CHAPTER 6

SUMMARY AND CONCLUSIONS

The purpose of this study has been to evaluate the effects of money supply and government expenditure changes on the economy based upon three economic indicators, viz, income, prices and the balance of payments. In addition, the changes in the exchange rate policy also has been evaluated.

A small and simple structural macroeconomic model of ten behaviorals and twelve identities is constructed within a consistent framework and has been estimated by the ordinary least squares. This model contains some variants of Keynesian and Monetarist features. There is not much different between this model and all the past models successfully developed for Malaysia. The only different is that this model is fairly aggregated and for certain extent the government expenditure components are endogenized. In particular, the link between the real sector and the monetary sector is not only through the money supply (availability of credit) in the real private investment and consumption function, as well as the price equation but also through the government budget or fiscal deficit. On the other hand, the developments in the external sector on the domestic sector is through the import equation. Dynamism is introduced in the model as all the behavioral equations posses a lagged dependent variable as a regressor, i.e. macroeconomic performance is deemed not only to be affected by current development but also of the past.

Several simulation experiments has been conducted on the model. The model is stable at least to the extent that it returns to the original equilibrium condition, albeit at different speeds of adjustment, after once and for all exogenous shock are administered to the system. In the dynamic simulation exercise, the model exhibits generally good ability to track the
turning points of the historical series of two major macrovariables, viz., prices and real income. However, the identities for money base, balance of payments and net foreign assets show poorer performance. This is perhaps due to their aggregated form as well as they are not expressed as a functional relation.

Despite the performance of certain variables is less than satisfactory, yet a certain degree of confidence may with justification be given to policy implications drawn from the model. As by implication, the model will be able to predict with some degree of accuracy the effects on macrovariables of whatever exogenous changes made to a policy variable then.

As the model seems to suggest, a restrictive monetary policy will be deflationary and have positive influence on the balance of payments. Whereas an expansionary fiscal policy tends to exert mild inflation as well as have positive influence on income but tends to deteriorate the balance of payments. It is a natural consequence that, as income and domestic price rises due to the increase in the government expenditure, unfavorable trade balance and hence the balance of payments is undeniable. Between fiscal policy defined in terms of an increase in government investment and the statutory reserve requirements as instrument of monetary policy, the former seems have more influence on changes in income. On the other hand, the monetary policy seems to be more influence on the price level. From this view, an expansionary fiscal policy can be pursued to boost economic growth without exerting any upward pressure to unwarranted degree on prices during the immediate period. Whereas the restrictive monetary policy can be pursued to curb inflation without much sacrificing output growth. Based on our findings, we cannot conclude or judge that the fiscal policy is more influential than the monetary policy. As our model is fairly aggregated, a wider range of monetary and fiscal policy instrument for policy simulations is limited. It might be more
useful to consider certain factors that undertaken in this study before a sound judgement can be drawn from the model.

As we have noted earlier, the relative effectiveness of the policy instruments is influenced not only by the magnitude of the policy changes but also by the initial condition and time lags. Therefore any empirical results must be interpreted with these elements in mind. Rather than focusing on the issue of the most effective policy instruments, it might be more useful to examine factors that affect the relative impact of the policy instruments. Apart from the aforementioned factors, other aspects too need to be considered. Such as the framework of structural model as well as the degree of disaggregated. It can be said that if the model for instance, is constructed more to the Keynesian-type, we may expect the outcome favors to it. And if the disaggregated of structural model is high, we may get a better understanding of the economic system in details and would also permit a consideration wider scope of fiscal and monetary policy instruments in conducting the policy analysis. However as far as our model is concerned, the aforesaid factors is beyond our scope of study. Nonetheless, for at least, some degree of reasonable outcome still can be drawn from the model.

In addition of the two policy variables investigated, import prices (as a proxy for exchange rate depreciation) appear to have the strongest impact on many of the endogenous variables, viz, money supply, prices, income and the balance of payments. This may reflect the highly openness of the Malaysian economy. From the simulation exercises too, it can inferred that consistent review or renewal of economic policies are needed to sustain the desired direction of changes in income.