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Pressure on Foreign Debt and Interest Rates on the Malaysian Economy, Is it True that the Money Supply Drives Economic Growth?

Abstract

The study aims to investigate foreign debt, interest rates, exchange rates, and economic growth in Malaysia. This study uses secondary data sourced from the world bank with an annual research period from 2000 to 2020. This research uses The data analysis method used in this research is the causal analysis method, namely the Autoregressive Distributed Lag (ARDL). We found that external debt hinders Malaysia's economic growth, this is reinforced by a significant negative relationship both in the long and short term from interest rates which actually suppress economic growth. It is intriguing that there is a strong positive correlation between economic growth and foreign debt in the short term. While it is logical that foreign debt boosts growth temporarily, it eventually (in long term) weighs down the economy. Economic growth is driven by the strengthening of the exchange rate, but not the money supply in both the long and short term. The money supply actually only encourages economic growth in the short term but depresses the economy in the long run.

Keywords : Foreign Debt, Interest Rates, Money Supply, Economic Growth
JEL Classification: C01,C15,E01,E02

Background

In history, several economic crisis phenomena have been recorded. The Asian crisis occurred in 1997 due to the lack of transparency and credibility from the government, and this also caused a structural distortion (Hidayanti & Prabowo, 2021). At the time of the economic crisis in Asia, East Asian economic growth fell due to the slow growth cycle in the world. So that several countries recorded that income growth became negative in 1998, as happened in Indonesia, Malaysia, Thailand, the Philippines, and South Korea (Ghazouani, Boukhatem, & Sam, 2020). From the incident in Malaysia, Thailand, and South Korea, they have to request a bailout loan program from the International Monetary Fund (IMF) (Mohamad, Sifat, Thaker, & Noor, 2021). The global economic crisis in 2008 have effect to global economic start from USA subprime mortgage (Sasongko, Bawono, & Prabowo, 2021). So that in this case, the development of a crisis occurred in various other continents which later, in a short time, became a global crisis due to the contagious effect amidst a globally integrated financial system and the rapid spread of information. Several European countries, one of them Britain and Asia, including Malaysia, were also affected by the financial crisis (Kawai,et al,2012).

The impact arising from global financial shocks illustrates that local shocks can spread rapidly to other countries and consequently affect the global economy, which affects not only the financial sector but also the real sector through various channel mechanisms such as monetary or trade transmission (Aktar, Alam, & Al-Amin, 2021). With the economic crisis of the last two decades, it is unfortunate, because the crisis that hit coincided with several countries reaching their best position in maintaining price stability and economic growth through financial supervision and macroprudential policy regulation, while price stability was imposed on policies regarding monetary policy (D'Orazio & Popoyan, 2019).

The economic crisis that hit the United States in September 2008 shows that imbalances in the financial sector have a serious impact on the real sector. In this situation, it has actually triggered the behavior of the financial system to tend to ignore risks and undertake a massive credit expansion, thereby creating bubbles in asset prices and instability in the financial system which resulted in a crisis (Duffie, 2019). The existence of the crisis made economic figures take action by concentrating on the consequences of a banking crisis that changed conditions in the economy. The financial crisis found that recession in the economy and transactions experienced a decline due to bankruptcy in the financial sector so that between banks and financial institutions had strong relationships in the economy that could not be ignored. instability in bank finances causes a decline in economic growth (Johnson,2012).

The crisis that occurred in 2008 has taught us that maintaining economic stability is not enough just to maintain price stability but also to maintain financial system stability (Kozarić & Žunić Dželihodžić, 2020). Price stability is reflected in low inflation and interest rates, while financial system stability is a condition in which the financial system can withstand shocks without disrupting the savings allocation process for investment and payment processing in the economy (Chugunov, Pasichnyi, Koroviy, Kaneva, & Nikitishin, 2021).

The global financial crisis in the United States in 2008 was triggered by excessive credit growth in the United States. The Global Crisis that started in the financial sector occurred when the world managed to achieve its best performance in maintaining price stability and economic growth. However, this condition actually triggered the behavior of the financial system which tended to ignore risk and carry out massive credit expansion, resulting in asset price bubbles and financial system instability which eventually led to a crisis (Rochon & Rossi,2015).

The term macroprudential policy has only emerged and has become a concern since the 2008 global financial crisis. However, macroprudential policy instruments have been implemented in various countries to address specific aspects of systemic risk without calling it macroprudential policy (Krishnamurti & Lee,2014). The role of banking is very large in encouraging the economic growth of a country. The bank itself is a part of the sector that drives the country's economic activities (Charaia, Chochia, & Lashkhi, 2021).

