Globalisation and the operation of monetary policy in Malaysia

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1. Introduction

Malaysia is a small, trade-dependent economy with a high degree of foreign presence in both the real and financial sectors; globalisation and capital flows have thus had a significant impact on the operation of monetary policy in the country. In the last decade, Malaysia has had quite a varied experience in its monetary policy operations, with the changes in the monetary framework being made mainly in response to global developments. In analysing the challenges to monetary policy, this paper examines the evolution of the monetary policy framework during the period just prior to the Asian crisis and the changes since the crisis, following the shift from a floating exchange rate regime to a pegged exchange rate system. A section also deals with structural reforms, a key success factor in a holistic approach to achieving the objectives of monetary policy to promote growth with price stability. The last section deals with the challenges to monetary policy going forward and the ongoing work to build domestic capacity to manage external risks and reduce vulnerabilities as Malaysia continues to liberalise its financial sector.

2. The period prior to the Asian crisis - shift away from monetary targeting to interest rate targeting

The evolution of the monetary policy framework can be broadly characterised by the following developments:

- The shift in monetary policy strategy from monetary targeting towards interest rate targeting in the mid-1990s; and
- The transitional changes in introducing more market-based monetary policy implementation procedures since the crisis.

Prior to the mid-1990s, the monetary policy strategy had been based on targeting monetary aggregates. This was an internal strategy and was not formally announced to the public. The deployment of this strategy was based on evidence that the monetary aggregates were closely linked to the ultimate objectives of monetary policy. In a correlation test conducted using quarterly data from 1980 to 1992, monetary growth (M3) was shown to be positively and highly correlated with inflation. Given that price stability was the ultimate objective of monetary policy, monetary targeting was seen as a suitable target for policy. During this period, the central bank, Bank Negara Malaysia (BNM) influenced the day-to-day volume of liquidity in the money market, consistent with the monetary growth target. This was to ensure that the supply of liquidity was sufficient to meet the demands of the economy, in line with the Bank's monetary policy objective of price stability.

However, subsequent developments in the economy and financial system during the early 1990s weakened this relationship and highlighted the problems associated with using monetary aggregates as policy targets. In particular, the globalisation of financial markets had altered the money demand function, making the relationship between monetary aggregates and output as well as prices less stable. The large capital inflows in 1992-93, followed by a reversal in the following year, brought to the

[1] A substantial portion of this paper is derived from the Bank Negara Malaysia publication "The Central Bank and the Financial System in Malaysia: A Decade of Change 1989-1999". Nevertheless, the analyses and conclusions of this paper are the sole responsibility of the author (Assistant Governor of Bank Negara Malaysia from October 1996 to November 2004) and do not necessarily reflect the views of Bank Negara Malaysia.

forefront the instability of monetary aggregates as targets. As can be seen in Chart 1, the annual money supply growth, as measured by M3, was extremely volatile during the periods of large capital flows. The large swings in M3 reduced the viability of M3 as an intermediate target.

