CHAPTER 5.
THE IMPLEMENTATION OF MONETARY POLICY-
THE CASE OF MALAYSIA.

In an open economy like Malaysia, there is the other avenue for monetary policy to affect the economy. With a freely floating exchange rate regime before 1st September 1998, the monetary policy stance had an effect on capital flows from abroad. Higher interest rates will lead to capital inflows from abroad resulting in the appreciation of the exchange rates while lower interest rates may cause outflows of capital, causing the depreciation of exchange rate. The issue of confidence, often dependent on the exchange rate level, becomes an important consideration in the monetary policy stance to be taken. This chapter contains a brief review of Malaysia's experiences in implementing monetary policy starting from 1959 until 1998. The rationale is to look at how monetary authorities, in particular the Central Bank, implements monetary policy in different situations. In addition, challenges faced by the central bank also will be highlighted.

5.1 MONETARY CONDUCT DURING 1959 –1980.

Monetary management only began in January 1959 with the establishment of the Central Bank of Malaysia. Prior to this, the Currency Board undertook the role of formulating monetary policy. During the 1960s, monetary policy was designed to strengthen and develop the existing financial framework, and to establish new institutions and markets. In earlier years, the central bank relied on interest rates as intermediate targets mainly to promote stable monetary conditions for the growing needs of an expansionary economy and to maintain the purchasing power of the national currency. During the period 1959 -1968, interest rates were varied in order to stimulate bank credit and savings and to prevent capital outflows.

Managing monetary policy in the decade of the 1970s was different from the earlier decade. It was challenged by the emergence of unsettling and destabilising international monetary conditions, the world economic performance and behavior of international currency was disrupted and led to a new experience of stagflation.

During 1971–1972, monetary policy was gradually eased to stimulate expansion in business activity through reducing the lending and the borrowing rate of commercial banks to stabilise the onset of a recession. However, by late 1972 to 1974, there was a cyclical upswing in the economy (due to the first oil shock) resulting in an increase in export prices. The price increases indicated inflationary pressures. To stabilise the effect, the central bank introduced monetary measures. Deposit and lending rates were raised in 1973, imposed for the first time in 1974 the credit ceiling of 20 percent and 25 percent for commercial banks and finance companies respectively. Due to a moderation of monetary growth, the central bank abolished the credit ceilings and lowered the deposit and lending rates as well as lowered the statutory reserve ratio. To promote a sustainable rate of recovery, the central bank used expansionary monetary policy and encouraged the expansion of credit activity.

The challenges faced by the central bank during this decade was to maintain monetary stability, a strong and stable currency; to further the growth and development of sound financial intermediation; and to ensure that the sharp external fluctuations (shocks) did not unduly hamper the process of balanced expansion in the domestic economy.

5.2 THE CONDUCT OF MONETARY POLICY DURING 1981 – 1988.

During the early 1980s, monetary management was confronted with challenges posed by a prolonged recession in the international economy; slowdown in domestic activity; government budget and balance of payment deficits and rising inflationary pressures. In 1982, government's budget and balance of payments deficits were close to 19 percent and 14 percent of GNP respectively. The Inflation rate had risen from 3.6 percent in 1979 to 6.7 percent and 9.7percent in 1980 and 1981 respectively. The objective of monetary policy during 1980-81 was to restrain monetary expansion, inflation and to reduce the deficit in the balance of payments. The central bank faced the hard choice; to maintain high interest rates to discourage capital outflows as well as to mobilise savings or to maintain lower rates to stimulate business confidence and domestic activity, hence increasing the prospect for an early revival. By maintaining a selective restrictive stance in monetary policy, money supply (M1) growth moderated to 12.8 percent in 1981 against 15 percent in 1980 while the inflation rate declined to 5.8 percent in 1982 from 9.7 percent in 1981. Some of the measures undertaken included:

> Allowing a gradual increase in the interest rate. Deposit and average lending rates had increased by 0.5 to 2.0 percent per annum and from 10.2 to 12.0 percent per annum respectively.

> Guidelines to discourage credit for non-productive and speculative activity.

To prevent the high interest rates from undermining business activity and having an adverse effect on the early revival of the economy, the central bank stepped in to ensure liquidity in the banking system and stability in the money and foreign exchange markets. The central bank introduced several measures including:

> Open market operations – to dampen interest rates volatility,

> Foreign exchange swap facilities – to counter the effect of short term capital flows,

> Recycling of Government paper – to inject liquidity into the system, and

> Reducing SRR – SRR was reduced from 5 to 3.5 percent in October 1986 to replenish liquidity in the banking system.

