Monetary Policy in 2009

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OVERVIEW

In 2009, monetary policy was confronted with heightened risk to growth arising from the global economic and financial crisis. The economy was severely affected by the steep decline in exports and private investment activity, as global demand contracted. Growth of the Malaysian economy turned negative for three quarters, with growth in the first quarter contracting markedly by 6.2%. Comprehensive policy measures were implemented by Bank Negara Malaysia and the Government to cushion the impact of the global recession on the domestic economy. The resilient financial system and the well-functioning monetary transmission process meant that Malaysia did not need to resort to unconventional measures, such as quantitative easing and the initiatives to address conditions of financial stress. Nevertheless, the severity of the crisis necessitated extraordinary responses in terms of the scope and size of monetary and fiscal policy measures. Cumulatively, these measures succeeded in containing the severity of the impact of the external developments. By the fourth quarter in 2009, the domestic economy had improved significantly and was on a path of firm recovery.

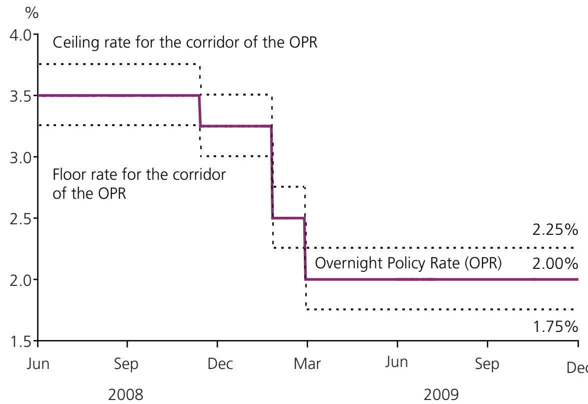
MONETARY POLICY IN 2009

Over the years, Bank Negara Malaysia has maintained a pre-emptive approach to monetary policy. Earlier in 2008, inflation was on the rise due to the sharp and significant increase in food and energy prices. The OPR, however, was left unchanged. The assessment of the Bank was that the food and energy price increases were largely supply driven. Raising interest rates under these conditions would have a limited impact in containing inflation. Importantly, it was also assessed that the Asian economies would also be affected by the spillover effects of the crisis, given the strong trade links with the developed economies. In addition, given the high percentage of food and energy in total consumption, higher prices in these categories would be contractionary on growth. While there were considerable uncertainties, the balance of risks was that growth would slow in the twelve-month period beginning mid 2008. This was the main consideration in the decision to maintain interest rates despite assertions that the Bank should have tightened monetary policy. Subsequently, as the global economy contracted, the Bank's decision to maintain interest rates was not only justified, but also enabled the initial monetary conditions to be appropriately positioned to provide support to the domestic economy.

The magnitude of the reductions in OPR and SRR were aimed at providing a highly accommodative monetary environment to prevent a fundamental economic downturn

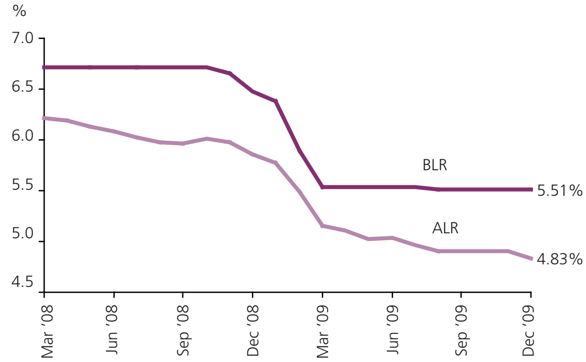
By early 2009, it was apparent that the Malaysian economy faced a severe threat of a fundamental slowdown arising from significant deterioration in global conditions. While domestic demand conditions were relatively sound, the severe collapse in exports, and the depressed economic outlook for several of Malaysia's major trade partners meant that significant policy support would be needed to prevent the economy from entering a deep and prolonged recession. With inflation decelerating, Bank Negara Malaysia frontloaded the interest rate cuts to cushion the economy from a rapidly weakening global economy. The Bank reduced its Overnight Policy Rate (OPR) by a total of 150 basis points between November 2008 and February 2009 to 2.00 percent. To ensure greater transmission from the policy rate to retail lending rates, the statutory reserve requirement (SRR) was also concurrently reduced by 300 basis points. Measures were also taken to ensure that existing borrowers benefited from the reduction in interest rate, by ensuring that monthly installments on floating rate loans were immediately reduced instead of the alternative of shortening of the repayment period. This was necessary to ensure that the reductions in interest rates led to an increase in borrowers' disposable income, which could then feed into higher domestic consumption. As variable rate loans account for a large portion of total loans in Malaysia, the increase in disposable income from lower interest costs was positive on consumption spending.

