

The Determinants of Monetary Policy in Malaysia: Impact on Economic Activity

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Abstract: The overnight interbank rate is an essential factor for central banks to impact economic activity and preserve financial stability. It refers to the rate at which banks lend and borrow short-term funds from one another, often overnight. The overnight interbank rate plays a crucial role in the transmission mechanism of monetary policy since changes in the rate can affect the cost of borrowing and the availability of credit, which in turn impacts consumption, investment, and economic activity. According to Bank Negara Malaysia (2021), overnight transactions in the interbank market run in parallel to the existing Kuala Lumpur Interbank Offered Rate (KLIBOR). This study intends to explore time series data from 1991 to 2021 to identify the relationship between dependent and independent variables based on the ordinary least square method (OLS). Meanwhile, the study investigates whether macroeconomic variables influence the overnight interbank rate in Malaysia. Therefore, this study uses the determinant of economic indicators of unemployment (UR), domestic private credit (DGR), gross domestic product (GDP), foreign exchange (FER), and inflation (I). The data comes primarily from the World Bank and the Federal Reserve Bank (FRED). Based on results demonstrate that unemployment and inflation have the most significant impacts on monetary policy. The reason why unemployment has an impact on economic growth is that high unemployment frequently indicates resource underuse, pointing to the need for stimulative monetary policy (such as decreasing interest rates) to promote investment and expenditure and promote economic growth. To slow down the economy and cut expenditure, central banks typically raise interest rates in response to rising inflation. On the other hand, declining inflation may lead to rate reductions to boost the economy. This is a significant element of inflation in monetary policy.

Keywords: *Overnight interbank rate, Unemployment, Domestic private credit, Gross domestic credit, Foreign exchange, Inflation*

1. Introduction and Background

Financial globalization is described as the overall trend toward more international economic integration, as evidenced by a rise in cross-border monetary transactions (Prasad et al., 2005). According to Bhanumurthy and Kumawat (2020), financial globalization become a hot topic that has been discussed globally in the last three decades. Unprecedented financial globalization has taken place during the 1980s, as evidenced by the dramatic growth in capital flows experienced by both developed and developing nations. The most current phase of financial globalization has been characterized by an increase in the cash flow, most significantly, between industrial and developing countries.

We have known for a long time that the financial system is critical to the implementation of monetary policy because monetary policy aimed at macroeconomic variables is essentially a financial operation. Thus, the financial sector, via the monetary transmission mechanism, connects central bank policies and the actual economy. Because monetary policy is primarily implemented through the financial system, any change that alters its structure or circumstances may disrupt the transmission mechanisms. As a result, the effectiveness of monetary policy is vitally dependent on a set of characteristics impacted by the expansion of the financial sector (Ma & Lin, 2016). In this context, research into the relationship between financial globalization and monetary policy success has substantial theoretical and policy implications for many economies, particularly those with rapid financial growth.

The study is based on the influence of financial globalization on the monetary policy in Malaysia. Thus, a global financial cycle that reflects domestic monetary and financial conditions has sparked our curiosity to study the link between monetary policy and financial globalization in these nations. The objective of this study is to

discover whether each country's monetary policy responds to the influence of financial globalization which consists of different variables. There are six variables used in this study. The variables are Unemployment, Domestic private credit, Gross domestic credit, Foreign exchange, Inflation and Monetary policy. The focus of these variables in this study may help individuals, groups and governments to understand how these variables may affect the changes of a country's monetary policy. The issue arose when there was instability of the overnight interbank rate which impacted to public, business, and financial sectors.

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2. Literature Review

Unemployment and monetary policy

Unemployment is when citizens are seeking and asking for jobs but are sometimes unable to secure jobs. They are actively seeking availability based on their knowledge and skills. Hence, graduates should look at this issue as an opportunity for them to uplift their skills and knowledge, in line with future industrial needs. As the future is more towards the gig economy, more focus should be given to the professional workers residing in that area (Abd Rahman, Ismail, Ridzuan, Abd Samad, 2020). The employment rate is the absolute most important indicator of economic growth. Indicators of the labor market, such as the unemployment rate, have generally been known as useful metrics by which to assess the economy as a whole (Lee & Kim, 2023).