Towards the fourth quarter of 1986, there was an inflow of funds due to the strengthening of the trade account when commodity prices began to recover. The strong export performance of manufactured products and services in 1987 and the continuing inflow of foreign direct investments reinforced this change of fortune. Consequently, the banking system was flushed with funds. Hence, central bank monetary policy during 1986-88 was confronted with the conflicting objectives of maintaining stability in the foreign exchange markets and reducing interest rates in the money market. The central bank needed to play a more active role to neutralise the excess funds to ensure that the excess liquidity would not generate any inflationary tendencies and to prevent interest rates from collapsing. During that year, a total of RM 1.7 billion of excess funds were mopped up through a range of liquidity operations, including unwinding of foreign exchange swaps, sale of government securities and the issuance of central bank certificates.

5.3 THE CONDUCT OF MONETARY POLICY DURING 1989 – 1994.

The period 1989 – 1994 was characterised by six years of prolonged and rapid economic growth since the recovery in 1987. The increase in money supply raised domestic demand amidst higher incomes, in a near full employment economy and imposed tremendous pressure on prices. The inflation rate increased from a low of 0.3 percent in 1985 to 3.1 percent in 1990, 4.7 percent in 1992 before it moderate to 3.7 percent in 1994. However, the inflation experience in this period was different from earlier periods[15] as the monetary expansion could be traced to larger capital inflows during 1992 and 1994. The substantial inflows – volatile in nature, were encouraged by sound economic fundamentals, large interest rate differentials in favour of Malaysia, buoyant activities in the local stock market and expectations of further appreciation of the ringgit. To contain the inflationary pressures (reduce excess demand), the central bank adapted a tight monetary policy. These monetary measures included:

[15] Inflation in 1970s and 1980s reflected higher imported inflation as sharp increase in oil prices lead to inflation in industrial countries.

➢ Six upward revisions in SRR – from 4.5 percent in May 1989 to 11.5 percent in July 1994.

➢ 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, and

➢ Guideline on hire purchase and credit cards.

While the above measures were effective in stabilising the inflation rate, their effects however were offset by substantial capital inflows. The swap limits imposed earlier were not sufficient to curb speculative funds (hot money) entering Malaysia. Obviously, these would have destabilising effects on the domestic economy. Thus, it required the central bank to impose monetary measures focused on curbing speculative activities by foreigners, especially banking institutions outside Malaysia. The measures 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, and

➢ Requiring commercial banks to place ringgit funds with banks outside Malaysia which are held in non-interest vostro accounts with the central bank in non-interest-bearing current account.

On the whole, these measures helped to stabilise the substantial capital inflows and moderate the growth in money supply (M3). Short-term speculative funds would either be repatriated or converted to long-term investment. During this period, however, monetary policy was complicated by several factors. The objective to sterilise capital inflows was thwarted by preventing a rise in interest rates, as this would dampen investments while further attracting capital inflows.

Consequently, the conflicting objectives of monetary policy and exchange rate stability helped to reduce the effectiveness of monetary policy. The large capital inflows created wide fluctuations in exchange rates, which required central bank intervention to mop up excess liquidity through other monetary instruments. Besides that, the implementation of tight monetary policy is effective only to interest-sensitive type of consumption expenditure. Furthermore, the effectiveness of monetary policy was influenced by adverse external factors for example, expansionary policies of other countries. As a result, the average annual growth rate of the monetary aggregates (M1, M2, and M3) increased to 17.7 percent, 16.5 percent and 18.4 percent respectively, while the inflation rate grew by 3.7 percent per year compared with 3.4 percent per year in the corresponding period.

5.4 THE CONDUCT OF MONETARY POLICY DURING 1995 – 1996.

During 1995, monetary policy faced major issues related to the large services account deficit, the efficiency and productivity of the industrial sectors, capital intensity of the production, the high import content of production, the need to upgrade skills and expertise of the labor forces. In this context, the role of monetary policy was to ensure that the excess demand would not create the inflationary pressures, which would jeopardise the growth process. To ensure sustained economic expansion, monetary policy continued to accord priority to achieve price stability.

In conducting monetary policy, there was always a need to balance external and internal considerations. The unprecedented, large inflows of funds in 1993 and 1994 complicated the monetary management. However, during January 1995, when the Mexican crisis occurred, a major portion of the funds flowed out thus reducing the contagion effect of the crisis on domestic market. The domestic liquidity conditions then become less influenced by destabilising capital inflows. Despite further firming of the interest rates (inter-bank rates rose from 4.91-5.89 percent in December 1994 to 6.48 - 6.85 percent in December 1995) and the interest rates differential between Malaysia and United States turned to 1.9 percent in favour of Malaysia from 0.8 percent in favour of United States, these were not associated with substantial short term capital inflows.

