Monetary Policy in 2006

OVERVIEW

Monetary policy in 2006 focused on attaining an appropriate balance between maintaining price stability and achieving the maximum sustainable level of economic growth. As with most countries in the global economy, inflation was one of the key macroeconomic issues in Malaysia during 2006. The robust performance of the global economy for a number of years has driven up demand for commodities and had contributed to significant upward pressures on the prices of resources worldwide. The intensification of cost pressures therefore warranted close vigilance against incipient signs of broader price increases. Although the upward price pressure had pushed inflation to levels not seen since the Asian Financial Crisis, the overall trend in inflation did not gain sufficient momentum to weaken the economy's medium term growth prospects or undermine price stability. The effects of supply-driven factors began to wane in the second half of the year, while core inflation remained relatively moderate. These developments mitigated the need for a strong response from monetary policy.

> In the challenging environment of 2006, monetary policy sought to ensure that interest rates were at a level that would enable the central bank to respond to any risk of rising inflation, while at the same time remaining supportive of domestic demand

With the economy maintaining a steady growth path, the opportunity was taken to align monetary conditions to the environment of higher inflation. The Overnight Policy Rate (OPR) was raised twice, in February and April, by 25 basis points each time. The normalisation of interest rates placed the Bank in a better position to respond to any risks of rising inflation. Equally important was that interest rates remained supportive of growth whilst minimising the risks from a prolonged period of negative real interest rates.

THE POLICY ENVIRONMENT AND CHALLENGES

In fulfilling the monetary policy objective of preserving price stability and ensuring sustainable economic growth, monetary policy was confronted by a number of challenges during the year. After remaining low and stable for several years, price pressures emerged in the first half of the year amid rising energy and commodity prices in the global markets. The rise in inflation since May 2004 was particularly felt by the general populace and the economy, which had grown accustomed to a history of low inflation. Prior to the period of rising commodity prices, the rate of consumer price inflation had generally been on a declining trend from the levels seen in the aftermath of the Asian Financial Crisis of 1997-98 and the sharp depreciation of the ringgit. For the period end-1999 - July 2005, the inflation rate remained below the 1980 - 2005 average of 3.2%. Nevertheless, inflation began rising, with the gradual ascent punctuated by discrete jumps in the trend resulting from the removal of fuel subsidies and the upward adjustments to administered

Chart 3.1
Headline Inflation: 1980-2006

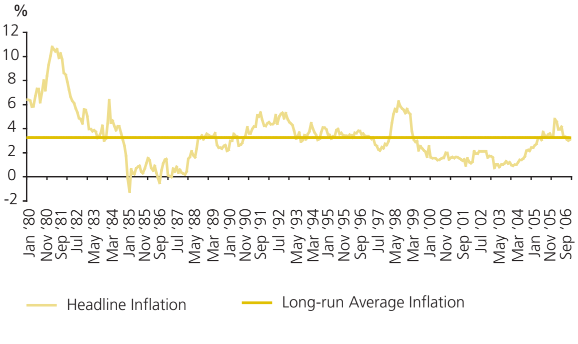
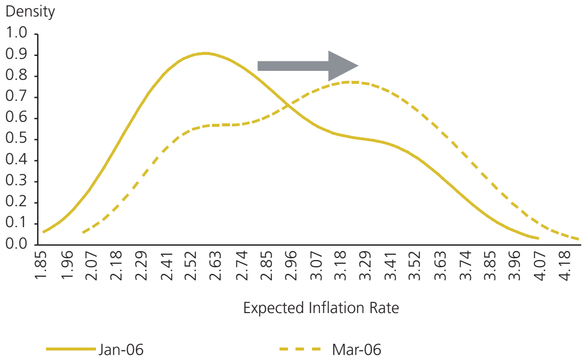


Chart 3.2
Market Inflation Forecast for 2006: Jan-06 vs Mar-06



Source: Consensus Economics

prices. With the building of momentum in commodity prices in the global markets at the beginning of the year, inflation was projected to be higher than Malaysia's long-term average.

