Money Supply, Inflation and Economic Growth in China：An ARDL bounds testing approach

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**【Abstract】**The empirical analysis applies the autoregressive distributed lag bounds testing approach to investigate the relationship between money supply, inflation and economic growth in China with the time series data from 1980 to 2018, estimate the cointegration of monetary and economic growth in long-run relationship and uses vector error correction model to determine the short-run adjustment between the variables. The research showed that the increase in national income met people's demand for goods and eased inflationary pressures. The results support the view of monetarism and help the government formulate economic policies in a prudent manner to control inflation in China.

**Keywords:** ARDL bounds test，Long-Run，Monetary Neutrality

1. **Introduction**

This report attempt to analyze the relationship between money supply, inflation and economic growth. Using ARDL bounds test (Pesaran and Shin, 2001) for such advantage: it performs better to small samples compared to alternative multivariate cointegration procedures; it does not require the restrictive assumption that all series are integrated of the same order, allowing for the inclusion of both I(1) and I(0) (but not I(2)) time series in a long-run relationship. And the results could estimate both the short-run dynamic adjustment and the long-run dynamic relationship if cointegration exist.

1. **Data**

All the data have been the time series data from 1980 to 2018 of China, from World Development Indicators. All the variables are followed: M (MONEY -Broad money growth), Y(OUTPUT -GDP growth),P(Inflation, GDP deflator),π (Real interest rate).

**3. Methodology**

ARDL model as follows：

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Where M--BROAD MONEY GROWTH (ANNUAL %)

Y-- GDP GROWTH (ANNUAL %)

P--INFLATION, GDP DEFLATOR (ANNUAL %)

π --REAL INTEREST RATE (%)

In the ARDL model, the bounds test is adopted to determine whether there is a long-run equilibrium between the variables, namely whether the cointegration relationship exists.

In the equation, α1i, α2i, α3i,α4i represent the short-run dynamic relationship and θ1, θ2, θ3, θ4 denote the long-run dynamic relationship.

The **bounds test** is based on the joint significance of F statistic and the Chi-sqaure statistic of Wald test, the hypothesis to examine whether there exists cointegration between the variables is expressed as follows:

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If the calculated F statistic falls above the upper critical value, the null of no cointegration hypothesis is rejected. If the calculated F statistic falls below the lower critical value, we fail to reject the null of no cointegration hypothesis, which means that there is no cointegration between the variables. While if the calculated F statistic falls inside the upper and lower critical bounds, it cannot be determined whether the cointegration exists between the variables .

The long-run relation between dependent and independent variables is

shown by the following equation:

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If it is confirmed that cointegration exists between the variables, an error correction mechanism (ECM) would be:



Where ECMt–i is the error correction term and λ is the coefficient of the error correction term which shows the speed of adjustment of the variables to equilibrium in long-run.

1. **Results**
	1. **stationary test and optimal lag length**
		1. Test of Stationarity

Augmented Dickey–Fuller (ADF) unit root test is used to ensure that the time series data possess the property of stationarity.

Table1. Unit root test

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| variable | （C.T.K） | ADFt-Statistic | Test critical values | Stationarity |
| 1% | 5% | 10% |
| M | C.0.0 | -2.105784 | -3.615588 | -2.941145 | -2.609066 |  |
| ΔM | 0.0.0 | -6.654945 | -3.621023 | -2.943427 | -2.610263 | \*\*\* |
| Y | C.0.1 | -4.275431 | -3.621023 | -2.943427 | -2.610263 | \*\*\* |
| P | C.0.1 | -3.214270 | -3.621023 | -2.943427 | -2.610263 | \*\* |
| π | 0.0.0 | -2.992245 | -2.627238 | -1.949856 | -1.611469 | \*\*\* |

All the variable are stationary except the broad money growth, but would be stationary after first difference.





Fig1.

 Using ADF test, Y,P, π are stationary, and only ΔM is I(1), ARDL bounds test is suitable because it does not require the restrictive assumption that all series are integrated of the same order ,thus allowing for the inclusion of both I(1) and I(0).

**4.2 ARDL cointegration test**

The selection of the optimal ARDL specifications is selected based on the Akaike information criterion (AIC) which is asymptotically consistent for the lag length and is based on a general-to-specific approach, starting with max p= max q= 4 and dropping all the insignificant lags using a 5% decision rule.

