Chapter 8: The behavior of selected economic indicators

An analysis of macroeconomic indicators following the implementation of capital controls is important to look for signs of where the economy is heading. It would be the evidence as to whether the move towards capital controls is in the right direction. Market players, researchers and policy-makers are, consistently monitoring economic fundamentals such as the inflation and the balance of payments.

8.1 Balance of payments

A balance of payments consists of the current and capital accounts. A current account deficit is often financed by a surplus in capital account and/or foreign exchange reserves. Deficits in the balance of payments are not inherently bad, nor are surpluses necessarily good. It is of much concern, however, that whether the balance of payments deficits are sustainable or will run out of credit? (Melvin, 1992; Levi, 1996).

Before turning into the more current economics data, it is useful to examine the historical trends in the balance of payments in Malaysia.

Table 8 shows the current account position of Malaysia's balance of payments had been in deficits during the period between 1990 through 1997. These deficits were sufficiently financed through the capital inflows, as reflected in the capital account, except for the years 1994, 1995 and 1997. During these years, BNM reserves fell correspondingly to the amount of those shortfalls, i.e. RM8.3 billion in 1994, RM4.4 billion in 1995, and RM10.9 billion in 1997. These shortfalls were largely due to an outflow of private short-term capital, i.e. an outflow of RM5.2 billion in 1994, a smaller inflow of RM0.6 billion in 1995 and another big outflows of RM15.7 billion in 1997. These flows were in response to the BNM's measures in curbing short-term capital flows in 1994/95 and the outbreak of the Asian financial crisis in 1997.

Table 8: Balance of Payments (net), 1990-1997 (RM billion)

Item	1990	1991	1992	1993	1994	1995	1996	1997
Current a/c balance	-2.5	-11.6	-5.6	-8.0	-14.8	-21.6	-12.2	-14.2
Capital a/c balance	7.8	15.1	22.4	37.2	6.5	17.2	18.4	3.3
Long-term	3.5	10.3	10.3	3.8	11.7	16.6	13.5	19.0
Official	-2.8	-0.7	-2.9	1.0	1.0	6.1	0.7	4.6
Private	6.3	11.0	13.2	12.9	10.8	10.5	12.8	14.4
Private short-term[1]	4.4	4.7	12.1	23.4	-5.2	0.6	4.9	-15.7
Overall balance	5.4	3.4	16.7	29.2	-8.3	-4.4	6.2	-10.9
Net change in reserves	-5.4	-3.4	-16.7	-29.2	8.3	4.4	-6.2	10.9
BNM reserves, net	27.0	30.5	47.2	76.4	68.2	63.8	70.0	59.1
Reserves as months of retained import	4.1	3.6	5.6	7.8	5.5	4.1	4.4	3.4
Current account as % of GNP	-2.2	-9.3	-4.0	-5.1	-8.2	-10.4	-5.1	-5.4

Source: Bank Negara Malaysia, Quarterly Bulletin, Jul-Sept, 1998.

[1] Including errors and omissions.

It is also shown in Table 8 that the counterpart of the overall balance in the balance of payments is the change in BNM reserves. The levels of BNM reserves throughout the years fluctuated in accordance with the overall balance, that is, the amount of net change in BNM reserves is tied to the amount recorded in the balance of payments.

Therefore, from the historical evidence, capital flows, be it short-term or long-term, is important in financing the current account deficits in Malaysia. And the short-term capital is evidently very volatile compared to the long-term capital.

For a more current data, the balance of payments for 1997 and the three quarters of 1998 is presented below (Table 9).

Table 9: Balance of payments, 1997 and 1998 Quarterly (RM billion)

(RM billion)	1997	1998				
		1st qtr	2nd qtr	3rd qtr		
Trade balance	11.3	11.5	14.4	16.6		
Exports, f.o.b.	218.7	N/a	68.9	73.6		
Imports, f.o.b.	207.6	N/a	55.5	57.0		
Services account balance	-21.1	-4.4	-4.7	N/a		
Current account balance	-14.2	6.6	8.5	14.0		
Capital account balance						
Total long-term capital	19.0	1.5	3.0	N/a		
- Official long-term	4.6	-1.3	0.8	N/a		
- Private long-term	14.4	2.8	2.2	N/a		
Private short-term capital[1]	-11.7	-9.9	-10.6	N/a		
Overall balance	-10.9	-1.9	0.9	N/a	14/11	30/11
Net official reserves	59.1	57.3	58.2	81.5	89.8	90.1
Reserves as months of retained imports	3.4	3.3	3.7	4.0	4.5	N/a

Source: BNM, Quarterly Bulletin, Jul-Sept 1998; and Economics Report 1998/99.

[1] Including errors and omissions.

