CHAPTER 5 CONCLUSION AND POLICY IMPLICATIONS

Monetary policy has come to be regarded as the dominant element of macroeconomic policy with the explicit mandate to ensure price stability. At the same time they continue to be called upon to assume responsibilities in securing the integrity of the financial and payments system. However, the economic literature contains prescriptions for the use of monetary aggregates in macroeconomic policy that range from exclusive focus on the aggregates to their almost complete disregards. For instance, the aggregates may be used as information variables to provide a guide for the conduct of monetary policy. Such an informal role places only minimal demands on the aggregates, concerning mainly their informational content. More ambitious uses of the aggregates are also possible. For example, they could be used to signal the intentions of the central bank so as to make it accountable for carrying out policies that are consistent with its basic mandates and to enhance its credibility and the public's expectations of the attainment of its goal.

Both theoretical considerations and empirical experience suggest that the stability of non-banks' demand for money, i.e. the principles in accordance with which they make their portfolio decisions, are of crucial importance. Financial liberalization and innovations that change non-banks' portfolio decisions have invariably turned out to be a major, if not the most important, cause of the instabilities of the relationship between monetary developments and GNP. Steadier demand behavior, which makes forecasting easier in turn facilitates the determination of an appropriate money supply policy by the central bank. In this respect, the German central bank has been in a much more fortunate position over the past twenty years than many other countries.

The effects of financial liberalization on the financial system and the economy as a whole have many facets. It is clear that financial liberalization has spurred the pace of financial deepening and broadening and helped create a wider range of financial assets in portfolios of households and corporate sectors. In addition, it also brought about a closer linkage between domestic and foreign markets. However, the task of monetary management has become more complex with less degree of autonomy. While maximizing the benefits accruing from liberalization, consideration must be given to minimizing its adverse effects so as to retain stability in financial markets and ensure the effectiveness of monetary policy. This constitutes the policy task of supreme importance in the ongoing course of financial liberalization.

As countries liberalized their financial system and move towards a more market-based oriented system of monetary control and away from regulated system, the technique of monetary control must also be changed to a more market-oriented approach of monetary control. That is, monetary targeting is appropriate under a monetary framework whereby the financial system is largely regulated. But as developing countries gradually implement financial reforms, the monetary targeting framework with monetary programs is no longer suitable. Greater reliance on short-term interest rates is necessary for the transmission to the rest of the economy to take effect. At the same time, institutional and operational arrangements must also be consistent with the move towards market-based approach of monetary control. Furthermore, countries that implement financial reforms related to the monetary arena in a gradual approach and can gradually adjust their technique of monetary control has better chance of success (or that their monetary policy are more effective) than countries that do a big bang approach in financial reforms. Countries which technique of monetary control still rely on quantitative variables as operating instruments would possibly see their conduct of monetary policy less effective. In other words, reorienting monetary control to rely increasingly on market-based instruments is not only desirable but also inevitable when countries begin to reform their financial system.

Nevertheless, money remains important in that aggregate money determines the aggregate price level over the medium term. That money is still an essential element of policy strategy cannot be disputed. At the home front, based on the empirical analysis, there seems to be a concern over broad money M3 as there appeared to be inconsistent results in the autoregression and the cointegration tests. In the former, M3 is statistically insignificant in its ability to explain movements in income, while the cointegration test revealed that there exists long run relationship between M3 and real income. However, with respect to the money-price relationship, although the cointegration tests revealed that both M1 and M3 has long run relationship with prices at the 5% level, the predictive power of the money variable on price is rather poor throughout the sample period. Furthermore, the correlation statistics showed a negative correlation between M1 and M3 with price especially in the second sub-period. Hence, on statistical ground, it can be concluded that inflation is not a monetary phenomenon in the country. On the other hand, the use of interest rates as policy variable is supported empirically by the autoregression and cointegration tests. In addition, the correlation of 3-month inter-bank rate with prices showed a high correlation coefficient in the second sub-period. This reflects the increase effectiveness of interest rate as a monetary policy variable. However, further work may be required to ascertain its significance especially its impact on the economy in terms of speed and magnitude.