Comments on: “Understanding monetary policy in Malaysia and Thailand: objectives, instruments and independence” by Robert Neil McCauley

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The paper by Bob McCauley provides a well written survey of the conduct of monetary policy in Malaysia and Thailand, highlighting the similarities and the points of divergence. Overall, I think it is a balanced and thoughtful note that seeks to draw insights into the conduct of monetary policy in these two countries. The paper, in a number of instances, displays the author’s sensitivity to key differences between the conduct of monetary policy in small developing open economies and the more developed but more closed economies. This is refreshing given that one often comes across views, sometimes expressed by “experts” in the developing countries themselves, that blindly seek to reflect the experiences of the developed countries onto the developing countries. Although I do not agree with everything in the paper, the areas of divergence of views are relatively minor. Therefore, in my comments I will seek to elaborate on some of the areas that I feel were not adequately covered in the paper, and will limit my comments to the Malaysian case.

Multiplicity of monetary objectives

The Central Bank of Malaysia (Bank Negara Malaysia) sees its multiplicity of goals as a natural outcome of being a central bank in a developing country. In wealthy economies, it may make sense for central banks to focus exclusively (though even then, not so exclusively) on the preservation of the value of wealth by focusing only on maintaining price stability. In developing countries, while preservation of the value of wealth is important, the creation of wealth is an equally important policy objective. Therefore, while recognising the importance of maintaining price stability as the paramount objective of monetary policy, the central bank also recognises that having an appropriate policy to support the financing of productive investments allows the economy to increase its potential output level and sustain a higher level of economic growth. It is for this reason that the monetary policy objective of Bank Negara Malaysia is stated as being “the promotion of maximum sustainable growth in an environment of price stability”.

The paper also notes that each central bank “at times pursues financial stability not through setting short-term interest rates but rather through credit or prudential policies”. In the case of Malaysia, Bank Negara Malaysia has clearly stated its belief that interest rates are a blunt instrument and may not be the appropriate tool for dealing with issues in the banking system. Bank Negara Malaysia is the regulator and supervisor of the banking system, insurance companies and the development finance institutions. This role provides many advantages and compliments the monetary function. For instance, excessive bank lending to asset markets can be dealt with through a tightening of prudential standards rather than higher interest rates. During the Asian financial crisis, the availability of detailed information about

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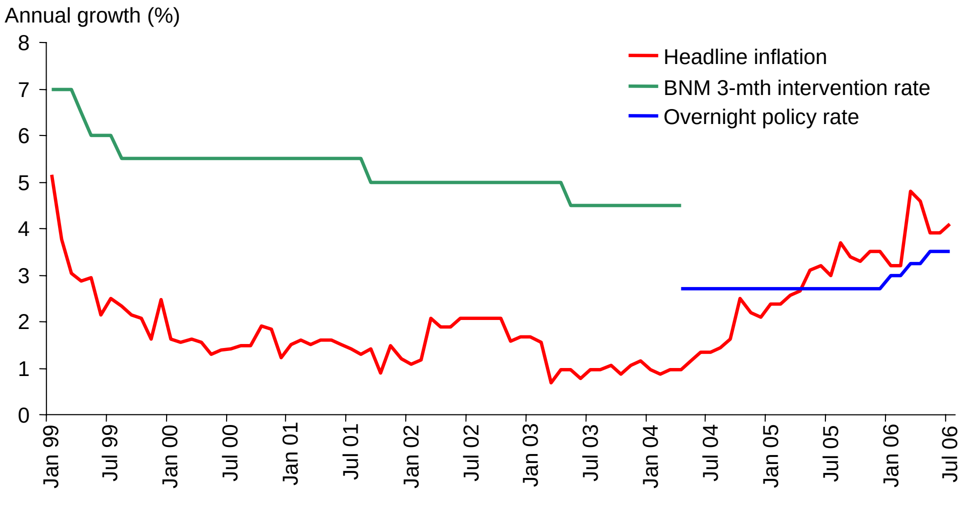
the balance sheets of banking institutions allowed the central bank to pre-empt a credit crunch.

Finally, another important goal of Bank Negara Malaysia has been to promote the development of the Malaysian financial system. It has played a leading role in institution building, including the setting up of the Securities Commission, the National Mortgage Corporation, rating agencies, development of the bond markets and the Labuan Offshore Financial Centre, just to name a few. In setting interest rates, a key consideration has been avoiding negative real deposit rates over sustained periods. This has promoted the mobilisation of funds through the formal banking system. The Bank sees the benefit of a well developed financial system through its increased contribution to economic growth, increased efficiency of financial intermediation and enhanced effectiveness of monetary policy.

