2014

MONETARY AND FINANCIAL CONDITIONS IN 2014

INTERNATIONAL MONETARY AND FINANCIAL CONDITIONS

Global financial markets in 2014 went through two phases. Throughout most of the first eight months of the year, global financial markets experienced a period of very low volatility, higher valuations across a broad range of asset classes and a compression in spreads. These developments were driven by greater financial risk-taking amidst ample global liquidity, low interest rates and perceptions of reduced policy uncertainty. This, however, subsequently changed, driven by the uncertainty regarding the monetary policy normalisation in the US, the resurgence of concerns over the pace of global growth arising mainly from weaker-than-expected developments in the euro area, and the sharp decline in crude oil and other commodity prices.

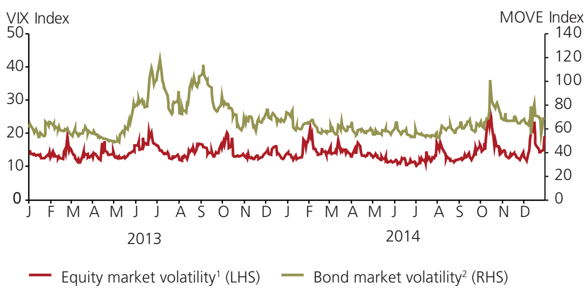
> Global financial markets experienced greater volatility towards the end of the year following concerns on global growth and the sharp decline in commodity prices

The beginning of the year saw global financial markets momentarily affected by growth concerns in the US and unfavourable developments in several emerging market economies. Nonetheless, the set of adverse country-specific factors was transitory. In the second and third quarters, although economic performance across the major economies was uneven, the improving growth prospects and reduced policy uncertainty in several advanced economies supported positive market sentiments. Correspondingly, asset prices increased and bond yields became more compressed. In addition, the environment of low foreign exchange volatility also contributed to the increased attractiveness of carry trades. As a result, net capital inflows to emerging markets were estimated to be about USD52 billion[1] during the second and third quarters. Despite intermittent spikes, the Chicago Board Options Exchange Volatility Index (VIX), a gauge of market volatility, fell in July 2014 to low levels last seen prior to the Global Financial Crisis. Correspondingly, the MSCI Emerging Market Index gained 16.2% while the JP Morgan Emerging Market Bond Index (EMBI) spread narrowed by 83.5 basis points from February to August 2014.

The buoyant financial conditions unravelled in September amidst uncertainties over the timing of the start of interest rate normalisation in the US. Given the intensity of the speculative flows and the search for yield driven by the very easy monetary conditions in the advanced economies, the reversal of these flows and risk aversion was equally intense. In October, the spike in global risk aversion intensified sharply following the downward revision of the growth outlook for some major economies. These developments increased investor nervousness, resulting in sharp readjustments in global financial markets. Consequently, the VIX index more than doubled from 12.7 on 17 September to 26.3 on 15 October, its highest daily level since the height of the euro area sovereign debt crisis at the end of 2011. Approximately 70% of portfolio investment

Chart 2.1

Global Financial Market Volatility



Note: [1]Refers to VIX Index
[2]Refers to Merrill Lynch Option Volatility Estimate (MOVE) Index

Source: Bloomberg

[1] Source: Emerging Market Portfolio Research (EPFR) Global.

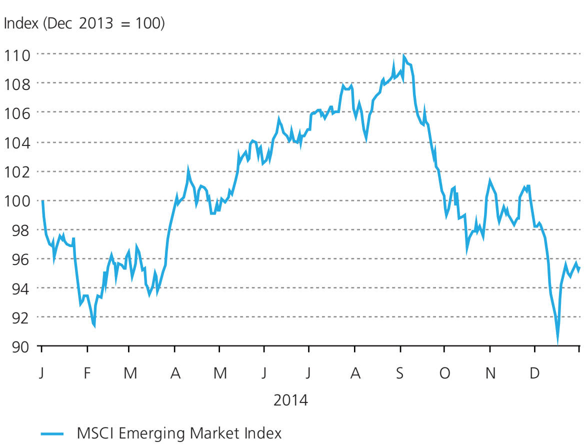
flows into emerging markets since January 2014 reversed over the period 16 September to 22 October. Between 1 September and 16 October, the MSCI Emerging Market Index declined by 10.8% while the JP Morgan EMBI spread increased by 63.1 basis points.

