ABSTRACT

A stable demand for money function assists to test a relation among money and prices which is a pre-requisite in formulating an effective monetary policy. A stable demand for money function confirms that the effect of monetary policy is anticipated besides that monetary policy actions are coherent with the needed objectives of stability of prices and growth in the long run. In this analysis a stable stationary long run affiliation amongst the rate of interest, real income plus the effect of real stock prices on real money balances in Pakistan during the period 1975 to 2012 is explored to take appropriate monetary policy measures. In order to conduct this relation empirically cointegration technique to test the long run relation, vector error correction estimates were applied to explain short run relation while a multivariate granger causality test was employed to check the cause and effect relationship. Results illustrated that real money balances were positively related to real income with income elasticity equal to 1.13 and negatively related to rate of interest with interest rate elasticity equal to 0.01 in Pakistan plus due to the bullish trend in stock market a significant negative substitution effect dominated on the long run real money balance, real stock prices elasticity equal to 0.37. The short run model justifies the presence of cointegrating relationship for the real money balance, 51.4%of adjustment to an exogenous shock occurs in one year. A bi-directional causality running from interest rate and real money balance, uni-directional causality running from real income to real money balance, real stock price to real money balance, real income to real stock price, interest to real stock price and real income to interest rate. It is recommended in order to promote saving i.e. reduction in real money balance government should try to develop stock market.

Keywords: money demand, stock price, Cointegration, endogeneity