

2014

MONETARY POLICY IN 2014

- 55 Monetary Policy
- 57 Monetary Operations
- 61 *Box Article: Financial Imbalances and Policy Responses in Malaysia*

MONETARY POLICY IN 2014

MONETARY POLICY

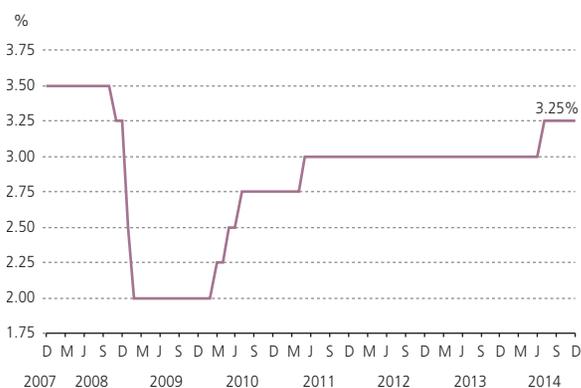
The Monetary Policy Committee (MPC) adjusted the degree of monetary accommodation by raising the Overnight Policy Rate (OPR) by 25 basis points to 3.25% on 10 July 2014, amid firm growth prospects and with inflation projected to remain above its long-run average. The normalisation of monetary conditions also aimed at mitigating the risk of a build-up of financial imbalances that could undermine the growth prospects of the Malaysian economy. Notwithstanding the increase in the OPR, monetary conditions continued to remain supportive of economic activity during the year.

The OPR was raised to 3.25% in July 2014 amid firm growth prospects and expectations of inflation remaining above its long-run average

Since the monetary policy stance was last adjusted in May 2011, the Malaysian economy had continued to experience sustained growth. Despite the challenging external environment, the domestic economy recorded steady growth,

Chart 3.1

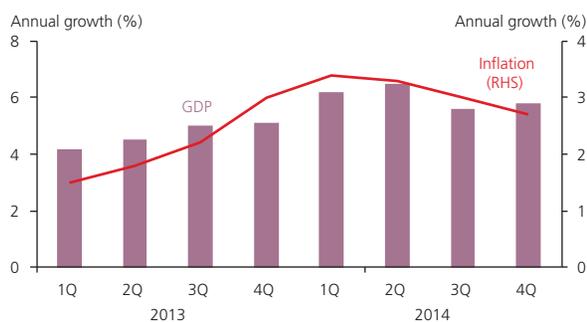
Overnight Policy Rate (OPR)



Source: Bank Negara Malaysia

Chart 3.2

GDP and Inflation



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

driven mainly by domestic demand. In light of this improved growth performance and with the prospects for the domestic economy continuing on a steady growth path in 2014, monetary policy was assessed to be considerably supportive of the economy. Thus, the MPC at the beginning of the year recognised the need for an adjustment in the degree of monetary accommodation. This recognition also took into account the ongoing concerns about the risks of broader financial imbalances given the extended period of relatively low and unchanged interest rates. The key consideration was, therefore, in identifying the appropriate timing for the adjustment, taking into consideration the ongoing assessment of the balance of risks to the outlook for growth and inflation.

In early 2014, the Malaysian economy was projected to continue on a steady growth path. Net exports growth was expected to improve, in line with the positive outlook for global growth. Domestic demand would remain the main driver of growth, supported by robust investment, particularly private investment. Private consumption growth was expected to trend towards its long-term average after experiencing above-trend growth during the previous years. By May 2014, the expectation was for growth in 2014 to be at the upper end of the initial forecast of 4.5% – 5.5%. Nevertheless, the MPC recognised that downside risks to growth

remained, particularly in relation to the risk of a moderation in private consumption growth and weaker external demand.

There were greater upside risks to inflation, which was expected to trend above its long-run average of 3% in 2014 and 2015. The higher inflation would be driven mainly by domestic cost factors, namely the upward adjustments in retail fuel prices, electricity tariffs as well as the implementation of the Goods and Services Tax (GST) in 2015. However, the risk of excessive spillovers arising from these adjustments to administered prices was deemed to be relatively small given the more moderate domestic demand and subdued global price pressures that were expected to prevail over the remainder of 2014 and into 2015. The increase in inflation was, therefore, assessed to be temporary, with inflation projected to decline to below its long-run average in 2016.

Amid the firm growth outlook, and with inflation expected to remain above its long-run average, the MPC decided to adjust the degree of monetary accommodation at the July 2014 MPC meeting. The normalisation of monetary conditions also took into consideration the need to mitigate the risk of a broader build-up of financial imbalances that could undermine medium-term growth prospects. While the implementation of macro and microprudential measures were having the desired moderation in the growth of household indebtedness, the MPC assessed that the sustained period of unchanged and low interest rates was creating an environment of understating risks and had the potential of incentivising broader financial imbalances.

