CHAPTER 1

INTRODUCTION

1.1 Overview

The modern economic analysis of financial policy started with the seminal works of Ronald Mckinnon (1973) and Edward Shaw (1973). Both authors drew attention to the prevalent "financial repression" and argued that such repression was imposing major cost on countries that practiced it. Generally, in a repressed financial system with extensive interest rate controls, credit controls and subsidies, markets are found to be typically underdeveloped and are not competitive. In response to these problems, there was a widespread move by the industrialized countries to liberalize their financial systems. In the early 1980s, the waves of financial innovation and liberalization, which were sweeping the advanced countries, have also started spreading to the developing countries. Thereafter, financial liberalization became a worldwide phenomenon.

The broad thrust of financial liberalization was to enhance efficiency through greater reliance on market forces and to reduce government intervention in the financial sector. In other words, liberalization can be characterized as the process of giving the market the authority to determine who gets and grants credit and at what price. As such, financial liberalization can be viewed as a set of policy measures, which are principally designed to deregulate and transform the repressed financial system and to achieve a liberalized market oriented system with an appropriate regulatory framework.

Monetary policy is generally implemented to achieve the long run ultimate goals of the monetary authorities and in most countries these goals are price stability and sustainable economic growth. However, the monetary authorities cannot directly control these variables because monetary policy affects prices and output with a lag. In addition, there is a problem of obtaining timely and accurate information on these final variables of prices and output. As a result, the central bank has to depend on some intermediate targets, which are deemed to be closely related to the prices and output.

The candidates for intermediate targets often included money stock, interest rate, exchange rate or credit aggregate. These targets are not only easily manageable, but also timely and accurate information on these variables are readily available. Having decided on the intermediate targets to pursue, the monetary authorities must also formulate detailed plans to put the targets into effect. Hence, the monetary authorities have to rely on monetary policy instruments and the selected instruments are usually under their control. The policy instruments are actually used to influence the path of the selected intermediate target variables that are deemed to be related in a reasonably predictable manner with the ultimate policy goals. Therefore, the right candidate for intermediate target largely depends on how much information is contained by the target about the goal variables and how much control can instruments transmit to the target for regulatory purposes.

Along with the scope of financial liberalization, various aspects of reform processes emerged and they include financial sector reform, deregulation, re-regulation and financial innovation. As for many countries, even though the main policy goals of maintaining price stability and output growth have not changed, the waves of financial reforms have changed the types of intermediate targets and instruments used. These changes posed a major challenge in the formulation and implementation of monetary policy.

1.2 Problem Statement

The effectiveness of monetary policy depends on setting an intermediate target and accomplishing it so that it would lead on to the successful achievement of ultimate economic goals of price stability and sustainable output growth. Therefore, monetary policy needs to be formulated with the purpose of achieving whatever intermediate targets that have been selected. As mentioned before, normally the candidate for intermediate targets are monetary aggregates, credit aggregates, interest rates and or exchange rates.

Intermediate targets are themselves not very important, but if they are achieved it will then be likely that the ultimate aim of the government's economic goals will also be attained. Consequently, for the effective implementation of monetary policy, the link between the selected intermediate target and the ultimate goal variables must be reasonably predictable and stable. If the link is not reliable or unpredictable, then the selected intermediate target is of little practical value in exerting influence on the ultimate goal variables.

Based on developed country experiences, financial liberalization have actually altered the channels of monetary policy, mainly affecting the relationship between credit aggregates, money aggregates and interest rates on income and prices. A number of studies, namely Goodhart (1989), Friedman & Kuttner (1992), Becketti & Morris (1992) and Estrella & Mishkin (1997) on this subject have been recorded. These studies mainly examine the relationship between credit and monetary aggregates with income and prices and were based on countries that have pioneered financial liberalization process.

Largely, the interesting outcome of these studies is that in the 1990s, the relationship between money and credit with income and price has become increasingly unstable. Therefore, although monetary or credit target seemed to have operational significance in the 1970s and 1980s, but in the 1990s, they had little significance in the monetary policy operations.

This clearly indicates that financial liberalization posed a major challenge to the formulation and implementation of monetary policy because the basic framework within which monetary policy operates has changed. As result, the reform processes prompted a reassessment of the appropriate intermediate targets, operating procedures and instruments of monetary policy.

1.3 Objective Of The Study

Since financial liberalization has changed the environment in which monetary policy operates, the objective of this research is to evaluate the effect of financial liberalization on the conduct of monetary policy in Malaysia. Numerous studies have been conducted in Malaysia concerning the instability of money demand behaviour such as Kwek (1990), Tseng & Corker (1991), Tan (1996) and Dekle &

Pradhan (1997) and on the effect of financial liberalization on the monetary transmission mechanism such as Mulayana (1995), Azali (1998), Azali & Matthews (1999) and Farizah (1999).

