CHAPTER III

WAYS OF MEETING THE DEFICIT IN THE BALANCE OF PAYMENT

1. Import Substitution

The balance of payments problem arises when the export proceeds of a country are either stagnant or not expanding as fast as the requirements for rising imports. The problem is further aggravated during the early stages of economic development since the import requirements rise steeply and the prices of exportable commodities of newly developing countries have a tendency to decline. In a country where the economy is heavily dependent on the prices and export performance of a few commodities, the problem becomes more serious. Such is the case of the Malaysian economy.

One solution to the problem would be to develop import - replacing industries. But "....the process of import replacement through the development of manufacturing indistries is only a partial remedy to the problem. We need to export the products of these industries overseas and to export them in larger quantities"[1]. The extent of import substitution is limited by the domestic market. The domestic market is determined by the size of population and per capita income. In the case of Malaysia the population size being small, the import substitution process has limit to which it is practicable. Hence besides import substitution, recourse had to be taken to expand exports. But first it is necessary to increase production for domestic consumption. "If per capita incomes are to continue to rise during the period when population is growing rapidly but exports are rising slowly, then production of goods and services for consumption by the domestic market must rise very rapidly"[2]. Under the first Malaysia Plan great emphasis will be placed on production for domestic market by introducing new industries and expansion of import - replacement process.[3] If this target is met, it

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[1]Mr. Khaw Kai Boh, the (then) Acting Minister of Commerce & Industry, speaking at the inauguration of a Trade Commissioners' Service - The Straits Times, July 9, 1966 p.9

[2]First Malaysia Plan 1966-1970 (Govt.Printers, K.Lumpur 1965,) p. 46

[3]Ibid. p.46

will go a long way in reducing our dependence on rubber and tin for our foreign exchange earning and will reduce our mounting imports of consumer and intermediate goods.

1.1. Import Substitution Through Manufacturing

The prospects of import substitution process are best in the field of manufacturing. "At the present stage of development, the immediate opportunities are principally in the domestic production of those consumer goods which are presently imported"[4]. The magnitude of these possibilities may be seen from the estimates that only about 40% of total Malaysian demand for manufactured consumer goods of roughly $2,000 million is presently met from local producer while 60% is imported. Large population increase (which would otherwise necessitate larger import volume) open wider opportunities for industrial development. As a next step, when export market are established, Malaysia should then prepare for expansion of manufacturing industry for export. At present most of machinary and equipments necessary for consumer goods industry are imported. As progressive expansion takes place in consumer industries, it would cut down imports of capital goods if Malaysia established and expands intermediate and producer goods industries.

There is no clear evidence thus far that the manufacturing development has taken any significant effect on the balance of payments. Bearing in mind the considerable gestation period involved in developing the manufacturing industry one can safely say that manufacturing is unlikely to have a significant favourable effect on the balance of payments within the next few years or so. The fastest rate of growth in the last five years were achieved by tobacco products, chemical products, machinary, metal products, non-metallic material products and basic metal industries, where the annual average rate of increase in net output was about 20%.[5]

The major new projects completed between 1960 and 1965 include three cement factories, three condensed milk factories, two oil refineries, two factories making asbestos cement products, two breweries, two textile mills, a tyre

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[4] ibid p. 129

[5] ibid p. 125

factory, a cigarette factory, a sugar refinery, a synthetic detergents factory, a factory producing monosodium glulamate, a metal box factory, an acid factory and an alluminium rolling mill.[6] Most of these will have sufficient capacity not only to satisfy domestic demand but to provide an exportable surplus as well.

Successful manufacturing development requires both the overcoming of numerous production problems and the provision of a market. In order to compete, heavy subsidization of infant industry, both in the form of cheap and adequate provision of public overhead facilities -- power, transport, technical training for employees etc. -- and in the form of direct subsidisation is necessary. It would be difficult for an industrial newcomer to succeed in breaking into foreign market without having first a previleged position in the home market. Even if the eventual aim is production for export, a previleged market at home will have to be provided first.

With regard to Malaysia, manufacturing development has been made possible by the financial and political stability of the country. There is adequate physical infrastructure of transport and communication facilities and of power and water supplies. To provide a previleged market, the new industries were granted tax relief. Between 1961-65 one hundred and ten firms were granted pioneer status certificates, 26 for manufacture of chemicals and chemical products, 18 for food and brewerages, 15 for metal products and other machinary and transport equipment, five for textiles and a large variety of other import substituting and export activities[7].

