An MSI-VAR Approach on investigating the broad money supply and consumer price index in Malaysia

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ABSTRACT

According to monetarism, the money supply is the leading cause of increasing price level in the short and long run. Previous works investigated the effect of money supply on inflation in several countries; however, inconsistent arguments from these studies resulted in the exploration of the correlations between money supply and inflation via a different approach in this work. This study investigates the broad money supply and consumer price index (CPI) using the Markov switching vector autoregressive model. The CPI, with 2010 as its base year, was used as a proxy for Malaysia’s inflation. The broad money supply is defined as the sum of money and quasi-money. Other countries use different measurements; therefore, M3 was selected based on the monetary authority measurement of the money supply in this study. The transition probabilities and expected duration of the recession and upturn/normal states were examined using a two-regime switching VAR model. Furthermore, the Augmented Dickey-Fuller test, Johansen cointegration, and intercept adjusted MS-VAR model with the first-order Markov process was also used in this study to estimate the observables variables. The results confirmed significant transition probabilities in the state shifting and an asymmetric economic model representing broad money and inflation correlations in Malaysia.

Keywords: Broad Money; Consumer Price Index, Malaysia, Regime Switching, MS-VAR