ABSTRACT

During a 10 year period, Malaysia experienced 3 economic cycles, which are 1994-96 boom, 1997-98 recession and 2001 downturn. In combating these cyclical fluctuations, Malaysia uses the variation mix of expansionary and concretionary of Monetary and Fiscal policy instruments. Findings shows that Malaysia's currency control measures only provide temporary (short-term) benefits and unsustainable befit long-term. The paper outline various economic management strategies for a improve performance for the future.

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"Perceptions will differ. But what is certain is that a totally corrupt and incompe tent Government surely cannot create a prosperous country. If a country does well, the Government cannot surely be totally corrupt and incompetent."

~ By former-Prime Minister (PM), Datuk Seri Dr Mahathir ~

Introduction

The sustainable success of an economy is the outcome of an effective economy management. A government manages economic fluctuations through the use policy instruments such as fiscal and monetary, which focuses on the demand-side of the economy as well as supply-side polices. Fiscal policy involves the use of taxation, government spending and borrowings to influence a country's economic activity and to grow the rate of the aggregate demand (AD) output as well employment (Mankiw 2004). Fiscal policy is often called the "*Keynesian policies*" as it is strongly associated with the British economist, John Maynard Keynes (Chicago School of Economics 1994). The Monetary policy attempts to use the level of the money-supply and interest-rates to influence the rate of growth of AD (Mankiw 2004). Monetary policy (also known as "*Monetarism*") is advocated by the American economist, Milton Friedman (Chicago School of Economics[1] 1994). Supply-side policies aim to increase both the short-run and long-run of supply-side of the economy (i.e. shifting the curve to the right) as this would lead to a reduction in the price level and an increase in national income (Mankiw 2004).

The primary focus of this report is to asses the Malaysia economic trends and the Malaysian government's role in the economy. The outline of this paper is as follows:-

(1) Fundamental Assumptions on the workings of an economy

(2) Research methodology undertook

(3) Analysing the economy indicators (inflation and employment) and its impact on the Malaysian economy cycles (i.e. data analysis and findings).

(4) Evaluation of Malaysia's past policy mix and its implication for future policies

Due to the limitation, the scope of this paper will be limited to Malaysia's Fiscal and Monetary policy development primarily during the Asian Crisis.

Section 1

Fundamental Assumptions of the AS-AD Model

The Aggregate Demand (AD)-Aggregate Supply (AS) Model was utilised in analysing the behaviour of the whole Malaysian economy.

(1) In an equilibrium market, it is assumed that:

$$\text{Gross Domestic Product (GDP)} = AD = AS = \text{Output}$$

(2) Output is demanded by 3 types of agents: consumers, firms and the government.

(3) Consumers' demand for products can be aggregated and represented by a consumption function (C). The propensity to consume (c^1) is entirely determined by the disposable income received, which is income (Y) after the deduction of government taxes (T) (Blanchard 2000, p.44). In short, consumption can be defined as:

$$C = c^\circ + c^1 (Y - T)$$

Note: - c° is interpreted as the consumption when income equal to 0.

(4) The firms' demand for products can be aggregated and represented by an investment function (I) (Blanchard 2000, p.45):

$$I = \bar{I}$$

Note: - $\bar{I}$ is interpreted as an exogenous variable as to keep the model simple.

(5) Government demand is determined and represented by the government spending (G) function (Blanchard 2000, p.45):

$$G = G^{\circ}$$

Note: - G° is interpreted as an exogenous variable as government's behavioural pattern is unpredictable due to the changing phases of the economy.

(6) Trade balance is determined and represented by the net export, which refers to the difference between exports (X) and imports (M) (Blanchard 2000, p.43). Therefore, trade balance can be defined as:

$$(X\text{-}M) = \text{net exports} = \text{trade balance}$$

Clearly, domestic demand (i.e. AD) is the simple sum of the consumption function, investment function, trade balances and government spending. Please view Appendix A for the macroeconomic relationships of the AD-AS Model.