Policy rate

The paper notes that, unlike Thailand, Malaysia's policy rate has remained unchanged since mid-2001. This statement is based on observing the overnight rate, which, as the author notes, only changed by 30 basis points during the period to end-2005. However, a more representative depiction of the conduct of monetary policy in Malaysia during this period is shown in Graph 1. The first thing to note is that over this period, there have been two different policy rates. The overnight policy rate (OPR) was adopted as a policy rate only in April 2004, with the introduction of the New Interest Rate Framework. Prior to that, there was Bank Negara Malaysia's three-month intervention rate. Excluding the transition between the two policy regimes, the policy rates were adjusted by a cumulative 280 basis points over the period until end-2005.

Malaysia: policy rates and inflation



There are two reasons why the intervention rate was not adjusted downwards more sharply over this period. First, a significant amount of the adjustment in the policy rate had already been undertaken in 1998, when it was reduced by 400 basis points, thereby requiring a smaller adjustment in the subsequent period. Second, further downward adjustment of the policy rate would have pushed deposit rates considerably lower and contradicted the policy objective of avoiding negative real deposit rates over a sustained period.

On the "rhythm" or frequency of monetary announcements, there is now no difference between Malaysia and Thailand. In August 2003, Bank Negara Malaysia started off by issuing the Monetary Policy Statement (MPS) four times a year to coincide with the quarterly release of the GDP growth numbers. Subsequently, an MPS was issued after every one of its eight Monetary Policy Committee (MPC) meetings, and since May 2006, the MPS has been issued on the same day as the MPC meeting. An advance calendar of MPC meeting dates for the following year is also now made available to the public.

Monetary policy and the exchange rate

I support the view expressed in the paper that because of the openness of the Malaysian economy, policymakers are very concerned about the exchange rate. However, this does not mean that the authorities actually try to determine a time path for the exchange rate. Rather, the major concern of policymakers has been to avoid excessive volatility and maintain a fairly valued exchange rate with respect to Malaysia's major trading partners. One of the main sources of distortion since the early 1990s has been the large and rapid movements of short-term capital in and out of the economy. If allowed to prevail, the outcome would be increased exchange rate volatility and overshooting of the exchange rate. Under these circumstances, Bank Negara Malaysia had intervened in the foreign exchange market. Of course, in earlier days, sterilisation was an important concern given that the central bank did not have sufficient instruments to absorb the excess liquidity, particularly when the inflows were large. It was also during the mid-1990s that the central bank moved from monetary targeting to interest rate targeting, as the former was distorted by the large inflows from the external sector. Finally, the central bank has never used its interest rate policy as a means to influence the exchange rate. While large changes in the exchange rate have a significant impact on the economy, the role of the exchange rate as a transmission channel for monetary policy has been relatively weak and uncertain.

Monetary policy instruments

Having enough instruments to undertake its monetary operations has been a perennial concern for Bank Negara Malaysia. In the period prior to the Asian financial crisis, this forced the choice towards more direct instruments such as the statutory reserve requirement. However, with the efforts put into the development of the financial markets, the central bank has been able to diversify its monetary instruments. While the bulk of monetary operations are still conducted through direct borrowing from the money market, the central bank has not used the statutory reserve requirement as a monetary instrument since the crisis.

As noted in the paper, Bank Negara Malaysia has focused increasingly on using repos as a monetary instrument, but in order to increase the scale of these operations, it has had to first address the problem of limited availability of appropriate paper. In an attempt to overcome this shortage, the central bank came out with an innovative solution called the Institutional Securities Custodian Programme (ISCAP) in January 2005, whereby the central bank borrows securities from major institutional holders such as pension funds and insurance companies (who typically hold these securities to maturity) and then uses them as collateral in its repo operations. Lenders of the securities are remunerated through lending fees paid monthly and calculated daily from an agreed percentage of the spread difference between the repo rates and the money market rates that would otherwise be incurred in comparable direct borrowings. Apart from lowering the cost of sterilising excess liquidity, ISCAP has also increased the availability and liquidity of government securities that were previously locked away and unavailable to the market.