Table2.

|  |  |  |  |
| --- | --- | --- | --- |
| variable | ARDL | F-Bounds TestF-Statistic | Cointegration(Signif) |
|
| P | ARDL(4, 4, 2, 4) |  6.630341 | 1% \*\*\* |

|  |
| --- |
| Test critical values |
|  I(0) lower bounds | I(1) upper bounds |
| 1% | 2.5% | 5% | 10% | 1% | 2.5% | 5% | 10% |
| 4.29 | 3.69 | 3.23 | 2.72 | 5.61 | 4.89 | 4.35 | 3.77 |

As the above results shows, only when Y, P and π acts as the dependent variable, the joint significance of the F statistic is larger than the upper bounds, the null of no cointegration hypothesis is rejected. In other words, there is cointegration between the variables.

**4.3 Long run relationship from ARDL model**

Based on the bounds test result ,there are three cointegration relations as follows:

Table3. Long-Run Impact of Money Growth on Inflation

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Regressor | Coefficient | Standard Error | T-Ratio | Prob. |
| M | 0.349929 | 0.033799 | 10.35327 | 0.0000 |
| Y | -0.210811 | 0.113246 | -1.861535 | 0.0801 |
| π | -1.163744 | 0.137340 | -8.473427 | 0.0000 |

P =0.34992851\*M -0.21081148\*Y -1.16374432\*R

Se (0.033799)\*\*\* (0.113246)\* (0.137340)\*\*\*

The results show that the positive impact of money supply on inflation rate is statistically significant. This finding is consistent with the theoretical and empirical evidence that money supply is always a monetary phenomenon.

**4.4 Short -run adjustment in ECM**

**Table2.**  Error correction (ECMt-1 ) coefficient

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Regressor | Coefficient | Standard Error | T-Ratio | Prob. |
| D(P(-1)) | 0.345778 | 0.163256 | 2.118012 | 0.0492 |
| D(P(-2)) | -0.071390 | 0.150220 | -0.475234 | 0.6407 |
| D(P(-3)) | -0.173287 | 0.128765 | -1.345768 | 0.1961 |
| D(M)\*\*\* | 0.071269 | 0.024490 | 2.910087 | 0.0098 |
| D(M(-1))\*\*\* | -0.142466 | 0.039607 | -3.597004 | 0.0022 |
| D(M(-2))\*\*\* | -0.151884 | 0.032140 | -4.725670 | 0.0002 |
| D(M(-3))\*\*\* | -0.097237 | 0.027578 | -3.525858 | 0.0026 |
| D(Y) | -0.017568 | 0.061499 | -0.285665 | 0.7786 |
| D(Y(-1))\*\*\* | 0.235537 | 0.077877 | 3.024483 | 0.0076 |
| D(π)\*\*\* | -1.025384 | 0.057848 | -17.72554 | 0.0000 |
| D(π(-1)) | 0.270575 | 0.192203 | 1.407760 | 0.1772 |
| D(π(-2)) | -0.122898 | 0.156809 | -0.783744 | 0.4440 |
| D(π(-3))\* | -0.261413 | 0.131052 | -1.994724 | 0.0624 |
| CointEq(-1)\*\*\* | -0.769023 | 0.137674 | -5.585840 | 0.0000 |

ECMp = -0.769023

Next, in order to check the short-run relationship between the variables the ECM is employed. The results of the short-run dynamic coefficients associated with the long-run relationships obtained from the ECMt-1, represents the error-correction term derived from long-run co-integrating friendship via ARDL model.

The absolute value of the coefficient of error correction term indicates speed of adjustment to restore equilibrium and the negative sign shows convergence in the short-run dynamic model. The coefficient of ECMt–1 in this model is -0.769023 and this means that in each period, about 76.9023% of shocks can be justified as a long-run trend. The coefficient of ECMt-1 in our model is negative and highly significant.It implies that, in China, money supply, inflation and economic growth are co-integrated when inflation serves as dependent variable.

The error correction coefficient shows, in the short -run adjustment, the adjustment of inflation almost come from money supply

**4.5 other test**

4.5.1 Serial Correlation



The result show the residual of ARDL has no serial correlation.

4.5.2 Heteroskedasticity Test



The result show that there is no heteroskedasticity

4.5.3 Stability Test

The long-run stability of the parameters to be estimated is tested applying the cumulative sum (CUSUM) and the cumulative sum of squares (CUSUMSQ) tests.



Fig2.



Fig3.

Diagnostic and stability tests confirm that models are econometrically sound and stable.

**5. Conclusion**

This study aims to use time series data to explore the short-term and long-term effects of money supply on China’s inflation rate. The author uses ARDL to estimate the results. An important policy variable is drawn, that is, money supply is the main cause of inflation, and any increase in interest rates can alleviate China’s inflationary pressure. The results showed that the increase in national income met people's demand for goods and eased inflationary pressures. This gives economic planners a clear reminder that by controlling interest rates, money supply and national output levels, it may be helpful to control inflation. The results of this research support the view of monetarism and help the government formulate economic policies in a prudent manner to control inflation in China.

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