CHAPTER 2.
CONCEPTUAL UNDERSTANDING.

Understanding the concept of monetary policy and how it will affect inflation is important to measure macroeconomic performance of any one country. Generally, it is believed that an investor will rate the country poorly if it constantly has a high rate of inflation. Inflation will cause a rise in the prices level, increases the unemployment rate and lower the rate of economic growth rate and this will result in a declining standard of living. Inflation is unpopular because it is associated with other disturbances to the economy and frequently is a major political issue.

2.1 Inflation

Although the inflation concept is widely used in monetary policy analysis[3], views differ about its precise definition. Most papers refer to Eckstein's (1981) definition of underlying or core inflation as *the rate of price increase* that would occur along the economy's long-term growth path. Thus, inflation is a steady-state concept and equivalent to the trend increase of price of aggregate supply. Alternatively, Parking (1984) assumes that in long-run equilibrium, factor prices for labor and capital fully reflect inflationary expectations, thus inflation is identical to expected inflation. As there is no single concept of what is understood by core inflation, it is not surprising that views on how to measure it differ.

---

[3] European Monetary Institute: "The Role of Underlying Inflation in the Framework for Monetary Policy in EU Countries". Background study, mimeo, Frankfurt a. M., October 1995.

2.2 Monetary Policy Theory.

Monetary policy affects output through causing disequilibrium by increasing or reducing the money supply (explained through IS-LM curve). To adjust to equilibrium position, output and prices will be affected. The difference in views of monetary policy is essentially in the transmission mechanism – how changes in money supply affect real variables.

2.2.1 Neoclassical View.

The neoclassical view of the operation of the economy implies that supply of money is a crucial guide for short-run monetary stabilisation policy. For the neoclassical economist, the supply of money is the most important driving force behind the determination of nominal income, is central to the determination of the general price level, and strongly influences the employment decision in the short-run. In the neoclassical view, the maintenance of a stable rate of growth of supply is vital to monetary stablisation policy.

2.2.2 Keynesian View.

In the Keynesian view, aggregate demand is the driving force behind economy activity, and the interest rate is the link between monetary actions and aggregate demand. By keying in an appropriate level of interest rate, monetary policy can be used to adjust the level of real aggregate demand. An expansionary monetary policy calls for a reduction in interest rate to stimulate investment demand, and a

contractionary monetary policy calls for an increase in the interest rate to curtail investment demand. Given the difficulties of interpretations nominal interest rate changes and the impact of inflationary expectations on aggregate demand, longer-term monetary policy adjustments generally are guided by the behaviors of monetary aggregates.

However, for monetary stabilisation purposes, a conflict still exists in the Keynesian view between the use of interest rate and monetary aggregates for the day-to-day conduct of monetary policy. It depends on the stability of the money market relative to the product market. When there is money market instability, an interest rate mechanism will result in greater economy stability, and when there is product market instability, monetary aggregates will lead the economy towards greater stability.

2.3 Targets and Indicators.

The ultimate goals of monetary policy are generally set in terms of unemployment rates, output and price levels. However, it is impractical to attempt to conduct policy in the short-run based on observations of the ultimate variables. The lags in observations are significantly long so that economic conditions could change and current monetary policy would be inappropriate. Thus, in the short-run, the conduct of monetary policy is based on other readily observable target and indicator variables.

2.3.1 Targets.

A target variable is used as a specific guide for the conduct of monetary policy. Reasonable monetary target variables are variables that can be directly controlled or at least strongly influenced by the actions of the central bank, variables that can be observed in the short-run so adjustment can be made, and variables that are linked in a discernable manner to ultimate goals.

Target variables can be grouped into operating and intermediate targets. Operating targets are used for the actual day-to-day conduct of monetary policy through open market operations. Possible operating targets are selected interest rate levels, banking reserves requirements, and the appropriate level of the monetary base[4]. Intermediate targets are used as a guide for adjustments and corrections of day-to-day operations of monetary policy. Possible intermediate targets are liquid assets measures, monetary aggregates, commodity prices, and exchange rates[5].

As for Malaysia, the Central Bank uses money supply as an intermediate target[6] and the interest rate level as the operating target[7].

---

[4] Ivan C. Johnson & William W. Roberts: Money and Banking; A Market-Oriented Approach. 2nd Edition. The Dryden Press. 1985

[5] Federal Reserve Bank of New York: " Intermediate Targets and Indicators for Monetary Policy". A Critical Survey, July 1990.

[6] Mulyana Seokarna: Financial Reforms and Transmission Mechanism of Monetary Policy in the SEACEN Countries. The SEACEN Centre, 1995.