The activity of a banking institution is the provider and channel of funds that will determine the health of the country's economy. Within the existing developments, the services that have been provided from banking have made quite rapid progress (Liu, Lee, & Lee, 2020). Many new entrants enter the market by presenting new products that have many variations and have their own characteristics, especially in the growing banking system such as the construction of office networks, assets, and many other products offered to the public. Not only conventional banks are experiencing changes, Islamic banks are also starting to appear with various banking products offered, so as to attract public interest (Akyüz,2014).

Almost all business sectors that are carried out really need the role of the bank which is used as a team of cooperation in conducting financial transactions. In the current and future individual business sector, it will not be separated from the role of banking in it, which will later turn into a need to carry out financial activities to smooth the business undertaken (Rivaldo, Kamanda, & Yusman, 2022). In general, the existence of conventional banks has a very strategic role, namely as intermediation and providing services in the payment system. In addition, it has an effect on economic conditions in

Malaysia, both macro and monetary, which in its development is controlled by the central bank, which plays a very important role in the absorption of society by banks (Náñez Alonso, Jorge-Vazquez, & Reier Forradellas, 2021).

From the monetary side, the phenomenon of inflation is a problem of classical thinking in economic conditions that have a profound economic impact on people's lives (Kolodko, 2021). Theoretically, the interest rate affects the money supply. Assuming the public keeps their money in the bank (Andolfatto, 2021). The higher the interest rate, the more the people's motive to save their money in the bank so that the money supply decreases and inflation decreases (Yanescha, 2022). Conversely, the lower the interest rate, the more money is in circulation, thus driving inflation higher (Maiti, Esson, & Vuković, 2020).

The impact of increasing interest rates which further suppress inflation is called the keyness effect. (McEachern,2012). The stability of the financial system is crucial for a nation's economy to develop. This is also supported by an increase in the financial sector (Charfeddine & Kahia, 2019). Financial stability is currently a classic issue in increasing economic growth. This is due to the direct connection between the health of the financial sector and economic expansion (Kirikkaleli & Adebayo, 2021). However, the implication is that financial stability policy requires monetary policy so that it can support market dynamics due to many factors that can affect economic growth (Blanchard, Leandro, & Zettelmeyer, 2021). The study aims to investigate foreign debt, interest rates, exchange rates, and economic growth.

Literature Review

Classical thinkers have a statement that inflation will occur anywhere and anytime, and all this is called a monetary phenomenon (Weimer, 2022). This thinking is written in The Crude Quantity Theory, which means that in equilibrium conditions, changes in the monetary economy will only affect the price level. Thus, changes that occur in the money supply are a form of monetary policy that changes the economy in nominal terms. In this theory there is an opinion that the price can be influenced by the money supply, which is explained by the relationship between the amount of money and the value of money, as well as the price and the value of money (Haig, 2020). If the money supply increases rapidly than output increases, the value of money falls. This incident will have an impact on the price offered to be expensive (Herrenbrueck, 2019). The Classical Opinion, inflation or price increases means that if there is too much money in society or a very large credit channeling event is carried out by banks compared to the number of transactions made, the solution is to reduce the amount of money circulating in society (Perloff,2016).

Inflation is an increase in general prices of output that is produced continuously. The price increases that occur in several types of output cannot be described as inflation, unless the increase that occurs can widen to some parts of the price of other commodities (Holtfrerich,2013). Inflation is an increase in the price of goods as a whole and continuously. If only one item rises, it cannot be called inflation unless the increase in the price of that good affects the prices of other goods (Tho'in & Prastiwi, 2019). Theoretically, the relationship between inflation and economic growth shows interesting things to observe. Inflation that is too low, even at the level of deflation, will suppress economic growth and inflation that is too high will also cause people's purchasing power to decline, resulting in the economy's wheels from running (Tien, 2021). Therefore maintaining the inflation rate needs to pay attention to two factors at once, namely the level of inflation which makes the economy's pulse optimum and at the same time does not decrease people's purchasing power (Crowley & Hudgins, 2022).

Economic growth is needed so that development targets such as job creation, increasing national output, tax revenue, poverty alleviation, reducing unemployment, and increasing the level of social welfare can be achieved (Tri, 2020). The low rate of economic growth will prevent these targets from being achieved. Both monetary and fiscal policies are needed so that the targeted inflation can be achieved within a tolerable vulnerability (Chenet, Ryan-Collins, & van Lerven, 2021). Too low an inflation rate is certainly not good for the economy, but too high will also be dangerous. This is what is currently a challenge for every authority in many countries (Rogoff, 2020). In general, a low inflation rate can also indicate low public demand and purchasing power. The low level of demand has kept price increases relatively under control in ceteris paribus conditions. Maintain and increase people's income to boost consumption levels (Jaravel & O'Connell, 2020).