The prices of oil and most other commodities had been falling since June as the rising global supply of these commodities exceeded the slowing demand. However, the further decline in oil prices since 28 November, after OPEC's decision to maintain its target supply, shifted the focus of global investors to the potential impact on the major commodity exporting countries, particularly on their fiscal and external positions. During this period, currencies of oil exporting countries[2] were under depreciation pressures, weakening between 2.3% and 20.0% in the face of significant capital outflows. As a whole, between 28 November and 31 December, the MSCI Emerging Market Index fell further by 5.6% while the JP Morgan EMBI spread increased sharply by 51.7 basis points.

Going forward, the increasing unevenness in the growth across major economies, the expected divergence in the monetary policies of the advanced economies and the uncertain oil prices will continue to cause shifts in global liquidity flows, accompanied by heightened volatility in financial markets and currencies.

Chart 2.2

MSCI Emerging Market Index



Source: Bloomberg

[2] These countries include Algeria, Canada, Malaysia, Mexico, Nigeria, Norway and Russia.

Chart 2.3

JP Morgan Emerging Market Bond Index (EMBI) Spread

Source: Bloomberg

DOMESTIC MONETARY AND FINANCIAL CONDITIONS

Exchange Rate

While the trend of increasing two-way trade and direct investment flows continued, portfolio flows was the primary driver of the ringgit exchange rate during the year. Ringgit movements during the year followed two noticeable patterns. Between February and August 2014, the ringgit was broadly on a strengthening trend due to sustained portfolio inflows. From September, however, the ringgit, along with most regional currencies, faced strong depreciation pressure as investors unwound their holdings of financial assets in the region amidst investor nervousness about a possible change in US monetary policy and signs of weakness in the momentum of global growth.

The period between February and August 2014 saw the global financial markets experience a period of unusually low volatility. This was mainly driven by rising investor confidence following reduced macroeconomic uncertainty and improved global economic outlook, especially in the advanced economies. This, coupled with expectations that low interest rates and ample global liquidity conditions would continue to prevail, attracted international investors into regional financial assets. Domestically, the continued underlying strength of the Malaysian economy, which was reflected in the stronger-than-expected GDP growth in the first half of the year, contributed to the optimism and strong interest in Malaysia's financial assets. Against this backdrop, Malaysia saw non-resident portfolio inflows of RM11 billion in the first three quarters of the year. As a result, the ringgit appreciated against the US dollar by 6.0% between February and August 2014, reaching RM3.1570 against the US dollar by the end of August. During the period, the ringgit appreciation against the US dollar was the largest among regional currencies. Given the extremely low volatility, there was growing concern during this period that the increased risk-taking by global investors and the accompanying rise in global asset prices could increase the vulnerability of the global financial markets to sudden shifts in sentiments.

The ringgit exchange rate was influenced by both domestic and external factors

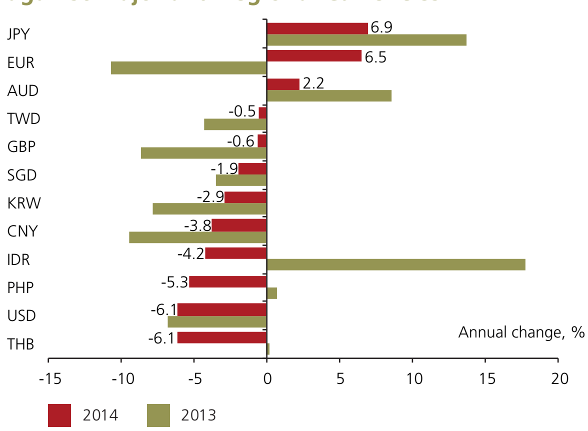
Sentiments started to shift in the September-October period, during which the ringgit, along with other regional currencies, broadly depreciated against the US dollar. The weakening of regional currencies was driven more by developments in the advanced economies than by any specific region or country-related factors. In particular, the developments reflected the strengthening US dollar amid the better economic prospects in the US and the possibility of an increase in US interest rates. For Malaysia, non-resident capital inflows that had accumulated over the first eight months of the year reversed sharply beginning in September. Capital outflows intensified towards the end of November and in early December. This reversal of portfolio flows resulted in the weakening of the ringgit.

