

## Chapter 5

# CURRENT ACCOUNT DEFICIT AND OTHER MACROECONOMIC INDICATORS

Financial liberalization brings with it heavy foreign capital inflow and easy access to liquidity. This chapter looks at how the accounts in the balance of payment and other macroeconomic indicators perform during the period of financial liberalization in the 1990s among the four countries.

### 5.1 Current Account Balance and Pattern of Foreign Capital Inflows

In table 5.1, only Singapore has a current account surplus. Getting a current account surplus means Singapore earns more than it spends, enabling it to be net exporter of capital to the rest of the world. Thailand has the worst current account deficit in the period under study.

Thailand has the greatest inflow of short-term investment in the 1990s, followed by Indonesia and Malaysia. Singapore experienced mostly outflow of short-term investment. For Malaysia, long-term investment is more important than short-term investment. In the 1990-96 period, 77.3% of investment inflows was in the form of long-term investment. Singapore experienced more of an outflow of long-term investment than an inflow. The inflow of short-term investment is as much as long-term investment in Thailand. The total 1990-96 long-term and short-term investment respectively took up 52.9% and 47.1% of the capital inflow. Indonesia has a more dominant long-term investment inflow than short-term investment.

Table 5.1 Foreign Capital Flows 1990-1996 (millions of US dollars)

	1990	1991	1992	1993	1994	1995	1996	1990-96
<b>Malaysia</b>								
Current Account	- 918	-4,234	-2,207	-3,079	-5,628	-8,644	-4,848	-29,558
Long-term Investment	1,284	3,757	4,054	5,386	4,443	6,633	5,376	30,933
Short-term Investment	617	1,724	4,662	1,772	-1,963	253	1,954	9,019
<b>Singapore</b>								
Current Account	3,181	4,687	5,614	4,571	11,695	13,641	13,850	57,239
Long-term Investment	2,432	2,878	-265	3,026	-914	-201	-1,509	-605
Short-term Investment	-154	-3,332	763	6,640	-5,863	-5,240	-5,332	-12,547
<b>Thailand</b>								
Current Account	-7,136	-7,383	-6,088	-6,126	-7,801	-13,206	-14,350	-62,090
Long-term Investment	3,195	4,649	3,732	3,268	-622	4,887	7,390	26,499
Short-term Investment	6,128	2,284	1,717	6,341	-1,296	4,316	4,126	123,616
<b>Indonesia</b>								
Current Account	-2,988	-4,260	-2,780	-2,106	-2,792	-6,431	-7,663	-29,020
Long-term Investment	4,817	5,495	6,080	4,100	2,965	7,486	6,194	37,137
Short-term Investment	-392	202	49	1,888	1,483	3,501	5,005	11,736

Note: Long-term investment for Malaysia comprises of official long-term capital and foreign direct investment.  
 Long-term investment for Singapore, Thailand and Indonesia includes foreign direct investment.  
 Short-term capital for Malaysia, Singapore, Thailand and Indonesia includes portfolio investment and errors and omissions.

Source: Bank Negara Malaysia, Asian Development Bank and International Monetary Fund.

Malaysia has been able to finance its current account deficit through its long-term capital except for years 1991, 1994 and 1995. The question of financing the current account has never occurred for Singapore during this period because the current account has always been in surplus. Thailand has not been able to cover its current account deficit by using only long-term investment. In fact, both long-term and short-term investments together were never able to finance its current account deficit in this period. Although the long-term investment

Indonesia can still cover the current account deficit, its short-term investment is higher than Malaysia's by 30%.

