Promoting Monetary Stability

In our role of promoting monetary stability, the Bank seeks to implement a monetary policy that maintains a low and predictable pace of increase in the general level of prices of goods and services, taking into consideration economic developments and the outlook. Ultimately, the aim is to promote monetary stability that is conducive to the sustainable growth of the Malaysian economy.

Decisions on monetary policy are made autonomously by the Monetary Policy Committee (MPC), which meets six times a year.[1] The Bank undertakes monetary operations[2] to implement the decisions of the MPC.

Monetary policy in 2020

The outbreak of the COVID-19 pandemic in early 2020 initially began as a health crisis that later brought about an unprecedented economic crisis. Most economies globally were confronted by both supply and demand shocks following the measures imposed to contain the pandemic. Global production, demand and travel activities were severely disrupted, while heightened risk aversion among global investors led to financial market volatility. Substantial policy stimuli introduced by many economies, however, partially mitigated the economic impact of the pandemic.

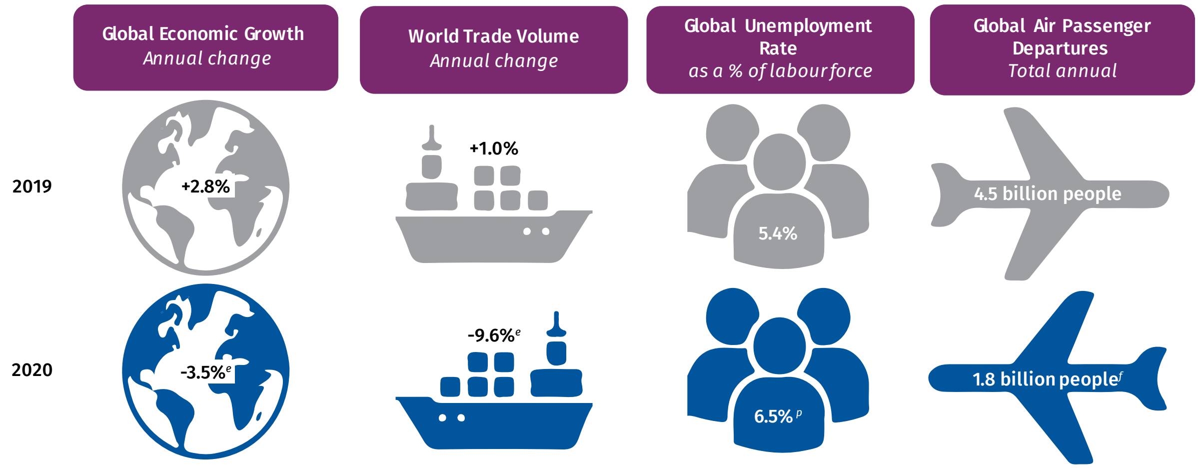
Malaysia was similarly affected by the pandemic. Widespread containment measures, international border closures and the consequent weak external demand environment exerted a large drag on domestic economic activity. Containment measures in the form of movement control orders and standard operating procedures (SOPs), while necessary to contain the spread of the virus, constrained domestic production and spending. Consequently, labour market conditions weakened considerably. Fiscal stimulus measures, alongside monetary and financial measures, however, provided support to the economy. Overall, Malaysia's GDP growth contracted by 5.6% in 2020 (2019: +4.3%). Meanwhile, inflationary pressures were muted with average headline inflation turning negative for the year at -1.2% (2019: +0.7%) due mainly to the substantially lower global oil prices during the year. However, Malaysia was not experiencing deflation as the decline in prices was neither persistent nor broad-based.

At each MPC meeting, the Committee decides on whether the current level of the Overnight Policy Rate (OPR) – the sole indicator of the monetary policy stance – is at the appropriate level to safeguard price stability while supporting economic activity. As the effect of monetary policy action normally takes three to four quarters to most significantly affect the economy, the MPC, in making its decisions, assesses and deliberates on the outlook for both domestic economic growth and inflation. The Bank's staff facilitate this process by presenting their surveillance analysis, simulation results, scenario analysis, research findings and forecasts to the MPC. The MPC also takes into consideration the risks that financial imbalances may pose to the broader economy.