Table 3.1

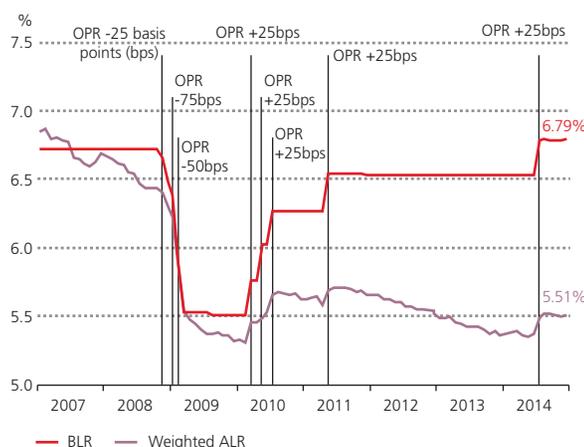
MPC Meetings and Policy Decisions in 2014

MPC Decision Dates	OPR	
	Change	Level (%)
29 Jan 2014	-	3.00
6 Mar 2014	-	3.00
8 May 2014	-	3.00
10 Jul 2014	+ 25 basis points	3.25
18 Sept 2014	-	3.25
6 Nov 2014	-	3.25

Source: Bank Negara Malaysia

Chart 3.3

Base Lending Rate and Weighted Average Lending Rate of Commercial Banks



Source: Bank Negara Malaysia

The adjustment in the policy rate occurred smoothly without disruption to the financial system and the broader economy. Retail lending rates adjusted quickly to the change in the OPR, with the average base lending rate (BLR) of commercial banks being raised by 25 basis points to 6.79% by end-August 2014. Depositors were also compensated with higher rates of return on their savings, with the average quoted fixed deposit (FD) rates of commercial banks for the 1 to 12 month tenures increasing by between 15 to 17 basis points to a range of 3.07% and 3.30% as at end-July 2014.

In the latter part of the year, the sustainability of external demand became more uncertain following rising concerns over the prospects of the global economy. Global growth continued to be uneven, with increasing evidence of weaker-than-expected growth momentum in a number of major economies. In addition, the marked increase in global financial market volatility beginning in September 2014 and the sharp decline in oil prices towards the end of the year further heightened the downside risks emanating from the external environment. The MPC, therefore, assessed that there was a need to establish greater certainty on the outlook for domestic growth.

As for inflation, despite a number of price adjustments, there was limited evidence of any pervasiveness in price increases. The absence of

external price pressures and the more moderate demand conditions were also expected to mitigate the impact of cost-push inflation. Nevertheless, inflation was expected to be above its long-run average. The MPC, therefore, remained vigilant to any upside risks to inflation, arising from possible second-round effects and changes in inflation expectations.

Given the evolving economic and financial environment, and the uncertainty it created around the inflation, and particularly, the growth outlook, the MPC was of the view that maintaining monetary conditions at their prevailing level was warranted. The MPC would also continue to monitor the risks of destabilising financial imbalances. In addition, the increase in the OPR in July 2014 had served as a warning against excessive risk-taking by sending the message that the interest rate outlook may not always be benign.

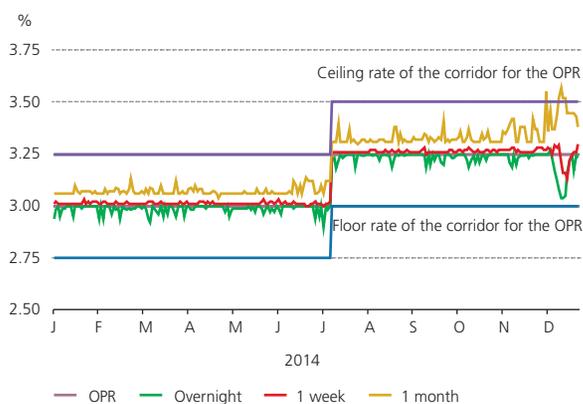
MONETARY OPERATIONS

The average overnight interbank rate (AOIR) remained stable around the OPR with an average deviation of 2 basis points. The AOIR traded between 2.90% to 3.00% before the OPR adjustment on 10 July 2014 and trended upwards to reach 3.27% in the subsequent months. Reflecting the increase in the OPR, the AOIR increased on 11 July 2014 from 3.00% to 3.22%.