Based on the Keynesian theory of economics, they are looking for the advocate deficit spending on labor intensive to ensure that unemployment can be stimulated and wages more attractive even during downturns (Jahan, S., Mahmud, A. S., & Papageorgiou, C., 2014). Consider that Keynesian economics also says that both market economies and capitalist economic systems are prone to boom and bust cycles (Stockhammer, 2022). Low aggregate demand and high unemployment rates characterize the economy's collapse period. If the economy can re-enter its growth phase, the unemployment rate will eventually revert to normal. The Keynesian theory of unemployment serves as the foundation for explaining cyclical unemployment since it describes the impact of regular shifts in the business and economic cycle on the labor market. This is due to the theory's explanation for why cyclical unemployment occurs. People who follow the Keynesian theory of economics think that demand from consumers is the most important factor in an economy.

According to the literature by (Christoffel and Linzert, 2005, Trigari, 2006), unemployment has a substantial impact on how monetary policy is transmitted. According to the researcher's approach, a direct link between wages and inflation is established by the right-to-govern pay negotiations. Thus, they can demonstrate that the dynamics of inflation following a shock to monetary policy depend greatly on the degree of real wage rigidity. This is because under these circumstances, however, the effect of unemployment on total consumption is rather small. Next, none of the cited research specifically used cointegration techniques, which are formally intended to reveal structural breaks in the relationship between the two variables. As a result, we discovered that there is a lack of agreement in the literature, particularly in research that pertains to the situation in Malaysia. The investigation included very little agreement on any of its topics. Researchers in Malaysia conducted studies between 1980 and 2010 to determine whether or not shifts in the country's monetary policy affected the country's high unemployment rate (Georgiadis & Mehl, 2016). According to Chicheke (2009), there is a cointegration between these two variables, which is in line with what Benazic and Rami (2016) found in Croatia. The Phillips curve is not true because of these results. This study also shows that changes in the inflation rate have a bigger effect on monetary policy than changes in the unemployment rate. So, changes in the inflation rate are more significant to the monetary authority than changes in the unemployment rate. In conclusion, a lower unemployment rate could also indicate strong economic growth and robust demand for goods and services, which could support a case for a tightening of monetary policy. Thus, there is a relationship between unemployment and monetary policy according to Keynesian theory.

Domestic private credit and monetary policy

Through careful management of the supply and demand for domestic credit, monetary policy has the ability to

influence both the growth of credit and overall spending, which in turn can affect inflation, employment, and other crucial economic indicators.

An identical study was conducted in Malaysia. However, these investigations solely utilized combined data from the works of Kassim and Turkhan (2008), Kassim and Shabri (2010), and Goh and Yong (2007). To fully capture the type of reaction from this banking institution against the policy change, this scenario summoned complexity (Hosono, 2006). As a result, research using data from microbanks is still in its early stages. The banking institution was not divided into Islamic banking and regular banking, therefore the conclusion made broad sense. Bernoth and Pick (2011), conducted research and the results show a positive domestic credit trend, which shows that domestic credit can be used to gauge the health of the banking industry, but a faster GDP growth rate reduces the risk of default. More crucially, the authors emphasized that, in contrast to a model with solely observed variables, the inclusion of unobserved common characteristics in the model is essential in predicting the instability of the banking and insurance sectors.

Gross domestic product and monetary policy

A strong and sustained increase in gross domestic product (GDP hereafter) can lead to increased demand for goods and services, putting upward pressure on prices. If this results in higher inflation, a central bank may tighten monetary policy by raising interest rates to curb inflation and maintain price stability. On the other hand, if GDP growth is sluggish, a central bank may loosen monetary policy by lowering interest rates to stimulate borrowing and spending, and thus support economic growth. The state of the economy as reflected by GDP can also impact market expectations for future interest rates. If GDP growth is strong, market participants may expect interest rates to rise in the future, which can influence the behavior of consumers and businesses. Therefore, the relationship between GDP and monetary policy is not one-sided, as GDP can also impact monetary policy by influencing the central bank's decisions regarding interest rates and the money supply. The interplay between GDP and monetary policy helps to maintain economic stability and support sustainable economic growth.