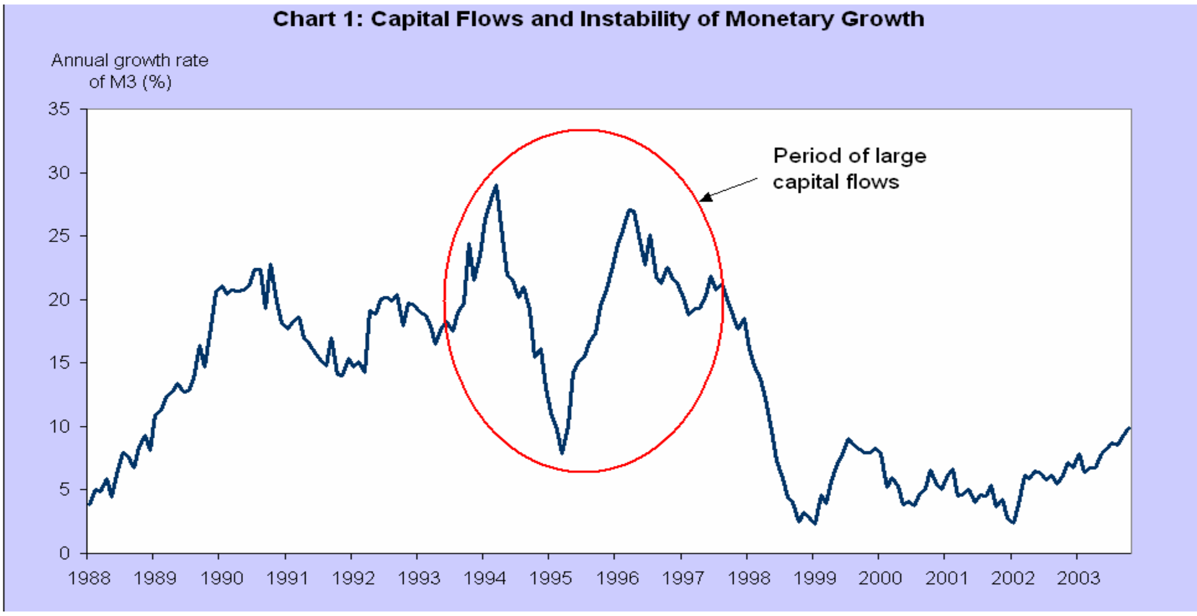
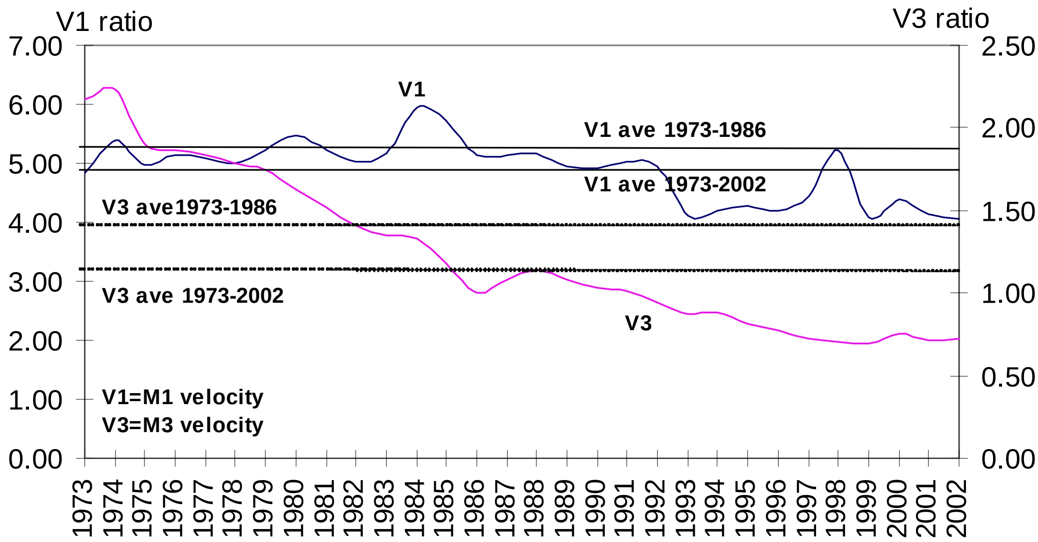


Chart 2 shows that monetary velocities, ratios of nominal GDP to various monetary aggregates, have shown marked departures from their historical patterns since the early 1990s, making the monetary aggregates unreliable as indicators of economic activity and as guides for stabilising prices. Consequently, towards the mid-1990s, BNM shifted its focus from monetary targeting to interest rate targeting. BNM, nevertheless, still monitors very closely monetary aggregates, credit growth and other economic and monetary indicators. These include price developments (including asset prices) and indicators of consumption and investment.