For the year as a whole, the ringgit depreciated by 6.1% to end the year at RM3.4950 against the US dollar. The ringgit also depreciated against the pound sterling but strengthened against the euro and Japanese yen. Against regional currencies, the ringgit was broadly weaker. The ringgit's Nominal Effective Exchange Rate (NEER), a measure of ringgit performance against the currencies of Malaysia's major trading partners, however, remained relatively stable with a depreciation of only 0.6%.

Activities in the foreign exchange derivatives market during the year also reflected the shift in investor sentiments since September. The volume was low early in the year, with the average daily volume of foreign currency derivatives standing at USD4.7 billion between February and August 2014. As the financial markets and ringgit exchange rate became more volatile from September onwards, the average daily volume rose to USD5 billion in September-October. Part of the increased activity was driven by local exporters hedging their foreign currency exposures through forward selling of the US dollar, taking advantage of the US dollar appreciation against most other currencies. The increased market volatility and strengthening US dollar increased the overall demand for hedging and resulted in an increase in the cost of borrowing in US dollars through the cross-currency USD/RM swap market.

Chart 2.4

Summary of Malaysian Ringgit (RM) Performance against Major and Regional Currencies

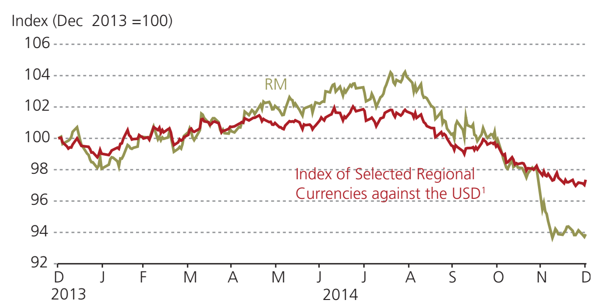


Note: (+) indicates an appreciation of the ringgit against foreign currency

Source: Bank Negara Malaysia

Chart 2.5

Exchange Rate of the Malaysian Ringgit (RM) and Selected Regional Currencies against the US Dollar (USD)



[1] Regional currencies: Chinese renminbi, Indonesian rupiah, Korean won, Philippine peso, Singapore dollar, New Taiwanese dollar and Thai baht. Each currency carries equal weight.

Note: An increase in the index represents an appreciation of the ringgit or of selected regional currencies against the US dollar

Source: Bank Negara Malaysia

The 5-year USD/RM cross-currency swap rates widened from an average of 73 basis points between February and August to 84 basis points in the September-October period.

With the prospect of the Federal Reserve (Fed) starting to normalise its monetary policy amidst continued monetary easing by the European Central Bank and Bank of Japan, the volatility of capital flows, financial markets and exchange rates will continue. Policy measures undertaken to ensure that such capital flow volatility and the corresponding fluctuations in the domestic financial markets and exchange rates do not spill over into the real economy will be a key focus of policy. In this regard, efforts to strengthen domestic buffers and resilience to tolerate larger and more volatile capital flows have become important. For Malaysia, strong domestic fundamentals, greater exchange rate flexibility, adequate levels of international reserves, deeper and more diversified financial markets and a strong banking system, have all been crucial to Malaysia's resilience to bouts of capital flow volatility. Policy flexibility, including the ability to use micro- and macroprudential tools, has also been important in managing the risks associated with such capital flows.

Interest Rates, Bond Yields and Equity Prices

Interest rates rose in 2014 following the Monetary Policy Committee (MPC)'s decision to raise the Overnight Policy Rate (OPR) by 25 basis points in July 2014. Interest rates also adjusted higher during the year as competition in the deposit market further intensified in both the retail and wholesale segments. Depositors were compensated with a higher rate of return on their savings following the increase in the OPR. Reflecting the increase in the cost of funds to banks, the cost of borrowing to the households and businesses were also revised higher. Despite the increase in the borrowing costs, however, monetary conditions continued to be supportive of growth.

