CHAPTER TWO

THE MALAYSIAN ECONOMY

2.1 Introduction

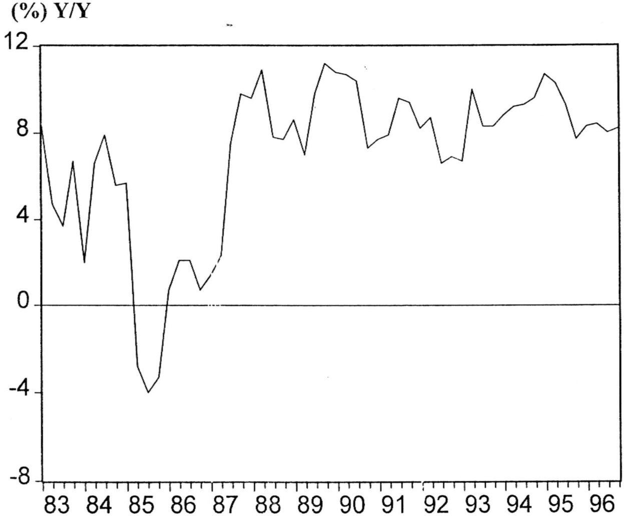
In this chapter, the Malaysian economy is analysed in order to see the relation between fiscal policy, real exchange rate and trade balance. The period analysed is between the first quarter of 1983 to the final quarter of 1996.

2.1.1 Economic growth

Malaysia registered an average growth of 7% between the first quarter of 1983 to the final quarter of 1996 (Chart 1). The Malaysian economy experienced a recession in 1985 with economic growth dipping to -2.8% in the second quarter of 1985 (1984 2Q: 6.6%). Real GDP growth continued to remain weak in the following two quarters by recording negative growth in the range of 3.3% to 4%. The downturn in the economy during this period was due mainly to weak export performance of commodities such as rubber and tin following oversupply of these commodities in the international markets, which in turn repressed prices of these two commodities. Another factor which also contributed to a recession of the Malaysian economy was the weak external demand of

Chart 1

GDP (1983:1 - 1996:4)



the industrialised countries which weakened the export performance of Malaysia.

Economic growth in Malaysia gradually improved after 1985, however real GDP growth still remained weak in 1986 with quarterly economic growth in the range of 0.7% - 2.1%. Nevertheless the positive upturn in the economy reflected that the economy was not expected to experience a prolonged recession. Economic growth strengthened beginning 1987 with real GDP growth of 1.4% in the first quarter of 1987 and reaching a peak of 11.2% in the final quarter of 1989. Economic growth during this period strengthened following prudent macroeconomic policies which increased the export performance of Malaysia, increased foreign direct investments and the favourable external demand situations. During this period policymakers made sure that the Malaysian economy was not dependent on exports of primary commodities in aiding economic growth, which in turn exposed the economy to volatile external demand situations. Policies were put in place to diversify the economic base by encouraging the development of the manufacturing sector, in particular the electrical and electronics sector, textiles, chemical and heavy machinery.

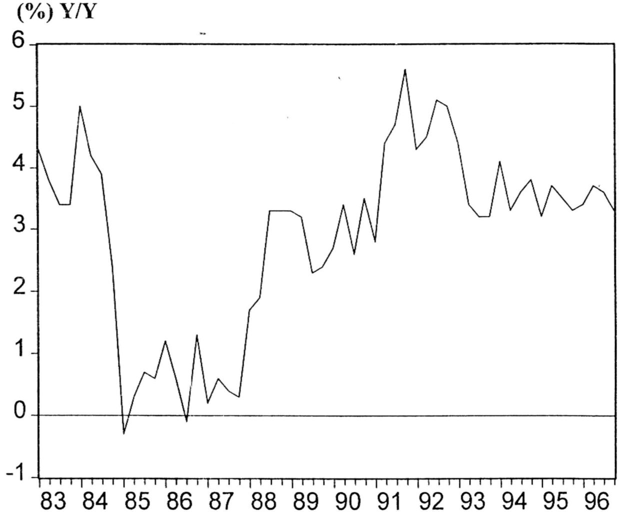
Beginning 1990 to 1996, economic growth in Malaysia has remained in the range of 6.6% to 10.7%. The strong performance of the economy was propelled by the robust expansion of the manufacturing and construction sectors. The pick up in economic performance also reflects the rising confidence of investors of the political situation in the country and prudent macroeconomic policies of the government. During the period between 1990 to 1996, real GDP growth peaked at 10.7% in the second quarter of 1990 and in the first quarter of 1995 and into a gradual slowdown of 6.7% in 1993.