Chart 2

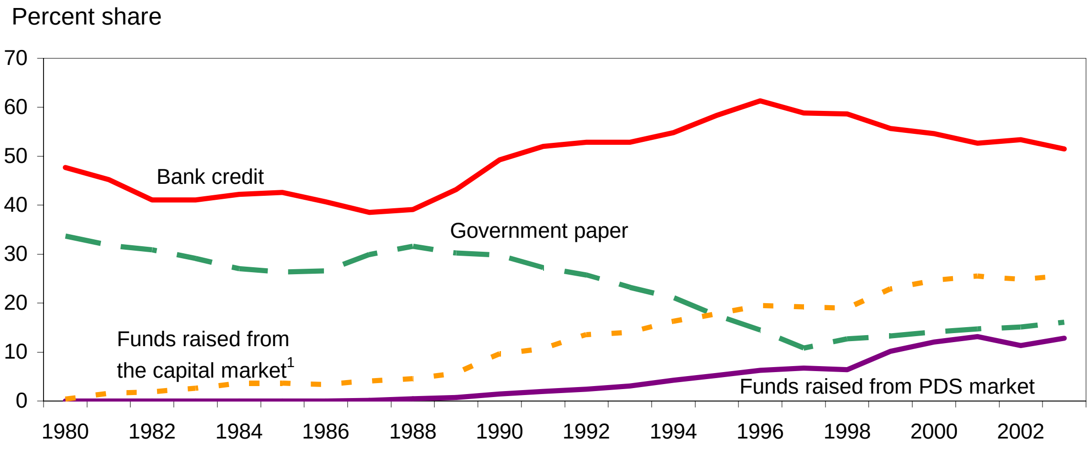
Monetary velocities



In Malaysia, the shift in the monetary policy strategy from monetary aggregates to one in which interest rates were the intermediate target was precipitated by four main considerations. First, the liberalisation of interest rates since 1978 led to a more market-oriented interest rate determination process. Second, financial deregulation and liberalisation measures undertaken during the 1970s had enhanced the role of interest rates in the monetary transmission mechanism. Third, there was a notable shift in the financing pattern of the economy since the mid-1980s following structural changes in the economy from an interest-inelastic market (government securities market) to a more interest-sensitive market (bank credit and capital market). Fourth, as a matter of policy, BNM has maintained positive real rates of return on deposits. The Bank also holds the view that interest rate stability is an important policy variable to promote a stable financial system which will contribute towards a more effective transmission mechanism of monetary policy. Given these developments and an economic environment where investors had become increasingly more interest-sensitive, a monetary framework based on interest rate targeting proved more suitable in meeting the objectives of monetary policy.

Chart 3

Financing of the economy



[1] Both equity and private debt securities markets.

The preference for interest rates over other variables such as reserve money in the conduct of monetary policy had been further reinforced by the globalisation of financial markets and global economic integration. A consequence of financial globalisation is the erosion of autonomy in domestic monetary policy formulation, as domestic policies need to take into account external considerations. Hence, movements in interest rates abroad vis-à-vis domestic rates could no longer be totally ignored in monetary policy implementation. At the same time, globalisation has made it increasingly difficult to forecast the supply of and demand for bank liquidity in the banking system given the volatility of capital flows.

3. Policy response during the Asian crisis

In 1997-98, the ability of BNM to influence domestic interest rates based on domestic considerations had been affected by the volatile short-term capital flows and the excessive volatility of the ringgit during the Asian financial crisis. In 1998, given the risk of large capital outflows due to higher interest rates offered in the offshore market to attract ringgit funds for speculation on the ringgit, BNM was not able to lower interest rates to contain a further contraction in the economy. Amidst the heightened uncertainty during the period, this policy option was itself a potential source of further instability in the foreign exchange market. Under these circumstances, selective exchange controls were introduced on 1 September 1998 and the ringgit exchange rate was fixed at the prevailing market rate on the following day. These measures provided BNM with a greater degree of monetary autonomy in influencing domestic rates to support the economic recovery without having to focus large resources on managing the ringgit exchange rate.

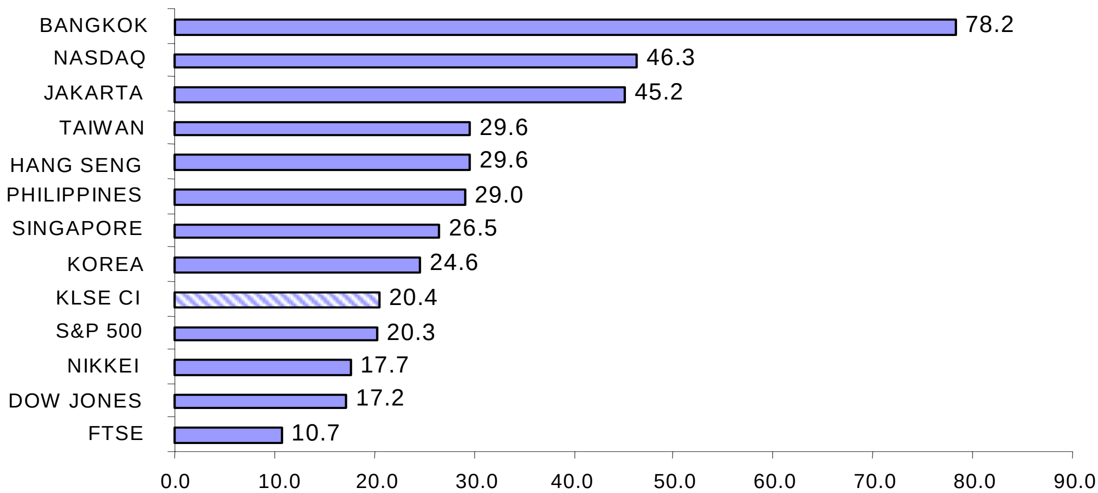
4. Operation of monetary policy with a pegged exchange rate regime

