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Bank Liquidity,Money Supply And Interest Rates : Does Monetary Policy Matter?

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ABSTRACT

Since 1989, Bank Negara Malaysia, the Central Bank of the country has faced a number of challenges in implementing the monetary policy. Liquidity assets have been increasing in the banking system from early 1989, emerging from several sources.At the same time , demand for loans did not growing at the same rate. This results in excess liquidity will put put pressures on the inflation rate. During the period 1989 to 1993, this has been the main barrier to Central Bank in achieving its ultimate goals of monetary policy.

Money supply (M3) and interest rates have been chosen by Bank Negara Malaysia as the intermediate targets in controlling excess liquidity to curb inflationary pressures. The research of the project paper is to study the sensitivity of those variables to the monetary policy instruments regulated by Bank Negara. From the research done, interest rates has been found to be the most sensitive indicator compared to the money supply.

Therefore, the detailed informations in this project paper will give a clear picture of the actual situation.

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1. INTRODUCTION

1.1 Introduction

Banking system in all countries of the world have Central Bank which plays a part in controlling the other banks. One of the basic functions of the of the Central Bank is to help implement government monetary policy, in particular by influencing interest rates and money supply.

The conduct of monetary policy in Malaysia is assigned to the Central Bank of Malaysia which is primarily to regulate the supply of money and to ensure that the volume of credit are sufficiently elastic to meet domestic demand in the economy, without creating undue pressures on resources.

In the period from 1989 to 1993, the Central Bank's management skills were put to test. Tan Sri Datuk Jaffar Hussein describes the period as "*the longest period of excess liquidity in Malaysia's banking system*"[1]. This was because the Central Bank was operating in an unusual environment.

During the period, the total amount of excess funds absorbed and locked in with the Central Bank amounted to a sizeable RM71 billion. Interest rates had to rise to contain inflation but it could not be allowed to rise

[1] *Economic Department,**Money and Banking**,Foreword to the Fourth Edition,Kuala Lumpur,Bank Negara,1994, page vi*