The Relationship Between Monetary Policy And Fiscal Policy On The Business Cycle in Malaysia

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Abstract : The purpose of this study is to understand the relationship between monetary policy and fiscal policy on the business cycle in Malaysia. Monetary policy is represented by the money supply, exchange rates, government spending and taxes, while the business cycle is represented by economic growth. This study uses the period 1970–2017 by using the Vector Error Correction Model (VECM). We found that the money supply, exchange rate and government spending have a positive effect on the business cycle in Malaysia, however, taxes have a negative effect. This means that tax reductions in Malaysia have a positive impact on the business cycle in Malaysia which has an impact on increasing economic growth. Fiscal policy that is presented on tax and monetary policy in the money supply management policy has a direct impact on the business cycle in Malaysia.

Keywords: Business Cycle, Monetary, Vector Error Correction Model, Money Supply

JEL Classification : C10,M12,M2

1 INTRODUCTION

Every economy in the country always experiences a problem to be faced. One of the problems that always exist in a country's economy is the problem of the inflation rate. Where the inflation rate always appears both when a country's economy is experiencing growth or when a country's economy is experiencing a slowdown. Likewise the economy in Malaysia, there are always economic problems that always arise over time, including the problem of the inflation rate. Monetary policy and fiscal policy are policies that become tools in economic planning in Malaysia in order to control the macroeconomy. The two policies are closely related to four sectors, namely the household sector, the corporate sector, the government sector, and the international sector, which each have their own interactions in an effort to create government revenue and expenditure. What affects fiscal policy are expenditures and taxes, while those that affect monetary policy include GDP, inflation, exchange rates, and interest rates. Fiscal policy has an impact on the economy with State revenues and state expenditures, while monetary policy will have an impact on the money market and market for securities, money markets, and securities markets will determine the level of interest rates, and the interest rate will affect the aggregate rate. Fiscal policy will affect aggregate supply and demand, which in turn the aggregate demand and supply will determine conditions in the market for goods and services. Conditions in the market for goods and services will determine the level of prices and employment opportunities will determine the level of income and expected wage levels. Both will have feedback, namely, income will provide feedback on aggregate demand and expected wages have feedback on aggregate supply and money and securities markets.The macroeconomic policy taken by the government is a government effort to build the economy including monetary policy (Gitman, et al., 2015).

Monetary policy is a set of economic policies designed to regulate the size and growth rate of the money supply in the country's economy. Monetary policy is regulated in such a way as to help regulate macroeconomic variables. Monetary policy and fiscal policy are two policies that are the main tools for national economic planners to control their macroeconomic balance. Both are very closely related to one another so that in practice that is often encountered is a fiscal policy which also has monetary consequences or monetary policy with fiscal consequences Monetary control can be carried out in various ways, including open market operations, determination of discount rates, the stipulation of the mandatory minimum reserve, and credit and financing arrangements that can also be implemented using sharia principles. The impact of monetary policy itself is not directly affected by the real sector, but will first be felt by banking parties which are then transferred to the real sector. Fiscal policy is one justification for government intervention in influencing economic growth and activity. Fiscal policy is an effort or government action as a policymaker by varying tax revenues and state expenditures. Taxes and government spending are the main variables in fiscal policy. The objective of this fiscal policy is to stabilize aggregate demand and production levels. Monetary policies that can be implemented include deficit budgets, surplus budgets, and balanced budgets. Monetary policies set by the central bank and fiscal policies set by the government must be interrelated in order to be more optimal in overcoming the problem of inflation. Inflation as the main problem, not only can be controlled only by the government or the central bank, but both must coordinate with each other. The inflation rate itself is an indicator of economic stability, inflation is considered a very important economic problem, this is what causes inflation to become the main target that must be controlled by the government. Inflation itself is a phenomenon of increasing prices in general and continuously. A stable inflation rate means sustainable economic growth can be achieved, conversely, if the inflation rate cannot be controlled, inflation will affect the economy as a whole, such as monetary policy set by the central bank will affect the money market, and the money market will determine the high and low-interest rates, and the interest rate will affect the aggregate rate. Fiscal policy set by the government will affect aggregate supply and demand, which in turn will determine aggregate supply and demand conditions in the market for goods and services.Economic growth is the result of economic development and is an indicator of macroeconomic performance (Bogoviz, 2020).

