Monetary Policy in 2007

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OVERVIEW

In fulfilling the objective of maintaining price stability and promoting sustainable economic growth, monetary policy in 2007 was complicated by the dual challenge of inflationary pressures emanating from escalating global commodity and food prices, and heightened downside risks to growth arising from unstable global financial markets. Although domestic demand had accorded considerable resilience to the economy, as a small and highly open economy, Malaysia is not insulated from external developments. Consequently, the growth momentum of the economy and the threat to inflation were clouded by considerable uncertainty. Developments in 2007 heightened the uncertainties given the wide range of possible outcomes surrounding growth and inflation, on account of the complexity of the issues facing the global financial markets and their potential impact on the US and global economy.

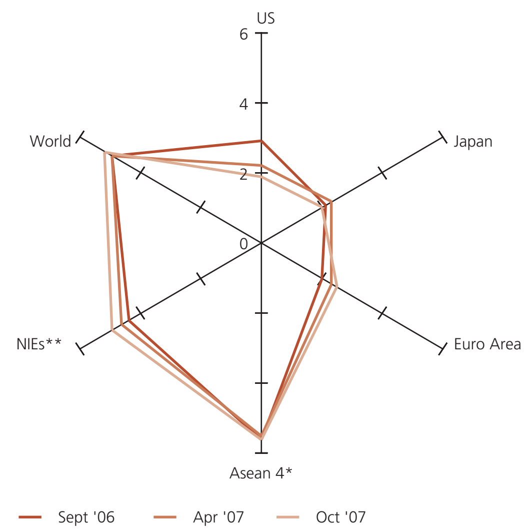
In 2007, monetary policy was confronted with the dual challenge of inflationary pressures emanating from escalating global commodity and food prices, and heightened downside risks to growth arising from unstable global financial markets

While the risks of slower global growth and higher inflation became more elevated as the year progressed, there was, however, no clear indication that one risk exceeded the other. The overall assessment was that the risks to growth and inflation were about balanced. The Monetary Policy Committee (MPC), therefore, judged that the prevailing monetary conditions were consistent with the medium term growth and inflation outlook, and the Overnight Policy Rate (OPR) was left unchanged at all of the eight policy meetings during the year.

MONETARY POLICY IN 2007

At the outset of 2007, conditions appeared to be favourable to the Malaysian economy achieving a growth rate that was projected to be close to the potential of the economy and for inflation to moderate from the levels in 2006. The prospect of moderating growth of the US economy and the consequent implications for global and regional growth were incorporated into the Bank's forward-looking assessment. The baseline scenario was that some softening in Malaysia's external sector was anticipated but it was not expected to be severe. The momentum of growth in domestic demand in the economies in the euro area and Asia was strong. The Asian economies were benefiting from rising final demand within Asia and hence, greater intra-regional trade. Two-thirds of Malaysia's trade is now with Asia, and therefore, the robust performance of the Asian economies would, to a certain extent, reduce some of the impact of the US slowdown.

Chart 3.1
Outlook for Real GDP Growth in 2007
(Annual change, %)



Source: IMF, WEO September 2006, April and October 2007
*Indonesia, Malaysia, Philippines and Thailand
**Newly Industrialised Economies

Of crucial significance for the Malaysian economy, domestic demand was expected to provide strong support to economic growth. Robust domestic demand was supported by the strengthening of private consumption and private investment activities, while the public sector was set to play an important supportive role. The economy was expected to expand at a stronger pace in the second half of 2007 underpinned by key growth-supporting developments, namely the implementation of projects under the Ninth Malaysia Plan, the commencement of production at a key oil field and gas plant, as well as the expected significant increase in tourist arrivals during the peak summer travel season.

