CHAPTER 3

THE FUNDAMENTAL FACTORS

3.1 FUNDAMENTALS OF AN ECONOMY

Fundamental is defined as something of or forming the basis or foundation of something, which also means something essential, most important, central and primary (Oxford Dictionary, 1993). However, until now the world economists still cannot reach a consensus of opinion on what constitutes a nation's economic fundamentals. In June 1997, Michel Camdesus, the head of IMF, had mentioned in an international conference on Global Capital Flows that :-

> "Malaysia is a good example of a country where the authorities are well aware
> of the challenges of managing the pressures that result from high growth
> and of maintaining a sound financial system amid substantial capital flows
> and a booming property market."

> (Quoted from the text of the speech by Mahathir
> Mohamad at the Fifth Symposium of the Institute for
> International Monetary Affairs in Tokyo, Japan on 6th
> June 1998)

There is currently a substantial amount of controversy among world economists as to what constitutes economic fundamentals. Until now, they still cannot find a clincher to settle the disagreement. Manuel F.Montes (1998) has argued that private asset managers have a different definition of what constitute fundamentals and what does not. According to him, private asset managers appear to associate "fundamentals" with factors that support the one-year to year-and-a-half stability of key asset prices, especially exchange rates. Economists and public officials would probably think along the "medium-term", that is in terms of three years. They look on fundamentals along the lines of the impact of asset prices on real economic variables, such as output growth, exports and employment.

Thus in this context, I would like to argue that the relevant economic fundamentals of Malaysia which need to be taken into consideration in this SACC analysis are as follows :-

1.   Prior to the SACC, exports had declined because of the increasing real effective exchange rates (REER), the increasing price pressure after the economy had grown above potential output level for a long period of time and finally the worsening Total Factor Productivity (TFP) growth rate.

2.   Imprudent and excessive lending to unproductive activities such as construction of unproductive items and speculating in shares. These might have caused financial and banking losses when the economic bubble burst in July 1997 ;

3.   The widening macroeconomic deficits might have worsened the problem already caused by the negative saving-investment gap. This was not apparent in the past 10-year because it was financed by portfolio investment and private loan.

Out of the 22-year of analysis, more attention will be given to the period between 1988 and 1996. 1988 was the year the Malaysian economy started to recover after suffering from the deflationary effects of the liquidity crisis in 1980s. According to Jomo (1997), since 1988, annual growth rates have topped 8 percent, the ratio of manufacturing to GDP has risen rapidly, and the share of manufactures in total exports has risen even more rapidly. He contended that from year 1988, there was dramatic recovery and sustained growth of Malaysia's manufacturing sector; liberalization probably contributed to the resurgence in manufacturing growth, exports and employment.

1996 is chosen as the end point because it was the last year before the economic turmoil started to erupt. Hence the Malaysian economic crisis of the late 1990s with cross reference to the mid-1980s can be portrayed clearly. In this research paper, there will be also an attempt to illustrate how the favourable economic impact occurring in the mid of 1980s' (which was due to the "Southeast Asian Flying Geese" phenomenon after the advent of [2] endaka) had evaporated in the mid of 1990s.

3.2   LOWERED COMPETITIVENESS IN THE MANUFACTURING EXPORTS

The Industrial Master Plan I (1986-1995) set manufacturing exports as the most crucial foreign exchanges earning strategy and effective way of achieving high Gross Domestic

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[2] *Endaka* was an era of the high yen followed after the agreement of Plaza Accord on September 22, 1985 to depreciate the dollar. Since then, Japanese industry has increasingly relocated to Southeast Asia as expensive yen and cheap labor shortages drove it offshore.

