Is Money Neutral In Stock Market? The Case of Malaysia

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Summary:  
The objective of this study is to examine whether the notion of monetary neutrality hold in Malaysian stock market. Our findings indicate that there is considerable evidence against the long-run neutrality (LRN) of money in Malaysia’s stock market. The important implication is that the stock market is inefficient with respect to money supply. Agents might have the opportunity to gain excess profit from the stock market using the information on changes in the stock of money to predict the movements in stock indices.

Keywords: monetary neutrality, stock market, Malaysia, ARIMA model

JEL classification: C30, E50, G10

I. INTRODUCTION  
Stock market plays a significant role in the economic development of a country by acting as an impetus to economic growth. Its existence allows for efficient transfer of funds from economic agents in financial surplus to those in financial deficit. In particular, it facilitates long-term financing for both the public and private sectors, which are the engines of economic growth. As such, policy makers are very concern about the stock market reaction due to changes in macroeconomic variables in particular the money supply. It is important to determine the relationship between stock prices and money supply for the following reasons. Firstly, at the micro level, if money supply and stock prices are related, then investors can gain higher than average rate of returns from the stock market using the information on money supply changes. Meanwhile, at the macro level, it casts doubt to the ability of the market to perform its fundamental role of channeling funds to the most productive sector of the economy. Lastly, if the stock market is informationally inefficient with respect to money supply, then the monetary authorities can play an active role to stabilize fluctuation in the market (Habibullah et al., 1998).

The debate regarding the role of money on the stock market is among one of the most controversial issues in macroeconomics study. Policymakers try to take effective measures in conducting the monetary policy as they expect that changes in money supply can significantly affect real stock prices. However, most economists argue that once inflation is built into people’s expectations, monetary expansion will eventually lead to a higher level of