Chart 3.1
Overnight Policy Rate



Source: Bank Negara Malaysia

Chart 3.2
Base Lending Rate and Average Lending Rate of Commercial Banks



Source: Bank Negara Malaysia

With the OPR reduced to historic lows in February, the Bank left the policy rate unchanged for the rest of the year. In the Bank's assessment, the accumulated monetary policy measures were sufficient to provide support to domestic demand. Unlike countries at the epicenter of the global financial crisis, the domestic banking system was in a sound and robust position, with strong capital buffers. The strong financial system and well-functioning monetary transmission process was effective in delivering the impact of the monetary policy stimulus to the economy. Within two weeks of the last OPR adjustment in February 2009, the base lending rate (BLR) of commercial banks adjusted downwards by a cumulative 121 basis points, while new loans were also re-priced lower across the business and household sectors. As a result, the average lending rate (ALR) on new loans had declined to historic lows in 2009.

A key question for the Bank's Monetary Policy Committee (MPC) was whether further reductions in interest rates would be beneficial in the context of a high savings country like Malaysia. In addition to questions about the effectiveness of further interest rate cuts, the potential risks also had to be considered. Lower borrowing costs alone would not be a key factor in supporting demand, especially in an environment where confidence and sentiments were adversely affected by the severely weak global outlook. In economies in which the threat of deflation was significant, policymakers lowered interest rates to near zero. Bank Negara Malaysia decided against such extreme measures as there was no indication of deflationary pressures in the economy. While inflation turned negative in June 2009, this was mostly a statistical development resulting from the high base inflation in 2008. In addition, low returns for depositors and maintaining negative real interest rates for a prolonged period could have a series of negative implications. It could also create distortions that have adverse effects on the economy over the long-term. Sustained low interest rates could lead to a search for yields that may lead to the excessive rise of asset prices.

The easing of monetary policy were complemented by other measures designed to reach specific sectors of the economy

In a crisis situation, interest rate cuts by themselves are not sufficient. Several complementary measures were also introduced to reach specific sectors of the economy. Hence, in addition to easing interest rates, the Bank also introduced a number of targeted measures to ensure continued access to financing, temporary extension of safety net, safeguarding the value of wealth and real income of depositors and cushioning highly vulnerable borrowers from the full impact of the crisis.

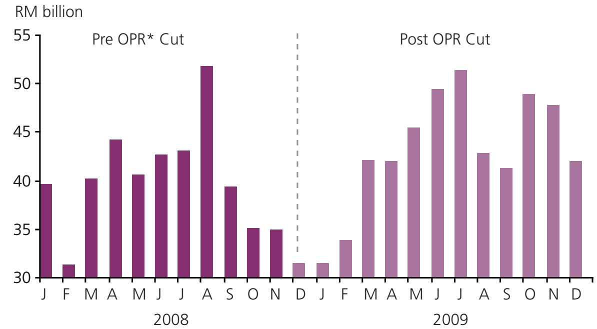
The Bank and the Government set up various special funds to ensure that viable small and medium-enterprise (SME) businesses that have been affected by the global financial crisis would continue to have access to financing. Consistent with the economic transformation objective, the Industry Restructuring Loan Guarantee Scheme was set up to assist viable enterprises in upgrading their business operations, with a long-term view of increasing efficiency and building future capacity. Danajamin Nasional Berhad was also established to provide financial guarantee insurance for investment grade companies to raise funds from the bond market.

Various dialogues between the private sector and banking institutions were initiated to allow impediments to be recognised and addressed and thus ensure the flow of credit. This alleviated concerns that lenders would be reluctant to extend credit or demand higher risk premiums. Avenues for individuals and businesses to seek help on credit issues were also established. This included the enhanced Integrated Contact Centre comprising BNMLINK and BNMTELELINK that includes the Complaints Management and Advisory Unit. In December 2008, the *ABMConnect* Toll Free Channel was set up by the Association of Banks in Malaysia (ABM), which represented a collaboration with banking institutions, to serve as a ready platform for general enquiries relating to banking and credit issues.

