CHAPTER 1

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1.1 Background

The most important financial institution in any modern economy is the central bank. Central Bank is the sole authorized agency, which conducts the monetary policies in the country. Legislation was enacted towards the end of 1958 to set up a central bank in the federation of Malaya which was renamed the Central Bank of Malaysia (BNM) with the establishment of Malaysia in Sept 1963. During that period, the Central Bank relied more on the interest rate to stimulate bank credit and savings as well as to prevent capital outflows (Lin,S.Y,1987).

Apart from performing its traditional function as an issuer of currency, Central Bank acts as banker and fiscal agent to the government, banker to banks, controller of credit and lender of last resort and conducts all the necessary monetary policies with regard to the economic situation in the country.

Monetary policy is defined as the use of various tools by Central Bank to control the cost and availability of loan-able funds in an effort to achieve national economic goals. The implementations of the monetary policy through the use of monetary instruments, which are used in almost every central bank in the world, depend on the degree of development of money and financial markets. The final objective of the monetary policy was to achieve final targets of the ultimate economic goal. The Central Bank has been given the task of regulating the money and credit system order to achieve economics goals.

Prominent among these goals are the achievement of full employment, a stable price level, sustainable economic growth, and a stable balance of payments position with the rest of the world. However the final target only will only be achieved by the use of the intermediate targets and also operating targets.

In Malaysia, the principal macroeconomic objective of monetary policy is to promote the highest sustainable rate of output growth, consistent with domestic price and exchange rate stability. The conduct of monetary policy in Malaysia, a task in which is assigned to the Central Bank of Malaysia, is primarily to regulate the supply of money and the volume of credit are which sufficiently elastic to meet domestic demand in the economy.

The Central Bank, as the nation's sole monetary authority, takes responsibility for promoting monetary stability and influencing the credit situation to help achieve the nation's overall objectives. At the same time it also regulates the volume of money and the generation of credit through a range of instruments, with quantitative and qualitative controls.

Central Bank's monetary instruments can generally be grouped into two broad categories, they are the general instruments and selective instruments. The general instruments affect the entire banking and financial system. Included in this list are statutory reserve requirement (SRR), discount rate operation and open market operations. A second set of policy tools labeled as selective monetary instrument are generally used complementary with the general instruments to enhance the impact of the monetary policy on a particular sector. These instruments include moral suasion, guidelines on credit card operations and margin requirements on the purchase of listed securities.

1.2 Central Bank and The Financial Market

BNM also actively promotes the development of financial instruments and thereby takes the necessary steps to develop a market in Government Securities. Until the end of 1990, the total resources of the financial system have risen from less than RM 3 Billion (1958) to more than RM 300 Billion, which is equal to 270% of GNP.(Malaysia Capital Market Summit, 2001)

Malaysian financial system can competitively intermediate. This was started in the 1960's. It began issuing a variety of medium and long term securities to meet the market's investment needs on a continuing basis. But during 1985 - 1986, Malaysia concentrated on resolving the economic phenomenon when the palm oil prices fell by about 60%. Therefore, in 1987 the Central Bank started to refocus on developing of the capital market.

The Central Bank also expanded the inter-bank money market whereby central bank was selecting finance companies which was allowed to issue negotiable certificates of deposit. The government securities yielded curve was moved to levels which reflected market values. So the interest rates had been changed whereby the distortions of interest rate were removed.

During 1990's, the strategy built on deepening the capital market and BNM developed viable private debt securities. Recently, new liquidity framework for banking institution has been introduced whereby this framework would help reduce price distortions on liquid assets, including Malaysia Government Securities (MGS). This development would promoted a more market oriented pricing of MGS. The government securities market has been dominated by the MGS market accounted 97% of outstanding government securities at the end of August 1999. Major holders of MGS were the Employees Provident Fund (EPF), commercial banks and insurance companies.

1.3 Malaysia's Experiences in Implementing Monetary Policy

1.3.1 Early 1990's

The period 1989 - 1994 comprised six years of prolonged and rapid growth which led to a steady upward rise in domestic inflation, starting as low as 0.4 % in 1985 to 3.1 % in 1990 and a maximum of 4.7% in 1992 (the highest since 1982, 5.7%).

Monetary expansion also accompanied larger capital inflows during 1992 to 1994 (Quarterly Bulletin, 199o). Such substantial inflows which were volatile in nature were encouraged by large interest rate differentials in favor of Malaysia, buoyant activities in the local stock market and expectations of further appreciation of the ringgit. The central bank adapted a tight monetary policy. There included steps such as:

- six upward revisions in the SRR, on July 1994 become 11.5 % from only 4.5 % in May 1989
- Limiting non-trade-related swap transactions with foreign customers
- Centralisation of Government and EPF funds with the central Bank
- Open Market Operations
- Issuance of Central Bank Bills
- Guideline on hire purchase and credit cards.