The upward trend in inflation led to upward revisions of expectations of inflation in 2006. More specifically, following the fuel price revision in March 2006, financial markets adapted their expectations and revised upwards their inflation forecast for 2006. The concern was that such persistent expectations could create additional upward pressure on the prices of goods and services, and on wages.

A concomitant effect of the rise in inflation was the decline in real interest rates. Interest rates had been at historical lows since the Asian Financial Crisis of 1997-98. As domestic inflation began to rise, real interest rates declined and turned negative in the second quarter in 2005. Given that Malaysia is a high savings nation, a particular concern was the declining real rate of return on savings. A prolonged period of low and negative real interest rates could lead to distortions in the form and allocation of savings, as well as the use of capital.

The earlier accommodative monetary policy following the currency crisis in 1997-98 had contributed towards ensuring that domestic demand was on a sustainable growth path. Domestic growth prospects continued to be resilient throughout the year, underpinned by strong private consumption and investment. Uncertainties with respect to the growth outlook, however, began to emerge in the second half of the year. Although the indicators for domestic demand suggested continued resilience, there were indications that the external environment might become less favourable. Global and regional economic growth was expected to moderate in the second half of the year as the impact of rising interest rates abroad, particularly in the US, became more evident. Geopolitical risks and sustained high energy prices also increased uncertainties over the prospects for global economic growth. The risks of inflation therefore needed to be balanced against the risks of a more moderate economic outlook.

Chart 3.3
Interest Rate and Inflation

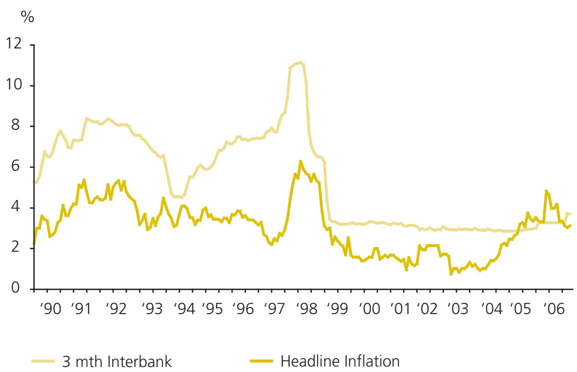
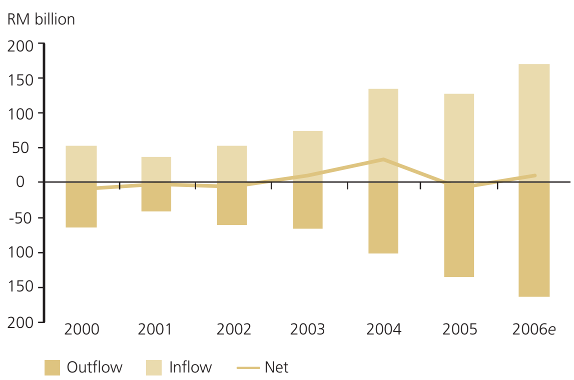


Chart 3.4
Portfolio Investment



Source: Cash BOP Reporting System, Bank Negara Malaysia

The increased volume of capital flows added another challenge to the policy environment. In line with the broad regional trend, private capital flows, particularly portfolio flows, were drawn to Malaysia by the favourable prospect for economic growth and expectations of currency appreciation. Although net portfolio flows in 2006 appeared modest compared to the high levels experienced in 2004, gross inflows and outflows of portfolio capital had risen significantly, and were considerably larger in relation to recent years.