Section 2

Data Collection Method

Secondary research was the prime method used to collect the required information. The secondary data sources comprises from various existing data bases data (i.e. Bank Negara Malaysia, Asia - Pacific Economic Cooperation's and United Nation's economic research report), Internet sources, journals, articles and publications. To ensure the effectiveness of the gathered and analysed data, the data collected was entered into the statistical software easily, which created a comprehensive data set that was used in analysis. Data collected was confined to only within the period from 1992-2004.

Section 3

Malaysia's Economic Outlook

Malaysia's economy can be considered to be one of the highly developed and successful free market economies in the Asian region. Chart 1 (view Appendix) summarises the past and current position of Malaysian economy. The dynamics of the economy can be seen to be highly volatile. Based on the fluctuating growth of the real GDP from 1994-2004 (view Appendix B), 3 economy cycles can be easily identified as: -

- The 1994-96 boom (Pre-Crisis phase)
- The 1997-98 recession (Asian Financial Crisis: July 1997-August 1998)
- The 2001 downturn (September 11 Attacks)

The 1994-96 boom (Pre-Crisis phase)

During the boom period, Malaysia was the most rapidly growing economy in the world. Analysts projected that Malaysia would soon become the next Newly-Industrialised Country (NIC) by the year 2020 (Drabble 2004). Malaysia's average real GDP from 1994-96 estimated at a robust growth of 9.7 percent per annum (view Appendix C). Growth was primarily driven by private sector investment and government spending (view Appendix D). The positive outlook on the Malaysian economic has also boosted consumer's confidents, which in turn lead to higher consumer spending (i.e. consumption) (view Appendix D). The boom of the early 1990s saw the expected trade-off (view Appendix E), with the slight decrease of unemployment associated notable increase in inflation. Thus, suggesting that Malaysia was experiencing mild 'cost-push' inflation caused by the price-wage spiral mechanism (Economic New School 2000).

The 1997-98 recession (Asian Financial Crisis: July 1997-August 1998)

Throughout the pre-Crisis phase, actual annual GDP output (estimated at 9.2 percent) was higher than the potential GDP output of the country (estimated at 8.2 percent) (view Appendix F). This caused Malaysia to have a 'demand-pull' inflation (or inflationary gap) during the 1997-98 recession (view Appendix G). The Crisis witnessed a 'stagflation' phase, in which, inflation remains high while unemployment increases (view Appendix E) (Tregarthen & Rittenberg 2000, p. 621). Malaysia's galloping inflation rate, which estimated at 4.8 percent, subsequently lead to the depreciation of the Ringgit Malaysia (RM) by approximately 50 percent against the US dollar by the end of 1997 (view Appendix H). The real GDP in 1998 contracted 7.4 percent. This was primarily due to the drop in the domestic aggregate demand which was caused by the sharp recline in private investment (firms) and to a lesser extent, by consumption (consumers) (view Appendix D).

During the early stages of the Asian financial crisis, Malaysia adopted the International Monetary Fund (IMF) prescription of a tight monetary and fiscal policy to restore the economy. The policy requests for government to reduce its spending in order to trim down its current account deficit of the balance of payments and to reduce inflationary pressures arising from the depreciation of the RM (Bank Negara Malaysia 1997). With the tight macroeconomic policies, the high interest rates and restriction on credit growth (Blanchard, Olivier 2000) had proven to be detrimental as business were badly affected and debts repayment could not be made. Subsequently, causing banks to have high non-performing loans (NPLs) which in turned caused the structural reformation of Malaysia's financial system.

However as the Crisis continued into 1998, the Malaysian government altered its policy to expansionary. The prominent policy instrument adopted since 1st September 1998 are capital control on outflows and fixing the exchange rate at RM 3.80 to the US dollar (Lye 2000). The implementation of the policies was based on the belief that its existing policies were unsustainable. The former-PM, Dr. Mahathir, who is often accused of "denial", claims profusely that George Soros and other hedge fund managers were orchestrating the collapse of Asia's currencies (Mahathir 2000). The first signs of the Crisis began with the sharp devaluation of the Thai baht currency, in which his thinks triggered the 'Tom Yam Effect' which spread turmoil cross the Asian region, much in the same way the 'Tequila Effect' that hit Latin America in 1994-95 (Dato' 1997).