[1] More information on Malaysia's monetary policy and the MPC can be found in the 'Governance' section of this report.

[2] Monetary operations are discretionary market operations and the main mechanism through which the Bank adjusts liquidity in the banking system. This is done by absorbing or adding liquidity via various types of instruments to achieve its operating target, the average overnight interbank rate (AOIR). More information on the various instruments used can be found in the 'Monetary Operations' section of the Bank's website.

Chart 1: Snapshot of Disruptions to Global Economic Growth, Trade, Labour Markets and Travel Arising from the COVID-19 Pandemic



e Estimate

p Preliminary

f Forecast

Source: International Monetary Fund (IMF), International Labour Organisation (ILO) and International Air Transport Association (IATA)

In 2020, the MPC reduced the OPR by a cumulative 125 basis points from 3.00% to 1.75% at four MPC meetings held in January, March, May and July 2020. At 1.75%, the OPR is at its historical low. The reductions in the OPR were intended to provide appropriate support to economic activities. This was particularly the case at the onset of the pandemic, which brought about the need to cushion its impact on businesses and households. Amid a decline in economic activity, the OPR reductions helped to ease debt servicing burdens and thus cash constraints for households, small and medium enterprises (SMEs), and corporates. The lower interest rates also reduced the cost of financing and lent support to new credit expansion and fund-raising activity. The policy stimulus from the significant OPR reductions in 2020 are expected to continue to have a positive impact on the economy in 2021.

These OPR adjustments complemented other monetary and financial measures undertaken by the Bank, as well as fiscal measures implemented by the Government, in mitigating the economic impact of the pandemic and supporting the economic recovery. At the last two meetings of the year in September and November 2020, the MPC kept the OPR unchanged. The MPC assessed that the domestic economy was on a recovery path and that the accommodative monetary policy remained appropriate. Additionally, the MPC stressed the need for demand management measures to be complemented with supply-side and structural policies. This is important to ensure the economic recovery will be sustained post-pandemic.[3]

For monetary policy decisions to have the intended impact on economic activity, the Bank undertakes monetary operations focused on ensuring that there is a sufficient level of liquidity in the banking system so that the average overnight interbank rate (AOIR) remains around the OPR. This, in turn, influences the level of other interest rates in the economy, such as deposit rates, lending rates and bond yields, which affect savings and spending decisions of households and businesses. The Bank uses various instruments in its monetary operations such as unsecured borrowings and repos of various short-term tenures to ensure that there is sufficient liquidity in the domestic financial markets to support financial intermediation[4] in the economy.

During the year, particularly at the onset of the crisis, global and domestic financial markets experienced heightened risk aversion and uncertainty, which

[3] Greater detail on the analysis underpinning the MPC's decisions can be found on the Bank's website in the Monetary Policy Statements, the BNM Quarterly Bulletins, as well as Chapter One of the Economic and Monetary Review 2020.

[4] Financial intermediation refers to transactions between lenders, savers and borrowers, or investors and firms in financial markets.

Chart 2: Key Domestic Figures at a Glance

2019		2020
4.3%	Real GDP Growth (Annual change)	-5.6%
0.7%	Headline Inflation (Annual change)	-1.2%
3.00%	Overnight Policy Rate (OPR)	1.75%
3.00%	Statutory Reserve Requirement (SRR)	2.00% With flexibility for banking institutions to use MGS and MGII to comply with the SRR until 31 May 2021 (which has been extended until 31 December 2022*)

* Effective 20 January 2021

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

resulted in periodic episodes of volatile financial conditions and capital flows. To preserve orderly financial market conditions and support financial intermediation activity, the Bank injected a total of RM63.6 billion worth of liquidity into the domestic financial markets through the outright purchases of Government securities[5], reverse repos and adjustments to the Statutory Reserve Requirement (SRR). The SRR was adjusted in March and May 2020, which saw the SRR ratio reduced from 3.00% to 2.00%, along with the temporary flexibility provided to all banking institutions to use Malaysian Government Securities (MGS) and Malaysian Government Investment Issues (MGII) to comply with the SRR.