. Product (GDP) growth rates. In year 1986, the net output of this sector accounted 20.9 per cent of the GDP only but it had been substantially increased to 33.1 per cent of the GDP in 1995. Meanwhile, its annual growth rate of 7.5 per cent in 1986 had doubled to 14.5 per cent in 1995 (kindly refer to Table 1 in the appendices). In fact, Malaysia was believed to have set the pace for the rest of the developing world in using outward-looking strategies to stimulate its rapid growth and industrial growth; because of the outstanding export-led performance, its economy has become the model for less-dynamic economies to emulate (Gillis, 1996). Despite such a pivotal role in the economy for the past 10-year, less competitiveness in its exports might possibly be one of the major factors in exacerbating the SACC. As alluded to earlier, three possible factors which challenged the manufacturing export sector are as follows :-

1. The decreasing REER.
2. The declining TFP percentage.
3. The price pressure after the economy had grown above the potential output level for a long period. (Negative Output Gap)

3.2.1 THE DECREASING REER

REER index is defined as the weighted average of percentage changes in the bilateral exchange rates of the domestic currency and the currencies of its trading partners. Thus it shows changes in the value of the domestic currency in relation to a fixed basket of currencies over time, arising from changes in the bilateral exchange rates of the domestic currency and the various currencies in the basket. (Dornbusch and Fischer, 1994)

REER is related positively with total exports. In other words, a higher REER will result in more exports and vice versa. This implies that if the underlying current account balance is significantly outside the range of current account balances that a country has normally experienced, this can be an indicator of potential exchange rate misalignments. Kindly refer to Diagram 1 in the appendices for graphical explanation.

3.2.2 NEGATIVE OUTPUT GAP

Output gap measures the gap between actual output and potential output (output which an economy is able to produce at full employment given the existing resources)[3] . IMF views it

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[3] Output gap = potential output - actual output.

as a representative in the economy supply side and perceives potential output as the maximum output an economy can sustain without generating a rise in inflation; over the medium term, the estimated trend in potential output helps to determine the pace of sustainable growth. In the short term, estimates of the gap between actual and potential output provide a key benchmark against which to assess inflationary pressures (De Masi, 1997).

In Malaysia, Bank Negara Malaysia (BNM) is the only government statutory body to measure potential output. Some measurement guidelines that commonly used by BNM are as follows :-

- A production function of the economy can be specified and then solved for some equilibrium rates of factor utilisation to estimate potential output with the assumption of a stable long-run relationship between output and the production factors is existing.

- BNM uses the following production function :-

  $Y_t = f(KCU_t, L_t)$, where KCU represents the utilised level of capital stock (capital stock multiplied by the average level of capital utilisation) and L represents the labor force in employment.

- Both KCU and L are substituted with K and L^* to derive the potential output. K represents full utilisation of available capital and L^* represents the potential employment. The potential employment means the labour force in employment that is consistent with the "natural" or "long-run" rate of unemployment (BNM's Annual Report, 1997)[4].

A study in the output gap can help to determine whether the rapid growth in the past 10-year had caused overheating or inflationary pressure in the economy. This might have raised the export prices[5]. In order to address the problem of whether the output gap model of inflation is applicable, a novel univariate detrending technique based on a nonparametric regression method has been used to estimate potential output for 13 Asian countries[6] by Coe and McDermott (1996). The result of their study indicated that the output gap was a

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[4] Annual data are used ; output is the real GDP at purchasers' value ; capital stock estimates are based on estimates made by the World Bank and using the perpetual inventory method ; capital utilisation rates are taken from manufacturing sector ; labor is defined as the number of workers in paid employment.

[5] $P = P_{-1}[1 + \lambda(Y - Y^*)]$, where P is the price level, Y is the level of output, Y^* is the full-employment level of output, $\lambda = \epsilon / Y^*$ where ϵ measures the responsiveness of wages to unemployment.

[6] These include Australia, China, Hong Kong, India, Indonesia, Japan, Korea, Malaysia, New Zealand, Philippines, Singapore, Taiwan Province of China and Thailand.

. significant determinant of the change in inflation in 11 out of 13 countries. (Only China and Thailand did not show any significant determinant of the change in inflation)

3.2.3 THE DECLINING TFP

Productivity measures the relationship between outputs (the quantity of goods and services produced) and inputs (the quantity of labor, capital and material resources used to produce the outputs). When a given amount of input produces a larger quantity of output, productivity has increased.