In chapter four, it was shown that the external borrowing of Indonesia had been very high while Malaysia had a much lower external borrowing. Thus, most of the capital flows to Indonesia may be in the form of external borrowing that has to be repaid in future. Therefore, compare to Thailand and Indonesia, Malaysia has a more sustainable source of capital (long-term investment) to finance its current account deficit than capital that is volatile in nature (short-term investment). Singapore on the other hand, lends to other countries (as shown through the negative figures of long and short-term investment in table 4.1) and has strong current account surpluses. Thus the risk of reversible hot money for Singapore and Malaysia is lower. On the other hand, current account deficits in Thailand have not been financed by stable capital sources. It follows that Thailand's baht and Indonesia's rupiah were the worst hit in the financial crisis.

## 4.2 Running a Current Account Deficit

The current account balance measures the degree to which a country borrows from or lends to the rest of the world. It measures the extent to which savings exceed domestic investments. When it is in surplus, export of goods and services exceeds the import of goods and services. Thus the surplus can be lent to the rest of the world. Domestic investments can be funded by the current account surplus. However, when a current account is in deficit, imports exceed exports and the country has to cover this deficit by borrowing from the rest of the world. Domestic investments have to source from foreign funds. Domestic imbalance

ways has an offsetting figure in the international imbalance (current account balance). The link is illustrated below:

$$Y = C + I + G + (X - M) \quad (1)$$

$$S = Y - C - T \quad (2)$$

$Y$  = national income

$C$  = private consumption

$G$  = government expenditure

$X - M$  = exports minus imports (current account)

$S$  = gross private savings

$T$  = government tax

(1) and (2) taken together:

$$X - M = (S - I) + (T - G)$$

The current account,  $(X - M)$  is the sum of the difference between private savings and investments,  $(S - I)$  and the difference between government income (tax) and expenditure  $(T - G)$ . Thus the current account,  $(X - M)$  is equal to net domestic savings,  $(S - I) + (T - G)$  (Dean, 1990).

The recent experience of the Asian countries shows that large current account deficits led to an accumulation of foreign debt that eventually become unsustainable. But is current account deficit really bad all the time? If Asian countries are net borrower but there are willing lenders, why should there be any problem? Imports of capital and intermediary goods are important for development but at the same time burn a hole in the current account.

nce this happens, foreign borrowing will be needed to fund the balance. Since Asian are capital scarce countries and in need of capital for development, is not running a current account deficit unavoidable? The answer depends on whether the deficit is sustainable or not, on the stage of development, the cause of the deficit and the kind of investments made. There is no clear cut on what is the appropriate current account deficit as a percentage of the GDP for the current account deficit to be at least sustainable. A certain percentage may be excessive in one country but may not be justified for another country. The market ultimately makes the judgement of sustainability. The period of sustainability can change as liberalization becomes more intense. Also, sustainability depends on the performance of exports and on how the deficit is being financed. Financing the deficit with short-term foreign capital inflows will be disastrous in the event of sudden massive pullout of these capital.

An increase in national investment and a fall in national saving may cause a current account deficit. Running a deficit and the accumulation of foreign debt should be sustainable if they originated from good profitable projects. As long as the return on the investment is as high as the cost of borrowed funds, the projects are viable. Expectations of the high future economic growth and the high profitability of new investments will need financial support for them to be materialized. If national savings are not enough, it is optimal for the country to run a current account deficit and rely on foreign savings. This will imply more capital inflow. The country can borrow from foreign banks or domestic banks, which in turn borrow from foreign banks. Local firms can issue bonds and equities to foreign investors. Given time, the return on investment will be used to repay the foreign debt. Subsequently there will be less dependence on foreign capital as the country becomes more developed.

