REVISITING MONEY DEMAND IN MALAYSIA: SIMPLE-SUM VERSUS DIVISIA MONETARY AGGREGATES

Chin-Hong Puah♣*, Choi-Meng Leong, Shazali Abu Mansor and Evan Lau*
Department of Economics, Faculty of Economics and Business,
Universiti Malaysia Sarawak,
94300 Kota Samarahan, Sarawak, Malaysia

ABSTRACT

This paper attempts to determine whether Divisia Monetary Aggregates is a superior monetary instrument in Malaysia where monetary targeting has been replaced by interest rate targeting due to the inadequacy of the monetary aggregates in predicting imperative economic activities. Is there any discernible evidence to suggest that Divisia monetary Aggregates possess significant relationship with the macroeconomics indicators? The empirical results in this study indicate that Divisia M2 performs excellently in the money demand function of Malaysia that incorporated the financial reform and financial development variables. The significance of Divisia money validates the usefulness of monetary targeting to formulate monetary policy in Malaysia.

Keywords: *Divisia Money, Money Demand, Error-Correction Model*

INTRODUCTION

The interest on the study on money demand has continued to draw considerable passion among researchers. The posit between monetary policy instruments and macroeconomic variables is well accepted in the field of monetary economics, where the monetary targeting and the interest targeting are the two major intellectual debates in this field. Arguments on the instrument used in monetary policy stemmed from the evolvement of the financial markets globally. There is substantial evidence in the developed countries to suggest that the Divisia monetary aggregate is a superior monetary targeting than interest targeting for these developed nations. Divisia definition of money emerges as simple-sum monetary aggregates are distorted due to the financial reforms Is this phenomenon also true for emerging economies nations particularly Malaysia?

The monetary policy that based on monetary targeting as intermediate policy target is critically depends on the role of money as the transmission mechanism to achieve macroeconomic stability. The traditional monetary aggregates such as M1, M2 and M3 are constructed and employed by the monetary authorities in most of the countries. These monetary aggregates are also named as simple-sum monetary aggregates. However, simple-sum definitions of money become flawed attributable to the financial innovation and liberalization. Simple-sum measures of money fail to maintain a stable relationship with the fundamental macroeconomic indicators such as

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♣ Corresponding author: E-mail: chpuah@feb.unimas.my

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