Following the 25 basis points increase in the OPR, the transmission to the money and financial markets was rapid. The average overnight interbank rate (AOIR) increased by 22 basis points on 11 July 2014 from 3.00% to 3.22%, with interbank rates of other maturities also increasing. Beyond the influence of the OPR, interbank rates of longer maturities also trended higher. During the year, banks sought to increase their level of stable funding[3] to comply with the phasing in of the new Basel III Liquidity Coverage Ratio (LCR)[4]. The competition for more stable funding was, however, made more intense due to the overall slower growth in deposits due to net external outflows which partly reflects diversification of investments by corporates abroad and portfolio outflows. To increase their level of stable funding for compliance with the LCR, banks competed to attract large corporate deposits by offering higher deposit rates, resulting in shifts in corporate deposits across banks. The banks which experienced a withdrawal of corporate deposits turned to borrowing from the interbank market to replace the loss of funds, bidding up the cost of interbank borrowing. For the year as a whole, the 3-month Kuala Lumpur Interbank Offered Rates (KLIBOR) increased from 3.31% to 3.86%.

A moderation in the 3-month KLIBOR was observed, however, following BNM's announcement on 30 January 2015 on the arrangements to facilitate a smooth transition to the full implementation of the LCR by 2019. These arrangements include broadening the scope of recognition of high-quality liquid assets (HQLA)[5] and further clarification on the treatment of banks' expected cash outflows, which have helped to ease funding pressures.

Rates on interest rate swaps and 3-month KLIBOR futures increased in the first half of 2014 in anticipation of an OPR increase in the second half of the year, and continued to trade higher after the OPR increase in July. These rates, however, moderated towards the end of the third quarter as market expectation for a further OPR increase was tempered by the MPC's decision to maintain the OPR at 3.25% in September.

The rise in the OPR resulted in an upward revision to retail deposit rates, compensating savers with

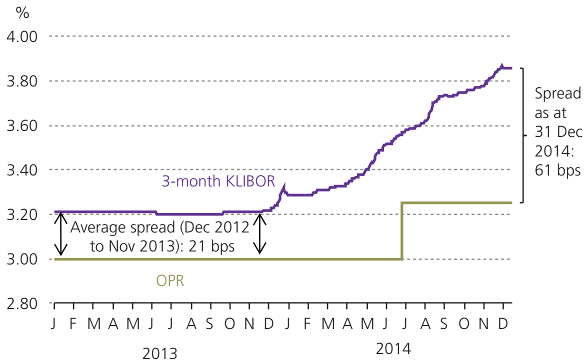
[3] Under the Liquidity Coverage Ratio (LCR), stable forms of funding are those with a low likelihood of withdrawal during episodes of financial stress. Funding which is deemed the most stable are those sourced from retail deposits, followed by corporate deposits, while funding from other financial institutions are most at risk of being withdrawn.

[4] Refer to the Financial Stability and Payment Systems Report 2014 for a detailed discussion on the LCR.

[5] HQLA refers to assets which can be easily and immediately converted into cash at little or no loss of value, even in times of stress. In the case of the Malaysian banking system, HQLA currently comprises mainly of banks' holdings of government securities and deposit placements with BNM.

Chart 2.6

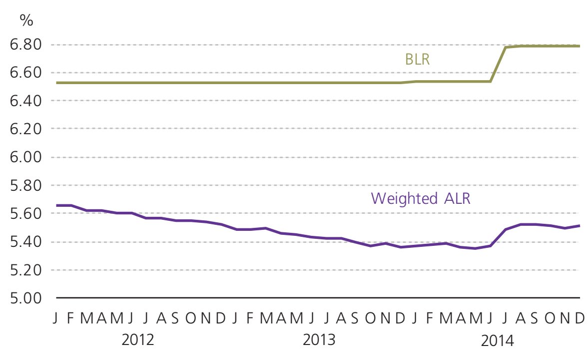
Money and Financial Market Rates



Source: Bank Negara Malaysia and Bloomberg

Chart 2.7

Commercial Banks' Lending Rates (at end-period)



Source: Bank Negara Malaysia

a higher rate of return. The average quoted fixed deposit (FD) rates of commercial banks for the 1 to 12 months tenures rose between 15 to 17 basis points to 3.07% to 3.30% as at end-July. Banks also competed to attract deposits by launching deposit campaigns that offered higher deposit rates for large deposit placements at selected maturities.

