The Bank's Policy Considerations

HIGHLIGHTS

- **With the economy firmly on a steady growth path, the MPC decided in January 2018 to normalise the degree of monetary accommodation.**

The OPR remained accommodative

The Monetary Policy Committee (MPC) kept the Overnight Policy Rate (OPR) at 3.00% at the September and November 2017 meetings. At the meeting in November, however, the MPC indicated that the degree of monetary accommodation could be reviewed given the assessment of improving macroeconomic conditions. Malaysia's economic growth had become more entrenched while prospects remained favourable for 2018, given expectations of sustained performance in both the domestic and external sectors. Nevertheless, downside risks to the global growth remained. Headline inflation was expected to be at the upper end of the forecast range of 3% - 4% for 2017 but to moderate in 2018. Underlying inflation was also expected to moderate in 2018, sustained by robust domestic demand but contained by the continued expansion in productive capacity.

More recently, at the January 2018 MPC meeting, the MPC assessed that there would be faster expansion in global growth, with more balanced risks to the outlook. The domestic economy is firmly on a steady growth path. Headline inflation is expected to average lower in 2018, on expectations of a smaller effect from global cost factors. A stronger ringgit exchange rate compared to 2017 will mitigate import costs. Global energy and commodity prices are expected to trend higher in 2018. However, the trajectory of headline inflation will be dependent on future global oil prices which remain highly uncertain. Underlying inflation, as measured by core inflation, remains moderate.

The MPC, therefore, decided to normalise the degree of monetary accommodation by raising the OPR by 25 basis points to 3.25%. The MPC recognised the need to pre-emptively ensure that the stance of monetary policy is appropriate to prevent the build-up of risks that could arise from interest rates being too low for a prolonged period of time, particularly in a high-growth environment. The adjustment does not constitute a tightening of monetary conditions, but rather a normalisation of the degree of monetary accommodation. The normalisation would contribute towards preserving the sustainability of growth, while ensuring ample policy space for buffers in the event of shocks to the economy in the future. At the current level of the OPR, the stance of monetary policy remains accommodative and supportive of growth.

Other policy highlights in fourth quarter of 2017

In October 2017, the Bank outlined the Principles for a Fair and Effective Financial Market for the Malaysian Financial Market. The aim of the Principles is to achieve a financial market environment that is trusted, competitive, resilient and best positioned to support the sustainable growth of the Malaysian economy.

In addition, as part of the overall strategy to deepen and broaden the financial market, the Bank and the Financial Markets Committee took several measures to improve bond market liquidity and enhance liquidity intermediation. These included the introduction of regulated short-selling of MGII, issuance of Bank Negara Interbank Bills (BNIBs), and expansion of eligible collateral for Monetary Operations.

In the insurance sector, greater flexibility was accorded for life insurers and family takaful operators in respect of operating cost controls under revised standards that came into effect on 1 January 2018. This represents part of broader reforms being undertaken to encourage greater innovation and competition in the insurance and takaful industry.

To protect the interests of consumers, the Bank also issued strengthened standards to be observed by financial service providers for handling customer information. Financial service providers are expected to ensure the effective protection of customer information in the process of collection, storage, use, transmission, sharing, disclosure and disposal, in line with the laws administered by the Bank.

Macroeconomic Outlook

HIGHLIGHTS

- Global growth to expand at a faster pace in 2018, supported by continued growth in advanced economies and improvements in emerging market economies.
- The Malaysian economy is expected to remain favourable in 2018.
- Going forward, inflation is expected to moderate due mainly to a smaller contribution from global cost factors and a stronger ringgit compared to 2017.

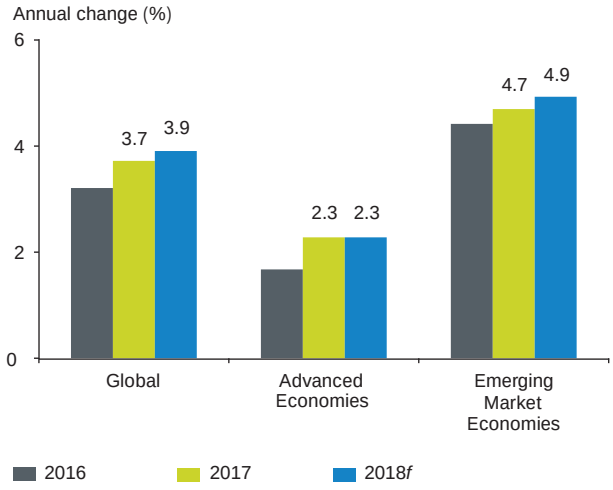
Global growth to expand at a faster pace

The sustained strong performance of the global economy in 4Q 2017 suggests that the current phase of expansion is likely to continue going into 2018. Of significance, the IMF revised its 2018 global growth projections upwards for the third time in its January 2018 publication of the World Economic Outlook Update.