During the first half of the years, the growth of monetary aggregates and the inflation rates relatively low. However, monetary policy was tightened during August 1995 and again in October 1995 due to increases in the credit activity. The private sector lending was the primary expansionary force for monetary growth. Lending to the private sector increased significantly by RM64.2 billion in 1995 compared with RM31.3 billion in 1994. Monetary aggregates M1, M2, and M3 rising at the annual rate of 10.3 percent, 16.5 percent and 15.2 percent respectively at the end of June 1995. The broad monetary aggregates (M2 and M3) ended the year at the annual rate at 24.0 percent and 22.3 percent respectively compared with 14.7 percent and 13.1 percent at the end of 1994, while the growth rate of narrow money (M1) stabilised at 11.7 percent from 11.2 percent in 1994. This deviation in the trend of monetary growth has given the potential to increases in the excess demand and inflationary pressures.

A broad monetary measure was introduced during the year. This measure was directed to manage the excess liquidity, to contain the rate of credit, monetary expansion and inflationary pressures that may arise. The measures included:

- Lowering the margin for financing passenger car to 70 percent of the purchase cost,
- Lowering the margin for financing houses and apartments cost above RM150 thousand and shop lots cost above RM300 thousand to 60 percent respectively. However, this measure was not applicable for own dwelling and for the conduct of own business,
- Increasing the minimum monthly payment on the outstanding balance of the credit card account from 10 to 15 percent, and
- Increasing SRR from 11.5 to 12.5 percent with effect from 1st February 1996.

With this intensification of efforts to contain inflationary pressures, the inflation rate moderated in 1995 to 3.4 percent from 3.7 percent in 1994.

In 1996, monetary management approach will still continue to be directed at achieving the price stability and to deal with any destabilising influences that may arise. These include closely monitor the monetary situations to assess the implication of the measures undertaken in 1995. Due to the tight monetary policy, the broad monetary aggregates, M2 and M3 growth rate reduced to 19.8 percent and 21.2 percent respectively compared with 24.0 percent and 22.3 percent at 1995, while the narrow money, M1 rising at annual rate 16.7 percent compared with 11.7 percent in 1995.

In principle, formulation of monetary policy took two considerations "shock" to the system. First, fundamental economic changes and second, non-fundamental economic changes. The fundamental economic changes refer to the increases in the excess demand, which would warrant further tightening of the monetary policy, whereas non-fundamental economic changes included changes in the market expectations, which would affect the exchange rates. The non-fundamental changes were difficult to control due to the limited of sources to stabilise the changes. Under these conditions, normally monetary authorities will respond by the series of intervention operations to restore stability. For example, due to limited reserves, monetary authorities (central bank) cannot effectively control the speculation activity of the Ringgit. At the end of the year, the Ringgit appreciated by 0.5 percent against US Dollar from 0.7 percent in 1995.

Although the inflation rate was contained at 3.5 percent, the inflationary expectations persisted due to the high wages and income (average wages in manufacturing sector increased from 6.1 percent in 1995 to 9.6 percent in 1996), strong corporate profits as well as the wealth effect from increasing asset prices especially housing. In addition, the concerns of that Malaysia economics was expending beyond its potential growth required remedial actions to contain both the inflation and the excess demand pressures. During the year, it saw some indicators that Malaysian economics was at the downtrend. The indicators included reduction in the private expenditures from 15.4 percent in 1995 to 9.0 percent in 1996 and lower real aggregate domestic demand from 13.4 percent in 1995 to 7.0 percent in 1996. The study made by central bank revealed that the growth of potential output for Malaysia economics during 1970 – 1997 averaged 6.9 percent as compared with actual output growth of 7.4 percent[16]. Other indicators included:

- Loss of efficiency in the utilisation 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). During 1988–1996 TFP declined from 4.5 percent to 1.5 percent while ICOR rose from 3.0 times in 1988 to 6.5 times in 1997. The steeply rising ICOR indicate that the use of capital has been increasingly less effective. The rising ICOR is also due to increase investments into capital-intensive projects (mega projects) with long gestation periods, leakages and underutilised capacity,

[16] See Bank Negara 1997 Annual Report page 28 for further clarification.

