CHAPTER IV

FOREIGN EXCHANGE RESERVE AND MONETARY SYSTEM

1. Foreign Exchange Reserve and the Balance of Payments

It is a very complex task to determine the foreign exchange reserves of Malaysia's official bodies and monetary authorities. In most countries, the Central Bank is the central holder of all these reserves, with the commercial banks holding only working balances. However in Malaysia the reserves are scattered. This can be explained by the monetary system which we have inherited from our colonial past. At this stage we only want to know the position of the reserves in relation to the prospective needs of Malaysia and how these reserves can be utilised for development plans and to improve the balance of payments position.

The holdings of gold and foreign exchange reserves of Malaysia are quite ample, the holdings in any one year being able to finance about ten months of current imports of that year. The holdings of gold and foreign exchange reserves for the period 1961 and 1965 are shown in Table 10.

The Currency Board, which still issues currency for Malaysia, Brunei and Singapore, holds reserves which circulates not only in Malaysia but also in the other two countries. The table below shows also the breakdown of the reserves held by various monetary authorities. These authorities include not only the Malaysian Government itself but also various public authorities and Post Office Savings Bank. Figures for commercial banks consist of net overseas assets of Malaysian Commercial banks.

Under the present institutional arrangements, all the reserves of the Monetary Authorities can be made available.[1] But in addition there are reserves held by other bodies not listed above, some of which could also concievably be mobilised and which can be regarded as second line of reserves. These include the overseas reserves of insurance companies estimated to be at $200 million at the end of 1960[2]

---

[1] Silcock T.H., Fisk, "Political Economy of Independant Malaya" (Canberra 1963) p. 119

[2] Ibid p. 120

TABLE 10

MALAYSIA: GOLD AND FOREIGN EXCHANGE RESERVE 1961-65

	As at December 31st ($ million)				
	1961	1962	1963	1964	1965[1]
Central Monetary Authorities (net) including IMF Gold Tranche	1,093	1,252	1,308	1,357	1,511
Central Government	1,070	1,046	1,004	819	747
State Government	118	116	95	80	87
Govt. Agencies and Public Authorities	133	145	141	130	123
OFFICIAL (NET)[2]	2,417	2,559	2,548	2,386	2,468
COMMERCIAL BANK (NET)	258	235	176	176	292
TOTAL	2,675	2,794	2,724	2,562	2,760

Footnote: 1. Preliminary

2. The market value of foreign securities in official reserves include changes due to revaluation. Since these revaluations do not reflect balance of payments transaction proper, annual reserve changes shown in this Table are not entirely comparable with the corresponding reserve changes in the balance of payments.

Source: Bank Negara Malaysia Annual Report and Statement of Accounts 1965 p. 32.

and can be expected to be larger in 1965. Agency houses and other private bodies probably hold large reserves overseas. However figures on these are not available. However, as a point of illustration, the Malayan Estate Staff Provident Fund has $21 million invested overseas at the end of 1958.

It may be observed then that Malaysia's foreign exchange reserves is relatively large. For example at the end of 1961 it stood at $2,675 million. In the balance of payments, this represent a $93 million increase in reserves. This figure does not represent exactly the same amount of the increase of the reserves because of revaluation of investments.

The foreign exchange reserves continued to increase in 1962 to $2,794 million. However 1963 showed a slightly different picture. The declining surplus on goods and services, combined with the continuing high level of private transfer payments abroad, has led to a reversal in the balance of payments on current account from a sizeable surplus in 1960 to a deficit after 1962. There has been a substantial increase in the net inflow of private long-term capital over the period for investment both in the agricultural sector and in the industrial sector. Official loans from government and international organisations and borrowings in markets abroad have also increased. The growth in all these sources of external finance however, has not been sufficient to match the change in the current account balance with the result that a moderate draw-down of total foreign assets was required after 1962. This has resulted in the decrease in foreign exchange reserves in 1963 and 1964.

However, at the end of 1965 we find that Malaysia's net total holdings of gold and foreign exchange reserves stood at $2,760 million. Of these $1,511 was held by the central monetary authorities, including I.M.F. gold tranche, $747 million was with the Central Government, $87 million with the State Governments, $123 with the Government Agencies and Public Authorities and $292 million with the commercial banks. (See Table above).