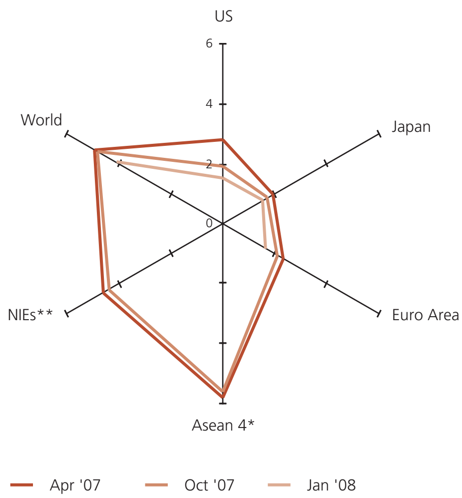
In May, there were, however, some market expectations for a reduction in the OPR following the release of weak data for the growth of exports and the industrial production index (IPI). Market expectations subsequently adjusted to an unchanged policy rate outlook for 2007 following the availability of a more complete set of indicators with the release of the first quarter GDP growth. The Bank's assessment at the time was that although exports, especially manufactured exports, had shown signs of softening, a broad range of forward-looking indicators pointed to sustained economic activity going forward. These included the uptrend in the Department of Statistics Leading Index, the double-digit increase in loan applications and approvals, as well as the relatively upbeat consumption and investment sentiments.

As the year progressed into the second half, the uncertainties surrounding US financial stress and global growth prospects increased. The global financial markets, which had been experiencing bouts of volatility arising from growing and mixed concerns about global imbalances, equity and property market overvaluations and exchange rate adjustments, experienced significant turbulence in August and September amid mounting concerns over the deterioration in the US subprime mortgage market. The rapid and significant reassessment of risks associated with US subprime-related securities created turmoil in the credit markets and led to the evaporation of liquidity from the interbank markets in the US, UK and Europe. This necessitated major central banks injecting large amounts of funds into the interbank markets to alleviate liquidity shortages and to bring interbank interest rates back down to their normal levels. In the Malaysian bond and equity markets, the reassessment of risks and increased caution by international investors led to episodes of outflows, causing considerable market volatility. Nevertheless, given the surplus liquidity condition, the demand for funds amidst the outflows was met comfortably through the non-rollover of short-term lending by banks to Bank Negara Malaysia. The possible adverse consequences for financial stability were also mitigated by the absence of direct exposure of domestic banks and the non-bank private sector to US asset-backed subprime-related securities.

Though the impact of market contagion on the Malaysian economy was largely contained, of greater concern was the spillover effect of the financial turbulence on global growth prospects. Downside risks became more pronounced towards year-end, as financial market strains and the US housing downturn appeared to be more widespread and deeper than previously anticipated. With these developments causing financial market meltdowns and weighing down heavily on US growth prospects, the Federal Reserve aggressively reduced its policy rate by large magnitudes in successive moves in September and in the last quarter of the year. Uncertainty over the degree and duration of the impact on global growth prospects also affected the policy bias for several economies, with a greater tendency for easing in several major economies towards the end of the year, in contrast to the tightening stance that was more prominent in the early part of the year. While central banks in regional economies were on a tightening stance in the early part of the year, there was a shift towards a more cautious stance towards the end of the year. Although the International Monetary Fund (IMF) made a marginal downward revision to its world growth forecast for 2008, from 4.9% in April 2007 to 4.8% in October 2007, by December 2007, however, it acknowledged that downside risks had increased markedly[1] . Thus, while global economic activity continued to remain resilient in the second half of 2007 with relatively robust growth in the Asian economies, global growth prospects were clearly subject to increased downside risks.

[1] In January 2008, the IMF further revised its world growth forecast for 2008 to 4.1%.

Chart 3.2
Outlook for Real GDP Growth in 2008
(Annual change, %)



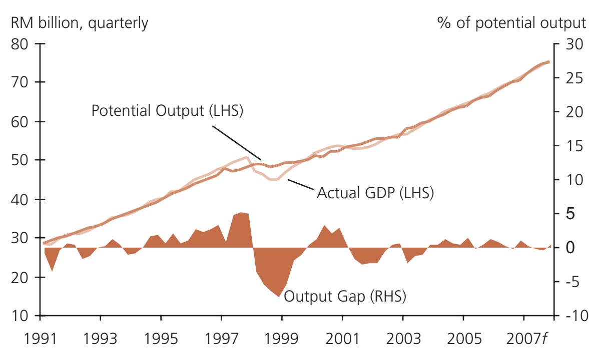
Source: IMF, WEO April 2007, October 2007 and January 2008
*Indonesia, Malaysia, Philippines and Thailand
**Newly Industrialised Economies

The domestic economy performed strongly in the third quarter of 2007, registering a growth rate of 6.6%, with faster growth in private consumption, and in both private and public investment. Near-term forward-looking domestic demand indicators pointed to sustained activity, and the economy was very much on track to achieve the 6% growth projection for 2007. With the economy operating from a position of strength, underpinned by a more diversified economic structure and a healthy financial system, the likelihood of a baseline scenario of relatively steady growth in 2008 increased. Nevertheless, the heightened downside risks to global growth had generated greater downside risks to this baseline scenario. The degree to which these downside risks to global growth could take place would determine the actual outcome on domestic growth.

