Chapter 3

Monetary Policy Developments in Malaysia, Thailand and Indonesia in the Last Two Decades (A General Assessment)

3.1 Overview of Monetary Developments

Monetary developments in the three ASEAN countries in this study (Malaysia, Thailand and Indonesia) have, since the early 1980s contributed to the rapid development of their domestic financial markets. Ironically, these developments took place in the context of very successful economic performances by these countries. In the case of financial liberalization, the interest rate deregulation and increased competition in banking markets, as well as the liberalization of restrictions on cross-border capital flows – this area of development has been considerably greater in these countries than in many other developing countries. In this respect, these structural changes in financial markets and the associated rapid growth have affected the relation between money, income, inflation and other economic variables hence complicating the process of monetary management. In short, the orientation of monetary policies in these countries has seen significant shifts and changes in the wake of the continuous financial deregulation and innovative developments. As a result of these financial reforms, monetary control became more market-oriented with the more indirect monetary instruments like open market operations subsequently replacing those direct instruments of monetary control like the interest rate ceilings or credit rationings.

Among these countries, financial liberalization since the mid-1970s onwards has included the deregulation of deposit rates, and the introduction or deepening of alternative monetary instruments, bonds, and equities. Liberalization of the interest rates appeared to be the most important aspect of the financial reforms that took place in these countries. In essence, financial liberalization can affect the choice of targets of monetary policy and the variables that are monitored by central banks to gauge the monetary conditions. In an underdeveloped financial market, interest rates tend to be set by administrative controls, and the central bank usually targets quantity variables such as broad money. However, with the process of financial liberalization, the stability of monetary aggregates may be reduced hence many central banks presiding over relatively advanced financial markets often resort to monitoring price variables instead, such as the exchange and interest rates. Hence liberalization and structural changes in the financial markets in the 1980s created a greater role for interest rates to transmit the effects of monetary policy.

The shift away from formal monetary targeting has in fact, been due to many factors. In essence, all these reflected the concerns that the demand for money may have become rather unstable in the face of continuous financial liberalization (i.e. new financial instruments and liberalization of interest rates) with the consequences of being relegated to being a less reliable guide to policy formulation. The continuous financial innovations have widened the array of financial instruments available and reduced the transaction costs of shifting among the financial instruments thus ultimately leading to portfolio shifts away from monetary assets. Liberalization of interest rates could also affect the interest elasticity of money. In practice, failure to allow for changes in money demand following financial reform could result in a monetary policy that is either tighter or looser than those planned before the reforms are implemented **(Dekle and Pradhan, 1997)**. Ultimately, the existence of a stable and predictable relationship between monetary aggregates, economic activity, prices and interest rates is crucial in the formulation of an effective and efficient monetary policy.

Economically, Malaysia, Indonesia and Thailand differed in many aspects. The important differences can be seen in the per capita incomes and economic structures. However, each of these three countries emerged from a difficult period in the mid-1980s only after the implementation of major adjustment programs. In this respect, exchange rate devaluation was a feature of all three countries, an objective aided by the fall of the US dollar following the Plaza Accord. Indonesia had devaluated its currency twice, in 1983 and later again, in 1986 while Thailand underwent devaluation between October to December 1984 in their bid to stimulate exports growth. However, although devaluation is a crucial tool in stimulating exports, it still remains to be seen whether it is a guaranteed recipe for fueling growth, as the internal economic structure of the country must be able to support and finance the growth.

3.2 Financial Liberalization

By definition, financial liberalization is about having domestic interest rates to be aligned to international ones, the credit constraints in expenditures become looser while the portfolio of allocation get expanded. As the overly regulated financial sector was regarded as discouraging financial savings and distorting investment decisions, the move towards financial liberalisation was inevitable, to say the least.

Different countries have different economic structure and hence, their degrees of financial market sophistication also vary. However, in terms of their financial systems before the liberalization process, Malaysia, Indonesia and Thailand actually share certain similarities. Some of these included the following:-

- Interest rate restrictions – Pervasive before the 1980s, they usually took the form of ceilings on deposit and loan rates of commercial banks, i.e. Thailand in the 1980s.
- Domestic direct controls – In trying to regulate both the aggregate supply and sectoral allocation of credit, these usually involved the form of ceilings on the level or growth of bank credit and directed credit schemes, i.e. Indonesia before 1983.
- High reserve requirements – With no interest paid, these reserves served as an implicit tax on commercial banks that often increased the cost of financial intermediation.
- Segmented financial markets – Each type of financial institution was restricted to conduct business within its explicitly prescribed sphere while the activities of foreign banks were restricted.
- Capital controls - Generally erected to insulate domestic interest rates and monetary conditions from any effects from abroad while as to support the fixed exchange rate in some cases.

