EFFECTS OF HIGHER ORDER INTERACTION IN MONEY SUPPLY OF A COUNTRY

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ABSTRACT

The money supply of a country is a very crucial aspect to be studied because it affects the whole workings of a country. The main purpose of this research is mainly to obtain the best model to decide the factors that influence the money supply of a country. The model will help the government to decide how much money is to be in circulation in future. In this research, the multiple regressions method is used to obtain the selected model. Then, the eight model selection criteria will be used to gain the best model. The interaction factor affecting the money supply is taken into consideration. Analysis up to the fifth order of interaction is considered. While the analysis is carried out, the model selected is analysed to see the effects and trends of the interaction. So, this research can show the characteristics of the variables and the significance of the higher order interaction variables. The best model is obtained and the significant variables include the highest order of interaction variable which is the fifth order interaction. By using the best model, a forecast will be carried out to predict the money supply. The forecast obtained is overestimating the money supply. It seems to have a relative deviation from the real value where it deviates about 5% from the real value. It shows that the forecast does not deviate too far from the real value. The results which are overestimated can be accepted in the money supply sector. This is because an overestimation of money supply provides a positive environment for the country which shows that the country is rich. So, the model obtained is a good model and it can be used in forecasting the money supply.
KESAN PEMBOLEHUBAH INTERAKSI PERINGKAT TINGGI YANG MEMPENGARUHI BEKALAN WANG SESEBUAH NEGARA.

ABSTRAK

## CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>DECLARATION</td>
<td>ii</td>
</tr>
<tr>
<td>ADMISSION</td>
<td>iii</td>
</tr>
<tr>
<td>ACKNOWLEDGMENT</td>
<td>iv</td>
</tr>
<tr>
<td>ABSTRACT</td>
<td>v</td>
</tr>
<tr>
<td>ABSTRAK</td>
<td>vi</td>
</tr>
<tr>
<td>CONTENTS</td>
<td>vii</td>
</tr>
<tr>
<td>LIST OF FIGURES</td>
<td>xi</td>
</tr>
<tr>
<td>LIST OF TABLES</td>
<td>xiii</td>
</tr>
</tbody>
</table>

## CHAPTER 1  INTRODUCTION

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.1 Introduction of Dissertation</td>
<td>1</td>
</tr>
<tr>
<td>1.2 Money</td>
<td>1</td>
</tr>
<tr>
<td>1.3 Money Supply</td>
<td>2</td>
</tr>
<tr>
<td>1.3.1 Interest Rate</td>
<td>4</td>
</tr>
<tr>
<td>1.3.2 Inflation Rate</td>
<td>5</td>
</tr>
<tr>
<td>1.3.3 Gross National Product (GNP)</td>
<td>5</td>
</tr>
<tr>
<td>1.4 Money Supply in Malaysia</td>
<td>6</td>
</tr>
<tr>
<td>1.5 Research Objective</td>
<td>8</td>
</tr>
<tr>
<td>1.6 Research Scope</td>
<td>8</td>
</tr>
</tbody>
</table>
## CHAPTER 2 LITERATURE REVIEW

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.1</td>
<td>Studies of Money Supply</td>
<td>10</td>
</tr>
<tr>
<td>2.2</td>
<td>Interaction Effects</td>
<td>13</td>
</tr>
<tr>
<td>2.3</td>
<td>Multiple Regressions Research</td>
<td>14</td>
</tr>
<tr>
<td>2.4</td>
<td>Source of Model Selection Criteria</td>
<td>15</td>
</tr>
</tbody>
</table>