The economic policies adopted by the government naturally have an effect on the economy such as the money supply, the exchange rate, and inflation. Inflation cannot be stopped without deliberate restrictions on the growth of the money supply. But once interest is raised, it naturally extends to the inflation cycle. (Dunning, 2014).When the inflation rate is unstable, there will be an increase in the prices of goods and services in general, and will occur within a certain period or period. When there is an increase in the prices of goods and services as a whole, it will cause a decrease in people's purchasing power because the prices of goods and services are considered too high, as a result, the goods and services produced are not sold out and cause losses for producers and producers will not make additional investments. So that the level of investment will decrease and will cause a decrease in the level of national income. So that it takes the role of government in the economy aimed at solving problems that arise in the economy of a country. For example, inflation occurs in line with economic growth, unemployment continues to increase, and also a deficit in the balance of payments. The uncontrolled inflation rate will certainly cause other economic problems. Therefore, the government was led to resolve the existing inflation rate problem. From a theoretical perspective, fiscal policy is an action or policy carried out by the government in influencing the economy, actions used in influencing the economy are by influencing state revenues and expenditures with the aim of increasing economic growth and economic stability. The two instruments of fiscal policy, namely revenue and expenditure are very important because these two instruments are closely related to the state budget. With the regulation of the state budget, it is hoped that fiscal policy can create a stable and growing economic condition. Fiscal policy has a very significant influence on the economy, fiscal policy through government spending has a multiplier effect on the economy, this opinion was expressed by Keynes. In suppressing the inflation rate in Malaysia, apart from fiscal policy, also through monetary policy. Monetary policy is a policy in terms of maintaining the stability of the value of money and also regulates the amount of money circulating in society so that the circulation of money can encourage economic growth, wherein encouraging economic growth monetary policy has policy targets, namely economic growth and equalization of income, employment opportunities, the stability of inflation rates and balance of payments balance.

Inflation is one economic indicator that needs attention. Where the inflation growth rate is strived to keep it low and stable, this is because the instability of inflation will cause economic problems which will later have an impact on economic instability. In addition to interest rates, the monetary policy instrument used in the regulation of the money supply. By determining the money supply, it is hoped that it can affect economic growth and also the inflation rate in Malaysia. By increasing the money supply, it is expected to be able to influence the level of consumption in society. But on the other hand, it will cause an increase in the inflation rate. From the facts, it turns out that the inflation rate set by the monetary authority from year to year is always not on target. So that raises the question, what is the relationship between fiscal and monetary policy and inflation in Malaysia? Because the inflation target that has been set always misses the demand for money in a society is a certain proportion of the volume of transactions, and the volume of transactions is a constant proportion of national income. So the demand for money will be affected by national income only, and not influenced by other factors such as the interest rate. In addition, the equilibrium level of national income cannot be influenced by fiscal policy. The money supply has a positive effect on inflation. where when there is an increase in the amount of money in circulation, it will encourage an increase in the price level beyond the expected price level, so that it will disrupt economic growth. in turn, will result in a low inflation rate.