The above measures were only partly effective which were offset by substantial capital flows. The Central Bank of Malaysia imposed a policy that focused on curbing speculative activity by foreigners due to a swap limit.

The measures for it included:

- Redefining the base of eligible liability to capture all inflows of funds from abroad
- Prohibiting all residents from selling short term monetary instruments to non residents
- Requiring commercial banks to place Ringgit funds with bank outside Malaysia which are held in non interest vostro accounts

with the central bank in non interest bearing current account. As a result these measures stabilized the capital inflows.

The Central Bank intervenes when there are conflicts between the objectives of monetary policy and the exchange rate stability reduces the effectiveness of monetary policy. Fluctuations in the exchange rate occurred when capital inflows were large. Effectiveness of monetary policy was reviewed. For example the intervention of the central bank occurs when there are wide fluctuations in the exchange rate due to the size of capital inflows. Secondly tight monetary policy would be effective given the interest- rate- sensitive type of consumption expenditure. Thirdly, expansionary policies of other countries also influences monetary policy and these have to be accounted for.

1.3.2 Monetary Policy in 1995 to 1996

Price stability is important to ensure sustained economic growth. Since 1995, the monetary policy role is to ensure that excess demand would not create inflationary pressures. Monetary Policy was tightened at the end of 1995 especially in August and October because of increases in the credit activity (Monthly Bulletin, 1995). To force economic growth, the private sector lending became the primary expansionary stimulus. This was proven by increases in the private sector lending with increases of around 32.9 billion from 31.3 billion in 1994 to 64.2 billion in 1995.

Monetary aggregates M1, M2 and M3 also rose at the end 1995. M2 and M3 as broad monetary aggregates increased whereby M2 changed from 14.7% to 24.0% the annual rate and M3 at 13.1% to 22.3%. Besides, M1 stabilized at 11.7% from 11.2% in 1994. These figures show that monetary growth has potentially increased excess demand and cause inflationary pressures. (Economic Report, 1995)

During 1995, a broad monetary measure was introduced. With this environment of excess liquidity, the aim was to contain the rate of credit, monetary expansion and inflationary measures. Monetary measures are as follows:

- Lowering the margin for financing passenger cars to 70% of its purchase cost
- Lowering the margin for financing houses and apartments costing above RM150 thousand and shop lots costing over RM300 thousand to 60% respectively. But this measure was not applicable for one's own dwelling and for conducting of own businesses
- Increasing the minimum monthly payment on the outstanding balance of the credit card account from 10 to 15%
- Increasing SRR from 11.5 to 12.5% with effect from 1st Feb 1996.

Finally, with broad monetary policy, the inflationary rate moderated in 1995 to 3.8% and 3.7% in 1994.

In 1996, the monetary policy to control price stability tightened monetary policy thus M2 and M3 growth rate reduced.

Basically, there are two shocks that have to be taken into account. Firstly the fundamental economic changes and secondly, non-fundamental economics. Fundamental economic changes warrant further tightening of the monetary policy when excess demand occurred. After crisis, Malaysia concentrated less on exchange rate fluctuation. Non-fundamental economic changes refer to changes in the market expectations, which would affect the exchange rate.

The second shock was more difficult to control; Malaysia before the crisis, monetary authorities responded by the series of intervention of operations. Inflationary pressures due to high wages, income and corporate profits increased prices especially in asset prices, even though inflation rate was contained at 3.5%.

The study proves that the growth potential output for Malaysia economics during 1970 - 1997 averaged 6.9% as compared with actual output growth of 7.4%. Among indicators are

- Loss of efficiency in the utilization of the resources in the economics as indicated by the declining in Total Factor Productivity (TFP) and the rising in Incremental Capital Output ratio (ICOR). TFP declined to 1.5% from 4.5% within 1988 - 1996 and the other hand ICOR rose 3.0 times to 6.8 times. ICOR increased steeply indicating that the use of capital has been increasingly less effective besides increasing in investments into capital-intensive projects with long gestation periods, leakages and underutilized capacity.

- Rising current account deficit – Inspite of having as one of the highest savings rate in the world, Malaysia ran into the current account deficits because of substantial investment. Current account deficits dropped to 5.1% in 1995.

- Excessive credit to non-tradable sectors - loans for the property sector rose. For example loan for purchases of stocks and shares grew at an average rate at 35% during 1993 - 1997.

1.3.3 Malaysia During Crisis And Recovery

Interest rate was rose while facing the tight liquidity as a response of monetary environment in July 1997. With the high interest rate prompted by the central bank, the monetary policy changes to expansion policy. Follow the Economic Report 98/99, GDP in 1998 projected to contract by 4.8% due to above matter. In the early of the crisis period, economy facing the impact of regions financial crisis on domestic financial markets and real economy.