The problem in Thailand and Indonesia was that the current account deficit was not sustainable. Large investments were made in the property sector that was encouraged by the illusion of the asset bubble. In Thailand, the bust of the real estate asset price bubble sent negative returns to the investments in the property sector. Furthermore, many Indonesia's projects are not based on profitability and viability but based on relationship linkages and rent seeking activities. Those close to the president will get financial support easier than those who do not. Credit is directed to politically favoured firms, sectors and investment projects. Malaysia on the other hand, have a lot of lumpy imports by the Malaysian Airlines Systems (MAS) and the Malaysian International Shipping Corporation (MISC); procurement of military vehicles and building materials for various mega projects that are questionable. In fact, foreign capital for financing of local projects are only good if the investments are in traded sectors because paying back the debt needs trade surpluses. If new investments are in the non-traded sector such as commercial, residential investments and so-called national pride projects like the Kuala Lumpur Twin Tower, they create goods that cannot be sold abroad. Thus the ability of the countries to repay its debts through trade surpluses may be limited. Although Malaysia did not borrow heavily from abroad, the fact that it wasted a lot of funds on non-tradable projects drove the current account into deficit. The private sector however is mainly the culprit in foreign borrowing instead of the government.

Governments gave incentives to firms to invest and borrow to finance dubious investment projects during the period of rapid financial liberalization. Interest rates of foreign loans are low, encouraging domestic firms to invest too much on projects that were not profitable.

From 1970 to 1982, Singapore ran a staggering current account deficit of 12.1% of GDP on average. In the early 1970s, the deficit peaked at around 20% of GDP many times but balance of payment crises never occurred. Almost half of the corresponding net capital inflows consisted of foreign direct investment. Thus foreign direct investment that is determined by non-cyclical considerations does not give the risk of inflows reversibility as short-term portfolio foreign investment does.

### **5.3 Performance of Trade**

Since a country's ability to service its external debt in future depends on its ability to generate foreign currency receipts, the size of its export as a share of GDP is an important indicator of current account deficit sustainability. Table 5.2 shows the export (fob)-GDP ratio, with the country with the higher ratio placed first. On average, Singapore's export (fob) is 1.36 times its GDP. Malaysia's is 0.75 times its GDP. Thailand's is 0.3 its GDP. Indonesia's is 0.26 its GDP. Thus, Thailand and Indonesia have a very low ratio. Overall, all countries' ratio has been increasing with Thailand and Indonesia increasing at a very moderate pace.

The sustainability of the current account deficit also depends on the composition of the current account deficit. The current account balance equals the sum of the trade balance and the net factor income from abroad. It is more unsustainable if the current account deficit comes from the trade deficit. The deficit will lower the cause for concern if exports were buoyant.

**Table 5.2 Export to GDP ratio (1990-1996)**

	1989	1990	1991	1992	1993	1994	1995	1996
Malaysia	0.66	0.69	0.73	0.7	0.73	0.81	0.85	0.8
Singapore	1.47	1.41	1.36	1.28	1.27	1.36	1.38	1.33
Thailand	0.28	0.27	0.29	0.29	0.3	0.32	0.34	0.3
Indonesia	0.25	0.23	0.25	0.27	0.27	0.27	0.28	0.27

Source: Asian Development Bank.

Table 5.3 shows the trade balance of Singapore, Malaysia, Thailand and Indonesia. Thailand's trade account has been in deficit even from 1989. The deficit has increased to US\$9,157 million in 1996 from US\$7,629 million in 1995 – the highest deficit in the period 1989-1996. A long period of trade deficit is certainly not a good sign. Thus in the 1997 currency crises, steps were taken to tone down the deficit to US\$1,472 million. Although Singapore experienced trade deficits in the period 1989-1997, its service account always registers surpluses and is able to cover the trade deficit. As a result, its current account is always in surplus. As for Malaysia, there has been a drop in trade surpluses in 1993, 1994 and 1995. Trade surpluses in Malaysia could not cover its service deficits and thus results in current account deficits as seen in table 5.1. For Indonesia, the trade account has always been in surplus for the period 1989-1996. Its trade surplus however has been decreasing from 1993 but is higher than the trade surplus of Malaysia. Also, its trade surpluses could not match the outflows in investment income, thus causing huge annual current account deficits, as shown in table 5.1.