During the year, interbank rates were influenced by market expectations for and the eventual increase in the OPR. These developments provided an early impetus for the rising trend in interbank

Chart 3.4

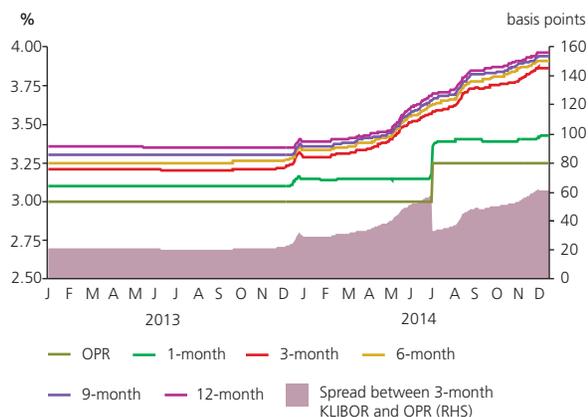
OPR and Interbank Rates



Source: Bank Negara Malaysia

Chart 3.5

KLIBOR Rates



Source: Bloomberg and Bank Negara Malaysia

rates witnessed in 2014. In addition, for interbank rates with tenures above 1-month, the uptrend in rates continued until the end of the year despite the unchanged OPR after July 2014. This reflected the bidding up of interbank rates by banks as they experienced lower growth in deposits amid intense competition for stable funding. The competition for stable funding was to comply with the phasing in of the new Basel III regulatory liquidity requirements, amid overall slower growth in deposits due to net capital outflows. As at end-December 2014, the spread between the 3-month Kuala Lumpur Interbank Offered Rate (KLIBOR) and OPR widened by 61 basis points, above the average spread over the December 2012 to November 2013 period of 21 basis points.

Total interbank money market transactions, which comprised deposits and acceptances, banker's acceptance (BA), and negotiable instrument of deposits (NID) in both the conventional and Islamic money markets, recorded a marginal increase in volume to RM3.2 trillion (2013: RM3.1 trillion). Among the instruments, conventional deposits, which were unsecured borrowing and lending, was the main instrument traded and contributed 68.3% of the total volume. Aggregate surplus liquidity in the system declined from RM336.8 billion as at end-2013 to RM269.9 billion at the end of the year due to capital outflows, particularly in the fourth quarter following expectations for interest rate normalisation by the Federal Reserve amid the recovery in the US economy and heightened concerns over the impact of the sharp fall in oil prices on the Malaysian economy.

Chart 3.6

Conventional Interbank Money Market Transactions

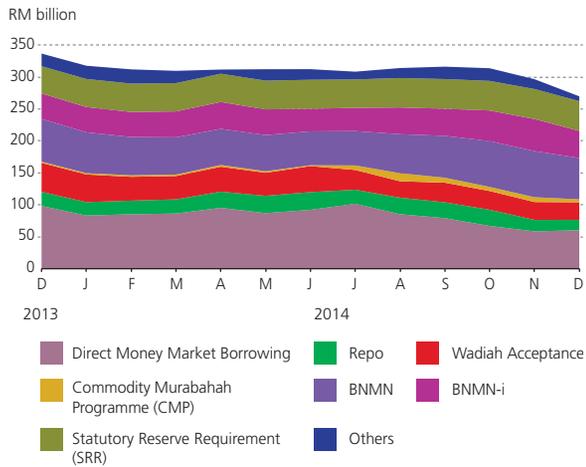


Source: Bank Negara Malaysia

Despite the decline in aggregate surplus liquidity, liquidity conditions remained ample at the system-wide level to support efficient intermediation and orderly market adjustments. The variety of monetary instruments available for the liquidity management of the banking system accorded flexibility to the Bank in meeting market expectations and liquidity needs. Amid rising yields on market expectations for an increase in the OPR, higher issuances of Bank Negara Monetary Notes (BNMNs), especially from July 2014 to October 2014, were undertaken to meet the strong market demand, including that of the non-resident portfolio investors. Consequently, total outstanding BNMNs rose from

