New Interest Rate Framework

A significant development in 2004 was the implementation of the new interest rate framework on 26 April 2004. The new framework involved the introduction of a new policy rate and improvements to the conduct of monetary operations, as well as the removal of the ceiling on base lending rates (BLRs) and prescribed lending spreads. Banking institutions now set their BLRs based on their respective cost structures and business strategies. The changes were designed to enhance the effectiveness of monetary policy by facilitating the transmission of movements in the policy rate to other market rates and ultimately to key macroeconomic variables. The new framework also serves as a catalyst for the efficient pricing of financial products and services by banking institutions. The deregulation of pricing is a key initiative under the Financial Sector Masterplan (FSMP) to ensure greater efficiency in the allocation and distribution of resources in the financial system.

The transition to the new interest rate framework was timely given the favourable macroeconomic fundamentals and the more developed financial infrastructure, which is supported by a strong banking system as well as sound regulatory and supervisory frameworks. These factors have been reinforced by on-going enhancements to the consumer protection framework.

Changes in Monetary Policy Implementation and Communication

To signal monetary policy more effectively and enhance the efficiency of the monetary transmission mechanism, Bank Negara Malaysia adopted a policy rate that is closely linked to other interest rates and has introduced enhancements to its monetary operating procedures. Under the new interest rate framework, the Overnight Policy Rate (OPR) replaced the 3-month intervention rate as the indicator of monetary policy stance. The OPR is effectively the target for the average overnight interbank rate (AOIR). In turn, the AOIR serves as the sole operating target for the Bank's daily liquidity operations. The overnight rate was chosen as the policy rate due to its minimal expectations content and high degree of controllability.

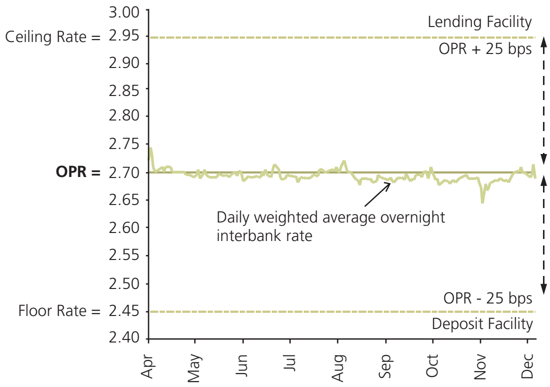
Liquidity operations conducted at maturities other than the overnight tenure are done without targeting any specific interest rate level, thereby allowing interbank rates for these maturities to be market determined. To reflect the unchanged stance of monetary policy at the time of the implementation of the new framework, the OPR was set at the prevailing AOIR of 2.70%. Over the period 26 April – 31 December 2004, the AOIR traded within a narrow range of 2.65 – 2.74% and averaged 2.70%.

In order to prevent excess volatility in the AOIR, the Bank has put in place an interest rate corridor and standing facilities. Essentially, the market rate is allowed to move within a corridor of ± 25 basis points around the OPR. The ceiling and floor rates of the corridor are the rates at which the Bank is willing to lend to or borrow from the market to alleviate residual overnight liquidity shortages or surpluses.

The Bank has begun to complement direct borrowing in the money market with repo-based open market operations in its liquidity management. The use of such open market operations had been previously hindered by the insufficiency of suitable papers. This has been partially addressed with the introduction of the Institutional Securities Custodian Programme (ISCAP) in late 2004. Through ISCAP, the Bank borrows securities, mainly Malaysian Government Securities (MGS), from major institutional investors such as pension funds and insurance companies for its repo operations.

An important aspect of enhancing the monetary transmission mechanism under the new interest rate framework is the communication of monetary policy. The Bank's stance has been made more transparent with explicit policy and operating target rates and the announcement of monetary policy decisions through the Monetary Policy Statement (MPS). The structured and transparent approach to the announcement of monetary policy decisions reduces uncertainty among market participants on the

Graph 1
Daily Weighted Average Overnight Interbank Rate
26 April - 31 December 2004



Bank's stance and policy direction. Any change to the OPR will be announced in the MPS. The MPS is issued at pre-determined quarterly intervals to coincide with the release of Malaysia's quarterly GDP data. Should there be a change in the monetary policy stance, in the period between two scheduled dates, an additional MPS would be issued.

The Impact of the New Interest Rate Framework

The introduction of the new interest rate framework involved changes to the system of implementing monetary policy. The monetary policy stance, however, remained unchanged. The introduction of the new framework did not bring about a change in the cost of funds of banking institutions. As such, no significant variation was expected in the general level of interest rates.

Lending Rates and Financing

Under the new framework, the maximum lending rates charged by banking institutions are no longer subject to the previous BLR formula and the maximum lending spread of 2.5 percentage points above the BLR has also been removed. Instead, the BLR of each banking institution is based on the institution's own cost structure and lending strategy as well as the level of competition in the industry.