MONETARY POLICY IN 2006

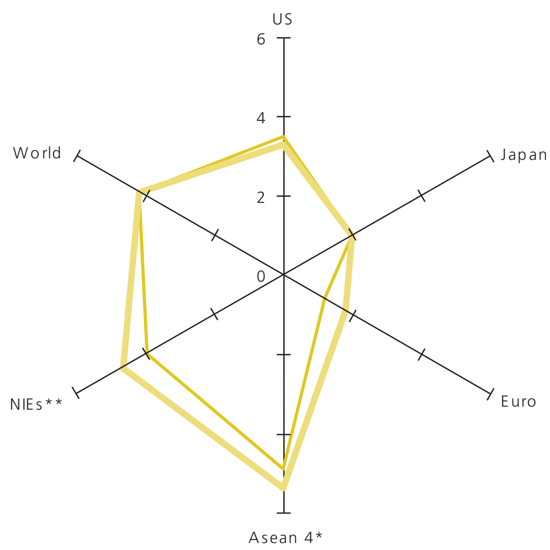
In the early part of the year, it was clear that sustained increases in energy and commodity prices in the global markets would exert upward pressures on prices. It was also clear that the higher cost of providing fuel subsidies would have an adverse effect on the Government's budgetary position. To ensure that resources were not diverted from the development needs of the country, the Government revised upwards domestic retail fuel prices in March 2006. Consequently, inflation rose markedly to 4.8% in March and was expected to remain at elevated levels for the rest of the year. What was not clear at that point in time was the extent of the second-round effects on inflation.

The OPR was raised to normalise monetary conditions to the prevailing environment of higher inflation

The rise in inflation prompted a normalisation of prevailing monetary conditions. While the OPR was raised by 30 basis points to 3% in November 2005, monetary conditions were not aligned to the elevated price conditions. The key consideration was whether the supply-driven price shocks would spur secondary rounds of price increases. The focus of monetary policy was not on responding to the initial supply-side shock, but rather on mitigating demand pressures and second-round effects to inflation. Based on the data that became available by the middle of the year, the assessment was that the impetus to inflation was mainly from the cost-driven factors and that there was little evidence of second-round effects. The pace of increase in core inflation was also relatively moderate. Furthermore, there were no signs of unusual wage pressures. Based on these trends, the forecast was that inflation would peak in the first half of the year and moderate thereafter.

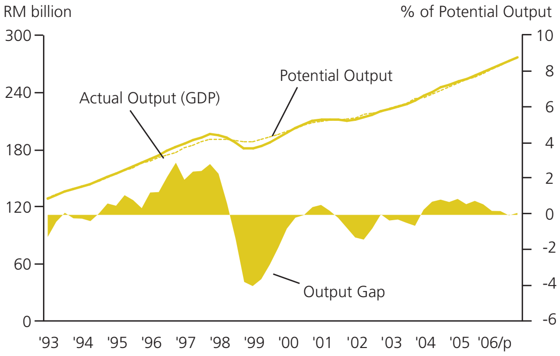
In terms of economic growth prospects, an assessment of coincident and forward looking indicators early in the year suggested that the economy was poised to sustain the economic growth momentum in 2006 on account of favourable external and domestic demand conditions. Firm economic growth in the US, supported by the recovery in Europe and Japan, were expected to spearhead an expansion in the major industrial countries and thus support the impetus for a continued uptrend in the global electronics cycle and commodity prices. Regional growth was also expected to remain strong as the region's electrical and electronics sector expanded

Chart 3.5
Outlook for Real GDP Growth as at end-2005
(annual percent change)



Source: IMF, WEO Sept 2005
* Indonesia, Malaysia, Philippines and Thailand
** Newly Industrialised Economies
e Estimate
p Projection

Chart 3.6
Actual and Potential Output as at early 2006*



* Estimate of potential output as at March 2006

Table 3.1
Monetary Policy Decisions in 2006

MPS Release Date	Overnight Policy Rate (%)
20 January	3.00
22 February	3.25 ↑
26 April	3.50 ↑
22 May	3.50
28 July	3.50
25 August	3.50
26 September	3.50
24 November	3.50

in tandem with the global electronics up-cycle. Meanwhile, income growth was expected to support domestic demand through increased private consumption and investment.

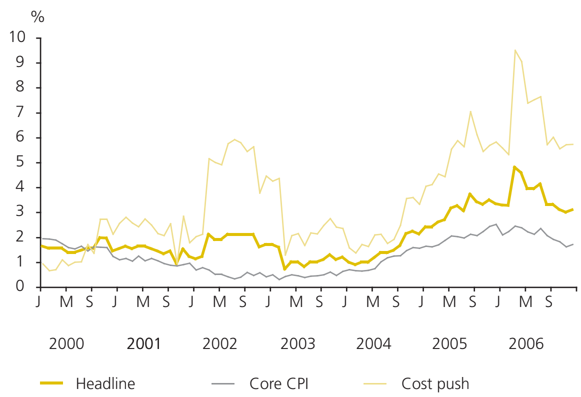
Measures of potential output monitored by the Bank suggested that the Malaysian economy would grow close to its potential. Continued improvements in productivity and an expansion of the capital stock and the labour force were expected to further augment the productive capacity of the economy, thereby increasing the level of economic growth that could be sustained without generating price pressures.