This study also examines to what extent the financial market development and the liberalization processes have affected the transmission channels of monetary policy and their ability to achieve the ultimate goals of price stability and sustainable real income growth. The specific objective of this study is to ascertain the appropriateness of the financial variables such as credit aggregates, monetary aggregates and interest rates as an intermediate target. The main focus is on the information content of these variables with respect to the future movements of prices and real income as goals of monetary policy.

Both Mulayana and Farizah used the Sim-type unrestricted vector auto-regressive model mainly to determine the short run properties of the financial variables in the monetary transmission process. While, Azali and Azali & Matthews used the forecast error variance decomposition method to examine the role of different monetary shocks in the monetary transmission mechanism. In this research project, however the co-integration technique and error correction model are used to investigate the long run and short run properties of the financial variables with respect to prices and income. The short run properties of the financial variables are examined mainly to identify their information content in the monetary transmission mechanism during the pre and post liberalization periods.

1.4 The Sources Of Data

Data sources were mainly obtained from the Bank Negara Monthly Statistical Bulletins, Bank Negara Quarterly Economic Bulletins, Bank Negara Annual Reports, The International Financial Statistics of the International Monetary Fund and Tilak and Lee (1996).[1] The length of the study is from 1973 fourth quarter to 2000 first quarter.

Quarterly series were utilized for the empirical analysis. A total of nine financial aggregates are employed that is three monetary aggregates, three credit aggregates and three interest rates. The quarterly gross domestic product is used to proxy economic activity while consumer price index is used to represent price level and Federal government expenditure to represent the fiscal variable. Variables, descriptions and sources can be obtained from Table 1.1 below.

[1] Quarterly Gross Domestic Product was obtained from Tilak and Lee (1996).

Table 1.1

Variables, Descriptions And Sources

Variables		Descriptions	Sources
Y	Real Income	Real Gross Domestic Product by expenditure components in constant price (1987=100).	BNM & Tilak
P	Price Level	Consumer Price Index (1994=100)	BNM
G	Real Fiscal Variable	Federal Governments current expenditure plus development expenditure.	BNM
M1	Monetary Aggregate Real M1	Currency in circulation plus demand deposits.	BNM
M2	Monetary Aggregate Real M2	M1 plus savings deposits plus fixed deposits plus NIDs plus Repos plus foreign currency deposits.	BNM
M3	Monetary Aggregate Real M3	M2 plus deposits placed with other banking institutions.	BNM
CR1	Total Real Domestic Credit	Monetary Survey's claims on central Government, state & local Governments, non-financial public enterprises, private sectors, other banking institutions and non-bank financial institutions.[2]	IFS
CR2	Real Monetary Survey's Claims On Private Sectors	It is the sum of Monetary Authorities claims on private sectors plus Deposit Money Banks' claims on private sector.	IFS
CR3	Real Deposit Money Bank's Claims On Private Sectors	Deposit Money Banks comprise commercial banks and other financial institutions.	IFS
ALR	Average Lending Rates	Commercial banks average lending rates.	BNM
IBR3	Three Month Inter-bank Rates	Inter-bank money market rates.	BNM
TBR3	Three Month Treasury Bill Rates	Average discount rate on Treasury bills.	BNM

Notes:

1. BNM is referred to Quarterly and Monthly Bulletin, Central Bank of Malaysia.
2. IFS is referred to International Financial Statistics of International Monetary Fund.
3. Tilak is referred to Tilak & Lee (1996).

[2] Monetary Authorities and Deposit Money Bank's data consolidated into a Monetary Survey.

1.5 Structure Of The Study

The study is organized as follows:

Chapter One starts off with an introductory chapter that primarily comprises the problem statement, the objective of the study, the period of study and sources of data.

Chapter Two presents an overview of the concept of financial liberalization and its effects and implications on the various aspects of the financial systems. The review dwells on the experience of the developed nations mainly discussing how the financial liberalization has changed the nature of their conduct of monetary policy.

Chapter Three discusses the reform processes and their implications on the Malaysian monetary policy framework. It largely reviews how financial liberalization has affected the money demand behaviour and the relationship between credit, money and interest rates on income and prices.

Chapter Four displays the empirical methodology, which includes the theoretical framework, sample selection, data measurement, model development and hypothesis. The method of estimation employs the econometric techniques namely the Augmented Dickey-Fuller unit roots tests, Johansen co-integration technique, error correction model and forecast error variance decomposition method.

Chapter Five encompasses the empirical findings and analysis. The findings present the role of the various financial variables in the monetary policy transmission mechanism during the pre and post liberalization periods.

Chapter Six provides the conclusion of the study with regards to the use of the various financial variables in the monetary policy transmission framework.