The evolving global growth prospects and its implications for the domestic economy also needed to be balanced against the inflation outlook. The Bank's forecast early in the year was for domestic headline inflation to moderate, averaging 2.0 - 2.5% in 2007, following the lapse of the effects of the increase in retail petrol prices in March 2006. It was, however, recognised that a key upside risk to inflation emanated from increasing global commodity and food prices.
The pass-through of these prices to domestic prices, nevertheless, was expected to be somewhat mitigated in 2007 by several factors, including capacity expansion and strong competition among producers and retailers. The economy was projected to operate close to its potential with a small negative output gap, suggesting limited demand-driven inflationary pressures. Additionally, the existence of administered and controlled prices for selected food items, and petrol and petroleum-related products, to some extent, reduced the impact of the global price pressures on domestic prices.

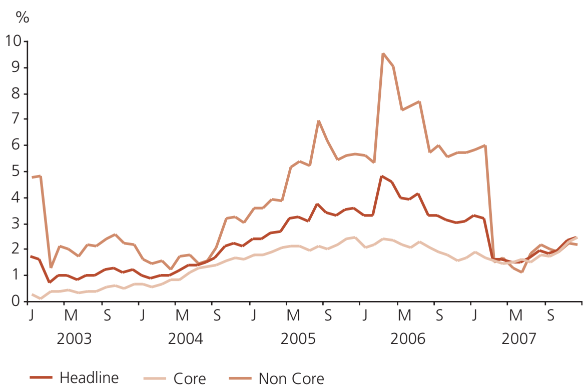
With the lapse of the effect of the fuel price adjustment and in the absence of new impetus to price increases, headline inflation trended downwards in the first half of 2007, averaging only 1.4% in the second quarter. In the second half of 2007, however, headline and core inflation edged up gradually, both averaging 2%. The rise was primarily a cost-driven phenomenon and was most discernible in food prices. Global oil and food prices had continued to escalate because of cyclical and structural factors. Higher global oil prices, however, did not translate into higher domestic fuel prices as the subsidies provided by the Government were unchanged during the year. Higher global prices of food commodities, however, had a more direct impact on domestic prices. A notable manifestation of this was the increase in wheat-based food product prices following the increase in the administered price of general-purpose wheat flour in May 2007.

Chart 3.3
Actual and Potential GDP as at March 2007



f Forecast

Chart 3.4
Headline, Core and Non Core Inflation



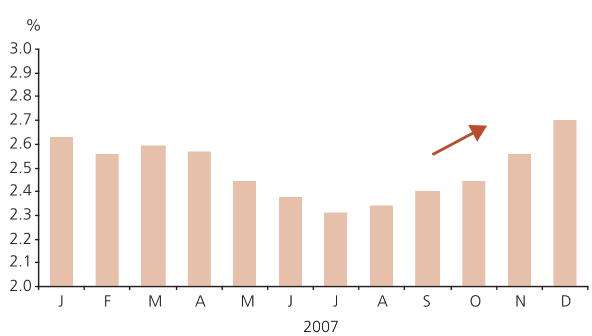
Stronger demand, arising from higher domestic purchasing power, also played an ancillary role in the price increases, allowing producers to pass on increases in their costs into final consumer prices. Important catalysts for the firm trend in private consumption were increases in public and private sector wages, the increase in incomes arising from higher commodity prices, the wealth effects from the stock market, and the steady employment prospects. In addition, consumer sentiments remained strongly positive during the year.