➢ Rising current account deficit – despite having one of the highest savings rates in the world (38.5 percent of GNP), Malaysia ran into the current account deficits problem because of substantial investment rates (44.8 percent of GNP). Current account deficits rose from 5 percent of GNP in 1993 to 10.5 percent in 1995 before a drop to 5.1 percent in 1996, and

➢ Excessive credit to non-tradable sectors – loans for the property sectors were growing from 14.4 to 26.3 percent of total loans in 1996. Loans for purchases of stocks and shares grew at an average rate of 35 percent during 1993 – 1997.

Table 6.

Malaysia: Trends in Growth of Monetary Supply and Inflation.

	Annual Growth Rate (%)				Average Annual Growth Rate (%)				
	1995	1996	1997	Sept 1998	1961-70	1971-80	1981-88	1989-94	1995-98
M1	11.7	16.7	4.6	-17.0	5.7	17.0	7.8	17.7	4.0
M2	24.0	19.8	22.7	5.9	9.6	21.1	10.9	16.5	18.1
M3	22.3	21.2	18.5	4.0	n.a	21.6	10.8	18.4	16.5
Inflation	3.4	3.5	2.8	5.5	1.1	6.0	3.4	3.7	3.8
Real GDP	9.5	8.6	7.8	-4.8a	6.0	10.4	3.6	8.9	5.3

Source: Bank Negara, Statistic Department & Economic Report 1998/99
a: Economic Report 1998/99

5.5 THE CONDUCT OF MONETARY POLICY DURING CURRENCY CRISIS.

When the currency crisis hit Malaysia in July 1997, the monetary response was to let interest rates rise in the face of tight liquidity. Given the severe impact of Ringgit depreciation, the increase in the inflation rate could have been higher, if not for the favourable effects of lower inflation from abroad and the tight monetary and fiscal measures undertaken, particularly credit squeeze, helped to dampen the excessive growth in domestic demand. (GDP growth contraction to negative 2.8 percent, negative 6.8 percent and negative 8.6 percent for first quarter, second and third quarter of 1998 respectively. The 1998/99 Economic Report projected the 1998 GDP to contract by 4.8 percent). The pain caused by high interest rates prompted the central bank to change from contractionary to expansionary monetary policy. The mistake in the initial response was to combine budget austerity with a tight monetary policy. The monetary expansion slowed down significantly during the first eight months of 1998. A simultaneous tightening of both fiscal and monetary policy is the recipe for this contraction[17].

During the first year of the crisis (from July 1997 to August 1998), the monetary policy was operating in a very difficult economic environments due to the impact of region's financial crisis on domestic financial markets and real economy. The priority was to restore macroeconomic stability in domestic financial markets and real economy. A tight monetary policy was adopted earlier but due to a prolonged crisis and a slow down in the external demand had affected the economy adversely.

Acknowledging this, the central bank abandoned a surplus budget in favour of deficit budget. The 1998 revised budget was faced with RM9.587 billion deficits and 1999 budget was estimated with RM16.135 billion deficits, due to the increased in expenditure allocations (RM59.110 billion in 1997 to RM64.641 billion in 1998 and RM63.295 billion in 1999) to stimulate the

[17] Given the deficient of domestic demand and current account surplus in BOP the appropriate policy mix would be budget deficits and low interest rates.

economy, while at the same time maintain high interest rates. Table 7 highlights Federal Government financial position between 1997-1999.

Table 7.

Malaysia: Federal Government Financial Position 1997 – 1999 (RM million)			
	1997	1998r	1999a
Revenue	65,736	55,054	47,160
Operating Expenditure	44,665	46,563	47,042
Current balance	21,071	8,491	118
Gross Development Expenditure	15,750	19,378	17,553
Loan recoveries	1,305	1,300	1,300
Net Development Expenditure	14,445	18,078	16,253
Overall Budget balance	6,626	(9,587)	(16,135)

r revised budget a estimate budget

In fact, higher interest rates (KLIBOR rate 10.2 percent as at August 1998) with a floating exchange rates policies were considered good for strengthening external value of the Ringgit but unfavourable for the domestic business activities. The central bank faced interest rates dilemma. The central bank cannot have both. If the central bank used the former as a target, the latter will have to be left free and vice versa.

