

CHAPTER 5

CONCLUSION

The objective of this research is to examine the response of aggregate commercial bank lending to money market interest rate changes for the case of Malaysia. The two-step procedure is used in this study. The first step involves the estimation of a model that explains the money market interest rate processes. The associated residuals from the models are then used for constructing the interest rate shocks for money market. The second step involves estimating the response of aggregate commercial bank lending to money market interest rate shocks. The study is based on quarterly data for the period from the first quarter of 1990 to the second quarter of 2000. Three series of money market interest rates are employed, namely, the seven-day, one-month and three-month KLIBOR.

The empirical results show that the response of aggregate commercial bank lending to one-month and three-month money market interest rate changes is asymmetric for the case of Malaysia. This implies that the response to a positive interest rate shocks is different from the response to a negative interest rate shocks. Possible explanations to this behaviour include market imperfections, asymmetric information, and government interventions in the financial market.

For the period of analysis, the aggregate commercial lending exhibits an upward trend. The negative and positive one-month and three-month money market

interest rate shocks have significantly influenced the aggregate commercial bank lending. The negative one-month and three-month money market interest rate shocks have negative effects on the aggregate commercial bank lending. This finding is different from the expectation that the effect is positive as lower rates should lead to an increase in the demand for loans.

The positive one-month and three-month money market interest rate shocks have positive effect on the aggregate commercial bank lending instead of decreasing in aggregate commercial bank lending. The expectation is such because in situations of positive shocks, loan default risks are much higher. In the case of Malaysia, however, the commercial banks are careful in their lending when negative interest rate shocks prevail in the money market and willing to increase lending when interest rate shocks are positive in the money market.

The commercial bank lending reacts quickly to the positive and negative shocks in the case of one-month and three-month money market interest rates. For any deviation in the aggregate commercial bank lending from the long run equilibrium, market adjustments are completed in less than one quarter to revert to the equilibrium position. This is true for the case of both one-month and three-month interest rates. However, the commercial bank lending reacts more quickly to negative seven-day money market interest rate shocks but not to the positive shocks of one quarter ago. Periodic government interventions could offer an explanation to this high speed of adjustment.

Besides that, this study also highlights that by purely examining the response of aggregate commercial bank lending to money market interest rate changes that do not take into account the asymmetric responses may lead to misleading results. This is because bank lending responds differently to positive and negative shocks. Given that the response of aggregate commercial bank lending to money market interest rate changes is indeed asymmetric, the design and implementation of monetary policy should take into account the asymmetric lag structure between credit contractions and expansions.

This study is subject to a few limitations. First, it is believed that the financial market behaviour could be different for the period before and after the start of the financial crisis. A comparative analysis could be useful but unfortunately the period after the start of the financial crisis is too short a sample period for analysis. Second, data constraints posed considerable difficulties for inclusion of interest rates of longer term in this analysis. Missing observations due to thin trading are rather common for the period after 1997 for interest rates with term longer than three months. Third, this research only focusses on the commercial bank lending without including the lending of the other financial institutions such as finance companies and merchant banks. The intention is to keep the current study sufficiently focus as the commercial bank represents the most significant component of the financial sector.

In light of the limitations, future research can take into account other interest rates, a longer span of analysis to allow for a comparison of behaviour before and after the financial crisis, and also lending of the other financial institutions in Malaysia.