CHAPTER SEVEN

CONCLUSION

7.1 Introduction

In this chapter, the evidence from the econometric studies on the relationship between fiscal policy, real exchange rates and the trade balance is discussed in tandem with the present currency crisis sweeping Malaysia.

7.1.1 Policy Mix

The policy mix is important in setting objectives for the economy. The study on fiscal policy and real exchange rate reflects that an increase in government spending relative to government revenue could induce a appreciation of the real exchange rate. This in turn would erode the competitiveness of exports of manufactured products. To offset this uncompetitiveness, monetary policy is needed to be tightened in order to lower inflation in the domestic economy. The reduction of non-tradable prices in the economy will once again restore the competitiveness of the economy.

If we assume that the prices of foreign goods increase much more than domestic products, it will also increase the competitiveness of our products. In a hyphotetical situation of a fixed exchange rate system it is important to keep monetary policy tight if the policy mix is an expansionary fiscal policy. However in the case of an freely floating exchange rate; excessive depreciation

of the nominal exchange rate would induce inflation in the economy and this in turn would appreciate the real exchange rate. This scenario occurs if the rate of inflation increases more than the rate of depreciation of the nominal exchange rate. On the other hand a excessive appreciation of the nominal exchange rate would induce a depreciation if the reduction in the rate of inflation is more than the rate of the nominal exchange rate appreciation. In both cases it is important not to allow a excessive depreciation or appreciation of the nominal exchange rate in a freely floating regime, therefore the currency must be allowed to be floated within a band that would provide the necessary results in tandem with its economic objectives.

The empirical evidence in this study showed that by increasing government spending it induced a appreciation of the real exchange rate while by increasing government revenue it depreciated the real exchange rate. This evidence indicates that if the government is adopting an increase in government spending, it must be prepared to have a appreciation of the real exchange rate, therefore it is important that domestic inflation be controlled in order to offset this real exchange rate appreciation. In the case of Malaysian, in a fixed exchange rate regime it is important to keep domestic prices subdued in order to avoid a real exchange rate appreciation.

On the external front, the study reflected that a depreciation of the real exchange rates does increase exports and reduces imports. Implications of this econometric evidence provides insights on improving the external balance of

Malaysia. A depreciation of the currency helps to improve the trade deficit of the economy mainly because the high level of import content on the exported goods which in turn will reduce imports following the depreciation of the currency. The evidence also reflects that as imports decline following a real exchange depreciation, it causes a weak domestic demand in the economy as investments decline. The close relationship between investments and imports reflects that the Malaysian economy is very dependent on external goods especially capital and intermediate goods for its long run economic expansion. The dependence on capital and intermediate goods that are imported reflects the lack of technology capability in producing these goods in the domestic economy, therefore it is important that policies are focused on the technology that will be used to produce these goods in order to avoid the dependence on imported capital and intermediate goods.

7.1.2 Capital Movement restrictions and Currency Speculation.

If capital movements were severely restricted, it would be possible to have a fixed but adjustable exchange rate regime. Extreme movements of real exchange rates brought about by speculative bubbles would be avoided. The exchange rate could provide a nominal anchor, provided the appropriate monetary discipline and credibility in the labour market were attained. At the sametime the exchange rate could be altered in response to shocks where policy could be switched from nominal anchor to real target as desired. In the case of Malaysia imposition of capital controls was mainly done to shelter the domestic economy from the turbulence in the external environment. Speculation on the

currency was stopped when the currency was pegged to the United States dollar and imposition of capital controls restricted capital mobility. The government is now able to stimulate the economy by easing monetary policy and expanding fiscal policy. The risk to this scenario is inflation. If inflation creeps up following expansionary fiscal and monetary policy, it could cause the government to revalue the currency or re-peg the currency to a level that can be used to stem inflationary pressures. Therefore it is important that policy makers adopt the appropriate easing without igniting inflation.

Speculative capital movements in a fixed but adjustable regime can be apparently destabilizing but actually stabilizing. They appear destabilizing because they force a devaluation at a time when the authorities would otherwise have continued to maintain the existing rate, either with the help of trade restrictions or by running down foreign exchange reserves. But speculation is actually a devaluation that was, in any case, inevitable, and eventually have been larger. The discipline of capital mobility will ensure that real exchange rates depreciate (or appreciate) more gradually instead of following the jerky path normal in a fixed but adjustable regime where exchange rate adjustment is usually postponed as long as possible. This view assumes that the markets have a correct view of the fundamentals.

If a Central Bank is trying to sustain a rate that is fundamentaly unsustainable and the markets see this, then Central Bank intervention is destabilizing and

speculation in the markets is stabilizing. Situation such as this occurred on July 14th 1997 when Bank Negara intervened to support the currency and was unsuccessful and thus it had to retreat and allow the market to determine the value of the currency. On the other hand, if the Central Bank is trying to maintain a rate that is really a fundamental equilibrium rate, and that could be sustained in the absence of speculation, while speculators in the markets still attack it, then Central Bank intervention is stabilizing and the markets are destablizing. This is the situation where Dr. Mahathir has been pointing out to the world, where in the case of Malaysia, a certain level of the exchange rate is reflecting the fundamentals of the economy and speculation in the markets over these levels of exchange rate would be considered as destabilizing in the economy.