In this environment, the Bank took the opportunity to normalise interest rates, which had been at historically low levels for an extended period of time. The normalisation of interest rates allowed monetary policy to be better placed to respond to risks of higher inflation. A prolonged period of negative real rates would also expose the economy to greater risks of distortions. The OPR was raised 25 basis points in February and again in April. Taking into account the increase by 30 basis points in November 2005, the OPR was increased by a cumulative 80 basis points to 3.5%, after remaining at 2.7% since the introduction of the New Interest Rate Framework in 2004[1].

[1] Before the New Interest Rate Framework was introduced in April 2004, the benchmark policy rate was the Bank Negara Malaysia 3-month Intervention Rate. It was last adjusted in May 2003, when the Bank reduced the rate from 5% to 4.5%.

Following these increases, the decision was made in May to leave rates unchanged. The overall assessment of the economic outlook was that the underlying trend had not changed. The Malaysian economy was expected to maintain its growth momentum on the basis of favourable domestic and external conditions. Strong private consumption and investment activity suggested that domestic demand would be sustained. Meanwhile, the continued growth in the US and China, the strengthening recovery in Japan and the Euro area, as well as the sustained momentum in global semiconductor sales indicated that external demand would remain strong. Although cost pressures remained, surveillance continued to indicate limited evidence of second-round price effects and

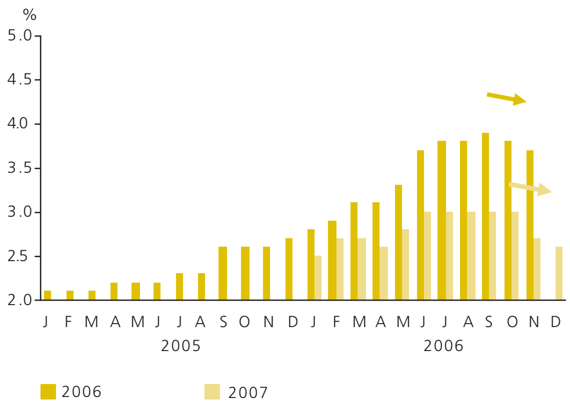
Chart 3.7
Headline, Core and Cost Push Inflation



demand-induced inflationary pressures. In line with the projections, headline inflation began moderating in May, while core inflation had stabilised. Given these trends, the OPR was kept unchanged at the May Monetary Policy Committee (MPC) meeting.

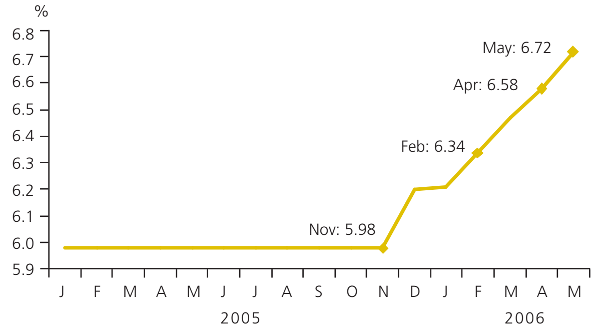
Headline inflation continued to moderate during the second half of the year following the lapse of the effects of price adjustments and in the absence of new price pressures. Weaker international oil and commodity prices and increased global competition, combined with a moderate environment of wage and price increases in the domestic economy, contributed towards sustaining the downward trend in inflation. Demand pressures also remained subdued as reflected in the moderation in core inflation. By the fourth quarter, financial market participants had revised downwards their forecasts for 2006 inflation in line with the outturn of lower inflation, while their average forecast for 2007 inflation was less than 3% as at December 2006. The lower inflation outcome was also the result of well-anchored inflation expectations that acknowledged the fact that the increase in inflation was transitory and was due mainly to supply factors. The track record of monetary policy response to address inflationary conditions has been a factor contributing to anchoring and stabilising expectations.

