THE RELATIONSHIP BETWEEN INFLATION, EXCHANGE RATE 
AND STOCK PRICES TOWARD GDP IN MALAYSIA

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ABSTRACT

The purpose of this study is to investigate the relationship between inflation, exchange rate and stock prices toward GDP in Malaysia as less similar studies were found. Through this study, the existence of bidirectional relationships of inflation, exchange rate and stock prices to GDP were determined as the interaction between these variables are importance as indicator for the health of economy in Malaysia.

This study was carried out using quarterly time series data from period of 2000 to 2011 in where GDP as dependent variable while inflation (CPI), exchange rate (NEER) and stock prices (SP) as independent variables. The empirical analysis choose were Unit Root test, Johansen Cointegration test, Granger Causality test and Vector Error Correction Model. The result for inflation and exchange rate to GDP was not significant as well as GDP does not Granger cause inflation, exchange rate and stock prices. While for stock prices, there is unidirectional result from stock prices to GDP. This means the economic growth is affected by the fluctuation of stock prices whereas the stock prices are not suggested to predict the growth of GDP.

In conclusion, the stock price is a good economic indicator to be emphasized by the Government financial policy to stabilize the economic growth.

Key words: Inflation, Exchange Rate, Stock Price, GDP, Granger causality method.
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CHAPTER 1

INTRODUCTION

1.0 Introduction

In September 2008, there is a global financial crisis that attacked global economic due to the default of the subprime mortgage in the US country which accelerated into a deep crash in international trade, serious global financial crisis and led to global depression. Among those Asian economies, Malaysia is one of the most badly affected countries from this external shock. The exports, industrial output and investments were deteriorated as well as consumer sentiment was negatively affected. This resulted in December of 2008, the GDP growth of Malaysia was drastically low at 0.1% compared with an average of 5.9% in the beginning of the year. The actions taken to overcome the recession by Bank Negara Malaysia (BNM) is depreciated the exchange rate and also cut 150 basis points of policy rates.

Information regarding this issue in Malaysia remains widely unclear. As one of the developing countries, the economy situation in Malaysia is fast growing, however, further stimulation is indeed needed. Therefore, increment of intellectual curiosity on the importance of the role of consumers, foreign investors or cooperate in affecting the GDP in Malaysia. Following this, the major idea of this study is to use of macroeconomic indicators, such as inflation, stock prices and exchange rate to reflect the GDP in Malaysia.

The definition of inflation is the increase average price of good sustain for a period of time that reduces purchasing power. Where it is very much difference from the increasing price
of goods once in several months, several times in several months or few times in a year. In addition, the increase price of good during festive season is assumed as inflation because it only happens twice a year and is not sustain. Economists consent that high rates of growth of the money supply will lead to high rate of inflation. For example, if an employee’s wages remain steady, but the costs of goods had been increased, then that employee only afford for less goods.

There are three categories of inflation namely demand-pull inflation, cost-push inflation, and monetary inflation. Cost-push inflation is caused by the increment of wage that leads businesses to raise prices to cover the production costs such as labor costs and raw materials. Demand-pull inflation is due to rise in the price of services and goods result through the increment of consumer demand. While monetary inflation is the expansion in money supply due to the reason of government has printing more money to cover its deficits.

Normally the inflation is measured on the percentage rate. The normal rate of the inflation is different from various countries. Before 1960 in Malaysia, the inflation of normal rate for Malaysia is 2% a year. There is large signal of inflation occurred from the year 1970 to 1974; therefore the normal rate had increased to 5% a year. While the normal rate of many countries in the world during that period is 10%. Now the normal rate of Malaysia inflation is less than 5% per count or per year. As the figure below, the inflation rate of Malaysia is high due to financial crisis during the period of 2008. The Malaysia nominal rate is more than 8% during that period.

On the other hand, stock prices and exchange rate both also play important tasks in the advance economy of a country. In general, the volatility of foreign exchange rate influences the firm’s value as the fluctuations of foreign exchange rate will cause changes in the firm’s future
cash flows. According to Joseph (2002), the international firms' competitiveness will directly influenced by the changes of exchange rate, and hence influence the output and input price. Once the exchange rate increases, the exporters are then loss their international competitiveness while the profits and sales of exporters get smaller and cause the decrement of stock prices. In contrast, the stock prices and profits will increase when importer do the increment in the competitiveness of domestic market. Stock prices can be affected by exchange rates in domestic firm other than export-oriented and multinational firms.