## CHAPTER 3 METHODOLOGY

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.1</td>
<td>Data Collection</td>
<td>17</td>
</tr>
<tr>
<td>3.2</td>
<td>Variable</td>
<td>17</td>
</tr>
<tr>
<td>3.3</td>
<td>Descriptive Analysis</td>
<td>18</td>
</tr>
<tr>
<td>3.4</td>
<td>Multiple Correlation Matrix</td>
<td>19</td>
</tr>
<tr>
<td></td>
<td>3.4.1 Multicollinearity</td>
<td>20</td>
</tr>
<tr>
<td>3.5</td>
<td>Ordinary Least Square Method (OLS)</td>
<td>22</td>
</tr>
<tr>
<td>3.6</td>
<td>$R^2$ and Adjusted $R^2$ Method ($\bar{R}^2$)</td>
<td>23</td>
</tr>
<tr>
<td>3.7</td>
<td>Multiple Regressions</td>
<td>24</td>
</tr>
<tr>
<td>3.8</td>
<td>Model Selection Criteria</td>
<td>29</td>
</tr>
<tr>
<td>3.9</td>
<td>Residual</td>
<td>31</td>
</tr>
<tr>
<td>3.10</td>
<td>Randomness Test</td>
<td>32</td>
</tr>
<tr>
<td>3.11</td>
<td>Forecasting</td>
<td>34</td>
</tr>
</tbody>
</table>
CHAPTER 4  DATA DESCRIPTIVE

4.1 Introduction of Descriptive Analysis

4.2 Descriptive Analysis of Variables

4.3 Normality Test
   4.3.1 The Dependent Variable, y
   4.3.2 The Independent Variable, X₁
   4.3.3 The Independent Variable, X₂
   4.3.4 The Independent Variable, X₃
   4.3.5 The Independent Variable, X₄
   4.3.6 The Independent Variable, X₅
   4.3.7 The Independent Variable, X₆

4.4 Correlation Coefficient Matrix

CHAPTER 5  RESULTS AND DATA ANALYSIS

5.1 Introduction of Results

5.2 Multiple Regressions Analysis

5.3 Best Model Selection Criteria

5.4 Residual between Actual and Expected

5.6 Random Test of Residual
   5.6.1 Comparison of Random Test

5.7 Forecasting of Future Money Supply
   5.7.1 Comparison of Forecasting Method
CHAPTER 6 DISCUSSION AND CONCLUSION

6.1 Selected Models
   6.1.1 The Cancellation Effects of the Significance Variables 103
   6.1.2 Effects of Interaction Terms 105
   6.1.3 The Existence of Same Variable 106

6.2 The Significance of Higher Order Interaction 106

6.3 Best Model and Forecasting 107

6.4 Prediction of $X_1$ and $X_2$ 108

6.5 Summary 108

6.6 Suggestion and Comments 109

REFERENCE 112

APPENDIX 115
## LIST OF FIGURES

<table>
<thead>
<tr>
<th>Figure</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.1</td>
<td>The rejection region for student-t distribution, two-tailed test.</td>
<td>33</td>
</tr>
<tr>
<td>4.1</td>
<td>The normal Q-Q plot of y.</td>
<td>41</td>
</tr>
<tr>
<td>4.2</td>
<td>The boxplot of y.</td>
<td>42</td>
</tr>
<tr>
<td>4.3</td>
<td>The normal Q-Q plot of $X_1$.</td>
<td>43</td>
</tr>
<tr>
<td>4.4</td>
<td>Boxplot of the variable $X_1$.</td>
<td>43</td>
</tr>
<tr>
<td>4.5</td>
<td>The normal Q-Q plot of $X_2$.</td>
<td>44</td>
</tr>
<tr>
<td>4.6</td>
<td>The boxplot of variable $X_2$.</td>
<td>45</td>
</tr>
<tr>
<td>4.7</td>
<td>The normal Q-Q plot for $X_3$.</td>
<td>46</td>
</tr>
<tr>
<td>4.8</td>
<td>The boxplot of variable $X_3$.</td>
<td>46</td>
</tr>
<tr>
<td>4.9</td>
<td>The Q-Q plot of the independent variable $X_4$.</td>
<td>47</td>
</tr>
<tr>
<td>4.10</td>
<td>The boxplot of $X_4$.</td>
<td>48</td>
</tr>
<tr>
<td>4.11</td>
<td>The normal Q-Q plot of $X_5$.</td>
<td>49</td>
</tr>
<tr>
<td>4.12</td>
<td>The boxplot of $X_5$.</td>
<td>49</td>
</tr>
<tr>
<td>4.13</td>
<td>The normal Q-Q plot of $X_6$.</td>
<td>50</td>
</tr>
<tr>
<td>4.14</td>
<td>The boxplot of $X_6$.</td>
<td>51</td>
</tr>
<tr>
<td>4.15</td>
<td>The matrix scatter plot between the seven variables.</td>
<td>53</td>
</tr>
<tr>
<td>5.1</td>
<td>Plot of observe versus prediction.</td>
<td>86</td>
</tr>
<tr>
<td>5.2</td>
<td>The plots of observe and prediction versus sample numbers.</td>
<td>87</td>
</tr>
<tr>
<td>5.3</td>
<td>The plot of randomness for residual.</td>
<td>88</td>
</tr>
</tbody>
</table>
5.4 The student-t distribution which overlaps on Normal distribution graph which shows the rejection region at 5% of significance level.