In addition to assistance provided by the government, financial institutions in the private sector have also played their part in stimulating manufacturing development. In Malaya, (Western Malaysia) loan and advances by commercial banks for manufacturing process have increased by $100 million from $50 million at the end of 1960 to $150 million at the end of 1964. In addition there has also been a significant increase in the amount of credit extended by Malaysian

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[6] Ibid p.125

[7] Ibid p.125

Industrial Development Finance Limited (MIDFL) amounting to about $44 million at the end of the third quarter of 1965.[8] Assistance was given to the development of both light and heavy industries, especially enterprices contributing to import substitution and export expansion, enterprise such as those producing flour, pharmaceutical, cosmetics, stout, plastic articles, electric appliances, cement, etc. The provision of assistance for the manufacture of veneer, plywood and coir, is resulting not only in the development of export-earning industries but also generating additional value added raw materials for export.[9] In case of the new cement plant, the additional production capacity has brought overall capacity in the industry to a level sufficient to meet all foreseeable domestic demand. Indeed, at present, there is a glut in the cement industry.

It is expected that manufacturing output will increase at the rate of 10% per annum. It is expected that each of the following major groups of industries will generate annual output increases in the order of 10% or more: food and brewerages, wood products, rubber products, chemicals and chemical products, basic metals and machinary manufacturing industries. Estimates on how much import requirements of Malaysia will be met by this is not available. However, the attainment of these targets are imperative if a significant degree of import substitution is to be affected.[10]

The immediate effect of investment in manufacturing for import replacement process or for export will undoubtedly be adverse on the balance of payments on current account, for such a development will necessitate greater imports of capital machinary and equipment which are not likely to be much higher than in either agriculture or other forms of social overhead capital. Some part of the finance may be locally owned capital which would otherwise have been invested overseas or which is withdrawn from overseas balance, so that a credit on capital account will help to finance the debit on current account, though it is unlikely that taking the two effects together the balance of payments would benefit.[11]

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[8] Ibid. p. 126

[9] Ibid. p. 127

[10] Ibid. p. 130

[11] Silcock, T.H. and Fisk, "Political Economy of Independent Malaya" (Canberra, 1963) p. 166

It follows that a process of rapid manufacturing development would probably increase rather than diminish the balance of payments problem. However this is only so in the initial stages when there is a great need to import machinary and the manufacturing industry is still in its infancy. Eventually it will bear fruit in form of import replacing and also export products. Imports on new goods will then fall (or increase less than otherwise). On the other hand, initial imports of raw materials and components will increase, and if the enterprise is purely of assembly or processing, the net reduction may be quite small though normally there should, on balance, be some fall in imports.

1.2. Import Substitution in Food

However, in the last five years that we have analysed, there does not seem to be any appreciable decrease in imports, indeed it has increased rather steeply.[12] However, the components of imports have changed, reflecting to a certain extent the effect of import substitution. The proportion of imports of food, brewerages and tobacco has shown a downward trend during the past five years, from 28.2% in 1961 to 25.8% in 1962 and subsequently to 25.8% in 1965. This is primarily due to the fast rate of growth in tobacco products and a moderate rate of growth in food product and brewerages.

Imports of rice have not grown appreciably inspite of the fast population growth. Output increased from about 940,000 tons in 1960 to 1,050,000 tons in 1965 - an annual rate of growth of 2.3%.[13] Production in Malaya increased from 760,000 tons in 1960 to 830,000 tons in 1965 although there was a decline from 850,000 tons in 1963 to 730,000 tons in 1964 due to unfavourable climatic condition at the end of 1964. However domestic consumption satisfy about three-fifths of total consumption.[14]

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[12] See Chapter II above.

[13] First Malaysia Plan 1966-70. p. 100

[14] Ibid. p. 100

Too much should not be expected from the apparent emphasis on rice growing. We should first note Malaysian Government's expectation as expressed in the First Malaysia Plan. It expected that output will expand by 7.6% per annum between 1965 and 1970. Despite the increase in population it is expected that this will enable the share of domestic production in total consumption to rise to over 70% in Malaya.[15] This will mean that the proportion of import of rice to total consumption will fall from 40% to 30%. However, Sabah and Sarawak will continue to be heavy importers. This would amount only to a very little saving in Malaysia's total net imports.

The increase in Malaysian rice-growing has two limits, one physical and the other economic. The physical limit, though it cannot be expressed precisely, is set by the suitable land available and by the foreseeable improvements in Malaysian rice-growing. However, if population growth continues at the rate of 3% per annum, a point will be reached in a few years when imports of rice will again have to increase.

The economic limit may already be reached earlier. It has been frequently pointed out that it pays Malaysia to export rubber and import rice, an unusually clear case of the benefits to be derived from trading on the basis of comparative cost. The cost differential appears in general to be so great that it can stand any foreseeable fall in the price of rubber. And if alternative crops to rubber have to be considered, there are other crops such as oil palm which probably offer more profitable opportunities than rice. This argument is further strengthened by the long-term downward trend in the price of imported rice.

In the case of other foodstuff, breverages and tobacco, there has been significant import replacement especially in tobacco, as seen above. Imports of certain items, notably fruit and vegetables, have not increased, even though there has not been a decline, so that (with growth in population) there must have been some fall in the ratio of import to total consumption.[16] There seem scope

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[15]Ibid. p. 107.