Chart 3.8

Outstanding Liquidity Placed with Bank Negara Malaysia

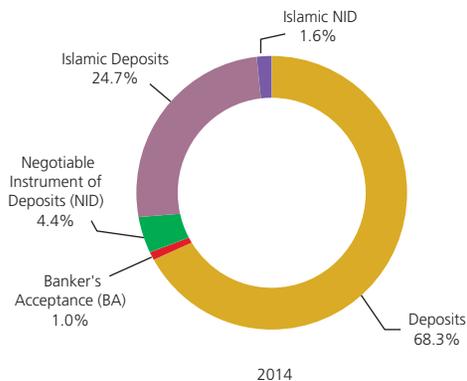


Source: Bank Negara Malaysia

RM106.7 billion as at end-2013 to RM122.4 billion by November 2014, in which non-resident holdings accounted for more than half of the total outstanding BNMNs. In December 2014, in response to the weak demand for BNMNs amid capital outflows, the issuances of BNMNs were adjusted accordingly and total outstanding BNMNs fell to RM107.1 billion at the end of the year. Given the volatility in the global financial markets during the year, BNMNs have been an effective tool in managing domestic liquidity arising from short-term capital flows. In particular, the ability to issue BNMNs to absorb excess liquidity during periods of large inflows and subsequently, unwinding these notes during

Chart 3.7

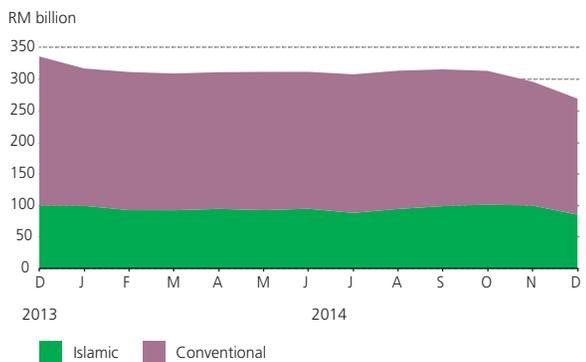
Breakdown of Interbank Money Market Transactions



Source: Bank Negara Malaysia

Chart 3.9

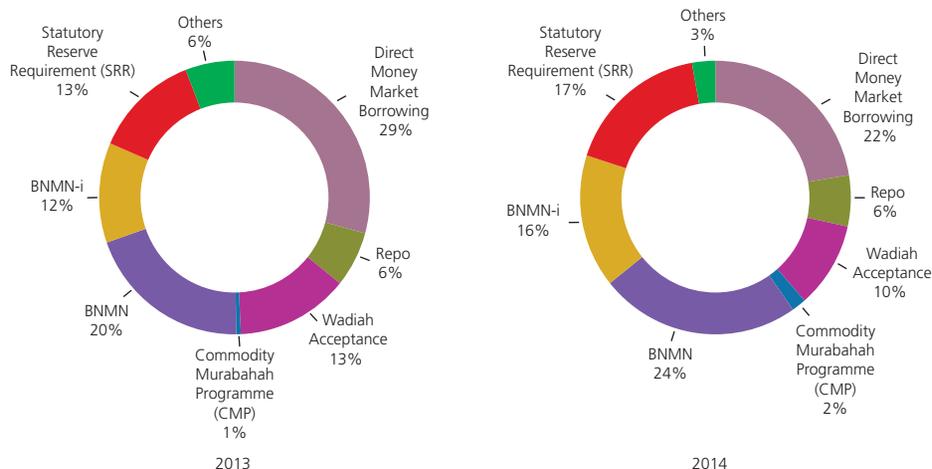
Outstanding Liquidity Placed with Bank Negara Malaysia (Conventional-Islamic)



Source: Bank Negara Malaysia

Chart 3.10

Breakdown of Outstanding Monetary Policy Instruments



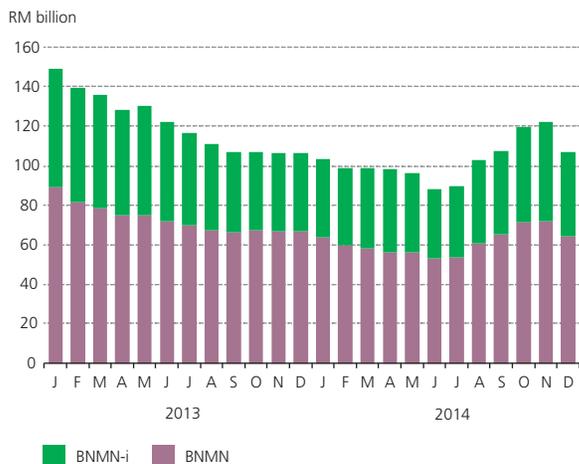
Source: Bank Negara Malaysia

periods of capital reversals, has ensured that adjustments in the domestic financial market remain orderly with minimal impact on overall domestic liquidity conditions. During this period, banks also shifted their liquidity profile to favour shorter maturities to manage uncertainties in corporate liquidity needs towards the end of the year. Correspondingly, the Bank facilitated these requirements by shortening the duration of money market borrowings and increasing the frequency of the Range Maturity Auction (RMA), which is typically a weekly feature of the Bank's operations.

