Testing the Effectiveness of Monetary Policy in Malaysia Using Alternative Monetary Aggregation

Abstract
The capability of monetary aggregates to generate stable link with fundamental economic indicators verifies the effectiveness of monetary targeting. However, traditional monetary aggregates have become flawed when financial reforms take place. As official monetary aggregates fail to maintain stable link with crucial economic indicators in Malaysia, monetary targeting has been substituted by interest rate targeting. Therefore, Divisia monetary aggregates, which are considered more superior than the simple sum counterparts are used in the investigation for the case of Malaysia. The findings imply that Divisia M2 money demand is stable and is capable to generate appropriate coefficients with correct signs for the variables included. Thus, Divisia money has shed new light on the usefulness of monetary targeting in formulating monetary policy in Malaysia.

Keywords: Divisia money; Money demand; Error-correction model

JEL Classification Codes: C22, C43, E41