Since excessive regulations had resulted in rather inefficient resource allocation, financial liberalization and reforms were seen as much needed and crucial for these countries. The removal of interest rate and credit controls appeared to be crucial if the financial sector is to reflect a market-determined sector. With the severe external shocks (for instance the worsening terms of trade and the rising international interest rates) prior to the 1980s, the traditional monetary policy instruments (like administered interest rates) became inadequate. In this aspect, the implementation (in terms of the pace and type of reforms) of financial liberalization varied across ASEAN countries. For instance, Singapore liberalized its financial sector and abolished capital controls in the mid-1970s and by the 1980s, the country's financial sector was already well-developed and internationally integrated. Likewise Malaysia, Philippines and Indonesia also initiated significant reforms in the early 1980s although Thailand took a more gradual step towards liberalization, which only intensified in the latter half of the 1980s. In any event, the financial liberalization in these countries had been a gradual and continuing exercise rather than a few discrete concentrated episodes of comprehensive liberalization.

Ironically, as far as the 1997 financial crisis in Southeast Asia is concerned, the main causes had been financial liberalization and its consequent undermining of monetary and financial governance. The 'quasi-pegs' of the region's currencies to the US dollar and the encouragement of foreign capital inflows to deal with the deficit in the current account had resulted to an increased in unhedged borrowing from abroad. In addition, this also rendered them vulnerable to currency speculators as the regional currencies appreciated with the US dollars despite their declining export competitiveness and growth.

In the case of Thailand, between 1990 to 1994, their financial system was subjected to a number of significant deregulation and liberalization. Some of these include the removal of ceilings on various kinds of savings and time deposits and the dismantling of all significant foreign exchange controls. The most significant financial liberalization step undertaken by the Thais was the establishment of the Bangkok International Banking

Facility in 1994. This was a system whereby local and foreign banks were allowed to engage in both offshore and onshore lending activities.

In Malaysia, financial liberalization is also believed to have contributed to the reduction in the efficacy of the Central Bank (Bank Negara Malaysia – BNM) in the workings of a sound monetary management. For instance, the establishment of the IOFC[1] on the East Malaysian island of Labuan is believed to have greatly enhanced domestic investors' access to foreign funds while reducing effective BNM surveillance of flows of funds as well as banking practices more generally **(Jomo, K.S., 1998).**

Financial liberalization in Indonesia led to a lending boom, which progressively involved lending for property development and an increasing proportion of bad loans. Although the financial reforms in Indonesia were somewhat meant to reduce the problems inherent in the state-dominated financial system, the problems of poor lending practices in the public sector did not subside even after the liberalization process. Liberalization of the domestic financial system saw an enormous increase in foreign financiers' interest in providing resources to the system. Banks had to compete for deposits, and when the deposit rates went up, the domestic corporations resorted to borrowing externally due to the high interest rates. Consequently, the Indonesian financial system approached the 1997 crisis with a banking system heavily in need of recapitalization, with the private sector and the banking system carrying heavily unhedged external liabilities that was mostly denominated in US dollars.

[1] IOFC – International Offshore Financial Centre

3.2.1 Capital Account Liberalization

The liberalization of capital movements has reflected a variety of reasons, including the benefits from increased access to and a lower cost of, investible funds. Such liberalization has been largely due to stronger net capital inflows, with the liberalization reflecting a wish to avoid the potential distortionary effects about the overall effectiveness of such controls on capital movement. In this respect, research has shown that controls may have some effectiveness in the short-run but it could be eroded fairly quickly. A major setback in an open capital account is that domestic stabilization policies become far less autonomous. For instance, any domestic policies, which are divergent from outside countries in the rest of the world, would have adverse effects on certain variables like the exchange rate or capital flows (balance of payments).

Both Malaysia and Thailand imposed or intensified existing capital controls during the period of 1993 – 1997. Most restrictions were specific to banks and credit controls while some were temporary. The recent Asian currency crisis has spurred tightening measures on capital outflows in countries like Thailand and Malaysia. Malaysia introduced a wide range of direct capital controls beginning September 1998 to insulate its economy against financial market shocks from abroad and to attain the desired degree of monetary independence again.