The 1997 phenomenon forced the central bank face the interest rate and exchange rate conflict. Higher interest rates with floating exchange rate policies were considered good for external value of the Ringgit but unfavourable for the domestic business activities. To release this pressure, Ringgit was disallowed to float in the foreign exchange rate and thus was pegged to US dollar at RM3.80/US $. So, there is no more conflict between Ringgit and interest rate.

Other measures taken to stimulate domestic activity included:

- Downward revision in the SRR - from 10% in February 1998 to 4% in September 1998
- Targeting 8% loan growth by the end of 1998
- Increasing the limit of the loan for shares and stocks financing from 15% to 20% of total loans
- Reducing the margin spread from maximum 4% to 2, 25% above the BLR for the loans effective from October 1, 1998
- Redefinition of the NPLs from 3 months to 6months
- Formation of the Danaharta Nasional Berhad, a national asset management company in May 1998
- Formation of the Danamodal National Berhad in August 1998

A further reduction in the SRR enhanced the capacity of the banks to lend more. Every one percent reduction in the SRR would release about RM4 billion into financial system. Narrower margin between deposit and lending rates would lower the cost of funds for the borrowers. The 8% loan growth target would exert pressures on the commercial banks to step up lending activities. The upward adjustment in the ceiling for the stocks financing would lift up the local bourse. The redefinition of the NPLs would reduce the pressures not only for the borrowers but also for the banks. At the end of August 1998, the net NPLs of the banking system was 11.4%. The Danaharta will buy over NPLs of the financial institutions so that they can refocus on their main business and the Danamodal will spearhead the recapitalisation and consolidation of domestic banking institutions.

According to the 1998/99 Economic Report, GDP was forecast to grow by 1% in 1999 with the inflation rate at 3.5%, down from 5.2% projected for 1998, based on a pegged rate. One, the speed and the extent of the implementation of both fiscal and monetary measures to revitalize growth and two, the developments in global economy, particularly in Japan and United States. The fiscal stimulus and monetary easing may induce some recovery in the domestic spending and investments, but uncertainty volatility in the international financial environment.

The importance of efficient functioning of the intermediation role of the banking institutions came to the forefront during the crisis period. In an environment of uncertainty, banking institution had become excessively cautious in their lending decisions, causing a sharp slowdown in credit. To avoid a credit crunch situation, banking institutions with sufficient capacity were encourage achieving a minimum loan growth rate of 8% for 1998. The motivation for the 8% credit floor was to free banking institutions from the self imposed credit freeze. Prudential considerations, however, were required to exercise financial discipline in making lending decisions. Governments also concern with the cost of funds, so there are several for example Fund For Food (RM1Bill) and Fund For Small and Medium Industrial (RM1.5Bil).

In terms of the outlook for 1999, there was an improvement in the underlying economic fundamentals. Despite the depreciated Ringgit in the first half of 1998, inflation had abated, with the stabilizing at 5.3% in 1998, lower than the earlier projection of 7-8%. The current account turn to surplus, the external reserves increased till enough to finance 5.7months of retained imports with value of US$26.2 billion at the end 1998. To eliminate the internationalisation of the Ringgit and discourage the short term capital flows government imposed selective exchange control measures. Measures were also taken to improve the intermediation process in order to generate lending to viable businesses. Monetary policy was eased further with progressive reduction in the central bank's intervention rate and the statutory reserves requirement. The banking sector reform programme was also accelerated.

(For more detail please refer: economic report/various series, statistic bulletin/ various series, and Money and Banking in Malaysia)

1.4 OBJECTIVE

The purpose of this study is to evaluate the monetary policy effect on economic variables. More specifically, aims of this paper are as below:

1. This paper attempts to evaluate the changes in the nominal interest rate in response to inflation expectation
2. To examine the effect of monetary policy induced changes in the nominal interest ate on the real interest rate
3. To study the pattern of movement in the short term and the long term period of the real rate of interest.

1.5 Organization f the Study

This chapter is concerned on the general objective and hypothesis from several issues that are related to monetary policy and the macroeconomic variables (especially from financial market). A brief introduction on the historical background is conducted. This is followed by the objectives to provide readers an overview of the study.

Chapter II provides a brief overview of the literature. First is the empirical evidence o the relationship between monetary policy and the macroeconomic variables. Secondly, the empirical evidence on the VAR approach and finally the empirical regularities.

Chapter III of the study states the theoritical framework in generally while as a benchmark to ensure the theories and methods in this study are in line.

In chapter IV, is states the methodology and data used in the study. It consists with general description on the technique adopted in the study such as VAR (Vector Auto Regression), a few concepts related to the technique. The remaining sections in the chapter are devoted to estimation procedures.

Chapter V presents the empirical results of the analysis as well as the interpretation of the estimation results. A summary of findings of the empirical analysis are given in chapter VI. This chapter ends up with the discussion of the implications of the result and the recommendation for further studies.