[16]Silcock Op.cit. p. 114.

both for increase in domestic product and for reduction in consumption of some food and drink items; to achieve this a price inducement in the form of higher import taxes, especially on the more income elastic foods and drinks may be appropriate.

2. Expansion of Exports

Expansion of exports is essential in view of the problem arising from the downward trend in rubber prices. Import replacement process alone is not sufficient. It only provides a partial solution to the balance of payments problem. Malaysia has to export the products of her manufacturing industries and export them in larger quantities. To expand export however, market has to be found. In this respect, the Government has instituted a Trade Commissioners' Service in July this year. At present there is only one Trade Commissioner in London.

With the establishment of the service, the Government hopes to be able to find markets for our products. However, much cannot be expected as yet. Malaysia must expect a stiff competition from the established industrial countries. What Malaysia can do is to produce goods which have not yet been established or which she can produce cheaply using local raw materials such as rubber shoes, tyres etc. Or Malaysia can export processed raw-materials such as veneer, plywood and coir which will result in generating additional value - added to raw-materials which would otherwise be shipped abroad in an unworked state.

3. Private Capital Inflow

The extent of private capital inflow has been discussed in the previous chapter where we saw that it has helped to make good the deficit in current account. But the interesting question is how private capital inflow, if it did take place on a larger scale, would affect the balance of payments.

The actual inflow of capital of course represents a credit item. Some parts of it will be spent on imports of machinary and equipment for the manufacturing industries and the remainder will be spent on local labour and material. The income which is generated will have its effects on the balance of payments. If this foreign investment brings forth complementary locally financed investment which would not otherwise have taken place, allowance must be made for the import content in this extra investment. In the long-run import-replacement process will bear fruit in the way discribed above, yielding a net reduction in imports. Export production process will also bear fruit, resulting in increased exports. Against this gain in the balance of trade, though reduction of imports and increase of exports, must be set the extra "invisibles" import in the form of profit remitted abroad and the services of "imported" personnel and knowhow.

Normally, however, a long-term gain to the balance of payments should still remain, but if foreign enterprises are heavily protected, so that local product sells at a price well above the import which it replaced, it becomes possible that there is no net gain in the balance of payments[17] because imports will not decline.

From the above analysis we can draw a broad conclusion that an inflow of foreign capital would probably, but not certainly, benefit the balance of payments. Because of various indirect repercussion as evidenced in the analysis, the benefit would certainly be less than it might first appear to be. This is not to deny the general economic benefits to be derived from private capital inflow, but it would be most unwise to expect private capital inflow to solve the balance of payments problems.

4. Official Foreign Loans and Grants

Malaysia's capacity for undertaking and meeting the payments on additional external debt is still large. The present foreign debt of $750 million is relatively modest. This amounts to less than 10% of national output and about 20% of total public debt. The amount of annual payments on this foreign loan at their peak will be less than 4% of government revenue and about 2% of Malaysian export earnings.[18] This is a light burden by comparison with most developing countries.

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[17] Silcock, op.cit. p. 115

[18] First Malaysia Plan 1966 - 1970 p. 76

From the point of view of foreign exchange and balance of payments, Malaysia could probably afford the interest and principal payments that would be required if the entire $1,900 million need from foreign assistance were to be obtained in form of loans.[19] However from the point of view of Government budget, annual service payments for such large amount of borrowing on conventional terms would be an extremely heavy financial burden.

For this reason the government aims to secure large part of foreign financing needs on grant basis. It is difficult at present to see the magnitudes of financial assistance that may be obtained from foreign countries and international agencies or to arrive at any definite view of the terms on which such assistance may be forthcoming. But in view of Malaysia's successful record of financial management and development progress, there seem to be no difficulty to get financial support from abroad on liberal terms. Malaysia is the type of country which international agencies like I.B.R.D. usually like to put their money. The objective, therefore, is to avoid an excessive heavy budgetary burden from additional debt service.

An additional factor why Malaysia can afford to restrict foreign loan is the fact that the country has still ample foreign reserve of its own. Even if exports remained constant and imports increase at the rate of 5% per annum the reserves are sufficient to finance six and a half years of import before the reserves completely run down. However, it would be unwise to run down the reserves to near-bankruptcy before obtaining foreign loan. The wisest policy seems to be to obtain maximum official loan first without placing too much burden on the budget, and then to meet the shortage by drawing down the country's reserves.

The analysis in Chapter II shows that Malaysia is facing balance of payments problems arising from the declining prices of rubber and mounting imports. The best solution seems to be to develop import replacing industries and to expand exports. Funds to develop these industries should be obtain from private capital inflow and official loans and grants. If the government targets are achieved, serious balance of payments problems can be avoided.

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[19]Ibid. p. 76.