The easing of the fiscal in turn supported economic activities. The fiscal instruments implemented were selective increase in infrastructure spending, establishment of funds to support small and medium-sized enterprises, a higher allocation for social sector development and a reduction in taxes (Bank Negara Malaysia 1997). Consequently, a fiscal deficit of 1.8 percent of GDP emerged after 5 years of surpluses was recorded due to extensive government spending.

With the revised policy in placed, the economy did improve as unemployment and inflation rate began to fall, hence suggesting that Malaysia was on the road to recovery. In 1999, real GDP grew to 6.1 percent and in 2000, grew robustly to 8.3 percent. Malaysia's economy 'bounce back' is mainly attributed to the rise in private consumption and a revival in domestic investment as well as to strong export growth (view Appendix D). The success of the selective capital control policy was attributed to its sufficient international reserves of about $ 20 billion to cover BNM's monetary liabilities.

The 2001 downturn (September 11 Attacks)

After the September 11 terrorism attack in 2001, the inverse relationship existed between inflation and employment, whereby the occurrences of the raising inflation lead to a marginal drop in unemployment rate. The country's potential output indicated that real GDP decreased at a faster pace (0.3 percent) compared to potential GDP (3.2 percent) (view Appendix F). However, despite the real GDP contracting 0.4 percent in 2001, the real GDP in 2002 made a stunning recovery at 4.2 percent growth. It suggested that the 2001 downturn was 'short-lived' as the notion that Malaysia was in the recovery phase was further supposed by its falling inflation and unemployment rates in 2002-03 (view Appendix E). Malaysia used Keynesian policy, in which government increased its budgetary expenditure by 10 percent (Bank Negara Malaysia 2002) to fight off recession. In addition, a looser monetary policy was placed, whereby low interest rates and based-based lending was implemented in hopes to stimulate growth (Bank Negara Malaysia 2002). The recovery was mainly attributed to the increasing net exports; government spending and consumptions (view Appendix D).

Section 4

Theoretical Workings of the Malaysia's Current Macroeconomic Policies

Since 1970s, the Malaysian government has played a more direct and active role in the country's overall social and economic development. The government primarily uses a Deficit Budget strategy to spur private savings and investment (local and foreign). Low interest rate regime plays a key role in spurring domestic consumption of goods and services. It is also currently maintaining an under-valued Ringgit Malaysia (RM) through currency peg to spur exports and reduce imports.

Through the government's use of fiscal policy instruments, it is reforming its tax structure to increase international competitiveness as well as to promote national savings to meet future levels of growth and investment requirements. The shift in emphasis is currently towards domestic sources of growth in particular, by commercializing the Agricultural Sector.

Thus, as often seen, fiscal and monetary policies often work at cross-purposes. In general, fiscal policy is more focus on stimulating growth in the economy even at the cost of moderately higher prices. In contrast, monetarism is mainly concerned with keeping inflation low while tolerating a relatively high unemployment to achieve that goal. It should be noted Malaysia's Monetary policy is in the hand of the Bank Negara Malaysia (BNM), Malaysia's Central Bank.

Controversy of Malaysia's Macroeconomics Management

"It is always easy to criticise others. It is always difficult to criticise ourselves."

For the longest time, Malaysia's macroeconomics policies, especially capital controls have sparked interesting debates among politicians and economists alike. Many arguments have been suggested to support the adoption of capital control, however, many have also argued for capital liberalization.

