CHAPTER 6

CONCLUSIONS

6.1 Findings

Credit-lending channel offers another alternative explanation on how a shift in monetary policy exerted its influence on the real economy. The theoretical construct of this view is the credit market imperfections. According to this view, a shift to a tight monetary policy will register a direct negative impact on bank loans. Due to credit market imperfections, many bank borrowers will be denied easy access to alternative sources of funds. Thus, the effect of monetary policy on bank lending will lead to a reduction in aggregate demand, as borrowers could not find a substitution for the declining bank loans. Accordingly, this alternative explanation has
motivated a lot of studies, to find the supportive evidence of this view, using different approaches.

However, despite the large number of studies, the role of credit-lending channel in the transmission of the monetary policy remains unsolved. On a conceptual level, broad agreement exists on how this channel might operate but the evidence about its actual impact on the real economy has been inconclusive. Scepticism about the practical importance of this channel arises following two basics factors: monetary policy failed to affect bank lending and even if it affects bank lending, such changes might not have an independent effect on the macroeconomic, since firms are able to obtain credit from sources other than bank.

This study, employing the data on the Malaysian economy and the methods advanced by Romer and Romer (1990) too, is unable to find the supportive evidence for this view. A preliminary descriptive study that was undertaken to get an overview of the Malaysian credit market also suggests the similar findings. In fact, the evidence is much more consistent with the conventional money view that claims the impact of a restrictive monetary policy on the economy is channelled through the money supply effect.
The descriptive analysis done in Chapter 3 suggests the possible explanation on why credit-lending channel has no important role in the Malaysian economy, at least during the period under study. By examining the behavior of bank loans, monetary aggregates and the banks' portfolio adjustment individually, during a series of restrictive monetary policy, it is possible to detect the path that the link between credit and output is broken.

The interest rates behavior adheres to the monetary theory; it rises during tight monetary policy. However, the direct impact of monetary tightening on loans is very minimal, compared to the monetary aggregates. Further examination on banks' portfolio adjustments demonstrates that banks hold securities as buffer stock, which they manipulate in times of monetary tightening as to enable them to insulate their lending activities. Thus, the Bank Negara's ability to affect credit growth in the economy is jeopardized. Therefore, credit-lending remains unaffected despite the tight monetary policy. In other words, the banks lending activities' response to a monetary shock does not follow the neatly documented path of credit-lending transmission mechanism. The condition that is considered necessary for the existence of credit-lending channel, which concerned with the ability of the authority to affect credit supply, is violated.

However, studying the focal episodes individually, during the third focal episode, the bank loans do decline in line with the shift to a restrictive
monetary policy and the inspection of interest rates spread confirms that the decline is attributed to the supply side, at least during the first six months of the third focal episode. Nevertheless, it should be noted that the shift is not an independent shift of monetary policy. The motivation is not to dampen inflation as the two previous episodes. The main consideration is to save the economy from the financial turbulence.

In Chapters 4 and 5, it is found out that there is no evidence that bank loans lead output. The evidence of credit-lending assuming an important independent role in the transmission mechanism is also absent, even in the third focal episode. The results are more supportive of the money channel. In addition, empirical results suggest that it is output that drives loans, and not vice versa.

Overall, the main implication of this study is the monetary policy in the Malaysian economy did not work via credit-lending channel, at least during the period under study. On the contrary, though on average the bank loans declined marginally, in the first two episodes they actually registered a positive growth rate. Thus, rather than providing an important transmission channel, banks in the Malaysian economy is more likely to cushion the macroeconomic impact of monetary policy by insulating their lending activity from monetary shocks. This might partly explain why there are hardly any significant real effects of monetary disturbances, and of
course excluding the most recent episode, which is subjected to the regional financial crisis.

6.2 Descriptive Analysis vs Empirical Findings: A Reconciliation

Chapter 3 and Chapter 4 suggest that the conditions for the credit-lending channel to exist, are satisfied. The bank loans do decline after the implementation of tight monetary policy in September 1997. Investigation on interest rates spread also suggest that the decline in bank loans emanated from the supply side, that is the decline in loans could be attributed to the unwillingness of the banking sector to extent new loans. In other words, the evidence suggests that there is a credit crunch during the third focal episode.

Following Walsh (2000), the presence of a credit crunch is sufficient to pin down the existence of a credit-lending channel. In other words, this is enough to claim that credit-lending channel is operative in the Malaysian economy during the third focal episode.

