CHAPTER 3

The Malaysian Economic Background

3.1 Introduction

This chapter is designed to examine the structure of the Malaysian economy and its development since 1960. It sets the background for the subsequent construction of the small macroeconometric model that is undertaken in the following chapter.

The chapter is divided into two sections. The first section gives a brief description of the basic structural features and magnitudes of the Malaysian economy. These include, a descriptive analysis of national expenditure aggregates, prices, the balance of payments and monetary aggregates.

The second section attempts to give a brief review of the development of demand management policies, namely monetary and fiscal policy.

3.2 Growth and Structural Change.

In the three decades since independence in 1957, the economic expansion in Malaysia was sustained at a high rate up to 1980, but the pace of growth slowed down in 1981-1985, as activity was dampened by the prolonged world recession which began in the latter part of 1980s. From table 3.1, growth in the gross domestic product at constant prices (real GDP) grew by an average annual rate of 4.1 percent in the second half of the 1950s to 8.1 percent in the 1970s. However in the early 1980s due to the unfavorable global economic conditions and structural weaknesses within the economy, the GDP growth rate slackened to an average growth rate of 5.2 percent before picking up to average 6.9 percent per annum for 1986-1990.

Table 3.1

Malaysia : Annual Growth Rate (%) of Gross Domestic Product (GDP) at Constant Prices.

Year	1956-60	1961-65	1966-70	1971-75	1976-80	1981-85	1986-90
1	2.9	1.4	6.2	10.0	11.6	6.9	1.2
2	2.5	6.9	1.0	9.4	7.8	6.0	5.4
3	0.5	5.5	4.2	11.7	6.7	6.2	8.9
4	4.5	5.8	10.4	8.3	9.3	7.8	8.8
5	9.9	5.6	5.0	0.8	7.4	-1.1	10.0
Average	4.4	5.0	5.4	8.0	8.6	5.2	6.9

Note: For 1956-60, 1960=100; 1961-70,1970=100; 1971-80, 1970=100; 1981-90, 1978=100.
Source: Bank Negara Malaysia, *Annual Report 1990,* Table A1, p.53

Malaysia is a trade-oriented economy based largely on agriculture. At the time of independence in 1957, value added in the agriculture, forestry and fishing sector accounted for about 40 percent of the GDP, provided two-thirds of the total employment and contributed two-thirds of the country's export earnings. Malaysia was already by then the world's largest producer and exporter of natural rubber contributing about one-third of the total world production. At the time, Malaysia was also the world's largest producer and exporter of tin metal (accounting for about 33 percent of world output and exports.)

The over-dependence on the two primary commodities subjected the economy to instability arising from wide fluctuations of these two commodities (Bank Negara Malaysia, 1989: p.12). This called for a governmental action to embark upon agricultural diversification program and industrial programs to broaden her export base. Since then the Malaysian economy undergone significant structural transformation for the past three decades until present.

Table 3.2

Malaysia: Gross Domestic Product (GDP) by Sector of Origin 1960-90
(percent of GDP)

Sector	1960	1965	1970	1975	1980	1985	1990
Primary	46.6	40.5	37.1	32.3	32.8	31.2	28.4
Agriculture, forestry & fishing	40.5	31.5	30.8	27.7	22.8	20.8	18.7
Mining & quarrying	6.1	9.0	6.3	4.6	10.0	10.4	9.7
Secondary	11.6	14.5	17.3	20.2	24.6	24.5	30.5
Manufacturing	836	10.4	13.4	16.4	20.0	19.7	27.0
Construction	3.0	4.1	3.9	3.8	4.6	4.8	3.5
Services/ Tertiary	44.6	45.1	41.9	45.0	40.0	43.9	41.7

Note: For 1960-80, 1970=100; 1980-90, 1978=100.
Sources: Jomo K.S. (1990), *Growth & Structural Change in Malaysia Economy*, Table 3.2, Pp. 40-41.
Sixth Malaysia Plan, 1991, Table 1.2 , p.20.

The structural shifts in the economy could be seen in terms of sectoral composition of the GDP of the country (from the supply side) is shown in Table 3.2 It is evident that the share of the primary sector has shown a marked decline since 1960. The percentage contributed to the GDP by the primary sector has decreased from 44 percent in 1960 to 37 percent in 1970, 33 percent in 1980 and 27 percent in 1990. The agriculture's share which accounted for 40 percent of GDP in 1960 has declined significantly to 28.4 percent in 1990 while the mining's share of GDP which recorded for 6 percent in 1960 decreased to 4.6 percent in 1975 before rising to 10 percent in 1980 and 9.7 percent in 1990. This is due to the increase in petroleum production and prices as well as the growth in natural gas production has more than compensated for the decline in tin-mining.

