THE IMPACT OF CASH RESERVE RATIO AND LENDING RATE ON BANK'S LENDING: THE STUDY OF ISLAMIC BANKING IN MALAYSIA

*Muhammad Sajjad
**Muhammad Irfan Chani
***Usman Islam
****Dr Muhammad Waqas
*****Dr Mohsin Altaf

Abstract

Purpose-This study was conducted to analyze the impact of cash reserve ratio and lending rate on the bank's lending in the Islamic banking system of Malaysia. The study was conducted after great literature review and the gap was observed in the study because no one considered Cash Reserve Ratio in their study.

Design/Methodology-The data was collected from World Bank, central bank and annual reports of the organizations. The data of 15 Islamic banks were collected and all the observations were on annual basis. The data was gathered from 2008 till 2014 as per validity of the annual reports of the selected banks. The **random effect of Hausman effect** was used due to the nature of the data. The fixed effect P-value was 0.976 therefore random effect was taken in study.

Finding-The results prove the significance of both lending rate and cash reserve ratio. CRR is inversely associated with the bank's lending while lending rate is directly related. The results were significant and the considerable impact of the core variables was found on the dependent variable. Significant impact of exchange rate and money supply was also observed in the study.

Keywords: Cash Reserve Ratio (CRR), Lending rate, Exchange Rate, Money supply, Hausman effect, multicollinearity

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*Assistant Professor Department of Management Sciences COMSATS University Islamabad, Vehari Campus
**Assistant Professor Department of Management Sciences COMSATS University Islamabad, Vehari Campus
***Lahore Business School The University of Lahore
****Lahore Business School The University of Lahore
*****Lahore Business SchoolThe University of Lahore

Introduction

The impact of monetary policy is always very key indicator for the future plans of the banking sector. The banking sector has transformed at large scale in the Islamic country due to the introduction of Islamic banks. (Editor, 2016) the impact of monetary policy can be transmitted to the real economy via several channels, such as the interest rate, credit, asset price, and exchange rate channels. In the most study the impact of cash reserve ratio is mostly ignored and only the interest rate impact is considered as the potential variable of the risk for the banks. The Islamic banking system which is based on the Islamic laws and sharia and considered as the risk free banking on the part of interest rate as it is interest free banking as per definition of the banking system. But the literature has shown completely opposite results. Islamic banks are considered more volatile to change in monetary policy.

Islamic Banking and its background:-

It is a banking system that is based on the sharia principles and practically implemented through development of the Islamic economics in the world. The concept of Islamic banking is growing very fats in the world especially after the global financial crisis of 2008-9. The major reason of its development is the failure of conventional banking system in the financial crisis. The Islamic banking law firstly was approved by the Malaysian government. In the time of 35 years many banks started the Islamic window in the Malaysia along with their conventional window. Now Islamic banking is the most growing sector in finance in the world. In the Muslim country people prefer to keep their money and assets in the Islamic institutions due to religious factor. The popularity of Islamic banking is due to the religious factor as it is based upon the interest free banking.

Islamic Banking and Monetary policy

There was a time when monetary policy was laid in order to main the performance of the conventional banks in the economy. The emerging sector of Islamic banking has enforced the monetary institutions to establish the new policies in order to grow Islamic banking sector as well. The volume of Islamic banking has increased from million dollar to billion dollar in the overall economy. Now it has a significant influence on the monetary institutions.

Central banks act to accomplish the goal of monetary policy, the economy is bound up with goals that are easy to change. Financial advantages help raise economic growth, price stability, and full employment and promote stability. Profit is the strong gold economy. For example, in the boom times, selling bonds to calm prices, the Central Bank requirement (SRR) i.e. on the rules Booking Surcharge, --other equipment using cash or monetary policy to raise the finance law firm maintains. Findings interest rates following debt conversion qui Price increases have not been found to stimulate the credit companies. As a result, money denied, and so many things all combined. Reduce the need. Thus, the yield falls.
Track virus economy effectively influence policy from very low initial and beautiful. The interest rate will help to paint a clear mechanism of getting transmitted through the channel.