In addition to the reserves above, Malaysia, like any other countries has a drawing potential with the I.M.F. This is its gross I.M.F. position (twice its I.M.F. Quota minus the Fund's holdings of its currency) and represents the potential contribution to Malaysia's reserves due to its membership of the I.M.F.

The question that remains to be asked is; what should be the appropriate policy regarding the reserves? Leaving aside the complications in connection with the monetary system for a moment, one can regard the present gold and foreign exchange holding of Malaysia as adequate to deal with emergencies in the short-run. For a longer term one can make various calculations. For example, let us suppose, in an unlikely case, that export earnings remained constant, while net imports increase at 5% per annum. It is estimated that the reserves could pay the extra imports for 6½ years before the reserves are completely exhausted, and Malaysia would have to borrow from I.M.F. and elsewhere or to draw on secondary reserves of her own. In practise, however, it is unlikely that a rising import bill will be practicable in these circumstances.[3] The adjustment mechanism of our monetary system will ensure that such an eventuality will not happen.

The next question is: Is it a good policy for Malaysia to keep such a large reserve which could otherwise have been more productively utilised?

It is often argued that it is extraordinary for a country like Malaysia to hold such a large reserve overseas in the form of investments in other countries. This after all is a simple form of foreign lending and a developing country like Malaysia could very well utilise this capital for development at home. The official stand however, is that the holding of foreign reserves is a form of insurance, a way of not placing all one's eggs in one basket. This insurance is of vital importance to Malaysia, being so overwhelmingly dependent on insecure export of one or two products. But one might add that the official stand is rather too cautious. It is indeed a waste of reserves especially in the face of possible rising import relative to export earnings and possibly even a decline in export earnings is in prospect. The rising import demand is due to the increase in economic activities. It would not be a wise policy therefore to keep such large reserves at the expence of development through a decrease in imports. Therefore there is no point in keeping vast reserves indefinitely.

Two circumstances justify the running down of reserves substantially. In the first instance it would be justifiable to draw down the reserves if there is a drastic decline in export earnings. Such drawing down of reserves could be justified on the grounds that it would maintain consumption and investment level for a period. This eventuality one might add, is exactly the eventuality against which

---

[3]Ibid. p. 121

the reserves have been stacked up. However the government was rather too cautios when it scaled down Development Plan expenditure in 1958-59 in response to a fall in rubber prices. With such large reserves Malaysia (then Malaya) could have safely utilised the reserves without cutting down expenditure.

The second instance when part of the reserves could justifiably be used is when it could be used to finance ambitious development expenditure. However plans must be well-laid and capable of execution. Such plans should not be sacrificed for want of funds due to a fall in export earnings, or a rise in imports of goods and services or both.

It will be observed that when the plans are genuinely well laid, the social returns to Malaysia for a $100 million of capital invested in the country will be far greater than that obtained overseas. Taking this into consideration one can conclude that the Malaysian Government could be well justified in further drawing down of the reserves, especially of the Currency Board.

However, during the period under the First Malaysia Plan, it is not envisaged that there will be an extensive use of the foreign exchange reserves. One of the financial principles of the Plan is that the reliance on credit from the banking system will be limited to the amount which can be used without inflationary effects and "without a more than reasonable use of the foreign exchange reserves".[4] The plan estimated that the balance of about $700 million needed for the public sector would be obtained from bank credit and draw-down on accumulated government asset but not through a draw-down of foreign exchange reserves.[5] "The target level of public investment financing by bank credit and the use of government accumulated assets is $1,000 million. When taken in conjunction with prospective development in private foreign financing, this will lead to some use of the country's foreign exchange reserves. However the use of these reserves is unlikely to be excessive."[6]

---

[4]First Malaysia Plan 1965-70 (Govt. Printers, K. Lumpur 1965) p. 72.

[5]Ibid. p. 74

[6]Ibid. p. 75

Thus the government policy seems to be that these reserves should be left alone as far as possible. The authority's attitude can be summed up by quoting the Plan. "....it is most important to keep the total reserves at a high level both for reasons of international confidence and also to ensure that there is still an adequate exchange reserve for the years beyond the period of the First Malaysia Plan"[7]. The plan relies rather on private long-term capital inflow and public foreign assistance to finance public sector programme and to avoid serious balance of payments problems and a major rundown on the reserves.