Furthermore, the statement that inflation is a monetary phenomenon implies that the high inflation rate will not continue if it is not accompanied by a high growth rate of money in circulation. The behavior of the public is holding wealth in the form of money because money is liquid so that it is easily exchanged into other forms of wealth. But on the other hand, if you hold wealth in the form of money, you will sacrifice the opportunity to get profit in the form of interest income if you hold wealth in the form of securities. The interest rate has a relationship with the inflation rate, when inflation is deemed too high, the interest rate is raised, thus giving consideration to money holders to place their funds in the bank because it has high returns. The desire to get a profit from the funds they have causes the public to place their funds in the bank, with the rate of circulation of money in the community that will be reduced and ultimately will reduce the rate of inflation that occurs. When the government adds the amount of government spending, it will affect growth in the real sector, with the growth of the real sector will reduce the inflation rate because of the balance between demand and supply. While from the monetary side, the interest rate and the money supply are used to regulate economic stability and the inflation rate by regulating the circulation of money.Real economic factors are the key to economic growth. Investment has played an important role in business cycle theory receiving new emphasis as a result of the Keynesian revolution. Investment is the motive force of the economy. When the economy is slowing down, effective economic policies are needed to restore the economy (Melicher & Norton, 2013). Stable inflation is the main target aimed at the central bank. The reputation of the central bank governor is very much at stake whether it is able to control inflation or not. Constant and stable inflation is the optimal policy to encourage the zero output gap. Even though it is not exclusively the central bank that can help reduce inflation, the government can also control inflation, especially inflation that comes from the supply side. The Output Gap or Gross Domestic Product (GDP) Gap is the difference between potential GDP and actual GDP. The GDP Gap calculation is Y-Y *, where Y is actual GDP, and Y * is potential GDP. If the calculation result is positive, it is known as the inflation gap, which indicates that GDP growth from the demand side exceeds the supply side, which in turn will encourage inflation; otherwise, if the result is negative it is known in terms of a recession gap, which is likely to push the occurrence of deflation (Warjiyo & Juhro,2019).

There is a strong consensus that inflation should not only be stable but should also below (most central banks target around 2 percent). Low inflation has led to a discussion about the impact of low inflation on the possibility of a liquidity trap, meaning that in line with low inflation is a low nominal interest rate, which makes it difficult to reduce nominal interest rates, in other words, room for expansion of monetary policy in the future. the crisis becomes limited. However, concerns about a liquidity trap position due to low inflation have received criticism. Monetary policy only focuses on one instrument, namely controlling interest rates, which means short-term interest rates where the central bank can directly control open market operations. The reasons for choosing this interest rate policy are based on two assumptions. First, the real impact of monetary policy occurs through interest rates and asset prices, not through policies directly affecting the money supply. Second, all interest rates and asset prices are linked through an arbitrage mechanism, so that the long-term interest rate is the weighted average value of the (i) adjustments to the risk of short-term interest rates in the future; and (ii) asset price adjustments which fundamentally risk adjustments from the present value of the asset price. Based on these two assumptions, the central bank only needs to influence expectations of one short-term interest rate (the central bank's interest rate), so other interest rates will automatically follow. Thus, intervening in more than one market, for example in short-term interest rates and also long-term interest rates for the bond market, is an inconsistent policy; and the form of policy repetition (redundant). The two assumptions above also underlie that monetary policy does not have a significant impact on financial institutions, except for the banking industry (particularly commercial banks), for reasons among others: Bank credit is considered unique, in the sense that it cannot be substituted for credit mechanisms from other financial institutions, so this leads to the importance of the credit channel where monetary policy can also influence economic activity through the number of bank reserves (quantity of reserve), and ultimately the amount of credit. banks distributed to the public (Mishkin ,2007).

Banking is an institution that transforms liquidity, originating from savings deposits (short-term in nature) then distributed to the public in the form of loans (long-term in nature). If a crisis occurs, and the central bank subsequently applies a policy to increase interest rates, it is feared that there will be a mismatch in the bank's balance sheet. The crisis, which causes depositors to withdraw their funds from banks, will lead to a bank run. Because depositors withdraw their money from the bank, while the bank runs out of funds (it takes a long time for the borrower to return the money because it is long term). A bank run occurs when a large number of customers take their deposits because these customers believe that the bank is in an insolvent position (a condition where the company does not have the ability to pay its debts), or is headed for insolvent in the future. When the bank run occurs continuously, the bank run will go to a self-fulfilling prophecy position, which is a condition where the more customers take their deposits, the greater the default condition will occur and continue to encourage other customers to drain their deposits. This in turn will push the bank into bankruptcy.