The balance of payments turned into positive from the second quarter of 1998, largely due to the continuing strengthening of trade surplus. The trade balance recorded a rising surplus of RM16.6 billion in the third quarter, compared to RM14.4 billion and RM11.5 billion respectively for the second and first quarters of 1998. However, both imports and exports declined in US dollar terms. Imports of both capital and intermediate goods continued to decline in US dollar terms, by 41.9% and 23.1% respectively in the third quarter, whereas imports for consumption goods declined by 35.7%. Gross exports in US dollar terms declined due to lower export prices (prices of manufactured goods declined by 7.5% in the quarter) and lower volume. The manufacturing output contracted by 14.3% (-8.9% in second quarter), with a decline of 10.3% in the export-oriented industries. Thus, despite the latest trade data showing a rise in exports in ringgit terms, the exports growth stayed well in negative in US dollar terms, with the latest surplus evidently the result of a sharper decline in imports than exports.

The counterpart of the change in the trade surplus or deficit is a change in central bank reserves (Sachs and Larrain, 1993). Thus, the huge trade surplus in recent months provides the much needed buffer in building up the reserves. BNM net official reserves increase steadily from RM59.1 billion in 1997 to RM81.5 billion in the third quarter.

However, data up to the third quarter of 1998 reflects the result of the earlier policy measures. Even the continued increase in trade balance and reserves (RM89.8 billion and RM90.1 billion 14 November 1998 and 30 November 1998 respectively) may not reflect the result of the capital control measures due to the problem of policy lag.

It is pointed out by Hallwood (1986) and Levi (1996) that the running of a country's balance of payments deficit is subject to the availability of its foreign exchange reserves. With the expected reduction in capital inflows as a result of exchange control measures, a positive current account is required to maintain an adequate level of foreign reserves for the settlement of import goods and payment for debts and services.

In the absence of promising exports prospect and attractive FDI and portfolio funds, the balance of payments remain in jeopardy beyond the near to medium term. The downgrade of Malaysian sovereign rating by Fitch IBCA to speculative status (BB), followed by Moody's and Standard and Poor's have put further pressure on external balance. The international bond issue to supplement domestic sources of funding is ruled out in the near to medium term. As a result, the Governmentis working on bilateral financing arrangement.

8.2 Selected real economy indicators

Table 10: Selected Economic Indicators, 1997-1999

	1997	1998 1st qtr	1998 2nd qtr	1998 3rd qtr	1998 forecast	1999 forecast
Real GDP growth (%)	7.5	-2.8	-6.8	-8.6	-5.2	0.9
Real domestic demand/Consumption (% of GDP)	58.6	N/a	N/a	N/a	56.1	55.7
Consumer Price Index, inflation (%)	2.7	N/a	5.7	5.7	N/a	N/a
Unemployment rate (%)	2.7	N/a	3.3	3.3	4.6	N/a
Gross national saving (% of GDP)	38.0	N/a	N/a	N/a	42.0	40.0
Gross domestic investment (% of GDP)	45.1	N/a	N/a	N/a	34.0	34.0

Source: BNM, Quarterly Bulletin, Jul-Sept 1998; and Economics Report 1998/99.

Note: GDP = Gross domestic product

Malaysia had for the past decade recorded an economic growth of averaging at 8%. Following the outbreak of the Asian financial crisis, however, the growth had been slowed to 7.5% in 1997, and subsequently contracted sharply by 2.8% in the first quarter, followed by a deeper contraction of 6.8% and 8.6% respectively for the second and third quarter of 1998.

With the wide ranging policy measures introduced by the Government recently, the Government however, expects the measures to provide increasing stimulus to the domestic demand from the fourth quarter of 1998, and to pull the economy out of the recession in 1999. Complemented by the fiscal stimulus as proposed in the 1999 Budget, a real GDP growth of 1% is expected in 1999, if external demand is sustained (1999 Budget Speech; Economic Report, 1998/99).

It is mentioned in the Economic Report, 1998/99 that 1 percentage point reduction in lending rates is estimated to reduce total financing costs of the corporate sector by 1-2%. This will encourage them to venture into new investments as more projects will become profitable. For households, lower interest rates will reduce their mortgage payments, thereby, enhancing their spending power. This will in turn stimulate the domestic demand.

Although the lower interest rate will stimulate the domestic demand, it must be mindful that the country requires export earnings for economic growth and development. The savings-investment gaps during 1990 through 1997 were attributed to private sector resource gap, a situation of insufficient national savings to finance capital formation. This has led to a severe strain in the country's balance of payments following the Asian financial crisis. It is only with the subsequent monetary and fiscal restraints that the current account turned into positive from November 1997, the first positive since 1989.

The recent economic measures, which is in line with the National Economic Recovery Plan submitted on 21 July 1998 and was accepted by the Government for implementation, is said to prevent the economy from being entrapped into a vicious circle of prolonged and worsening recession. However, it is worth putting forward the argument that the appropriateness of those measures are depended on:

(i) projects selected must be those with strong linkages with the export earning sector;

(ii) minimal leakages in terms of imports in the economic activities, and

(iii) inflation is kept in check with lowering of interest rates.

As mentioned in the Economic Report (1998), the economy recovery is also depending on external demand. The export competitiveness has to be monitored closely. For the first 10 months of 1998, CPI rose by 5.2%, compare with 2.6% in the corresponding period of 1997 (BNM, 1998c). Thus, with expanded domestic demands, inflation has to be checked to maintain the country's export competitiveness.