CHAPTER 1   INTRODUCTION

Money supply growth in Malaysia recorded significant increases over the past decade. All three monetary aggregates (M1, M2 and M3) including reserve money accelerated rapidly especially since early 1990s (Appendix I.1). During the period from 1987-1997, that is the period between the two recessions in Malaysian history, the country had achieved high economic growth with relatively low inflation. The development in the relatively low price increases over the past decade with concomitant rapid increase in money supply questions the effect of money on inflation in Malaysia.

The theory on money and the rich literature on the role of money in economic activity have in a great way influenced the nature and implementation of monetary policy which conduct has been entrusted with central banks or monetary authorities. However, over the past two decades or so, globalization and financial liberalization has changed the nature of the conduct of monetary policy as countries began to implement financial reforms to move towards market-based economy and away from regulated market system. Financial liberalization and innovations have also changed the landscape of financial systems and operations.

The purpose of this study is to highlight the effects of financial liberalization on monetary operations of several central banks, as the waves of financial reforms had changed the types of monetary instruments and targets as well as the mechanism of monetary transmission. This posed as major challenge to the formulation and implementation of monetary policy. Because, although it is widely recognized that

financial liberalization may contribute to the improvement of financial efficiency by promoting competition, financial liberalization can itself lead to a reduction in the overall effectiveness of monetary policy by way of the increase instability in the demand for money and the changes in the nature of monetary transmission mechanism. Not only is this the case, there is also the possibility of a threat to the health of the financial system which could be triggered off by the deterioration of the financial institutions' position in the face of intensified competition and increased uncertainty.

Most industrialized countries have embarked on measures to liberalize their financial systems in some manner in the last two decades, and a growing number of developing countries are moving along the same course. This indicated that 'market-oriented' financial systems can exert a positive influence on the economy, albeit with significant differences as to proper or optimal role for market forces. Based on the experience of countries that pioneered financial liberalization, financial liberalization and the technologically driven process of financial innovation have significantly changed the basic framework within which monetary policy operates. For instance, monetary targets seemed to have operational significance for monetary policy in the 1970s and 1980s, but in the present day little significance remained. It was discovered that in the light of financial liberalization, the relationship between nominal income and money has become increasingly unstable. In many countries, the perception of unstable velocity was the most important single factor leading central banks to abandon monetary targeting.

The central objective of this study is to evaluate the effectiveness of monetary policy in the light of financial liberalization with special focus on Malaysia. The methodological approach employed by this study is a mixture of reviewing the experience of developed countries as well as Malaysia, and undertaking an empirical analysis. Although numerous studies have been done on the instability of money demand functions in Malaysia and on the effect of financial liberalization on the monetary transmission mechanism, studies on the effect of financial liberalization on the monetary framework and also on the relationships between money and interest rates on income or prices in Malaysia were rather limited. It is for this interest that this study is undertaken. For the purpose of this study, the sample period of assessment is from the fourth quarter of 1973 to the second quarter of 1999. Data on Malaysia were obtained from Bank Negara Malaysia's Monthly Statistical Bulletin while data of foreign countries were obtained from the International Financial Statistics of the International Monetary Fund as well as from the Datastream.

This study is organized as follows. The following chapter, Chapter II, presents the Malaysian experience on monetary policy and financial liberalization. The chapter highlights the evolution of monetary framework in Malaysia as the technique of monetary control had changed due to financial liberalization. The literature review is covered in Chapter III, which dwells on the experience of four major industrial countries and two ASEAN countries on how financial liberalization had changed the nature of their conduct of monetary policy. The central purpose of the chapter is to provide a comparison of the experience of the developed countries to the experience of Malaysia. The previous two chapters then provide the basis for the empirical methodology, which is presented in the subsequent chapter, Chapter IV. This chapter

will seek to quantitatively investigate the relationships among major economic variables, i.e. income, prices, money and interest rates in Malaysia. As explained in detail, the aim of the empirical analysis is to investigate how the relationship between the variables indicated had changed over time and to assess the significance and stability of the relationships. It is to be noted in advance that the empirical study does not seek an all-round satisfactory empirical estimate. The aim of the findings is to enable to draw a general conclusion from a series of estimates on the effectiveness of monetary policy. The method of estimation employs the econometric technique, whereby the stationarity of variables were first verified. The econometric work uses the least squares method for autoregression tests and the Engel-Granger method to test for cointegration. Finally, from the work undertaken in the previous three chapters, an overall conclusion is made in Chapter V. This last chapter also puts forward some policy suggestions with regards to the use of monetary variables in policy making.