The share of Islamic interbank surplus liquidity as a percentage of total market surplus liquidity continued to increase to 31.7% in 2014 from 23.4% in 2009, reflecting the growth and the development of the Islamic banking industry. With the requirement to distinguish between Islamic deposit and investment accounts under the implementation of the Islamic Financial Services Act 2013 (IFSA), it is expected that there will be greater use of commodity murabahah transactions as an instrument of Islamic deposits in the Islamic financial market. Accordingly, the Bank has increased the use of the Commodity Murabahah

Chart 3.11

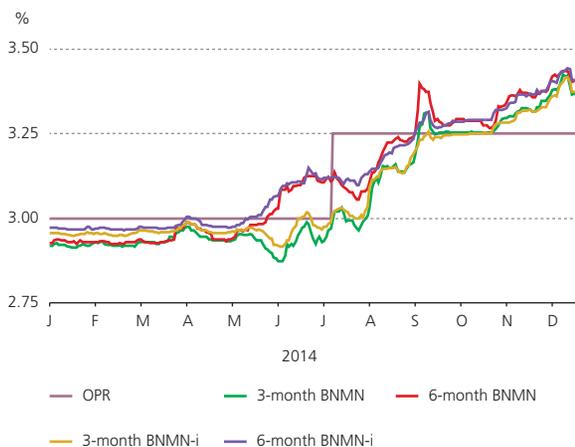
Outstanding Amount of BNMNs



Source: Bank Negara Malaysia

Chart 3.12

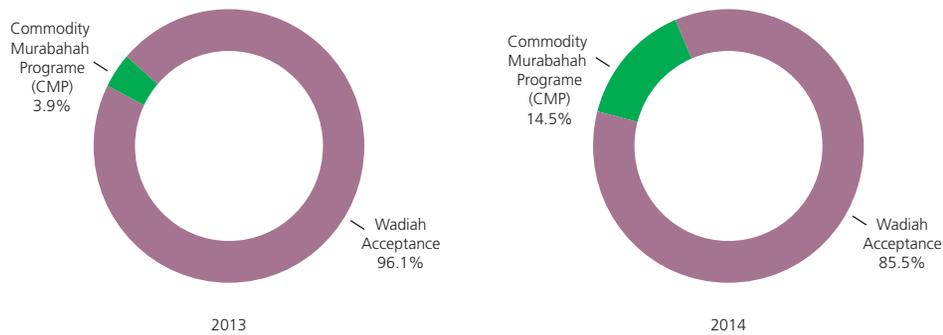
BNMN Yields and OPR



Source: Bank Negara Malaysia

Chart 3.13

Outstanding Amount of Islamic Short-term Borrowings



Source: Bank Negara Malaysia

Programme (CMP) in its Islamic liquidity management operations since early July 2014. Consequently, banks have progressively switched their short-term placements with the Bank to the CMP, as evidenced by the increase in the share of the CMP from 3.9% in 2013 to 14.5% of total Islamic short-term borrowings in 2014.

As innovative structures evolve in the issuance of Shariah compliant securities, the Bank has taken the initiative to move its Islamic securities issuances towards the more efficient and cost-effective trustee-based structure. The new Islamic BNMNs (BNMN-i), under the Murabahah concept

of using a trustee-based structure, were issued at the beginning of September 2014. This was a change from the previously used special purpose vehicle (SPV)-based structure. Although other characteristics of the BNMN-i remain unchanged, the new trustee-based structure simplifies the issuance structure by allowing the Bank to be the direct issuer of the BNMN-i, instead of an SPV. This eases investors' understanding of the BNMN-i issuances structure and facilitates risk assessments on the issuer of the BNMN-i, and subsequently, may attract wider interest from both Islamic and conventional investors.

Financial Imbalances and Policy Responses in Malaysia

Financial Imbalances

While there have been numerous studies and discussions on financial imbalances, there is no clear or specific definition of financial imbalances. Rather, financial imbalances are often defined by their symptoms or manifestations. These could include over-investment in specific sectors, excessive credit growth, sharp increases in asset prices, or fiscal and current account imbalances. The most typical and frequently identified symptoms are asset price misalignments and excessive credit growth. These imbalances reflect the misallocation of resources and the disintermediation of funds towards speculative activity in asset markets.