A new exchange control measures (introduced in October 1,1998) which disallowed the Ringgit to float in the foreign exchange markets obviated this dilemma. The new exchange controls made the Ringgit become non-legal tender outside Malaysia and the exchange rate vis-à-vis the US dollar was fixed at RM3.80 per US dollar. The exchange controls have forced billions of oversea Ringgit deposits to return home, hence easing the credits crunch in the financial system. The central bank has no longer to worry about the impact of the interest rates on the exchange rates. All these measures were tantamount to reorientation of the monetary policy towards the domestic sector of the economy. The interest rates have been on the downtrend since exchange controls were introduced. KLIBOR rates nose-dived from an average of 10.2 percent in August 1998 to 7.7 percent in September 1998.

Another measures taken to stimulate domestic activity included:

➢ Downward revisions in the SRR - from 10 percent in February 1998 to 4 percent in September 1998,

➢ Targeting 8 percent loan growth by the end of 1998,

➢ Increasing the limit of the loan for shares and stocks financing from 15 percent to 20 percent of total loans,

➢ Reducing the margin spread from maximum 4 percent to 2.25 percent above the BLR for the loans effective from October 1,1998,

➢ Redefinition of the NPLs from 3 months to 6 months,

➢ Formation of the Danaharta Nasional Berhad, a national asset management company in May 1998, and

➢ Formation of the Danamodal Nasional Berhad in August 1998.

A further reduction in the SRR would enhance the capacity of the banks to lend more. Every one-percent reduction in the SRR would release about RM 4 billion into the financial system. Narrower margin between deposit and lending rates would lower the cost of funds for the borrowers. The 8 percent 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 percent. 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.

In October 1998, Danaharta signed an agreement to manage RM 6 billion of Sime Bank's (now defunct) NPLs. In 11th November 1998, Danaharta bought over RM 11.255 billion NPLs from 11 financial institutions (representing 57 percent of total NPLs of these institutions) and would issue 10-year bonds (government guaranteed) as a purchase consideration. Table 8 lists all the NPLs bought by the Danaharta.

Table 8.

Malaysia: List of Non Performing Loans (NPL) Bought By Danaharta.

Financial Institution.	Amount of NPLs.
Arab-Malaysian Bank Berhad	RM 1.26 billion
Arab-Malaysian Finance Berhad	RM 368 million
Arab-Malaysian Merchant Bank Berhad	RM 1.17 billion
BSN Commercial Bank Berhad	RM 621 million
MBf Finance Berhad	RM 3.89 billion
Oriental Bank Berhad	RM 1.04 billion
Perdana Merchant Bankers Berhad	RM 94 million
RHB bank Berhad	RM 1.66 billion
Sabah Bank Berhad	RM 154 million
United Merchant Finance Berhad	RM 756 million
Utama Merchant Bankers Berhad	RM 236 million

Source: Pengurusan Danaharta Nasional Berhad.

We are not sure whether the expansionary monetary policy will jump-start the recovery process. It would depend more on the response of consumption and investment expenditures although the base lending rate of commercial banks had declined from a peak of 12.27 percent at end-June 1998 to 8.92 percent by the end of September 1998 and is expected to decline further to 8.5 percent by the end of October 1998. We hope that the increased liquidity through reduction in the SRR would not lead the economy into "liquidity trap" (increased liquidity with lack of consumer and investor confidence). Pushing interest rates down further below the inflation rate (inflation expectation within 7 to 8 percent per annum) would not benefit people whom save. The lower interest rates would only benefit the business sectors at the expense of the savers, if there were no inflationary impacts.

According to the 1998/99 Economic Report, GDP was forecast to grow by 1 percent in 1999 with the inflation rate at 3.5 percent, down from 5.2 percent projected for 1998. (The inflation forecast is based on a fixed exchange rate at RM3.80 per US Dollar). But how well the economy will recover in 1999 will hinge on two major factors. One, the speed and the extent of the implementation of both fiscal and monetary measures to revitalise 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 domestic spending and investments, but uncertainty volatility in the international financial environment combined with the sluggish and the negative growth among Malaysia's trading partners, is expected to weigh down growth prospect[18].

The wide-ranging policy measures introduced in the third quarter of 1998 are expected to provide increasing stimulus to domestic demand in the fourth quarter of 1998. The 1998/99 Economic Report is optimistic that these measures are expected to pull the economy out next year from the recession. The report said that these measures had not exerted inflationary pressure, in fact the inflation rate had decelerated since July 1998.

With the inflation rate expected to remain low and the current account in the balance of payments expected to be surplus in 1999, easier monetary and fiscal policy stance can continue to be pursued to stimulate growth within the context of maintaining domestic price stability and external payment equilibrium.

[18] Most foreign economists are conservatively forecasting between zero to 0.5 percent growth in 1999.