A strong advocate for capital control is economist Paul Krugman with his 'Plan B' theory. At a seminar in Singapore he said, " Asian economies were reaching the end of the road and it was time to 'do something radical' including implementing foreign exchange control since pressures on the Asian economies were too high (Krugman 1999)." Krugman also added, "…after having gone to IMF and finding that its policies [which he refers to as 'Plan A'] did not work it was time now for Asian countries to adopt [what he termed] 'Plan B', which

comprised foreign exchange control (Krugman 1999).” Krugman was certainly not the first person to advocate capital control as a part of the solution to the Asian financial crisis. This notion is also supported by Robert J Barro, a professor of economics at Harvard University. He stated, “Capital controls, while not ideal, are preferable to the IMF’s customary fix of intervention with high interest rate (Barro, 1998).” He believes that the conventional protection of the exchange rate through IMF interventions that feature high interest rates, would fail (Barro, 1998).

There has also been increasing acceptance by the international financial community in recent years on use of capital controls. In the words of Joseph Stiglitz, the World Bank’s chief economist, “There has been a fundamental change in mindset on the issue of short-term capital flows and these kind of interventions, a change in the mind set that began two years ago (Unknown Author September 21, 1999).” He also added, “…in the context of Malaysia and the quick recovery in Malaysia, the fact that the adverse effects that were predicted…some might say that some people wished upon Malaysia….did not occur is also and important lesson (Unknown Author September 21, 1999).”

World Bank has broken the taboo and legitimized short-term capital controls by retract its opposition on Malaysia’s use of capital controls. Stiglitz’s startling remarks came a week after the IMF praised Malaysia for its skilful unorthodox handling of capital controls (Unknown Author September 21, 1999). This suggests that capital controls is not only reasonable but also a good policy instrument to be implemented in stabilising economic crisis in the short-run.

Recent study conduct (Pontes 1999) on controls on capitals outflows and inflows covering a variety of instruments showed an agreement with most economists that advocate capital control. Findings showed that a capital control do temporality (i.e. short-term) benefit a country (Pontes 1999). It creates temporary 'buffer-zone' for countries to deal with its balance of payments and help to reverse capital outflows (Pontes 1999). The study also indicated that controls can also serve to discourage potential destabilizing short-term capital flows and reduce a country's vulnerability to shifts in market sentiment (Pontes 1999). However, the study seem to it seems indicate that capital control ineffective in preventing sustained outflows of savings or avoiding a crises induced by inconsistent macroeconomic policies (Pontes 1999).

What is the appropriate strategy for the Future?

I think Malaysia needs to put in place a policy mix that would reward productivity and spur higher value-added economic activity is the key. The Malaysian government needs to review, amend or remove tariffs, duties and taxes that promote inefficiency, low productivity and the lack of initiative to innovate. The new policies should need to focus on New Sources of growth & wealth creation (i.e. Biotechnology, ICT and Multimedia Services). In short, Malaysia needs to focus on the Knowledge-based industries that primarily use "human capital" as the main factor of production.

In my opinion, the un-pegging of the RM is inevitable strategy (and an absolute must) for the development of a sustainable macroeconomic management. A pegged RM simply implies pegging the Ringgit against the US dollar, not against every currency. Hence, the pegging of the RM currency only creates an 'artificial stability', thus reinstalling that Malaysia is reluctant to face the realities of the marketing conditions.

In the long-run, pegging expensive foreign goods will hurt imports. This will mostly have a detrimental affect (in terms of cost) on industries that depends heavily on imports, for example Malaysia's health industry (particularly, the health food industry), technology, automobile and petrol (finished product) industry.

Furthermore, Malaysia is trading partners with many countries that practise a 'free-floating currency' system. As the Malaysian currency is strengthening, it keeps Malaysia's exports cheap, hence allowing BNM to build it current reserve. However, this could cause possible retaliate from Malaysia's trading partners due to this unjust 'artificial' currency controller. For example, trading partners may take their business to other countries, like Thailand. Therefore, I see the un-pegging as `paving` the way for widening of the trading band. However, the vital question it posses is – When should the re-pegged of the RM happen? The Answer is - Now. The strengthening of the Malaysia economy suggest that it would be able to absorb any immediate 'shock' (which should not occur as Malaysia has been preparing for the un-pegging for a long time) especially with China suggesting similar actions.

