

Abstract

The 1997 East Asian currency crisis has highlighted the great fragility of the economic systems of the community of East Asian countries, especially on the monetary side. In the case of the ASEAN countries, Malaysia, Indonesia and Thailand were the most significantly affected. In this respect, it is widely assumed that the source of this catastrophic economic episode was, to a large extent, due to the openness of their financial systems. In essence, these countries' financial systems were products of intense financial liberalization and deregulation, which began in the 1970s and accelerated rapidly from the 1980s onwards. Thus the last two decades have witnessed the rapid transition of the financial architecture of these countries which had governed and shaped their monetary systems. Throughout this 20 years, monetary policy had played a pivotal role in shaping the financial developments from the turbulent recessionary era of the early and mid-1980s to the more recent currency crisis in the later part of the 1990s.

In theory, there are two dimensions to monetary policy, with the difference stemming from the control vehicle from which the policy operates through. Basically, the monetary authorities could affect output by altering the nominal money supply (which will also lead to changes in the interest rates) or alternatively, they could set the interest rates (nominal) directly to affect the economy. In essence, both methods are just as effective provided that the structural features are known with certainty. However, in developing countries like ASEAN, there is uncertainty in money demand and aggregates, given their levels of developments. This is particularly so for the monetary side which has seen significant deregulations in the last two decades. Thus given the fact that these ASEAN countries had undergone various forms of financial



liberalization and economic adjustments, the choice of an interest rate or a monetary targeting regime has been critical. In addition, the liberalization of capital account convertibility while adhering to a managed or pegged exchange rate had also further complicated the avenues for monetary policy, thus at times leaving the burden of demand management to its fiscal counterparts.

In any event, the currency crisis had underlined the potential backlash of maintaining an overly liberal financial system, thus leading to countries like Malaysia reverting to the use of capital controls and a pegged exchange rate (US dollar peg). On the other hand, the intense speculative pressures on the exchange rate meanwhile, forced both Indonesia and Thailand to abandon their previous regime of pegged and managed exchange rate respectively. In both cases, the moves enhanced the avenues of monetary policy and eventually, the economies of all three have made significant recovery. As the economies of these countries continue to evolve under uncertainty in the post-crisis period, both Thailand and Indonesia have embarked on a new type of monetary policy framework, namely inflation targeting.

ACKNOWLEDGEMENT

Firstly, I wish to express my appreciation and gratitude to Dr.Yap Su Fei and Professor Madya Dr. Tan Eu Chye for their keen assistance and meticulous supervision which have played a crucial and significant role in ensuring the completion of this paper.

Thank you to my parents and the rest of my family for their encouraging support and continuous love. Their belief in my ability gave me the confidence and the necessary strengths to rise up not only to the academic demands but also to life's many challenges as well. Many thanks to all the staff of the Master of Economics program in Universiti Malaya, whom on many occasions were very helpful, to say the least. Thanks also to the many lecturers whom have taught me throughout the course and have been instrumental in shaping my intellectual thinking and further enhancing my capabilities as a student.

Last but not least, I also want to reserve a special appreciation to all my close friends in the Master of Economics program. I thank you all for being such good and helpful friends during our stint as students in this program. The pleasure, has been all mine.

TABLE OF CONTENTS

	Page
Abstract.....	i
Acknowledgement.....	iii
Table of Contents.....	iv
Chapter 1	
Introduction	
1.1 Overview.....	1
1.2 Objectives of Study.....	5
1.3 Monetary Policy: A Brief Introduction.....	5
1.4 Monetary Policy Framework.....	7
1.5 Instruments of Monetary Policy.....	9
1.6 The Asian Currency Crisis: A Brief Encounter.....	13
1.7 Monetary Policy after the Crisis.....	18
Chapter 2	
Literature Review.....	19
2.1 What is Money?.....	21
2.1.1 Commodity Money versus Fiat Money.....	22
2.1.2 Issues in Counting Money.....	22
2.1.3 The Total Supply of Money.....	24
2.2 Monetary Policy.....	24
2.2.1 Money Stock and Interest Rate Targets	28

2.2.2 Targeting the Monetary Base.....	36
2.3 Monetary Policy and Interest Rates.....	36
2.3.1 The Relationship between Interest Rates and Exchange Rates	37
2.3.2 Real Output, Short-term and Long-term nominal interest rates	39
2.4 Inflation Targeting: Another Variation to Monetary Policy.....	40
2.5 The Mundell-Fleming Model.....	42
2.5.1 The Flexible (Floating) Exchange Rate Regime.....	42
2.5.2 The Fixed Exchange Rate.....	45
2.5.2.1 Devaluation as a Policy Instrument.....	47
2.5.3 Imperfect Capital Mobility.....	47
2.6 The Theory of “overshooting”.....	48
2.7 Monetary Policy in the Mundell-Fleming model.....	51
2.8 The Significance of Capital Controls.....	52
2.9 Central Bank Independence.....	54

Chapter 3

Monetary Policy Developments in Malaysia, Thailand and Indonesia in the Last Two Decades (A General Assessment).....	56
3.1 Overview of Monetary Developments.....	56
3.2 Financial Liberalization.....	58
3.2.1 Capital Account Liberalization.....	62
3.3 Monetary Policy in Malaysia, Indonesia and Thailand.....	63
3.4 Economic Analysis during the Crisis.....	68
3.4.1 Interest Rate Management.....	70
3.4.2 Money Supply Management.....	71

3.4.3 Exchange Rate Regime.....	73
3.5 Monetary Policy in the Aftermath of the Currency Crisis.....	76
3.6 Conclusion	78

Chapter 4

A Theoretical Analysis of Monetary Policy in the Last Two Decades: The Case of Malaysia.....	79
4.1 Overview of Economic and Monetary Developments in the Last Two Decades.....	79
4.2 Money Supply versus Interest Rate Targeting	84
4.2.1 Interest Rate Management.....	85
4.2.2 Money Supply Management.....	92
4.3 Exchange Rate Management.....	97
4.3.1 Exchange Rate Management:The Case for Capital Controls.....	102

Chapter 5

A Theoretical Analysis of Monetary Policy in The Last Two Decades: The Case of Indonesia.....	107
5.1 Overview of Economic and Monetary Developments in the Last Two Decades.....	107
5.2 Monetary Targeting versus Interest Rate Targeting.....	111
5.2.1 Interest Rate Management.....	111
5.2.2 Money Supply Management.....	118
5.3 Exchange Rate Management.....	127
5.4 After the Crisis: Inflation Targeting.....	133

Chapter 6

A Theoretical Analysis of Monetary Policy in The Last Two Decades: The Case of Thailand.....138

6.1 Overview of Economic and Monetary Developments in the Last Two Decades.....138

6.2 Monetary Targeting versus Interest Rate Targeting.....144

 6.2.1 Interest Rate Management.....144

 6.2.2 Money Supply Management.....150

6.3 Exchange Rate Management.....155

6.4 After The Crisis: Inflation Targeting.....161

Chapter 7

Conclusion.....164

Bibliography.....172