The impossible trinity suggests that it is not possible to have a situation of perfectly mobile capital, monetary independence and a stable exchange rate at the same time. Under the pegged exchange rate, Malaysia has to some extent been able to effect monetary policy based on domestic policy objectives. This has been made possible due to several factors. First, interest rates in Malaysia have not been the main push-pull factor behind the movements of financial flows. The bulk of the reserve accumulation reflects trade flows rather than financial flows. This has largely mitigated the concern over possible sudden reversals of flows that could complicate monetary management. Despite higher domestic interest rates, inflows in search of higher yields were not excessive in 2003. Inflows into ringgit-denominated papers and ringgit external accounts by foreigners account for only 7% of the increase in reserves in January-October 2003. While bank borrowings have a greater correlation with interest rate differentials, such borrowings mainly reflect trade flows. Inflows into non-interest income assets (including equity markets), the main cause of instability in the past, have been manageable.

Chart 4

Growth of selected regional stock market indices

31 Dec 02-27 Nov 03



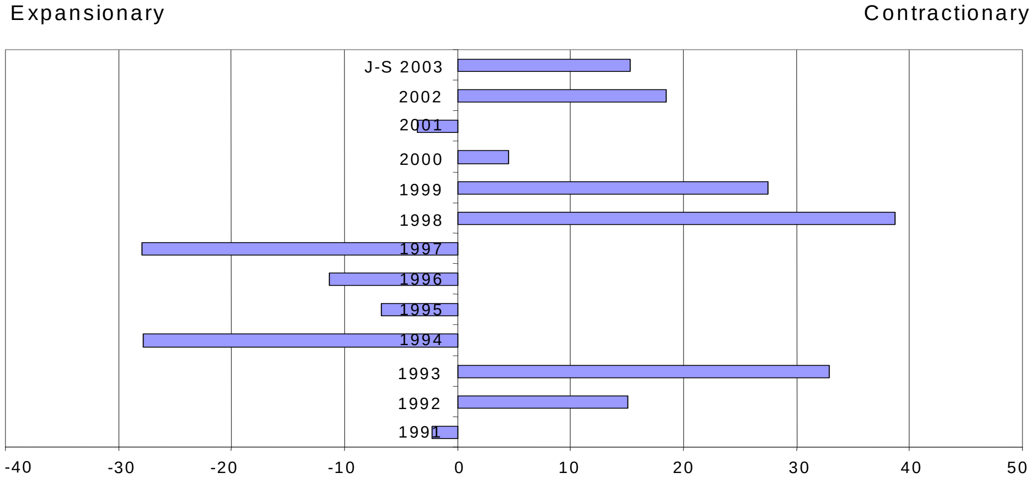
This development is the result of putting in place a system of administration of capital flow management that balances the ability of residents to source funds from abroad as well as invest abroad for productive purposes, without causing undue instability in domestic financial markets. The current policy of not allowing transfers among external ringgit accounts (non-internationalisation of the ringgit) also limits the availability of ringgit in offshore markets for speculative positions. This is a major factor in foreclosing the necessity for monetary policy in Malaysia to shadow US monetary policy in spite of pegging the ringgit rate to the US dollar. In other words, a balanced approach in managing flows to support real economic activities without unduly constraining corporate efficiency has contributed to stability in domestic financial markets. This is an important factor in facilitating some independence in influencing interest rates to support domestic growth and price stability objectives.