At the end of 2004, the average BLR of commercial banks was relatively stable at 5.98% per annum (end-2003: 6.00% per annum), with one banking institution having reduced its BLR. The average BLR of finance companies remained unchanged at 6.90% per annum. Given the unchanged stance of monetary policy, it was expected that most banking institutions would not vary their BLRs in the short- to medium-term.

With the removal of the ceiling on lending rates, loans are increasingly priced according to the risk profile of borrowers or projects. The flexibility accorded to banking institutions in the pricing of spreads allows wider access to financing for borrowers who previously faced difficulty in obtaining funds. Already, several banking institutions have introduced new specialised lending packages for individuals and small businesses.

SMEs have continued to enjoy access to financing under the new interest rate framework, with increased demand for funds as reflected in higher loan applications in the second half-year. Loan approvals and disbursements also rose in the second half-year. At the same time, the lending rates on loans to the SME sector have, on average, remained competitive. In the second half-year, the average lending rate on new loans approved to SMEs by commercial banks was 6.37% per annum compared with 6.42% per annum for the first half-year. In the business sector as a whole, the average lending rate on new loans approved in the second half-year was 5.79% per annum compared with 5.89% per annum in the first half-year.

For the consumer-related sectors, the average lending rates on new loans approved for the purchase of residential property and passenger cars, the latter by finance companies, were 3.27% per annum and 6.74% per annum respectively in the second half-year compared with 3.58% per annum and 6.82% per annum respectively for the first half-year.

The Bank will continue to monitor lending rates charged by banking institutions. To ensure fair and just pricing, the Bank has undertaken several new initiatives to safeguard the interests of consumers. These measures are aimed at ensuring greater product transparency and disclosure, strengthening the infrastructure for consumer redress as well as increasing the financial literacy of the public (See **Management of the Banking System** in Chapter 5 for further details).

The prescribed lending rates have been maintained for financing allocated through the Bank-administered special funds for SMEs and the ceiling still applies on lending rates on housing loans extended to the low- and middle-income groups under the Lending Guidelines to Priority Sectors. In addition, lending rates on hire purchase loans remain subject to the Hire-Purchase Act 1967, while lending rates on credit card loans are subject to the maximum interest rate of 18% per annum as prescribed in the Credit Card Guidelines issued by the Bank.

Deposit Rates

In the sequencing of interest rate liberalisation, a distinction was made between wholesale and retail transactions as well as loan and deposit transactions. The gradual approach adopted aimed at facilitating a smooth transition while at the same time recognising the different levels of financial sophistication among different market participants, namely financial institutions, business enterprises and the general public.

The gradual approach ensures a smooth transition under the new interest rate framework, such that the intermediation process is not disrupted. Another important consideration is the fact that a large section of the population, particularly the middle to lower income groups and retirees, relies on savings in the form of bank deposits. Minimum rates are thus prescribed for deposits of RM1 million and below with tenures between 1 to 12 months. Notwithstanding the current prescribed deposit rates, the Bank has provided an enabling environment for banking institutions to broaden their product range to serve the growing sophistication of the range of savers with different risk-return profiles. In addition, the Bank has channelled efforts towards increasing the financial literacy of the general public.

further expansion in private investment and consumption, as well as buoyant export growth. The external sector had benefited from the global electronics up-cycle, high commodity prices and increased tourist arrivals. However, this faster growth was taking place in an environment of low inflation, with the CPI rising by an average of 1% in the first four months. The increase in crude oil prices was assessed to have minimal impact on inflation given the control of retail prices of petroleum products through the automatic pricing mechanism. In terms of production capacity, the weighted average of capacity utilisation in the manufacturing sector remained relatively stable at 82% in the first quarter and there was evidence of capacity expansion in sectors experiencing strong growth. Further, labour productivity, as measured by real sales value of products per employee in the manufacturing sector, rose by 9%, exceeding the 2.7% increase in real wage per employee. With these considerations, interest rates could continue to remain low to support the growth momentum in an environment of positive output gap still prevailing in the economy. Thus, the OPR remained unchanged at 2.70%.

By the time of the release of the second quarter GDP along with the third MPS in August, global growth for the first half-year had exceeded expectations. During this period, the global monetary cycle entered a tightening phase, engendered by the stronger-than-expected recovery cycle and higher commodity prices. Indicators, however, pointed to some moderation in global growth in the second half-year, but the consensus was that the impact of high crude oil prices and rising interest rates would be modest. In the domestic economy, GDP expanded by 8.2% in the second quarter, with stronger household consumption and private investment activity as the public sector continued to consolidate. Growth for 2004 was now expected to surpass previous forecasts, with the