On the other hand, the share of the secondary sector (manufacturing and construction) of GDP shows a significant increase during 1960-1990. In 1960, this sector contributed 11.7 percent of GDP and its share of GDP rose to 30 percent in 1990 with significant contributions coming from manufacturing sector. This is an indication that a determined effort is being made to industrialize the economy by the government.

Since the implementation of National Economic Policy (NEP), the government has been actively promoting industrial development through various kinds of incentives by introducing the pioneer status, investment tax credit and export incentives to the manufacturing sector. Such incentives were part of the government strategy to diversify the economy output of primary sector and to establish a strong base in the economy to reduce the instability associated with over-reliance on one or two primary commodities.

The services sector remained an important sector in the Malaysian economy, which was characteristic of an open, traded-oriented economy. Between 1960-1990, the share of the services sector in the economy had been sustained above 41 percent, dropping only slightly to 40 percent in 1980. Growth in the services sector was due mainly to trading activities related to agriculture, mining and manufacturing sectors - especially services in wholesale and retail services, transport, communications and utilities. The government services sector also increased rapidly in the 1970s, with the expansion in the role of government in the economy, associated partly with the implementation of the National Economic Policy programs. Overall, the relative share of the services sector remain slightly above 40 percent during the past three decades.

Structural changes in national product may also be viewed from the demand side, that is, from the sectoral composition of the GNP, as shown in

Table 3.3. Over the past three decades, the investment activity in Malaysia has grown rapidly where private fixed investment (or fixed capital formation) which share accounted for about 10 percent of GNP in 1961-1970 has expanded rather significantly. In 1986-1990 private investment's share of GNP had more than doubled to 23.8 percent from its previous share of 10.5 percent. This could partly be attributed to active government funding of investment projects. These developments coupled with the 1985 global realignment of exchange rates against the US Dollar and the depreciated ringgit led to a boom in direct foreign investment in Malaysia. This increased flow in direct foreign investment was directly responsible for stimulating private investment (Yokoyama, 1991). The government investment too has risen particularly since the implementation of the NEP. The share of government investment which was only 8.4 percent in 1961-1975 has increased to 17.3 percent in 1981-1985. The rapid expansion of the government investment in the early part of 1980s was due to the implementation of counter-cyclical fiscal policies to counteract the prevailing global recession. The expansion of the public sector also reflected in its consumption expenditure on final goods and services. It's share of GNP has remained surprisingly constant, about 16 to 18 percent during the period 1961-1985 before decreased to 13.9 percent in 1986-1990. By 1991, it's share is about 14.9 percent.

Meanwhile, private consumption expenditure share's of the GNP has shown a secular decline. In 1961-1965, private consumption expenditure accounted for about 64.5 percent of GNP, but by 1976-1980, its share had diminished to only 53.1 percent. The decline in private consumption expenditure has corresponded with the increase in private sector savings - both voluntary and contractual. The voluntary savings of the private sector, in turn have been channeled to investment expenditure through bank loans and advances. From the period 1981 to 1991, it's share of GNP remained constant at about 55 to 57 percent.

Table 3.3

Malaysia: Distribution of Gross National Product in Current Prices (%), 1961-91

Expenditure item	1960-65	1961-70	1971-75	1976-80	1981-85	1986-90	1991
Consumption	80.5	80.2	77.7	69.5	72.5	70.0	72.3
Private	64.5	62.5	60.2	53.1	55.1	56.1	57.4
Public	16.0	17.8	17.5	16.4	17.4	13.9	14.9
Investment	18.9	16.7	24.4	27.4	36.3	35.4	37.3
Private	10.5	10.3	16.6	17.4	19.0	23.8	25.4
Public	8.4	6.4	7.8	10.0	17.3	11.6	11.9
Total private expenditure	75.0	72.8	76.8	70.5	74.1	79.9	82.8
Total public expenditure	24.4	24.2	25.3	26.4	34.7	25.5	26.8
Imports of goods & services	41.0	44.2	48.6	55.6	67.2	75.5	91.5
Exports of goods & services	50.2	47.4	46.4	58.2	58.9	77.5	85.4
Total external trade	91.2	91.6	95	113.8	126.1	153	176.9
Gross national savings	17.8	18.3	20.8	30.0	27.5	30.3	29.4

Sources: Bank Negara Malaysia (1989), *Money & Banking in Malaysai.*
Bank Negara Malaysia, *Quarterly Economic Bulletin*, various issues.