However, the empirical analysis shows no such evidence. There is no obvious or significant deviation of the loan-output relationship during the focal episodes from the usual times. If credit-lending channel were to be important, the loan-output relationship must be stronger than the usual relationship. Although there is a credit crunch, further analysis shows that
the decline in credit does not pose the expected impact on output, as predicted by the credit-lending channel. This may be due to the fact that borrowers especially large firms are able to seek alternative financing since the banks are reluctant to extend loans.

In short, the existence of credit crunch does not indicate the existence of a distinctive credit-lending channel in the economy. The credit-lending channel is only complete after the impact on loans is transmitted to the output. The impact of reserves on loans or the reserves-loans relationships is not yet the complete path of the channel. Therefore, the ultimate results suggest that there is no evidence of a distinctive credit-lending channel in the Malaysian economy.

Where the money channel is concerned, note that the empirical findings in Chapter 4 show that despite the tight monetary policy, on average, M3 and M2 increases. However, this is due to the large inflows of foreign capital due to the interest rates differential in favour of Malaysia. Being an open economy, the authority does not have complete control over the monetary aggregates. Due to external developments, the results indicate that on average, M2 and M3 increases despite the tight monetary policy.
Nevertheless, note that these two monetary aggregates do decline during the first and the third episode for several months after the monetary shock. Given the fact that the average movements in M2 and M3 is significantly influenced by the large foreign capital inflows in mid 1990s, it is justifiable to take into account their paths in individual focal episode as well, showing that these two monetary aggregates indeed show the negative deviation, as expected by the money channel during monetary tightening.

Only M1 shows the expected negative deviations from its usual path, substantially. Further, M1 is found to have the lagged relationship with output. This provides strong evidence that M1 have an important role in the transmission mechanism. Apart from that, the M1-output relationship is also stronger during the focal episodes than usual. As for M2 and M3, their relationships with output is significantly stronger during the focal episodes compared to usual but there is no evidence that both M2 and M3 leads output. Taken together, the findings indicate that the money channel is more important in the Malaysian economy compared to the credit-lending channel.

6.3 Policy Recommendations

The fact that credit-lending channel is not operative in the Malaysian economy guide us to one important policy measure: the Bank Negara
Malaysia has to adhere to credit actions if their intention is to reduce the growth of loans. This is so since they could not afford to rely on the higher interest rates to cut down loans. Available evidence suggests that monetary tightening did not lead to a decline in growth of loans. Banks prefer to alter their portfolio holdings in order to maintain their lending activities. Therefore, to ensure that Bank Negara has a grip over the loan supply, which is one of the macroeconomic important variables, they should keep up with their credit actions. Apart from that, the fact that the economy is on the path towards recovery, yet facing another prospect of global recession, it is smart for Bank Negara to carefully design the pattern of the loans supply that is ideal and blend well with the needs of the economy.

In comparing the credit and money view, it is also found out that money has the most significant relationship with output. The evidence suggests that regardless of the motivation behind each restrictive monetary policy, M1 leads output. In other words, M1 predicts output better than other financial variables. The results suggest that M1 is still an ideal target variables although Bank Negara Malaysia (1999) claimed that, "Studies has shown that monetary growth no longer provided any additional explanatory power beyond that provided by the output gap. This could be interpreted as suggesting that monetary growth is caused by output and
not vice versa, making monetary variables a lagging indicator, and therefore unsuitable as an intermediate target.

6.4 Conclusions

Overall, the operation of the credit-lending channel relies on the willingness of Bank Negara Malaysia to sacrifice output in order to achieve its ultimate target. Obviously, a monetary tightening would lead to a decline in output. However, the Malaysian economy is a developing economy. Therefore, monetary tightening has to be carefully designed in such a manner so that it would not pose any destruction to development effort. In other words, monetary tightening could not be so stringent, except when there are considerations that are more important such as saving the currency, as experienced by Malaysia during the financial crisis.

Other than that, Bank Negara Malaysia has to be moderate in controlling the growth, including credit although the authority keeps claiming that it is an important monetary tool. Credit control in the economy works mostly through moral susansions. On the other hand, the rapid development of the security and private debts market has reduced reliance on loans and the importance of loans. That might be the candidate explanations on why the credit-lending channel is not distinctively important in the Malaysian economy.
Nevertheless, given the fact that the existence of a distinctive credit-lending relies on the nature of the policy itself and other developments in an economy, it is very unlikely that the importance of the channel in the economy will remain constant over time. It might evolve through times according to the economic environment that prevails.