Prior to the crisis, and since the late 1980s, many of these economies, particularly Malaysia, Thailand and Indonesia had been enjoying a boom in foreign capital inflows. For example, in Thailand, high profit margins in stocks, high interest rates and relatively low risk due to a US-dollar-pegged currency led to rapid foreign capital into the country.

Ultimately, a reversal of these flows occurred when the currency was floated which saw massive amounts of capital fleeing the country thus culminating to an economic catastrophic when it spread to other neighbouring countries.

3.3 Monetary Policy in Malaysia, Indonesia and Thailand

Since the 1980s, nearly all the Asian countries have undergo major aspects of financial liberalisation. In ASEAN countries like Thailand, Malaysia and Indonesia, the removal of the various capital and exchange rate controls coincided with increased capital mobility, overborrowing, increased capital market risk and inevitably, financial crises. The increased capital mobility leaves open the question of the many potential problems of such flows thus highlighting the importance of exchange rate management. In the case of financial liberalization, the environments in which monetary policies operate in these countries have significantly changed. In essence, such changes have significantly changed the dynamics of monetary policy and also the effectiveness of the different variations to it. The implications of financial reforms in these countries would have been the changes it has made on the linkages between monetary policy and the domestic economy, the changes in the monetary aggregates and also the constraints on the effectiveness of the many monetary policy instruments.

In essence, countries with underdeveloped financial systems/markets (i.e. interest rates regulations, restrictions on international capital flow) conduct monetary policy via the use of directly affecting the availability of credit. For example, the changes in credit rationing (credit ceilings or selected credit controls) or reserve requirements will affect aggregate demand. However, the post-liberalisation environment entailed a different perspective for monetary policy channelling. In this case, interest rate will played a more crucial role as the reforms had led to the liberalization of the interest rates. There will be more emphasis on indirect monetary instruments like the open-market operations. With open-market instruments, the interest rates will be affected hence influencing the demand for financial assets with the ultimate aim of increasing (or decreasing) aggregate demand, especially in the investment side.

Besides the implications of interest rates liberalisation, the targets of monetary policy can also be affected by the exchange rate regime and the capital mobility stance. In the case of an open economy practising a fixed exchange rate and perfect capital mobility, the monetary authorities does not have any control over money supply since any changes in the money supply will alter the interest rates and influence the flow of capital. For instance, a tightening monetary stance will lead to an increase in the interest rate but such a situation will lead to increased capital inflow which will reverse the interest rate trend. However, the authorities of an open economy with capital mobility and flexible exchange rate would have control of the money supply since the monetary effects on the interest rates are not reverse by the capital flow that will arise due to the change in the interest rates. For example, an expansionary monetary policy (i.e. an increase in the money supply) will lead to reduction in the interest rates and ultimately result in capital outflow. Since the excess demand for foreign exchange will not reverse the fall in the interest rate the authorities are not constrained in their monetary policies.

As far as the management of the exchange rate is concerned, Indonesia have been using a managed float regime since 1978. This system was enforced until the currency crisis in 1997. Under a system of managed float, the central bank announces a daily "conversion rate band" (for official transactions with foreign exchange banks, governments, as well as with supranational institutions) and an "intervention band" of buying and selling rates based on a basket of currencies. The price of the Malaysian Ringgit is determined by the market mechanisms, with The Bank Negara Malaysia (BNM) intervening only to maintain orderly market conditions and to avoid any excessive fluctuations in the Ringgit's value. However, the BNM also monitors the exchange rate of Ringgit against a weighted basket of currencies of the country's major trading partners. In the case of Thailand, the baht is determined on the basis of an undisclosed, weighted basket of currencies of Thailand's major trading partners.

In a practical setting, the important question would have been the selection of monetary targets given the country's economic environment. During the 1980s, the general relaxation of capital controls and the shift from the fixed regime to the flexible exchange rate approach coupled with the financial reforms (most notably the liberalization of interest rates) by these countries have inevitably affected the choice of monetary targets. In particular, Indonesia adopted an interest rate targeting stance after the early 1980s reforms but reverted back to having more flexible rates when the Rupiah was under speculative pressures in 1987. Malaysia and Thailand on the other hand, monitored a number of monetary targets and economic variables.