As a small, open and developing economy, the most important feature that inherent in the Malaysian economy was the high degree of openness. The degree of openness is measured by the ratio of total exports and imports to GNP. Table 3.3 shows that, throughout the period 1961-1991, the ratio has consistently remained above 90 percent. Between 1961-1965, exports of goods and services accounted for 50.2 percent of the GNP. It had become more important in 1986-1990 accounting for about 77.3 percent of GNP and by 1991 it's share increase to 85.4 percent of GNP. The success of Malaysian export-led growth has been based primarily on the expansion in the quantum of products exported and changes in the composition of exports, and to lesser extent, on favorable commodity prices, for example, in the late 1970s and 1980s.

Similarly, imports of goods and services as a percentage of GNP have risen from 41 percent in 1961-1965 to 75.5 percent in 1986-1990 and by 1991 it's share is about 91.5 percent of GNP. The high import growth was not only associated with the high growth in income, but also the growing dependence on imports of investment and intermediate goods particularly during the 1980s. This development was in line with the rapid rate of capital formation and the expansion of manufacturing industries, particularly the growth of export-oriented industries.

3.3 Price Development and Stability

A unique feature of the Malaysian experience in economic development since independence was the rapid economic growth was achieved with relative price stability, particularly before 1972. As shown in Table 3.4 , for the period of 1957-1970, the rate of growth of consumer prices (CPI) in Malaysia averaged only 0.8 percent per annum.

However, the remarkable record of price stability could not be sustained for the subsequent period. For the first time ever, the CPI recorded a sharp increase of 10.5 percent in 1973 and subsequently 17.4 percent in 1974. This phenomenon of double-digit rate of inflation was largely due to the imported inflation. In addition, rapid growth of domestic aggregate demand and supply bottlenecks were also contributory factors. The freeing of the exchange rate in mid-1973, which resulted in a significant revaluation of the ringgit was sufficient to offset the impact of the massive bout of world inflation in the early 1970s. Recourse to stringent monetary, fiscal and administrative measures, however, helped to bring about an improvement in the price situation by 1976, when inflation was reduced sharply to an annual rate of 2.6 percent. Subsequently in line with relatively lower world inflation rates in the 1980s associated with the protracted global recession, growth in consumer prices in Malaysia had remained stable except for a brief resurgence in 1981. For the whole period of 1957-1992, the overall average in the consumer prices is about 3 percent, which suggests a remarkable degree of price stability for a developing country.

Table 3.4

Malaysia: Average Annual Growth Rate (%) of Consumer Prices (CPI)

Year	1956-60	1961-65	1966-70	1971-75	1976-80	1981-85	1986-90	1991-95
1	1.0	-0.2	1.4	1.6	2.6	9.7	0.6	4.4
2	5.1	0.1	4.1	3.2	4.7	5.7	0.8	4.7
3	-1.0	3.1	-0.2	10.5	4.9	3.7	2.5	
4	-2.9	-0.4	-0.4	17.4	3.6	3.6	2.8	
5	-0.2	-1.0	1.9	4.5	6.7	0.4	3.1	
Average	0.4	0.5	1.4	7.4	4.5	4.6	2.0	4.5

Note: For 1956-66, 1959=100; 1968-80, 1967=100 & 1981-90, 1980=100; 1991-92, 1990=100.
Source: Bank Negara Malaysia, *Annual Report,* various issues.

3.4 The Balance of Payments

Until the 1980s, Malaysia's balance of payments was the envy of many other less fortunate Third World countries. The basic strength of Malaysia's balance of payment is merchandise trade account, which had consistently been in surplus since 1950s, except in 1981-1982. For the first time in many years, the merchandise account recorded a deficit of RM 243 million in 1981 and RM 1,758 million in 1982. The deterioration in the merchandise account in 1981-1982 reflected the impact of the world recession on export earnings, compounded by the adverse impact of global inflation on imports growth through higher import prices. Since its recovery in 1983, the merchandise trade balance has been enjoying surplus until 1990 when it was RM 5,203.

On the other hand, the services account has persistently been in deficit through out the period 1961-1990 (Table 3.5). As a result of the poor performance of the balance of services, Malaysia's current account suffered numerous deficit for most of the year, except during the export boom years of 1965-66, 1968-70, 1973, 1976-79 and 1987-88. The outflows can be traced mainly to freight, insurance, transportation, investment income repatriation abroad (reflecting the profitability of foreign investment and other services payments.

