Chapter 7

Conclusion

In conclusion, monetary policy for countries like Malaysia, Indonesia and Thailand in the last two decades have seen major changes and substantial evolvement in terms of policy target, implementation and ultimately the direction as well. However, given the unpredictable and volatile nature of the global economy, such developments in monetary economics are not surprising. In the meantime, these developing economies will continue to adapt and to evolve to an ever changing and dynamic atmosphere, as they have in the wake of globalization in the 1990s and also through the various stages of trade and financial liberalization during the late 1970s and throughout the 1980s.

The trend towards a greater exchange rate flexibility has been associated with more open, outward-looking policies on trade and investment generally and increased emphasis on market determined exchange and interest rates. Given the impact of the recent currency crisis, both Indonesia and Thailand have since then, subscribed to more flexible exchange rates in their monetary policies although Malaysia is still enforcing the Ringgit-Dollar peg. In this respect, the adverse economic developments in the form of the East Asian currency crisis have shown just how vulnerable these economies were and how the move towards a more open economy had in fact, contributed to these countries' own shortcomings/constraints as far as monetary management is concerned.

However, the importance of monetary policy in influencing and steering the economy has and is still undeniably significant to these developing economies. Over the last two decades, monetary policies in Malaysia, Indonesia and Thailand appear to share certain similarities (i.e nominal exchange rate "anchor", monetary base targeting etc...) largely because these countries shared certain similarities as far as the level of economic development, geographical location and to a certain extent, culturally. These economies has certainly came a long way since the demise of the Bretton Woods system and has also endured the turbulence years of the oil shock era and global slowdown of the late 1970s. In spite of these developments, all three countries had experience rapid economic growth, especially in the late 1980s and early 1990s. These periods also witnessed the intense development of the financial system in these countries, which were mainly skewed towards the deregulation and liberalization of the financial sector.

Basically, prior to the currency crisis of 1997, all three countries at one time or another had monetary policy involving the interest rate and money supply targeting. In addition to this spectrum of monetary policy, the exchange rate had also acted as a "nominal anchor" in the country's monetary management. In this respect, prior to the crisis, all three countries had opted for an exchange rate, which was either pegged to a single currency, a basket of currencies or a managed float regime. In essence, by opting for these regimes, the countries were in fact, to a certain extent, constrained by the exchange rate "anchor" as far as monetary autonomy was concerned, as the exchange regime appeared rather "fixed" (although to a lesser degree than the "fixed" exchange rate. This was further complicated with the deregulation, which saw the capital, and exchange controls being gradually relaxed. However, as these countries

were heavily depended on exports, the move for a more "fixed" exchange rate was considered a wiser choice. This was evident in the case of Indonesia, which devalued its own currencies several times to enhance its own export competitiveness. Hence, the depreciation served as a tool to prevent the loss of competitiveness, in example due to the different level of inflation rates between the local country and its trading partners. In this respect, Indonesia was on a crawling peg, offsetting the inflation gap between home and abroad by sliding its currency by a predictable few to several percent per year. In addition, as some of these countries were facing very high inflation, the move towards a pegged regime was seen as a move to arrest the inflationary pressures by eliminating the uncertainties hence reducing the "expected inflation" element.

In theory, monetary policy is powerless in a fixed exchange regime assuming perfect capital mobility, as the capital flows will upset the fixed rate. However as capital controls had been a feature in Thailand's economy throughout the 1980s there appeared less constraint in Thailand's case. In fact, even Malaysia had resorted to it in 1994. In any event, the trend towards more open, outward-looking policies on trade and investment and ultimately more market-determined exchange rates and interest rates were crucial since these countries had experienced a number of external shocks. For instance, the early 1980s had seen shocks like the industrial world slowdown and the rise in international rates, which led to currency depreciations while the more recent capital inflows and outflows in the 1990s had suggested the need for more flexible rates. Since the 1997 currency crisis, the need to maintain a fixed but adjustable exchange rate raises much uncertainty and question. For one, if the de-facto dollar pegging was much blamed for the ill-fated crisis, then how and what should the

new regime focus on? In this case, with the creation of the Euro currency and the importance of the Yen to the Asian region, it has been suggested by some that a collective pegging which include a target basket consisting of a trio of currencies – dollar, Euro and Yen be adopted. In any event, both Thailand and Indonesia are now adopting a floating (flexible) exchange rate although Malaysia is still practicing the US dollar peg system. Generally, the move towards a flexible exchange rate does serves its purpose. For example, in "fixed" regimes, monetary policy is subordinated to the requirements to maintain the peg. In this respect, the fiscal policy must be kept consistent with the peg, hence constraining the avenues of the authorities, a situation Thailand found themselves in during the early 1980s when they were still using the US dollar peg system. In any event, a flexible exchange rate provides more avenues for maneuvering for the authorities. Besides monetary autonomy, the authorities are also free to allow the inflation to rise – a move which indirectly increases the tax revenue. In the case of both Thailand and Indonesia, the move towards a flexible regime after the currency crisis was mooted on the authorities' move to maintain the high interest rates to reverse the depreciations in their currencies. However, the choice of regimes can be attributed to many factors, i.e. the nature and source of the shocks to the economy, policymakers' preferences and also even the structural dimensions of the economy. One should view the policymaker's decisions not simply as an extreme choice between fully flexible or fully fixed but rather a range of choices with different degrees of flexibility. Ultimately, the best regime would have been the one which minimizes the fluctuations in crucial macroeconomic variables like the output and the domestic price level.