For domestic firms, it might be affected through the exchange rates changes since the firms export the outputs and import the inputs. In multinational firms, an instant value change of foreign operations and ongoing transform in prosperity of foreign operation were resulted by the changes of exchange rates and replicated in succeeding income statements. Hence, the stock prices might be influenced by the economic value changes of foreign firms.

![Malaysia Inflation Rate](http://www.tradingeconomics.com/malaysia/inflation-cpi)
1.1 Inflation in Malaysia

Due to the local trade act had caused the value of ringgit has turn down and lowering. Previously, the value of ringgit can buy good in certain quantity by increasing the price of good. Currently, the value of ringgit has move downward where less quantity can be bought for the same good as compared to last few years. The example of local trade act is the price of rice. In 2006, the price of 1 kg rice is RM 2.00. While in 2007, it had increased to RM 2.50 with the same quantity of good. This means the price of same good had been increased as 25% as compared to the previous year. Therefore, the inflation is actually decreased the purchasing power to the households.

According to economist speculation, it will caused by shock demand. News as increasing future price had lead consumers to purchase good in bulky quantity in where usually makes that certain good been out of demand. The local retail hide the stock in order to decrease demand and increase the price of good that had actually caused the inflation rate increased.

The other factor caused inflation in Malaysia is the increment of crude oil price. The increment of crude oil had infected increases of country gas price because the Government no longer stands the subsidies increase. The high price of natural resource has increased the price of local gas from RM 1.92 to currently RM 2.80 per liter. This is then going after the increment of local goods such as flour, rice, cooking oil, and others. The local broker at the same time take advantages on increment of the prices of goods with the reason of increment of oil price.
Figure 2: Malaysia Consumer Price Index, CPI
(Source: http://www.tradingeconomics.com/malaysia/consumer-price-index-cpi)
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Table 1: Consumer Price Index for Main Groups, Malaysia
(Source: http://www.statistics.gov.my)
1.2 Policies

Macroeconomic policies are divided to two main types of policies. Firstly is the fiscal policy, which related to Government initiatives such as taxation, spending and borrowing. Secondly is monetary policy which involved currency policy such as devaluation, cash flow that to control interest rates. These policies are the strategies that Government will be applied to overcome and control the inflation in Malaysia as well as determine present and future actions.

1.2.1 Monetary policies

Monetary policies help to determine the size and growth rate of the money supply to stabilize the market. There are few instruments to be used in monetary policies to control the inflation, namely open market operation, reserve requirements and discount window.

Open market operations comprise buying or selling of Government bonds, however it is depends on whether the central bank desires to increase or reduce the money supply. Through buying Government bonds from the public, to position additional money into circulation be able to raise the money supply. Conversely, capability of loan and money supply can be reduced by selling the bonds to public. The reduction of loan offering is to prevent the flowing of money in the market.

While for reserve requirements, the central banks will reserve certain amount of funds to achieve unexpected outflows. For higher reserve requirements, banks will be required to reserve
more money, lending less money and vice versa. The reduction of money supply in the market directly declined the consumers’ purchasing power.

Discount rate is the interest rate tariff by the central banks as loan to the financial institutions. Central banks used discount rate charge to control money supply, reduced the outflow of money and to reduce the loan offering.

Central banks used the available information such as economic and monetary statistics up to prior month, followed by evaluation of the present state of the economy at each end of time. Then monetary policy is conducted to accomplish policy targets in the future. The central bank will constrict the monetary policy such as mopping up overload liquidity, if there is an inflationary stress. Nevertheless, the process of tighten monetary policy required several months to reflect the inflation rate.

During Asian Financial Crisis 1997, the Malaysia ringgit was dealing freely all over the world. Previous to the crisis, the Ringgit was traded in Rm2.50 against the dollar. After the crisis, the Ringgit was fallen to RM4.10 at the dollar in a period of few weeks. The nation’s central banks, Bank Negara Malaysia, decided to impose capital controls to avoid the Ringgit to be outflow in the open market. Therefore, the Ringgit is not exchanged internationally; the tourists need to proclaim themselves to the central bank if bringing out exceed than RM10, 000 from Malaysia and the Ringgit was traded at RM 3.80 to US dollar.
1.2.2 Fiscal Policies

Fiscal policies are usually related to Government spending and taxation as to control and observe the economy. The Government can transform in effect to modify the sum of disposable income available to its taxpayers by altering the tax laws. If taxes were increased, consumers would have less disposable income and meaning it would have less money to be consumed. The Government could choose to rise their spending directly to private companies by purchasing goods and services, at the same time stopped the development plan to avoid the outflow of money to market.