2.1.2 Inflation

The inflation rate in Malaysia between the first quarter of 1983 to the final quarter of 1996 averaged at a rate of 2.9% (Chart 2). In the first quarter of 1983, the inflation rate recorded an increase of 4.3%, nevertheless price pressures gradually declined to 2.4% in the final quarter of 1984. Inflationary pressures remained subdued during the recessionary period of 1985 and 1986. During this period falling commodities prices and weak domestic demand repressed the inflation rate to -0.3% in the first quarter of 1985. The inflation rate remained low until the final quarter of 1987 with an inflation rate of 0.3%. As the Malaysian economy gradually recovered from the recession, economic activity once again increased, thus increasing inflationary pressures into the economy.

Chart 2

INFLATION RATE (1983.1- 1996.4)



Rapid expansion of the domestic economy over the period 1988 to 1996, exerted substantial pressures on existing resources, which led to a steady increase in domestic inflation from 1.7% in the first quarter of 1988 to 3.3% in the final quarter of 1996, while the inflation rate peaked at 5.6% in the final quarter of 1991. The increase in domestic prices was due largely to a significant expansion in domestic demand, as world inflation remained relatively low. The excess demand pressures imposed a strain on existing resources and this was reflected by labour shortages, and infrastructure and other supply bottlenecks. These factors as a group exerted further pressures on domestic prices to rise. Rising inflationary pressures since 1990 basically reflects the pick up in economic activity and the increase in purchasing power of consumers. Increased disposable income following investment returns from the buoyant equity market and strong wage gains also attributed to price pressures in the economy.

2.1.3 Real exchange rate

Malaysia's real exchange rate in this study is computed as follows:

RER = NER * (PPI / CPI)

Where:

RER = Real exchange rate (RM/USD)

NER = Nominal exchange rate (RM/USD)

PPI = Producer price index of United States (proxy for cost of tradable items)

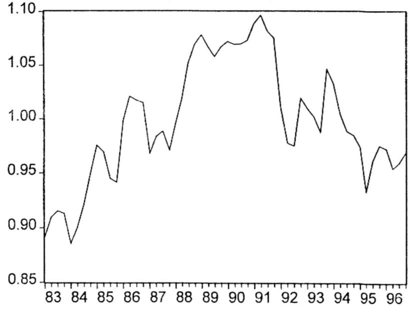
CPI = Consumer price index of Malaysia (proxy for cost of non – tradable items)

In order to see each of these variables influence on the real exchange rate, a few assumptions are made. If we assume the producer and consumer prices remain constant, a depreciation of the nominal exchange rate would in turn depreciate the real exchange rate, while appreciation of the nominal exchange rate would in turn appreciate the real exchange rate. On the other hand, if we assume the nominal exchange rate and the producer prices in United States to remain constant, an increase in consumer prices in Malaysia would in turn appreciate the real exchange rate, while a reduction in consumer prices would depreciate the real exchange rate. Finally if we assume the nominal exchange rate and the consumer prices to remain constant, an increase in the producer prices in the United States would depreciate the real exchange rate , while a decrease in the producer prices would however appreciate the real exchange rate.