TFP is a measure which attempts to take into account the contributions of all inputs - the services of plant and equipment, energy and other materials, as well as that of managers and their employees, is a better measure than labour productivity. TFP is thus the best expression of the efficiency of economic activity and the prospects for longer term growth. TFP is more difficult to be estimated but it is very useful in determining the causes of changes in labor productivity and the efficiency in industries and other sectors (Maisom, 1998).

Productivity thus relates output to all inputs to assess net savings in terms of real costs per unit of output. Productivity gains emerge from improvements in the techniques, technology and management of the production process as well as management - labour relations.

3.3   MACROECONOMIC DEFICITS

Balance of payments (BOPs) is defined as the record of the transactions done by the residents of a country with the rest of the world in two types of accounts : the current account and the capital account. The former records trade in goods and services as well as transfer payments whereas the latter records purchases and sales of assets, such as stock, bond and land. Deficit in the current account indicates that total imports are more than total exports and surplus in the current account indicates otherwise. Meanwhile, deficit in the capital account indicates that total capital outflows are more than total capital inflows and surplus in the capital account indicates otherwise.

BOPs is a crucial area in an economy system. As pointed out by [7]National Economic Recovery Plan (1998) or abbreviated as NERP that the current account of the BOPs is an

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[7] This is a document presenting six strategic areas and 585 recommendations for action to address the economic crisis. National Economic Action Council which is headed by Tun Daim Zainuddin, the Special Function Minister, is the implementing and monitoring statutory body.

indicator of economic resilience and it will influence an investor's confidence. A persistent current account deficit implies that the investment and consumption of a country have consistently been above its available resources, thereby making it increasingly dependent on foreign capitals. If foreign capital inflows are insufficient to finance the current account deficit, the foreign reserves will fall. This will raise the concern about the long-term strength and stability of the economy.

Therefore, it is prudent to always keep the macroeconomic deficits small in order to create sustainable growth. However, since year 1989 Malaysia had been dogged by severe current account deficits problem (kindly refer to Table 2 in the appendices).

According to "Lawson Doctrine", this was due to the *"what-me-worry"* attitude by the government towards privately determined macroeconomic deficits. Corden (1994), quoted by Begg and Griffith-Jones (1997), has decomposed the doctrine as follows:

> "The current account is the net result of savings and investment, private and public saving and investment will lead to a net balance - the current account - which will also be optimal. There is no reason to presume that governments or outside observers know better how much private agents should invest and save than these agents themselves, unless there are government-imposed distortions. It follows that an increase in a current account deficit that results from a shift in private sector behaviour should not be a matter of concern at all. In fact, the public budget balance is a matter of public policy concern and the focus should be on this."

The "Lawson Doctrine" can be suitably applied in the Mexico currency crisis that happened in the end of 1994. In January 1994, the governor of the *Banco de Mexico*, the central bank of Mexico, told *The Economist* that the current account deficit was not a problem because it was associated with the inflow of foreign funds, rather than expansionary fiscal or monetary. A year later, the sudden pull-out of the foreign and domestic investors forced Mexico government to reduce the deficit on its current account from almost 8 percent of GDP in 1994 to about zero. (Reisen 1997 : 1)

Nevertheless, the government would ask how should one know whether a deficit is excessive or not. No economists can provide a definite quantitative answer although some qualitative comments still can be seen. Reisen (May 1997) argued that offers of financing by non-residents should be resisted when these have caused unsustainable currency appreciation,

excessive risk-taking in the banking system and a sharp drop in private savings; he went on arguing that Malaysia and Thailand current account deficit "appear to be sustainable". During that time, the current account deficit of Malaysia and Thailand was -6.3 per cent and - 8.1 per cent of GDP respectively (Asian Development Bank, 1997). However, the SACC started two months after his book was published. This showed that his argument was totally wrong.

3.4 SAVING AND INVESTMENT GAP

Harrod-Domar Model, a model which was developed independently during the 1940s by economists Roy Harrod of England and Evsey Domar of Massachusetts Institute of Technology, has been used extensively in most developing countries as a direct way of looking at the relationship between sustainable growth and capital requirements.