The lending of Islamic banks particularly based upon the available funds of the banks. In Islamic banking money is not just like conventional banking on a specific lending rate. They invest money in real assets and this way the give the loan to the general consumer for a specific rent of the money.

This study is based upon the performance of the Islamic banks on the basis of some new variables like cash reserve ratio and lending rate. (Kassim, 2013)

Money supply is the amount of circulating currency in the country. This money supply segregated into 3 categories like M1, M2 and M3. The M3 is considered in this study.

There are many channel of implementing the monetary change in the economy. The relative importance of a particular channel in the transmission of monetary policy generally depends on, among other things, the structural characteristics of the economy. For example, a highly open economy where the external trade sector plays a very crucial role in generating economic activity might find that the exchange rate channel plays a significant role in the monetary transmission process. Similarly, a country which is highly dependent on bank credit to finance its economic activity might find that the credit or bank lending channel is an important channel for monetary policy transmission. The bank lending channel is a likely candidate for an important channel of monetary transmission process in the Malaysian economy due to the critical role that the banking sector plays in financing economic activities in the economy. At the end of 2006, of total financing in the Malaysian economy, 70 percent were in the form of bank loans. (Ongena, 2013)

Literature Review

In January 2016 a unique study was published that was based upon Dynamic Slack Based Model (DSBM). Peter Wanke and his colleague conduct this study in 2015. This was a unique study as first time efficiency of dual banking of Malaysia was studied in this paper. They used 2009 to 2013 time series data of the banking system. The CAMEL rating systems were also used in first stage to check the relative efficiency of the banking system. In second stage generalized linear mixed models (GLMM) with DSBM results as a part of building an model for banking performance. The results of the combined models showed the higher inefficiency level and slacks in the Islamic banking system as compared to the conventional banking system. The study also incorporate the performance of foreign banks with national banks and it was found that foreign banks are less efficient due to geographic and cultural reasons. (Peter Wanke, 2016)

In 2003 Ahmad Kaleem and Mansor conduct the casual research in the Malaysian banking sector. They conducted the study to develop the casual relationship between conventional and Islamic banks of Malaysia. Islamic banks are playing significant role in the economic growth of Islamic countries. The growth is tremendously higher in the Islamic banking sector as compared to the conventional banks. According to the author there is a relationship among the deposits of the both banking system. They applied two test one is unit-root test and other is Granger causality test to complete their research. The results shows that conventional TDRs haave a significant impact on Islamic TDRs. The overall finding was that in the Islamic banking system interest rate is considered before adjusting the deposits returns and that was the major finding of this paper. (Isa, 2003)

In 2009 a unique study was conducted to understand the impact of monetary shocks on banking system. This study was different than the previous studies as it was a comparative work in term of monetary shocks. Both Islamic and conventional banks were taken in this study. Before this study it was considered that response of conventional banks to monetary shocks must be different from the response of the Islamic banks. 7 year data from 1999 to 2006 was included in this study, the aim of the study is to understand the sensitivity of the monetary shocks in Islamic banking system. To complete the research vector-auto regression (VAR) model was used. The

results were quite unexpected as the items of Islamic banks' balance sheets were more sensitive to the monetary shocks as compared to the conventional banks. (Salina H.Kassim, 2009)

In 2008 a study was conducted to understands the determinants plays important role in the deposits of Islamic banks The purpose of this study is to examine the condition of selected economic variables deposits in Islamic sacred and many of the financial system in Malaysia. Design / methods / ways - with Botha long and short term between these variables. They are measured by use of the time-series econometrics. This technical co-Meeting error correction frame, which was held under vector auto regression. By using recent econometric techniques, choosing such profitable prices. Islamic shore in fruit prices on deposits in several banks, based on interest, Kala Lumpur The composite index, the index of consumer prices, money supply and gross domestic product are different. It makes the bank deposits in all Islamic and many of the world. In many cases, customers many plan to conduct concerning the doctrine of saving behavior. In contrast, many these are not used by consumers on the banks of the Islamic. Therefore, there is a chance religion plays an important election banks Muslim customers. Research is unable / proverb - Since consumers are sensitive to the rewards they receive deposits, we can gain moderate Islamic state should at any time be like those many systems. Finally, the religious side, it can be a priority attracting more people to put their money Islamic system. (Azmi, 2008)

