Chapter 1

Introduction

1.1 Overview

During the last quarter of a century or so, the theory and practice of monetary policy have undergone momentous changes. Thus unsurprisingly, the evolution of monetary policy has also seen some rather dramatic changes. By the end of the 1960s, mainstream macroeconomics had regarded the monetary management as a "game against nature" in which the optimal setting of monetary instruments could be determined by solving the economy's econometric model after imputing the desired policy targets. Of course, there have been many debates between supporters of discretion-based policies and rule-based policies on the degree of knowledge of the model's parameters thus also on the feasibility of such activist policies. However, the fact that monetary discretion could, in principle, be optimally used was virtually undisputed.

In essence, the history of the international monetary arrangements of the last century actually began with the gold standard and this continues into the era between the two world wars using the gold exchange standard. The Bretton Woods system later took over during the 1950s and 1960s. Although in each of these periods, currencies were pegged, there were also periods whereby the currencies of the major countries were not. However, many industrial countries stopped pegging their currencies to gold or to the US dollar in the early 1970s[1] although a number of European countries have pegged their currencies to the currencies of their other European counterparts. In retrospect, the gold-exchange principle was effectively brought to an end by the unilateral US decision to suspend dollar convertibility into gold in 1971. Hence although in global terms pegged exchange rates remained the most frequent form of exchange rate policy, the key currency (the dollar) and a number of other major industrial currencies have been allowed to float relatively freely or within (unspecified) bounds since the early 1970s.

The case for flexible exchange rates as made by **Friedman (1953) and Johnson (1969)** rests on the argument that flexible rates would provide a more efficient international system of adjustment (free-market) while ensuring the free use of domestic fiscal and monetary policy instruments for domestic uses. However, **Nurske (1944)** argues that flexible rates are subjected to volatile rates and this, in fact becomes a source of disturbance and instability.

In other areas of monetary developments, the increased integration and reduced policy barriers between the financial markets of industrialised economies has increased the international mobility of capital over the post-war period. With the increase in the importance of international capital flows, the ability of governments to influence the level of income or output through domestic financial policies can no longer be independent from the type of exchange rate regime the country pursues.

[1] In February 1973, after the German authorities stopped pegging the mark to the US dollar, the authorities in most other industrial countries also stopped pegging their currencies.

During the 1980s, many of the ASEAN countries liberalized their domestic financial systems through more relaxed capital controls and a more flexible exchange rate arrangements. Such developments, of course, altered the channels of monetary policy, affecting the relationship between money demand, incomes and interest rates, and inevitably led to a reassessment of the appropriate instruments of monetary policy.

ASEAN countries like Indonesia, Malaysia and Thailand have, since the early 1980s, witnessed enormous developments in their domestic financial markets. In fact, the financial sector liberalization in these countries has been significantly more critical than any other developing countries. In any event, many developed and developing countries have moved towards liberalization of their financial systems since excessive controls and regulations were viewed as inappropriate for efficient resource allocation and the fostering of economic growth. In this respect, the developments included the liberalization of interest rates and promoting the deepening of money and capital markets. In some instances, countries actively encouraged the entry of foreign financial intermediaries. Generally, the trend towards financial liberalization was to enhance a greater reliance on market forces as well as to improve the effectiveness of monetary policy.

However, the positive view of financial liberalization has somewhat been clouded by the marked increase in financial fragility experienced by both developed and developing countries in the 1980s and 1990s. Such liberalization had led to the volatility in the financial markets during the 1980s. In fact, financial liberalization that improves the quality of economic signals, changes the institutional environment and varies the possible range of financial opportunities will also create potential for instability in the demand for money. This is critical since the reduction in the predictability of money demand can result in a monetary policy that is either too tight or too loose. In this context, the East Asian currency crisis beginning in 1997 highlighted the urgent need for the financial community and authorities to re-analyse the whole financial architecture that governs the world trading and economics. A key feature of the affected countries had been the surge of capital inflows into their financial markets as a result of continuing reform and rapid integration into the global financial markets. In fact, many East Asian enterprises were "encouraged" to over-leverage mainly in US dollars since this move had led to a lower cost of capital. Such "improved" access resulted in the national financial markets to open up to a much deeper foreign presence that inevitably increased the likelihood of an intense and frequent speculative attacks. In retrospective, while there were many reasons that triggered the currency crisis, at the same time, we also witnessed many different approaches by those affected countries in mitigating the effects and also reforms, which were initiated to pave the way for a recovery in their economies.