2 LITERATURE REVIEW

Demand for money represents the total money people want to hold, rather than storing it in other assets such as stocks and bonds. Central banks try to match the money supply with their demand to control inflation. People need money to pay for various transactions. They prefer cash over financial assets for liquidity and security reasons. By holding money, people can use it whenever they need it. This is different when we hold financial assets, which take time to cash in because we cannot pay directly with those assets. In aggregate, the demand for money for transactions is positively related to GDP size and average transaction size. The higher the two, the greater the demand for cash. People hold extra cash for necessities or unforeseen circumstances that require cash outlays. In general, individuals hold cash to cope with uncertainties regarding income, living expenses, unaffordable medical expenses, and imperfect insurance coverage. In this case, demand is positively correlated with total transaction volume, average transaction size, and overall GDP. Speculative demand is related to the choice between holding cash or investing it in multiple assets. By saving cash, people can immediately use it for transactions. But it also means they miss the opportunity to get more money on their investment returns. In general, speculative demand is inversely related to the rate of return on various assets such as deposits, stocks, and bonds. At the same time, demand is positively related to the perceived risk in the asset. The higher the risk, the more people are reluctant to invest in assets and more likely to choose to hold cash. Economists explain that the demand for money is a function of income and price, ceteris paribus. When income goes up, demand will increase. Likewise, when prices rise (inflation), people need more money to buy the same quantity of goods and services. The frequency and average size of transactions affect demand. When the two increase, people need more money to buy. Most people keep their money in the bank, especially when other financial assets such as stocks and bonds are not yet developed. Therefore, the interest rate is an important determinant of the demand for money. When interest rates rose, people would rather save than hold cash.The demand for money is the same as the demand for cash in today's modern era. The demand for money is driven by the needs of public transactions so that money is demanded to be exchanged for available goods and services. When the demand for money rises, it encourages interest rates and public consumption which has an impact on economic growth. Stable demand for money can reflect economic stability because fluctuations in money demand have an impact on fluctuations in exchange rates and interest rates, resulting in economic turmoil. Monetary policy is needed in maintaining the stability of money(Handa, 2008).

The definition of inflation is the increase in the prices of goods and services in a country in the long term or continuously caused by an imbalance between the availability of goods and money. In essence, even though people have a lot of money, this does not rule out inflation. After discussing the definition of inflation, the causes, effects, calculations, and ways of dealing with inflation will be discussed. Inflation can be interpreted as an increase in the prices of goods and services in general and continuously within a certain period of time. Deflation is the opposite of inflation, which is a general and continuous decrease in the price of goods(Baiden,2012). Likewise, at the time of determining the minimum wage, traders also increase the price of their goods even though the wage increase is not too significant in driving an increase in demand. Low and stable inflation is a prerequisite for sustainable economic growth which in turn provides a profit. to improve people's welfare. Inflation can erode people's purchasing power. If purchasing power decreases, people become frugal in shopping. Even though the driving force of the Malaysian economy is still supported by public consumption. If people reduce spending, national economic growth will automatically move slowly or stagnate, even lower. Inflation is of course detrimental to consumers because wages or income are stagnant, but expenditures or expenditures swell as a result of rising prices for goods or services that are the main needs. Inflation also affects a country's exportability. As a result of inflation, export costs become more expensive and the competitiveness of export products decreases. Finally, foreign exchange decreased. Inflation will reduce people's interest in saving at the bank. The reason was that the small savings interest rate was eroded by inflation. In addition, saving at a bank also incurs an administrative fee every month, so that the interest earned by customers decreases almost imperceptibly. Inflation can affect currency stability.Inflation control can be done through contractionary monetary policy. By reducing the money supply in an economy by lowering bond prices and rising interest rates. This has an impact on people's spending or consumption because when there is less money to use, when people who hold money or have money prefer to keep money, the demand for money will decrease because transactions are reduced so that the money supply decreases and inflation can fall. This shows that the money supply has an impact on inflation. (Hutton, 2012).