The cost of borrowing for households adjusted upwards, reflecting the financial institutions' higher cost of funds. The benchmark lending rate, as measured by the average base lending rate (BLR), increased by 25 basis points to 6.79%. Retail lending rates for the purchase of property and securities adjusted higher by 22 basis points and 25 basis points respectively. Following the implementation of the Risk Informed Pricing, hire purchase rates increased by a larger magnitude, reflecting the enhancement of banks' risk management practices. Lending rates to businesses also adjusted upwards, but by a lower degree, due to intense competition between banks.

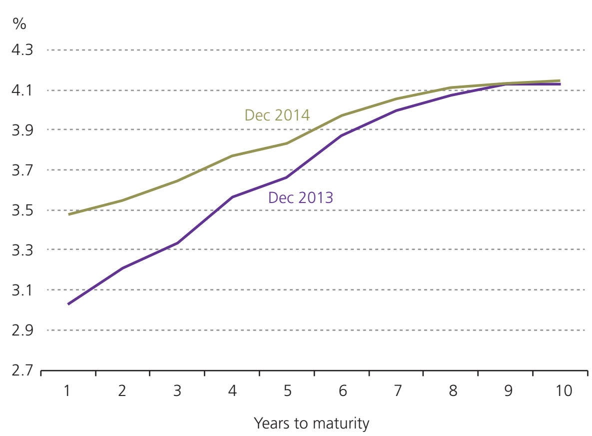
Malaysian Government Securities (MGS) yields were affected by a confluence of domestic and external factors during the year. For the first 11 months, while market expectations and the eventual policy rate increase by the Bank led to upward adjustments at the shorter-end of the MGS yield curve, sustained interest from investors contributed to the downward shift at the longer-end of the MGS yield curve. This downward trend, however, was reversed in December following an increase in the long-term MGS yields.

Yield curve flattened during the year

After a period of relative stability in the earlier part of the year, short-term MGS yields trended upwards beginning May following market expectations of a policy rate increase. Yields continued to increase even after the OPR adjustment in July as market participants were anticipating another increase in the policy rate in September. Short-term yields were stable after the MPC's decision to keep the OPR unchanged in September. Towards the end of the year, however, yields increased as non-resident investors unwound their portfolio investments. For the year as a whole, the 1-year MGS yields increased by 45 basis points.

Chart 2.8

MGS Yield Curve



Source: Bank Negara Malaysia

In contrast, the long-term yields were on a downward trend for the most part of 2014. Portfolio inflows into the domestic bond market during the first three quarters of the year saw the share of non-resident holdings of MGS increase to reach its peak of 48.4% in July (end-December 2013: 44.9%)[6]. As a result, despite the 25 basis points increase in the OPR in July, the 10-year MGS yield declined by 25 basis points[7] between January and July 2014. In addition, there was also an increase in MGS holdings by resident investors, namely financial institutions, in anticipation of Basel III requirements which further contributed to the decline in long-term yields in the first 11 months. Nevertheless, 10-year MGS yield increased in mid-December as resident investors consolidated their investment position towards the end of the year. The 10-year MGS yield increased by 29 basis points in December. For the year as a whole, the 10-year MGS yields increased by only 2 basis points.

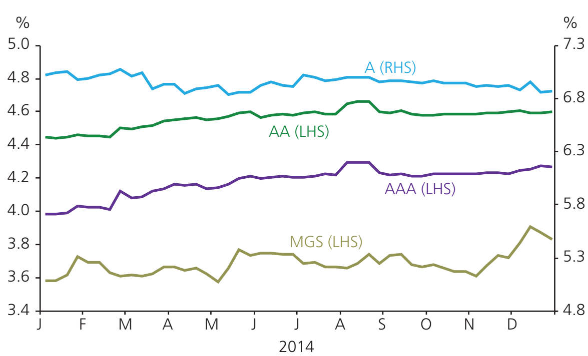
Chart 2.9

MGS Yields

Source: Bank Negara Malaysia

Chart 2.10

5-year MGS and 5-year PDS Yields



Source: Bank Negara Malaysia

In the private debt securities (PDS) market, yields were broadly higher, reflecting the change in the OPR. Yields on the 5-year AAA and AA-rated papers increased by 31 and 20 basis points respectively during the year. Total new issuances of PDS[8] amounted to RM117.3 billion in 2014 (2013: RM117.9 billion). Of note, the domestic market saw the issuance of the largest renminbi bond in South East Asia amounting to RMB1.5 billion which was oversubscribed by 3.1 times. Additionally, during the year, the PDS market saw the issuance of a sukuk by the first Islamic bank from Turkey amounting to RM3.0 billion.