A comparative study was done by Salina and et al in 2006 to check the impact of monetary shocks on items of balance sheet. This study was comparative as items of conventional banks were studied against the Islamic banks balance sheets items. They took 8 year data from 1998 to 2006. They modified the VAR model and used impulse response function and variance decomposition analysis. The results were quite unexpected as the items of Islamic bank's balance sheets were found more in-stable against the monetary shocks taken in amount through interest rate impact. The study results were significant and clearly implicated that Islamic financial institutions are more vulnerable to interest rate changes as compared to the conventional banking system. (Salina Hj. Kassim, 2007)

In 2010 a study was conducted in Turkey to analyze the impact of interest rate volatility on Islamic and conventional banks. The purpose of this paper was to understand the contribution of

Islamic financial institutions towards the financial stability of the country. They checked the impact of interest rate variation effect towards loans and deposits of the both banking system. The data was collected from 2005 to 2009 the data was gathered on the basis of Vector Error Correction (VEC) methodology. The study was conducted with the hypothesis that Islamic banks were not be influenced by the interest rate fluctuation as it is considered the interest free banking but the statistics were significant and clearly depicting that Islamic banks are visibly affected by the interest rate volatility. (Arslanb, 2012)

In 2015 a study was conducted in Pakistan to understand the interest rate volatility upon Islamic banking system of Pakistan. The took 4 year data from 2009 to 2013 monthly based data that was extracted from the monthly statistical bulletins issued by state bank of Pakistan and Pakistan bureau of statistics. The used the overnight rate (ONR) as the key variable and used impulse response model for the analysis. The results were different than the result of Turkey and Malaysian economics. The statistics shows that Pakistan's are not much influenced by the monetary shocks as in other economies. The results clearly indicate that interest rate is more effecting to the conventional banks as compared to the Islamic banks in Pakistan. (NAVEED, 2015)

The risk of interest rate is the most traditional risk in the banking sector. The policies of central banks are in the favor of economic objects and therefore many time the polices implemented were against the benefits of pure banking sector. The interest rate risk not only effect the banking sector but also the corporate sector as corporate sector was forced to redeem the bonds and other securities issue in the term of going rate of interest. (Herings, 2014)

In 2012 a paper was presented in the eight international Islamic conferences by Harrison Hong. This paper was a study of monetary shocks with respect to the size of the bank, liquidity and conventional verses Islamic banks systems too. The collect the data of 10 years and conclude some interesting finding. The small banks make adjustment in response to the monetary shocks and this affect their liquidity ratio as well on the other hands large banks show great deal of sustainability to such shocks. Their assets are sufficient enough that they adjust to the monetary shocks without adjusting to the deposits and current liquidity. The response in Islamic banks is

much severs as compared to the conventional banks. The size of Islamic banks is not as big as of old established conventional banks. (Sajjad Zaheer, 2013)

Zamrah Hasin and his colleague conduct a research in order to find empirical evidence of the impact of Islamic banking channels in the monetary reforms. To conduct this study they used autoregressive distributed lag (ARDL) testing approach and collect the data on the quarterly basis from 1991 to 2010. They find that Islamic channels exist in the Malaysian economy impacting the monetary policy in the economy. The also implicated that Islamic banking working in the dual banking sector therefore they are not free from the impact of interest rate shocks. (Majid, 2012)

Gap Identification:-

The literature is very rich and knowledgeable and it was clearly observe that no study has incorporated the cash reserve ratio and lending rate in there empirical study. Therefore it is an obvious gap among the previous literature that no researcher has included these variables in their study.