Inflation is a condition in which the economy in a country has a propensity to raise prices for goods and services over an extended period of time. Inflation occurs when the amount of money in circulation is more than what is needed (Nikensari, Santosa, & Sugiyanto, 2019). When inflation occurs, economic conditions do have various kinds of impacts, both positive and negative impacts, this impact will also be felt by the state and its people. This impact can be seen in many aspects of life (Choi & Cook,2018).

Inflation can indeed provide various kinds of impacts, both positive and negative, especially on people's income (Evans,2014). Inflation has both positive and negative impacts on people's income (Yang & Shafiq, 2020). In certain conditions, such as soft inflation will encourage entrepreneurs to expand production thereby boosting the economy (Wales, Shirokova, Beliaeva, Micelotta, & Marino, 2021). However, inflation will be bad for those with fixed income (D'Acunto, Malmendier, Ospina, & Weber, 2021).

Therefore, in some conditions, soft inflation can actually encourage entrepreneurs to expand production to improve the national economy. But inflation can also have a bad impact on those who have a fixed income, because the value of money will of course also be the same while, on the other hand, the prices of goods and services increased (Stoykova, 2021). This happened because the price of export goods was getting more expensive. Inflation can make it difficult for both parties, both the exporter and the state. The country experiences losses because the competitiveness of exported goods is reduced. As a result, the number of sales is reduced. Foreign exchange earned is also getting less. The exportability of a country can be reduced because when inflation is high, the cost of exports increases (Storm, 2019).

The competitiveness of exported goods also tends to decline and ultimately leads to a reduction in income from foreign exchange. The emergence of inflation can certainly make the calculation and determination of the cost of goods more difficult, considering that it can be too small or too large (Qiang, Lin, Zhao, Liu, Liu, & Wang, 2019). The percentage of inflation that can occur at a later date is often unpredictable. This is what makes the process of determining the cost of goods and selling prices sometimes incompatible. In some conditions too, inflation can make producers difficult and lead to economic chaos (Nugroho, Arif, & Halik, 2021). One of the other impacts is a person's interest in saving which can decrease due to inflation because the income from savings interest is much smaller, while savers have to pay administrative costs for their savings. (Comley,2013).

According to Keynes, price increases are caused by the gap between the forces in the economy in society to buy the resulting output (Ginting, Hutasoit, & Peranginangin, 2021). The gap that is meant here is that public demand for goods increases from the amount supplied will cause an increase in prices which is called the inflation gap (Eser, Karadi, Lane, Moretti, & Osbat, 2020). Keynesians thought that changes in the monetary economy could increase the economic cycle and affect prices through interest rates and inflation. Inflation plays an important role in influencing people's behavior to keep more money in the bank. When inflation is exceptionally strong, the real worth of the money saved will decline (Newman, 2020). Therefore, an inflation rate that is higher than the interest rate will result in a decrease in the value of real money in the future and in the end will make people reduce their interest in saving in banks. Where price increases will also lead to a tendency for people to hold money as a precautionary motive (Collins,2017).

The opinion of the monetarist theory states that the increase in prices (inflation) is influenced by expansionary monetary policy and fiscal policy, this means that the amount of money circulating in society becomes large. A large amount of money supply in society results in an increase in the demand for output in the real sector (Bordo & Levy, 2021). According to the monetarist class, the price increase that occurs can be reduced by using decision making through monetary policy originating from the central bank and fiscal policy issued by the government which is contractionary in nature or controls the increase in the number of wages for the community and eliminates subsidies for the foreign exchange rate (Handa,2008).

Interest rate theory here means that one of the variables that affect the economy is the movement of interest rates that will influence the decision to consume or save and buy securities (Minesso, Mehl, & Stracca, 2022). The Fisher effect is a theory that describes a long-term economic relationship that has a relationship between the price level and the interest rate (Akbar, Iqbal, & Noor, 2019). The concept in this problem explains that everything that has in common in the increase in prices in a country is expected that inflation will also cause the same increase in the interest rate (and vice versa) (Ho & Yuen,2003).

The link between the purchasing power of money and products and services that affect a nation's economy in terms of exchange rate swings is explained by the Purchasing Power Parity (PPP) theory (Bawono, Zainuri, & Wilantari, 2019). This Purchasing Power Parity theory approach uses the Law of One Price as a basis. In this law, it assumes that the resulting output to be sold must have the same price as applied in all places or countries, the assumption that two identical (same) goods should have the same price (Heshmati,2017).