1.3 Stock Prices and Exchange Rate

In Malaysia, the economic conditions were influenced by the Global Financial Crisis in 2008. The instability of international financial markets had overflow inside the domestic financial markets. After amendment in stock market and currency, the decrement of export and domestic demand had turned Malaysia to launch an expansion contributing policies. The institution that influenced was stock market in Malaysia. For Malaysia, the main stock exchange is the Kuala Lumpur Stock Exchange (KLSE). Therefore, the main index of KLSE focused in this study is Kuala Lumpur Composite Index (KLCI). KLCI was established in year of 1986, and currently known as FTSE Bursa Malaysia KLCI where present as an exact performance indicator in stock market of Malaysian plus the economy of Malaysia.
During crisis 1997, the overnight rate had jumped from below 7% to over 40% which had caused rating downgrades and sold off stock and currency markets. The KLSE had lost half of the rating from above 1200 to below 600 during the end of 1997. The Malaysia Ringgit had lost 50% of its value, fallen to less than 4.57 from above 2.50 to the dollar. Malaysia’s Prime Minister, Tun Dr. Mahathir Mohamad obliged authoritarian capital controls and established the 3.80 pegs against the US dollar. With clogged the trading abroad for ringgit currency and other ringgit assets had lead to offshore make use of the ringgit unacceptable for one year. This had stopped the sources of ringgit been outflow that investors borrow from to manipulate the ringgit such as short selling. In Sept 1998, Malaysia had overcome the crisis.

Stocks in Malaysia had a positive performance and above expectation during year of 2010. The Ringgit of Malaysia which was just over 9% against dollar had gave the foreign investor a double grow as the equity and currency returns for those buying Malaysian stocks had earned a return of 29% during that year. In the beginning of year 2012, the KLCI showed a dynamic uptrend configuration as well as breaking historical high for 1655 points in the month of August (Figure 5).

In recent years, the mission of appraising the movement of Ringgit is certainly complicated as the upward volatility in global exchange rates. The possible influence among all of the total forces that might affect the movement of Ringgit would be the outpouring of portfolio investment and perhaps it is the mainly vital in verifying the movement of the Ringgit. Moreover, the Ringgit will have restricted upside RM3 level against US dollar for to the reasons such as the funds into US dollar-denominated assets is in growing trend as the US economy remains to release positive hints; the Malaysia’s economy is predicted in lower growth while Asia on the
hole following the lag effects of the European economic turmoil and others (Alias & Rashid, 2011).

Figure 3: The Malaysia stock prices, Kuala Lumpur Composite Index (KLCI) (Source: http://www.btimes.com.my/Current_News/BTIMES/articles/snock/Article/)
Figure 4: The long term trend analysis of FBMKLCI
1.4 Inflation, Stock prices and Exchange Rate

The movement in exchange rate can cover either direct or indirect result on inflation. The alteration in exchange rate will straightforwardly influences the prices of the goods that to be imported.

In a small economies, stock market acts an important character in mobilizing the resources within and from outside of an economic to enhance economic potentials. Therefore, higher stock returns implied higher profitability by firms and corporate bodies, in turn affect the growth of economy and vice versa. According to Fama (1981), the variables such as exchange rate, interest rate, industrial production, and inflation would be reflected by stock prices. This also supported by Ratanapakorn and Sharma (2007) on investigation the long run relationship between US stock prices and industrial production. They found that there is positive relationship between stock prices and inflation as well as exchange rate in long-run relationship using Granger causality test.

When domestic currency increase adjacent to the counter country currency, the domestic exports value will be declined and escorts to loss and decline in stock prices. On the other hand, there is positive effect on import oriented country when exchange rate has decrease, in where declined the cost of imports and at the same time the competitive among importers will raise in domestic market. This will decline the stock prices and profits.