Thailand's years of trade deficit has put it at a very vulnerable position. Singapore on the other hand has ample service account surpluses to result in healthy goods and services



**Table 5.2 Export fob to GDP ratio (1990-1996)**

	1989	1990	1991	1992	1993	1994	1995	1996
<b>Malaysia</b>	0.66	0.69	0.73	0.7	0.73	0.81	0.85	0.8
<b>Singapore</b>	1.47	1.41	1.36	1.28	1.27	1.36	1.38	1.33
<b>Thailand</b>	0.28	0.27	0.29	0.29	0.3	0.32	0.34	0.3
<b>Indonesia</b>	0.25	0.23	0.25	0.27	0.27	0.27	0.28	0.27

Source: Asian Development Bank.

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account balances. Trade account of Malaysia and Indonesia has been deteriorating since 1993 and 1994 respectively.

**Table 5.3 Trade Balance (1989-1997) (US\$ million)**

	1989	1990	1991	1992	1993	1994	1995	1996	1997
<b>Malaysia</b>	3,913	2,622	527	3,380	3,198	1,739	93	3,430	3,435
<b>Singapore</b>	-1,881	-3,614	-2,634	-3,909	-4,939	-1,048	-1,309	-530	-1,770
<b>Thailand</b>	-2,812	-6,612	-5,723	-3,860	-4,053	-3,392	-7,629	-9,157	-1,472
<b>Indonesia</b>	6664	5352	4801	7022	8231	7901	6,533	5,948	9,456

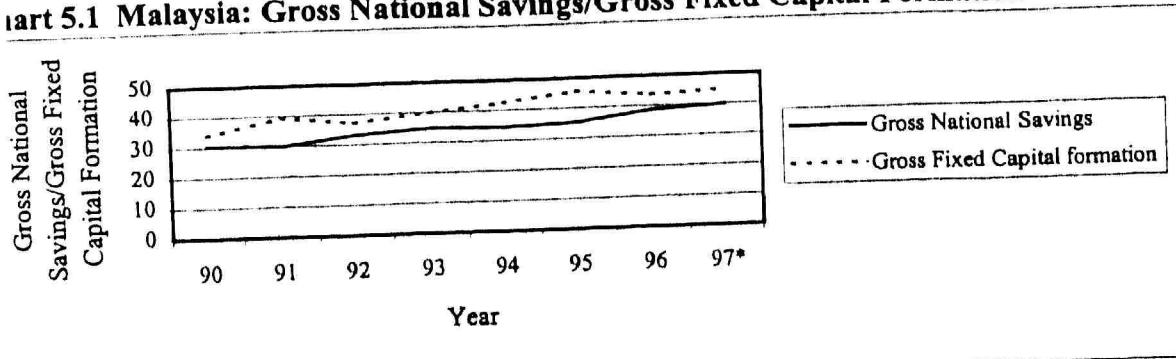
Source: Asian Development Bank, Bank Indonesia and Reuters.

## 5.4 Savings and Investment

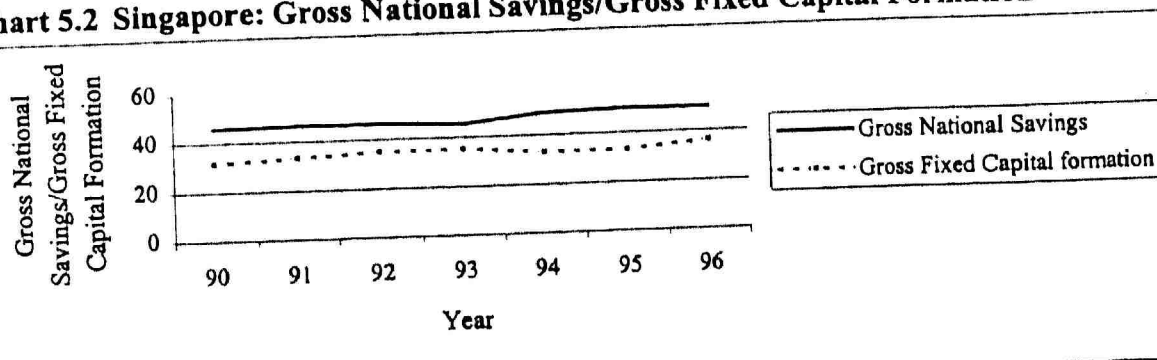
Charts 5.1-5.4 show the gross national savings and gross fixed capital formation as a percentage of GNP for all the countries in the 1990s. Only Singapore has greater gross national savings over the gross fixed capital formation. Slowdown in investments in machinery and equipment may be expected following the sharp increases in the capital output ratio since the mid-1980s. The bigger gross fixed capital formation over the gross national savings has been the greatest in Thailand, followed by Malaysia and Indonesia, except for years 1991, 1994 and 1995. Thailand has been increasing the gap between the gross fixed capital formation and the gross national savings from 1993. This may indicate that the other countries are still in the process of development and thus need more fixed capital formation.