2. The Monetary System and the Balance of Payments

As a final step in our exercise we shall discuss the mechanism by which the balance of payments adjust itself under our monetary system. We shall also consider, in the light of the prospects outlined above whether it is justifiable to deliberately change this mechanism. As a preliminary we shall briefly outline the Monetary System.

2.1. The Present System

The Monetary Authorities in Malaysia are the Bank Negara Malaysia and the Board of Commissioners of Currency. These two bodies have been operating side by side eversince the establishment of the Bank Negara in January 1959, with the Board of Currency as the sole currency issuing authority and administrator of the automatic currency for the three territories of Malaysia, Brunei and Singapore. The Malayan dollar has remained fixed at 2s-4d sterling since 1906. From the point of view of active monetary management, and the independent status of the country, the Currency Board system is no longer appropriate. However, the powers given to the Central Bank to issue currency and to maintain reserves safeguarding the value of currency have been held in abeyance in order to provide member countries of the Currency Board a further opportunity for full consideration of the possibilities of some form of common currency arrangement when the Currency Board ceases to operate.

---

[7]Ibid. p. 75

On December 12, 1964 the Malaysian Government gave notice of its intention to replace the Currency Board with the Central Bank as the sole currency issuing body. Under the provisions of the Currency Agreement 1960, the serving of such notice involved the relinguishment by the Currency Board of its powers to issue note not late than December 12, 1966. However, recently the "life" of the Currency Board has been extended for a further six months. Thus it is envisaged that the Central Bank will become the sole monetary authority by the middle of next year.

Having thus outlined the Monetary system, we shall now analyse how the balance of payments adjust itself under such an automatic currency system.

2.2. Adjustment under the Present System

Let us suppose that export earnings derived from rubber decline by $100 million. This reduction in resident Malaysian income will bring about a series of repercussions. Assuming further that in accordance with the fall in Government revenue (as a result of the fall in export earnings) Government spending is reduced, so that there is no Government deficit, the final result will be that the decline in Malaysian income will be larger than the initial fall of $100 million. Allowing for time lag, imports will also fall. If we further assume that there is no decline in savings and that the marginal propensity to is 40% the eventual Malaysian incomes will have fallen $250 million and imports will have fallen $100 million. If, however, there is some fall in savings, than the decline in income and imports would be somewhat less. This analysis is nothing more than the familiar multiplier mechanism.

If this mechanism is allowed to operate in the manner discribed above it ensures that a fall in export earnings will automatically lead to a fall in import. The balance of payments is automatically adjusted to a new equilibrium position. In this instance, the equilibrium is maintained by reducing Malaysian income derived from production for domestic market by $150 million in addition to the $100 million fall in incomes derived from export production.

This kind of mechanism will bring the balance of payments into automatic adjustment insofar as the Malaysian 100% currency system is allowed to operate without qualification. A fall in export earnings will inevitably lead to a fall in the currency circulating in the country and cufrency cannot be supplied to substitute other income for the lost export earnings. The reduction in income is then split up between home produced goods and services on the one hand and imports on the other; on the basis of the propensity to import. There is no devices such as import restriction or variable exchange rate to deliberately alter this split-up, perhaps directing the fall in income primarily to imports.

However there are qualifications such as the fiduciary issue, bank credit and government finance. There is a fiduciary issue of $300 million which is made available if the government wishes, subject to limitation. This fiduciary issue, if made available, would not lead to a decline in the supply of currency with a fall of export earnings. The fall in export earnings would be offset by a rise in government expenditure financed by the fiduciary issue. However, once the fiduciary issue is used up, the system revert back to the 100% currency system. Thus far, the authorities have not yet used this fiduciary issue provision.

Another qualification concerns with bank credit. The commercial banking system is highly developed in Malaysia, with bank credit amounting to $2,255 million in 1965.[8] But the question is whether the supply of credit can be expected to change in the same direction as export income or whether it is likely to vary in the opposite direction and so sustain spending power at a time of declining export.