Chart 3.8
Average Market Forecasts for 2006 and 2007 Inflation



Source: Consensus Economics

Chart 3.9
Commercial Banks' BLR



Market adjustments to the OPR changes were efficient and predictable. This was a significant development given that the upward adjustments in the policy rate were the first since the introduction of the New Interest Rate Framework in 2004, whereby the setting of retail interest rates was deregulated. The adjustment in lending rates was generally more responsive relative to the adjustment in deposit rates. The slower response of the deposit rates was primarily due to the ample liquidity in the financial system. Despite the increase in the OPR, real deposit rates were negative due to the higher inflation. However, as inflation trended downwards in the later part of the year, real fixed deposit rates turned positive in October.

While lending rates adjusted upwards, the rates remained close to historical lows.

Chart 3.10
Commercial Banks' Fixed Deposit Rates

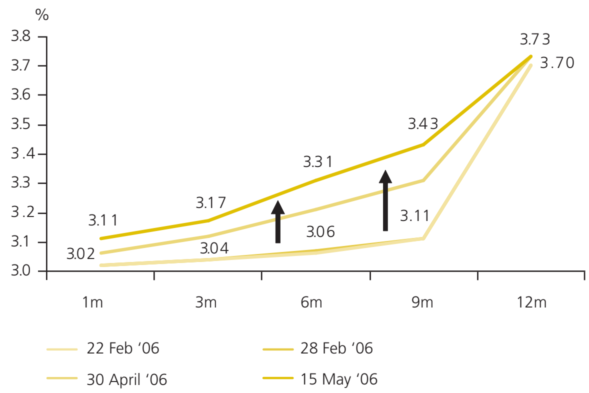
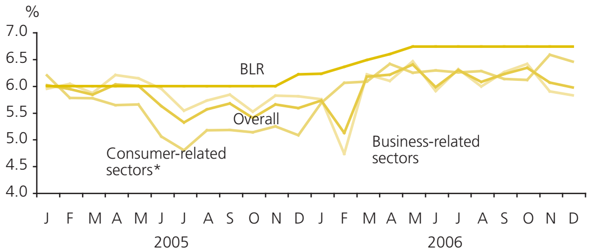
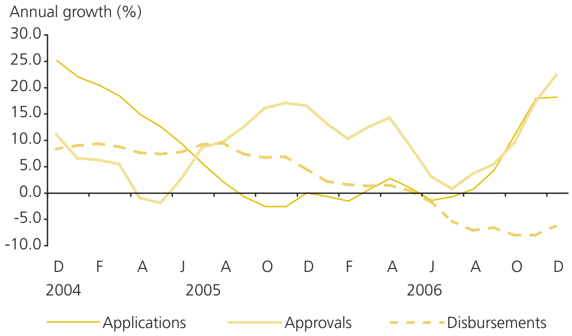


Chart 3.11
Weighted ALR on New Loans Approved by CBs



* Excludes loans for the purchase of residential properties and credit card

Chart 3.12
Trended Businesses Loan Indicators*



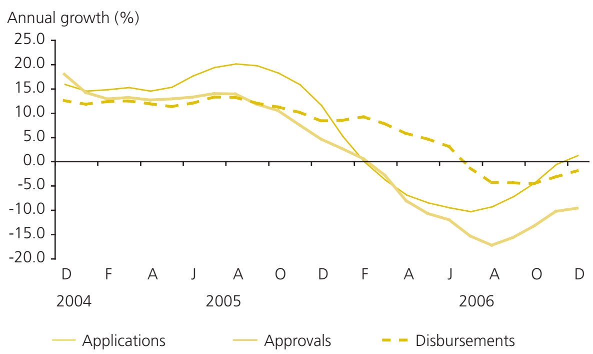
* Indicators are smoothened using a 6-month double centred moving average

Furthermore, despite the increase in the Base Lending Rate (BLR), the weighted average lending rates on new households and business loans continued to be below the average BLR of the banks. This reflected the continued competition in the loans market.