5.5 The randomness plot of model M235.

5.6 The randomness plot of model M694.

5.7 The random plot of the best model.
### LIST OF TABLES

<table>
<thead>
<tr>
<th>Table</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.1</td>
<td>The existence of multicollinearity by inspecting the correlation coefficient matrix.</td>
<td>22</td>
</tr>
<tr>
<td>3.2</td>
<td>The calculation to obtain the total number of initial combination model for six dependent variables</td>
<td>25</td>
</tr>
<tr>
<td>4.1</td>
<td>Measure of central tendency and measures of variability for all the seven variables including dependent and independent variables.</td>
<td>36</td>
</tr>
<tr>
<td>4.2</td>
<td>The Kolmogrov-Smirnov and Shapiro-Wilks test of normality for the six dependent variables.</td>
<td>40</td>
</tr>
<tr>
<td>4.3</td>
<td>Table shows the correlation between the all the variables.</td>
<td>52</td>
</tr>
<tr>
<td>5.1</td>
<td>The coefficient table of the model in equation (5.1).</td>
<td>56</td>
</tr>
<tr>
<td>5.2</td>
<td>The multiple regression result of M41.</td>
<td>57</td>
</tr>
<tr>
<td>5.3</td>
<td>The multiple regression result of M17.</td>
<td>58</td>
</tr>
<tr>
<td>5.4</td>
<td>Result of the first step of multiple regressions.</td>
<td>59</td>
</tr>
<tr>
<td>5.5</td>
<td>The coefficient table after the first variable is rejected.</td>
<td>61</td>
</tr>
<tr>
<td>5.6</td>
<td>The coefficient table after the second variable rejected.</td>
<td>61</td>
</tr>
<tr>
<td>5.7</td>
<td>The coefficient table after the third variable is rejected.</td>
<td>62</td>
</tr>
<tr>
<td>5.8</td>
<td>The coefficient table for the model in equation 5.8.</td>
<td>64</td>
</tr>
<tr>
<td>5.9</td>
<td>The result of multiple regressions for the reduced model of the initial model in equation (5.8).</td>
<td>65</td>
</tr>
<tr>
<td>5.10</td>
<td>The model selection criteria computation to get the best model.</td>
<td>77</td>
</tr>
<tr>
<td>5.11</td>
<td>The coefficient table from SPSS for the best model obtained.</td>
<td>83</td>
</tr>
</tbody>
</table>
5.12 The table of residual. 85
5.13 The data of independent variable. 93
5.14 The relative deviation of the predicted money supply by using the multiple regressions method. 93
5.15 The forecast of money supply using SMA method. 96
5.16 The relative deviation of the forecast which gained by the SMA method. 98
5.17 The forecast of money supply by using the SES method. 99
5.18 The relative deviation of the forecast obtained by using the SES method. 101
6.1 The deviation of three methods for forecasting. 108
CHAPTER 1

INTRODUCTION

1.1 Introduction of Dissertation

Money supply of a country plays a very important role in managing a country’s economy. So, an effort is taken to research on the factors which are really needed to be considered before an amount of money to be released in future. It does not only take in consideration of the single factor effects only but also included the effects of the interaction between the factors on the money supply. It shows that, the main purpose of this dissertation is to find the best model which can be used to forecast the amount of money to be supplied in future.

