الجامعة الاسلامية العالمية ماليزيا
INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA
يونيۏرسيتي اسلام انتارابڠسا مليسيا

DOES ANTICIPATED MONETARY POLICY MATTER IN MALAYSIA ?

BY

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RESEARCH PAPER

This is to certify that Bro. ~~/Sis~~ ZIAUL AHSAN has written the Master of Economics research paper entitled:

DOES ANTICIPATED MONETARY POLICY MATTER IN MALAYSIA?

under my supervision. The relevant comments made on the paper during its presentation have been incorporated in the present version of the paper to my full satisfaction.

I have pleasure in recommending that the graduate committee may approve the paper in partial fulfilment of the requirements for the degree of Master of Economics.

Name of Supervisor : Dr. OMAR MARASHDEH

Date: 03/08/93

Omar Marashdeh
(Signature)

Table of Contants

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DOES ANTICIPATED MONETARY POLICY MATTER IN MALAYSIA?

Abstract

The purpose of this paper is to test the proposition: anticipated monetary policies do not matter, but unanticipated ones do in Malaysia over the period 1978 Q1 to 1992 Q4. The results suggest that anticipated money movements in Malaysia affect real economic variables; whereas unanticipated movements do not affect real economic variables. However, unanticipated changes in fiscal policy and inflation has influence on real variables. In addition, no evidence was found to support the long run neutrality of money in Malaysia. The Chow test shows that the coefficients remain stable over the period of study.

INTRODUCTION

An interesting controversy still persists in economics regarding the policy ineffectiveness proposition, associated with the 'rational expectations school'. It probably started when the school focussed its attention on business-cycle models, which incorporated features of the natural-rate model of Friedman (1968) and Phelps (1967) with the assumption that expectations are rational in the sense of Muth (1961). Continuation of the research program, in the works of Lucas (1973), Sargent and Wallace (1975), first spelled out 'the policy ineffectiveness' proposition explicitly. The important conclusion of the research is that anticipated changes in aggregate demand policy will have been taken into account already in economic agents' behavior and will evoke no further output or employment response. Therefore, deterministic, feedback policy rules will have no impact on output fluctuations in the economy. This policy ineffectiveness proposition of Lucas-Sargent-Wallace (henceforth LSW) runs counter to much previous macroeconomic theorizing as well as the views in policymaking circles. It thus, calls for empirical research for its verification or refutation.

Macroeconomic performance of Malaysia in recent years, has been highly commendable. In the 1970s, it grew rapidly at an annual rate of 7.8 percent. Except for the recession year of 1985, Malaysia registered real GDP growth rates of 8 to 10 percent per year in the late 80s and early 90s. Domestic price level had been remarkably stable with inflation rate as low as 0.4 percent in 1985 to 4 percent in the 90s. Unemployment rate is low and balance of payments condition are favorable. In 1988, Malaysia's external reserves amounted to nearly 6 months of imports, a comfortable level by developing country norm. All in all, there are only a few developing countries in the world that can match Malaysia's track record. Leading economists are ready to give the credit to the vigilance of the policy makers (See Ariff 1991).

The purpose of this study is to investigate if the credit is really deserved by the policy makers for this magnificent performance of Malaysian economy. More specifically, we investigate the LSW policy ineffectiveness hypothesis by empirically testing the effect of anticipated and unanticipated monetary policies on real output, nominal government expenditures, balance of payments and external public debt in Malaysia during 1978 Q1 to 1992 Q4.

The rest of the paper is organized into four sections. We review the literature and some studies on the subject matter in Section II and spell out our methodology of analysis in Section III. The data and findings are reported in Section IV. Section V is for summary and conclusions.