The quantity theory of money is one of the theories studied in monetary science where monetary science is a branch of economics that studies the theory of money to understand money itself. (Stimson et al. 2013).Based on the quantity theory of money, when the amount of money increases, it will encourage public transactions and consumption so that the demand for goods and services increases. Because of the demand for goods and services increases, it has an impact on rising prices for goods and services. When price increases are generally accepted, inflation occurs. So it can be said that an increase in the money supply drives inflation (Clarke, et al. 2019; Bawono, et al., 2019).Based on business cycle theory, price increases are not driven by the money supply. But from the real business activity cycle. This of course goes against the quantity theory of money. Based on business cycle theory, the business sector has a cycle where when the business cycle is optimistic or is experiencing an increase in demand, production will follow suit and prices will also follow suit. However, when the business sector is in a pessimistic cycle demand will fall and prices will follow suit. (Hartley, et al. Al., 2013; Vroey, 2016). Inflation occurs due to increased demand from the public. The increase in demand for certain goods and services is one of the things that can cause inflation. This occurs because the needs for the goods or services requested are not available. While the public demand for it is getting higher, and this is what causes the scarcity of goods on the market. Not only is the high demand from the domestic community, but the increasing demand for goods to be exported abroad is also one of the causes of inflation. In addition, the increasing demand for shopping for the government and the private sector is also a factor that can lead to inflation. Inflation is caused by increased costs for production. When the demand for an item is high, the raw materials to be used are also scarce because of this. This is another factor that causes inflation. These goods will be much more expensive than before, while the related companies must continue to produce the goods that are being demanded by the market so that production is also choked up. Not only that, the increase in fuel prices and workers' wages is also an obstacle for producing companies so that they are unable to meet market demand. Meanwhile, public demand is getting higher for the desired goods or services. There is an imbalance that causes inflation. This inflation is caused by the high circulation of money in society, so that it becomes more than needed. This can happen when the number of goods on the market is fixed, but the money circulating in society has doubled. Then there can be an increase in the prices of these goods, even reaching an increase of up to 100%.

The imbalance between the flow of goods and money circulating in society is what causes inflation. That is the reason why the government does not simply print large amounts of money to pay off state debts and others. Because when the amount of money in circulation is more, it can cause inflation in that country. Inflation does not always have a negative impact on the economy, there are several positive things that result from this inflation. The following are the effects of inflation in each sector, both negative and positive impacts. While inflation will have some people who will be affected by both good and bad impacts in terms of their income. Businessmen will experience this positive thing when there is soft inflation. They will expand production activities so as to improve their economy. Meanwhile, workers who have regular income will feel negative. Because the value of the money they get is fixed, while the price of goods or services rises, export activists will feel the negative impact. Because export costs will soar when inflation occurs. Not only that, these exported goods will be less competitive with exported goods from other countries. As a result, foreign exchange earnings from exports decrease. When inflation occurs, a person's interest in saving reduces. Because the interest earned will be smaller, while they have to keep paying the administration money for their savings (Solanki & Sen,2015).

The inflation that occurs makes it difficult to fix the price of a basic commodity. Because the price set can be too big or too small. Predictions made to predict future inflation are often incorrect.This is the reason why the selling price and cost of goods are determined incorrectly. So that it makes producers into difficulties and the economy becomes chaotic. Fiscal policy is a step to deal with the problem of inflation by regulating government spending and revenue. You do this by saving on government spending, this one method has been proven to be able to overcome inflation in a country. In addition to reducing its spending, the government can take other ways, namely by increasing the tax rates for households and companies. This method can reduce the level of consumption of consumers so that the prices of goods can fall. Monetary policy aims to maintain monetary stability so that people's welfare can be increased. The first way of monetary policy is to limit the amount of money in circulation. The central bank must make decisions and determine the availability of cash in other banks. Another way is by increasing the interest rate so that many people are interested in saving. The next way is to use an open market operating policy, which means selling securities to reduce the amount of money in circulation.Inflation targeting is an alternative economic policy that is currently being chosen by many countries. Inflation targeting is more focused on maintaining the inflation rate in the economic policies taken and considered the best for the economy by policymakers.(Gerdesmeier, 2011).Economic instability can of course disrupt a country's economy. Both excessive deflation and excessive inflation. Inflation targeting aims to maintain economic stability with targeted economic growth in order to achieve economic growth accompanied by improvements in social welfare. This of course requires serious attention and understanding for policy makers in a country at the national level (Grauwe & Ji, 2019).