According to Jorion (1990), the exchange rates were ten times as explosive as inflation rates while it is four times as explosive as interest rates. If there is alter in exchange rate, brings the meaning of foreign exchange risk for those investors. There will be big losses for the
investors, if there are high fluctuations in exchange rates due to uncertainty return of investments. For international market, the movements in foreign exchange rates will affect the prices of goods and thus affects the profit margin of exporting and importing companies.

Wu (2000) explained the relationship between stock prices and exchange rate through a inflationary disturbance and real interest rate. The real interest rate happen when interest rate increases, the capital inflow will be increases and lead the decrease in exchange rate. Due to the current value of future cash flows has been declined by greater real interest rate, it has decreases stock prices. Once the inflation increases, the exchange rates will increase, and lead to great inflation expectations. This is because the investors will request high rate of return and a higher risk premium which causes decrement of stock prices. In where explained the inflationary disturbance where negative relationship between stock prices and exchange rate.

By looking at Gross Domestic Product (GDP), is the best alternative to understand the country's economy, which refer to total amount of goods and services a country produces. It is dangerous if GDP increases greatly, as it will mostly come with an increment in inflation, which erodes stock market raise by decrease the value of money. While for stock price, is the primary macroeconomic indicator of strength and development for a country (Shahbaz, Ahmed, & Ali, 2008). The future economic condition could be predicted when the stock prices move upward or downward, due to the demand and supply of stock prices. The movement of stock prices always reflects the economy condition. For example, a fall in stock prices will discourage investors from investing in stock market which is then lead to inactive of economy.
1.5 Problem Statement

According to Granger et al. (2000), the causality direction between inflation, stock prices and exchange rates are empirically and theoretically inconclusive. Currency depreciation could either increase or decrease the company value and the stock prices are estimated to respond ambiguously towards exchange rate. However, it is still depends on whether the main trading of firms, either mostly exports or imports. The appreciating of stock prices acts as indicator of economic expansion which expected to lead in higher inflation. The direction and relationship of these three variables applicable during crisis is still unknown in Malaysia case. Moreover, there was some research found on these variables shown unidirectional causality also bidirectional relationship as well. Thus, there is need to find the direction and importance of the interaction between these three variables in Malaysia. The result found from previous studies has changed consistent with the macroeconomic variables and research methodology used. Besides that, global inflation, stock prices and exchange rate have a combinatorial impact of overall health of economy in Malaysia. Studies on the trend of international economic fluctuation in relation to the run of Malaysian economy should be carried out. This is mainly due to the fact that the instability of stock prices has significant impact on the exchange rate and inflation in economic activities in Malaysia. This study will be able to outline the possibility of crisis in Malaysia occurs in relation to the variables mentioned or rather incidentally.

After global economic crisis in year 2008, the information such as relationship between variables namely inflation, exchange rate and stock prices still remain significant to each other or not should be found out as there is less study was found in Malaysia case. Also the directions of
inflation, exchange rate and stock prices toward GDP remain questionable. After the crisis, will these macroeconomic variables remain identical as theories concept are questionable as well. The example such as, the fluctuation of inflation affects the standard of living and the prices of goods, significantly impact on the economy of a country. Thus, after the crisis will the inflation still positively correlated with GDP? Similar questions applied to other variables as well.

Moreover, after the crisis, how long is GDP needed to recover back as the healthy economy in Malaysia is unclear. Same goes to other variables, in how long do those variables needed to recover to normal trend is interesting to be find out. Will the fluctuate of GDP, as dependent variable affect the independent variables, namely inflation, stock prices and exchange rate is being unconscious. With the information of relationship in between the variables could help in prediction or forecasting the economic growth of Malaysia. The actions such as depreciated exchange rate and cut of policy rates by Bank Negara Malaysia (BNM) to overcome the recession is really the working or not will be find out in this study.
1.6 Objective of Study

1.6.1 General Objective

The general objective of this study is to analyze the relationship between inflation, stock price, and exchange rate.

1.6.2 Specific Objective

The specific objective for this study included:

i. To determine the effect of macroeconomic variables namely inflation, exchange rate and stock prices that affect the growth of economy in Malaysia.

ii. To determine the existence of bidirectional relationship of the variable towards GDP.

iii. To suggest policy to stabilize the economy growth in Malaysia.