PDS yields remained supportive of private sector financing

Like the bond market, the performance of the domestic equity market also followed two noticeable trends during the year that largely reflected changes in the global environment. The domestic equity market was generally on an upward trend between February and mid-July given the positive global and domestic sentiments. Against the background of low global financial market volatility, low interest rates in the major economies and ample global liquidity, international investors were attracted to the domestic equity market by the positive earnings prospects amid the strong domestic macroeconomic performance. During the period, the share of non-resident holdings of the domestic equity market increased to 24.1% in July (end-2013: 23.9%). Strong demand from non-residents was reinforced by resident investors, resulting in the FTSE Bursa Malaysia Kuala Lumpur Composite Index (FBM KLCI) reaching its new historical peak of 1,892.7 points on 8 July 2014, an increase of 6.4% from February.

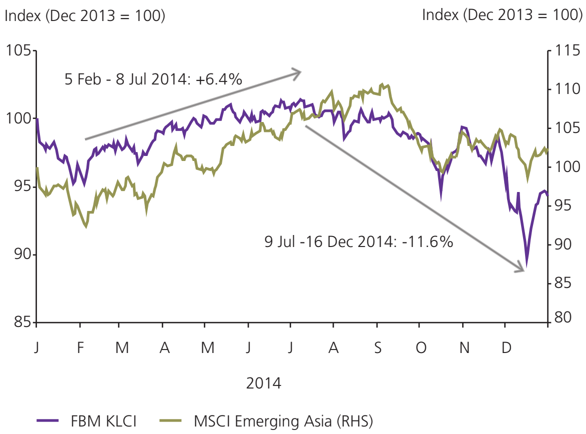
[6] As at end 2014, non-resident holdings of total government securities amounted to 28.0%. Total government securities include Malaysian Government Securities (MGS), Government Investment Issues (GII), Treasury bills and *Sukuk Pinjaman Perumahan Kerajaan (SPPK)*.

[7] The decline in the spread between 10-year MGS yield and the OPR was therefore 50 basis points over January to July 2014.

[8] Refers to securities issued in Malaysia by both local and foreign companies which can be either short-term, medium-term or long-term papers in Conventional or Islamic principles.

Chart 2.11

Equity Market Indices



Source: Bloomberg

The rally in the domestic equity market subsequently reversed due to rising global uncertainties and, to some extent, domestic developments. The upward trend was initially interrupted by the Malaysia Airlines flight MH17 incident which affected investor sentiments. Additionally, the market was also affected by disappointing second quarter corporate earnings, particularly in the plantation sector, in view of the weak crude palm oil prices. The downward trend was further weighed down by profit-taking and the unwinding of portfolio investments by non-resident investors from regional equity markets, including Malaysia.

Sentiments in the domestic equity market were largely affected by external factors

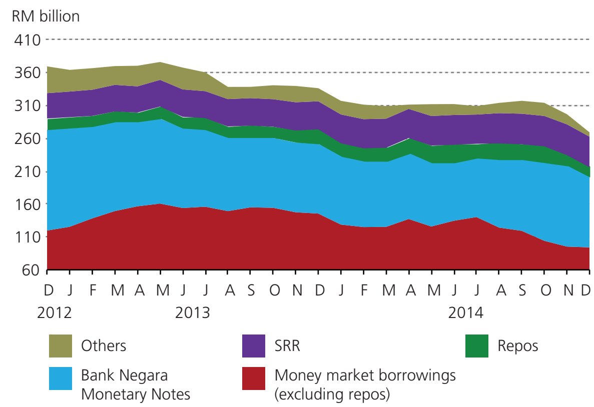
Towards year-end, sentiments in the domestic equity market were also affected by the sharp decline in oil prices. Concerns over the impact of lower oil prices on the domestic economy led to a sell-off in the domestic equity market. The oil and gas sector was particularly affected amid concerns that lower oil prices would lead to lower corporate earnings and investments. The index declined by 11.6% from its peak to reach its lowest level for the year at 1673.9 points on 16 December 2014. For the year, the FBM KLCI declined by 5.7% (2013: +10.5%) to close at 1761.3 points. As at end-December 2014, the FTSE Bursa Malaysia's market capitalisation stood at RM1.65 trillion (2013: RM1.70 trillion).

