MONEY DEMAND IN MALAYSIA: PRE- AND POST-CRISES ANALYSIS

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Abstract

The main purpose of this study is to analyze money demand behavior using a standard money demand model over a period of time 1970:Q1 to 2009:Q4 taking into consideration the experiences of the Asian financial crisis 1997-1998 and the global financial crisis 2007-2008. Specifically, it examines the long-run money demand stability. Using the cointegration technique and error correction model, money demand behavior is made distinct into four different periods, namely full sample (1970:Q1 - 2009:Q4), pre-crisis (1970:Q1 - 1997:Q2), post-crisis I (1997:Q3 - 2007:Q3) and post-crisis II (1997:Q3 - 2009:Q4). The parameter constancy of M1 and M2 is justified by utilizing the CUSUM and CUSUMSQ tests. The findings suggest that real money balances, real income, interest rate, exchange rate and foreign interest rate are cointegrated. When exchange rate is included as part of the regressors during the period of financial crisis, money demand does not behave as a prior theory and the CUSUM and CUSUMSQ show that the function is not stable. Although, the policy makers should monitor closely monetary variables however they must not to rely heavily on these monetary aggregates.

Keywords: Financial crisis, money demand, cointegration, error correction model.

1.0 Introduction

Demand for money plays a major role in macroeconomics analysis, especially in selecting appropriate monetary policy actions. The importance of a well-specified demand for money to the implementation of monetary policy is well recognized in the existing literature. Goldfield (1994) considers that the relation between the demand for money and its main determinants is an important building block in macroeconomics theories and is a crucial component in the conduct of monetary policy. As a result, the demand for money is one of the topical issues that have attracted the most attention in the literature both on developed and developing countries. In the context of developed countries it is argued that disequilibrium in the demand for money (defined as the difference between the real money stock and the long-term equilibrium real money stock) may affect the efficiency of interest rate policy in the long run via its impact on output gap and/or inflation.

Fisher (1911) analyses the institutional details of the payment mechanism and therefore concentrates on the velocity of circulation of money rather than the motives for holding money. Keynes (1936) transaction and precautionary money demand are determined mainly by the level of income and institutional factors such as the frequency of wage payments.