However the current account position has been supported by strong inflows of both official and private long-term capital from abroad. The inflow of net official long-term capital, comprising both market and project loans to finance the substantial increase in public development expenditure during 1976-80 and 1981-85. Whereas, the substantial private capital inflow emanated largely from retained earnings in manufacturing and oil products, from reinvestment in plantation and mining, as well as new flows of foreign private investment.

The Malaysian economy has become very dependent on foreign investments and foreign loans to offset the adverse current account deficits. The country must understand that these foreign inflows are not a fundamental solution to adverse balance of payments deficits since they must eventually involve even larger outflows abroad in the form of investment income payment and debt servicing. Theoretically, such capital inflows should eventually be utilized to increased economy's productive capacity especially for exports. Practically, however, foreign borrowings has been used to finance economically unproductive expenditure on defense and internal security as well as inefficient, prestigious and unprofitable public projects and enterprises (Jomo. 1990). In recognition of this, the Malaysian government has reduced foreign borrowings since the mid-1980s and tried to lure investment, especially from abroad and particularly for export-oriented manufacturing.

Table 3.5

The Balance of Payments, 1961-90
(shown acumulatively, in RM billion)

Item	1961-65	1966-70	1971-75	1976-80	1981-85	1986-90
Exports f.o.b.	16.834	21.498	35.962	97.189	162.636	279.238
Imports f.o.b.	14.910	17153	32.163	73.893	147.766	225.868
Merchandise balance	1.924	4.153	3.799	23.296	14.87	53.37
Net services payments	−1.632	−2.722	6.446	−18.742	−42.19	−48.494
Net transfers abroad	−0.700	−0.751	0.628	0.344	−0.278	1.205
Current account balance	−0.408	0.872	−3.275	4.210	−27.598	6.081
Official long-term capital (net)	0.477	0.862	2.355	2.631	21.665	−8.106
Private long-term capital (net)	1.000	0.925	3.378	6.413	12.697	15.038
Private financial capital (net)	0.057	0.176	0.339	−2.449	0.742	2.106
Capital accout balance (net)	1.534	1.963	6.072	6.595	35.104	9.038
Errors & omissions	−0.840	−2.256	−1.006	−4.581	−5.747	−0.288
Overall paymets position	0.286	0.579	1.791	6.225	1.759	14.831

Sources: Bank Negara Malaysia (1989), *Money & Banking in Malaysia,* Table 1.4-1.5, Pp. 12- 13; Bank Negara Malaysia, *Quarterly Economic Bulletin,* various issues.

3.5 Fiscal Management

Before the end of the 1970s, the Malaysian government pursued a prudent fiscal policy, accumulating surpluses in good year and incurring deficits in lean years, which help insulate the economy to a considerable extent from external shocks (Ariff, 1991, p.31). During the 1970s, the public sector play a more active role in the economy in order to facilitate the achievement of NEP objectives as well as to promote rapid economic development. During the 1979-83, fiscal policy was highly expansionary. Development expenditure as a proportion of GNP rose from 13.6 percent in 1975 to 18.8 percent in 1980 and 27.2 per cent in 1982 as shown in Table 3.6. This tremendous increase in public sector spending was due to the implementation of counter-cyclical policies by the government to ride out the prevailing global inflation.

Public sector operating expenditure also rose rapidly in the early 1980s. It's share of GNP has risen from 21.2 percent in 1970 to about 30 percent for the period 1980-84. The bulk of the increase was accounted for by the provision of economic services in agricultural and rural development, commerce and industry, and general administration. The early 1980s also witnessed the period of the government "big push" into heavy industries. Consequently the period of the 1981-85 (during the Fourth Malaysia Plan), the public sector's share of GNP reach a peak of average 34.7 percent (see Table 3.6)

The highly expansionary fiscal policy in the early 1980s caused a numerous budget deficit in the first half of 1980s, especially in 1980 to 1984. From Table 3.6, the overall deficits percentage of GNP rose from 15.7 percent in 1980 to 18.9 percent in 1982 before declined to 13.2 percent in 1984. At the same time the public sector also compounded with sluggish revenue growth because of the liberalization of taxes and the dampening impact on income and commodity prices caused by the world recession. As a

Monetary growth, however, moderately during 1981-85 with M1 increasing at an average annual rate of 7 percent and M2 at 11.9 percent, reflecting the impact of deteriorating global economic conditions of the country's balance of payments, the maintenance of selectively restrictive monetary policy to restrain inflation, and a contractionary fiscal stance implemented since the latter part of 1982. However, with the turnaround in the economy in the latter part of 1986, monetary growth picked up moderately with M1 growing at an average annual rate of 12.4 percent and M2 10.8 percent.