1.2 Money

Money is anything that people are willing to accept in payment for goods and services or to pay off debts (Hubbard, 2000). Money is a medium which human being use to
exchange things and this directly will be an important financial asset in the economy. Actually money is just an invention which is used to simplify trade. The function of money is a standard value or unit of account in trading which is apparently to improve the barter system which is done in the old ages for trading goods or services. This is because the system was facing some problem where people cannot meet each others' need and satisfaction. Money also serves as a store of value because purchasing power can be stored in currency or in checking account until the times is right to buy it (Rose, 1997).

1.3 Money Supply

Money supply is an economic variable which is the total quantity of money in the economy of a country. The factors that give impact to money supply are the interest rate, inflation rate, and the gross national product (GNP) of a country. The money supply has an impact on interest rate, exchange rate, inflation, and economy's output of goods or service (Hubbard, 2000). This shows the importance of getting a good model which could help to forecast the amount of money needed in future. This is because the money supply gives a very big impact on the country's economy where it affects all other important economic factors and also the politics department.

All these factors depend on the monetary policy which is the management of the money supply and it links the entire economic variable. The monetary policy will depend on the monetary theory which explores the relationship linking the changes in money supply to changes in economic activities and prices.
The monetary theory can be different between countries because it depends on the government’s policies and decisions.

The amount of money to be supplied in the country must be well decided by the government because the money supply will cause the decreasing of the currency value which will cause the standard of living to drop when the money supply is too much. While, if the money supply is insufficient to meet the demand of money, it will cause the citizens to live in difficulty because the standard of living is too high especially for the citizens staying in urban places. So, this shows that the government’s decision on the amount of money supplied will affect the whole country especially when the economy faces recession.

The problem caused by money supply must be avoided by the government as it causes a lot of bad effects to the country. So, every country will have a central bank which is an institution designed to oversee the banking system and regulate the quantity of money in the economy (Mankiw, 2004). The central bank can control the money supply because if the Central Bank holds all the deposits in reserve than the supply of money will be fully controlled by them. All the extra money is hold by the Central Bank. This is a way of controlling the money supply where the bank does not hold all the deposits in reserve and create the fractional reserve ratio.

While the bank only holds a fraction of the deposits in reserve according to the reserve ratio decided. The rest of the deposits will be given out to be as loans to the customer where this is compulsory for a bank to create more money. This is because when money is loan out, then the money will be deposited in other banks and the bank
will reserve a ratio of the deposit. So, finally the total money supply will be the total money deposited in the entire bank. The amount of money circulate will be increasing as the money are circulated in the country and this will increase the amount of money in the bank. So, the control of the reserve ratio to a bank by the Central Bank can help to control the supply of money in the country.

In the next section, all the variables that considered are explained and all the variables will be tested to see which variables affect the money supply. So, a model which includes the factors that influence money supply will be obtained by searching the best model. Before the best model is obtained, the selected model must be searched first. The process will be done by using the multiple regressions analysis. Then, with the best model obtained by using the eight model selection criteria, the money supply can be forecasted to prepare the budget of the country.

1.3.1 Interest Rate

The interest rate is the borrower’s cost on a loan and the lender’s reward on the investment (Hubbard, 2000). The interest rate will affect an individual’s decision about whether to borrow for spending or to save the money for future spending in bigger amount such as buying a house or for retirement planning. This is the affect for individual, while in economic aspects the interest rates helps guarantee that current savings will flow into investment to promote economic growth. It also rations the available supply credit where it generally providing loanable funds to those investment projects with the highest expected returns and it brings into balance the supply of money with the public’s demand for money. Furthermore, it is also an
important tool of government policy through its influence on the volume of saving and investment (Rose, 1997).

1.3.2 Inflation Rate

Inflation is an economy-wide phenomenon that concerns the value of the economy’s medium of exchange (Mankiw, 2004). So, inflation is a rise in the average level of prices for all goods and services. Inflation occurs when the average level of all prices in the economy rises or too many dollars chase too few goods. This happens when demand exceeds supply at or near full unemployment (Kaufman, 1995). It can cause wealth effect, income effect, income tax effect, and depreciation effect (Rose, 1997).

