# Testing Long-Run Monetary Neutrality in Malaysia: Revisiting Divisia Money

Chin-Hong Puah[a♣], Muzafar Shah Habibullah[b], Evan Lau[a] and Shazali Abu Mansor[a]
[a]Faculty of Economics and Business, Universiti Malaysia Sarawak
[b]Faculty of Economics and Management, Universiti Putra Malaysia

**Abstract**

This study re-examines the long-run neutrality (LRN) of money on real output in Malaysia using quarterly Divisia money data from 1981:1 to 2004:4 based on Fisher and Seater's (1993) nonstructural reduced form bivariate ARIMA model. Special attention has been given in identifying the number of unit root and cointegrating vector, as a meaningful LRN test is critically depends on such properties. Empirical results indicate that LRN is deviated from Malaysian economy when Divisia money is used. In particular, Divisia monetary expansion seems to have long-run positive effect on real output in Malaysia.

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**Keywords:** ARIMA Model, Divisia Money, Long-run Neutrality of Money

## 1. Introduction

There are voluminous studies in finding out the influence of money on real economy activity. Different methodologies and models have been applied to test the empirical validity of money in order to give the answer whether money is a viable monetary policy variable. Literature shows that most of the earlier studies on money use different level of monetary aggregates such as M1, M2 and M3 to evaluate the performance of money. Until 26 years ago, the traditional or simple sum monetary aggregates are the most commonly used measure of money in the empirical literature. However, the use of simple sum monetary aggregates has received much criticism because it is inconsistent with the microeconomics and statistical index number theory.

In the simple sum aggregation method, different monetary component assets are given the same weight. In other words, the component assets are regarded perfect substitutes. This implies that coins and notes are assumed to provide the same transactions or liquidity services as interest-bearing deposits such as savings deposits or time deposits within the broad monetary aggregate. Clearly, this assumption is not valid in the context of optimizing agent. In reality, nevertheless, it is obviously that the different monetary components included in the broad monetary aggregates are actually imperfect substitutes. Generally, the role of coins and notes are limited to the function of media of exchange to facilitate market transactions. They do not serve as a

♣ Corresponding author: Chin-Hong Puah, Department of Economics, Faculty of Economics and Business, Universiti Malaysia Sarawak, 94300 Kota Samarahan, Sarawak, Malaysia. E-mail: chpuah@feb.unimas.my