Problem Statement

This study is also based upon the impact of monetary shocks on Islamic banks' lending. The literature gives a clear picture about the previous work and it was found that in every work researcher has used interest rate as the proxy of monetary shocks. Some key variable were not yet touched like cash reserve ratio and lending rates of the banks. Therefore the literature gives the untouched areas of the study. The problem statements of this paper are

- To identify the significance of cash reserve ratio on the lending of the Islamic banks.
- To identify the significance of lending rate on the lending of Islamic banks.
- Further to identify the degree of variation caused by these two core variable on the lending.

Research Questions

What is the relationship between banks deposits and Cash reserve ratio?

What is the strength of relationship between the both variables?

Does lending rate impacts the bank's deposits in Islamic banking system?

What is the significance of both variables in Islamic banking system?

Hypothesis

Ho = Cash reserve ratio has no impact on Islamic banks deposits

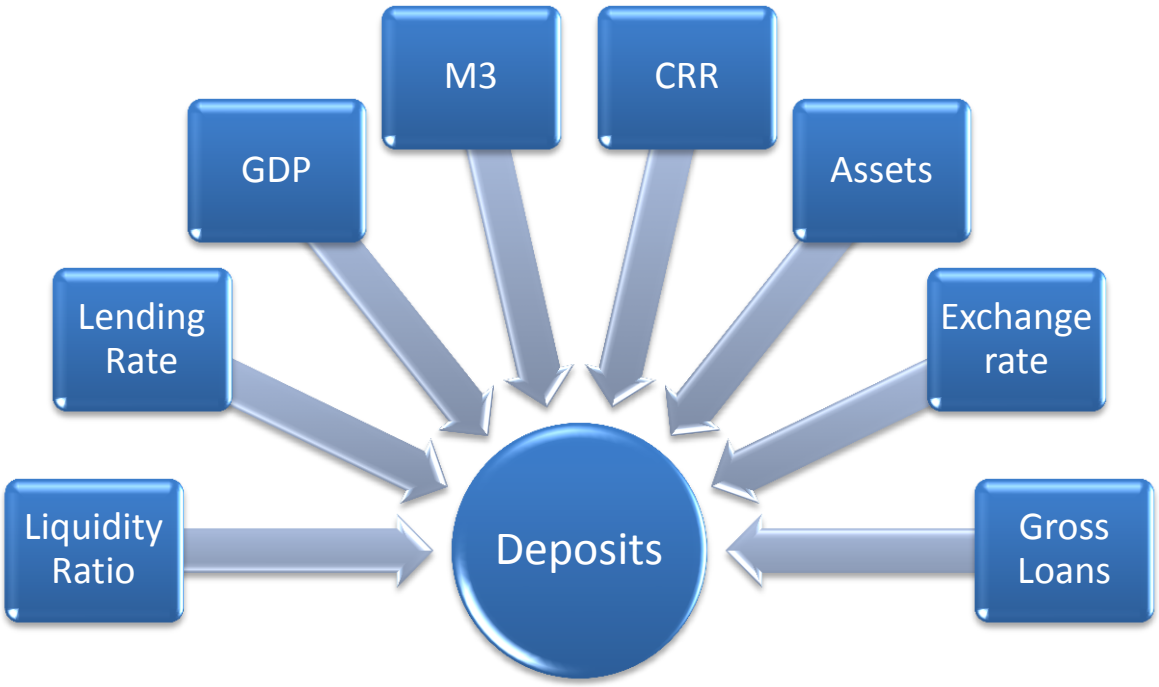
H1 = Cash reserve ratio has impact on Islamic banks deposits

Ho = Lending rate has no impact on Islamic banks deposits

H1 = Lending rate has impact on Islamic banks deposits

Theoretical Model

In the proposed model of our study there are total independent variables out of 6 are controlled variables while two CRR and lending rate are the core variables. The model is designed to test the impact of all these variables on the deposits of Islamic banks. The flow of the model can be seen in the below diagram.



