

Chapter 1 Introduction

1.1 Problem statement

Looking back at the history of Malaysian economy, one can observe that the concern of current account deficits arose in the 1980s and attracted even greater attention in the 1990s. When Malaysia recorded current account deficit of 10.2% of Gross National Product (GNP) in 1995, there were serious doubts about the health of Malaysian economy. Most observers during that time predicted that Malaysia was heading for economy hard landing.

However, as the current account deficit narrowed from RM21.6 billion in 1995 to RM11.2 billion (or 4.6% of GNP) in 1996, many observers believed that Malaysia had successfully manoeuvred the economy into a soft-landing. This was however untrue with the onset of the East Asian economic crisis in 1997 of which Malaysia suffered from sharp GDP contraction.

The crisis highlighted and forced the Malaysian government to face with the reality. That is, there are some fundamental weaknesses in Malaysian economy. One of them is the acute savings-investment gap¹ as reflected by the severe current account deficits.

¹ The issue of the savings-investment gap is about how an economy could mobilize enough savings to fund its investment activities to fuel the economic growth. Traditionally, Malaysian government resorts to the inflow of foreign capital to bridge such gap.

What type of policy can rectify Malaysian trade imbalances, especially in the situation of trade deficits? Traditionally, there are three alternatives, that is, fiscal policy, monetary policy and exchange rate policy.

1.2 Objective

Consequently, this paper aims to empirically investigate the long run determinants of Malaysian trade balance. Put it differently, the main objective of this paper is to determine which macroeconomic variables (that resemble various policies) have long run relationship with Malaysian trade balance.

1.3 Methodology

To this end, we apply the Engle and Granger (1987) cointegration analysis for the period of 1973 1Q to 1998 4Q. This is because cointegration is good at discovering the long run equilibrium relationship and the Engle and Granger method is suitable for the case of bivariate analysis.

The macroeconomic variables used in this study are nominal exchange rates, real exchange rates, money supply, interest rates, fiscal balance, income and terms of trade. They are identified as the important factors which determine trade balance according to theories. However, some of them are found to be insignificant empirically for the case of the United States and India.

1.4 Organization of the paper

This paper is organized as follows. Chapter 1 is the introduction while Chapter 2 presents the scenario of the Malaysian current account. Chapter 3 discusses the review of some previous studies done in Malaysia and other countries as well as the rationale for choosing the variables. We will then discuss the methodology, data definitions and sources as well as empirical results in Chapter 4 while the conclusion will be in Chapter 5.

1.5 Definition

But before we proceed into Chapter 2, we need to be clear about some of the terminology which will be used frequently. Firstly, **trade balance** is defined as the merchandise account balance. Secondly, **cointegration** means the existence of stationarity for the linear combination of two or more variables that are not stationary. When these variables are cointegrated, they have long run equilibrium relationship.

Finally, a time series is said to be **stationary** if its mean and variance are constant over time and the value of covariance between two time periods depends only on the lag between the two time periods and not on the actual time at which the covariance is computed. In short, if a time series is stationary, its means, variance and autocovariance (at various lags) will remain unchanged no matter at what time we measure them.² (Gujarati 1995)

² Mathematically, If a time series, Y_t , is stationary, then it must have the following properties (Gujarati 1995):