In the past bank credit actually varied in accordance with export income and currency supply,[9] that is to say, a fall in export earnings leading to a fall in the currency supply will at the same time reduce bank credits. Liquidity has not been a primary reason for this phenomenon because the banks have ample fund in London to support a reduction in liquidity due to a fall in export earning. The primary reason lies in the fact that a large part of credits provided by the foreign owned (exchange) banks had been for the finance of foreign trade so that when export income or imports fall, demand for such credit would also decline.

---

[8] Bank Negara Malaysia 1965 p. 20.

[9] Silcock. op.cit. p.134

In recent years, however, the field of bank lending has been extended to finance more domestically-orientated economic activities. During 1963 and 1964 there has been a small but noticeable change in the pattern of bank lending in Malaysia, reflecting to some extent the increased pace of industrialisation in the country.[10] The position now is that the decline in domestic economic activity would be modified by an expansion of credit for non-external trade activities. Thus with the growing importance of local banking and commercial institutions, a fall in export earnings does not necessarily lead to an equal fall in the money supply.

In the long-run too, the expansion of credit for non-external trade activities, especially in the field of manufacturing may increase production for domestic consumption and thus reduce imports. This would have an important effect on the balance of payments. (The extent and prospects of import substitution are discussed in Chapters III and V respectively).

The last aspect we shall discuss regarding the adjustment mechanism of the balance of payments under the present monetary system is Government finance.

The fact that the Government holds large and fluctuating reserves means that government expenditure may not fall with a fall in Government revenue. A fall in export earning will lead to a fall in revenue due to a decline in export duty, personal and corporate tax and finally to a fall in import tariffs. However, with the government holding large reserves, Government spending may not be adjusted completely to this changed circumstances. Spending may be sustained by a drawing down on the foreign exchange reserves. This is quite a natural thing to do since one of the purposes of the reserves is to sustain spending during a period of depression.

On the other hand, when government revenue increases, there is no limit to which variation in the official reserves can absorb this increase. This is clearly demonstrated during the Korean War Boom. Of the total rise in (then) Malaya's, revenue in the course of 1950 and 1951, over 35%

[10] Bank Negara op.cit. 1965, p. 42.

went into official sterling balances and thus did not affect spending in Malaya.[11] More recently, in the period 1957 and 1960, the government has allowed changes in its reserves to absorb most of the fluctuation in its revenue. In 1958 government revenue fell by $39 million due to a fall in export income and yet expenditure actually rose. However these variations in official reserves has not been a deliberate stabilizing measure. It was in fact due to lags in spending policies which incidently helped to stabilise Malaysia's income which would have fluctuate violently due to fluctuation in the balance of trade.

However, the policy of sustaining government policy would only moderate but not eleminate the multiplier effect of an export decline; the modification being greater the greater the marginal liability to tax.

In passing, it could be mentioned that the foreign exchange reserves can be used to sustain bank liquidity in the country if the Government chose to deposit the reserves in the country. But the reserves have not been manipulated this way. But clearly this could be an instrument of policy available, which, with the help of the Central Bank could be of use if a liquidity problem arose or if the balance of payments is unfavourable and there is a need to sustain or increase bank lending for development.

2.3. The Significance of the Present System

We have thus discussed the foreign exchange reserves and the monetary system of Malaysia in relation to the balance of payments. In this last part we shall discuss the significance, effects and advantages and disadvantages of the Monetary System.

After considering various aspects, we can conclude that the Malaysian currency and credit system magnifies the internal effect of external disturbance, but in its rather clumsy way helps to bring about a tendency towards restoration of the balance of payments equilibrium. It is automatic in the sense that no one needs to worry about the balance of payments position, the concern being only for official and private income and liquidity position.

---

[11] Silcock op.cit. p.125

The Korean boom demonstrate most dramatically how this mechanism operated. During the period ending 1951, the value of exports of domestic produce rose 324% over the 1949 figure due primarily to the phenomenal rise in the price of rubber and tin. However the effect on the internal level of demand was modified by a large rise in official balances, by a 337% increase in profit payable abroad and by a large capital outflow (I.B.R.D. Report). Nevertheless after discounting all this, the foreign assets of the monetary systems i.e. the Currency Board and the banks (the Central Bank was not in existence then) rose 125%. This rise provided the basis of expansion of money supply. Added to all this was the fact that local bank advances rose in 1950. As a result of all these, imports for domestic use rose 194%.