The wealth effect happens when the purchasing power is reduced and people cannot buy whatever they want and the income effect is the effect which causes people to reduce their money holding. People have to travel more frequently to the bank. The income tax effect occurs because the inflation is not considered by the tax law. So, the inflation tends to raise the tax burden on income earned from savings. The depreciation effect will happen because after tax income is less than it would be when there is no inflation. This will cause the profit to decrease and the contribution to the economy will be lowered and this can cause depreciation.

1.3.3 Gross National Product (GNP)

Gross National Product (GNP) is the total income earned by a nation’s permanent residents called nationals and it is usually assessed quarterly or yearly. It includes the
income that our citizens earn abroad and excluding income that foreigners earn in the
country (Mankiw, 2004). The GNP of a country will highly influence the money
supply because of the flow of the money of a country when their citizens earn abroad.
This is because if the citizens migrate, then a big amount of money will flow out of
the country which causes the money in the economy to be reduced and affect the
money supply.

GNP in current dollars is the GNP measuring the changes in overall levels of
economic production from one year to the next using the money price. This will cause
problem when measuring is done because money price differs in every year. So, the
GNP constant is obtained by getting the real gross domestic product (GDP) in 1972
and transform it to GNP to compute a possible price index which can solve the
different money price problem (Mankiw, 2004). The GNP computed is the GNP
constant. It is not necessary to be 1972 but 1972 is chosen because for this year the
price is more stable as the average yearly rate of growth from 1961 to 1973 rose to 3.9
percent which is the highest average rate of entire postwar period under review
(Spulber, 1995).

1.4 Money Supply in Malaysia

According to Cheah (1997), the money supply in Malaysia was quite stable and it
gradually increased since 1956. From this study, we can see that from 1956-1971, the
amount of money supply increased gradually around 4% per year. From 1966-1970,
the increment of the currency value decreasing to 3.4% per year because of the
development in current deposit which increase the bank network in main cities. This
current deposit is growing very fast in 1956 where it increase from 1.8% in 1956 and it increase to 9.1% in 1966-1970. Furthermore, this growth satisfies the economy development of the country.

These happen because of the increment in the main item and the pressure of inflation. This cause the citizens to carry along a lot of cash because of the trading demand are very high. From 1976-1980, the Central Bank of Malaysia practice a very lenient monetary policy to encourage the economy development. So, this cause the increased of money supply in the country and this period the currency value was the highest rate. After 1980, the increment of the currency value starts to drop until the end of 1984 where it starts increasing.

The money supply increases very fast because there are lots of banks providing the facilities for the citizens to keep their extra money. Moreover, they can choose any bank that they feel beneficial to them. This is because they wish to maximize returns of their saving in bank. So, this will affect the supply of money and cause increment. Next, are the factors that decide the money supply in Malaysia. The government’s debts are one of the main factors because the management of the government expenses will influence the money supply. There are other factors too such as the open economy in this country can cause the in and out flow of money and many other factors too which are decided by the government policies.
1.5 Research Objectives

This research will be studying about the money supply of a country. So, the research objective of this dissertation is as follow.

i. To find out the possibility where money supply only depends on the interaction of main factors.

ii. To verify the influence of higher order interaction variable to the money supply.

iii. To verify the influence of main factors to the money supply.

iv. To examine the contribution of main factors with the interaction factor to money supply.

v. To examine the characteristic of the money supply and get a best model to describe the money supply.

vi. To forecast the future money supply and compare the method of forecasting.

1.6 Research Scope

In this study, there are total of seven variables and the data were used as it is collected and no further information given after data were collected. So, there are two variables will be considered as unknown quantitative variable as their status are unknown. So, the variables are treated as continuous variables. The number of variables involved will not be confined only to the seven variables in a model because there are interactions variables involve. This study is to find the selected model which are selected by referring the p-value which is provided by the multiple regression test. In this study, only the variables discussed are considered to influence the money supply.
where no other factors influence or other factors are considered remain the same. The best model will be obtained by using the eight model selection criteria. There is time constrained as the period is too short and this might cause some weaknesses to this study.
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