Liquidity and Monetary Aggregates

In 2014, aggregate outstanding liquidity placed with Bank Negara Malaysia remained high despite the net withdrawal of liquidity due to net outflows from the external sector. At the individual bank level, most banking institutions continued to operate within surplus liquidity positions.

Chart 2.12

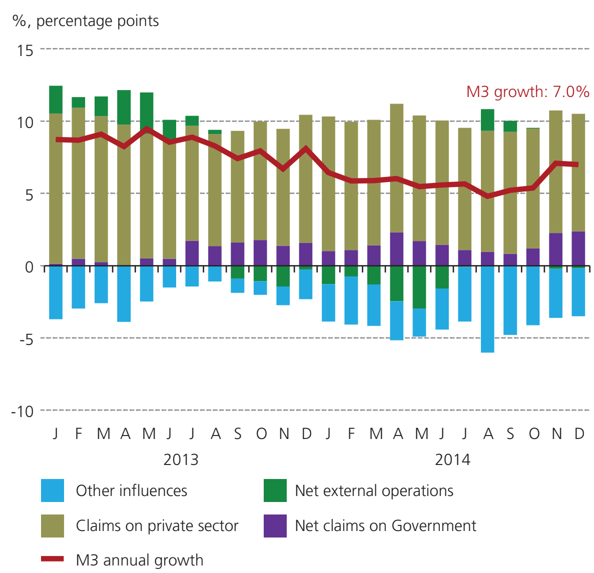
Outstanding Liquidity Placed with Bank Negara Malaysia (at end period)



Source: Bank Negara Malaysia

Chart 2.13

Contribution to M3 Growth



Source: Bank Negara Malaysia

Throughout the year, Bank Negara Malaysia's operations were focused on maintaining stability in the interbank money market. During periods of outflows, the large placements with Bank Negara Malaysia served as a liquidity buffer for the banking system as the contractionary pressure on liquidity was offset by the net release of funds lent to the Bank.

Given the net external sector outflows, private sector liquidity, as measured by broad money (M3), grew at a more moderate pace of 7.0% during the year (2013: 7.9%). The moderation in M3 growth was also partly due to the slower growth in bank lending to households.

FINANCING OF THE ECONOMY

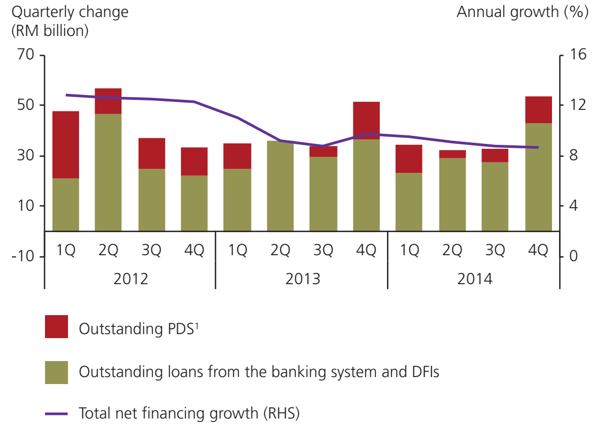
For the year as a whole, the growth in net financing through the banking system, development financial institutions (DFIs) and the private debt securities (PDS) market expanded at an annual rate of 8.7% in 2014 (2013: 9.7%; average over 2006-2013: 10.7%). Financing to businesses remained healthy with higher growth in outstanding loans to businesses. The growth in outstanding loans to households continued to moderate as intended following measures to ensure prudent levels of household debt.

Financing to the private sector remained healthy with higher growth in outstanding loans to businesses

The growth of outstanding business loans[9] was higher at 9.0% with continued double-digit growth in SME loans of 13.3% in 2014 (2013: 7.9% and 12.7% respectively). This was despite the faster pace of growth in loan repayments relative to loan disbursements between January and August 2014. The level of loan disbursements, including to SMEs, remained robust (monthly average in 2014: RM65.6 billion; 2013: RM55.3 billion) moving in tandem with the growth in domestic demand. The increase in loan disbursements was broadly distributed across various sectors, particularly to the *wholesale and retail trade, restaurants and hotels; manufacturing;* and *finance, insurance and business services* sectors.