As a results of these developments, the percentage composition of M1 and M2 changed significantly over the period 1961-90, as summarized in Table 3.8 In 1961-65, quasi money comprised 34.9 percent of private sector liquidity (M2); but by 1986-90, it accounted for 72.7 percent. The growth in the relative importance of QM has meant the corresponding decline in the relative importance of M1 in total private sector liquidity.

The determinants of the changes in money supply, M1 and M2 (Table 3.8) can be analyzed in terms of four factors[1] : net lending to Government; credit to private sector; net foreign assets and other influences. They add up to the money supply, M2 or private sector liquidity. Over the years, all the principal "determinants" of money supply M1 and M2 were generally expansionary. The relative importance of these determinants depending not only on cyclical economic fluctuations but also on the rapidly expanding public sector as well as the growing resort to banks financing by both the public and private sector for their capital expenditures. The expansionary trends is however, counterbalanced by increasing quasi money, consequent upon increasing income and savings, so that the resultant money supply M1 increase at a lower rate the M2.

Table 3.6

Consolidated Public Sector Finance, 1960-90
(at current prices, RM million)

	1960	1965	1970	1975	1980
General Government[a]					
Revenue	1174	1833	2861	5929	16371
Operating expenditure	888	1702	2429	5554	15063
	(13.4)	(19.4)	(21.2)	(25.7)	(29.1)
Current surplus/deficit	286	131	432	375	1308
NFPEs current/deficit	24	46	96	96	291
Public sector current surplus	310	177	527	471	1599
Development expenditure	195	769	959	2930	9711
	(2.9)	(8.8)	(8.4)	(13.6)	(18.8)
General Government	167	669	878	2467	8162
	(2.5)	(7.6)	(7.7)	(11.4)	(15.8)
NFPEs	28	100	81	463	1549
	(0.4)	(1.2)	(0.7)	(2.2)	(3.0)
Overall surplus/deficit	115	–592	–432	–2459	–8112
	(1.7)	(–6.7)	(–3.8)	(–11.4)	(–15.7)
Sources of financing					
Net domestic borrowing	32	101	3	1012	1590
	(0.5)	(1.1)	(0.02)	(4.7)	(3.1)
Net domestic borrowing	162	404	330	1219	3650
	(2.4)	(1.1)	(2.9)	(5.6)	(7.1)
Change in assets[b]	–343	28	99	228	2872

Notes: [a] General government comprises of federal government, state government, statutory authorities & local government .
[b] (+) indicates a drawdown of assets.
Figures in parentheses are percentage in GNP.

Sources: Ministry of Finance, *Economic Report,* various issues.

Table 3.6

Consolidated Public Sector Finance, 1960-90
(at current prices, RM million)
(continued)

	1982	1984	1986	1988	1990
General Government[a]					
Revenue	19754	24084	24852	28732	37784
Operating expenditure	18233	21915	23190	24709	29606
	(30.5)	(29.5)	(34.7)	(28.8)	(26.9)
Current surplus/deficit	1521	2169	1662	4023	8178
NFPEs current/deficit	3423	5005	2825	3717	5787
Public sector current surplus	4944	7174	4487	7740	13965
Development expenditure	16235	16965	11033	9103	14840
	(27.2)	(22.9)	(16.5)	(10.6)	(13.5)
General Government	12229	9203	7183	5650	10329
	(20.5)	(12.4)	(10.8)	(6.6)	(9.4)
NFPEs	4006	7762	3850	3453	4511
	(6.7)	(10.5)	(5.7)	(4.0)	(4.1)
Overall surplus/deficit	–11291	–9791	–6546	–1363	–675
	(–18.9)	(–13.2)	(–9.8)	(–1.6)	(–0.8)
Sources of financing					
Net domestic borrowing	6700	5226	972	–3468	–712
	(11.2)	(7.0)	(1.5)	(4.0)	(0.6)
Net domestic borrowing	6497	3545	4764	5701	5375
	(10.9)	(4.5)	(7.1)	(10.1)	(4.9)
Change in assets[b]	–1906	1020	510	–3570	–3755

Notes: [a] General government comprises of federal government, state government, statutory authorities & local government .
[b] (+) indicates a drawdown of assets.
Figures in parentheses are percentage in GNP.
Sources: Ministry of Finance, *Economic Report*, various issues.