This higher growth of gross fixed capital formation means those countries will have to look for other alternative funds beside national savings to cover the balance. Foreign funds may cover the difference. Foreign savings need not necessary be resisted because they finance a current account deficit. During reform periods, current account deficit is inevitably temporarily, yet important for development to happen. If these funds are invested in profitable projects, no problem will arise. However foreigners cannot finance large deficits forever.

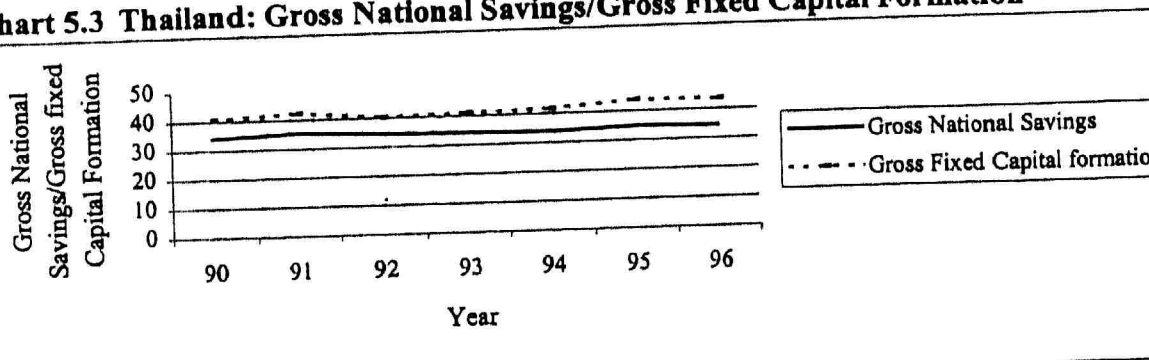
**Chart 5.1 Malaysia: Gross National Savings/Gross Fixed Capital Formation**



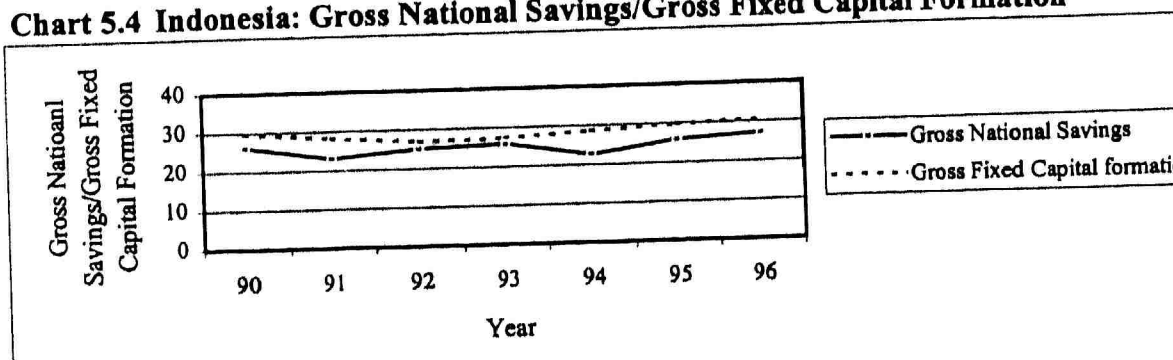
**Chart 5.2 Singapore: Gross National Savings/Gross Fixed Capital Formation**