As financial imbalances result in a build-up of domestic vulnerabilities and are ultimately unsustainable, they could lead to destabilising adjustments in the economy and pose risks to macroeconomic and financial stability. This phenomenon is not new. Historically, the build-up of financial imbalances has often preceded financial and economic busts¹. As illustrated by the experience of the advanced economies in the recent financial crisis, the slow build-up of financial imbalances, if left unchecked, can unravel rapidly and in a disorderly manner, leading to financial and economic disruptions, threatening price stability and longer-term economic growth prospects. Of greater relevance to emerging economies, in the post-crisis period, the unprecedented monetary policy accommodativeness in the advanced economies had led to a surge in capital inflows into these economies. These inflows can directly increase asset prices as foreign investors purchase assets, or they can lead to increased liquidity in the financial system, which in turn can intensify pressure on banks to lend, leading to credit booms and asset price bubbles. Such inflows and the consequent downward pressure on the interest rates of recipient countries can significantly influence monetary and financial conditions in small open economies.

Financial imbalances, at their core, are driven by shifts in the risk-taking behaviour of economic agents and a pervasive underestimation of risk exposures. Through the conventional transmission channels of monetary policy, which include the interest rate, credit and asset price channels, a prolonged period of low interest rates may induce investors or savers to take on greater risks. This could occur when valuations and incomes are expected to remain high, or in search of yield given low returns on safe investments. These channels, when interacting with the risk-taking channel, aggravate the risk of financial imbalances², as a prolonged period of low interest rates may lead to a fundamental shift in the perception and tolerance of risk.

With the risk-taking channel, a prolonged period of low interest rates results in lower measured risk and an increase in the search for yield. From the perspective of banks, a low interest rate environment eases loan repayment obligations and boosts asset and collateral values, consequently lowering banks' estimates of probabilities of defaults. When improvements observed are misperceived to be permanent in nature, banks become more willing to supply credit on terms that may not necessarily reflect the actual risks associated with the loans. Banks may also actively seek to go beyond conventional loan origination methods and take on riskier investments in order to boost nominal returns. The cumulative effect is a rise in the riskiness of the banks' asset portfolios³.

The risk-taking channel is also closely linked to liquidity⁴. When there is an increase in liquidity, assets become easier to trade with minimal impact on prices (market liquidity) and funds can be easily sourced (funding liquidity). This increase in liquidity further amplifies risk-taking behaviour as the lower perceived

¹ In a historical account of over 40 financial crises, Kindleberger (2000) describes financial crises as the end result of a process where expectations lead to speculative excesses, facilitated by excessive credit creation. Claessens, Kose and Terrones (2011) find that recessions associated with episodes of financial disruption, notably house price busts, tend to be longer and deeper than other recessions.

² The risk-taking channel is different from the credit channel in that it strengthens the financial accelerator with amplification mechanisms *within* the financial sector, namely risk perception and tolerance, as well as liquidity. See Borio and Zhu (2008), and Adrian and Shin (2009) for further details.

³ This channel is also associated with excessive bank balance sheet expansion through leverage (Adrian and Shin, 2010).

⁴ See Borio and Zhu (2008).

risks increases the appetite to participate in the asset markets and to undertake a search for higher returns. For small open economies, liquidity in the financial system can be significantly influenced by external sector inflows. Capital inflows affect asset markets and banks' balance sheets, contributing to higher asset prices and an increase in liquidity with banks^{5,6}. Banks are thus able to match credit demand while maintaining low or stable lending rates. In fact, the ample liquidity could increase competition to lend and thereby increase the risk appetite of banks. The combined effects may result in monetary and financial conditions becoming looser even if the policy interest rate remains unchanged. Crucially, the possible reversals of capital inflows and their attendant adverse effects may not be fully taken into account by the banks and their customers.