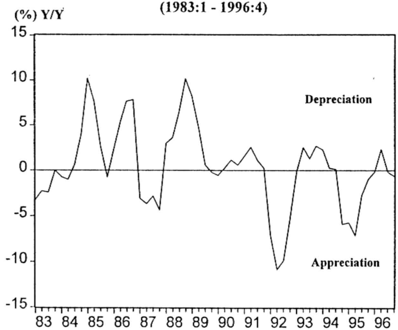
The performance of the ringgit Malaysia against the United States dollar in real terms has appreciated and depreciated within a band of +/- 11% on a year on year basis during the first quarter of 1983 to the final quarter of 1996 (Chart 3). The ringgit appreciated against the United States dollar during the first quarter of 1983 to the second quarter of

Chart 3

REAL EXCHANGE RATE
(1983:1 - 1996:4)



REAL EXCHANGE RATE (RM/USD)
(1983:1 - 1996:4)



1984. It's appreciation was in the range of 1.02% to 3.2% during this period. The appreciation trend buckled in the third quarter of 1984, when the ringgit gradually depreciated against the United States dollar. The depreciation phase lasted until the final quarter of 1986. During this period the ringgit weakened against the United States dollar by almost 10% in the first quarter of 1985.

As the Malaysian economy gradually recovered from the 1985 – 1986 recession, real value of the ringgit gradually gained strength against the United States dollar. The ringgit's appreciation during this period was in the range of 3% - 4%. However, the ringgit begun to depreciate in the first quarter of 1988 by 2.9% and it's depreciation rate increased, reaching a peak of 10% in the final quarter of 1988. In the period between 1990 to 1991, real value of the ringgit still remained weak, depreciating in the range of 0.2% to 2.5% .

In 1992, the ringgit strengthened by almost 10.8% in the second quarter of 1992, however the ringgit's gain against the United States dollar was gradually eroded by the first quarter of 1993. The ringgit continued to depreciate in the range of 0.1% to 2.6% between the second quarter of 1993 to the third quarter of 1994. Nevertheless the performance of the ringgit improved beginning the final quarter of 1994 and continued to appreciate in the range of 0.6% to 7.1% against the United States dollar until the final quarter of 1996.

2.1.4 Government spending

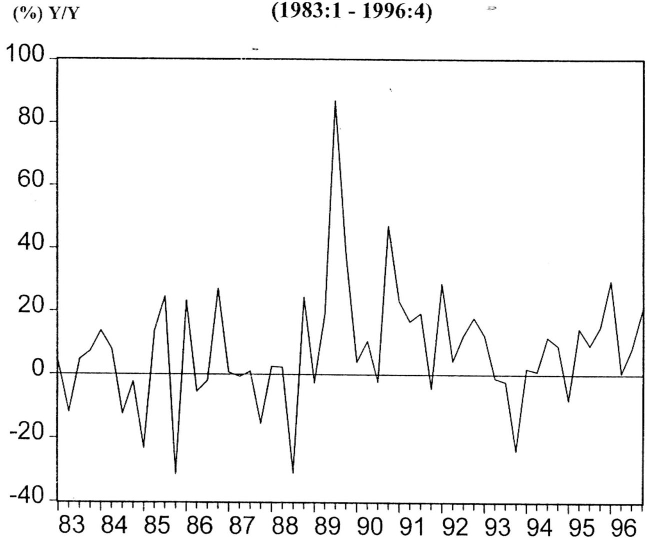
Government spending increased by 3.4% in the first quarter of 1983 and declined by 2.40% in the final quarter of 1984 (Chart 4). The decrease in government spending in the second half of 1984 reflected the privatisation policy implemented by the government in 1984. It reflected the government's drive to make the private sector to play an important role in developing the economy. In the recessionary years between the first quarter of 1985 and the final quarter of 1986, government spending increased between 23% to 27%. The increase in government spending at that period reflected the expansionary fiscal policy implemented by the government in order to stimulate the economy and also to ensure that a self sustained economic recovery is achieved.

Government spending increased from 0.63% in the first quarter of 1987 and reached a peak of 87% in the third quarter of 1989. The rise in government spending during this period was mainly due to the weak performance of the heavy industries project initiated by the government in the early 1980's. A number of these projects suffered from heavy financial losses due to the gradual recovery of the

Chart 4

GOVERNMENT SPENDING

(1983:1 - 1996:4)



economy, weak domestic demand and the inability of these industries to compete in international markets. The sluggish performance of these industries were exacerbated by high costs of production in relative to international levels, poor management expertise and the low capacity utilisation of the industrial plants. The increase in government spending during this period was to offset the setbacks faced by the government in promoting heavy industrialisation in Malaysia. The expansion of government spending consolidated to 3.99% in the first quarter of 1990, however it increased again by 47.1% in the final quarter of 1990 and gradually slowed down to 20.3% in the final quarter of 1996.