With the ample liquidity situation in an environment of low interest rates, domestic monetary and financial conditions remained supportive of the private sector. Alternative avenues and instruments for financing allowed for access to more diversified forms of financing. Increased competition amongst lenders also spurred banks to offer attractive financing options. The moderating trend in bank loans masked several key explanatory factors. First, business operations and investment activity were supported by greater reliance on financing from internal funds and the capital market. The reliance on internal funds to some extent accounted for the disconnect between the slower pace of growth in financing activity vis-à-vis the sustained growth in private investment activity. Second, household financing was gradually adjusting to more sustainable levels after increasing rapidly in recent years. Loans for the purchase of passenger cars, which were one of the main contributors to loan growth in 2004 and 2005, also moderated following general uncertainty in the car market. Third, despite the downward trend in credit growth, domestic demand remained resilient. Household consumption was supported by income growth and stable employment conditions. Meanwhile, investment by businesses remained strong, in part augmented by strong corporate cash flow and foreign direct investment (FDI). The subsequent upward trend in loan applications and approvals, especially to businesses, suggest some recovery in financing trends going forward.

In terms of the exchange rate, the ringgit has experienced greater two-way movement following the transition to a more flexible exchange rate regime. To date, the gradual strengthening of the ringgit exchange rate has been broadly in line with the currencies of Malaysia's major trading partners and is reflective of Malaysia's strong underlying macroeconomic fundamentals. After more than a year and a half, the economy has benefited

Chart 3.13
Trended Households Loan Indicators*



* Indicators are smoothened using a 6-month double centred moving average

from the more flexible exchange rate regime in a number of ways. In the face of structural changes in the regional and global environment, the two-way flexibility accorded by the exchange rate regime allows for greater policy flexibility to deal with potential external shocks. Early evidence suggests that the gradual appreciation of the real exchange rate has been another factor that has encouraged those in the tradable sector to undertake further adjustments to improve their efficiency and productivity. Such structural adjustments have moved Malaysia up the production value chain and thus improved the overall competitive position of the economy. Finally, the stronger currency had contributed to alleviate some of the price pressures emanating from imported inflation.

Nevertheless, as with any small open economy with liberal exchange control policies, global developments and capital flows can be a challenge for the management of the exchange rate. In Malaysia's case, the healthy two-way flow of capital enabled orderly foreign exchange market conditions throughout 2006. The upward pressure on the ringgit arising from inflows due to international trade, FDI and portfolio investment was counterbalanced by outflows arising from external debt repayments and prepayments, the large repatriation of profit and dividends by non-resident corporations, as well as overseas investments by residents. On the latter factor, there were increased investments overseas, as resident companies took advantage of their improved financial strength to venture into strategic investments abroad. The sum of outflows accounted for by the repatriation of profits and dividends and overseas investments amounted to RM29 billion or 5.3% of GDP in 2006.

With countries attaining a higher degree of economic and financial openness amid the growing sophistication of financial instruments and markets, developments in the global markets are having an increasingly more significant effect on domestic monetary and financial conditions. As the economy and the financial system become more integrated with the global system, the magnitude, channels and speed of risk transmission across countries are also becoming more challenging. This has prompted closer regional cooperation between central banks to pool their resources to enhance the surveillance networks and promote regional monetary and financial stability. The following box article highlights several ongoing initiatives that are being earnestly pursued by regional central banks, including Bank Negara Malaysia.

Selected Ongoing Central Bank Initiatives for Promoting Regional Cooperation

The EMEAP Task Force Initiative

- During the year, a significant development in regional cooperation was the establishment of the Task Force on Regional Financial Cooperation in Asia in February 2006. It represented the intensification of efforts to foster deeper financial cooperation among the regional central banks with the overriding objective of promoting macroeconomic and financial stability in the region and thus achieving mutually reinforcing regional growth and stability. The initiative focuses on the six mandates of cooperation: regional macro-monitoring and risk management; crisis management and resolution; financial market and infrastructure development and integration; capacity building; sharing of information, expertise and experience; and in communications.