Conclusion

Malaysia is safe but for how long? A strong commitment to fiscal and monetary sustainability is critical for macroeconomic stability as well as to ensure sustainable long-term growth. Malaysia continues to enjoy flexibility in expanding its fiscal position, which remains sustainable given the government's fiscal prudence and discipline. As a long term strategy, Malaysia should un-pegged it s current currency control in order to achieve better competitive edge for the future. Therefore, it is imperative that the Malaysian government find and sustain and a suitable long time economic management strategy.

(2,881 words)

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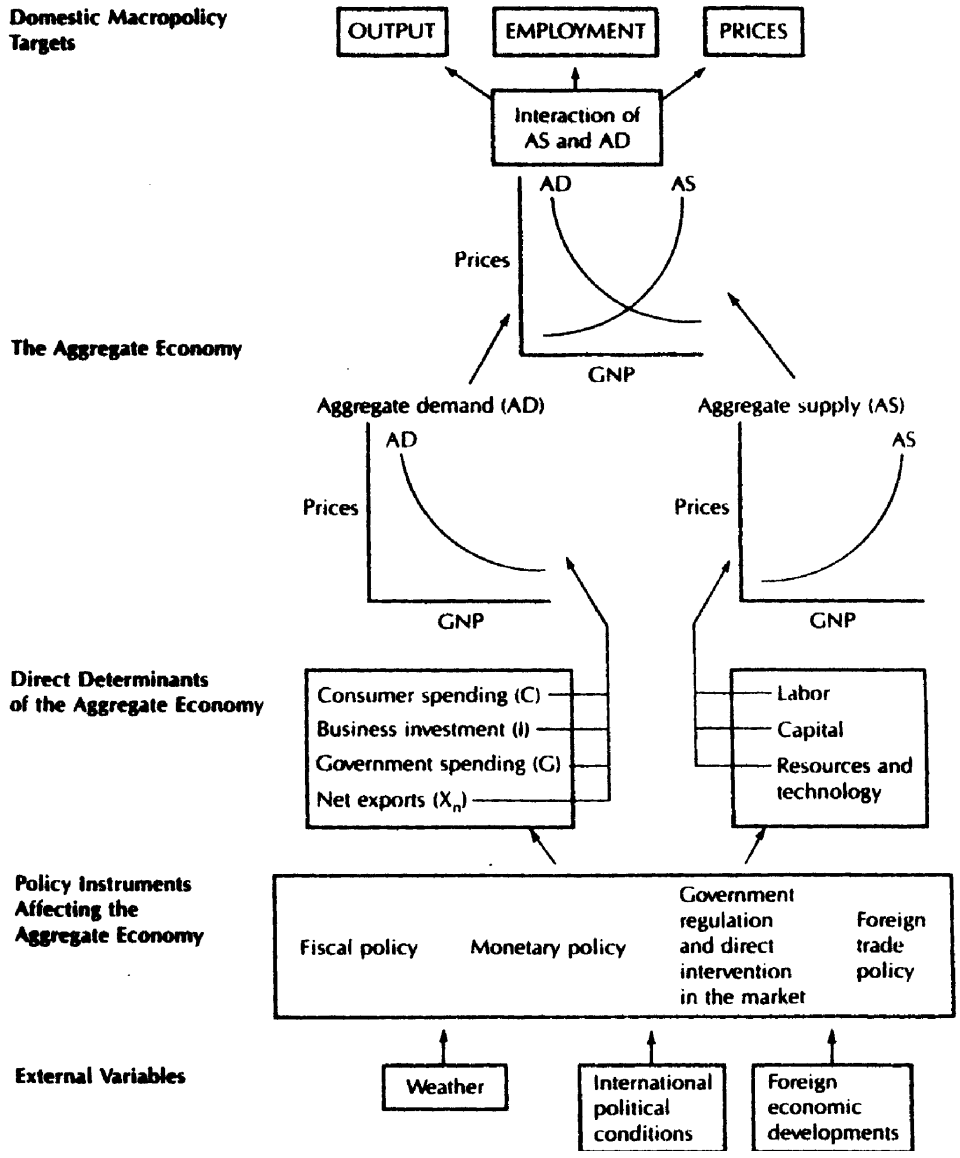
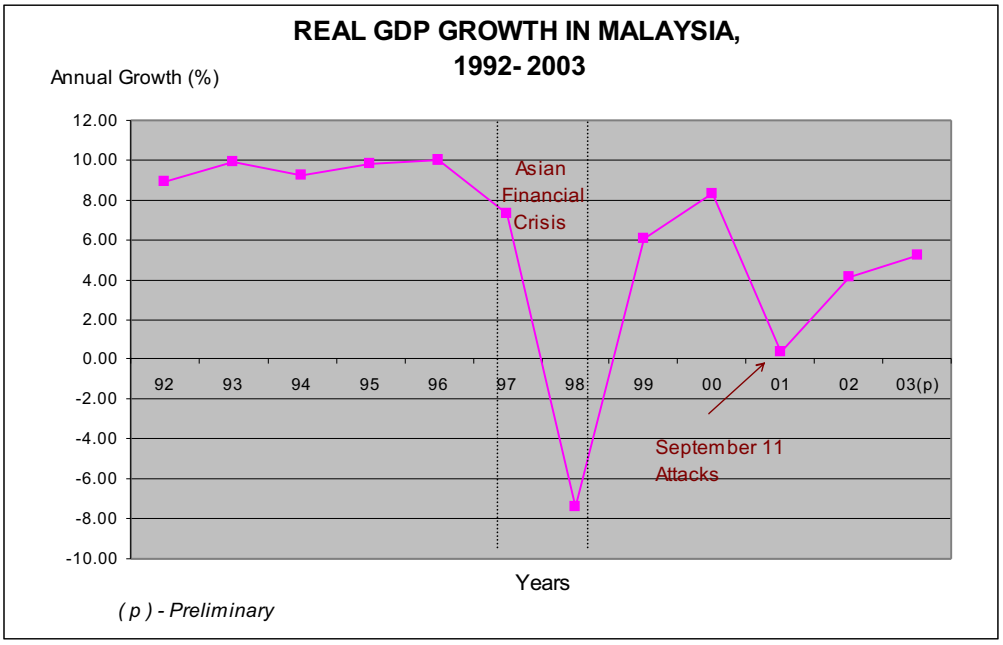
Appendices