Among the ASEAN countries, Malaysia, Indonesia and Thailand were the worst affected, with Indonesia being the hardest hit. The currency attacks eventually led to other economic catastrophes, with the private corporate sector heavily affected. Both Indonesia and Thailand were forced to accept the so-called "rescue packages" from the International Monetary Fund while Malaysia went ahead with their own policies and economic strategies. Hence, this study attempts to analyze monetary policy, its significance over the last two decades and its theoretical underpinnings while at the same time providing a critical assessment on its role.

1.2 Objectives of study

The objective of this paper is to analyze the role of monetary policy in the context of three ASEAN countries and assess its role and significance (in terms of their theoretical basis and validity) to their economy since the 1980s. In this respect, the study attempts to consolidate the theoretical concepts and models in regard to the experiences of these countries in the last two decades. This is especially so in recent years in the wake of the East Asia financial crisis in 1997 and the continuous global economic slowdown going into the new millenium.

Monetary policies have been instrumental in government policies of these countries given that the recent crises were largely monetary related. The ASEAN countries selected in this study comprise of Malaysia, Indonesia, and Thailand as they shared rather close similarities as far as economic development and structure are concerned. As far as the period is concerned, our focus in this study is rooted in the time period from the early 1980s onwards in order to have a more general analysis of the evolving monetary policy framework that has been advocated by these countries.

1.3 Monetary Policy: A Brief Introduction

Monetary Policy is a policy of influencing the economy through the changes in the banking system's reserves that influence the money supply and credit availability in the economy. In essence, monetary policy is one of two main traditional macroeconomic tools (the other being fiscal policy, of course) by which the government attempts to control the aggregate demand. According to the conventional view, monetary policy works by first, affecting the interest rate and then, affecting the aggregate demand. Basically, an increase in the money supply reduces the interest rates, which leads to an increase in investment spending and the country's aggregate demand thus leading to an increase in the equilibrium national output. The monetary authorities will determine the money supply (usually through the use of open market operations) thus pinning down the position of the LM curve to influence the interest rate. However, the authorities can also target the interest rate directly instead of relying on monetary targeting. In any case, manipulation of the money stock itself will lead to a change in the interest rates. Thus, sometimes the monetary authorities are saddled with the dilemma of whether to engage in interest rate targeting or money supply targeting. Those advocating these regimes are also known as "horizontalists" and "verticalists" **(Moore, 1988)** respectively in reference to the shape of their respective LM curves (refer to Fig. 1.1 and 1.2 respectively).