As the year drew to a close, the elevated levels of global prices continued to pose upside risks to domestic inflation going forward. Analysts' forecast of average inflation for 2008 edged up from August 2007 onwards after a stepwise decline in the first seven months. Nevertheless, the expected average inflation rate of 2.7% for 2008 in December 2007 was not significantly different compared to the forecasts made at the beginning of 2007. The factors that had mitigated some of the inflationary pressures in 2007, namely capacity expansion, competition, and Government surveillance on prices and the monitoring activities on supply and distribution were expected to continue in 2008. It should be noted that slower global growth could also have a moderating impact on global commodity price trends. Thus, going into 2008, the inflation risks from cost-driven pressures were expected to remain elevated, but these were expected to be contained by the higher downside risks to global growth.

Given the assessment on the growth and inflation prospects, the OPR remained unchanged at 3.50% during 2007. In essence, the risks to growth and inflation were viewed to be broadly in balance at the eight MPC meetings during the year. Conditions became gradually more challenging as the year progressed, as the Bank had to confront opposing forces in the form of greater downside risks to growth and potentially higher upside risks to inflation. Monetary policy was thus aimed at achieving a balance between supporting economic activity and not generating undue demand-driven inflationary pressures. Of crucial importance was that the upside risks to inflation emanated mainly from cost-driven and global factors. Changing interest rates and monetary conditions was not considered the appropriate strategy to alleviate the impact of these developments. It was recognised that considerable price pressures originated from structural factors, which in turn, would require structural adjustments and policies to increase efficiency or flexibility of the economy.

With the OPR unchanged at 3.50% during the year, monetary conditions were assessed as being supportive of economic activity. Average nominal lending rates on new loans approved trended downwards in 2007, amidst ample liquidity and intense competition among banks. The supportive monetary conditions were reflected in the continued steady and broad-based growth in financing. Banking system loans outstanding expanded by 8.6% in 2007

Chart 3.5
Average of Analysts' Forecast for 2008 Inflation

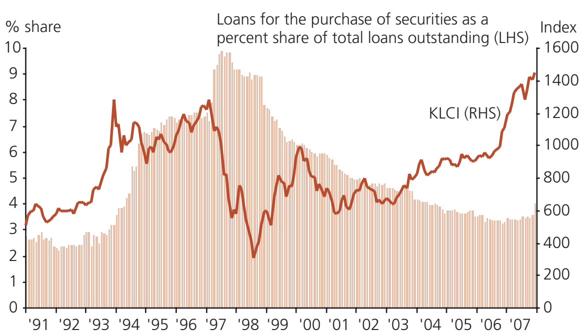


Source: Consensus Economics

(6.3% in 2006). In particular, this reflected stronger business loan growth as businesses across the various sectors sought financing for working capital and to expand production capacity. In the bond market, funds raised to finance new activity amounted to RM31.8 billion compared with RM21 billion in 2006. Notwithstanding the prevailing environment of surplus liquidity in the banking system, there was no evidence of excessive lending or over-concentration in specific sectors that could be fuelling inflationary pressures and excessive asset price increases. Although the growth in bank financing for share purchases picked up during the year amidst the uptrend in the KLCI, the increase remained relatively modest, especially when compared to the experience a decade ago. Overall, financing developments were assessed to be consistent with the objective of monetary policy of obtaining a balance between sustainable growth and price stability.

The trend in the ringgit exchange rate also affected monetary conditions. Strong two-way international trade and investment flows continued to determine the ringgit performance against the major and regional currencies during the year. In particular, volatility of portfolio flows in response to global developments created some volatility in the exchange rate of the ringgit. The Bank smoothened the impact of these flows on the exchange rate of the ringgit, while also sterilising the increase in liquidity to contain the impact of these flows on domestic monetary conditions.

Chart 3.6
Banking System Loans Outstanding for the Purchase of Securities



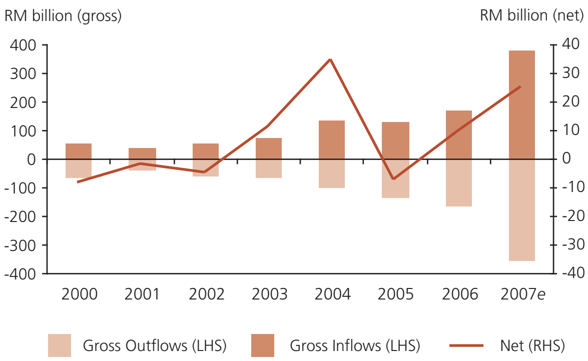
MONETARY OPERATIONS IN 2007

Bank Negara Malaysia conducted monetary operations to stabilise the average overnight interbank rate around the OPR and to ensure that there was sufficient liquidity in the interbank market. Through a combination of market operations and providing collateralised lending and deposit standing facilities at the upper and lower limit of the corridor respectively, the Bank ensured that the overnight rates traded within a corridor of ± 25 basis points of the OPR. Throughout the year, the ringgit overnight interbank rate was relatively stable and closely tracked the OPR with an average deviation (average interbank rate minus OPR) of less than one basis point.