Chiang Mai Initiative

- Significant effort has been devoted into regional crisis management and resolution, in particular the development and further enhancement of the regional self-help and support arrangement. The Chiang Mai Initiative (CMI) marks a particularly important step towards promoting such a regional self-help and support arrangement among the ASEAN+3 countries[1] with the objective of ensuring regional monetary and financial stability.

- The CMI was launched on 6 May 2000 by the ASEAN+3 Finance Ministers to supplement existing international financial facilities, and hence, make available, in a timely manner, financial resources to member countries facing temporary balance of payments and short-term liquidity needs. The CMI has two components, namely the ASEAN Swap Arrangement (ASA) and a network of bilateral swap arrangements (BSAs).

- To further strengthen the regional self-help financial support, the ASEAN+3 countries have agreed to work towards an advanced framework of regional liquidity support arrangement and as such achieve the long-term goal of multilateralising the CMI. In this regard, a task force was set up to study the possible options and progressive steps in multilateralising the CMI. The proposed framework is aimed at promoting a more effective and efficient pooling and utilisation of liquidity support among member countries.

- Under the CMI, Malaysia has entered into three BSA agreements, namely with Japan, Korea and PR China. The total amount of Malaysia's BSAs stands at USD4 billion. Collectively, as at end-2006, the BSA network, which comprised 16 agreements among eight ASEAN+3 countries, totalled USD77 billion, compared to USD58.5 billion at end-2005.

- Recent developments have also highlighted the need to enhance collaboration in the areas of macroeconomic and financial surveillance to provide early detection of risks within the region. As such, the region has embarked on a series of efforts to promote greater surveillance, particularly in complementing the BSAs under the CMI. In May 2006, the ASEAN+3 Finance Ministers agreed on measures to further strengthen regional surveillance capacity to assist the policy dialogue under the ASEAN+3 Economic Review and Policy Dialogue (ERPD) process. The ASEAN+3 Finance Ministers agreed to establish the Group of Experts (GoE). The GoE, which is made up of several regional professional experts, would serve as an independent economic assessment vehicle for this region. The experts are expected to identify and undertake in-depth studies on economic and financial vulnerabilities and concerns within the region, especially in the areas of macroeconomic policy, fiscal policy, external sector (trade and international finance), and monetary policy.

- In addition, the ASEAN+3 Finance Ministers also agreed to establish the Technical Working Group on Economic and Financial Monitoring (ETWG) to assist in further strengthening the surveillance process in the region. The ETWG would play an important role in developing the Early Warning System to facilitate early detection of emerging risks in the system. The ETWG is also expected to assist in enhancing and strengthening member countries' capacity building and surveillance capability.

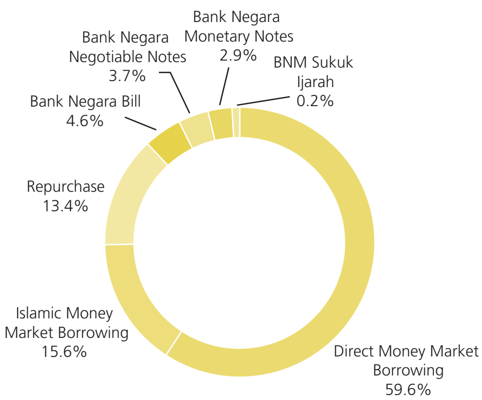
[1] ASEAN countries comprise Brunei, Indonesia, Malaysia, Philippines, Singapore, Thailand, Cambodia, Lao PDR, Myanmar and Vietnam. '+3' countries comprise Japan, Korea and PR China.

MONETARY OPERATIONS IN 2006

Monetary policy implementation throughout 2006 was focused on managing the liquidity situation in implementing the monetary policy decisions and maintaining orderly conditions in the money and foreign exchange markets. Policy operations were centred on managing the excess liquidity in the interbank system arising primarily from large inflows due to international trade and inward portfolio investments. Aggregate liquidity during the year increased, with the total amount of surplus liquidity sterilised by the Bank's various market-based monetary policy instruments increasing from RM163.7 billion on 31 December 2005 to RM207.5 billion as at 31 December 2006. Most of this surplus liquidity was sterilised through the conventional money market, which accounted for 79.6% of the total operations, with the remainder being accounted for by monetary operations in the Islamic money market.