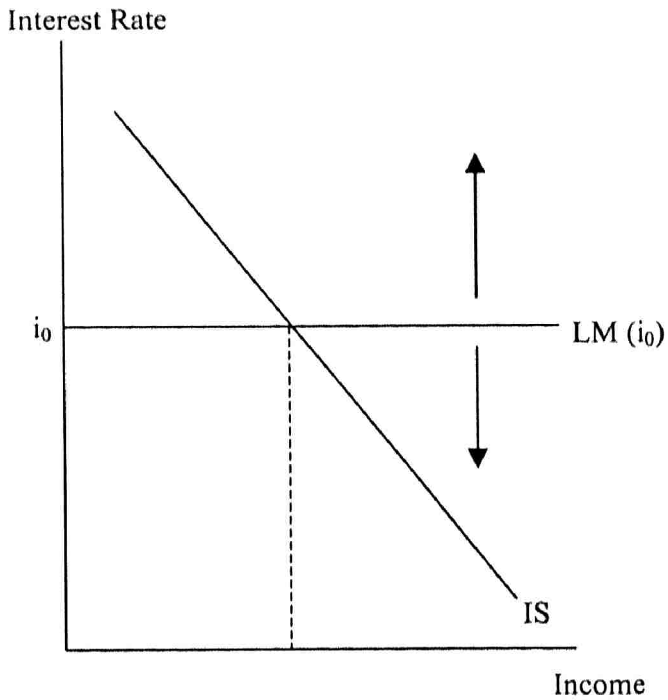

Fig. 1.1

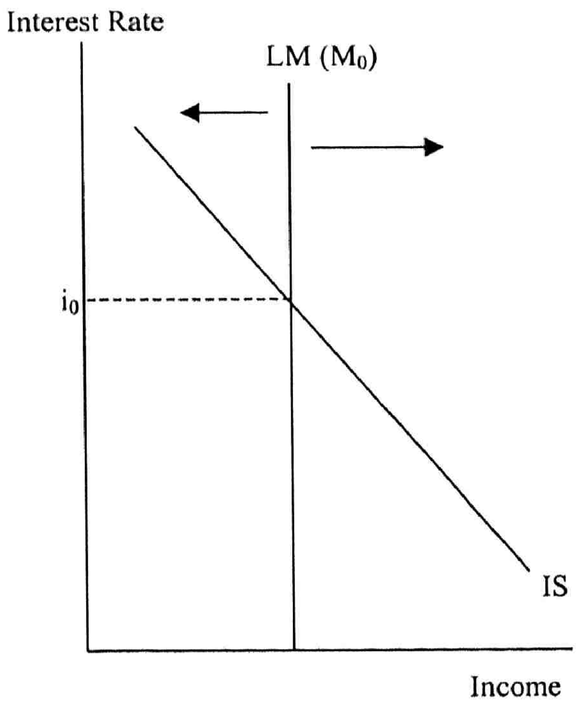

Fig. 1.2

1.4 Monetary Policy Framework

With financial reforms come problems in the workings of monetary policy. Since financial liberalisation result in greater flexibility in the interest rates and financial markets, the authorities have to decide whether to target mainly prices (such as the interest rates) or quantities (such as monetary or credit aggregates). If the authorities have decided to opt for the latter target, then the next question that will arise will be whether the authorities should look at the "narrow" or "broad" money.

The fundamental function performed by a monetary framework is to facilitate monetary exchange while preserving the trust in the price stability and the predictability of the future price level. Over the years, monetary practice in most countries has increasingly been characterised by attempts in achieving credibility of purpose while increasing the freedom of controlling policy instruments. Thus, lies the importance of monetary frameworks in balancing a trade-off between credibility of goals and flexibility of instruments.

Monetary frameworks can, in principle, be differentiated according to the following three aspects: (1) whether there exists announced rules or formal institutions affecting the behaviour of the monetary authorities; (2) the costs of repudiating the announced rules; (3) the costs of monitoring any possible discrepancies from the announced rules. In essence, high monitoring costs favour non-compliance of the rules even when there are no formal repudiation. In the case of monitoring costs, exchange rate based frameworks are usually considered easier to monitor than monetary rules.

Monetary policy framework **(Johnston, Swinburne, Kyei, Laurens, Mitchem, Otker, Sosa, & Tamirisa, 1999)** can be categorized to the following groups:-

The exchange rate anchor: The monetary authority stands ready to buy and sell foreign exchange at given rates to maintain the exchange rate at its pre-announced level or range (the exchange rate serves as the nominal anchor or intermediate target of monetary policy). These regimes cover exchange rate regimes with no separate legal tender, currency board arrangements, fixed pegs with and without bands, and crawling pegs with and without bands, where the rate of crawl is forward-looking.

The Monetary Aggregate Anchor: Here, the monetary authority uses its instruments to achieve a target rate for a monetary aggregate (M1, M2 and so forth). In this respect, the targeted aggregate becomes the nominal anchor or intermediate target of monetary policy.

Inflation-targeting Framework: A framework that targets inflation involves the public announcement of medium-term numerical targets for inflation with institutional commitment by the monetary authority to achieve these targets. Additional key features include increased communication with the public and the markets about the plans and objectives of monetary policymakers and increased accountability of the central bank for obtaining its inflation objectives.

Interest Rate Targeting: The monetary authorities can also target the interest rates. With the growing sophistication in the financial sector, the monetary aggregates (in example, M3) have, over the years undergone major changes. Coupled with fact that such developments have also led to the volatility and unpredictable nature of money demand, some countries have opted to subscribe to an interest rate targeting instead of a money supply targeting.

Other programs involve the implementation of monetary/exchange rate policies within the confines of a framework that establishes floors for international reserves and ceilings for net domestic assets of the central bank. As the ceiling on net domestic assets limits increases in reserve money through the central bank operations, indicative targets for reserve money may be appended to this system. Alternatively, a country may have no explicitly stated nominal anchor but rather monitors various indicators in conducting monetary policy.