The presence of excess liquidity posed a key challenge to monetary management during the year. The Asian region as a whole continued to receive substantial inflows during the year. For several countries in the region, liquidity management was a challenge on several fronts in terms of avoiding sudden and disruptive movement of the currencies, addressing the potential adverse impact on central bank balance sheets and limiting the inflationary effects on the economy and the financial system of the continued inflows. Central banks had turned to a broader range of monetary instruments, using both direct measures such as reserve requirements, and indirect instruments such as repos and the issuance of central bank papers to manage liquidity. Malaysia remained a net recipient of trade and capital flows, which contributed to an increase of RM58.6 billion or 24.4% in aggregate domestic liquidity during 2007. Net portfolio investments were higher during the year compared to 2006. The net position, however, masked the significant size of gross inflows and outflows, particularly during the key market events that occurred during the year, namely the global equity market correction in February, the global bonds sell-off in June and the subprime mortgage fallout in August and September.

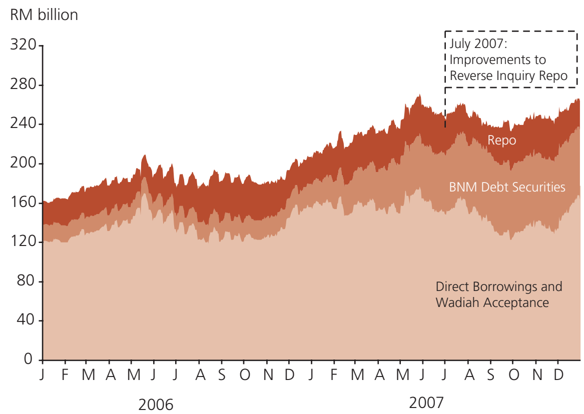
Several major overseas money markets experienced a severe liquidity crunch amidst the subprime mortgage turmoil in August and September. Though much calmer, the domestic money market was affected by the temporary

Chart 3.7
Portfolio Investment



e Estimate
Source: Bank Negara Malaysia's Cash Balance of Payments Reporting System

Chart 3.8
Outstanding Monetary Instruments



reversal of capital flows arising from the pullback of portfolio funds during these periods. The liquidity impact from capital flow reversals was offset by the unwinding of existing outstanding sterilisation operations, thus ensuring an orderly adjustment in the money and financial markets.

The swift and flexible monetary response in dealing with such heavy outflows experienced in the August-September period was possible due to the short-term average maturity structure of the various monetary instruments utilised by the Bank in its operations. By the end of the year, the total amount of surplus liquidity sterilised by the Bank using various market-based monetary instruments amounted to RM309.7 billion. The weighted average maturity of these total borrowings was 39 days, which provided the Bank with significant operational flexibility. Furthermore, the Bank has at its discretion the ability to provide additional liquidity if necessary via reverse repo or its collateralised lending standing facility against the estimated RM160 billion of Class-1 liquefiable assets held by financial institutions as at the year-end.

In terms of the types of instruments used for monetary operations, uncollateralised direct borrowings and acceptance of Shariah-compliant deposit placements under the Al-Wadiah (custody and safekeeping) concept remained as the principal instruments, accounting for 51% of the surplus liquidity sterilised as at end-2007. The use of direct borrowings has been de-emphasised (74% of total sterilised liquidity as at end-2006) in favour of greater issuance of Bank Negara Monetary Notes (BNMNs) to further develop the short-term ringgit debt securities market. Operationally, the Bank increased the frequency of issuances to twice per week (from once a week in 2006) and raised the total outstanding amount from RM15.1 billion as at end-2006 to RM69.5 billion by end-2007.

