MONETARY POLICY AND INFLATION IN MALAYSIA.

CHAPTER 1.

INTRODUCTION.

For a century or more it has been accepted that inappropriate decisions as to the price and availability of credit or as to the expansion of monetary aggregates, could have damaging effects on price and output stability in the economy as a whole. Just how such monetary policy actions have their effect and what is the best way to implement policy have, however, remained controversial.

Some basic relationships are fairly reliably established for many countries and can be taken as a basis for a more complete understanding of how monetary policy and inflation work in a market-oriented economy. For example, over a protracted period, rapid growth in the money supply will lead to sustained inflation; an increase in the cost of credit or a reduction in credit availability will dampen economy activity and will also tend to slow the underlying rate of inflation despite representing an additional cost to industry. On the other hand, there is not a clear one-to-one relationship between monetary growth and inflation in the short run. Domestic price can be sticky; exchange rates can overshoot their equilibrium levels following a disturbance and may even veer away from equilibrium for a while.

Accelerating inflation in many industrial countries in the 1960s and 1970s caused authorities to review their approach to monetary policy. It became widely believed that the common use of interest rates as an operating target for monetary policy had contributed to inflation[1]. They began to rely heavily on the quantity of money as an intermediate target and indicator of monetary conditions. It was felt that the money supply would prove to be a good leading indicator of inflationary conditions; keeping it under control would stabilise inflation.

1.1 SIGNIFICANCE OF THE STUDY.

The issue of how to measure inflation and, in particular, its underlying trends have attracted increasing attention in recent years. A major reason for this renewed interest is that a number of central banks have committed themselves to explicit quantitative inflation targets[2]. The assessment of deviation of current and expected inflation from the target requires taking volatile and temporary price influences into account. The issue of distinguishing transitory from persistent price movement is also relevant for countries, e.g. Malaysia, aiming for price stability in other monetary policy frameworks than inflation targeting. Alternative inflation indicators, especially those of underlying inflation, may cast light on the sustainability of a country's inflation performance.

1.2 THE OBJECTIVE OF THE STUDY.

The main objective of this paper is to study and analyse the role and efficacy of monetary policy in controlling inflation in Malaysia. In addition, specific objectives are:

(i) To establish the time lag, in particular impact lag, between the growth of monetary aggregates and the inflation rate,

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[1] Gerard Caprio, Jr. and Patrick Honeham: "The Use of Market Instrument for Monetary Policy", World Bank Symposium on Monetary Policy Instruments for Developing Countries, 1991.
[2] For a comprehensive survey see Luderman and Svensson (1995), and Haldare (1995), Debelle (1997) and Masson et.al. (1997).

(ii) To examine the impact of monetary growth on inflation in Malaysia, and

(iii) To analyse money demand in a regression framework. This will explain the behaviors of the demand for money in the inflation situation.

1.3 METHODOLOGY OF THE STUDY.

The study is based on secondary data on monetary aggregates, inflation rates, interest rates, and Real Gross Domestic Product (GDP). The Quarterly data were collected from Central Bank publications and books. The sample period selected for this study is from the first quarter 1993 to third quarter 1998.

All the variables were estimated in linear-form. A linear-form analysis was run using the SPSS package to produce money demand regression equation and the graph of the equations was plotted using the Microsoft Excel program to identify impact lag.

In the analysis, Consumer Price Index (CPI) was used as a proxy for the inflation rates and prices, 3-month fixed deposit rates of commercial banks was used as a proxy for interest rates, real GDP was used as a proxy for income while monetary aggregates (M1, M2 and M3) represented the proxy for money demand.

1.4 SCOPE OF THE STUDY.

The focus of the study is on Malaysia's experiences in handling and conducting as well as formulating monetary policy to maintain price stability from the first quarter of 1993 to the third of quarter 1998.

1.5 ORGANISATION OF THE STUDY.

The study will start off by providing a conceptual understanding of important concepts like inflation, monetary policy and will provide a brief overview of Keynesian and Monetarist theories behind the transmission impact of monetary policy on inflation, and targets and indicators. The study will also highlight problems in conducting monetary policy. Chapter 3 highlights the objectives of monetary policy. The discussion is focused on the single objective of monetary policy - price stability.

Chapter 4 discusses the targets and the choice of targets of monetary policy. In addition, it reviews some of the empirical studies on the relationship between targets and ultimate objectives, on the stability of the money demand functions and the effectiveness of monetary policy.

Chapter 5 discusses the Malaysian experience in sustaining inflation using monetary policy and the challenges faced by the monetary authorities during the period of 1959-98. This chapter is divided into five sub-chapters. Sub-chapter 1 explains monetary conduct during the period of 1959-80; sub-chapter 2 explains monetary conduct during the period of 1981-88. Sub-chapter 3 and 4 highlight the implementation of monetary policy during the 1989-94 and 1995-96 period respectively. Sub-chapter 5 discusses on the conducting monetary policy during the recent currency crisis.

Chapter 6 discusses the empirical findings on the impact lag; the impact of monetary growth on inflation and the money demand functions. Finally, chapter 7 presents the recommendation and conclusion of this study.