CHAPTER 3
THE OBJECTIVE OF MONETARY POLICY.

Many economists have argued that Central Bank should emphasise price stability as a single most important objective of monetary policy and abstain from other objectives such as employment and output growth. They propose this with the view that monetary policy cannot affect the long term growth of the economy – any attempt to stimulate growth above its potential level will lead to inflation, thus, policy can only moderate short run fluctuations in output. Can discretionary monetary policy effectively dampen economic fluctuations? This is the question that raises doubt among many analysts.

Developing countries, like Malaysia, face difficulties advocating a single objective of monetary policy. With the output in a small range of products and limited development in financial markets that could diversify risk, the country is more vulnerable to both internal and external destabilising shocks. Furthermore, limitation and uncertainty of access to international capital markets makes the central bank depend on balance-of-payment equilibrium in its monetary objectives. Due to the under development of the financial system, monetary policy is sometimes used to influence direct credit to certain sectors regarded as vital for nation's development strategy.

On the other hand, monetary policy in developing countries may be less able to achieve goals other than price stability. Monetary expansion, for example, may lead immediately to higher prices with very little transitional impact on economic activity. This event happens when monetary policy action generates immediate

changes in inflationary expectations and, in turn, increases actual prices due to the inflationary psychology of the citizen together with the lack of Central Bank credibility. The presence of shallow and volatile financial markets may also undermine the effectiveness of monetary policy to influence output. In these circumstances, monetary authorities are required to focus solely and exclusively on price stability.

And if price stability alone is the ultimate goal of monetary policy, it may not be possible to ignore its implication on output and employment. In particular, the output costs of reducing the level of inflation should be taken into consideration in determining the extent and pace of inflation. For example, exchange rate can sharply reduce output costs at the outset of stabilisation policy; however, this may lead to overvaluation, and a large external deficit and possibly which may possibly result in the collapse of the exchange rate. Therefore, monetary authorities may choose a more gradual disinflation policy – relying on domestic channels, because the inflation reduction can be more sustainable.

The debate on the objective of monetary policy is still alive and views continue to differ. In Indonesia[10] for example, multiple objectives of monetary policy are to be achieved "primarily through the control of monetary aggregates at levels adequate to support the targeted rate of economic growth without giving rise to internal and external macroeconomic equilibrium". In Thailand[11], the objective is described as "to achieve sustainable economic growth with a reasonable level of

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[10] BIS Policy Paper No.3. "The Transmission of Monetary Policy in Emerging Market Economies". January 1998.
[11] Ibid.

internal and external stability"; while in India[12] it is "to ensure an adequate provision of credit for the productive sectors of the economy without jeopardising price stability. And in Peru[13], one emphasising that "price stability is the sole objective of the central bank" replaced three mutually inconsistent objectives.

[12] Ibid.
[13] Ibid.