The reduction in cost of borrowing and measures undertaken to ensure undisrupted credit flows to the economy were successful in sustaining financing activity. Although financing growth slowed in the early part of the year, credit flows had continued despite the prevailing recessionary conditions in the domestic and external sector of the economy. There was continued flow of credit to finance domestic demand, for both businesses and households. As measures implemented by the Bank began to take effect, demand for bank loans picked up from the second quarter onwards, matched by a corresponding increase in loan approvals. In the capital market, funds raised by the private sector increased significantly, exceeding the amount raised in 2008. Given these positive developments, financing growth rebounded in the third quarter from its lowest level of 7.1% in August 2009, to register a growth rate of 8.5% by end-2009.

With the collapse of prominent financial institutions in advanced economies, and to avoid contagion to the domestic banking system, the Bank and the Ministry of Finance, announced the pre-

Chart 3.3
Loan Applications



*Overnight Policy Rate

Source: Bank Negara Malaysia

emptive measure of the blanket deposit guarantee until December 2010. In addition, Bank Negara Malaysia's liquidity facility was extended to all insurance companies and takaful operators. The blanket deposit guarantee was part of a coordinated regional response to the crisis, with both Singapore and Hong Kong also announcing the same measure simultaneously. Extending access to the liquidity facility to insurers was a precautionary move following the run on AIG in parts of the region following developments in the United States. The fact that the facility remains unutilised was an indication that the measure was successful in instilling confidence and mitigating contagion risk.

The aftermath of the Lehman Brothers collapse also witnessed a major global shortage of US dollar liquidity as investor risk aversion resulted in a pull back of funds and marked increase in deleveraging activites. This affected the ability of banks around the world to extend US dollar loans for trade activities. To facilitate international trade, the Bank provided an arrangement for firms involved in international trade by guaranteeing the availability of dollar for trade purposes.

Measures to stabilise economic activity were facilitated by orderly movements in the ringgit. Movements in ringgit throughout the year were driven mainly by external factors including global deleveraging in the first quarter, followed by renewed interest of international investors toward emerging market assets from the second quarter onwards. After depreciating in the first quarter, ringgit recorded a broad upward trend, reaching its

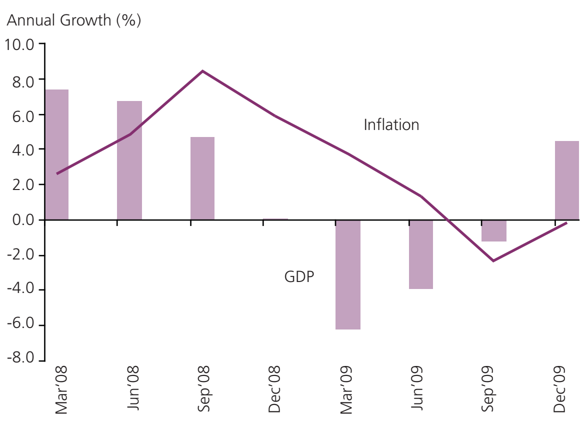
2009 peak against the US dollar at RM3.3475 on 15 October, an increase of 11.3% from its lowest level of RM3.7255 recorded in March. Ringgit adjustments and conditions in the domestic foreign exchange market remained orderly and did not adversely impact trade activity during the year.

As Malaysia is an economy with a high savings rate, and with a high level of the financialisation of these savings, it was recognised that low interest rates would reduce returns on deposits to a large segment of the economy. In order to support savers, the Bank issued Merdeka Savings Bond amounting to RM2 billion specifically targeted for segments of savers that depend on income from deposits for their livelihood. In addition, the Government issued a Sukuk Simpanan Rakyat worth RM5 billion that was also targeted at households.

A key lesson from the 1997/98 Asian Financial Crisis is the need for comprehensive and coordinated policy measures. A coordinated policy response allows for a larger and more effective impact on the economy by ensuring that the different policies reinforce each other. Accordingly, in managing the current crisis there had been a collective and coordinated response from Bank Negara Malaysia and the entire Government machinery.

The Malaysian Government responded promptly to the global economic crisis, announcing a fiscal stimulus package totaling RM7 billion on 4 November 2008 to support private spending. As the global economic outlook worsened, the

Chart 3.4
GDP and Inflation



Source: Bank Negara Malaysia

Government unveiled a second stimulus package on 10 March 2009, this time amounting to RM60 billion to provide adequate support for economic activity. Balancing between the need to be decisive and bold, and the need to maintain fiscal prudence, only RM15 billion of the second stimulus package involved direct fiscal injection, with the remainder in the form of government guarantees, equity investment by Khazanah Nasional Berhad, private finance initiatives and tax incentives. The large size of the overall stimulus packages, which together amounted to 9.6% of GDP, was considered necessary to spur businesses and households at a time of heightened uncertainty. At the same time, the limited fiscal outlay was to ensure the long-term sustainability of the Government's fiscal position.

