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ABSTRACT

The purpose of this study is to examine the relationship between monetary policy inflation rate, and stock market in Malaysia. The techniques used in this study are Unit Root test, Johansen's Cointegration test, Pairwise Granges Causality test, Multivariate VAR tests, Impulse Response, Variance Decomposition, and Multivariate Error Correction Model (ECM) tests. Five variables used in this study are exchange rate, lending rate, consumer price, and aggregate money supply. Data will be collected monthly and the data will be divided into two periods. The first period will be from January 1980 until August 1998 representing the period before the government pegged the exchange rate. The second period will start from September 1998 until September 2003 representing the period after the government had pegged the exchange rate. The major findings are: (i) there exist a dynamic interaction between monetary policy, inflation rate, and stock market in Malaysia, and (ii) there is a linkage between the variables and stock market before and after the government had pegged the exchange rate.

ABSTRAK

Tujuan penyelidikan ini ialah mengkaji perhubungan di antara polisi kewangan, kadar inflasi dan pasaran saham. Teknik yang digunakan dalam kajian ini ialah "Unit Root test", "Johansen's Cointegration test", "Pairwise Granges Causality test", "Multivariate VAR tests", "Variance Decomposition", "Impulse Response", dan "Multivariate Error Correction Model tests". Lima pembolehubah telah digunakan dalam kajian ini adalah indeks komposit, kadar pertukaran wang asing, kadar pinjaman bank, indeks harga pengguna, dan penawaran wang agregat. Data yang dikumpulkan secara bulanan dan ia dibahagikan kepada dua tempoh. Tempoh pertama bermula dari Januari 1980 hingga Ogos 1998 yang menggambarkan keadaan sebelum kerajaan menetapkan kadar pertukaran wang asing. Tempoh kedua bermula dari September 1998 hingga September 2003 yang menggambarkan keadaan selepas kerajaan menetapkan kadar petukaran wang asing. Kesimpulan penyelidikan ini ialah (i) terdapat perhubungan di antara polisi kewangan dengan pasaran saham, (ii) polisi kewangan, kadar inflasi dan pasaran saham di Malaysia adalah saling menpengaruhi di antara satu sama lain.

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LIST OF ABBREVIATIONS

ADF	Augmented Dickey-Fuller Test
AIC	Akaike Info Criterion
BNM	Bank Negara Malaysia
CP	Consumer Price
ECM	Error Correction Model Test
ER	Exchange Rate
GDP	Growth Domestic Product
GLS	Generalized Least Squares
IC	Stock Market
IFS	International Financial Statistic
KLCI	Kuala Lumpur Composite Index
KLSE	Kuala Lumpur Stock Exchange
LGCP	Logarithm Consumer Price
LGER	Logarithm Exchange Rate
LGIC	Logarithm Stock Market
LGLR	Logarithm Lending Rate
LGM1	Logarithm Aggregate Money Supply
LR	Lending Rate
LR	Likelihood Ratio Test
M1	Aggregate Money Supply
OLS	Ordinary Least Square
PP	Phillips-Perron Test
VAR	Vector Autoregression Test

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CHAPTER ONE

INTRODUCTION

1.1 Introduction

The aim of this study is to examine the monetary policy, inflation rate, and stock market in Malaysia. The issue of monetary policy, inflation rate and stock market has become an important topic in Malaysia's economic environment. The central bank, Bank Negara Malaysia (BNM), is entrusted with the responsibility for the formulation and implementation of monetary policy to attain price stability in the country.

Monetary policy, specifically interest rates, is an important tool to ensure growth and stability in the economy of a country. The government will set the interest rate according to the prevailing economic conditions. If they feel that there are significant inflationary pressures in the economy, they will tend to increase the level of interest rates. This will discourage borrowing and therefore reduce aggregate demand.

Before the mid-1990s, monetary policy strategy was based on monetary aggregates targeting. Monetary aggregates targeting ensure that the excess liquidity does not translate into acceleration in loans, which will in turn expand money supply beyond its target rate and hence fuel inflation. However, subsequent developments in the economy and the financial system during the early 1990s weakened this relationship and highlighted the problems associated with using monetary aggregates as policy targets.

Towards the mid-1990s, BNM shifted its focus from monetary aggregates targeting to interest rate targeting. BNM still monitors, very closely, monetary aggregates, credit

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