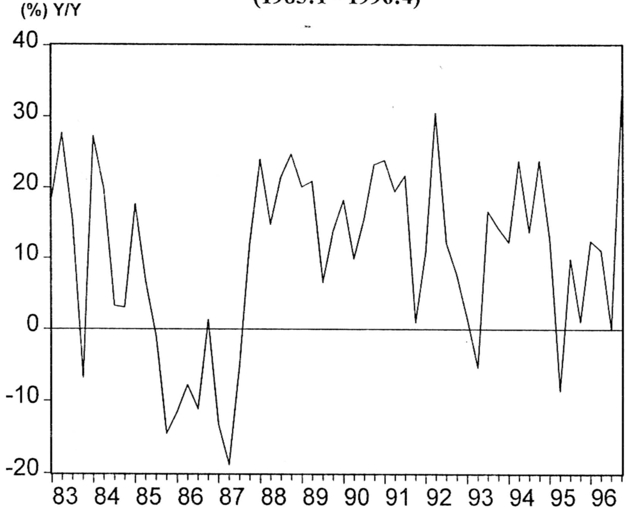
The strengthening of economic growth during this period induced the government to privatise numerous public projects. These projects include the National sewerage system, Light Rail Transit system in Kuala Lumpur, Rapid Rail Electric System connecting major towns in the Klang Valley, Petronas Twin Tower project, Kuala Lumpur, Telecommunications Centre and the new government administrative centre in Putra Jaya. The privatisation of these projects has reduced the governments financial constraint, however initial investments, by the government was needed especially in gaining the private sector's confidence and to reflect the viability of these projects, this situation explains the large increase in government spending.

2.1.5 Government Revenue

Government revenue increased from 18.6% in the first quarter of 1983 to 27.1% in the first quarter of 1984 (Chart 5). Buoyant economic activity enabled the government to increase its revenue from import, export and excise duties. In tandem with increased economic activity and higher disposable income, the government was able to boost its revenue obtained through income taxes and business taxes. During the recessionary period between the third quarter of 1985 to the third quarter of 1986, government revenue contracted between 0.98% to 11.13%. The decrease in government revenue reflected the slowdown in economic activity and this affected the government's ability to increase its revenue. The slowdown in the external sector of Malaysia, affected the government's revenue from export and import duties, while sluggish domestic economic activity depressed revenue obtained from income taxes, business taxes and excise duties.

GOVERNMENT REVENUE

(1983:1 - 1996:4)



As the economy gradually recovered from its recession, government revenue increased 1.2% in the final quarter of 1986 to 13.78% in the final quarter of 1989. The increase reflected improved tax collection methods, increased economic activity which led to higher revenue obtained from business taxes and the increased economic activity in the external sector of Malaysia. The privatisation of many government projects beginning 1984, had gradually increased the government's revenue, mainly through sale of utilities companies such as Telecoms and National Electricity Board to the private sector. The government owned part of these privatised companies in the form of equity holdings. The government's revenue increased in the first quarter of 1990 from 18.16% to 32.91% in the final quarter of 1996. The increase in revenue was due to strong domestic economic activity following robust economic growth, buoyant external economic activity and the government's involvement as partner in privatised projects.

