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The purpose of this thesis is to study the factors affecting money supply and to test for the validity of the New Classical Economist's hypothesis which states that only the unanticipated components of the money supply have an influence on real output. Moreover the rational expectation hypothesis and neutrality of money hypothesis are tested. The time period of this study is separated into two periods, before the financial liberalization period between 1970 to 1989 and after the financial liberalization period between 1990 to 1994. Data used are quarterly time series data.

By estimating the narrow money supply(M1) using the Ordinary Least Square and testing the stability of money supply equation using the Chow test, it is found that the factors influencing the money supply before the financial liberalization period are the money supply in the previous quarter, the government expenditure and revenue in the previous quarter, the real income in the previous quarter and the dummy variable representing second quarter. After the financial liberalization period, the factors influencing the money supply are the money supply in the previous quarter, the real income in the previous quarter, and the dummy variable representing second quarter. We call the money supply by using the above method-anticipated money supply.

The finding from estimating the real output using the OLS and the Polynomial Distributed Lag method are as follows. Unanticipated money supply has less an influence on the real output than anticipated money supply, both before and after the financial liberalization period. The joint test between the Rationality and Neutrality test shows that the hypothesis is not valid. This prompts further investigations of each hypothesis. The result demonstates that the invalidity of the joint test is due to the invalidity of the neutrality hypothesis.

This study shows that if the economic goal is to stabilize the real output, financial authority should stabilize the change in money supply because economic agents have rational expectation on money supply which affects the real output.

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