CHANGES IN STRUCTURE OF DEMAND FOR MONEY IN FOUR CRISIS AFFECTED ASIAN COUNTRIES

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ABSTRACT

This paper performs a comparative analysis on structures of demand for money before and after the 1997 Asian Crisis by constructing cointegration and error-correction models, utilizing monthly observations under an open-economy framework. The findings postulate the differences in the nature of long-run relationships in periods before and after the Asian crisis, as well as speed of adjustment towards equilibrium among ASIA-4: Korea, Malaysia, the Philippines and Thailand. Interest rate policy interventions have no influence on short-run relationship of demand for money function.

Introduction

During the 1980s, remarkably successful economic performance in East Asian countries used to be one of the contemporaneous economic issues. Monetary development was believed to be a factor of contribution (Dekle and Pradhan, 1997). However, the evidence from the 1997 Asian Crisis (hereafter, the Crisis) has shown that some defects in financial policies could result in vulnerabilities to a financial crisis and could turn an economy into a recession. When the onset of the crisis is too sudden and severe, it may cause dramatic structural changes. Demand for money is one of the issues that policy makers should pay attention to in order to select appropriate adjustment on monetary policy actions. However, in the five most severely affected countries, namely, Indonesia, Republic of Korea, Malaysia, the Philippines, and Thailand, the changes in structure of demand for money after the crisis have not yet been clearly investigated although they already have recovered during 1999 to 2000.

There are extensive empirical studies on modeling and estimating the demand for money in the five most affected countries before the Crisis. One of widely employed approaches is the error-correction model (ECM), which allows investigation on long-run relationship and short-run adjustment among cointegrated nonstationary variables. However, due to insufficient quarterly data available, similar attempts have not yet been made for an analysis of the period after the crisis.

Taking into consideration the changes in the structure of the long-run relationship and short-run adjustment of demand for money in four Asian countries, comprising Korea, Malaysia, the Philippines and Thailand (hereafter, ASIA-4) after the Crisis, this paper tries to develop ECMs by applying monthly data, similar to the initiative of Sriram (1999b).

Literature Review

The standard functional form of long-run demand for money illustrates the relationship between demand for money and two main determinants: scale variable and opportunity costs of holding money, which, basically, comprises the own-rate of money and rate of return on alternative assets. With the assumption of unity price elasticity of nominal money balances, money is usually specified in real terms.


2They were regarded as “High Performance East Asian: by World Bank (1993).


4Particularly the GDP which are proxy variables for real sector.

5The analysis has to exclude the case of Indonesia due to lack of qualified monthly proxy variable for real sector.

6Scale variable is a proxy variable representing economic activity.

7This implies demand for money balance changes proportionally to the change in price level. See Sriram (1999a), pp. 28.