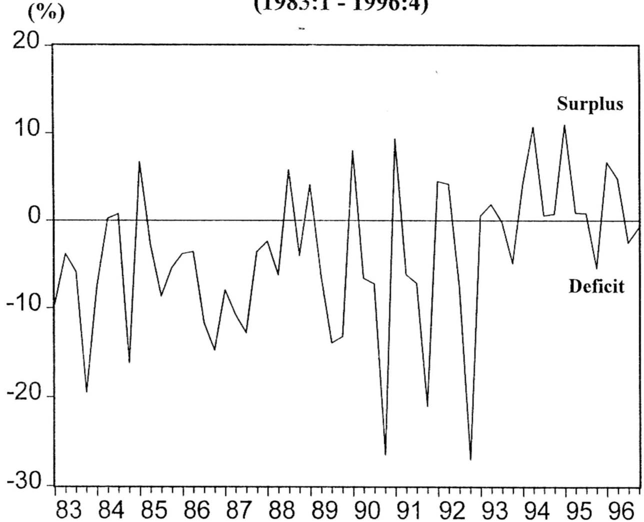
2.1.6 Fiscal Balance

Malaysia's fiscal balance situation begun in 1983 with a deficit of 9.5% of GDP in the first quarter of the year (Chart 6). The large deficit in the government sector was due mainly to the slow progress of transformation of the Malaysian economy into a private sector driven economy. Large scale development projects initiated by the government such as steel mills, production of automobiles, cement mills and hydro-electric projects were anticipated as risky ventures by the private sector and involved huge sums of capital which the private sector was not able to finance these projects. The government was needed to kick start these projects and this in turn increased government spending . The long gestation period of these projects also aggravated the government's fiscal balance.

The Malaysian economy plunged into a recession in the mid 1980's especially in 1985 and 1986 which further deteriorated the fiscal balance. As of the final quarter of 1986 the fiscal balance was in a deficit of almost 14.7% of GDP. The slowdown in economic growth, the need to arrest the high unemployment situation in the economy and the need to stimulate economic growth by increasing public works spending contributed to the increase in the fiscal deficit. The gradual economic recovery in 1987 enabled the government to reduce it's fiscal deficit to

Chart 6 **FISCAL BALANCE (% of GDP)**

(1983:1 - 1996:4)



7.9% of GDP in the first quarter of that year. The gradual pick up in the economy gained momentum in the following years, this in turn boosted the government's revenue and the confidence of the private sector on the economy enabled many government projects to be undertaken by the private sector, thus reducing the government's expenditure burden, these factors enabled the government to register a fiscal surplus of 7.9% of GDP in the first quarter of 1990.

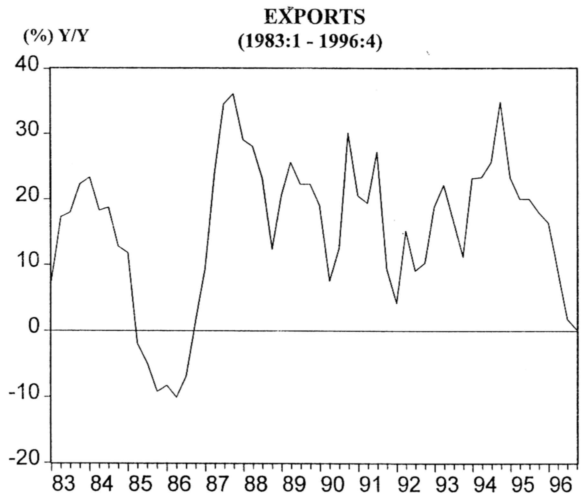
The strong economic growth in the early 1990's and the need to further spur economic growth once again strained the government's fiscal balance. In the final quarter of 1992 the fiscal deficit ballooned to almost 30% of GDP. The strain on the public sector was mainly due to development projects such as the Petronas twin towers, the Light rail transit project, the second causeway connecting Johor Baru and Singapore and the West Port project in Klang. The government had to play an important role in making sure these projects are implemented and thus needed the private sector to complete these projects. Nevertheless the government had to initiate these projects in the beginning to gain the confidence of the private sector. The initiation of these projects attributed to the increase in the deficit of the public sector. The continued momentum in the economy gradually reduced the governments public deficit to 0.8% of GDP in the final quarter of 1996. The completion of the major development projects, the increase in government revenue from strong domestic economic activity attributed to the decline in the public sector deficit.

