CHAPTER 6

CONCLUSION

Financial liberalization brought many new challenges for the monetary authorities and these challenges mainly relate to the way in which monetary policy is formulated and implemented. In particular, financial liberalization has altered the relationship between income and price level with money, credit and interest rates, complicating the interpretation of developments in the monetary policy. As such, the liberalization policies had important implications for both the transmission mechanism and the operating procedures of monetary policy. With respect to operating procedure of monetary policy, financial liberalization has affected both the setting of policy targets and the choice of instruments.

As countries liberalized their financial system and move towards a more market-based system of monetary control, the technique of monetary policy must also be adjusted to a more market-oriented approach. The institutional and operational arrangements must also be consistent with the move towards a liberalized system. As countries gradually implement financial reforms, they had difficulty in retaining their monetary aggregate as an intermediate target. As a result, the monetary policy framework evolved away from strict adherence to monetary target to alternative policy framework such as interest rate targets and exchange rate targets.

The Malaysian experience in moving towards a liberalized system also had many implications on the conduct of monetary policy. As a result, monetary policy is complicated by the structural changes in the demand for money. Therefore, the underlying relationship of the broad money with economic activity has become less stable and thus less predictable.

After the major reform in the late 1980s, it was found that the relationship between broad monetary aggregates and economic activities have changed and thus had a strong negative implication on the effectiveness of monetary policy. Though the co-integration test supports the existence of the long-term relationship between the financial variables with income and price level, the error correction model (ECM) gives a different result.

The ECM which mainly captures the short run dynamics, found the monetary aggregate M1, average lending rates and three month inter-bank rates to be significantly affecting income. As for price level, only interest rates are found to be significant in the post liberalization period. The variance decomposition method also further supports the use of real M1 and interest rates as intermediate target in the monetary transmission mechanism especially in affecting the income level.

The broad monetary aggregates M2 and M3 failed to provide the necessary information about the future income and price movements and thus raised some pertinent questions about the ability of monetary target to serve as a communication device. These results bear strong negative implications for many familiar monetary policy frameworks that centered the design and implementation of policy on broad money. This is because, the money–income or money-price relationship does not satisfy the stringent conditions that would be required to render the strict use of money as an intermediate target.

This study's one important finding with potentially positive implications for monetary policy is the reliance on interest rates. The average lending rates and the three-month inter-bank rates contained the information about subsequent movements in real income and price level and it is highly significant in the 1990s. This reflects the increased effectiveness of interest rate as a monetary policy variable.

Overall, it can be concluded that in a liberalized financial environment, monetary aggregates and credit aggregates can no longer contain information about the macroeconomic outcomes that monetary policy seeks to affect. Therefore monetary authorities should concentrate more on the interest rate target which seems to be an appropriate and necessary condition for an effective implementation of monetary policy.