CHAPTER V

SUMMARY AND CONCLUSIONS

5.1 Conclusions

An empirical analysis of the monetary approach to the balance of payments and exchange rates was undertaken in this dissertation. Malaysia was chosen as the country to be studied. The time period of the study was from 1986 to 1997 and in all cases the annually data was used.

The central proposition of the monetary approach is that both the balance of payments and the exchange rate are essentially monetary phenomena and thus the analysis should be centered around the money supply process and the demand for money. Since the study is dealing with the money supply and money demand, the concern will be with stock and not flow concepts. Thus equilibrium conditions and disequilibrium situations require analysis of stock equilibrium conditions and stock adjustment processes. Therefore, according to the monetary approach, if there is an excess demand for money in the economy then either the balance of payments will go into surplus or the exchange rate will appreciate or the domestic component of the monetary base will increase or some combination of the three to return the money market back to equilibrium.

Based on the above discussion of the monetary approach thus indicated the manner in which the empirical analysis should be conducted. The importance of money in this approach suggested that the discussion should begin with the money supply process and demand for money in Malaysia. The supply of money is under the "control" of the Bank Negara that acted on behalf of the Malaysian government. The Bank Negara is responsible for formulating the monetary policy as well as issuing all the government securities.

The analysis firstly started with testing the monetary approach to the balance of payment. The monetary model had the form:

$$\left[\frac{R}{H}\right] gR = \eta_0 gP + \eta_1 gy - \eta_2 gi - ga - \left[\frac{D}{H}\right] gD$$

From performing the empirical analysis for the period 1986 to 1997, the results found to be consistent with the predictions of the monetary model. The R^2 indicated that about 94 percent of the variance in the international reserves variable was explained by the regression whereas the F-statistic further proven the significant at the 0.001 level of significance.

The next empirical analysis was conducted for the monetary approach to the exchange rate using the model

$$e = \beta_1 \left[\frac{m_t}{m^*_t}\right] + \beta_2 y_t + \beta_3 y_t^* + \beta_4 \; m_t + \beta_5 \; m_t^*$$

The results obtained did not lend support to the monetary approach because the exchange rate model was derived under the assumption of a perfectly flexible exchange rate regime. Another reason could be the 12 yearly data considered may not be sufficient enough to measure for the long run equilibrium model as the adjustment process may have not been fully worked out. Taking into account the above first reason as well as including the reaction functions of the monetary authorities and the asset holders, assume that asset holders expect money supply to decrease next period and their expectations are accurate. Substitute into the model

$$m_t = \; m_{t+1} \text{ and } \; m_t^* = \; m^*_{t+1}$$

The results from the equation provided at least a modest empirical support for the monetary approach model predictions. However using the same equation for a managed floating system is still not appropriate.

Based on the discussion in the literature review and in the last chapter, a more accurate version of model used is