A STUDY ON THE RELATIONSHIP BETWEEN EXCHANGE RATE, INTEREST RATE, OIL PRICE AND MONEY SUPPLY TOWARDS INFLATION RATE IN MALAYSIA

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CHAPTER 1: INTRODUCTION

1.0 INTRODUCTION TO THE STUDY

The issue relating to inflation has generated an enormous volume of literatures and heated debates in recent years. Different research and views carry different evidence on the nature and causes of inflation. It is essential to study inflation not only in Malaysia, but also each country because inflation is devastating. Inflation creates problems and introduces noises in the functioning of the economy that is likely to affect economic growth. However, it is not an easy task to tackle the inflation problem effectively. In order to hand the inflation problem successfully, accurate assessment of the causes of the problem is critical as wrong diagnosis of the nature of the problem will lead to the application of inappropriate cures that might produce unintended adverse effects on the economy.

1.1 OVERVIEW INFLATION IN MALAYSIA

Inflation rate, as measured by the annual rate of increase in the Consumer Price Index (CPI), continued to decelerate from a high of 6.2% in June 1998 to 2.1% in September 1999. On average, the CPI increased by 3.0% during the first nine months of 1999, against 5.2% during the corresponding period of 1998. Major factors that have contributed to the relatively low inflation rate are the mild recovery in domestic demand against a background of excess production capacity;

lower cost of production as indicated by the 4.8% decline in Producer Price Index during the first eight months of 1999 largely as a result of lower non-oil primary commodity prices such as palm oil and rubber due to higher output, the pegging of the Ringgit since 2 September 1998 makes exchange rate stronger exchange when compared with the ringgit average exchange rate during the first eight months of 1998; and subdued rate of inflation among Malaysia's major trading partners. (Economy Report 1999/2000)

Inflation continues to be subdued in 2000 as reflected in the marginal increase of 1.4% in the Consumer Price Index (CPI), during the first nine months of 2000 (January-September 1999: 3%). The Producer Price Index (PPI), however, registered a marked increase of 4.8% for the first eight months of 2000 (1999: -4.8%). The increase was largely on account of higher prices (5.7%) charged by local producers (1999: -5.7%) and to a lesser extent (1.1%) by importers (1999: -0.9%). In terms of components, the increase was highest for mineral fuels, lubricants and related materials group (41.8%) due largely to higher global crude oil prices. The moderation in CPI is reflected in most of the major sub-indices, including food, which rose by 2.1% in the first nine months of 2000, and transport and communications (1.3%), which together account for 52.8% of the total CPI weights. The gross rent, fuel and power sub-index, however, increased at a lower rate of 1.3% (January- September 1999: 1.8%). The growth in CPI was more moderate in the first nine months of 2000. (Economy Report/2000/2001)