[5] This includes Malaysian Government Securities (MGS) and Malaysian Government Investment Issues (MGII).

The ringgit exchange rate

Another key role of the Bank is to maintain the efficient and effective functioning of the foreign exchange market. The ringgit exchange rate plays an important role in the economy, as it affects, among others, the prices of our exports, imports and level of foreign currency debt. Malaysia continues to maintain a flexible exchange rate policy for the ringgit. This means that the ringgit exchange rate is predominantly determined by market demand and supply. This flexibility in the ringgit exchange rate plays an important role in ensuring that the economy is able to withstand external shocks by facilitating the appropriate adjustments in the country's international economic and financial transactions.

Nevertheless, as a highly open economy that faces large cross-border capital flows, this flexibility can at times lead to considerable volatility in the ringgit exchange rate, particularly when investors react to major global and domestic developments. Therefore, the Bank continues to ensure that movements in the exchange rate are not excessive so as to not disrupt domestic economic activity such as trade and investments. The Bank also supports the orderly functioning of the domestic foreign exchange market by ensuring there is sufficient liquidity at all times through our two-way foreign exchange interventions.

Analysis and research

Rigorous analytical surveillance and research on short-term and longer-term issues, including from the Bank's regional offices, support the MPC in formulating its monetary policy decisions.

A key focus for the Bank in 2020 was analysing how the pandemic and the consequent health and policy measures imposed both globally and domestically affected the economy, prices, employment and access to financing. The analysis was also crucial in assessing the strength of the expected recovery. The Bank faced unique and considerable challenges due to the rapidly changing nature of the public health crisis. Growth forecasts were consequently highly dependent on developments and key assumptions surrounding the course of the pandemic and the policy reactions of authorities worldwide. New high-frequency data and indicators such as mobility indicators, online credit card transactions and the usage of online delivery platforms for groceries and essentials were used to gauge the impact of containment measures and the pace of economic recovery.

Some of the key research undertaken by staff included assessing the channels and propagation of the pandemic through economies, and analysing the fiscal, monetary and financial policy responses globally.[6] To better understand the impact of the pandemic on inflation dynamics, staff also evaluated some of the ways that inflation was affected in the immediate term, and provided a preliminary assessment on how structural changes in the economy arising from the pandemic could have a longer-term impact on inflation.[7] Given the negative headline inflation experienced during the year, staff assessed the criteria that would constitute a deflationary environment.[8,9] Extending this analysis further, staff constructed a framework to identify items in the Consumer Price Index (CPI) basket that would be most vulnerable to price changes in the event of a resurgence in the pandemic, in order to better assess potential deflationary risks.

The Bank also evaluated the transmission of the OPR reductions to the domestic financial markets, the banking system, the economy and inflation. Additionally, given the low interest rate environment globally, research surrounding the effective lower bound (ELB) was conducted in order to assess the Bank's monetary policy space.[10]

Joint Policy Committee (JPC) meetings are held in order to holistically assess issues that pose implications to both monetary and financial stability. The JPC met during the year to consider an in-depth assessment on the impact of the pandemic on banks' asset quality and lending activity, as well as their potential implication for the recovery and growth prospects of the economy. Particular attention was given to assessing potential risks of rising gaps in the demand and supply of credit resulting from changes in both the borrowing and lending appetites and behaviour.

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6 Refer to the First Quarter 2020 BNM Quarterly Bulletin box article titled 'Crises and Policy: COVID-19 Truly is Different' on the Bank's website for the analysis.
7 Refer to the Second Quarter 2020 BNM Quarterly Bulletin box article titled 'COVID-19: Impact on Inflation' on the Bank's website for the analysis.
8 Deflation is defined as the persistent and pervasive decline in prices.
9 Refer to the Third Quarter 2020 BNM Quarterly Bulletin box article titled 'Understanding Deflation' on the Bank's website for the analysis.
10 Refer to the Box Article titled 'Asset Purchases by Central Banks' in the Economic and Monetary Review 2020 for the analysis.

