

Monetary Policy in 2018

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MONETARY POLICY AND MONETARY OPERATIONS

Monetary policy in 2018 focused on ensuring price stability that was supportive of the sustainable growth of the Malaysian economy

The Monetary Policy Committee (MPC) normalised the degree of monetary accommodation at the January 2018 MPC meeting and raised the Overnight Policy Rate (OPR) by 25 basis points to 3.25%. In the MPC's assessment, the economic conditions that had called for the previous OPR reduction in July 2016 had vastly improved. The MPC had earlier communicated its consideration for a review of the degree of monetary accommodation in the November 2017 Monetary Policy Statement.

In early 2018, the domestic economy continued to show signs of strength and resilience, after a strong expansion of 5.9% in the previous year. Domestic growth was expected to be within the range of 5.5% - 6.0%.¹ Global growth was also expected to continue being broad-based across regions. This, in turn, would benefit Malaysia's trade performance, with positive spillovers to the domestic economy. Domestic demand was projected to remain the key driver of growth, underpinned by favourable income and labour market conditions; coupled with spending on new and ongoing infrastructure projects and sustained capital investments in the manufacturing and services sectors. Risks to the global growth outlook were assessed to be balanced, and prospects for the Malaysian economy remained strong. Headline inflation was projected to average at 2.0% - 3.0% in 2018² (2017: 3.7%). Higher global oil prices were expected to result in higher domestic retail fuel prices for the year, although the impact would be partly offset by a stronger ringgit exchange rate.

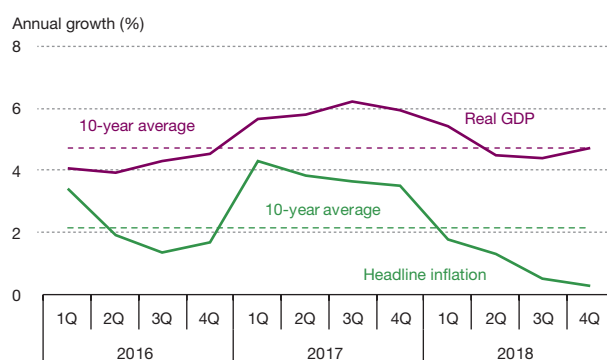
^{1,2} This forecast was published in the Bank Negara Malaysia Annual Report 2017.

The OPR adjustment, however, did not constitute a tightening of monetary conditions, as the overall stance of monetary policy remained supportive of economic growth. The normalisation of the degree of monetary accommodation contributed towards preserving the sustainability of growth, while ensuring ample policy space in the event of shocks to the economy in the future. The MPC also recognised the need to prevent the build-up of risks that could arise from interest rates being too low for a prolonged period of time even as the risks of financial imbalances remained contained.

By mid-year, however, the prospects to both the global and domestic growth outlook shifted as economic and financial conditions evolved. Even though the global economic expansion continued, there was increasing divergence across economies and signs of moderating growth momentum,³ mainly reflecting the weaker performance in several major economies and the materialisation of downside risks from global trade tensions. Domestically, unanticipated commodity supply-side shocks led

Chart 3.1: Real GDP and Headline Inflation

Monetary policy focused on ensuring price stability that was supportive of sustainable growth

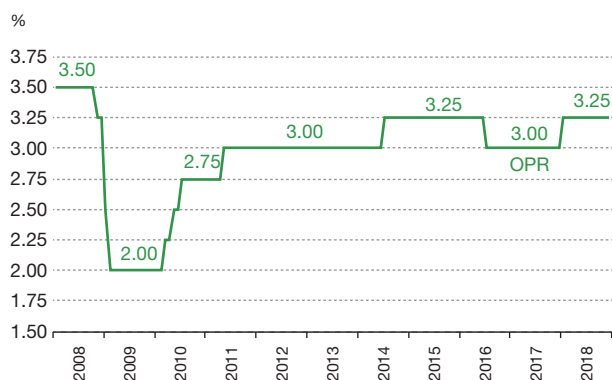


Source: Department of Statistics, Malaysia and Bank Negara Malaysia

³ The International Monetary Fund (IMF), for example, revised downwards its global growth forecast in October 2018 to 3.7% for both 2018 and 2019, compared to the July 2018 forecast of 3.9% for both years.