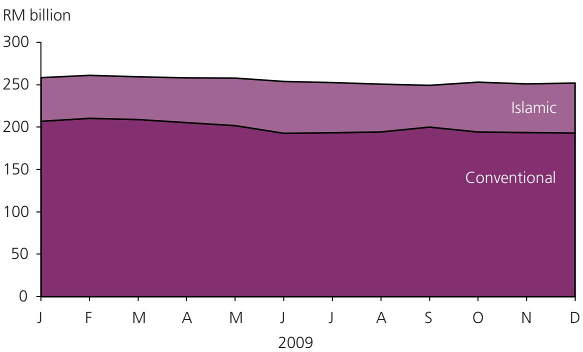
The outcome of policy measures implemented in concert was seen in the second half of 2009 as clear signs emerged that the impact of the crisis was contained. By the second half of 2009, indicators including industrial production, financing trends, external trade and conditions in the labour market, pointed towards broad-based stabilisation and improvements in the domestic economy. Business and consumer sentiments, which began to turn around in the second quarter, also improved further. The economy improved in the second half of the year, as the pace of contraction declined to -1.2% in the third quarter. By the fourth quarter, the economy expanded by 4.5%. GDP growth for the year registered a more modest decrease of 1.7% compared to the earlier projection of -4 to -5%, amid a low inflation of 0.6%.

MONETARY OPERATIONS IN 2009

Conditions in the domestic money market were generally stable in 2009. The Malaysian money market continued to operate under a surplus liquidity environment, with aggregate surplus liquidity declining only slightly from RM261 billion as at end-2008, to RM252 billion as at end-2009. The tumultuous external events proved to have a limited impact on domestic money markets. The money market continued to function smoothly and experienced minimal volatility.

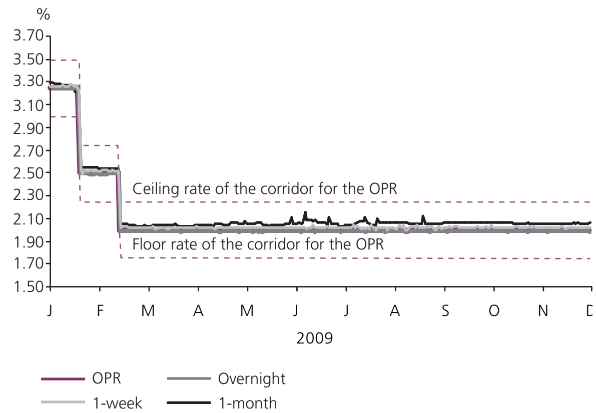
During the year, the average overnight interbank rate (AOIR) was stable and closely tracked the OPR despite the higher uncertainty and general market volatility earlier during the year. The Bank continued to use a wide range of monetary instruments for managing monetary operations and maintained the AOIR within the policy corridor of ± 25 bps.

Chart 3.5
Outstanding Liquidity Placed with Bank Negara Malaysia (RM252 billion, as at 31 Dec 2009)



Source: Bank Negara Malaysia

Chart 3.6
OPR and Interbank rates



Source: Bank Negara Malaysia

In early 2009, the domestic money market continued to be affected by the deleveraging activity of international financial institutions. Short-term portfolio outflows were recorded in the first quarter, as foreign investors reduced their holdings of domestic assets. This caused domestic liquidity to contract slightly, with the surplus liquidity placed by the banking system with Bank Negara Malaysia decreasing from RM261 billion to RM256 billion, between December 2008 and March 2009.

