CHAPTER ONE

INTRODUCTION

1.1 Introduction

The purpose of this study is to give a broad overview of how changes in fiscal policy influences the real exchange rate of Malaysia and in turn analysing the impact on trade balance of Malaysia. The study is divided into seven chapters which includes the first chapter as introduction followed by a detail study on the Malaysian economy as the second chapter. The third chapter reviews the literature related to the study while in the fourth chapter there will be a detail discussion of the methodology used in this study. The fifth chapter would discuss the empirical evidence from the study while in the sixth chapter there will a discussion on the economic crisis being experienced in Asia, and the final chapter will include the conclusion of the study. This study is centred on analysing three main areas of the Malaysian economy, the fiscal balance, the real exchange rate and the trade balance. It is focused on analysing the long-run linkage between those variables, and its relation with the crisis that is being experienced by the economy.

1.2 Estimation Period

The period of study is between the first quarter of 1983 to the final quarter of 1996. This period was considered appropriate mainly because it provides insights on the structure of the economy from a agriculture based economy to one that is based on industrialisation. It also reflects the period where the economy is closely related to the external situation in determining the domestic economy. The period between 1983 to 1996 was also chosen because it takes into account the recessionary period of 1985-86 which in turn provides insights on how the economy can be managed during economic downturns. The frequency of data analysed in this data is quarterly because the gross domestic product data is released every quarter and therefore it provides an accurate picture of the economy when it is related to the fiscal policy and the trade balance.

1.3 Methodology

The methodology used in this study is the cointegration approach using the Engle-Granger method. This method was seen as appropriate mainly because it can be used to analyse the long-run effect between fiscal policy and real exchange rate and in turn to analyse the real exchange rate with the trade balance. Unit root tests are also included in this study in order to test if each variables were stationary or non-stationary.

1.4 Data

The data used for this study includes government spending, government revenue, exports, imports, inflation rate, gross domestic product and the bilateral nominal exchange rate of RM againt the USD, which was obtained from the quarterly publication of Bank Negara Malaysia. The producer price index of the U.S. was obtained from the International Financial Statistics published by IMF.

1.5 The linkage between Fiscal Policy, Real Exchange Rate and the Trade Balance.

The mechanism of the linkage between fiscal policy, real exchange rate and the trade balance is important. Suppose the government adopts an expansionary fiscal policy, allowing, the nominal exchange rate and prices of tradables to remain constant, the prices of non-tradables would increase and thus appreciate the real exchange rate. The appreciation of the real exchange rate would induce a trade deficit, which ultimately erode the economy's competitiveness and bring about a current account deficit.

An austerity policy of tightening fiscal policy would reduce the prices of non-tradables in the economy and thus allow the real exchange rate to depreciate and increase the competitiveness of the economy. This scenario would bring about a trade surplus in the economy. It is important to note that the most important assumption here is that prices of tradables (i.e. U.S. producer prices) and the nominal bilateral exchange rate (RM/USD) is kept constant. However any changes in these two variables would bring about a different scenario to the economy. If we relax the assumption and assume that only prices of tradables are constant, while the nominal exchange rate and the prices of non tradables are flexible, therefore an expansionary fiscal policy can cause an trade deficit or an surplus, depending on the degree of changes in the nominal exchange rate and prices of non tradables. If expansionary fiscal policy increases the prices of nontradables less than the exchange rate it would induce the real exchange rate to depreciate and therefore a trade surplus can be achieved. However if the increases in the prices of nontradables is more than the depreciation of the nominal exchange rate, it would induce an appreciation of the real exchange rate and therefore a trade deficit.

In the case of an tight fiscal policy, the prices of nontradables would fall and if the decline in prices is more than the appreciation of the nominal exchange rate, it would induce a real exchange rate depreciation which would ultimately increase the trade surplus. On the other hand if the fall in prices of non tradables is less than the appreciation of the nominal exchange rate this would induce an appreciation of the real exchange rate and thus cause an trade deficit in the economy.