**Chart 5.3 Thailand: Gross National Savings/Gross Fixed Capital Formation**



**Chart 5.4 Indonesia: Gross National Savings/Gross Fixed Capital Formation**



Source: Malaysia Economic Report, various issues; Asian Development Bank, Bank Indonesia, various issues

## 5.4 Other Macroeconomic Indicators

From table 5.4, the real GDP growth has been high for all countries under study, ranging from 6.2% to 11.63%. Inflation has been the lowest for Singapore, at no more than 3.5% but highest for Indonesia, that ranged from 7.4% to 9.7% in the years studied. Malaysia has a better performance in controlling inflation than Thailand. Malaysia's inflation rates ranged from 3.1% to 4.8% whereas Thailand's inflation rates ranged from 3.3% to 6.0%.

Surge of capital inflows can cause money supply expansion. The fastest growth of M2 happened in Indonesia every year except for 1991, where Thailand was the highest. This tally with the high inflation rates in Indonesia. The growth of M2 in Singapore has been moderately low, with most of the rates below 10%. Data on M3 growth is not available in Indonesia. Again, Singapore has relatively low annual M3 growth. In contrast, high M3 growth of around 20% has been the case for Malaysia and Thailand. High money supply growth can indicate increasing lending to the private sector that will increase inflation because of excess demand. This is so particularly if lending is for less productive activities. Overvaluation of the local currency that follows can lead to a speculative attack on the currency. Indonesia also has the majority of the highest annual private consumption growth in years 1989, 1993, 1995 and 1996.

The size of the current account deficit relative to GDP is another indicator of the economic sustainability. As mentioned in section 5.2, the current account deficit was caused by unproductive investments. All countries have been experiencing current account deficit except for Singapore in the 1990s. Singapore has reached the status of a Newly Industrialized Country and thus does not need to depend so much on foreign capital.

Thailand has the highest current account deficit as a percentage of GDP every year. It was only in 1991 that Malaysia has the highest percentage. Malaysian authority was aware of the danger and took steps to tone down the current account deficit, hence the lower deficit in 1996, after a height of 8.5% in 1995. Indonesia's current account deficit condition is better than both Thailand's and Malaysia's.

Huge foreign exchange reserves do not necessarily be better because they involved foregone investment and consumption in favour of accumulating foreign assets. It will only be appropriate if the foreign rate of return is high or if the country needs a reserve built-up against economic shocks and high-yielding domestic investments have already been made. On the other hand, the danger of adverse future developments implies that countries should always maintain some safety net in the form of external reserves. It has been suggested that reserves equal to more than three months of imports provide an adequate cushion under normal circumstances (Williamson, 1973).

Singapore has the highest foreign exchange reserves. The foreign exchange reserves of Singapore stood at US\$27,534.50 million in 1989. This amount increased to US\$76,491.30 million in 1996, an increase of 177.8% in 7 years. Indonesia has the lowest foreign exchange reserves. It grew from US\$7,352.70 million in 1989 to US\$17,820.40 million in 1996, an increase of 142.4% in 7 years. Thailand has higher foreign exchange reserves than Malaysia. Thailand's foreign exchange reserves grew from US\$13,247 million in 1989 to US\$37,192 million in 1996, an increase of 180.8%. Malaysia increased its foreign exchange reserves by 180.4% from US\$9,327 million in 1989 to US\$26,156 million in 1996.