During the year, the Bank continued to provide advisory support to the Government in navigating the economy through the crisis. The Governor is a member of the Economic Action Council (EAC), and the Bank participated in selected policy groups that focused on a range of economic priorities, including the formulation of the Twelfth Malaysia Plan (*Rancangan Malaysia Kedua Belas*, RMKe-12). In mitigating the impact of the pandemic on growth, the Bank was actively involved in proposing short to medium-term policy responses in order to protect the lives and livelihoods of Malaysians. Furthermore, as the financial advisor to the Government, the Governor is also a member of the Fiscal Policy Committee (FPC), which is responsible for strengthening public finances and preserving long-term fiscal sustainability. In addition, the Bank provided support on strategies to preserve the country's sovereign ratings.

The Bank also intensified its research on longer-term and structural issues facing the economy, focusing in particular on priorities to mitigate permanent scarring effects from the crisis and build the resilience and agility of the economy going forward. Major areas of work included strategies to promote more sustainable and inclusive growth, the continued need to reform investment policy and incentives, renewed urgency for holistic reforms in the labour market, and the need to increase digitalisation efforts.[11]

Communication and outreach

Despite movement restrictions and physical distancing requirements, the Bank's engagements with the public, media, economists and financial market participants on economic and financial market issues continued uninterrupted during the year, primarily through online platforms. Press conferences for the release of the Bank's Annual Report 2019, Economic and Monetary Review 2019, the Bank's Quarterly Bulletins and other engagements were conducted virtually. Previous efforts to increase the Bank's online presence allowed for the continued seamless sharing of information, assessments and analyses. In light of heightened uncertainties due to the pandemic, the Bank also intensified engagements with financial institutions, firms, members of industry, foreign direct investors and other central banks, including via the Bank's regional offices, to exchange views on economic, price and financial conditions, so that the Bank's assessments would be robust and well-informed.

The Bank's publications continued to provide timely and comprehensive information on monetary policy and economic analysis. The Monetary Policy Statement (MPS) provides the MPC's assessment on the economic outlook and the rationale behind the Committee's decisions. The Monthly Highlights provide monthly updates on economic, monetary and financial developments. Further in-depth economic analysis is published in the Bank's Quarterly Bulletins. The Bank's Annual Report 2019 was refreshed to be more accessible to the general public while the Economic and Monetary Review was launched in 2020 as a dedicated technical publication to share the Bank's assessments and outlook on the economy.[12] In line with the trend of embracing more digital forms of communication, content is also disseminated through social media platforms.

Going forward

In 2021, amid continued uncertainty surrounding the pandemic globally and domestically, the Bank will continue to deploy policies that will facilitate the pace and sustainability of the economic recovery. In this regard, monetary policy assessments by the MPC will be data-driven, as incoming information on economic and monetary developments will be crucial in ensuring that monetary policy remains accommodative to provide the necessary support to the economy. Monetary operations will continue to be directed at ensuring sufficient liquidity in the foreign exchange, bond and money markets, as well as complementing other policies by the Bank to ensure the orderly functioning of domestic financial markets and uninterrupted financial intermediation. The Bank will also continue to provide advice to the Government on appropriate policy measures to see Malaysia through a post-pandemic recovery and further strengthen the country's resilience for the future.

[11] Refer to the Box Article titled 'Getting the Great Reset Right: Structural Labour Market Issues in the Post-COVID World' in the Economic and Monetary Review 2020 for the analysis.

[12] The Monetary Policy Statements, Monthly Highlights, BNM Quarterly Bulletins, BNM Annual Report 2019 and Economic and Monetary Review 2019 can be found on the Bank's website.