With the liberalization of interest rates, Indonesia, Malaysia and Thailand all switched their attention to the indirect monetary policy instruments, namely open market operation. In this respect, the orientation towards the use of open market operations inevitably led to a reduction in the reliance on reserve requirements. During these periods, both Malaysia and Indonesia substantially lowered their reserve requirements to avoid the potential problem of disintermediation. In essence, the reduction in the use of reserve requirements were due to the concern that changes in them being too disruptive and that the high reserve requirements may adversely affect the development of the financial system.

In essence, the shift to indirect instruments is believed to have enhanced the effectiveness of monetary policy. In short, the financial liberalization and reforms has had its implications on the transmission mechanism and the operating procedures of monetary policy. This has led to the interest rates playing a more influential role in the allocation of finance and credit while the abolition of capital controls and the adoption of a flexible exchange rates regime has rendered the exchange rate as another transmission channel for monetary policy.

During the late 1980s and early 1990s, domestic financial liberalization coupled with the economic boom saw Malaysia, Thailand and Indonesia enjoying a boom in foreign capital inflows. Foreign capital was attracted to Thailand with its high interest rates and relatively low risk because of the US dollar-pegged currency. However, when the baht was floated in 1997, massive amount of these capital flows began to leave the country and the result was the Asian currency crisis, which inevitably spread to its neighbours, including both Malaysia and Indonesia.

Evidently, economic policies like monetary policy is still being viewed in the light of the traumatic Asian currency crisis that griped the region during the period of 1997-1998. Of course monetary issues are synonymous with the financial crisis as the source of the crisis was pretty much rooted in the area of financial liberalisation. However, the problem was a rather complicated phenomenon and shouldn't be linked just to the argument of excessive laxist fiscal and monetary policy by those respective countries. In any event, excessive foreign borrowing coupled with moral hazard (which was encouraged by implicit government loan guarantees) played a major role in the crisis. Admittedly, the countries which were involved allowed the exchange rate to appreciate when faced with a positive current account but attempted to maintain a pegged rate in times of a deteriorating external balance. As a result, the currencies were over-valued and hence vulnerable to speculative attacks. In this respect, while the fixed exchange regime was not much of the problem *per se*, they were adopted without full commitment while the potential threat was largely ignored. With the currency crisis, there appears to be an urgent need for a clearer definition of the global financial system architecture in the future.

Prior to the crisis, although there was diversity in the living standards and the level of development between Malaysia, Indonesia and Thailand, these countries still share a number of common features, such as prudent macroeconomic management, high savings rate, high investment rates and sustained rapid growth. Malaysia and Thailand have a higher per capita income level than Indonesia, largely with the help of significant capital inflows over the years, which have propelled their remarkable growth rate over the last 2 decades. However, the onslaught of the currency crisis in 1997 had greatly affected these countries, with the latter worst affected. The crisis that erupted in Asia's financial markets that year has had dramatic effects on these countries; firstly it has led to a serious recession in these so-called "tiger economies", with later saw a critical fall in the standards of living, coupled with rising unemployment and eventually culminated in social dislocation and unrest in some of them.

3.4 Economic Analysis during the Crisis

Malaysia suffered from the combined impact of a steep depreciation of the Malaysian Ringgit against the US dollar, significant increases in the short-term domestic interest rates and finally alarming tumble in the stock market. In this context, the situation became critical as this was exacerbated by the substantial exposure of the banking system to the property sector and the stock market. Similarly for both Indonesia and Thailand, their currencies depreciated precipitously. However, although the inflationary consequence of the depreciation of its currency was reasonably well contained in Thailand, the same cannot be said about Indonesia. Meanwhile, the growth rate plummeted in both countries with their external current accounts undergoing deep and abrupt swings. In fact, in several respects, the outturns from the crisis were worse than expected in the sense that there were sharp revisions to projections for growth and exchange rate leading to several significant changes in their program targets.

As far as the crisis was concerned, Malaysia proceeded with their own policies, preferring not to engage in the "rescue package" presented by the IMF while the other two countries, Indonesia and Thailand reluctantly took up the offer and subsequently, the region saw two rather diverse prescriptions undertaken to counter the deep recession brought about by the crisis. In retrospective, although the region has since then managed to see out the impact of the crisis, it still remain difficult to conclusively pinpoint the exact remedies that contributed to the improvement, be it the Malaysian's capital controls led regime or the IMF's band of recovery dosage prescriptions. However, one thing is certain, is that in times of economic turbulence and recession, the approach to demand management is of utmost crucial and evidently, during the crisis, monetary policies played a pivotal role in steering the economies of those affected back to the right direction and restore the much needed stability.