Since 1998, the management of monetary policy has focused mainly on managing liquidity to maintain interest rates at levels that are sufficiently low to promote economic activity while at the same time, ensuring positive real rates of return to depositors. During this period, liquidity operations by BNM have been largely contractionary to sterilise inflows from the external sector arising from the large trade surplus and to a lesser extent, portfolio inflows. Unlike some emerging economies that have experienced a large accumulation of reserves during this period, net inflows into Malaysia have been relatively moderate, and hence the sterilisation exercise has been manageable. The sterilisation coefficients, estimated at –1.54, indicate a relatively high degree of sterilisation. Liquidity operations were conducted mainly through direct borrowing from the market and, to some extent, via the issuance of bills. There is also centralisation of deposits of the federal government and a non-bank financial institution with Bank Negara Malaysia, a practice since the 1980s.

Chart 5

BNM Liquidity Operations[1]

RM billions



[1] Direct borrowing & BN bills.

More importantly, the ability for some independence of monetary policy to prevail under the fixed exchange rate regime has been due to the underlying support accorded by achievements in structural reforms. In addition to the reforms in the financial markets, reforms and changes in market practices have been instituted that have resulted in greater flexibility of labour markets and more market-based price determination in both the goods and services sectors.

(a) In the banking sector, the consolidation and rationalisation exercise through the merger of 54 domestic banking institutions into 10 banking groups has enhanced the operational efficiency and resilience of domestic financial institutions. Ongoing work to prepare the financial sector to compete in a more challenging environment focuses largely on enhancing the capacity of domestic financial institutions. This involves implementing a comprehensive consumer education programme and deepening the risk management and governance framework. Where it benefits the economy in terms of strengthening the financial sector, liberalisation plans have also been brought forward. Three new licences for foreign Islamic banks will be issued.

(b) In the labour market, to overcome constraints such as wage system rigidity which is determined through collective bargaining or contractual agreements, the implementation of the Productivity-Linked Wage System (PWLS) was encouraged. As a result, during 2000-2002, from a total of 311 collective agreements signed, 167 or 53.5% contained elements of productivity linkages. Increasing acceptance by trade unions and commitment by employers to the PWLS have resulted in greater flexibility in the wage mechanism, determination and implementation.

(c) More market-based price determination is most visible in the services sector, which has a more direct correlation in influencing the cost of operations and consumer and investor responses to changes in interest rates. The liberalisation of administered prices for essential goods and the deregulation of several industries have resulted in greater competition and, hence, price flexibility. The most significant liberalisation is in the retail petroleum prices, where the subsidy is being gradually removed.

At the same time, measures were also introduced to enhance the effectiveness of monetary policy in the medium to long run, through the implementation of monetary policy procedures that were more market-based. A three-pronged strategy to facilitate this transition process was implemented, comprising: enhancing transparency; improving the payment and settlement arrangements; and accelerating regulatory and prudential reforms.

First, BNM has stepped up its efforts to enhance transparency in the conduct of monetary policy by improving the Bank's communication strategy and enhancing the dissemination of information to the market. In the wake of rapid developments in the financial sector and the economy, and given the broader-based market participants in the financial markets, the increasing risk of the misperception of monetary and financial policy changes emerged. A significant move towards the effective communication of monetary policy has been the announcement of the monetary policy direction at fixed, predetermined periods. This is a major shift from the previous practice of announcements only at times when there is a policy change. The recent practice of regular monetary policy pronouncements on a quarterly basis creates certainty for investors while enabling BNM to manage expectations.

In addition, BNM has announced the daily liquidity forecast and its daily tender operation results to the public since 1998. Hence, an important channel of policy signalling is through its daily tender operations, with the intervention rate performing a reinforcing role in conveying its policy intention to the market. Prior to this, policy signalling was less explicit, with the Bank conducting its money market operations on a less regular basis and occasionally through money market brokers rather than directly with money market players.

BNM has also placed increasing emphasis on the information content of the conduct of monetary policy and publishes previously undisclosed positions of its money market activities as well as a wide range of other information, including adhering to the templates under the International Monetary Fund's Special Data Dissemination Standard (SDDS). In addition, greater disclosure requirements have been imposed on banks and corporations. BNM has also launched a homepage to provide simultaneous releases of information through the media.