According to Harrod (1939) and Domar (1946), the underlying assumption of the model is that the output of any economic unit, whether a firm, an industry or the whole economy depends on the amount of capital invested in that unit. Thus the output and the stock of capital is called Y and K respectively and both can be related by $Y = K/k$ where k is the capital-output ratio and it is constant. Incremental capital-output ratio (ICOR) is widely used and it measures the productivity of additional capital while the capital-output ratio refers to the relationship between a country's total capital stock and its national product. Converting into growth of output, it can be written as $\Delta Y = \Delta K/k$ where the notation Δ represents increases in output and capital. As such, the growth rate of output, g, equals to $\Delta Y/Y$. $\Delta Y/Y$ equals to $(\Delta K/Y) \times (1/k)$. For the whole economy, ΔK is the same as investment (I), which must equal savings (S). Therefore, $\Delta K/Y$ becomes I/Y or S/Y because $I \equiv S$. S/Y can be denoted as the saving rate (s), a percentage of national product. Therefore, the basic of the relationship is $g = s/k$. Given the constant value of k, an economist can determine a sustainable g by knowing the s value.

However, the model does carry certain caveats. Firstly, this equation is a dynamised version of the fact that investment is always necessarily equal to saving. Secondly, representing saving as a fraction of income does not imply that saving has a functional relation to the size of income. Thirdly, desired government savings those that are made to regulate the economy and

. would not be made if it were not intended to regulate the economy in a certain way should be excluded.

Meanwhile, Domar (1946) defined the capital accumulation, K, as follows :-

1. There is a constant general price level.
2. No lags are present.
3. Savings and investments refer to the income of the same period.
4. Savings and investments are net of depreciation.
5. Depreciation is not measured by historical costs but by the cost of replacing the depreciated asset by another one of the same productivity capacity.
6. Productivity capacity of an asset or of the whole economy is a measurable concept.

3.5   FINANCIAL INSTITUTION

During rapid economic growth period in the early of 1990s, many banks and depository institutions were able to manage high loan growth and generate significant fee income, while building a productive asset base, increasing profits, making provisions for losses and expanding their capital base.

In order to develop Malaysia as one of the international financial centres, the government had launched the Federal Territory of Labuan as an international offshore financial centre (IOFC) on 1 October 1990. Resembling the *Bangkok International Banking Facilities (BIBF), the main function of the IOFC is to provide Malaysia with greater access to the international markets in attracting surplus funds into Asia-Pacific region (BNM's Annual Report : 1991).

The inception of IOFC was perceived as the gateway to tap international funds and also to pave the way for domestic financial industry liberalisation in the future. In fact, in order to show our full commitment in the liberalisation, the government had also announced a liberalisation package in June 1995 to open the fund management industry.

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* BIBF was set up in March 1993 by Thai to internationalize its financial market. Since then, the BIBF has evolved into a vigorous source of short-term funds for Thai banking operations.

Nevertheless, there are economists arguing that the above approaches had caused the deficiencies and weaknesses spawning in the banking system prior to the SACC. According to the NERP (1998), the weaknesses are due to the following factors :-

1. Rapid credit growth and high exposure to property and stock markets.

2. High leverage, with large short-term domestic debt.

3. Increasing non-performing loans.

These three undesirable occurrences showed that the commercial banks and finance companies lacked self-discipline in their lending practices. As argued by Lee (1992),

> "These lending guidelines contain several important deficiencies.
> Admittedly, there have been attempts to correct some of these but
> a number remain."

The four deficiency areas that he found out to be existing then are as follows :-

1. Lacked of focus in some cases where the guidelines for lending had been too broadly defined. For example, a specified proportion of the loans of banks and finance companies were allocated to the Bumiputra community without requiring the subsidized interest-bearing credit to be directed to this community should be for the acquisition of capital assets or for directly increasing the productivity of the borrowers.