Appendix A: AD-AS Model: Macroeconomic Relationships



(Source: Carson 1990)

Appendix B: Real GDP Growth in Malaysia, 1992 -2003



(Source: Adapted from the compilation of Asia - Pacific Economic Cooperation 2005)

* Note: The economy from 1994 -2004 is at 1978 Prices

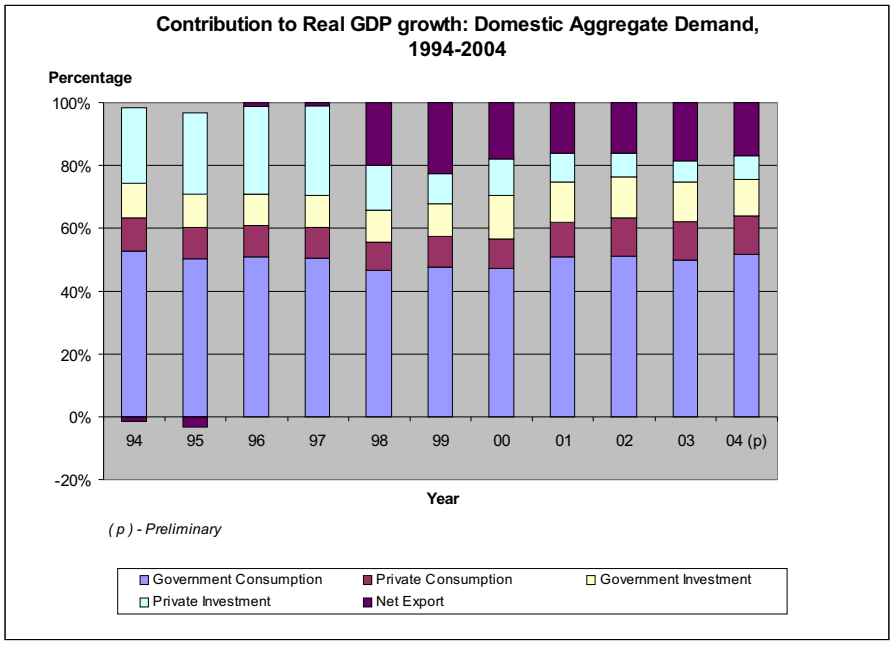
Appendix C: Average Real GDP Growth (per annum), 1994-1996

