to be considered in a holistic manner. There may be a need to complement monetary policy with more targeted macro-prudential measures[1] if risks emerge in specific sectors of the economy. Malaysia has a long history of relying on a broad array of policy instruments in managing the risks of financial imbalances. During the episode of asset price bubbles in the mid-1990s, in addition to monetary tightening, the Bank implemented prudential credit measures such as lowering the loan-to-value ratio for the purchase of selected non-owner occupied properties. These measures were also complemented by fiscal measures such as the upward revision of the graduated real property gains tax to between 15-20%. Third, monetary policy is a blunt tool. Merely raising interest rate aggressively to prevent financial imbalances could unnecessarily increase the cost of borrowing at the expense of broader economic growth.

In conclusion, monetary policy is relevant in addressing financial imbalances due to its influence on the behaviour of economic agents, and the need to obviate the consequences of financial imbalances on the efficacy of monetary policy itself. Hence, in addition to balancing the risks to inflation and growth, it is important to ensure that the stance of monetary policy is appropriate to prevent the build-up of financial imbalances.

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[1] The Asian experience also suggests that macro-prudential tools are likely to be an integral part of the tightening in monetary and credit conditions as the economic recovery continues. For example, PR China, Hong Kong SAR, Korea and Singapore announced various measures to deflate housing prices in 2009 and 2010.