2.1.7 Exports

Malaysia's export performance is closely linked with the government's policy on export promotion and import substitution strategies. In the beginning of the first quarter of 1983, exports increased by 7.5% and gradually declined to -10% in the second quarter of 1986 (Chart 7). The deterioration of export performance was due to weak demand from industrialised economies and declining commodity prices. Malaysia's export base which largely remained export of commodity products was vulnerable to fluctuations in commodity prices. In tandem with these fluctuations, weak overseas demand from industrialised economies and sluggish domestic demand further dampened Malaysia's export performance. The recession period between 1985 and 1986, also induced manufacturers, exporters and investors to scale down their expansion plans and this in turn exacerbated the downturn in exports.

Beginning 1987, the government stressed on increasing exports of manufactured goods and gradually lessened the dependence on commodity products for exports. Exports increased from 9.3% in the first quarter of 1989 to almost 22.3% in the final quarter of 1989, in tandem with gradual improvement in the economy. As expansion plans by

Chart 7


EXPORTS
(1983:1 - 1996:4)
(%) Y/Y
40
30
20
10
0
-10
-20
83
84
85
86
87
88
89
90
91
92
93
94
95
96

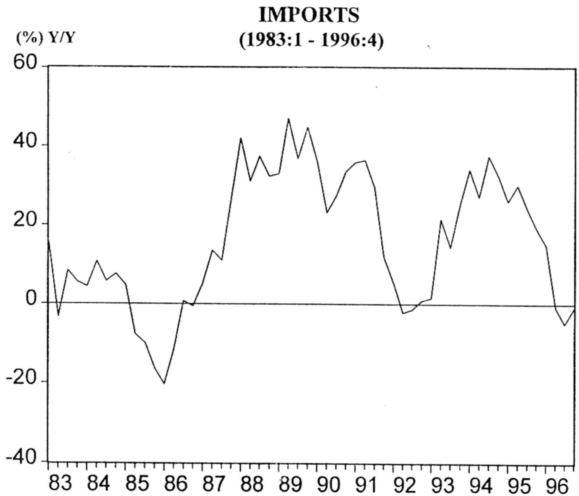
manufacturers and exporters increased, investors took opportunity to invest in export based goods, particularly textiles, electrical and electronic components and chemical products. As economic growth surged ahead in the 1990's, exports continued to increase backed by strengthening of global demand particularly in United States and Japan. Exports increased from 19% in the first quarter of 1990 to 34% in the final quarter of 1994.

The buoyant performance of Malaysia's exports gradually declined since 1995, mainly due to increased competition from other regional economies particularly China, India and Vietnam, which have large excess capacity in their economies. The low cost of labour in these economies attract investors to set-up their manufacturing plant in these economies, thus eroding Malaysia's export competitiveness. Malaysia's exports declined from an increase of 34% in the final quarter of 1994 to a mere 0.21% increase in the final quarter of 1996. The slowdown reflects Malaysia's inability to compete with other low cost producers in the region and also reflects the need for domestic manufacturers to produce export goods of higher value added and target new export markets.

2.1.8 Imports

Malaysia's import performance strongly reflects the performance of Malaysia's economic growth . In the beginning of the first quarter of

Chart 8


IMPORTS
(1983:1 - 1996:4)
(%) Y/Y
60
40
20
0
-20
-40
83 84 85 86 87 88 89 90 91 92 93 94 95 96

1983, imports increased by 15.5% and gradually declined to -20.3% in the first quarter of 1986 (Chart 8). The first slowdown in imports reflect the sluggish economic performance in 1985 and 1986 and declining demand for imports following lower disposable income, high unemployment and manufacturers and investors which scaled back their expansion plans. As economic growth slumped into a recessionary period, imports of intermediate and capital goods also declined, thus lowering import growth.