Average Real GDP Growth (per annum) 1994 - 1996		
Annual Real GDP (%) per annum	=	$\frac{9.2 + 9.8 + 10}{3}$
	=	**9.67 %**

(Source: Adapted from Bank Negara Malaysia 1997)

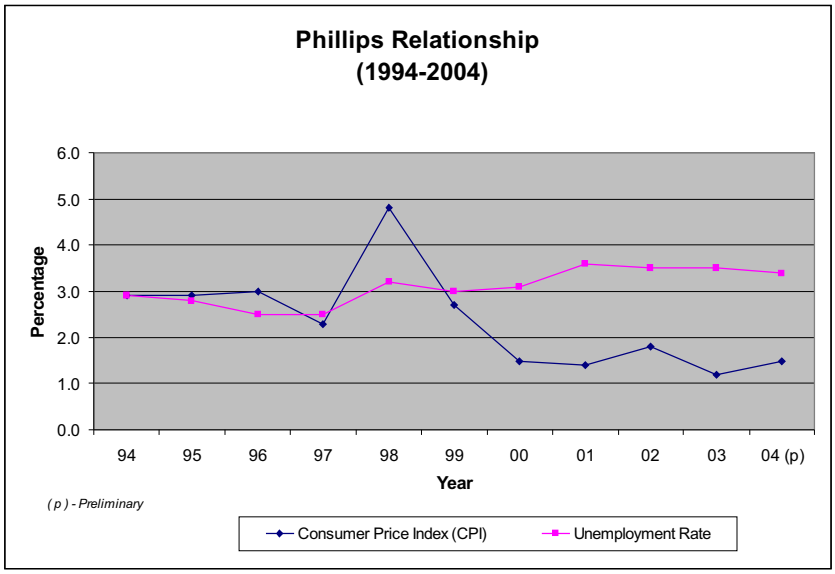
* Note: Actual figures are listed in Appendix

Appendix D: Domestic Aggregate Demand's contribution to Real GDP growth



(Source Adapted from the compilation of Bank Negara Malaysia 1994 - 2003)

Appendix E: Phillips Curve Relationship (1994-2004)



(Source: Adapted from the compilation of Bank Negara Malaysia 1994 – 2004)

* Note: CPI (2000 = 100)

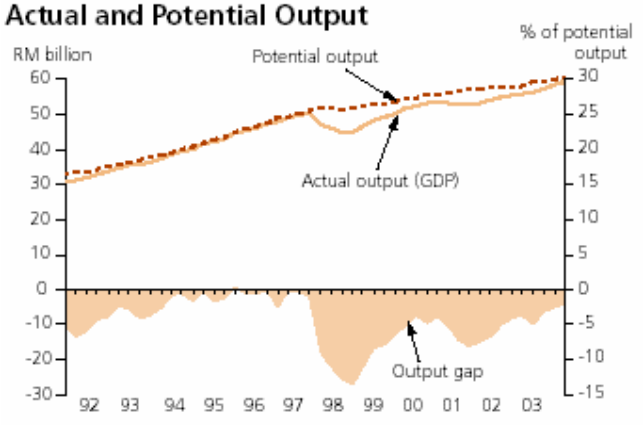
Appendix F: Potential Output of the Malaysian Economy