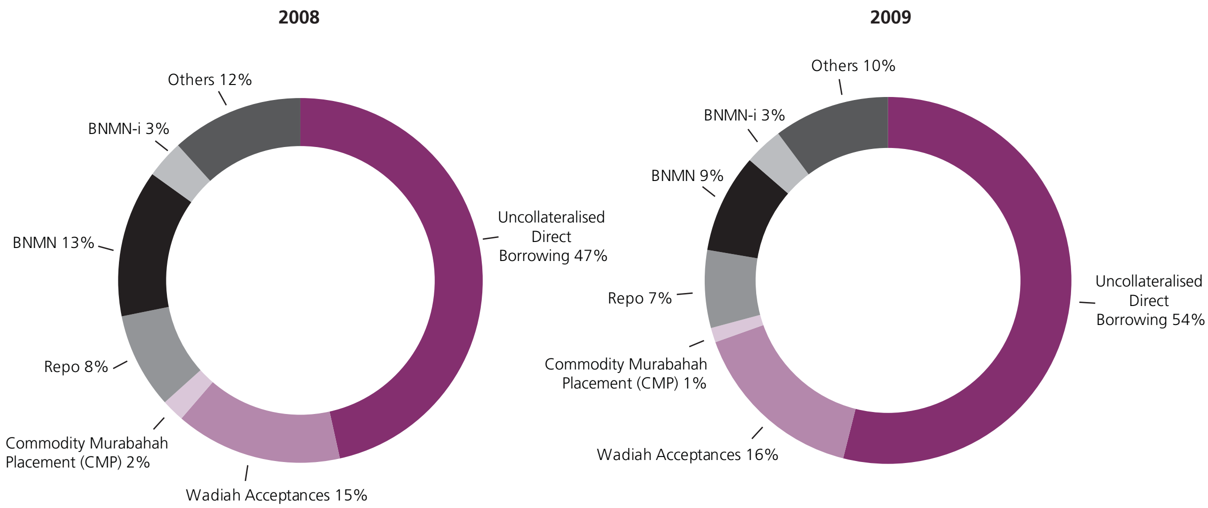
To compensate for the outflows following foreign selling of domestic assets, Bank Negara Malaysia released some of the excess liquidity kept with the Bank. In this respect, the large net interbank placements with the Bank acted as a liquidity buffer for the banking system. While the size of the surplus liquidity was reduced by the outflows, liquidity in the banking system, nonetheless, remained in surplus. This was evidenced by the loan-deposit ratio of the banking system remaining at modest levels, ranging from 72.2% in January to 77.5% in March 2009. At the institution level, all banks operated from a position of surplus liquidity. The ample liquidity condition was also supported by Bank Negara Malaysia's decision to reduce the required reserves that banks hold against eligible liabilities from 4% to 1%. While the main motivation for reducing the SRR was to bring down the cost of intermediation, lowering the SRR also increased the liquidity available to banks.

Interest rates in the interbank market remained orderly. The average overnight interbank rate (AOIR) traded within a narrow range of 1 basis point above and below the OPR. Following the reduction in the OPR on the 21 of January to 2.50%, the AOIR decreased and stabilised at a lower range of 2.49% - 2.51% during the period 22 January – 24 February. With the further reduction in the OPR on 24 February to 2.00%, the AOIR decreased accordingly and stabilised at the lower range of 1.99% - 2.01%.

From the second quarter onwards, the global economic and financial environment began to improve. Investors' risk appetites for financial assets from emerging economies increased and led to net portfolio inflows into emerging markets, including Malaysia. Conditions in the money market during this period returned to normal. Monetary operations of the Bank were focused on draining surplus liquidity in the banking system by utilising various monetary instruments.

In terms of monetary instruments, uncollateralised direct borrowings and Al-Wadiah acceptances remained as the main monetary instruments, sterilising 70% of the surplus liquidity in the banking system. While the maturities of the borrowings through direct borrowings and Al-Wadiah acceptances ranged from overnight up to 3 months, their average borrowing maturities were shorter, ranging between 7 to 25 days. The share of direct borrowings increased from 47% in 2008 to 54% in 2009, following the reduction in the level of the SRR.

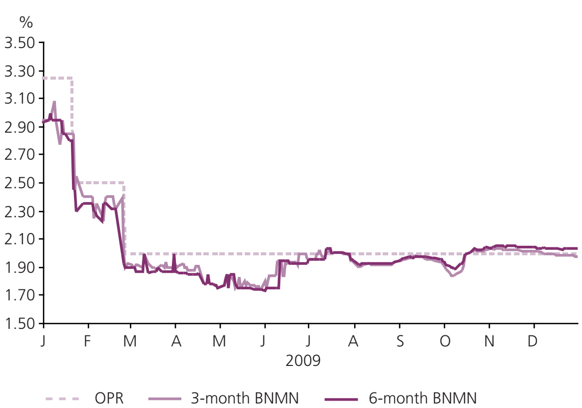
Chart 3.7
Breakdown of Outstanding Monetary Policy Instruments



Source: Bank Negara Malaysia

Bank Negara Monetary Notes (BNMN for conventional and BNMN-i for Islamic money markets) were also utilised significantly, accounting for 12% of total monetary instruments. The BNMN/BNMN-i remains an important instrument for the Bank as a steady issuance of the papers helps to promote secondary market liquidity. In addition, BNMN/ BNMN-i provides a cost effective means of sterilising excess liquidity. BNMN/BNMN-i yields sometimes traded below OPR, especially during periods of expectations for interest rates cut as was the case during the first quarter of 2009, and due to the higher demand for short-term securities from non-resident investors in the subsequent quarters.

