MONETARY POLICY AND EXCHANGE RATE ARRANGEMENTS IN EAST ASIA BEFORE AND AFTER THE CRISIS.

by

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MONETARY POLICY AND EXCHANGE RATE ARRANGEMENTS IN EAST ASIA BEFORE AND AFTER THE CRISIS.

Abstract

This dissertation examines the monetary policy and exchange rate regime choices made by central banks in East Asia before and after the Asian Crisis in 1997-8. The crisis was something of a defining moment in the way central banks conducted their monetary policy and all of the crisis-affected economies – Korea, Thailand, Indonesia, Malaysia and the Philippines substantially changed their policies thereafter.¹ Chapter 2 offers an empirical overview and analysis of the monetary policy and exchange rate arrangements before and after the crisis.

Before the crisis, each of the countries mentioned above conducted largely exchange rate based monetary policy that centred around a soft US dollar peg (although Philippines was more of a chaotic managed float). Reserves were used to manipulate the value of the local currency against the US dollar and, as such, the central banks of these countries subordinated much of their monetary policy, and therefore interest rate movements, to the US. Any attempt at establishing monetary control was with the aid of sterilised intervention. As such Chapter 3 of this dissertation presents a model assessing the effectiveness of sterilised intervention and the effect of sterilisation on domestic interest rates. The results indicate significant evidence of sterilisation before the crisis in all the countries sampled. Furthermore, the existence of sterilisation had a weak impact on the domestic interest rate for Korea, Thailand, the Philippines and Malaysia, but a stronger effect in Indonesia. When the model is generalised to incorporate a lag structure using a VAR, the effects are stronger across the board.

¹ Singapore and Taiwan were also affected. Data for Taiwan is difficult to obtain and Singapore’s regime is rather unusual and didn’t lend itself to the type analysis conducted in this dissertation.
After the crisis, Malaysia (September 1998) instituted a system of rigidly fixed exchange rates and effective capital controls. Korea, Thailand, Indonesia and the Philippines instituted an inflation-targeting (IT) regime fashioned around a floating exchange rate. Chapter 4 focuses on the effectiveness of IT regimes in East Asia. A simple analytical model is specified and calibrated using data for Thailand. The model is then simulated to examine a range of different policy positions, and the stochastic and dynamic properties of the model are generated and analysed. The results show that IT is more effective when the exchange rate is included as part of the central bank’s set of objectives. An important feature of the parameterisation of the model is the existence of possible contractionary devaluation, which further promotes the use of exchange rate augmented IT based policies.

One of the main results from the study in Chapter 2 is that, while there was a general increase in the flexibility of exchange rates, they did not float as freely as they do in countries like Australia and the USA – countries known to be ‘floaters’. There seems to be a fear of floating (FoF) in many cases. Chapter 5 analyses the existence of, and possible justification for, FoF and examines the effectiveness of different optimal monetary policy types using a small open-economy model and dynamic programming techniques. The policies examined are solved in the model as optimal policy under discretion. The numerical results indicate that, for most model configurations, those policies with exchange rate involvement perform well and in some cases are the most suited policy. This suggests that there may be some justification for fear of floating attitudes amongst central banks. FoF policies appear to control exchange rate movements with relatively little cost to inflation for most scenarios examined.

Chapter 6 offers some concluding remarks and discusses the scope for future research on this topic.