3.6 Monetary Aggregates

In Malaysia, money narrowly defined (M1) comprises currency in circulation (coins & notes) plus demand deposits on the chequeing accounts. Private sector liquidity (M2) includes M1 and the fixed and savings deposits held with the commercial banks. The broadest definition of money (M3) consists of M2 plus the savings and fixed deposits held with other non-bank financial institutions. The term "quasi-money" (QM) refers to all these fixed and savings deposits held with the commercial banks and non-bank financial institutions. For policy purposes, the M1 definitions is regarded as the most appropriate measure for money in Malaysia. Beginning in the early 1980s, however, the M2 become the more appropriate aggregate for the purpose of monetary management (Bank Negara Malaysia, 1989, p.400).

The trends in the growth of monetary aggregates or money supply is shown in Table 3.7. The money supply (M1) expanded moderately from the annul average 5.3 percent in 1961-65 to 6.3 percent in 1966-70. The rate of expansion of M1 has corresponded quite closely with the growth in real output. However, during the early 1970s, M1 expanded much more rapidly and this was due to increased uncertainty and the consequences of high inflation on transactions demand (Bank Negara Malaysia, 1989, p.406). Of the two components of M1, demand deposits have grown much faster, particularly after 1975 with the rapid development of the financial network. The annual average rate of growth of demand deposits has expanded to 18.9 percent compared to 16.3 percent for currency during 1976-80. Table 3.7 also shows that, historically, the average growth rate of quasi money (QM) has always exceeded that of M1. The gap between their growth rates was considerably narrowed

Table 3.7

Average Annual Growth Rates and Composition of Money Supply and Private Sector Liquidity 1961-90

Monetary aggregates	Average annual growth rates (percent)					
	1961-65	1966-70	1971-75	1976-80	1981-85	1986-90
Demand deposits	4.4	3.4	17.5	16.3	5.6	10.1
Currency	6.5	9.1	15.4	18.9	8.3	14.1
Money supply (M1)	5.3	6.1	16.4	17.6	7.0	12.4
Quasi money (QM)	14.2	17.6	21.9	26.0	14.3	10.2
Private Liquidity (M2)	8.2	11.0	19.3	22.6	11.9	10.8
Nominal GNP	5.4	7.1	13.7	18.4	7.1	8.8
"Implied" Real GNP	4.9	5.7	6.3	13.9	2.5	7.5
			Average percentage distribution			
Percent of M1						
Currency	56.5	50.3	49.0	49.3	45.5	44.7
Demand deposits	43.5	49.7	51.0	50.7	54.5	55.3
Percent of M2						
Currency	36.8	26.5	22.7	19.3	14.3	12.2
Demand deposits	28.3	26.3	23.6	19.8	17.1	15.1
Quasi money	34.9	47.2	53.7	60.9	68.6	72.7

Sources: Bank Negara Malaysia (1989), *Money and Banking in Malaysia*, Table 15.1-15.2, p.405 & p.408;
Bank Negara Malaysia, *Quarterly Economic Bulletin*, various issues.

during 1971-75, for the reasons given above, that is a consequence of uncertainty and higher inflation. During 1976-80, QM grew faster than M1, and this shift was closely associated with the emergence of oil as a major foreign exchange earner, as a large part of oil exports proceeds was held in the form of fixed deposits with the banking system (Bank Negara Malaysia, 1989, p.408).

Monetary growth, however, moderately during 1981-85 with M1 increasing at an average annual rate of 7 percent and M2 at 11.9 percent, reflecting the impact of deteriorating global economic conditions of the country's balance of payments, the maintenance of selectively restrictive monetary policy to restrain inflation, and a contractionary fiscal stance implemented since the latter part of 1982. However, with the turnaround in the economy in the latter part of 1986, monetary growth picked up moderately with M1 growing at an average annual rate of 12.4 percent and M2 10.8 percent.

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The determinants of the changes in money supply, M1 and M2 (Table 3.8) can be analyzed in terms of four factors[1] : net lending to Government; credit to private sector; net foreign assets and other influences. They add up to the money supply, M2 or private sector liquidity. Over the years, all the principal "determinants" of money supply M1 and M2 were generally expansionary. The relative importance of these determinants depending not only on cyclical economic fluctuations but also on the rapidly expanding public sector as well as the growing resort to banks financing by both the public and private sector for their capital expenditures. The expansionary trends is however, counterbalanced by increasing quasi money, consequent upon increasing income and savings, so that the resultant money supply M1 increase at a lower rate the M2.