In the context of actual business cycles, there has been a lot of talk about the connection that exists between Gross Domestic Product and monetary factors. Recent studies, such as the one conducted by Ellison and Sargent (2015), have demonstrated that nominal factors, such as inflation and money supply, are unable to provide an adequate explanation for actual production. However, this is not always the case because it depends on the type of economy. To formulate the most effective monetary policy, it is essential to determine the phase of the business cycle (whether it be a period of economic contraction or expansion) during which the monetary variables exert their influence on production. In conclusion, based on classical growth theory, there is a relationship between gross domestic product and economic growth.

Both monetary policy and exchange rate values are interrelated. The supply and demand of a nation's currency are both impacted by the monetary policy of that nation, which in turn has an impact on the currency exchange rate. The increase in demand for a currency might lead to an increase in that currency's value in comparison to other currencies if the central bank decides to hike interest rates. In the opposite direction, if the central bank reduces interest rates, it may cause demand for the currency to decrease, which in turn may cause the value of the currency to decrease. In the opposite direction, fluctuations in exchange rates can also affect the monetary policy of a country by influencing inflation and economic growth.

Foreign exchange and monetary policy.

Based on the findings, researchers also analyze the effects of US monetary policy transmission across different types of loans and their distribution. Lower policy rates shift bank allocation toward riskier borrowers, as shown by several empirical research (Jiménez et al., 2014, for Spain; Ioannidou et al., 2015, for Bolivia). They hypothesize that banks will move toward less risky loans as a result of their research into the effects of an increase in foreign monetary policy on lending. The data on loan disbursements is broken down into many categories, including currencies, maturities, security, and industries, so we can look into whether or not banks shift their lending toward safer bets. In addition, they assess the results of foreign monetary policy.

Foreign Exchange and monetary policy

Foreign exchange (FX) refers to the exchange of one currency for another or the conversion of one currency

into another currency. A decentralized market where currencies are purchased, sold, and traded is the foreign exchange market. The value of currencies fluctuates based on a variety of factors, including interest rates, economic growth, and political stability. Foreign exchange is used by businesses, investors, and governments to pay for goods and services, invest in foreign countries, and manage currency risk.

To understand why the impact of monetary policy on the exchange rate may have changed, it is helpful to consider a general explanation of the relationship between the exchange rate and interest rates (Ferrari et. al., 2021). The Interest Rate Parity (IRP) theory suggests that changes in interest rates may affect the value of a currency. Additionally, if a location has a higher interest rate than another, it is expected that investor would flock there in quest of larger returns on their investments, increasing the value of that region's currency.

Due to changes in the current and anticipated future differences between domestic and foreign interest rates, changes in expectations for the currency risk premium, and changes in opinions about the long-term level of the exchange rate, there are three main causes for currency rate changes in response to monetary policy events. The monetary policy transmission channel through the exchange rate has survived this period of considerable changes in financial markets and monetary policy implementation by using a properly designed event analysis to account for the multiple elements in monetary policy news.

Inflation and monetary policy

Kumawat and Bhanumurthy (2018) indicate that the monetary policy in India has been sensitive to the rate of inflation, the output gap, and the volatility of the exchange rate. In addition, the results of several studies that were conducted in the past indicate that monetary policy reacts more to the issue of inflation than it does to the issue of unemployment (Chicheke, 2009). Next, Zhang & Clovis (2010) claim that the dynamic equations for inflation in China provide signs of structural instability over time. These indications are based on the fact that the equations change over time. It has been established that the considerable change in the inflation persistence parameter is due to a response of inflation expectations to a series of adjustments in China's monetary policy framework that took place in the middle of the 1990s. These reforms took place during this period. Given that the structural change in the inflation process is primarily attributable to improvements in monetary policy and the associated improvements in inflation expectations, it is also possible for high inflation to strike back at China in the absence of a determined effort by the monetary authorities to continue managing inflation expectations. This is the case even though China has made progress in improving its monetary policy.

The relevant theory that indicates inflation related to monetary policy was Irving Fisher's theory. American economist Irving Fisher established the Irving Fisher theory (1867-1947). Fisher's theory on inflation, interest rates, and money supply underpins it. Fisher's theory also addresses inflation-interest rate relationships. Fisher felt money supply fluctuations might affect interest rates, economic activity, and inflation. He predicted inflation and higher interest rates if the money supply grew faster than the economy. Economists continually study and debate Fisher's theory, which shaped monetary economics. His research on money, pricing, and economic activity has offered a foundation for monetary policy decisions. In Irving Fisher's theory, monetary policy and inflation are linked. Fisher believes money supply changes can significantly affect the economy and inflation. Fisher predicted inflation and higher interest rates if the money supply grew faster than the economy. If the money supply declines, interest rates and inflation fall. Fisher advocated monetary policy to curb inflation. According to Irving Fisher's theory, there is a connection between monetary policy and inflation, which leads us to the following conclusion.