Chart 3.2: Overnight Policy Rate (OPR)

The stance of monetary policy remained accommodative



Source: Bank Negara Malaysia

to slower GDP growth in the second and third quarters of the year. In addition, public sector spending was lower arising from the reprioritisation of expenditure by the new Government. Domestic growth was, however, supported by better-than-expected private consumption growth as household spending increased due to the zerorisation of the Goods and Services Tax (GST) rate.⁴ On balance, taking all of these factors into account, the Malaysian economy was expected to remain on a steady growth path, but with the growth outlook revised downwards to 4.8% for 2018 and 4.9% for 2019.⁵ Nevertheless, risks to the global growth outlook were now tilted to the downside, which could cause headwinds to the domestic economy. These included the escalating trade tensions, and spillover effects to emerging market economies from global liquidity shifts due to monetary policy normalisation in the advanced economies. Domestically, risks remained from any prolonged weakness in the mining and agriculture sectors, and policy uncertainties.

Headline inflation for 2018 was projected to be lower⁶ compared to the forecast at the beginning of the year, due mainly to the net impact of consumption tax policy changes⁷ amid stable retail fuel prices.⁸ A key challenge

⁴ This refers to the reduction in the GST rate from 6% to 0% between 1 June 2018 to 31 August 2018.

⁵ This was reflected in the growth projections for 2018 and 2019 by the Ministry of Finance Malaysia in the Economic Report 2018/2019 published on 2 November 2018.

⁶ This was reflected in the headline inflation projection for 2018 by the Ministry of Finance Malaysia of between 1.5% - 2.5% in the Economic Report 2018/2019 published on 2 November 2018.

⁷ Subsequent to the zerorisation of the GST rate, it was replaced by the Sales and Services Tax (SST) effective 1 September 2018.

⁸ The Government in June 2018 announced the fixing of the retail fuel price of RON95 petrol at RM2.20 per litre for the remainder of the year, with the price itself unchanged from 22 March 2018.

in forecasting headline inflation in 2018 was in ascertaining the extent of the pass-through by firms to the changes in costs following the zerorisation of the GST rate and the implementation of the Sales and Services Tax (SST). Throughout the year, headline inflation projections were also highly dependent on the trend and forecast of global oil prices, which in itself were highly uncertain.⁹ Headline inflation for 2019 at that time was projected to increase primarily due to higher projected global oil prices, the prospective floating of retail fuel prices¹⁰ and the impact from the consumption tax policy, although the net impact of the consumption tax policy changes was expected to start to lapse towards the end of 2019.

Throughout 2018, underlying inflation, which excludes the impact of changes in the consumption tax policy, was expected to moderate following expectations of smaller pass-through from external and domestic cost factors, and the absence of excessive demand pressures.

Subsequent to the OPR increase in January, the OPR was maintained at the prevailing level throughout 2018. The degree of monetary accommodativeness was assessed to be consistent with the intended policy stance of ensuring that the domestic economy continued on a steady growth path with price stability. The MPC was also cognisant of the need to ensure sufficient liquidity to support financial intermediation. However, in assessing the role of monetary policy in supporting growth, the MPC was mindful that other measures are needed to further support and sustain domestic growth in the medium term, most pertinently structural reforms that would boost potential growth.

Monetary operations remained focused on ensuring sufficient liquidity to support the orderly functioning of the domestic financial markets

Domestic monetary and financial conditions, and continued healthy growth in financing to the private sector were supportive of economic activity. The Bank's monetary operations ensured sufficient liquidity to support the orderly functioning of money and foreign exchange markets. During the year, domestic financial markets were affected by capital flow volatility arising from external and domestic developments. Nevertheless, domestic financial

⁹ Brent crude oil prices (ICE Brent Futures) started the year at USD66.6 per barrel, peaked at USD86.3 per barrel on 3 October 2018, troughed at USD50.5 per barrel on 24 December 2018 and ended the year at USD53.8 per barrel.