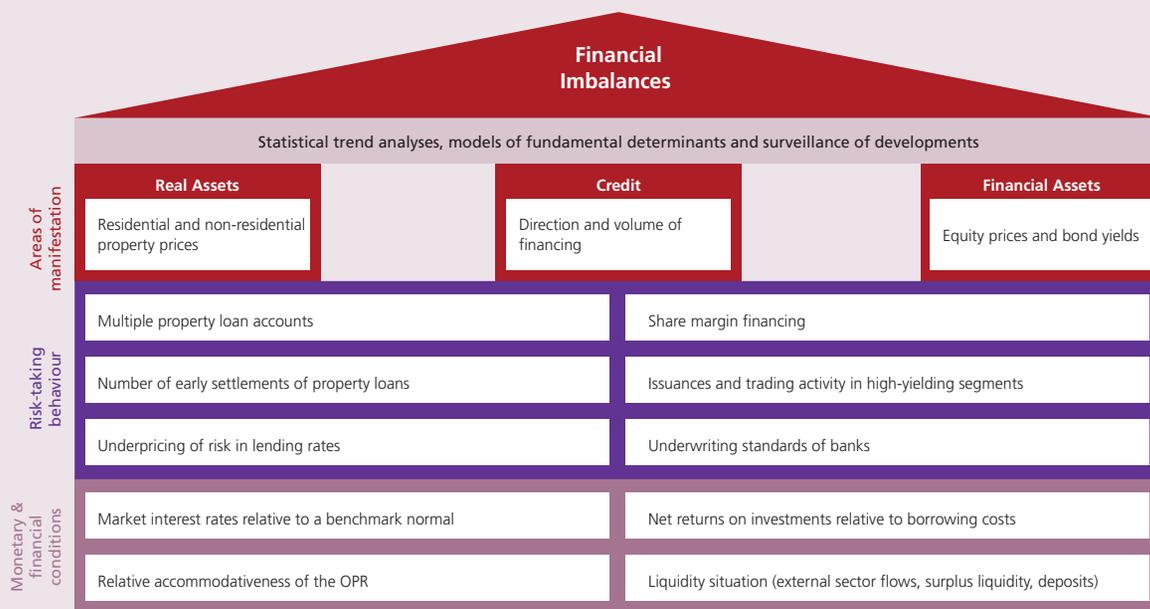
Indicators of Financial Imbalances

In assessing the build-up of financial imbalances in the economy, the Bank conducts surveillance using a wide range of indicators, both in granular and aggregate form. The main focus of surveillance is on (i) the accommodativeness of monetary and financial conditions, (ii) manifestations of increased risk taking, and (iii) signs of excessive credit growth and potential asset price misalignments.

The surveillance of monetary and financial conditions takes into account various price and quantity indicators which set the baseline for risk-taking behaviour. These indicators include borrowing costs and net returns on investments, as well as external sector inflows, surplus liquidity and deposits growth. To gauge risk-taking behaviour, the Bank monitors the risk-taking capacity of banking institutions by assessing their measured risk, and evaluates if shifts in this capacity translate into changes in lending practices. In evaluating credit growth and asset market developments, statistical trend analyses and econometric estimations are carried out. This is complemented by continuous surveillance of economic developments, which help differentiate

Chart 1

A Snapshot of Key Indicators for the Assessment of Financial Imbalances



⁵ Persistent current account surpluses also lead to a rise in banks' sources of funds, and potentially, domestic structural surplus liquidity.

⁶ Singh (2014) provides a discussion on the direct and indirect effects of global liquidity on Malaysia's monetary and financial conditions. Meanwhile, Bruno and Shin (2014) elaborate specifically on how prolonged loose monetary policy in advanced economies translates into greater risk tolerance by local banks in other countries through the increased leverage of global banks and their cross-border funding of these other banks.

fundamental and cyclical factors, as well as speculative elements. For example, when assessing the housing market, the Bank analyses structural factors such as housing supply, demographic changes and construction costs, which may explain deviations in price trends vis-à-vis income. At the same time, information such as the early settlement of loans and the number of borrowers with multiple loan accounts are also taken into consideration, in order to make an assessment of the level of speculative activity. This comprehensive approach enhances the robustness of assessments⁷.

At the aggregate level, the Bank also monitors the financial cycle. The financial cycle captures the evolution of credit and asset prices over time, which reflects changing perceptions of risk and financing constraints⁸. Empirically, peaks in the financial cycle have been shown to be closely associated with financial crises⁹. Additionally, financial cycles also tend to be longer in duration compared to business cycles. Consequently, financial imbalances tend to build up and unwind over a longer period compared to business cycle fluctuations.

Bank Negara Malaysia's Policy Approach to Financial Imbalances

As financial imbalances tend to build up gradually with the potential destabilising effects only emerging at time horizons that are beyond those of conventional monetary policy, it is important to pre-emptively react to early signs of financial imbalances. In this regard, apart from the main focus on the near-term balance of risks to the inflation and growth outlook, the Bank's monetary policy decisions also take into account the potential risks related to financial imbalances¹⁰.

At the same time, the policy approach does not overly rely on any single policy tool, including monetary policy, as adjustments to the policy interest rate would have a broad-based impact across the entire economy. As part of the Bank's broad policy toolkit, policy measures such as macro- and micro-prudential instruments are also considered and deployed to reign in financial imbalances. Coordination with fiscal policy, and the introduction of tax measures, increases the overall effectiveness in dealing with financial imbalances. The decision to use monetary policy or other policy measures, or a combination of these measures, in response to financial imbalances is based on their relative benefits and costs given the assessment of the prevailing situation. When imbalances are assessed to be contained in specific segments of the economy, targeted macro- and micro-prudential as well as fiscal measures may be more effective in curbing excesses while minimising unintended cross-sectional policy spillovers to other segments of the economy¹¹.