3. Research Methodology

Model Specification

To test the relationship between the variables of unemployment (UR), domestic private credit (DGR), gross domestic product (GDP), foreign exchange (FER), and inflation (I). Model specification for determining the connection between a dependent variable (y) and an independent variable (x). To describe the link between one dependent variable and two or more independent variables, the Multiple Regression Analysis Model is used. There are just a few models that can be employed with the multiple linear regression model. As a result, the Ordinary Least Squares (OLS) approach is being used in this research investigation. The OLS technique is a statistical analysis method that evaluates the link between variables by minimizing the sum of squared

differences between observed and corresponding values. In this research, the OLS method is used to analyze the data between monetary policy and its determinants which are unemployment, domestic private credit, gross domestic product, foreign exchange and inflation. The regression model is given below:

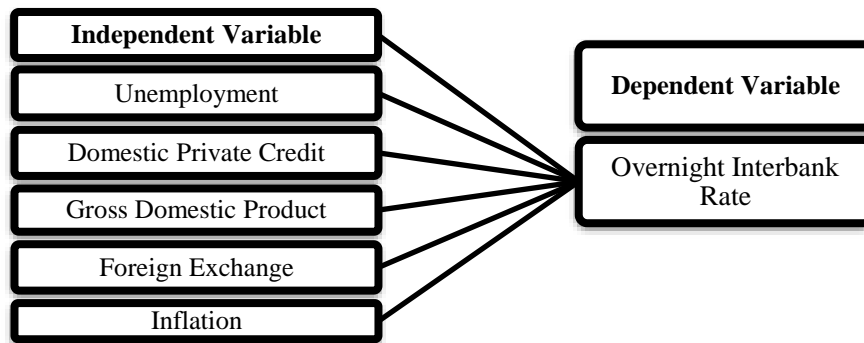
$$\gamma = \beta_0 + \beta_1 LNUR_t + \beta_2 LNDGR_t + \beta_3 LNGDP_t + \beta_4 LNFER_t + \beta_5 LNCPI_t + \varepsilon_t$$

Data Collection and Measures

This study uses annual data in the context of Malaysia, covering the period from 1991 to 2021. We began the data in 1991 due to the changes in monetary policy. This is a preliminary investigation that aims to identify the sources of the issue and provide the most accurate explanation that can be provided. To put this another way, the objective of exploratory research is not to produce conclusive answers to questions that have already been posed; rather, its focus is on merely investigating the research questions. The purpose of doing a study of this kind is often to investigate a subject that has not yet been precisely identified. The purpose of exploratory research is not to provide evidence that an issue exists; rather, it is to provide us with a deeper knowledge of the nature of the problem. This study is done to determine the nature of the problem, and its purpose is not to supply evidence that the problem exists. Quantitative research can be used to argue about how variables in a study interact with one another. According to (Ivankova, 2023), the significance of the teaching and learning process can be studied and understood through qualitative research, which focuses on investigating people's experiences with and views of social phenomena.

According to the figure 1 above shows two variables that be used in this research which are dependent variables and independent variables. The figure above indicates and explains how macroeconomic components influenced the monetary policy effectiveness in Malaysia. Based on the figure, monetary policy effectiveness is the dependent variable, and the independent variables are unemployment, domestic private credit, gross domestic product, foreign exchange, and inflation. The result of implication on the monetary policy in Malaysia comes out from the independent variables. In other words, the independent variables are the elements that will affect the monetary policy. The sources of the data are in Table 1.