[7] Dr. Lin See-Yan: "Monetary and Exchange Rate Policies in Open Economy: The Malaysia Case 1959-92". National Conference on Economic Globalisation: Issues, Challenges, and Responses. August 1992.

2.3.1 Indicators.

An indicator is a variable that reflects the effect of the use of monetary policy instruments on economic activity and the relationship between that activity and the ultimate goal. An indicator would serve as a barometer of the "easiness" or "tightness" of monetary policy relative to the general level of economic activity.

As for Malaysia, the Central Bank looks at a broad range of indicators to gauge the impact of the current and prospective monetary measures. Monetary policy has been guided by the growth in monetary aggregates as well as the level of the interest rate. However, the main variable of concern is bank liquidity.[8]

2.4 PROBLEMS IN CONDUCTING MONETARY POLICY*.

2.4.1 Inflation Measurement.

An important limitation of commonly used inflation measures such as the CPI is their susceptibility to specific disturbances, which are unrelated to the "pure" or "core" inflationary process. It seems a widely accepted fact that there is a mismatch between the measurement of inflation by means of CPI and the theoretical concept of inflation as a *sustained increase of the general price level*. This mismatch is due to the fact that the CPI is just a weighted average of consumer prices. As such, it is based only on a small subset of prices and it cannot distinguish between transitory and

---

[8] Ibid.
* For full discussion see Dudley G. Luckett: Money and Banking, McGraw-Hill, 1980. Page 516-526.

sustained price increases. Moreover, due to the differential weighting of the commodities included in the computation of the CPI some price changes have a greater impact on measured inflation than others. As a result, measured inflation may give a misleading picture of underlying price trends that is relevant for monetary policy.

2.4.2 Rules versus Authorities.

One basic conflict in conducting monetary policy is evident in the debate over establishing a set of rules for monetary growth as opposed to allowing the monetary authorities to pursue a discretionary policy. Discretionary policy is the use of monetary policy instruments on a short-term basis to stabilise economy activity. A problem with discretionary policy, and with the design of short-term monetary policy, is the timing of policy changes. There are substantial lags between the actual change in economic conditions that warrant a policy change and the impact of the policy change.

Recognition lag is the time it takes between the need for action and the recognition of that need. For example, the economy may experience a negative growth for the first quarter, but technically we recognise a recession if the second quarter also reports negative growth. This may be due to the unavailability of economic data and the failure to interpret economic data accurately.

Implementation lag or *action lag* is the time that elapses between when the need for action is recognised and when the action is in fact taken. For example, although it was well understood by July 1997 that the Malaysian economics had reached a turning point, corrective measures were not undertaken until December 1997.

Impact lag is the time between when a particular action is taken and when the effects of that action have some substantial impact on the goals of monetary policy. For example, the Central Bank may switch from a tight to an easy monetary policy in December 1997, but this action may not affect the rate of credit growth until the following August.

A set of rules for the conduct of monetary policy on the other hand, would eliminate (in theory)[9] the possibility of short-term discretionary policy changes that would contribute to destabilising effects and is perceived to promote confidence and longer term planning. Inherent in the argument for a set of monetary rules is the belief in the stability of private sector activity.

2.4.3 Monetary Aggregates versus Interest Rates.

This is the conflict in the choice of specific guides for the day-to-day conduct of monetary policy. In the short run, monetary policy can be guided either by the need to alter monetary aggregates (money supply) or

---

[9] Milton Friedman, A Program for Monetary Stability, Fordhem University Press, New York, 1960.

to control money market conditions (interest rates). Increases in money supply *ceteris paribus* will result in lower interest rates. Open market operations will result in increases in the prices of those instrument decreases in the rates of those instruments and expansion of money supply. However, others may not remain constant. Inflationary expectations may change and feedback between the markets could result in significantly different effects being achieved when different targets are used. The different views of how the various markets interact and adjust in the face of uncertainty have led to a difference in design of short-run stabilisation policy and long term policy.

2.4.4 Inflation versus Unemployment.

This argument focuses on the Phillips curve analysis that full employment and price stability are mutually exclusive goals – can have one but not both. While acknowledging that inflation is bad, advocates of inflation maintain that widespread unemployment is even worse. At least, they argue that, people can hedge against inflation that is, wage contracts can be written so that wages vary according to price index.

However, in some recent analysis of the Phillips curve, there is evidence to suggest that the curve is shifting outward. If this is the case, the choice must be made not between the unemployment rate and the inflation rate but unemployment and an accelerating rate of inflation. It may be much more difficult to choose between these two variables.