Tabie: 3.8

Determinants of Changes in the Money Supply (M1 & M2)

	Change in RM million					
	1961-65	1966-70	1971-75	1976-80	1981-85	1986-90
Net lending to Government	0.6	134.1	1283.2	−764.1	815.3	2284.9
Claim on government	148.5	706.9	1643.0	3053.1	4633.8	4242
Government deposits	147.9	572.8	359.8	3817.2	3818.5	1957.1
Credit to private sector	599.3	1123.3	3831.4	14859.9	27872.2	38555.2
Net foreign assets	229.1	447.0	1103.7	6150.9	-243.8	17331.8
Official reserves	285.7	643.6	1372.6	6913.2	2152.9	14568.4
Commercial banks' foreign assets	−56.6	−196.6	−268.9	−762.3	−2396.7	2763.4
Other influences	−33.0	−26.6	−359.1	−2576.2	−7699.2	−22665
Private sector liquidity (M2)	796	1677.8	5859.2	17670.5	20744.5	35506.4
Quasi money	452.3	1159.3	3542.9	12257.9	16927	22829.1
Money supply (M1) of which:	343.7	518.5	2316.3	5412.6	3817.5	12677.3
Currency	164.1	154	123.8	2518.9	1462.3	3800.1
Demand deposits	179.6	364.5	1077.5	2893.7	2355.2	8877.2

Sources: Bank Negara Malaysia (1989), *Money & Banking in Malaysia,* Table 15.3, p.410;
Bank Negara Malaysia, *Quarterly Economic Bulletin*, various issues.

3.7 Monetary Policy

The principal macroeconomic objective of monetary policy in Malaysia is to promote the highest sustainable rate of output growth, consistent with domestic price and exchange rate stability. To achieve this objective, the Central Bank seeks to maintain monetary stability by ensuring that the growth in bank credit and money supply are just adequate to accommodate and fuel real growth in the economy without causing inflationary pressures (Lin, 1992, p.70).

In Malaysia, deliberate monetary management only began with the establishment of the Central Bank of Malaysia in January 1959. Prior to this, it was managed by the Currency Board System. Basically the role of monetary policy was confined mainly to promoting stable monetary conditions consistent with the growing of an expanding economy and maintaining the purchasing power of the national currency. During that period, the Central Bank relied more on interest rate to stimulate bank credit and savings as well as to prevent capital outflows. In 1969, the effect of the export boom on the domestic economy was minimized by the Central Bank's increase of the statutory reserve ratio from 3.5 to 5 percent to dampen the growth in liquidity. (Semudram, 1987, p.95)

Unlike the 1960s, the decade of the 1970s were characterized by unstable international economic conditions, such as the breakdown of the Bretton Woods, oil prices rise and crop failures. Under these circumstances, monetary policy were directed to maintain monetary stability and a strong and stable currency as well as to ensure that the external fluctuations ("shocks") did not unduly affect the process of balanced expansion in domestic economic activities.

Between 1971-72, the stance of monetary policy was changed in response to emerging recesionary tendencies. Monetary policy was gradually eased to stimulate expansion in business activity and private investment consistent with price stability, through reducing lending and borrowing. By late 1972 to 1974, there was a cyclical upswing in the economic activity, which was spurred by a boom in export prices which was mainly associated with the first oil "shock". The economy by then faced the inflationary pressures. To resolve these economic problems, the Central Bank introduced a series of monetary policy measures. Deposit and lending rates were increased in 1972. In 1973, both liquidity and statutory reserves ratios were raised. Credit ceilings of 20 and 25 percent were imposed in 1974 for the commercial banks and finance companies respectively (Lin, 1992, p.72). Inflationary pressures were contained, but the economic slowdown of the industrial countries affected economic activity in Malaysia. In 1975-76, the monetary stance was much easier, as the bank deposit and lending rates and statutory reserves ratio was lowered and credit ceilings were abolished. The objectives of monetary policy in 1978-79 remained essentially to expand the volume of money and credit needed to promote sustainable rate of recovery in economic activity

Economic and management during the early 1980s, was confronted with multiple challenges posed by the prolonged recession in the international economy, the consequent slowdown in domestic economic activity, a deterioration in the government's finance and the balance of payments deficits. At its height, the overall budgetary deficits was 18 percent of GNP and the deficit in the current account of the balance of payments deficits, 14 percent of GNP. Considering these circumstances, the overall stance of monetary policy selectively accommodative to counteract the fiscal expansion.(Lin, 1992: p.72; Bank Negara Malaysia, 1989, p.435). This was to ensure that money will not be the source of financial instability but instead, will promote an orderly growth of the economy. At the same time, selective restraints were applied to curb undesirable consumption, speculation and discourage capital flight.