The following table shows the relationship between the value of exports and the value of imports. We see that an increase in the value of exports will always lead to an increase in the value of imports, though with a lag and to a lesser extent.

TABLE 11

MALAYAN EXPORTS OF DOMESTIC PRODUCE/IMPORTS DOMESTIC CONSUMPTION 1949 - 53

	Malayan exports of Domestic produce	Malayan imports for Domestic Consumption
1949	$ 943 m.	$1,191 m.
1950	$2,129 m.	$1,449 m.
1951	$3,051 m.	$2,312 m.
1952	$1,973 m.	$2,175 m.
1953	$1,486 m.	$1,864 m.

Source: Silcock: Political Economy of Independent Malaya, p. 126.

More recently, in the period 1955 to 1960, the result was similar, an increase in export proceeds leading to an increase in imports and a decrease in export proceeds being followed in the same direction by imports.

TABLE 12

MALAYAN NET EXPORTS/IMPORTS 1955 - 1960

	Malayan net Exports	Malayan net Imports
1955	$1,374.5 m.	$ 956.4 m.
1956	$1,432.9 m.	$1,054.8 m.
1957	$1,398.0 m.	$1,102.6 m.
1958	$1,882.9 m.	$1,656.1 m.
1959	$2,473.1 m.	$1,739.3 m.
1960	$2,927.4 m.	$2,150.6 m.

Source: Federation of Malaya Annual Statistics of External Trade (1955 to 1960).

In 1957 and 1958 we notice a drop in export earnings. However, compared to earlier and later years the fall in money supply was smaller, suggesting that trade deficit must have been covered by a rise in other net credit in the balance of payments; the reduction in the money supply was in fact limited to bank credit, since currency supply stayed almost constant in 1957 and 1958.

Having thus described the monetary system we shall discuss its disadvantages. There are broadly three disadvantages. Firstly, as we have said earlier, it magnifies the internal effects of external disturbances or fluctuations, when the aim of a monetary system should be to moderate these effects. The impact of such fluctuation on our economy, on private and public planning, on investment and incentive and on efficiency of allocation of resources has been frequently discussed and need not concern us here.

Secondly, a large part of our foreign exchange reserves has been tied up, due to the 100% currency system which we follow. The amount of reserves tied up is equal to the Malaysian currency issued less that part which is the fiduciary issue (i.e. $300 million). The currency in turn broadly depends on national income and on the ratio between currency holdings and income which the various sectors of Malayan economy wishes to maintain.

While the holdings of such a large reserve may be justified on the grounds of international confidence and to ensure that there is adequate reserves for the future, it is unreasonable not to make use of them, even when the community would profitably invest them in import-substituting and export promoting Malaysian development or when sharp adverse movement in export income has been experience and is in prospect in the years to come.

Thirdly, since under this system a fall in export proceeding will mean a greater fall in national income, monetary demand for goods produced for the home market will also fall. This will lead to under-utilization of capacity and unemployment of the "Keynsian" variety rather than of a structural nature. It is true that underemployment in the form of redundant labour cannot be completely eleminated in an economy such as ours by merely creating more monetary demand but such a step could reduce it. At various periods of slumps in our history there is clear evidence showing that a fall in export income acting through the multiplier effect has led to a loss in output.

Therefore the working of present monetary system in restoring the balance of payments equilibrium due to fall in export income can lead to unemployment and waste of productive capacity.

Therefore, from the point of view of active monetary management and independent status of the country, the present system is no longer appropriate. Accordingly, the preparations are made by the Central Bank to assume the power to issue currency and take over all the responsibilities of the Currency Board.

To ensure that the Central Bank would be able to manage the monetary system to the national advantage and to promote monetary stability and a sound financial structure in the country, legislation was enacted in the latter part of 1964 to extend the application of the Central Bank Ordinance 1958, throughout Malaysia. The Central Bank of Malaysia (Amendment and Extension) Act, 1965 became effective on January 21, 1965.

The steps thus taken will no doubt bring about a more active management by the monetary authorities to avert the undesirable effects of fluctuation in export earnings.