Figure 1: Theoretical Framework for Monetary Policy



In this study, there are Furthermore, Multiple regression also being used to determine the connection between a dependent variable (y) and an independent variable (x). To describe the link between one dependent variable and two or more independent variables, As a result, the Ordinary Least Squares (OLS) approach is being used in this research investigation. The OLS technique is a statistical analysis method that evaluates the link between variables by minimizing the sum of squared differences between observed and corresponding values. In this research, the OLS method is used to analyze the data between monetary policy and its determinants which are unemployment, domestic private credit, gross domestic product, foreign exchange and inflation. R-squared is a statistical measure that represents the proportion of the variance in the dependent variable that is predictable from the independent variables. The t-test is used to evaluate the degree of significance to reject the null hypothesis by comparing it to the P-value. Another way to say this is that the T-test is used to decide whether or not the null hypothesis should be accepted. Another statistical is the F-Test. It is used to compare the variances of two populations. It is used to determine whether the variances of two groups are equal, and thus whether the two groups have similar dispersion.

In the diagnostic test, this study used four tests that involved time-series data which are the Variance Inflation Factor (VIF) procedure, Serial Correlation Test Normality Test on Residuals and Multiple Regression Model. Variance Inflation Factor (VIF) is a statistical measure that indicates the degree of multicollinearity (correlation between independent variables) in a multiple regression analysis. When there are strong correlations between two or more independent variables, multicollinearity occurs. It is stated to exist among the independent variables in a regression if the independent variables are connected to or reliant on one another. Next is the serial correlation test where any error terms of a time series are correlated in the manner described above, we can perform a Durbin Watson (DW hereafter) Test. The common rule is that when the DW statistic is lower than Durbin (dL) or the DW statistic is higher than 4-du, it suggests that serial correlation exists (Studenmund, 2017). Moreover, a normality test is to establish the likelihood that a given sample represents a normal distribution in the larger population. For quantitative variables to be tested using parametric methods like correlation, regression, the t-test, and analysis of variance (ANOVA), the data must follow a normal distribution. When represented on a graph like a histogram, a Box Plot, or a Frequency Polygon, time series data should take the shape of a bell-shaped curve, representing a normal probability distribution. If the data set is not normally distributed, it indicates that the 'model is not good in the representation of the data generation process (Lütkepohl, 2005).

Table 1: Definition and sources of variables

Variables	Description	Data source	Expected Relationship
Monetary Policy	Overnight Interbank Rate (OIR)	World Bank, FRED	-/+
Unemployment	Unemployment Rate (UR)	International Monetary Fund, World Bank, FRED	-/+
Domestic Private Credit	Domestic Growth Rate (DGR)	World Development Indicator	-/+
Gross Domestic Product	Gross Domestic Product (GDP)	World Bank, FRED	-/+
Foreign Exchange	Foreign Exchange Rate (FER)	World Bank, FRED	-/+
Inflation	Consumer Price Indexes (CPIs)	World Bank, FRED	-/+

The hypothesis will be considered and tested in this analysis:

Hypothesis 1

H01: Unemployment has no relationship with monetary policy.

HA1: Unemployment has a relationship with monetary policy.

Hypothesis 2

H02: Domestic private credit has no relationship with monetary policy.

HA2: Domestic private credit has a relationship with monetary policy.

Hypothesis 3

H03: Gross domestic product has no relationship with monetary policy.

HA3: Gross domestic product has a relationship with monetary policy.

Hypothesis 4

H04: Foreign exchange has no relationship with monetary policy.

HA4: Foreign exchange has a relationship with monetary policy.

Hypothesis 5

H05: Inflation has no relationship with monetary policy.

HA5: Inflation has a relationship with monetary policy.

4. Results

Regression result

Estimates are used to carry out the empirical investigation based on model specification. This allows us to examine the effects of the explanatory variables at different points in the relationship based on the impact of economic indicators on monetary policy. The empirical results discussion between the independent variables and dependent variables are shown in Table 2. The OLS estimates are shown below:

Table 2: Regression Result

DV – Overnight Interbank Rate (OIR)	$\gamma = \beta_0 + \beta_1 LNUR_t + \beta_2 LNDGR_t + \beta_3 LNGDP_t + \beta_4 LNFER_t + \beta_5 LNCPI_t + \varepsilon_t$
	Regression Method: Ordinary Least Square (OLS)
LNUR	-0.744** (-2.188)
LNDGR	0.315 (1.289)
LNGDP	0.019 (0.273)
LNFER	-0.205 (-0.621)
LNCPI	-1.356***(-5.703)
cons	7.814*** (5.873)
R-squared	0.832
F – statistic	24.815
Durbin Watson	1.025

t statistics in parentheses, p<0.10* p<0.05**, p<0.01***

Table 2 provides the regression result for the variables used in the OLS analysis. The result shows two economic indicators have a negative relationship with monetary policy determined by overnight interbank rate. It shows that if the Unemployment Rate (UR) increases by 1%, the Overnight Interbank Rate (OIR) will decrease by 0.744%. Another negative coefficient was if the Foreign Exchange Rate (FER) increases by 1%, the Overnight Interbank Rate (OIR) will decrease by 0.205%.