Changes in the money supply always affect macroeconomic indicators such as inflation, economic growth, trade, and fiscal and monetary policy (Jacobs, 2012). Monetary policy is the policy of the state authority in maintaining the stability of the money supply and interest rates that have an impact on the economy which is generally mandated by the central bank, and fiscal policy to increase demand for goods and services as well as productivity in the real sector which has an impact on the economy which is generally determined in terms of the amount of tax and type of tax imposed (Caprio & Bacchetta, 2012).

3 RESEARCH OBJECTIVE AND METHODOLOGY

The type of data used in this study is secondary data from time series in the period 1970-2017 in Malaysia. The research period was determined based on the conditions of the Malaysian economy before and after the Asian financial crisis in 1997. Data was obtained from Bank Malaysia, the Central Bureau of Statistics (BPS), and the International Monetary Fund (IMF). This study uses the Vector Error Correction Model (VECM) method with the following models:

PDB = F (M2, EXR, TAX, GE, INF)

With the derivation of the econometric model, it is as follows:

$GDPt = \alpha 0 + \beta 1M2t\text{-}1 + \beta 2EXRt\text{-}1 + \beta 3TAXt\text{-}1 + \beta 4GEt\text{-}1 +$

β 5INFt-1 + μt
Where:
GDPt = Economic Growth
M2 = money supply (M2)
EXR = Exchange Rate
TAX = Tax
GE = Government Expenditure
INF = Inflation.

4 RESULTS AND DISCUSSION

The results of the VECM model estimation are as follows:
GDP = -3.908430- 0.032743 M2t-1 +0.440504 EXRt-1 + 0.178543 GE t-1 - 0.523138 TAX t-1 + [6.01821] * 4.06218] * [5.51581] * [2.20821] * 0.020844 INF t-1 + et

The money supply has an effect on economic growth as a proxy for the business cycle with a coefficient value of 0.032743, meaning that if there is a decrease in the money supply by one percent, it will reduce economic growth by 0.03 percent. The exchange rate (EXR) has a significant positive effect on GDP with a coefficient value of 0.440504. Government spending has an effect on economic growth with a coefficient value of 0.178543, meaning that every one percent decrease in government spending (GE) will reduce economic growth by 1.78 percent. Tax (TAX) has a negative influence on the business cycle which is proxied by economic growth with a coefficient value of 0.523138 which means that a one percent reduction in tax (TAX) will increase economic growth by 5.23 percent. From the estimation results, it can be understood that monetary policy in this study is represented by the money supply and fiscal policy proxied by taxes has a very significant influence on the business cycle in Malaysia. Where in this study the business cycle is proxied with economic growth. The money supply affects inflation and the real sector, namely the business sector, which is the foundation for the economy. Tax with a quantitative tax compensation program has a good effect, namely encouraging business growth and ultimately encouraging economic growth.

5 CONCLUSION

The money supply, exchange rates, inflation, and taxes as representatives of government policies have an influence on the business cycle. The money supply, the exchange rate, and government spending have a positive effect on the business cycle in Malaysia, however, taxes have a negative effect. This means that tax reductions in Malaysia have a positive impact on the business cycle in Malaysia which has an impact on increasing economic growth. Fiscal policy that is presented on tax and monetary policy in the money supply management policy has a direct impact on the business cycle in Malaysia.

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