Monetary policy in the Asian crisis programs (which included Thailand and Indonesia) faced a difficult and delicate task of attempting to balance two crucial areas. Firstly there is a desire to avoid a depreciation-inflation spiral (if the authorities attempt to deal with the alarming deprecations in the exchange rate – they faced a potential inflation backlash) while there were also concerns that an overly tight monetary policy may lead to further depressing the market economies. Although the IMF-supported programs in Thailand and Indonesia attempted to deal with such concerns, it was carried out amid an environment where there were high debt-equity ratios in the corporate sectors as well as systemic and structural problems which rendered the financial sector even more vulnerable to the increases in the interest rates. In the midst of these, there were also the prevalence of unhedged foreign currency liabilities of these countries' financial and corporate sectors which meant that any further exchange rate depreciation would have a substantial effect on the real economy. In the process, many have voiced out their opinion that the crisis programs appeared to be too tough in its calling for higher interest rates, the tightening of government budget positions and also the closing down of a number of financial institutions. However, according to the IMF these programs were not just a set of austerity measures but rather a set of forceful, far-reaching structural reforms designed to strengthen financial systems, increase transparency, open markets and ultimately restoring the market confidence.

Meanwhile, unlike its neighbours, Malaysia embarked on their own demand management policies, which included the use of capital controls (to stem the large outflow of capital) and the pegging of the Ringgit Malaysia to the USD (at 3.80 to USD1) instead of seeking the help of the IMF.

3.4.1 Interest Rate Management

With financial liberalization, which was a prevalent monetary development during the 1980s, one important aspect that came with it was the liberalization of the interest rates. Excessive controls and regulations were deemed counterproductive to the efficiency of resource allocation while in the longer run these may even hindered growth. Hence, liberalization was inevitable and so this led to a key reform area, which was the liberalization of the interest rates. In fact, the liberalization of the interest rates was a prominent feature of financial liberalization in most Asian countries. Indonesia fully deregulated its interest rates in the early part of the 1980s while Malaysia began liberalizing it in the late 1970s. Thailand's liberalization was on a more gradual scale beginning in 1980 and then, the process intensified towards the later part of the decade.

In recent years, the emphasis has been on managing the interest rate as its principal monetary instrument rather than the previous practice of monitoring the intermediate targets like the monetary base. For example, in Malaysia, the emphasis of monetary policy shifted during the 1980s from M1 to M2 and then M3. Later policies have since focused more on short-term interest rates. Similarly, the Bank of Thailand has also shifted its policy emphasis from M2 towards commercial bank credit and domestic interest rates. The situation is also rather similar in Indonesia's case, which also saw them giving an increased weight to interest rates.

Although interest rate liberalization should, in theory give rise to a greater resource allocation, such a move may come with certain implications. In the case of a scenario whereby there is a deregulated environment with imperfect and oligopolistic financial markets, real interest rates can sometimes rise to very high levels thus hindering economic growth, a phenomena in countries like Argentina, Chile and Uruguay back in the 1980s. However, although Malaysia and Thailand both registered high real interest rates during the 1980s, only Indonesia was faced with an unusually high rates – its real interest rate peaked nearly 20% in 1986.

3.4.2 Money Supply Management

There is no doubt about the importance of money in an economy, since the quantity of money and credit affects the level of output of goods and services and their prices. Like normal goods and services, there is a demand for it and also a supply of it. In this respect, the demand and supply of it will determine its price, which in this case denoted by the interest rates. While the demand for money basically comes from the private sector, the amount which the private sector wishes to hold at a particular moment of time may not correspond to the amount that is being supplied to the economy. If the demand does not equal to the supply at any moment, the adjustments on the interest rates will ensure that the equality be maintained. In essence, in any country, the central bank through its influence on the quantity of money, the price of money (interest rates) and credit allocations can influence the economy in its pursuit of more desirable objectives such as price stability and a high level of employment/output. Overall, it is the responsibility of the central bank to strive for monetary stability thus it is entrusted to regulate the amount of money in circulation and of credit supplied to the economy.