Chart 2.14

Total Net Financing to the Private Sector through the Banking System, DFIs and PDS Market



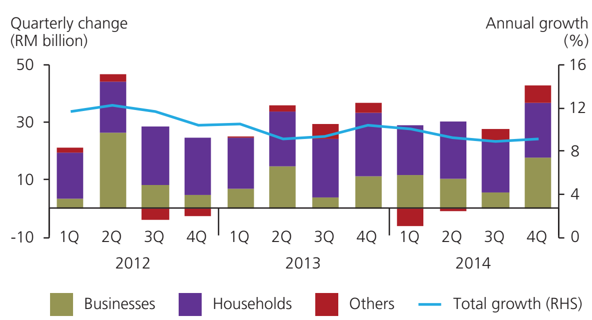
[1]Excludes issuances by non-residents, Cagamas, and of short-term papers

Source: Bank Negara Malaysia

Demand for funding from the capital market[10] also remained robust with the bond market continuing as a key source of financing for the private sector. New PDS issuances[11] amounted to RM82.1 billion in 2014 (2013: RM82.1 billion) with issuances mainly from the *finance, insurance, real estate and business services* sector. A substantial portion was also raised by businesses, including public enterprises, for working capital and project financing purposes. Financing via the equity market amounted to RM19.2 billion in 2014 (2013: RM16 billion), with two large rights issuances from corporations in the *finance* and *trading and services* sectors.

Chart 2.15

Outstanding Loans by Borrowers[1]



[1] Comprises banking system and DFI outstanding loans

Source: Bank Negara Malaysia

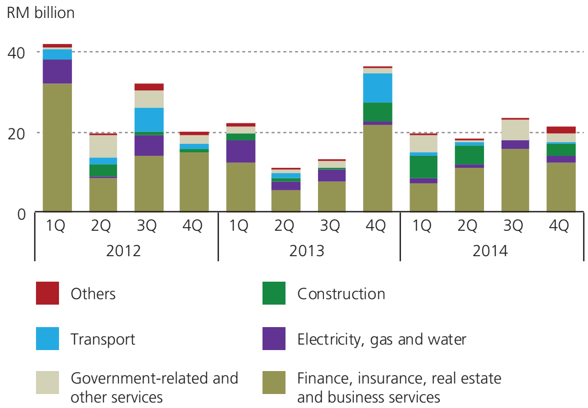
[9] Includes outstanding loans of public enterprises, but excludes outstanding loans of domestic banking institutions, domestic non-bank financial institutions, Government, domestic other entities, and foreign entities with the banking system and DFIs.

[10] Includes funds raised by domestic banking institutions and non-bank financial institutions.

[11] Excludes PDS issuances by non-residents, Cagamas and of short-term papers.

Chart 2.16

Gross PDS Issued by Sector[1]



[1] Excludes issuances by non-residents, Cagamas, and of short-term papers

Source: Bank Negara Malaysia

The growth in the outstanding loans of the banking system and DFIs to households, and the overall growth in household debt[12] moderated during the year (2014: 9.8% and 9.9% respectively; 2013: 11.6% and 11.5%). This was attributable to the pre-emptive macro- and microprudential measures implemented by the Bank since 2010 and the Risk Informed Pricing guidelines introduced in March 2014. The moderation was observed across household loans[13] for most purposes, particularly loans for the *purchase of passenger cars* and *securities*, and for *personal use*.

The growth in *residential property* loans, however, increased slightly to 13.2% in 2014 (2013: 12.9%), reflecting the continued disbursement in stages of previously approved loans. The growth in new approvals of *residential property* loans to households moderated significantly to 4.2% in 2014 (2013: 26.8%) reflecting the lower growth in loan applications during the year, in part due to the increase in the real property gains tax (RPGT) and the prohibition of developer interest bearing schemes (DIBS) by the Government in January 2014. These measures contributed to a moderation in credit-driven speculative purchases in the property market which was further evidenced by the lower growth in the number of household borrowers with more than three housing loan accounts.

[12] Comprises outstanding household loans extended by banks and non-banks (DFIs, other non-bank financial institutions, Treasury Housing Loans Division, insurance and stockbroking companies).

[13] Includes outstanding household loans with the banking system and DFIs, but excludes loans extended by other non-banks.