7.1.3 The Nominal Anchor Approach and the Real Targets Approach of Exchange rate.

The Exchange Rate can be used as a nominal anchor in maintaining a low inflation rate in the economy. In a nominal anchor regime, a country prone to high inflation fixes the exchange rate of its currency to the currency of another country. The anchor country has an independent Central Bank that is likely to ensure low inflation. In the case of Malaysia, the ringgit was fixed to the United States dollar at 1USD = RM3.80. This implicitly reflects that the Federal Reserve Bank of the United States will ensure a low inflation policy. The Malaysian government in surrendering the autonomy of reducing inflation in

Malaysia to the Fed, which also reflects that the fixed exchange rate commitment would act as a discipline in Bank Negara Malaysia not to create more domestic credit than the growth in Malaysia's demand for real money balances and the foreign exchange reserves that it can support.

In adopting the exchange rate as a nominal anchor, it is important to determine that the rate of inflation in Malaysia is equal roughly to that of the United States (allowing for differences in relative productivity growth) will be maintained. If the rate of inflation of nominal wages in Malaysia causes a similar rate of inflation in the non-tradables, it would lead to a continous real appreciation, making tradables less competitive while ultimately reflect a current account deficit. Therefore in Malaysia it is important that the recent pegging of the ringgit to the USD does not cause a appreciation of the real exchange rate and this can be avoided if nominal wages is controlled.

The real target approach in attainment of low inflation is actually the alternative to the nominal anchor approach. The real target approach hinges on some flexibility of real wages combined with downward rigidity or sluggishness of nominal wages. The nominal exchange rate is used not as an instrument to keep the real exchange rate constant nor as a nominal anchor against inflation, but to bring about necessary real adjustment. It has a role in achieving real targets, such as its switching role when the current account has to be improved . In the case of Malaysia the current account deficit can be improved, by allowing agrgregate demand to temporarily contract and thus allowing nominal wages

and prices of non-tradables to fall. During this contraction, the nominal exchange rate stays fixed but the market would produce the necessary real devaluation. In Malaysia due to downward rigidity of nominal wages and also to avoid an increase in unemployment, the government can re-fix or allow further devaluation of the nominal exchange rate. By using the nominal exchange rate instrument, it would speedup the process of real devaluation and thus reduce or avoid completely an increase in unemployment and loss in overall output. The key assumption of allowing the nominal exchange rate to be devalued in order to induce a real exchange rate devaluation is that the rate of the nominal exchange rate devaluation must be more than the increase in the inflation rate.

7.1.4 Conclusion

Empirical evidence from this study reflects that an increase in government spending relative to government revenue would lead to an real exchange rate appreciation while depreciation of the real exchange rate reduces imports but increases exports. In tackling the present crisis in Malaysia, an alternative to the fixed exchange rate that the government implemented would be to re-fix the nominal exchange rate. Re-fixing the nominal exchange rate to a level below than the present $1USD = RM3.80 would reflect that the government is using the nominal exchange rate as an anchor to subdue price pressures in the economy. This method would depreciate the real exchange rate following lower domestic inflation and at the same time reduce imports and thus improve the

trade position in the economy. Re-fixing the nominal exchange rate on a appreciating mode would depreciate the real exchange rate and arrest the deficit in the external trade while at the same time subdue price pressures in the domestic economy. This in turn would allow the government to adopt a more easing monetary policy stance to revive the domestic economy, without creating excessive upward price pressure in the economy. The other side of the coin is that when the government continues to adopt a increase in government spending relative to government revenue for a longer period, the impact on prices of non-tradables would continue to rise and thus cause more pressure on the government to revalue its fixed exchange rate system. This is one aspect the government must realize that excessive increase in government spending must only be implemented for a temporary period and not for long term purposes in order to avoid refixing the nominal exchange rate at levels not reflecting fundamentals of the economy as this would only invite further speculation on the currency.

Malaysia also has another approach it could tap to further strengthen its economy amidst the crisis. This approach is using a crawling peg exchange rate system. A crawling peg exchange rate involves the Central Bank undertaking a public obligation to maintain its country's exchange rate within a wide band around a parity that is periodically adjusted in relatively small steps to help the band in line with fundamentals. A typical band that can be envisaged is something like +/-10% around parity. The crawling peg has two objectives. Firstly the band can be widened away from its parity if the objective is to

improve the current account deficit and secondly the band can be narrowed towards its parity if the objective is to subdue domestic inflation in the economy. A crawling peg exchange rate is defended with the same tools that are used to honour any other exchange rate commitment. The first line of defence involves intervention which is obligatory when the exchange rate hits the edge of the band. Whether or not the intervention is sterilized depends on the judgement of the Central Bank, which has to decide whether the change in monetary stance inherent in non-sterilization runs counter to the needs off the domestic economy. For example, if a country with undersired inflow has to decide whether to sterlize this by selling bonds in the open market so as to keep the money supply constant. Event if it decides to sterilize in the first instance, it may be driven to a subsequent change in monetary policy if the exchange market pressures persist.

On conclusion this study reflects that there is a link between fiscal policy, real exchange rates and the trade balance in Malaysia. The crisis being experienced by Malaysia has provided insights on the policy options that can be undertaken to overcome the crisis. It is important to note, policy options be it fiscal policy, monetary policy or exchange rate policy is related to the overall macroeconomic conditions. This study has shown that policies undertaken thus far must have a positive chain effect on the economy and ultimately must focus on stimulating economic growth.

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