

Reduction of the 3-month Intervention Rate and the Introduction of a New Liquidity Framework

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Bank Negara Malaysia announces the reduction of the 3-month intervention rate and the introduction of a new liquidity framework.

I. Reduction in Interest Rates

The objective of monetary policy has been to contain inflationary pressure and hence achieve an environment of overall macroeconomic stability. Since the onset of the financial crisis and the depreciation of the ringgit, monetary policy has been tightened to moderate the inflationary impact of the depreciation. Interest rates during this period were increased in line with the depreciation of the ringgit and the upward revision of the expected inflation rate. This policy essentially aimed to preserve the domestic purchasing power of money and, thereby, provide the incentive to sustain the high rate of savings prevailing in Malaysia. While monetary policy also had to take into consideration external developments and its implications on the external value of the currency, it was felt that exchange rate stability could only be achieved with a comprehensive set of policies and measures that addressed all the areas of weakness and vulnerabilities rather than being over reliant on any specific measure. This would, therefore, require not only appropriate macro economic policies but also policies to deal with structural weakness within the system. During the course of the recent twelve months, several sets of policy measures were implemented to build on existing policies. Macro economic policies in general, and monetary policy in particular, worked to reinforce these policies to achieve the economic and financial objectives of the nation.

In the current environment, positive results have been achieved on the inflation front and the current account deficit is expected to turn around to a surplus position. Looking ahead, it is assessed that this represents a fundamental trend over the medium term. Indeed, recent developments confirm the absence of inflationary pressures emanating from aggregate demand. Aggregate demand has declined and leading and lagging indicators, such as sales and service tax collections, car sales, credit card spending and import demand, are sharply down. In this environment of economic slowdown, there has also been an absence of wage pressures. Similarly, the sharp downturn in equity prices and the softening of the property market have eliminated the inflationary potential of the asset markets. In addition, the growth of money supply and credit has moderated sharply to levels that are well below the ceilings projected under the credit plan. Furthermore, the likelihood of inflation being imported into the economy is also relatively low within the medium term horizon with inflation in the OECD countries expected to remain subdued. The moderation in petroleum prices would also support to sustain this trend.

The increases in the consumer price index and the producer price index that have been observed essentially reflects the pass-through effects of the depreciation of the ringgit exchange rate or for certain specific items such as food, to supply related factors. The adjustments resulting from the depreciation have, however, for the most part already been priced into current prices. The price increases due to the currency depreciation has in effect been partially offset by dampening demand. These trends have allowed Malaysia to maintain one of the lowest rate of inflation in the region, a track record that Malaysia has had for more than three decades. On the external front, the maintenance of an improved current account balance supported by the recent long-term committed inflows in the form of foreign direct investment has provided support to steady the currency, an important element required for the recovery process. International reserves have also remained intact in the region of US\$20 billion equivalent to 3.5 months of retained imports.

These fundamental trends provides Malaysia with the room for a cautious easing of monetary policy to minimize the severity of the downturn in domestic economy. With effect of 3 August 1998, Bank Negara Malaysia will undertake to reduce the 3-month intervention rate by 50 basis points to 10.5 percent. The judgement is made that this monetary easing can be made without the risk of breaching the inflation objective.

II. New Liquidity Framework

As part of the policy measures under the stabilisation package announced in March 1998, Bank Negara Malaysia has issued a new framework of liquidity measurement to the banking institutions. This new framework is modelled against international best practices on liquidity management.

The present liquidity framework which require banking institutions to hold a specified amount of liquid assets, amounting to at least 17% of their eligible liabilities base for commercial banks and 10% for finance companies and merchant banks (12.5% if they issue negotiable instruments of deposit) will be gradually phased out and eventually be replaced with the new framework.

maturing obligations with maturing assets. To ensure there is sufficient liquidity to meet their liability obligations in the near term, banking institutions will be required to maintain, as a minimum standard, adequate liquidity surplus not only to meet expected obligations but also to sustain unexpected heavy withdrawal for at least one month.

The new framework recognises individual banking institutions' strengths and weaknesses in managing their assets and liabilities portfolio. Banking institutions that manage their liquidity prudently and efficiently will no longer be required to hold excessive amounts of liquid assets. The focus on more efficient matching of assets and liabilities' profile will allow better utilisation of funds, which would result in higher returns for the banking institutions.

The new framework will also help remove price distortion on liquid assets in view of the captive demand created under the present liquidity framework. This will promote a more market oriented pricing of such assets, which will also be more reflective of the liquidity needs of individual banking institutions. The removal of such structural problem will eventually lead to more efficient market operation that would, among others, facilitate the development of a more active secondary market for such assets, as their yields adjust to a more market determined level.

The new liquidity framework is now under a 6-month parallel run, starting July 1998 before its full implementation in January 1999. During the parallel run, compliance will continue to be based on the present liquid asset framework. Bank Negara Malaysia will be monitoring the situation and ensuring a smooth transition to the new framework.

Bank Negara Malaysia
31 July 1998

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