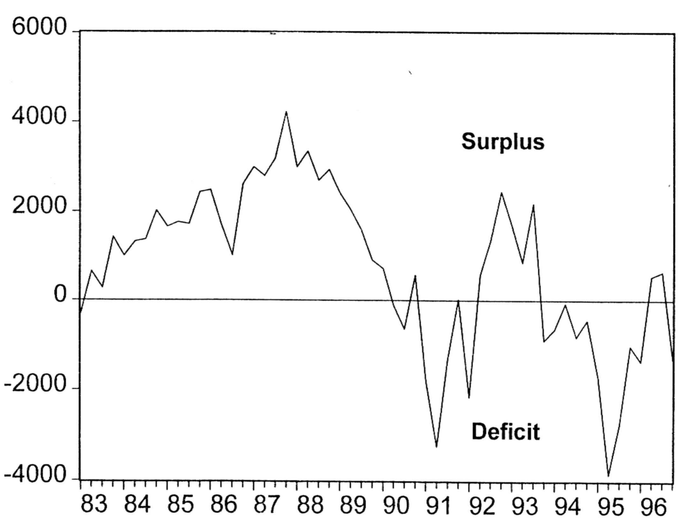
The gradual pick up in economic growth in 1987, propelled imports to increase. Import growth increased from 42% in the first quarter of 1988 to almost 47% and 44.7% in the second and final quarter of 1989. The increase, mainly is due to the low base of imports in 1987 and the strengthening of demand of imported goods, particularly capital and intermediate goods in order to expand production capacity. As Malaysia continued on it's path of industrialisation, imports increased but gradually declined beginning 1991. Import growth declined to 0.8% in the final quarter of 1992 and further declined to – 0.92% in the final quarter of 1996. The slowdown in imports reflects increasing cost of importing capital and intermediate goods , curbs on imports of luxury consumption goods, and the government policies of streamlining imports particularly lumpy items in order not to widen the current account deficit. The gradual decrease in imports can also be attributed to the ability of local manufacturers to produce these goods in the domestic market, thus avoiding the need to import these items. Some of these items include electric and electronic parts, automobile spare parts and transport equipment's.

2.1.9 Trade Balance

Malaysia's trade position in the first quarter of 1983, was in a deficit of RM$311.1 million (Chart 9). However buoyant performance of the export sector, reversed this position to a surplus of RM 2020 million in the final quarter of 1984. The external sector of Malaysia was affected by the recessionary period during 1985 – 1986. Nevertheless the trade position was in a surplus during this period. The surplus remained in the range of RM $ 1657 – 2608 million. As the Malaysian economy recovered gradually from the recessionary period, the trade position improved, with the trade surplus increasing from RM$ 2988 million to almost RM$ 4222.1 million at the final quarter of 1987.

Rapid economic expansion, induced an increase in imports, particularly capital , intermediate and consumption goods. This in turn eroded Malaysia's trade surplus from RM$ 2991.0 million in the first quarter of 1988 to a mere RM$ 567.5 million at the final quarter of 1990. Since 1990 Malaysia's trade position has been volatile. The trade position has not been recording sustained surpluses. In the first quarter of 1991,

Chart 9 TRADE BALANCE (1983:1 - 1996:4)



Malaysia registered a deficit of RM$ 1785 million and this deficit increased to almost RM$ 3246.0 million in the second quarter of 1991. Strong economic growth and increased competition among regional economies limited Malaysia's trade surplus increase.

In the final quarter of 1991 Malaysia recorded a surplus of RM$ 15.2 million. However this surplus continued on a upward trend to RM$ 2451.2 million in the final quarter of 1992, reflecting aggressive export promotion by Malaysia in foreign markets. The trade position, could not sustain these surpluses and continued to record deficits in the range of RM$ 900 million to a high of RM$ 3862.0 million during the period between the final quarter of 1993 to the first quarter of 1996. The surge in imports during this period is attributed to strong economic growth which increased the import demand for investment goods, lumpy items (i.e. aircrafts, shipping liners, and materials for construction of oil rigs and platforms), and consumption goods. However the trade position did revert to a surplus of RM$ 536 million and RM$ 640 million in the second and third quarter of 1996, nevertheless in the final quarter of 1996 the trade balance recorded a deficit of RM1.3 billion.

Since 1991, Malaysia has not been able to keep a sustained trade surplus, mainly due to increased demand for intermediate and capital goods, following strong economic growth. This indicates rapid expansion of the

Malaysian economy does have an inclination to worsen the trade position unless these items which are imported is produced in the domestic market or it is used to expand exports at an faster pace in order to arrest the deficit in the trade balance.