Research Method

The study aims to investigate foreign debt, interest rates, exchange rates, and economic growth in Malaysia. This study uses secondary data sourced from the world bank with an annual research period from 2000 to 2020. This research uses The data analysis method used in this research is the causal analysis method, namely the Autoregressive Distributed Lag (ARDL) with the equation as follows :

$$EG_t = \beta_0 + \beta_1 ED_{t1} + \beta_2 Ir_{t2} + \beta_3 ER_{t3} + \beta_4 MS_{t4} + \mu_t$$

Information :
EG = Economic growth with GDP growth indicator
ED = Logs of foreign debt or External Debt
IR = Interest Rate (%)
ER = Log of Exchange Rate

MS = Money Supply

Results and Discussion

The following will present the estimation results of the ARDL model for each period in Malaysia to see the long-term and short-term relationships. The ARDL model in this study will be used in observing the condition of economic growth in Malaysia by looking at the coefficient of foreign debt and macroeconomic indicators of economic growth in either long-run or short-run which are estimated at full periods.

Table1 Long-term and short-term ARDL Estimation Results in Malaysia

Estimated Outcomes Over the Long Term		
Variable	Coefficient	Probability
ED	-0.01663	-0.07817
IR	-0.00095	-0.07527
ER	0.396745	0.05924
MS	-0.378467	-0.06716
C	1.480226	-
Estimated Outcomes in the Short Term		
D (ED)	0.00822	0.06352
D (IR)	-0.00734	-0.09467
D (ER)	0.00923	0.06413
D (MS)	0.02422	-0.07412
C	0.000923	1.61729

* significant $\alpha = 5\%$, with t-table = 1.99346

According to the estimation results, foreign debt significantly negatively affects economic growth, with larger levels of foreign debt stifling growth, this is agreed by a significant negative relationship both in the long and short term from interest rates which actually suppress economic growth. . It is interesting that the relationship of foreign debt and economic growth in the short term has a significant positive relationship. It can be understood that foreign debt provides an impetus for growth in the short term but in the long term it becomes a burden on the economy. Economic growth was driven by the strengthening of the exchange rate, but not the money supply in both the long and short term. The money supply actually only encourages economic growth in the short term but depresses the economy in the long term.

The money supply is closely related to inflation. The intentional inflation view, argues that an increase in the price level will provide a stimulus to a relatively productive segment of the economy, giving more profit to more mobile and innovative factors. According to structural inflation theory, price rises are brought on by bottlenecks, namely obstacles to supply-side production expansion, such as quotas on international trade, aspects of transportation, food production, and so on. The surprise inflation view, states that inflation surprises are part of growth because price increases will be followed by increased production, where investors expect that the speed of price increases has not had an impact on the cost side so that profits will increase.

In Malaysia, interest rate policy instruments are used as a tool to control the inflation rate that occurs. During the crisis that occurred in 2008/2009, Bank Malaysia controlled the high rate of inflation by raising its benchmark interest rate. So that the circulation of money in the community can be withdrawn to the bank so that it can suppress the inflation rate. In controlling interest rate policy, Bank Malaysia will continue to be calibrated in accordance with economic developments, both domestically and globally, so that inflation remains under control within the target. A controlled inflation rate will lead to stable economic growth.

The exchange rate's evolution varies from year to year. We are aware that there was a worldwide financial crisis in 2009, which had an impact on the movement of currency rates and caused the exchange rate to decline as a result. As can be seen, the exchange rate stance was more stable in the years prior to and following the global financial crisis of 2009 than it was during that crisis.

Irving Fisher's hypothesis, which contends that an increase in the money supply will have a favorable influence on economic growth (GDP), lends support to this research. However, this only occurs in the short term. These findings show that, although an increase in the money supply has a short-term positive impact on economic growth, it has no long-term beneficial effects, this is related to an increase in the money supply, people will put some of their funds for consumption so as to make producers produce more goods than demand so that factors production increases. This will affect per capita income and then increase economic growth.

Conclusion

External debt hinders Malaysia's economic growth, this is reinforced by a significant negative relationship both in the long and short term from interest rates which actually suppress economic growth. It is intriguing that there is a strong positive correlation between economic growth and foreign debt in the short term. While it is logical that foreign debt boosts growth temporarily, it eventually (in long term) weighs down the economy. Economic growth is driven by the strengthening of the exchange rate, but not the money supply in both the long and short term. The money supply actually only encourages economic growth in the short term but depresses the economy in the long run.

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