Chapter 5: An overview of macroeconomic policy management in Malaysia

The macroeconomic management in Malaysia owes more to development economics, with its objective to achieve rapid, sustained, and non-inflationary growth rather than to traditional macroeconomic objective of stabilization (MBf, 1996; Seventh Malaysia Plan, 1996). Given this orientation, higher economic growth is always a priority in Malaysia.

As a result, other than the traditional monetary and fiscal policies, the policy-makers also involve actively in garnering resources and facilitating investment, managing structural shifts, defining detailed sectoral policies, defining and undertaking trade policies, undertaking public investment, upgrading social and physical infrastructure, and etc.

The section below discusses the conduct of fiscal and monetary policies and the exchange rate policy in Malaysia.

5.1 Fiscal policy

Theoretically, it is possible to adopt a contractionary fiscal policy to restrain aggregate demand or an expansionary fiscal policy to boost aggregate demand. In reality, however, invoking such a fiscal policy involves a lengthy actual budget-making process and time-consuming discussions by parliamentary committees.

In Malaysia, the fiscal plan is an integral part of the planning process and the yearly fiscal budget is the vehicle through which the public sector's role, as delineated in the Malaysian Five Year Plans, are translated into reality.

The fiscal budget as reflected in the government's finance comprises:

(i) current account which is made up of revenues (taxes) and expenditure (operating expenditures); and

(ii) development expenditure incurs by numerous non-financial public enterprises (NFPEs) that carry out Government projects.

Items (i) and (ii) will add up to arrive at the overall budget surplus or deficit.

In the face of the growing fiscal and balance of payments difficulties in the mid-1980s, the Government of Malaysia made a change in direction of fiscal policy to whittle down both the budgetary and the balance of payments deficits. The change in direction was interpreted by the Government as the consequence of excessive intervention by state in the economy and the concomitant constraints on the free market mechanism (Salleh and Rani, 1991). Consequently, the Government was in an effort to a foster better public-private relationships.

Guidelines in the Second Outline Perspective Plan, which set out the following fiscal targets also reflect the change in policy direction:

(i) reduction of the fiscal deficit to below 3% of gross national product (GNP);
(ii) reduction of the debt service ratio to below 7% of exports; and
(iii) reduction of the ratio of debt service payments to operating expenditure to below 20%.

As a result, since 1988, with the government's effort in cutting back on development expenditures and encouraging privatization, and in addition to a steadily rising tax revenues supported by strong economic growth (arguably due to external factor in recovery of world economy), have resulted in rapid fiscal improvement. The current balance had turned into positive from 1988 while the overall balance turned into positive by 1993, and both remained that way through 1997 (Table 4). Table 4 shows the trend of fiscal balance in 1990s.

Table 4: Trends in Federal Government's fiscal finance, 1989-99 (RM million)

Period	Current account surplus(+)/ deficit(-)	Net development expenditure	Overall surplus(+)/ deficit(-)
1989	2,291	5,701	-3,410
1990	4,495	7,932	-3,437
1991	5,757	8,397	-2,640
1992	7,175	8,418	-1,243
1993	9,474	9,120	354
1994	14,382	9,974	4,408
1995	14,380	12,520	1,860
1996	14,415	12,600	1,815
1997	21,071	14,445	6,626
1998 1st Qtr	5,377	1,174	4,203
1998 2nd Qtr	2,022	2,405	-383
1998 3rd Qtr	4,800	3,500	1,300
1998[1]	8,491	18,078	-9,587
1999[2]	118	16,753	-16,635

Source: BNM Quarterly Report, November 1998.

[1] Figures based Government forecast.

[2] Figures based on budget allocation.

With the onset financial turmoil from July 1997, an expansionary budget is adopted to boost economic growth in 1998 and 1999.

5.2 Monetary policy

The overriding objective of the monetary policy in Malaysia is to attain macroeconomic and monetary stability (BNM, 1997). Towards this end, the final and intermediate targets[13] of the monetary policies in Malaysia are as follows (Kuroyanagi and Hayakawa, 1997):

Final target: Economic growth; controlling inflation; international reserves.
Intermediate target: M3, the broad money of money supply.

These targets seem to be consistent with the macroeconomic management objective of non-inflationary growth as mentioned earlier.

In Malaysia, monetary policy is transmitted through the money market to the financial system by the price (i.e. interest rates) and quantity (i.e. market liquidity) effects (BNM, 1996). Bank Negara Malaysia (BNM) 's basic monetary tools are:

(i) open market operations via the issue of BNM certificates to control liquidity;
(ii) changes in statutory reserve requirements[14] (SRR); and
(iii) the BNM's lending policy.

The use of BNM certificates in open market operation is a characteristic unique to Malaysia monetary policy (Lin and Chung, 1994) as is the frequent adjustment of the reserve requirement. The first two monetary tools are effective in controlling market liquidity and thus controlling money supply to influence the interest rate levels. Whereas the lending policy is to promote or restrain certain economic sectors.

5.3 Exchange rate policy

The important role of exchange rate can be understood through its adjustment mechanism in relative prices of import and export and the trade balance in the balance of payments:

---

[13] This information is based on interviews with staff members of the relevant sections of the central bank.
[14] The reserve requirement was lowered to cut financing costs, provide liquidity, and lower domestic interest rates; consequently, raising the reserve requirement would indicate a strong money-tightening stance.

'A depreciation of the domestic exchange rate makes foreign imported (exported) goods more expensive (cheaper) when priced in domestic (foreign) currency. So a currency depreciation will lead to a reduction (increase) in the demand for imported (exported) goods as these goods become more expensive (cheaper). This reduction (increase) in the demand for imports (exports) should improve the trade balance of the country concerned. On the other hand, an appreciation of the domestic exchange rate, through the change in relative prices of imports or exports, should worsen the trade balance (Roubini, 1998).'

In Malaysia, the exchange rate of ringgit vis-a-vis the US dollar was floated in 1973 (BNM, 1997). Subsequently, in 1975, the flexible exchange rate system based on the basis of a currency basket was instituted.

The present currency basket comprises the US dollar, yen, deutsche mark, and other currencies. The weightage of each currency is determined through its importance in trade. Various estimates of the relative proportions of the component currencies have been made, taken together, indicate the following ranges: US dollar, 15%-30%; yen, 20%-30%; deutsche mark, 15%-30% (Kuroyanagi and Hayakawa, 1997).

Although Malaysia is officially maintaining a system of flexible exchange rate, actual exchange rate trends however, indicated the use of a managed float (Kuroyanagi and Hayakawa, 1997; Roubini, 1998; Economic Forum, 1998). It was more than an open secret, at least amongst foreign exchange dealers, that in the past year or so Bank Negara intervened to keep the ringgit within the RM2.49/55 range.

A managed (or dirty) floating exchange rate regime exists when governments intervene in foreign exchange markets to influence the exchange rate but do not commit themselves to maintaining a fixed exchange rate (Sachs and Larrain, 1993). The rationale used by Central Banks to justify interventions is that they intervene to smooth out fluctuations in exchange rates.