The outlook is underpinned by expectations for continued synchronised expansions in both the advanced and emerging market economies. In the advanced economies, leading economic indicators such as purchasing managers' indices (PMI), manufacturers' orders and capital spending intentions surveys point towards continued expansion in business spending by corporations and smaller firms. Economic activity is projected to be further supported by favourable labour market conditions, continued access to financing and the implementation of pro-growth policies. In the US, the passing of the Tax Cuts and Jobs Act in December 2017 is expected to provide additional impetus to domestic demand, with positive spillovers to the rest of the world. Strong external demand will continue to benefit Asian economies. In addition, recently announced fiscal measures, including higher infrastructure spending, will complement the strength in domestic demand in several regional economies.

Global economic activity to expand at a faster pace in 2018

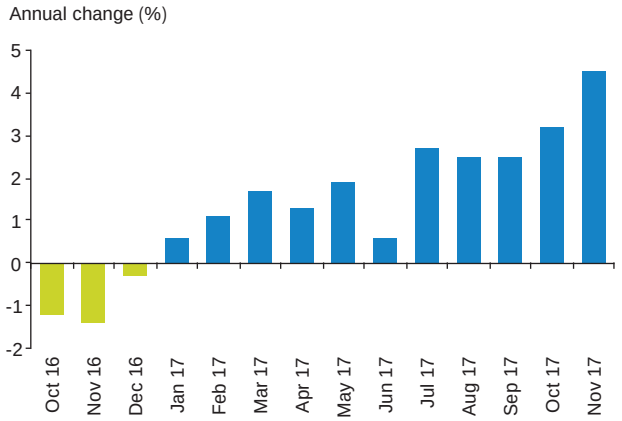
Chart 33: GDP Growth



Source: IMF World Economic Outlook (January 2018)

Leading indicators suggest continued expansion in the domestic economy

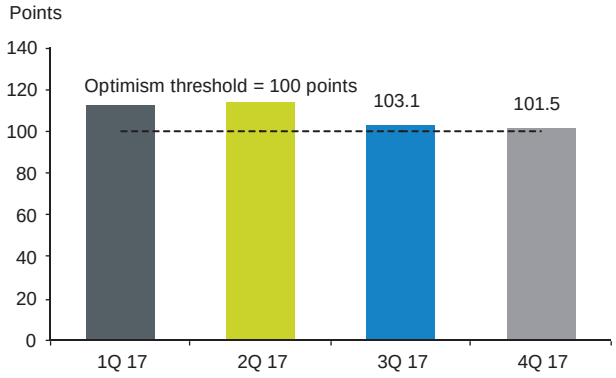
Chart 34: Composite Leading Index



Source: Department of Statistics, Malaysia

Business sentiments remained above the optimism threshold in 4Q 2017

Chart 35: MIER Business Conditions Index



Source: Malaysian Institute of Economic Research (MIER)

Risks to the growth outlook have become more balanced. Upside risks to the forecast include higher-than-expected investment growth due to the tax cuts in the US, stronger wage growth in the advanced economies and a continued expansion of the global tech cycle. In contrast, downside risks to the outlook arise mainly from uncertainty regarding the timing, pace and magnitude of monetary policy normalisation in major economies in the event of stronger inflationary pressures and wage growth, the lingering risk of rising trade protectionism and residual political risks in certain European countries. A sudden escalation of geopolitical tensions, abrupt corrections in the global financial markets and significant reversals of capital flows in emerging markets also pose additional downside risks to the global growth outlook.

Growth in the Malaysian economy to remain favourable in 2018

Malaysia registered a strong growth of 5.9% in 2017 (2016: 4.2%). For 2018, growth is expected to remain favourable with domestic demand continuing to be the key driver of growth. The positive growth momentum will continue to benefit from spillovers from better global growth on to domestic economic activity.

The Department of Statistics Malaysia's composite leading index has shown a sustained increase in recent periods. The MIER Business Conditions Index also points towards sustained expansion of the economy. Overall, the assessment is for growth to remain strong in 2018.

On the supply side, the manufacturing and services sectors are expected to benefit from continued growth across both export- and domestic-oriented sub-sectors. The agriculture sector's growth will be driven by further improvements in CPO yields and the maturing of oil palm trees. Growth in the mining sector is projected to be supported by higher output from new oil and gas facilities. In the construction sector, growth will be mainly supported by new and existing civil engineering projects.

Going forward, inflation is expected to moderate due mainly to a smaller contribution from global cost factors and a stronger ringgit compared to 2017

While global oil prices are expected to be higher in 2018, the magnitude of increase would likely be smaller compared to 2017. The impact of higher global oil prices on domestic fuel prices will also be partly offset by a stronger ringgit exchange rate. As such, the contribution of domestic fuel prices to headline inflation in 2018 will be smaller leading to a moderation in headline inflation.

Underlying inflation, as measured by core inflation, is expected to moderate following the expectation of smaller spillovers from external and domestic cost factors and a stronger ringgit. Upward pressures from the robust demand condition will be contained by continued spare capacity in the labour market and on-going investment for capacity expansion.

For 2018 as a whole, while the expectation is for inflation to moderate, the trajectory will remain dependent on the trend of global oil prices, which is highly uncertain.