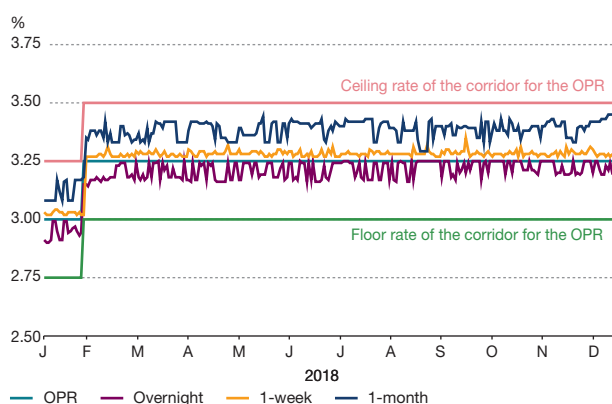
¹⁰ The Government in the 2019 Budget announced that the retail fuel price of RON95 petrol would be floated in the second quarter of 2019.

markets remained resilient and adjusted to the capital flows in an orderly manner, ensuring uninterrupted intermediation activity to the real economy.

During the year, the average overnight interbank rate (AOIR) was stable and closely tracked the OPR despite the heightened uncertainty and market volatility. In January, the AOIR adjusted higher following the 25 basis point increase in the OPR from 3.00% to 3.25% and traded within the range of 3.14% - 3.25% thereafter. Similarly, the Kuala Lumpur Interbank Offered Rate (KLIBOR) rates were stable across the tenures following the increase in the

Chart 3.3: OPR and Interbank Rates

Interbank rates remained stable



Source: Bank Negara Malaysia

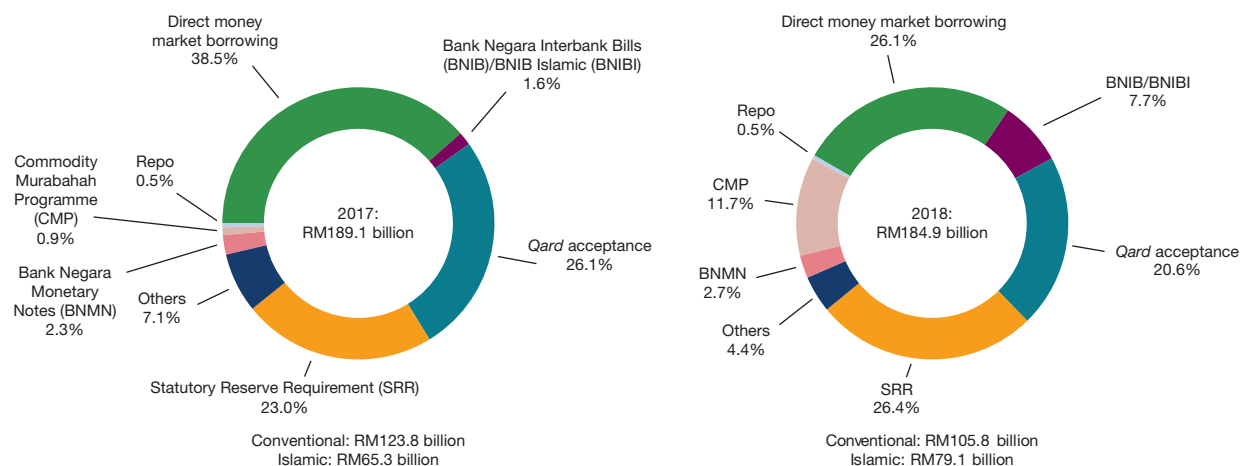
OPR, with the 3-month KLIBOR having increased by 25 basis points to 3.69% in January 2018.

The wide range of both conventional and Islamic liquidity instruments accorded flexibility to the Bank in meeting the liquidity needs of the banking system. The Bank actively adjusted its monetary operations through the various liquidity instruments and tenures. In the first quarter of the year, during periods of higher banking system liquidity arising from capital inflows, the Bank lengthened the maturity profile of its monetary operations. As banking institutions shifted their funding preference towards shorter maturities during episodes of capital reversals, the Bank responded likewise. The Bank facilitated these requirements by increasing the frequency of the Range Maturity Auction (RMA), from a weekly operation to two to three times a week. The Bank also conducted liquidity injection operations through reverse repos and foreign exchange swap facilities to ensure liquidity conditions remained conducive to support financial intermediation despite heightened financial market volatility.