2. Lacked of a clear perception of the goals to be set for some of the sectors. For example, there was no appropriate quantitative increase target set for finance companies for each guideline period for the miscellaneous group of sectors (agriculture, forestry, fishing, manufacturing, building, construction and real estate). Surely, these sectors had different values and implications for the development process and should not be treated alike.

3. Lacked of uniformity in the list of priority sectors for commercial banks and finance companies. For example, it was hard to fathom the logic behind why many of the sectors in the miscellaneous group of sectors (agriculture except food production, forestry, fishing, building, construction and real estate) were priority sectors for finance companies but not for commercial banks.

4. The lending guidelines for both commercial banks and finance companies appeared to be open-ended exercises where the guidelines appeared to have been set from one guideline period to another on an ad-hoc basic without any long-term objectives.

In this financial sector analysis, Basle Core Principles (BCPs) will be used as the benchmark to measure the domestic banking and financial system prior to the SACC. BCPs comprise twenty-five basic principles which include preconditions for effective banking supervision - principle 1, licensing and structure - principles 2 to 5, prudential regulations and requirements - principles 6 to 15, methods of ongoing banking supervision - principles 16 to 20, information requirements - principles 21, formal powers of supervisors - principle 22, and cross-border banking - principles 23 to 25 (kindly refer to Appendix 1)

According to Folkerts-Landau and Lindgren (January 1998), under the BCPs, quantitative supervisory tools which are normally used by supervisors to assess commercial banks and finance companies conditions are the ratio of [9]capital adequacy, liquidity, large exposures, connected and insider lending, interbank positions, and open foreign exchange positions.

They claimed that the BCPs have called for a ratio between capital and risk-weighted assets of at least 8 percent whereas there are no internationally agreed prudential standards on bank liquidity, although the Basle Committee has issued material discussing some of the fundamental issues[10]. In addition, the BCPs have called for and the European Union has set a limit of 25 percent of regulatory capital for exposures to single borrowers or related groups of borrowers (Basle Committee, 1991). The European Union defines an exposure larger than 10 percent of regulatory capital as a large exposure. In the United States, federal regulations set the limit at 15 percent of a bank's regulatory capital for unsecured loans and an additional 10 percent for loans secured by specific and liquid marketable security.

In order to ensure capital adequacy in a commercial bank or finance company, Capital Accord (kindly refer to Appendix 2) was signed in 1988 by the member countries of the Basle Committee on Banking Supervision (BCBS). According to the BCBS (1988a), the types of acceptable capital for supervisory purposes are consisting of permanent shareholders' equity

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[9] There are two main types of capital adequacy ratios: the "risk assets" method as used in the Basle Capital Accord (see Appendix II), and the simpler "gearing" or "leverage" ratio, which is the ratio between shareholders' funds and total assets or liabilities.

[10] Basle Committee (1997b). The Core Principles recognize the elements of strong liquidity management ("good management information systems, central liquidity control, analysis of net funding requirements under alternative scenarios, diversification of funding sources, and contingency planning") and recommend that banks have a diversified funding base and maintain adequate liquid assets.

and disclosed reserves that are created or maintained by appropriations of retained earnings or other surplus (e.g., share premiums, retained profit, general reserves and reserves required by law). The Accord assigns risk weights to on- and off-balance sheet exposures according to broad categories of relative riskiness. The framework of weights has been kept only five weights : 0, 10, 20, 50 and 100 per cent. The Accord also sets minimum capital ratio requirements for internationally active banks of 4 per cent tier one capital and 8 per cent total (tier one plus tier two) capital relation to risk-weighted assets.

3.6 CONCLUSION

The fundamental factors review comprises three areas of discussion. These include competitiveness in exports, macroeconomic deficits and weaknesses in the financial sector. The gist of this chapter will be the guidance economic facts for the following analyses. These facts are very important as they will form as the points of argument on the final results obtained in the study. In addition, this fundamental factors review will also help the readers of this research paper to have a common understanding or interpretation on certain economic concepts. As such, we will be able to achieve the most effective way of fully tapping the benefits from reading this research paper.