Second, the Bank has taken measures to improve trading, payment and settlement arrangements to reduce the potential problems created by the handling of large volumes of securities, as well as the settlement lags, thereby enabling a larger volume of transactions to be undertaken.

Third, BNM accelerated both regulatory and prudential reforms to foster an environment for sound credit decisions, enhance bank soundness, and improve bank liquidity management. Amongst the measures taken to improve the liquidity management of banking institutions was the introduction of a new liquidity framework, replacing the liquidity requirement imposed on banks. This framework, which is modelled against international best practices on liquidity management, focuses on an efficient matching of the assets and liabilities profile that will enable banks to be better positioned in times of liquidity shocks and allow better utilisation of funds, as well as remove price distortion on liquid assets resulting from the captive demand created under the previous framework.

For the most part, the transition in the monetary policy framework towards a more market-based approach has proceeded at a relatively smooth pace, largely owing to three main factors. First, the existence of a coherent policy strategy between financial sector liberalisation and monetary policy reform. Recognising that financial stability is crucial in the conduct of monetary policy, special emphasis has been placed on policy coordination and measures required to strengthen the effectiveness of monetary policy and to maintain financial stability. Second, the transition towards a more market-based system has been facilitated by the appropriate sequencing of reforms. BNM did not resort to a "big bang" approach in liberalising the financial sector. Liberalisation was only allowed at a pace consistent with the prevailing market conditions and the evolution in the structure of the economy and the financial system. Third, financial discipline and prudent fiscal policy have contributed positively to macroeconomic stability, which has allowed a smooth implementation of financial reforms.

5. Further deregulation of financial markets

Moving forward, the stability accorded by the fixed exchange rate regime provides opportunities to further liberalise regulations. As provided in the Financial Sector Master Plan, a key component of the financial liberalisation process is to move towards a more market-based system in the determination of interest rates. This involves building the capacity of domestic banks in the pricing of loans and strengthening their risk management systems to compete in a more liberalised environment. Liberalising the existing base lending rate (BLR) formula, which guides ceiling lending rates of financial institutions and its linkages to the monetary policy rate, will also necessarily include some changes to the monetary policy framework and procedures. Currently, the BLR provides the guidelines to financial institutions on the ceiling lending rates. The formula itself is linked to the monetary policy rate, a link that was intended to ensure almost immediate pass-through of changes in interest rates directly to lending rates.

Under the current conditions of increasing volatility in financial markets, the fixed exchange rate will continue to provide stability and certainty to facilitate trade and investments. In this regard, the focus of policy continues to be directed at sustaining, and where necessary strengthening, the economic fundamentals to support the sustainability of the exchange rate. In the six years since its introduction, the exchange rate level has remained at fair value with minimum misalignments. This has been achieved through building stronger fundamentals of low inflation, increasing reserves, current account surpluses in the balance of payments, relatively low and largely hedged external debt and a strong banking sector. Further strengthening in fundamentals is being ensured through concerted measures to reduce the fiscal deficit to a balanced position within the next two to three years. An important development in enhancing fundamentals is also the strengthened corporate health and more stringent governance practices, which will further reduce risks to the financial institutions from any adverse external shocks. Continuing the judicious management of capital flows will further allow monetary policy to be based on domestic conditions with stable exchange rates.

The further liberalisation of capital account transactions is an ongoing process. The focus of liberalisation is to reduce the regulatory cost of doing business in Malaysia and to increase efficiency in the management of financial resources, particularly by the corporate sector. Liberalisation to accord greater flexibility to individual investors in the choice of instruments to enhance the returns on savings is also being facilitated. In all these efforts, a primary guiding principle is that changes will not create destabilising conditions in domestic markets. Deregulation and liberalisation will be pragmatic, with the necessary management of the trade-offs between the efficiency of markets and ensuring stable economic and financial conditions.

6. Conclusion

In today's globalised environment, a key precondition for monetary policy to remain effective, in any exchange rate regime, is establishing a track record of credibility. In Malaysia, this credibility is being achieved by adopting a holistic approach to policy formulation. Rather than overburdening one policy tool, policymakers have used a combination of several instruments for more effective results. Policy coordination and an effective machinery to facilitate this coordination are cornerstones of ensuring credibility through the policies achieving their stated objectives. The Malaysian experience has, over time, demonstrated that interest rates as a policy tool can be more effective when working in concert with other complementary policies.

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