1.5 Instruments of Monetary Policy

Instruments of monetary policy, in general, depend on the maturity and depth of financial and capital markets. As far as Asian countries are concerned, financial liberalization have reduced the scope for the conduct of monetary policy. With the increased flexibility in the interest rates and the reforms in the financial markets, the monetary authorities have to decide whether they should target the interest rates or the monetary aggregates. In the case of the three ASEAN countries in our study, over the recent years, there has been a greater reliance on open-market operations to affect short-term interest rates thus reflecting a move from achieving broad money targets by limiting bank lending through moral suasion or reserve requirement changes. Instruments to achieve monetary targets, in general are as follows:-

- Direct intervention to define the credit

- Measures to control lending by the banking system via regulated reserve ratios
- Measures to influence liquidity by sale or purchase of securities (also known as open-market operations)
- Measures to control the monetary base, (with some liberalization of interest rates)

During the 1980s, a number of Asian countries moved toward a greater reliance on market-based instruments of monetary policy and away from direct controls. One advantage of using indirect instruments is that economic decisions are left to the market hence resulting in more efficient allocation of resources. The shift toward indirect monetary controls has generally entailed a greater reliance on open-market operations and generally less dependent on reserve requirements. In this respect, Indonesia, Malaysia and Thailand all intensified the use of open-market operation. However, the absence in the early 1980s of government debt instruments resulted in the issuance of the Central Bank's own debt instruments to accompany the open-market operations. For instance, when there is a contractionary monetary stance, the Bank Negara Malaysia will raise the reserve requirement or in the case of Thailand, the Bank of Thailand sells its Bank of Thailand paper. However, Indonesia is different from the other two, in the sense, it has a short-term paper market of sufficient depth to conduct the traditional open-market operations.

In any case, changes in the reserve requirements were considered too blunt since these small changes had resulted in relatively large and potentially disruptive shifts among commercial bank assets. In addition, there were also concerns that the high non-interest bearing reserve requirements, by exerting a tax on the banking system, may encourage disintermediation. In this respect, both Malaysia and Indonesia lowered their reserve requirement during this time.

In the context of Malaysia, Indonesia and Thailand, the monetary policy instruments utilized in general appear to include a wide range of variety. For instance, the 1990s (pre-1997) saw Indonesia concentrating on open market operations (involving Bank Indonesia paper and commercial bank paper), reserve requirements and foreign exchange operations while Malaysia's policy (monetary) instruments included reserve requirements, direct lending and borrowing from the inter-bank market and sales of Bank Negara bills. Thailand's main focus as far as monetary instruments are concerned included the usage of repurchase operations and the sales of Bank of Thailand bonds.

During the currency crisis, different types of monetary policy instruments were utilized in their bid to restore economic stability and revive growth. In this context, both Indonesia and Thailand opted to use the IMF approach while Malaysia resorted to using their own policies to counter the crisis. Monetary policy in Asian crisis programs (namely Indonesia and Thailand) had two main tasks to address; the first being to avoid a depreciation-inflation spiral while the other concerned the fact that excessive monetary tightening may lead to a severe cutback on economic activity.

In any event, Malaysia was the only country among those affected to resort to capital controls during the currency crisis. In fact, Malaysia had initiated such measures even before the currency crisis had occurred. During 1993-94, capital controls were initiated on a temporary basis and to complement the macroeconomic policies to restore a rapid adjustment in the stabilization process. However, during the currency crisis, the Ringgit was heavily devalued. The unstable Ringgit subsequently led to an outflow of portfolio funds which saw the Malaysian government resorted to a wide range of direct capital and exchange controls (beginning September 1998) in their bid to regain monetary policy independence by containing speculation on the Ringgit through the elimination of the offshore Ringgit market and to stabilise short-term capital flows. The Ringgit was then, officially pegged at 3.80 per US dollar.

In their quest for exchange rate stability, the crisis programs in Indonesia and Thailand made no attempt to stick to a pre-announced level or range for the exchange rate. The objective was to deal with the slide of the exchange rate but there were no exchange rate targets. Hence, the IMF's immediate effort to establish confidence was led by a prescription of temporary tightening of monetary policies. Instead of the credit or the monetary aggregates, the nominal interest rate was adopted as the de facto gauge and instrument of monetary policy tightening, which together with exchange rate guided day-to-day policy **(Lane *et al*, 1999)**. One of the instruments used then, was the maintenance of high interest rates. Of course, this was accompanied by a set of comprehensive reform in the financial systems as well. However, neither Indonesia nor Thailand had policies that went to the limit that was needed to ensure absolute exchange rate stability. Although there were no moves to repeg the exchange rates, Thailand's currency recovered substantially by mid-1998 as interest rates declined to pre-crisis levels and inflation remained subdued hence suggesting that there were indeed stability restoration with these policies. With a later firmer monetary policy, Indonesia's progress on stabilization came a year later.

