Exchange Rate and Monetary Policy: 
Selected Comparative Experiences during the 
Pre- and Post 1997 Asian Financial Crisis

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Exchange Rate and Monetary Policy: Selected Comparative Experiences during the Pre- and Post 1997 Asian Financial Crisis

ABSTRACT

The aim of this thesis is to examine empirically the relationship between the exchange rate, the instruments of monetary policy and the measures of economic performance for Indonesia, Korea and Thailand during the pre- and post 1997 Asian financial crisis. The first core chapter (Chapter 2) assesses the possible linkages between the increase in domestic inflation and the exchange rate targeting policy adopted in these countries. Using the cointegration technique and a simple monetarist inflation model, Chapter 2 finds strong evidence that the exchange rate policy that generates a predominant domestic currency undervaluation has caused an increase in the domestic inflation rate for Indonesia and Korea. However, the exchange rate targeting policy that brings about a predominant baht overvaluation especially during the pre-crisis period has lowered Thailand’s inflation.

Soon after the outbreak of 1997-crisis, instead of using the exchange rate as the nominal anchor, all three countries have implement their monetary policy around an inflation target following an inflation targeting framework. Owing to this significant structural break, the second core chapter (Chapter 3) uses a Markov-switching VAR framework to determine if the effects of monetary policy shocks have changed across different monetary policy regimes in these economies.

Chapter 3 finds that regime switches occur in mid-1997 to 2000 for Indonesia, which coincides with the period after the onset of 1997-crisis and the economic recovery period; and in 1999 for Korea and Thailand, which coincides with the period when the inflation-targeting framework is adopted. From the regime-dependent impulse response functions, the responses of macroeconomic variables to monetary policy shocks have changed significantly across different regimes only for the case of Korea and Thailand.
From the above discussions, Chapter 2 found that exchange rate targeting policy caused higher domestic inflation in Indonesia and Korea especially during the pre-crisis period; while Chapter 3 found that inflation targeting policy seemed to cause structural changes in Korea and Thailand. Therefore using a structural VAR framework, the third core chapter (Chapter 4) explores further the role of the exchange rate and inflation targeting policy on the economic performances of these economies during the pre- and post crisis periods.

Chapter 4 finds that in the case of Indonesia and Korea, the foreign exchange market does create most of its own shocks during the pre-crisis period but not during the post crisis period. For Indonesia and Thailand, the soft US dollar peg policy during the pre-crisis period has caused additional distortions in the domestic economy. Moreover the role of the exchange rate as a shock absorber has increased during the post crisis period only for the case of Indonesia and Thailand. For all three economies, following the introduction of the inflation targeting policy, domestic short-term interest rates have been adjusted systematically to offset inflationary pressure following the real and nominal shocks. Moreover, in the case of Indonesia and Thailand, the unsystematic part of monetary policy plays a smaller role in explaining the variations in domestic economy during the post crisis period.
DECLARATION

This work contains no material which has been accepted for the award of any other degree or diploma in any university or other tertiary institution and to the best of my knowledge and belief, contains no material previously published or written by another person, except when due reference has been made in the text.

I give consent to this copy of my thesis, when deposited in the university library, being available for loan and photocopying.

SIGNED: ___________________________ DATE: ______________________
(Si Wei Goo)
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