However, the rapid economic expansion beginning in the late 1980s onwards into the 1990s in the ASEAN regime had contributed to the increased in money supply. This to a certain extent was also due to continuous capital inflows, although a large portion of those funds was mainly short-termist in nature.

There has been rapid expansion in monetary policy in the 90s as echoed by the rapid growth of monetary aggregates. In the case of M1, between the period of 1990 – 1996, Indonesia had an annual growth rate of about 15.2%, Malaysia 13.7% while Thailand registered an 11.7% figure. Such loose monetary policy was inevitably accompanied by certain implications. A comparison of the real growth rates to monetary growth rates showed the extent of the policy looseness. In Malaysia, Indonesia and Thailand, the average annual growth rate in both M1 and M2 has been more than twice the growth in the real GDP. In this respect, when monetary growth is faster than the real GDP growth, the obvious result is inflation. In essence, the adoption of such rapid money growth policy is partially due to the countries' attempts at keeping interest rates artificially low **(Obiyathulla I. B., Malaysian Journal of Economic Studies, 1997)**.

However, the increased in the money supply in these countries, to a certain extent, was the product of the high amount of capital inflows which began when these economies started to experience rapid economic expansion in the late 1980s following a stagnating reccessionary period in the mid-1980s. The openness of these economies coupled with the low international rates inevitably led to such phenomena. Besides the rapid expansion of various monetary aggregates, these developments also in some way affected the demand for money. Consequently, these developments had complicated the affairs of monetary management. However, during the currency crisis, both Indonesia and Thailand were recipients of the IMF assistance and their policy programs involve the task of monetary base targeting. Basically, liquidity management is crucial to ensure that excessive volatility in the interest rates and liquidity were avoided. In this respect, this also led to the use of more innovative monetary instruments, for instance Indonesia introduced the "Rupiah Intervention" in its bid to counter the volatility of interest rates.

3.4.3 Exchange Rate Regime

Exchange rate "policies" and "management" are differentiated in the way that the management is the technique to which a policy is enforced. In practice, the exchange rate management can range from a single currency peg to a market-determined float. Before the currency crisis, the exchange rate of the East Asian economies had been characterised as a quasi-US Dollar peg **[Ito, Ogawa and Sasaki (1998), Edwards (1999)]**, in which the currencies had been tied to the US Dollar **[Frankel and Wei (1994), Kwan (1995), Gan (2000a)]**. Both Malaysia and Thailand have used a currency composite peg in their objective to set their exchange rates on a month-to-month and day-to-day basis against the U.S. dollar. Although the "soft dollar zone" formed by these countries are undisputed by now, but questions still persists regarding how rigid was the dollar peg and to what degree was the currencies overvalued prior to the crisis. However, there were still questions pertaining the desirability of such pegging policy in the following area:-

- The standard of the peg – pegging to a single currency or a basket of currencies
- The weighting scheme in the case of basket pegging – i.e. which currencies used.

In any event, such pegging can be regarded as a policy of using the exchange rate as a "nominal anchor approach". Basically, this approach means that the exchange rate is used as a nominal anchor for a country, one, which restrains the government from practising inflationary policies. In this respect, pegging the exchange rate can import stability while avoiding a home made inflation.

Although the East Asian quasi-Dollar peg is much less transparent than the traditional fixed exchange rate regime in the sense that there was no publicly announced central parity and the band around it, it has, in fact been managed with some degree of flexibility. In this respect, its record as a nominal anchor for domestic prices has been impressive. The fiscal position of this ASEAN countries (namely Malaysia, Thailand and Indonesia) from 1990 – 1996 were with the view that the quasi-Dollar peg regime imposed certain fiscal discipline on the governments. However, although the quasi-peg system has provided some form of restraint on the fiscal positions of these 3 countries, it was not able to restrain the strong private sector spending. Inevitably, this led to large current account deficits in these countries. In this respect, since the late 1980s, the surge of capital inflows into these countries has been crucial in relieving the balance-of-payment constraint imposed by the quasi-fixed peg. For instance, in Malaysia, the network private capital flows reached a peak of 23% of GDP in 1993 while Thailand registered a 12.3% of GDP in terms of the private capital inflows for 2 consecutive years in 1990 to 1991 **(Monetary Authority of Singapore, December 2000).**

Despite the efforts of the central banks to exercise greater control over the domestic money supply, broad monetary aggregate and the banking system credit continued to expand in these countries. This indicates that, in economies with an open capital account, the fixed exchange rate system has been unsuccessful in its role in restraining the monetary expansion and domestic spending. In fact, some experts have argued that the fixed exchange rate system have resulted in the domestic money supply and interest rates of economies with liberalised capital account moving in a pro-cyclical manner. According to **Hausmann *et al* (1999)**, to the extent that the monetary authorities are unable to sterilise the monetary effects of the foreign exchange intervention adequately, money supply and interest rate will tend to exhibit pro-cyclical movement, thereby serving to amplify the magnitude of the business cycle fluctuations.