Chart 3.8
BNMN Yields and OPR



Source: Bank Negara Malaysia

In 2009, conventional monetary operations accounted for 77% of the total operations, while Islamic monetary operations accounted for the remaining 23%. The scale of Islamic monetary operations was in line with the size of the Islamic banking system in Malaysia which has increased to 19.6% of total assets of the banking system as at end-2009 (17.4% as at end-2008).

The Bank also undertook measures to improve operational efficiency in the money market. On 2 July 2009, the Bank introduced a BNMN based on the Murabahah concept (BNMN-Murabahah), to gradually replace the issuance of BNMN-i based on Bai Al-Inah concept. Issuance of BNMN-Murabahah is based on a widely accepted murabahah contract, which essentially is a certificate of indebtedness arising from a deferred mark-up sale transaction of an asset, normally commodities (e.g. crude palm oil). As murabahah is an acceptable concept by both resident and non-resident investors, it has expanded the investor base and has consequently encouraged the secondary market in the Islamic money market.

Monetary Policy Process under the Central Bank of Malaysia Act 2009

The Central Bank of Malaysia Act 2009 (``the Act´´), which came into force on 25 November 2009, formally institutionalises the monetary policy formulation procedures that have been established since the beginning of the decade.

The Act stipulates that monetary policy shall be autonomously formulated and implemented by Bank Negara Malaysia (``the Bank´´). The objective of monetary policy is also articulated with greater clarity – "In promoting monetary stability, the Bank shall pursue a monetary policy which serves the interests of the country with the primary objective of maintaining price stability giving due regard to the developments in the economy."[1]

The Act also formally and legally recognises the Monetary Policy Committee (MPC) as the body responsible for formulating monetary policy and the policies for the conduct of monetary operations. The MPC consists of 7 to 11 members, with the Governor being the Chairman of the Committee. The Governor and Deputy Governors remain as members of the MPC for so long as they hold office. Members, other than the Governor and the Deputy Governors, are appointed by the Bank's Board of Directors from amongst senior officials at the Bank with relevant expertise, on the recommendation of the Board Governance Committee. Meanwhile, the Board Governance Committee may recommend external members to the Minister of Finance for their appointment to the MPC. The appointment term of the members is 3 years, and the eligibility for reappointment is subject to the assessment of the members' performance by the Board Governance Committee. The Act also provides extensive safeguards in terms of membership of the MPC. Members of the MPC must be persons of probity, competence and sound judgment with relevant expertise and experience. The governance of the MPC meetings and the accountability of the members are guided by the MPC by-laws, which have been approved by the Board of Directors of the Bank. The current MPC members are:

Tan Sri Dr. Zeti Akhtar Aziz	(Governor)
Dato' Ooi Sang Kuang	(Deputy Governor)
Dato' Zamani bin Abdul Ghani	(Deputy Governor)
Dato' Mohd Razif bin Abd. Kadir	(Deputy Governor)
Dato' Muhammad bin Ibrahim	(Assistant Governor)
Puan Nor Shamsiah binti Mohd Yunus	(Assistant Governor)
Dr. Sukhdave Singh	(Assistant Governor)
Puan Norzila Abdul Aziz	(Assistant Governor)

The MPC is required to hold six regularly scheduled meetings during a year, and additional meetings may be convened if necessary.[2] At the MPC meetings, members review economic and financial conditions and assess the risks to achieve the long-run goals of price stability and sustainable economic growth, before deliberating and reaching the decision on the appropriate stance of monetary policy. The Committee adopts a collegial approach to decision-making. Therefore, the Governor, as Chairman, has a crucial role in leading the discussion and deliberation process, as well as in building a consensus decision amongst members. A Monetary Policy Statement[3] is released after each MPC meeting to announce the monetary policy decision. The MPS also provides an assessment of the prospects for the economy and inflation, as well as other issues relevant to the policy decision.

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1 Section 22 (1) of the Central Bank of Malaysia Act of 2009
2 The schedule for the six meetings is published together with the final Monetary Policy Statement of the preceding year.
3 The Monetary Policy Statement can be found on the Bank's website at www.bnm.gov.my