Data and Methodology:-

Sample collection

The data is of secondary nature and collected from the authentic sources like

i. Asian development Bank
ii. International Monetary funds (IMF)
iii. Bank Nagara of Malaysia
iv. World Bank
v. The regression equation used in analysis is

$$\text{Deposits} = \alpha_0 + \beta_1 LR + \beta_2 GDP + \beta_3 GL + \beta_4 LnR + \beta_5 ExR + \beta_6 Assets + \beta_7 M3 + \beta_8 CRR$$

LR= Liquity Ratio of the 15 banks

GDP= Gross Domestic Product of Malaysia

GL= Gross Loan of The Banks

LnR= Lending Rate of The Malaysia

ExR= Exchange Rate

Assets= total Assets of the banks

CRR= Cash Reserve ratio on demand deposits fixed by Central Bank of Malaysia

M3= Money Supply 3 (It is the money supply that include M2 and long term deposits, institutional money market funds and short term repurchase agreement)

The data of exchange rate and lending rate is collected from World Bank data base, money supply data is collected from Asian development bank data base, liquidity ratio is calculated manually from the balance sheets items. The lending rate and money supply rate is also been justify from central bank of Malaysia. The data is collected from 2008 to 2009 of 15 Islamic banks and annually basis. The data of assets and gross loan I extracted from the annual reports of the indivual banks.

Analysis

The data was arranged in the panel format to conduct the hausman test. The Hausman test is the standard procedure used in empirical panel data analysis. in order to discriminate between the

fixed effects and random effects model. the analysis clearly shows that random effect is suitable for the data as the fixed effect statistics was highly insignificant. The table-1 in appendix shows the fixed effect and p-value is 0.9927 that is highly insignificant therefore the data is analyzed on the random effect.

The random effect was also run through stata and the results are shown in the table-2 in the appendix. the results can be seen in the table-2 but the majors point are shown as

Total Observation= 98

F-Statistics = 2179

P-Value = 0.000

The F-Statistics and P-Value clearly indicate the significance of the overall data.

Variables	**T-Statistics**	**P-Value**	**Impact**
Ln M3	-27.32	0.000	Significant
Ln GDP	-8.40	0.000	Significant
Exchange Rate	8.30	0.000	Significant
Lending rate	18.18	0.000	Significant
CRR	-22.34	0.000	Significant
Liquidity Ratio	0.25	0.803	Insignificant
Ln Gross Loan	0.21	0.833	Insignificant
Ln Assets	-0.18	0.854	Insignificant
Constant	39.6	0.000	

According to the table out of 8 selected independent variables 3 variables are insignificant. As both significance indicator T-Statistics and P-Value are insignificant. All the result can be seen from Table-2. In this table the results of CRR and lending rate are as per the proposed hypothesis. There are three variables Liquidity ratio, Gross Loan and Assets are insignificant in our analysis therefore another analysis was run without these observations.

The test was run again and the results are shown in the table-3 in appendix. In table-3 F-statistics and P-value is again significant for the panel data. The second analysis has taken two core

variables CRR and lending rate while 5 control variables. The key statistics of the table-3 are shown below

Variables	T-Statistics	P-Value	Impact
Ln M3	-24.32	0.000	Significant
Ln GDP	14.40	0.000	Significant
Exchange Rate	32.00	0.000	Significant
Lending	16.18	0.000	Significant
CRR	-39.34	0.000	Significant
Constant	47.62	0.000	

The coefficients are a bit changed but the relationship is still same the variables are significant as they were previously but the value of slope is a bit varying.

Multicollinearity Issue:-

The data nature is secondary and time series as well therefore the issue of multicollinearity is very common among the variables usually in same units. To concrete the study the test for multicollinearity was run and it was found that this issue is significantly exist in the previous analysis and the slope values are not in the most realistic magnitude. The analysis results of multicollinearity are shown in table-4 in the appendix.

The variance inflation factor (VIF) is shown in table-4 as per the result M3 and GDP have multicollinearity issue. As their VIF value is greater than 10 and overall value is also near 10 that are not acceptable as per standards. To overcome this issue one variable must be skipped from the analysis. A third analysis was run to overcome the multicollinearity issue. To overcome the issue GDP was excluded from the data set and lnM3 was retained. The reason behind retaining M3 in analysis was that our analysis is relating bank sector and M3 is a direct source of banking sector as compared to GDP. The new analysis of two core and 2 control variables were conducted and shown in table-5.