Direct borrowing remains as the principal monetary policy instrument, accounting for 74.4% of the surplus liquidity sterilised. This type of borrowing is a highly flexible monetary policy instrument as new borrowings may be conducted with a short turnaround time via competitive multiple-price auctions through the Fully Automated System for Tendering platform (FAST). The maturity of these borrowings ranges from overnight to up to 6 months, with average maturities of total borrowings remaining short, ranging between 20 to 30 days. In the Islamic interbank money market, placements under the Al-Wadiah Yad-Dhamanah (custody and safekeeping) principle are generally undertaken with the same level of flexibility. The Bank also increased its use of repurchase transactions (repos) as a means to sterilise excess liquidity. The greater use of repos was made possible by the availability of collateral securities, primarily Malaysian Government Securities (MGS), from major institutional investors through the lending of securities via the Bank's Institutional Securities Custodian Program (ISCAP).

Chart 3.14
Monetary Instruments (As at end-2006)



A major development in the Islamic money market operations was the inaugural issuance of the Bank Negara Malaysia Sukuk Ijarah on 16 February 2006 with an issue size of RM400 million. This instrument is effectively a claim on a stream of lease payments from a sale and leaseback arrangement. A special purpose vehicle, the Bank Negara Malaysia Sukuk Berhad has been established to issue the Sukuk Ijarah. Proceeds from the issuance were used to purchase a pool of identified assets of the Bank, which were subsequently leased to the Bank and the rental payments are distributed to investors as a return on a semi-annual basis. Upon maturity of the Sukuk Ijarah, which coincides with the maturity of the lease tenure, Bank Negara Malaysia Sukuk Berhad would sell the assets back to Bank Negara Malaysia at a predetermined price. The Sukuk Ijarah adds to the diversity of money market instruments in Malaysia and contributes to the long-term development of a vibrant and comprehensive Islamic sukuk market in Malaysia.

A key enhancement to the breadth of the Bank's monetary policy instruments is the introduction of Bank Negara Monetary Notes (BNMNs). Pursuant to amendments to the Central Bank of Malaysia Act 1958, effective 19 October 2006, the Bank is able to issue this new instrument to manage liquidity in both the conventional and Islamic financial market. BNMNs are subject to a flexible limit expressed in terms of the prevailing level of international reserves held by the Bank and may be issued in either coupon-bearing or discount-to-face-value format with tenures of up to 3 years. Conventional Monetary Notes may also be issued by re-opening existing issues, and increasing the size of the re-opened issue. The first issuance of BNMNs was conducted in December 2006 with a total issue amount of RM1 billion. A total of RM6 billion of BNMNs were issued in 2006 on a discount-to-face-value format, all of which have a maturity of less than one year. Going forward, the BNMNs are likely to have a greater role as a monetary policy instrument given their flexibility, depth of the secondary market, and the larger issuance threshold accorded to the Bank by the amendments to the Act.

COMMUNICATING MONETARY POLICY

In 2006, the Bank undertook several initiatives to enhance the communication of monetary policy decisions and the transparency of the monetary policy decision-making process. The schedule of MPC meetings for the year has been announced to the public and released in advance since 2005. The schedule of MPC meetings for 2007 was released in November 2006. In addition, since April 2006, the Monetary Policy Statement (MPS) is released on the same day as the MPC meeting. The advanced release of the MPC meeting schedule, coupled with the timely release of the MPS, have contributed towards reducing uncertainty among market participants regarding the timing of monetary policy decisions and announcements. The more frequent issuance of the MPS has also enhanced market understanding of the issues and thus has been important in the formation of market and public expectations. Importantly, the content of the MPS serves to signal the MPC's assessment of the balance of risks to price stability and economic growth. Through the use of speeches, interviews and other communication channels, senior officials of the Bank have sought to expand and reiterate the MPC's views, which have enabled market participants to deepen their understanding of the considerations that affect decisions on the stance of monetary policy.