Overall, in the last two decades, the dynamic monetary environment have also seen these countries changing their policy direction to better accommodate these developments in order to effectively conduct their monetary management in their ultimate aim of economic growth and price stability. During this time, these countries had shifted in their policy targets, from a money supply/base targeting to an interest rate targeting and perhaps more recently, the move towards an inflation-targeting framework. In addition, exchange rate targeting was also partially a feature when the rate was devalued to increase exports. Even in the case of money supply targeting, there was also the dilemma of which of the monetary aggregates to target. Malaysia had used M1 as the intermediate target prior to 1984 but later used M3 while Thailand tracked the growth of M1 and M2 and domestic credits as intermediate targets. In the case of Indonesia, since 1983, reserve money has been an intermediate target. However, the growing sophistication of monetary aggregates over the years coupled with the unpredictability of money demand further fuel problems as far as the delicate task of monetary management was concerned. Global financial innovations and liberalization have tempered with the stability of money demand in addition to complicating the relationship between income and money. Besides, the difficulty in controlling the monetary targets had convinced countries to shift from quantity targets to price (interest rates) targets. For instance, Malaysia's monetary policy in the 1980s was geared towards money supply targeting but the continuous development in the financial sector gradually undermines the effectiveness of such a regime thus the country switched to an interest rate targeting framework in the 1990s. Deregulation in interest rates also saw Thailand's monetary policies framework to change. During the 1980s, interest rates ceilings were a prominent feature of Thailand's monetary policy

but the continuous financial liberalizations led to the end of such ceilings by the early 1990s.

Ultimately, monetary policy will still continue to play a crucial role in the economies of these countries. In this respect, the real importance lies in the issue of where and when to make policy adjustments including the use of official intervention to avoid or ease any substantial volatility or serious misalignments. In the very long run, co-operation among these countries in the area of monetary developments should also play a greater part in the region especially given the stark implications of globalization. Regrettably, it was in fact the openness of these economies, which culminated in a catastrophic economic crisis, known as the currency crisis beginning July 1997. Ironically, the problem actually originated from this region (Thailand to be specific) and gradually muscled its way to other parts of Asia. Although the other parts of the world were somewhat spared, the global effect of the crisis were inevitable. In short, such macroeconomic crisis has underlined the implications of the negative spillover effects that tend to affect the entire region given the openess of today's economies. Thus the 1997 currency crisis, although has been nothing short of an economic catastrophe for these countries, has however, highlighted to them two major opportunities to enhance their social and economic development. Firstly, there is a need to improve the financial and the banking systems and second, to work towards more integration as far as economic development is concerned. In the latter, the use of a regional currency regime may hold a lot more significance as far as economic co-operation and regional stability than the previously advocated de-facto dollar peg. In this respect, with regards to the financial crisis, not only for these three countries but generally Southeast Asia or even East Asia itself, may find that it is in

their best interest to strengthen their currency and financial co-operation to avoid another crisis while fostering a stable economic development. Undeniably, globalization has reached a stage whereby economies are so integrated that it is very difficult to insulate one economy from the problems of another. Hence, such co-operation and integration point to the rationale of introducing a common currency in Southeast Asia, or even Asia itself. There are many benefits for such a move. Firstly, there will be increased economic integration thus leading to higher levels of investment and trade. In addition, the lower transaction costs as a result of eliminating the many different exchange rates will increased the efficiency of trade. In the long run, a common currency may be the best thing in light of the inevitable levels of trade liberalization that accompanies globalization. The common currency move will ensure that the region would be well stacked of foreign reserves to handle and deter any speculative attacks. So unless a new regime (i.e. single currency) is to be erected from this crisis, there will always be the risk that of another crisis, perhaps albeit a much more critical one, that may follow suit in the years to come.

Meanwhile, in the case of capital account convertibility, although the crisis had undermine the significance of capital flow flexibility, there is no doubt that in today's world of globalized trade and financial activities, flexible capital account convertibility is still very in the picture. Undeniably the need to have some sort of flexibility in capital account convertibility is crucial even if it meant exposing a country's vulnerability to the potential of irrational herd-like behaviour of the capital flows pattern. However, we have indeed witness countries which have derived much success with capital controls, notably in the case of China, or perhaps even Malaysia, which have successfully use capital controls to manage their capital flows during the

turbulent currency crisis years. In addition, with close co-operation and exchange of information among countries (in this case, Southeast Asia), this can foster better co-ordination of monetary policies and work towards more co-ordinated "inflation targeting". In this respect, both Indonesia and Thailand had already led the way by announcing the move towards an "inflation-targeting" regime.

Finally, it is undeniable that the recent events have proved that badly managed banks and the open capital markets is a dangerous mix. Thus, in the light of the currency crisis and the hazards of a globalization, there is a dire need to strengthen banks' risk-management practices and the supervisor's oversight and regulation pertaining to those practices. In addition, there is also the need of insulating supervisory authorities from political influence. Such matters are especially crucial to be dealt with, especially since the move towards "inflation-targeting". In any event, the dangers of foreign funds in threatening the stability of domestic financial systems has since created an argument for limiting or taxing bank borrowing abroad as a measure against banking system instability. In fact, this may extend to all business entities as Chile has done so successfully with their capital controls, which places tax on short-term foreign borrowing. Thus, the developing countries (like those in ASEAN), until they graduate into mature markets, should practice cautious steps in the direction of capital account liberalization, and these measures should not extend to the removal of taxes on capital inflows.