INTEREST RATE AND CREDIT CHANNELS OF
MONETARY TRANSMISSION MECHANISM:
A STUDY
OF THE MALAYSIAN EXPERIENCE
(JANUARY 1996 – JUNE 2012)

By
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Keputusan menunjukkan bahawa kadar faedah, kadar pinjaman, jumlah pinjaman bank perdagangan dan indeks harga pengguna adalah berkointegrasi. Kajian ini mendapati bahawa kedua-dua saluran adalah penting dalam mekanisme transmisi monetari di Malaysia.

Kata Kunci: mekanisme transmisi monetari, saluran kadar faedah, saluran kredit dan kaedah Vektor Autoregresi (VAR).
ABSTRACT

Monetary transmission mechanism as defined by Taylor (1995) as a process through which monetary policy decisions are transmitted into changes in income and inflation. Monetary transmission mechanism works through various channels namely interest rate channel, credit channel, exchange rate channel, asset price channel and expectation channel. A review of the related literature supported that the credit channel to be a more significant monetary transmission channel than the interest rate channel in foreign countries like China, Korea and United States.

This project paper investigates the interest rate and credit channels in the monetary transmission mechanism in Malaysia over the period of January 1996 to June 2012 by employing a Vector autoregressive (VAR) approach. It planned to meet two major objectives. Firstly, is to examine the significance influence of overnight policy rate (OPR) and total loans by commercial banks (TL) as channels of monetary transmission mechanism in Malaysia. Secondly, to identify the direction of causality between the variables used in this study which are overnight policy rate, total loans by commercial banks, lending rate and consumer price index.

The results show that, overnight policy rate, lending rate, total loans by commercial banks and consumer price index are cointegrated. This study finds conclusive evidence that both channels are important in the monetary transmission mechanism in Malaysia.

Keywords: Monetary transmission mechanism, Interest rate channel, Credit channel and Vector Autoregressive (VAR) approach.
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CHAPTER 1
INTRODUCTION

1.0 Background of the Study

The impacts of monetary policy on the economy and the channels through which they pass constitute a long standing discussion in which no clear consensus has been reached. Various explanations from specific to general, complementary and contradictory, have been given to explain the way monetary policy decisions are transmitted to prices.

Monetary policy consists of rules and regulations implemented by the central bank to achieve its objectives. In fact, price stability has been viewed as one of the major monetary policy goals in most countries like United States, Japan, Germany and including Malaysia. Apart from price stability, central bank implements monetary policy in order to achieve full employment, economic growth, stability in financial markets and stability in foreign exchange market. Stability in prices is important as it will increase the confidence in the value of money and leads to a healthy economy. In ensuring the price stability; central bank needs to have effective monetary policy. Central bank uses various channels like monetary aggregate, interest rates, credit aggregate or exchange rate in formulating its policy or as policy tools. These channels will work as transmission mechanisms in achieving the policy goals.

The purpose of this paper is to provide useful insight on the channels of monetary transmission mechanism in Malaysia. Two channels that will be studied are interest rate
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