In any case, it is widely agreed that the role of exports had been significant in propelling the success of the East Asian economies. As such, the movement of one country's exchange rate against another can and may exert significant effect on the exports. Such feature is likely to be of importance in the case of Southeast countries like Malaysia and Thailand whose earnings are largely export-dependent. Hence the exchange rate management has at times, proved to be a major instrument in these countries' macroeconomic policy. For example, Indonesia depreciated its currency in 1983 and in the following year, exports grew by 11%.

Prior to the 1997 currency crisis, the rapid liberalisation of the capital controls complemented by the gradual increment in the shift towards a more market-determined exchange rates in these countries were successful and entailed no signs of sharp exchange rate adjustments or large shift in capital flows. In any case, the currency management in these three countries were sufficiently flexible in their pegs thus they did not register any potential problems as the exchange rate appeared stable.

3.5 Monetary Policy in the Aftermath of the Currency Crisis

Admittedly, the currency crisis has forced these countries to learn new lessons and acquire new perspectives in order to more effectively address their own weaknesses while looking into the uncertainties surrounding the inadequacies in the global financial "architecture" and the allocation of the world resources and capital flows. Hence, the solution may be a new "architecture" to help sort the need for free-flowing private capital while also addressing the unpredictable risk that accompanies such capital mobility.

However, more still needs to be done, as monetary policy in the future will operate in a much more complex world. Financial markets will continue to grow in sophistication, as technological advancement will designate more rapid movements in cross-border capital movements. For financial markets to work efficiently, it requires more reliable information so as to reduce the potential implications of moral hazard and adverse selection. Monetary policy will have to operate within a framework of consistent macroeconomic policies while being supported by strong economic institutions. With the threat of the so-called contagion effects seen during the crisis, there appears to be a need to promote a closer dialogue and co-operation within ASEAN countries and perhaps also the need to evaluate the strengths and weaknesses of the existing arrangements in exchange rate regimes and international finance, particularly in the operations of the growing hedge funds and their impact on the efficacy of monetary policy.

As economies like Indonesia and Thailand began to recover from the crisis and stability is restored in the financial market, these countries have since transited to a more flexible post-crisis exchange rate regime. The authorities there have, as such redesigned the monetary policy framework to one of inflation targeting in order to provide a new anchor under such regime. In this context, both Thailand and Indonesia adopted the interest rates as the key-operating instrument. New measures were undertaken to enhance the "instrument independence" of this new framework. Open market operations and the reverse repo facilities were improved to ensure better management of the supply of reserves thus enabling the central banks to better influence more closely, the short-term interest rates.

By the beginning of 1999, two different monetary policy frameworks had evolved, with both targeting to secure more discretion in their conduct of monetary policy without being encumbered by the commitment to the exchange rate peg. Thailand and Indonesia secured their monetary independence through the adoption of a more flexible exchange rate regime while Malaysia resolved the conflict between the maintenance of a fixed exchange rate system and monetary autonomy using a system of tight exchange controls **(Monetary Authority of Singapore, 2000).**

3.6 Conclusion

Over the last two decades, financial developments in Malaysia, Indonesia and Thailand have seen some rather similar developments. For starters, financial liberalization was a significant aspect in the monetary developments of these countries. In addition, the recessionary conditions during the early and mid 1980s also saw these countries adhering to various structural adjustments. Unsurprisingly, these developments eventually led to some changes in the instruments of monetary policy, with the direct monetary controls being phased out by indirect ones in the quest for greater efficiency. On the international front, these countries were previously advocating a pegged exchange rate (or managed float) but eventually also succumbed to pressures to let the exchange rates be determined by market forces (although with the exception of Malaysia, which pegged its currency to the US dollar during the currency crisis).