Under the above circumstances, monetary policy was directed to cushioned monetary growth in the early 1980s. A major element to this monetary policy was to allow a gradual rise in the general real interest rates in respond to demand. This was considered necessary to promote savings as well as to combat inflation. While keeping to its moderate monetary expansion stance, the Central Bank had simultaneously intervened in the money market through open market operations to dampen interest rate volatility.

The slowdown in government expenditure and the resulting rapid build-up of government deposits with the Central Bank during 1983 had a sharp contractionary impact to counteract the tightening conditions in the money market. This was done mainly through open markets, foreign exchange swaps and the recycling of government deposits which were by then managed by the Central Bank. With the onset of the poor international environment and depressed commodity prices in the mid 1980s, conditions in the money market were extremely tight. Bank Negara had to pursue an expansionary monetary policy to ensure bank liquidity was sufficiently ample to fund private sector demand. Again, the Central Bank had to manage interest rates judiciously to balance two conflicting tendencies: high interest rates to mobilize savings and discourage capital outflows and low rates to stimulate private investments. With low domestic inflation, real rates of interest of 11-12 percent per annum prevailing in Malaysia in the first half of 1985 were very high by international standards (6-7% in the United States). At the same time, the Central Bank also resorted to moral suasion to bring about downward trend in interest rates (Bank Negara Malaysia, 1989, p.444).

In 1985, the Central Bank continued to rely on recycling government deposits and foreign exchange swaps to inject liquidity into the system. in a move to stimulate private investment, the Central Bank set a RM1 billion (later raised to RM1.7 billion) New Investment Fund in September 1985 to fund new investment in productive capacity in selected priority area at a reasonable cost.

In managing the liquidity situation during 1986, the Central Bank policy was, for most part of the year, confronted with the conflicting objectives of maintaining stability in the foreign exchange market. The contractionary influence of the balance of payments on bank liquidity, arising from weak commodity prices, was compounded by mounting speculative pressures on the ringgit, which necessitated the Banks's intervention to purchase ringgit in exchange for US dollars. As a matter of policy, priority in the short term was given to maintaining stability in value of the ringgit. Consequently, interbank interest rates during the first ten months of 1986 soared to record levels (Hussein, 1990, p.81).

The whole scenario charged considerably in October 1986. There was an inflow of funds into the country because of the strengthening of the current account of the balance of payments. This reinforced by the strong export performance of manufactured goods in 1987 and the continuing inflows of capital, especially direct foreign investments. Consequently, the banking system was flushed with funds. To ensure that these funds would not generate any inflationary pressure and prevent interest rates from collapsing, the Central Bank assumed more active role. A total of RM1.7 billion of excess funds was mopped up through liquidity operation.

With the economy recovery in late 1986 and in 1987, the Central Bank's attention focused on developing and strengthening the financial system and increasing the effectiveness of monetary instruments, particularly open market operations. In 1989, with strong economic expansion and the accompanying sharp increase in private credit demand, the Central Bank became more concerned about excess liquidity in the banking system for fear of building up inflationary expectations. Therefore, the monetary policy stance was contractionary to mop up the excess liquidity in the system, mainly through open market operation, direct borrowings from the market, raising the statutory reserve requirements of the banking institutions. This helped to ease inflationary expectations and raised interest rates.

The stance of monetary policy in 1990 was tightened in order to contend the low interest rates and the raising inflationary expectations. This was due to the large overhang of excess liquidity from preceding years in the financial systems, which was accentuated by continued large capital inflows and the rapid expansion of bank credit. As a result of he tightening monetary policy measures, domestic interest rates firmed in 1990. However, the mopping up operation was implemented gradually to ensure that the rise in interest rates was moderate so as not to cause much dampening effects on economic activity. As a result, monetary growth moderated during the year.

Note to chapter 3

1. For a detail discussion, see Bank Negara Malaysia (1989), *Money & Banking in Malaysia*, pp.408-415.