Based on the result, the adjusted r-squared is 79.88%. It depicts that 79.88% of the variations in the dependent variable can be explained by two of the independent variables which are the unemployment rate and consumer price index in the model. The remaining 20.12% is due to the omission of the other important independent variables.

Moreover, on the t-test, we have enough evidence to reject the first and fifth null hypotheses because the p-value is at significance levels of 0.05 and 0.01 respectively. Therefore, we conclude that unemployment (UR), and inflation (CPI) are influencing the movement of monetary policy in Malaysia.

Lastly, Based on F-test, we have enough evidence to reject the null hypothesis because the p-value is at 0.01 (1%). Therefore, we can conclude that there is a significant relationship between at least one of the macroeconomic variables which are unemployment (UR) and inflation (CPI) with monetary policy in Malaysia.

Diagnostic Test

VIF Procedure

Table 3: VIF Test

Variable	VIF
LNUR	1.602
LNDGR	1.397
LNGDP	1.281
LNFER	2.582
LNCPI	2.603

Sources: Author's calculation

Based on table 3 shows the test of Variance Inflation Factors (VIF) results to identify the multicollinearity. The results show all five variables scored in VIF are below 5. We found out that the Unemployment Rate (LNUR), Domestic Growth Rate (LNDGR), Gross Domestic Product (LNGDP), Foreign Exchange Rate (LNFER), and Consumer Price Index (LNCPI) were scored below 5 (Centered VIF) at the first order. Hence, we can accept all the independent variables.

Durbin Watson

Next, based on Table 2, the test proceed to the second diagnostic which is the Serial Correlation Test which is

the Durbin Watson Statistic the 1st order serial correlation test. Since DW Statistic 1st order does not fall within the range of 1.5-2.5 whereby 1.025, hence it requires us to rerun a serial correlation test at 2nd order using the Breusch Godfrey test for corrections.

Since a Durbin-Watson stat score at 2nd order (Breusch-Godfrey) falls within the range of 1.5-2.5 whereby 1.847729, hence we have enough evidence to reject the H₀ of having a severe correlation among the error terms. Therefore, we may proceed with the 3rd Diagnostic Check which is Normality Test.

5. Conclusion

A total of five independent variables been found which include unemployment, domestic private credit, gross domestic product, foreign exchange and inflation have been utilized and a total of 31 annual data have been collected for Malaysia spanning from year 1991 to year 2021 from a reliable secondary source to achieve and solve the research objectives and questions. This model has been constructed in a significant way in which the independent variables utilized in explaining the dependent variable which monetary policy are derived to be at a 99% confidence interval. Furthermore, the result also emphasizes that 95.41% of the variation in monetary policy can be explained by all independent variables, therefore proving the variables that have been chosen are suitable. Overall, unemployment and inflation are the most significant to the impact of monetary policy. According to the literature by (Christoffel and Linzert, 2005, and Trigari, 2006), unemployment has a substantial impact on how monetary policy is transmitted. Kumawat and Bhanumurthy (2018) indicate that the monetary policy in India has been sensitive to the rate of inflation, the output gap, and the volatility of the exchange rate. As a result of the multiple regression, it is found that unemployment and foreign exchange have a negative relationship with monetary policy whereby the increase of unemployment and foreign exchange may decrease the monetary policy of the country. While for domestic private credit, gross domestic product and foreign exchange have both positive and negative relationships with monetary policy depending on various countries. This study will be significant to policymakers and may potentially be used as a basis for the formulation of legislation and policies about the industry. The findings of the study can be used by central banks as policymakers to design rules that promote stability and safeguard the interests of investors using the information gained from the study. This would apply specifically to enterprises in the industry. Moreover, existing and potential investor make better investment selections depending on their long-term or short-term investment objectives and for future research.

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