It is important to highlight that while these other measures can complement monetary policy, they are usually not a substitute for having the right level of the policy interest rate. In this regard, three key considerations make a strong case for monetary policy action. First, if prolonged loose monetary conditions are a likely source of financial imbalances, a change in the monetary policy stance may be better than treating the symptoms using other measures, as the cause of distortion is addressed directly. Second, if there are signs of financial imbalances becoming pervasive, driven by widespread underlying risk-taking behaviour, a monetary policy adjustment ought to be considered rather than relying solely on a set of more targeted measures. This is because monetary policy broadly affects the returns on assets and borrowing costs and is less subject to circumvention. In contrast, the use of a variety of other measures on a large scale may lead to distortions and substantial administrative costs. Third, the bluntness of monetary policy is less of a concern if the cost to near-term growth and inflation is low and is outweighed by the likely

⁷ The assessments form part of the staff evaluations deliberated upon by the Monetary Policy Committee in determining the balance of risks to growth and inflation. Given the nature of the issues and indicators, however, there is some overlap with the surveillance carried out under the financial stability mandate, which encompasses rigorous assessments on the risks to the financial system. See the Bank's annual publication, Financial Stability and Payment Systems Report for further details.

⁸ See Borio (2012).

⁹ Drehmann, Borio and Tsatsaronis (2012) find for a sample of seven industrialised countries, that all the financial crises with domestic origin occur at, or close to, peaks of the financial cycle.

¹⁰ For an earlier discussion on the role of monetary policy in addressing financial imbalances, refer to Bank Negara Malaysia (2010).

¹¹ For broad principles guiding the design, deployment and calibration of macroprudential policies in Malaysia, refer to Ibrahim (2014).

benefit to future growth and inflation. This trade-off tends to be smaller when the business cycle and financial cycle are synchronised.

This approach is reflected in the Bank's policy responses to the potential emergence of financial imbalances in the recent period. After reducing the Overnight Policy Rate (OPR) to a historic low of 2.00% during the financial crisis in the advanced economies in 2008-2009, the Bank progressively reduced this extraordinary monetary accommodation, raising the OPR by a 100 basis points to 3.00% between March 2010 and May 2011. The Bank recognised that keeping the OPR unusually low for an extended period could induce broad-based financial imbalances. This was especially so when asset prices and credit growth had also recovered fairly strongly amid sustained capital inflows arising from the highly accommodative monetary policy stance among advanced economies. Hence, at the earliest possible opportunity, when domestic economic growth was assessed to be more entrenched, the OPR was normalised. However, at the same time, it was recognised that higher interest rates could attract further capital inflows, potentially complicating efforts to avoid a build-up in financial imbalances. In this regard, the Bank's broad policy toolkit, which includes sterilised intervention under a flexible exchange rate regime, and the Statutory Reserve Requirement (SRR), had played an important role in complementing monetary policy. The Bank relies on a wide range of sterilisation instruments for liquidity management. After the initial reduction during the financial crisis in the advanced economies, the Bank raised the SRR by 300 basis points to 4.00% between April and July 2011¹². This move was aimed at providing longer-term sterilisation of the excess liquidity in the financial system.

A series of macro- and micro-prudential measures were also implemented in stages between 2010 and 2013 to curb financial excesses, which were mainly confined to segments of household lending. These targeted incremental measures have been effective, generally preserving sound lending standards and improving affordability assessments; thus contributing to the significant moderation in the growth of personal loans, particularly among non-banks. Along with fiscal measures, these measures led to reduced speculative activity in the property market¹³. In July 2014, amid firm growth prospects for the economy, and with inflation remaining above its long-run average, the Bank adjusted the degree of monetary accommodation. While the macro- and micro-prudential measures continued to have the desired effects, there remained risks of a broader build-up of financial imbalances. Consequently, the OPR was increased by 25 basis points to 3.25%.

The use of a comprehensive set of measures in tackling financial imbalances reflects the Bank's overall policy philosophy of considering all policy tools available to it and the mix that would most effectively address the issues at hand. Such an approach is necessary given the increasingly complex interactions within and between the financial system and the economy.

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¹² See press statements on the increases in the SRR in March, May and July 2011 to manage the build-up in liquidity which may result in financial imbalances.

¹³ For more details on the measures implemented, refer to Chapter 1 of Bank Negara Malaysia's Financial Stability and Payment Systems Report over 2010-2013.

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