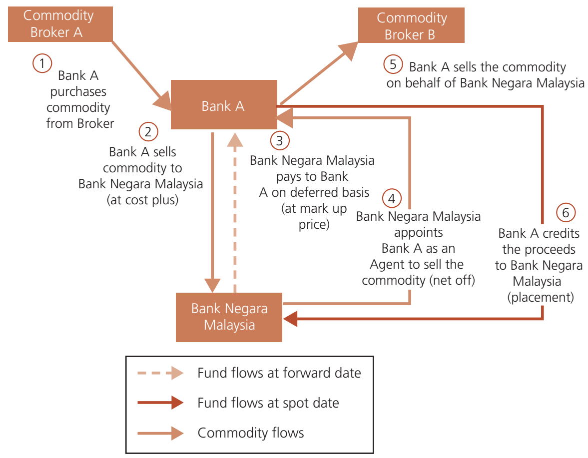
The importance of BNMNs as a monetary instrument has also grown, accounting for 26.4% of the total instruments utilised versus 11.2% in 2006. BNMNs are a preferred investment asset class compared to direct borrowings, as these securities are typically a short-duration low-risk asset class tradable in the secondary market and they qualify for Class-1 liquefiable asset status under the Liquidity Framework for banking institutions.

The Bank has also been fine-tuning its reverse inquiry repo facility for interbank market participants since 2 July 2007 to enhance its operational transparency and flexibility. The Fully Automated System for Issuing/Tendering (FAST) website provides a daily list of Malaysian Government Securities (MGS) available for loan via repo. The securities on this list are drawn from securities in the Bank's own inventory, as well as those that have been lent to the Bank by major institutional investors through the Institutional Securities Custodian Program (ISCAP). Through ISCAP, participating institutional investors transfer their MGS holdings to the Bank, and receive a fee. The Bank uses MGS borrowed through this arrangement as collateral in the Bank's repo operations. These measures have facilitated the greater use of repos in the interbank market, while also contributing towards the development of a market reflective benchmark yield curve for MGS.

A floating rate version of BNMNs was also introduced on 19 July 2007 to expand the spectrum of debt instruments used for managing liquidity in the financial market. This instrument allows the Bank to issue, and for investors to purchase, debt securities at longer maturity terms without undertaking correspondingly longer-term interest rate risks. The instrument also added a high quality issuer, for the first time, to the floating-rate debt securities market space. The inaugural issue pays a floating-rate coupon of the 6-Month Kuala Lumpur Interbank Offered Rate (KLIBOR) minus a pre-determined fixed spread. Price discovery of the fixed spread element is facilitated by way of a competitive variable-rate uniform price auction (also known as a Dutch auction) via the Principal Dealer network. The issue size of RM500 million was over-subscribed by 2.09 times and issued at par value to all successful bidders at the coupon rate of 6-Month KLIBOR minus 10 basis points that resets semi-annually. Future issuance of this instrument may also be pegged to alternative reference rates like the 3-Month KLIBOR and may have different coupon reset periods.

The use of Islamic monetary instruments increased to 23.2% of total instruments as at end-2007. The expansion of liquidity in the Islamic money market was contributed by the growth of Islamic financial assets in tandem with the increased number of full-fledged Islamic banks. A key development to enhance the efficiency of liquidity management in the Islamic money market was the introduction of the Commodity Murabahah Programme (CMP) on 8 February 2007. CMP is a cash deposit product that is based on a globally accepted Islamic concept. As depicted in Chart 3.9, CMP utilises over-the-counter crude palm oil contracts as well as

Chart 3.9
Commodity Murabahah Programme



selected metal contracts like palladium and platinum on the London Metal Exchange as the underlying commodity transactions to facilitate liquidity management.

Going forward, the Bank will continue to be confronted by the challenges posed by continued volatility in global financial markets, including volatility in global exchange rates. Such volatility would likely have significant influence on the direction of capital flows, which in turn, would have an impact on the domestic financial markets and the overall financial system. Thus, operational flexibility, through a diverse and effective set of monetary instruments, remains crucial for the Bank to continue to manage liquidity effectively. Continued strengthening and deepening of the domestic financial markets will further enhance both the capacity of the economy to absorb the large and volatile capital flows and the effectiveness of the Bank's market operations in dealing with them. In addition, in its catalyst role towards realising the vision of Malaysia as an International Islamic Financial Centre, the Bank will develop new and flexible Islamic monetary instruments that are widely acceptable among global investors.