

CHAPTER ONE: INTRODUCTION

1.1 SAVINGS AROUND THE WORLD: AN OVERVIEW

As we grow up, we are told of the virtues of thrift. Those who spend all of their incomes are condemned to end up poor. Those who save are promised a happy life. Similarly, governments tell us, an economy that saves is an economy that will grow strong and prosper. This is because, saving provides funds required to finance investment and capital formation for a country.

Over the past three decades, although an abundant amount of literature has focused on various issues of savings behavior, but many questions still remain unanswered. Recently, a completed World Bank research project on “Saving across the World”, addressed these three broad questions (Schmidt-Hebbel, K. & Serven, L., 1999):

1. Why do savings rate differ so much across nations and periods?
2. What is the causal linkage in between savings and growth? Is that a higher growth rate lead to a higher savings rate or a higher savings rate being associated with higher growth rate?
3. Which policy measures have the dominant effect on increasing national saving? And which are improbable to function?

These three questions can be analyzed in the context of separate countries. It is because, different government policies, economic performances and demographic structures yields dissimilar results. Generally, savings rate has risen around the world since the mid-1970s. The gap between savings rate of developed and developing countries has become more widened: savings have collapsed in Sub-Saharan Africa, stagnated in Latin America and doubled in East Asia. What are the factors that cause such phenomena?

Since the early 1970s, national savings rates in Southeast Asian economies have risen steadily and are among the highest in the world. The high national savings rate associated with great economic success, has received much notice from researchers and policymakers alike. For instance, the savings rate rose from 15 percent to 25 percent of gross domestic product (GDP) and the region's real per capita GDP increased by almost 200 percent from 1975 to 1995. This situation has risen to the question of whether there is a causal relation between high saving and high economic growth.

Theoretically, the impact of economic growth on saving is still under investigated, but empirically, saving and growth are complementary over the long run, with higher rates of growth being associated with higher saving. Empirically, a 1-percentage point increase in the growth rates hike the savings rate by a similar amount even part of this effect may be transitory. As a result, sustained accelerations in growth are associated with permanent raises in saving (Carroll & Weil, 1994)¹.

¹ At an empirical level, Carroll and Weil (1994) find growth to Granger-cause saving, but saving not to Granger-cause growth.

1.2 SOUTHEAST ASIA'S SAVINGS RATE

Based on previous studies, several conclusions have been drawn regarding Southeast Asia's savings rate. Firstly, in this region, savings have not preceded growth, but have actually followed it. Secondly, savings have risen due to change of demographic influence that reduce dependency ratio. Then, savings have risen because the financial sector has developed rapidly and macroeconomic stability. Lastly, savings have been high by the reason of prudent government policies to protect a country against unexpected vulnerability to sudden shifts in international capital flows.

Within Southeast Asia itself, saving is still an issue. High current accounts deficits in Malaysia, Thailand and Indonesia show that domestic savings are not yet high enough to cover domestic investment needs. Furthermore, as East Asia's 1997 financial crisis shows, high saving alone does not provide complete insurance against the consequences of weak financial systems or unsustainable exchange rate policies. This crisis was similar to the European monetary crisis in 1992-1993 and the Mexican peso crisis. The Mexican peso crisis of December 1994 has shed light on the fact that low and declining saving rate have contributed to generating unsustainable current account deficits. More specifically, it is a current account crisis. The basic cause comes from structural problems in the area of financial markets that lacked both adequate supervision and regulations. Beside that, the prominent role of short-term private capital inflows in creating vulnerabilities was also triggering the crisis.

In late 1997, the sharp devaluation of the Asian currencies triggered a massive outflow of capital and put a stop to economic growth. The crisis had restricted the availability of foreign private capital. The reduction in private flows has caused macroeconomic tightening, which lead to slowdown in economic growth and reduce the need for external finance. This is because international capital flows are highly sensitive to domestic macroeconomic policies, the soundness of banking systems and political developments. And the markets are not always “right” and may be misjudge. The crisis then quickly turned into a vicious circle: capital outflows forced the value of currencies downward and created risks for companies that were indebted in foreign currencies. Therefore, the characteristic of foreign capital flows had shed light to the need for more local financing.

A high national savings rate parallel to an economy’s investment needs is the key to reducing vulnerability to sudden unexpected shifts in international capital flows. It also helps to increase international financial integration, prevent macroeconomic instability and create a sound business environment. In fact, macroeconomic stabilization can both increase and decrease savings. On one hand, macroeconomic stability reduces the precautionary motive for saving thereby decreases national savings. On the other hand, fiscal adjustment through higher public saving raises national savings. The net effect on saving is likely to be positive because growth will increase as a result of macroeconomic stability.

In an open economy, it is not necessarily the case that increases in domestic savings will be automatically passed into higher domestic investment. According to **Edward (1997)**,

if capital is internationally mobile, shifts in domestic savings and investment are uncorrelated. Savings generated in one country can be invested in another country. If domestic savings and investment are individually independent, increases in the former will not be translated into a higher capital stock, thereby will not result in accelerated growth. But, the cross-section analysis fails to validate the assumption that capital is perfectly mobile between countries (Cadoret, I, 2001).

In contrast, if capital is not internationally mobile, higher domestic savings will transfer into higher domestic investment and growth. Empirical evidence suggests that domestic savings and aggregate investment are highly correlated. This implies that, changes in capital accumulation due to respond shifts in domestic savings. Therefore, it is important to use recent data to establish our understanding of the relationship between national and foreign savings.