The table-5 in the appendix is the main results of the analysis are shown below the F-statistics and P-value both are significant in the results.

Variables	T-Statistics	P-Value	Impact
Ln M3	-3.22	0.000	Significant
Exchange Rate	1.350	0.000	Significant
Lending rate	.2318	0.000	Significant
CRR	-.1394	0.000	Significant
Constant	68.62	0.000	

Test for Multicollinearity

The table-6 is the results of multicollinearity issue and it was very obvious that skipping one control variable has increase the credibility of the analysis. All the values in table 6 representing VIF are below the standard value and overall value is also very much less than 10.

Final Results

Deposits = 68.62 -3.22M3 +1.350 ExR+0.23LnR-.1394 CRR

Discussion and interpretation

Furthermore it is necessary to find which variable have strong contribution towards the hypothesized model. For this information we used the coefficient table which shows that two facets in table-5 exchange rate and lending rate positively influence the Islamic banks deposits. Other two facets CRR and money supply also statistically significant contributor in the deposits but their impact is inversely justifying the proposed hypothesis. On the basis of the results shown in the table-5 it is clear that M3 is the most influencing variable among all the variables with the highest slope value of -3.824. The value of M3 is negative indicating that both variables are negatively related. Increase in M3 will reduce the deposits and naturally it is as per practical understanding. To acquire M3 assets ones must purchase them and to do so they will utilize the available assets in the form of the deposits. The second most influencing variable is the exchange rate and the value of the slope is 2.14 as per table-5. These values indicate that both variables are moving in the same direction.

Core Variables Impact:-

The aim purpose of this study was to study the two new variable in the study CRR and lending rate. The results indicate that both variables significantly impact the deposits. Its mean the null hypothesis can be rejected in the favor of the alternative hypothesis. The direction of relationship

is also in the understandable direction. Both variables are negatively related to each other. Its indicate that increase in cash reserve ratio will decrease the deposits and ultimately the lending of the money will also be decreased as bank will left with less loanable funds. This is also a significant variable in the study and its impact is reasonably considerable. The other core variable is lending rate the higher the rate decrease in the lending funds. the results shows that as the lending rate lending also increases.

The results shows that both CRR and lending rate are significant variables in the study of bank lending and both has considerable slope value meaning change in these variable will cause the monetary balance to be change and shifted.

Conclusion

The study shows that CRR and lending rate are significant variable in determining the bank lending. The bank's lending is directly influence due to the change in selected variables. CRR is inversely related towards the lending of the banks. Because once central bank has increase this ratio more money need to be deposits in the central bank as per fulfill the binding conditions of the country central bank. Lending rate was variable not considered in any study previously gone through for the study. But the analysis shows that it is very significant variable. This study shows that cash reserve ratio is the least considered variable in the monetary shocks but it has significant impact on the lending of the Islamic banks.

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Appendix

Table-1

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. hausman fixed random


                 ---- Coefficients ----
             |      (b)          (B)            (b-B)     sqrt(diag(V_b-V_B))
             |     fixed        random       Difference          S.E.
-------------+------------------------------------------------------------
    lnAssets |    .0159059     .0002617        .0156442        .0148001
Liquidityr~o |    -.001773     .0004392       -.0022122        .0039026
         CRR |   -.1004245    -.1014208        .0009963        .0019943
Interestra~d |    .2734329     .2738137       -.0003808        .0059323
ExchangeRate |    .6058864     .6130538       -.0071674        .0293604
       lnGDP |   -1.061904    -1.074191        .0122867          .05149
        lnM3 |   -2.732402    -2.695839       -.0365631        .0514937
------------------------------------------------------------------------------
                           b = consistent under Ho and Ha; obtained from xtreg
            B = inconsistent under Ha, efficient under Ho; obtained from xtreg

    Test:  Ho:  difference in coefficients not systematic

                  chi2(7) = (b-B)'[(V_b-V_B)^(-1)](b-B)
                          =        1.12
                Prob>chi2 =      0.9927
```

Table-2