1.6 The Asian Currency Crisis: A Brief Encounter

The spread of the Asian financial crisis which originated from Thailand and then gradually spreading to other countries in the region during the second half of 1997, plunged the countries affected into deep recessions which consequently led to alarming rates of unemployment, severe poverty and in some countries, social dislocation. What started off as a speculative attack on currencies quickly turned into a stock market meltdown which eventually led to a regional banking crisis.

The crisis had somewhat baffled many economists as the countries most affected were the so-called "tiger economies" which generally had few weaknesses. In essence, the Asian currency crisis was not a typical balance of payment crisis such as those experienced with such frequency under the Bretton Woods system. In fact, most of the affected countries have been near surplus on their trade balance, if not on their current balances, and have a long-term record of fiscal rectitude **(Jomo, K.S., 1998)**. In addition, these countries also boost of high private savings rates, low inflation and in most cases their exchange rates did not seem out of line.

Although several factors may have contributed to the onset and spread of the Asian crisis, many believed the main cause was one of financial fragility. In this respect, there appears to be four related aspects **(Lane, T., 1999);**

- Many financial institutions / corporations in those affected countries had borrowed in foreign currencies without adequate hedging (hence vulnerable to currency depreciation)

- Much of the debt was short-term while assets were long-term (thus creating the possibility of a liquidity attack)
- Prices in these countries' equity and real estate markets had risen substantially before the crisis (which increased the likelihood of a sharp deflation in asset prices)
- Credit was often poorly allocated (contributing to increasingly visible problems at banks / financial institutions even before the crisis)

In short, such financial fragility was a product of ineffective financial supervision and regulation in the context of the affected countries' financial sector liberalization. Capital account liberalization was somewhat poorly sequenced while limited exchange rate flexibility led borrowers to underestimate the exchange risk. In essence, such financial fragility were stemmed in part from the weaknesses in governance in the corporate, financial and government sectors which made these economies increasingly vulnerable to the changes in market sentiment, a deteriorating external situation and contagion. In any event, in the last two decades, many developing countries have moved towards liberalization of their financial system. In this respect, such liberalization is part of a broader trend towards reduced direct intervention of the state in the economy. In fact, in many cases, financial liberalization is also a deliberate attempt to move away from "financial repression" [2] as a policy to fund government fiscal imbalances and subsidize priority sectors.

[2] According to McKinnon (1973) and Shaw (1973), financial repression, by forcing financial institutions to pay low and often negative real interest rates, reduces private financial savings, thereby decreasing the resources available to finance capital accumulation. In this respect, through financial liberalization developing countries can stimulate domestic savings and growth, and reduce excessive dependence on foreign capital inflows.

In the case of Malaysia, Indonesia and Thailand, financial liberalization, together with the easing of bank entry and advances in banking technological developments (i.e. credit cards), had contributed to an "overborrowing syndrome". In this context, too much lax credit gave rise to increasing default rates of loans both before and during the financial turmoil. The allowance of voluminous unhedged foreign borrowings by domestic banks and private firms was later diagnosed as one of the main cause of the speculative currency attacks during the 1997 crisis. Hence, the lack and inadequacy of prudential regulation by the central banks was a common feature in these countries.