1.3 MALAYSIA SAVINGS RATE: AN OVERVIEW

The rate of saving is an important factor in the economic development of a nation. A high saving rate will result in a higher capital accumulation, consequently generating greater economic spin-off effects. With the spontaneous savings based upon a nation-wide network of banks and the compulsory savings whose basis was social welfare funds, Malaysia succeeded in mobilizing domestic small savings, and in bringing its national savings rate to a remarkable height.

The Malaysian government, at the same time, worked wonders achieving its goal to improve native Malays' social status. The domestic savings rate recorded only a gradual increase in the early 1970s but since the late 1970s it has started to grow rapidly and the average rate reached as high a level as 34% in 1991-1995. It can safely be said from either of the indexes, the gross national products (GNP) growth rate or per capita income that Malaysia entered the phase of taking-off in the late 1970s after the preparatory period of the 1960s.

In addition to that, it should be noted that the savings by the government have worked to supplement private savings in Malaysia. Malaysia's savings rate has long been stable at a high level through such governmental complementation. The governmental savings are chiefly composed of the general budget surplus and the surplus from Non-Financial Public Enterprises (NFPEs). From the late 1970s to the early 1980s there took place a hike in the prices of primary products, and the policy aimed to equip the country with

chemical and heavy industries such as oil-well drilling increased surplus; these resulted in greater governmental savings during the period. The increase of the governmental savings seen during the period from the late 1980s to the early 1990s is due to such measures as the privatization of public businesses, restructuring for improvement of performance and setting up a supervisory organization the government took in response to the reduction of the fiscal budget and to the fall in prices of primary products.

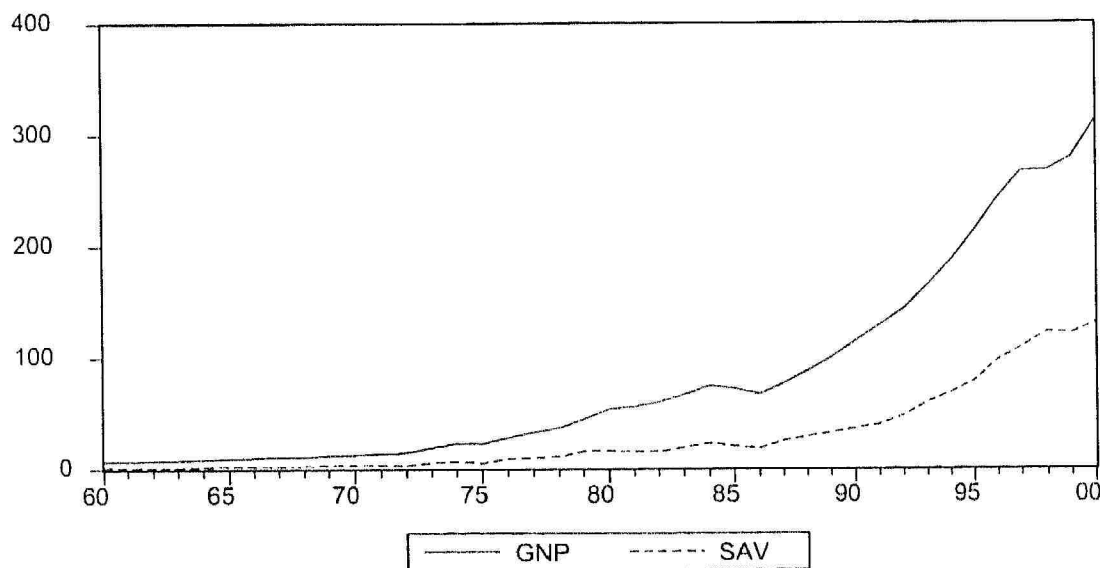


Figure 1: Gross National Products and Gross National Savings in Malaysia, 1960-2000 (Billion of RM)

Generally, Malaysia's national savings rate has trended up from more than 20 per cent in 1970 to around 40 per cent at 1995 and is heading into the 20s. Figure 1 graphs the relation between gross national products and gross national savings (GNS) in Malaysia from the years of 1960 to 2000. Indeed, savings rate raised more than doubled during 1973-2000 and appear to have been trending upward throughout the period. The figure

also indicates that economic growth measures by gross national product are highly correlated with gross national saving: high savings rate in Malaysia tend to accompany higher economic growth. It's suggests a virtuous cycle in which high rates of saving lead to greater economic successful that in turn opens to even higher rates of saving.

Thus, the outstanding feature of economic success is due to high saving and economic growth rates. The strong and rising saving achievement has reflected from the both private and the public sector. A supportive macroeconomic environment and the maintenance of the competitive returns on financial saving instruments were promise avenue increase in saving.

1.4 OBJECTIVES OF THIS PAPER

The purpose of this paper is to highlight the relationship between savings and its determinants in Malaysia. The paper also tries to find out the long run relation existing between savings and its determinant in Malaysia. To do this, the paper estimates a variety of empirical equations for the savings rate by using unit root test, co-integration test and error correction modeling (ECM) approach. Then, the issue of Granger-causality between savings and its determinant is analyzed based on ECM estimation.

1.5 ORGANISATION OF THE PAPER

The paper is structured as follows. Section 2 of this paper provides the literature review. Furthermore, Section 3 deals with the theoretical background and the supportive empirical evidence. Consequently, Section 4 describes the data sources used, the econometric method of estimation employed and theoretical model use in the analysis. Section 5 provides the empirical results, while the final section has the concluding remarks.