```
      Source |       SS       df       MS              Number of obs =      98
-------------+------------------------------           F(  8,    89) = 2179.97
       Model |  31.7105035     8  3.96381294           Prob > F      =  0.0000
    Residual |  .161827336    89  .001818285           R-squared     =  0.9949
-------------+------------------------------           Adj R-squared = 0.9945
       Total |  31.8723308    97   .32858073           Root MSE      =  .04264

------------------------------------------------------------------------------
        lnDeposits |      Coef.   Std. Err.      t    P>|t|     [95% Conf. Interval]
-------------------+----------------------------------------------------------------
              lnM3 |  -2.698932   .0987788   -27.32   0.000    -2.895203   -2.502661
             lnGDP |  -1.071666   .1275215    -8.40   0.000    -1.325048   -.8182832
      ExchangeRate |   .6128397   .0731199     8.38   0.000      .467552    .7581273
Interestratespread |   .2738336   .0150609    18.18   0.000     .2439079    .3037593
               CRR |  -.1014475   .0045418   -22.34   0.000     -.110472   -.0924229
    Liquidityratio |   .0028462   .0113963     0.25   0.803    -.0197979    .0254903
       LnGrossLoan |   .0078927   .0378658     0.21   0.835     -.067346    .0831313
          lnAssets |  -.0070887   .0384255    -0.18   0.854    -.0834393    .0692619
             _cons |   85.49978   2.157317    39.63   0.000     81.21324    89.78632
------------------------------------------------------------------------------
```

Table-3

```
      Source |       SS       df       MS              Number of obs =      98
```

Model	31.6779127	5	6.33558255	F(5, 92)	2998.04
Residual	.194418087	92	.00211324	Prob > F	0.0000
Total	31.8723308	97	.32858073	R-squared	0.9939
				Adj R-squared	0.9936
				Root MSE	.04597

lnDeposits	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
lnM3	-2.479788	.101274	-24.49	0.000	-2.680927	-2.278649
lnGDP	-1.734528	.1214746	-14.28	0.000	-1.975787	-1.493269
ExchangeRate	1.518536	.0471652	32.20	0.000	1.424861	1.61221
LendingRate	.1893868	.011494	16.48	0.000	.1665588	.2122148
CRR	-.1486486	.0037814	-39.31	0.000	-.1561587	-.1411385
_cons	97.55832	2.048707	47.62	0.000	93.48941	101.6272

Table-4

Variable	VIF	1/VIF
lnM3	14.87	0.067244
lnGDP	14.72	0.067940
ExchangeRate	2.28	0.438721
LendingRate	1.35	0.738668
CRR	1.16	0.864288
Mean VIF	6.88	

Table-5

Source	SS	df	MS		
Model	31.2470484	4	7.8117621	Number of obs	98
				F(4, 93)	1161.87
				Prob > F	0.0000

```
    Residual |  .625282406    93  .006723467           R-squared     =  0.9804
-------------+------------------------------           Adj R-squared =  0.9795
       Total |  31.8723308    97   .32858073           Root MSE      =    .082

------------------------------------------------------------------------------
  lnDeposits |      Coef.   Std. Err.      t    P>|t|     [95% Conf. Interval]
-------------+----------------------------------------------------------------
ExchangeRate |   1.353203   .0815541    16.59   0.000     1.191252    1.515153
 LendingRate |   .2318165   .0198048    11.71   0.000      .192488     .271145
         CRR |  -.1399464   .0066566   -21.02   0.000    -.1531651   -.1267276
        lnM3 |  -3.824365   .0664863   -57.52   0.000    -3.956393   -3.692336
       _cons |   68.96273   .7705628    89.50   0.000     67.43254    70.49291
------------------------------------------------------------------------------
```

Table-6

```
    Variable |       VIF       1/VIF
-------------+----------------------
ExchangeRate |      2.14    0.466858
        lnM3 |      2.01    0.496397
 LendingRate |      1.26    0.791574
         CRR |      1.13    0.887337
-------------+----------------------
    Mean VIF |      1.64
```