Table 1
Actual GDP and Potential Output

Period	Actual GDP	Potential output	Investment	Labour	Output Gap
	Annual change (%)				(% of potential output)
1992-1997	9.2	8.2	14.1	3.9	-1.9
1998	-7.4	3.7	-43.0	-2.1	-11.4
1999	6.1	2.4	-6.5	3.7	-8.3
2000	8.5	4.0	25.7	4.3	-4.3
2001	0.3	3.2	-2.8	3.3	-6.9
2002	4.1	1.7	0.3	3.1	-4.8
2003	5.2	3.4	2.7	3.3	-3.1

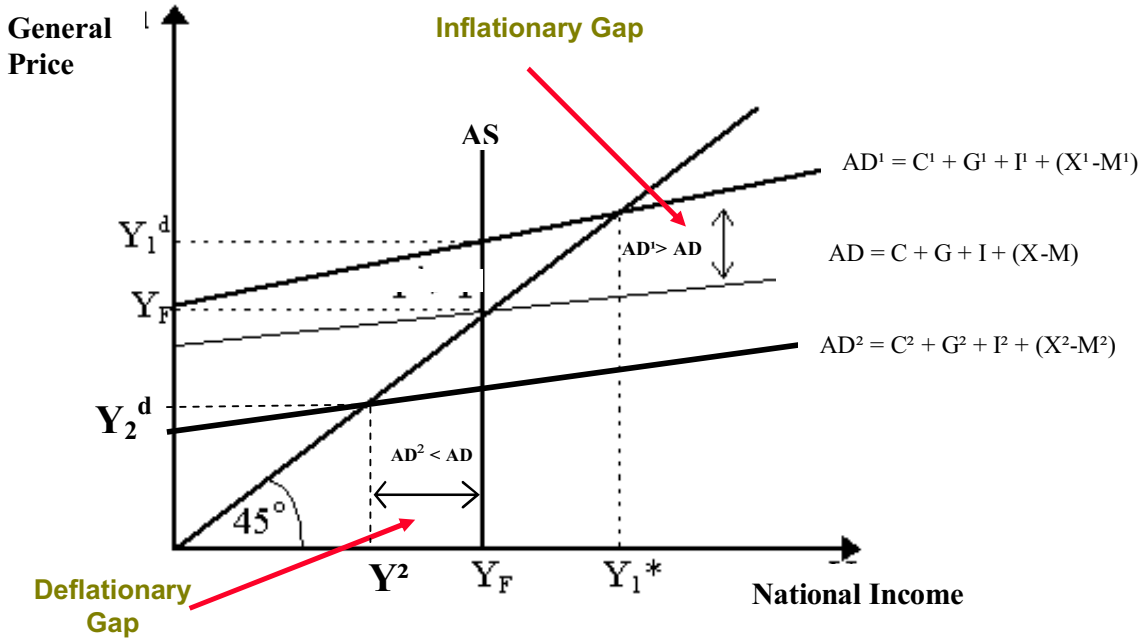
(Source Bank Negara Malaysia 2003, p.7)

Graph 1
Actual and Potential Output



(Source Bank Negara Malaysia 2003, p.7)

Appendix G: Inflationary and Deflationary Gaps (AD -AS Model)



(Source: Adapted from Economic New School 2000)

Note: -

(1) **Inflationary Gap** = The notion is that if planned aggregate demand *exceeds* full employment output there will be upward pressure on prices (demand pull inflation).

(2) **Deflationary Gap** = If aggregate demand *is less than* the full employment output there will be downward pressure on prices (prices reduced to sell).

Appendix H: Depreciation of the Ringgit Malaysia vs. US Dollar (1997)

Depreciation of the Ringgit Malaysia vs. US Dollar, December 1997 (end period)
Depreciation (%) = $\frac{3.89 - 2.59}{2.59}$ x 100 %
= **50.19 %**

(Source: Adapted from Bank Negara Malaysia 1997)

* Note: Actual figures are listed in Appendix