The fact that these countries were highly vulnerable to a turnaround in foreign investor confidence and a subsequent capital outflow was clear by the end of 1996. The excessive bank lending following a period of rapid financial market and capital account liberalization, particularly in foreign bank lending, was the key contributing factor to the Asian economic crisis; i.e. deregulation and privatization of banks without appropriate regulatory measures allowed them much greater latitude to borrow from abroad **(Ang, Lee, Lim, Kulwant Singh and Tan; 2000).** Since the domestic interest rates were much higher than foreign interest rates in Thailand and Indonesia, as well as a stable peg (Thailand) and limited depreciation of about 5% against the US dollar per year (Indonesia), the private corporate sector in these countries were confident of limited exchange rate risks, and thus, borrowed massively in cheaper, foreign currencies **(McKinnon and Pill, 1996).** The chain of events that follows can be traced to the following: When the loans to domestic firms became non-performing, domestic banks becomes saddled with foreign currency. Meanwhile, as exports declined and current account deficits became unsustainable, foreign reserves began to dip and the foreign banks/investors began to lose confidence on the sustainability of the currency peg. Hence, as the foreign funds began to withdraw from the equity market, foreign banks became less willing to roll over the short-term loans, the stock markets started to plummet culminating in the depreciation of the local currencies. The end result is a liquidity squeeze and the bankruptcy of domestic financial institutions/private corporate sector. Thus, for these economies to embark on a continuous sustained recovery, it is crucial to regain the investors' confidence. In any event, once there is a return of foreign/local capital, the exchange rate will stabilize and slowly appreciate, paving the way to a recovery in the stock market and also easing the way for the Central Bank to reduce the interest rates.

Nonetheless, by the end of 1998, a measure of calm had been restored to the financial markets in Southeast Asia, owing in part to policy programs supported by international financial institutions and to a lowering of official interest rates in many industrial countries. With continued progress in stabilization and reform in the Asian crisis countries implementing IMF-supported programs, currencies began recovering and monetary policies were eased by mid-1998 **(Annual Report 1999 – International Monetary Fund).** Economic and financial conditions improved in 1999 and early 2000 as the world economy proved more resilient to the financial crisis that erupted in 1997-98 than initially believed. The turnaround in Asia was stronger than expected, with recoveries in Korea, Malaysia and Thailand helped by supportive and monetary policies (which contributed to a turnaround in domestic demand) and buoyant exports. Even in Indonesia, the country that was worst hit among the ASEAN countries during the crisis, has experienced gradual recovery in their economic output. In 1999, Indonesia registered a positive real GDP growth compared to a severe output contraction in 1998 **(Annual Report 2000 – International Monetary Fund).**

Although Malaysia did not tackle the crisis with any foreign assistance, both Indonesia and Thailand opted for the IMF's "loan package" in dealing with their financial dilemma. Malaysia did not have an "IMF programme" since it initially did not have an external crisis to the same extent as Thailand. This is because its international short-term borrowing in the period preceding the crisis (in proportion to its GDP) was much less. In this context, these IMF-led "rescue packages" which led the initial loan bailout for Indonesia and Thailand was crucial in its attempt to provide an initial stabilising platform for these countries. However, the IMF's approach did not appear to bring the desired results although the loans did helped these countries to shore up their central banks' foreign exchange reserves, which in turn, helped to start the bad loan reduction process. However, unlike the "peso crisis" in Mexico (1994), the debt problem this time was largely corporate rather than at the national level. Huge corporate foreign-currency denominated debt in very short-term maturities meant that Asian corporates and banks had demanded for dollars to mature or rollover in short order. As the reversal of currency over-appreciation continued, the amount of local currency these parties had to pay in order to buy the dollars to hedge, repay or refinance their dollar debt continued to grow – a vicious circle **(Henderson, 1998).** In the case of Thailand, in return for the IMF loan package, it was forced to initiate a severe austerity campaign in order to shrink both its current account and budget deficits. Inevitably, this led to a massive recession. The IMF's insistence on high interest rates to reverse the excessive exchange rate depreciation was partly blamed for such undesirable conclusion.

However, it is obvious that the presence of the IMF is still needed, especially in a situation like the Asian crisis. Hence, it should be provided with the adequate resources to cope with major crisis. In this respect, these resources should not be used primarily to rescue international banks or other financial institutions – nor the owners and managers of domestic institutions in crisis countries – but to provide temporary relief to allow for necessary adjustments without major recessions **(Corden, M., 1998).**

1.7 Monetary Policy after the Crisis

In the aftermath of the crisis, the affected countries in the region are beginning to undertake reforms and to develop their financial markets to address the weaknesses that were exposed by the financial crisis. Many of these countries are strengthening the institutional framework for conducting their monetary policy. Indonesia and Thailand are putting in place an inflation-targeting framework. This may be a good move as the market looks positively at such efforts. Arrangements like inflation-targeting systems and central bank independence help establish credibility in monetary policy management, in the sense, that it provides a clear conceptual and institutional framework for the conduct of monetary policy.