The liquidity instruments used in the Bank's monetary operations were varied accordingly during the year. While direct money market borrowing and *Qard* acceptance continued to be the main instruments for conventional and Islamic financial institutions respectively, the use of Commodity Murabahah Programme (CMP) increased following the introduction of overnight CMP¹¹ in October 2018 to replace the existing instrument which was

Chart 3.4: Composition of Outstanding Ringgit Liquidity Placed with Bank Negara Malaysia (as at end-period)

Direct money market borrowing and *Qard* acceptance were the main liquidity absorption instruments



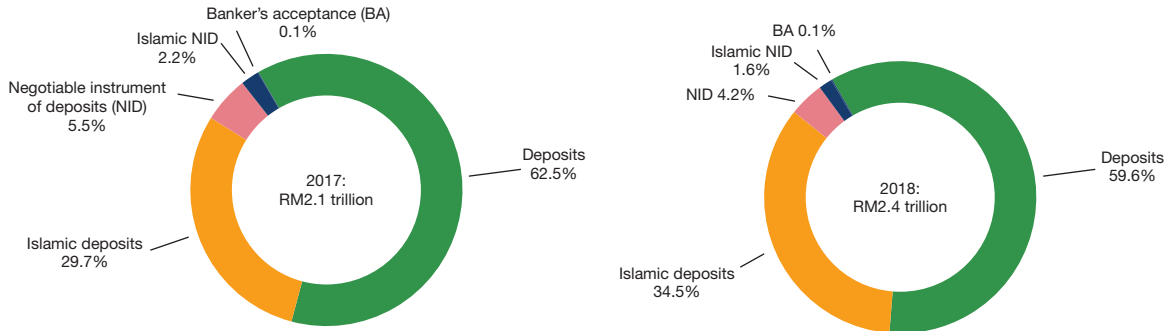
Note: Figures may not necessarily add up due to rounding

Source: Bank Negara Malaysia

¹¹ Previously, the CMP was offered for Islamic term placements only.

Chart 3.5: Breakdown of Volume of Interbank Money Market Transactions

Interbank money market transactions were mainly in conventional and Islamic deposits



Source: Bank Negara Malaysia

based on *qard*. This was reflected in the increased CMP composition from 0.9% in 2017 to 11.7% in 2018 of total outstanding ringgit liquidity absorbed through monetary operations. In comparison to *qard*, where *hibah* is declared upon maturity at the Bank's discretion, the CMP rate is made transparent upfront, thus providing impetus for a competitive and efficient price discovery mechanism in the Islamic money market.

In March 2018, the Bank introduced ringgit Bank Negara Interbank Bills Islamic (BNIBI) under the Shariah principle of *murabahah* to complement the existing conventional ringgit Bank Negara Interbank Bills (BNIB) which was introduced in November 2017. Since the introduction, the ringgit BNIB and BNIBI issuances have been well-received as their tradability features offer flexibility for banking institutions to manage their short-term liquidity

needs efficiently. The interbank demand for BNIB and BNIBI was reflected by their pricings which were, on average, 6 basis points lower than other monetary instruments of similar tenures. The Bank gradually increased the issuance of BNIB and BNIBI to accommodate the stronger demand. As at end-2018, the outstanding amount reached RM14.2 billion (7.7% of total outstanding ringgit liquidity absorbed through monetary operations).

Total interbank money market transactions, which comprised both conventional and Islamic instruments of deposits, banker's acceptance (BA) and negotiable instrument of deposits (NID), recorded a marginally higher volume of RM2.4 trillion (2017: RM2.1 trillion). Conventional money market deposits remained the major instrument for liquidity management, representing 59.6% of the total volume traded, followed by Islamic deposits and NIDs.