**Table 5.4 Macroeconomic Indicators (1990-1996) (year on year % growth)**

	1990	1991	1992	1993	1994	1995	1996
<b>Malaysia</b>							
Real GDP	9.74	8.24	7.8	8.35	9.24	9.46	8.60
Private Consumption	13.09	9.51	2.98	4.60	9.79	9.39	6.66
M2	12.78	14.53	19.14	22.12	14.71	24.01	21.38
M3	18.19	15.32	19.57	23.52	13.08	22.32	21.24
Inflation	3.10	4.40	4.80	3.60	3.70	3.40	3.50
Current Account balance	-2.10	-8.90	-2.80	-4.80	-6.30	-8.50	-4.90
Foreign Reserves <sup>1</sup>	9,327	10,421	16,784	26,814	24,888	22,945	26,156
<b>Singapore</b>							
Real GDP	8.97	7.34	6.22	10.44	10.05	8.75	6.90
Private Consumption	7.57	6.12	22.87	10.82	5.98	5.27	8.04
M2	19.98	12.45	8.90	8.45	14.43	8.5	9.79
M3	18.41	11.09	8.17	10.86	15.91	10.08	8.54
Inflation	3.50	3.40	2.30	2.20	3.10	1.70	1.40
Current Account balance <sup>2</sup>	3,181	4,687	5,614	4,371	11,695	13,641	13,850
Foreign Reserves <sup>1</sup>	27,534.5	33,930.7	39,661.4	48,066.4	57,889.6	68,349.1	76,491.3
<b>Thailand</b>							
Real GDP	11.63	8.41	7.77	8.27	8.78	8.65	6.40
Private Consumption	12.78	6.61	7.79	8.74	8.25	8.55	6.47
M2	26.68	19.84	15.58	18.38	12.86	17.01	12.57
M3	-	19.88	18.54	19.69	17.60	18.72	13.39
Inflation	6.00	5.70	4.10	3.30	5.00	5.80	4.80
Current Account balance	-8.30	-7.50	-5.50	-5.50	-5.60	-8.00	-7.90
Foreign Reserves <sup>1</sup>	13,247	17,287	20,012	24,078	28,884	35,463	37,192
<b>Indonesia</b>							
Real GDP	7.24	6.95	6.46	6.50	7.70	8.21	7.82
Private Consumption	17.20	7.97	3.10	11.77	4.71	9.73	9.20
M2	44.16	17.05	20.19	21.96	20.19	27.58	29.64
Inflation	7.40	9.40	7.50	9.70	8.50	9.40	6.50
Current Account balance	-3.40	-3.80	-2.10	-1.60	-1.70	-3.60	-3.30
Foreign Reserves <sup>1</sup>	7,352.7	9,150.7	10,181.2	10,988	11,819.9	13,305.6	17,820.4

Note: 1 in US\$ million

2 Current account surplus in US\$ million

Source: Asian Development Bank, Bank Negara, Economic Report, Bank of Thailand, International Monetary Fund.

All these showed that Singapore has the healthiest macroeconomic indicators while Indonesia has the weakest macroeconomic indicators. This explains why Singapore has been able to survive the current financial crises the best among these countries and with Indonesia on the other extreme. Singapore has the lowest inflation, a moderately low money supply growth, a current account surplus and the highest foreign exchange reserves. Indonesia on the other hand has the highest inflation, highest money supply growth rate, highest private consumption and lowest foreign exchange reserves although its current account deficit condition is moderate. The performance of Malaysia and Thailand lies between these two countries. Thailand has a lower money supply growth rate in most of the years and a higher foreign exchange reserve compared to Malaysia. Malaysia has a lower inflation rate and a lower current account deficit in most of the years, compared to Thailand. These indicators taken together with the viability of the financial sector are important in signaling the health of the economies. As already shown in chapter 4, Thailand has excessive funds available for credit creation from foreign as well as local banks. The rapid liberalization of the financial sector without the implementation of prudential regulations in both Indonesia and Thailand saw the growing amount of bad debts. Once the initial damage is done, a confidence crisis will worsen things more than it should be.