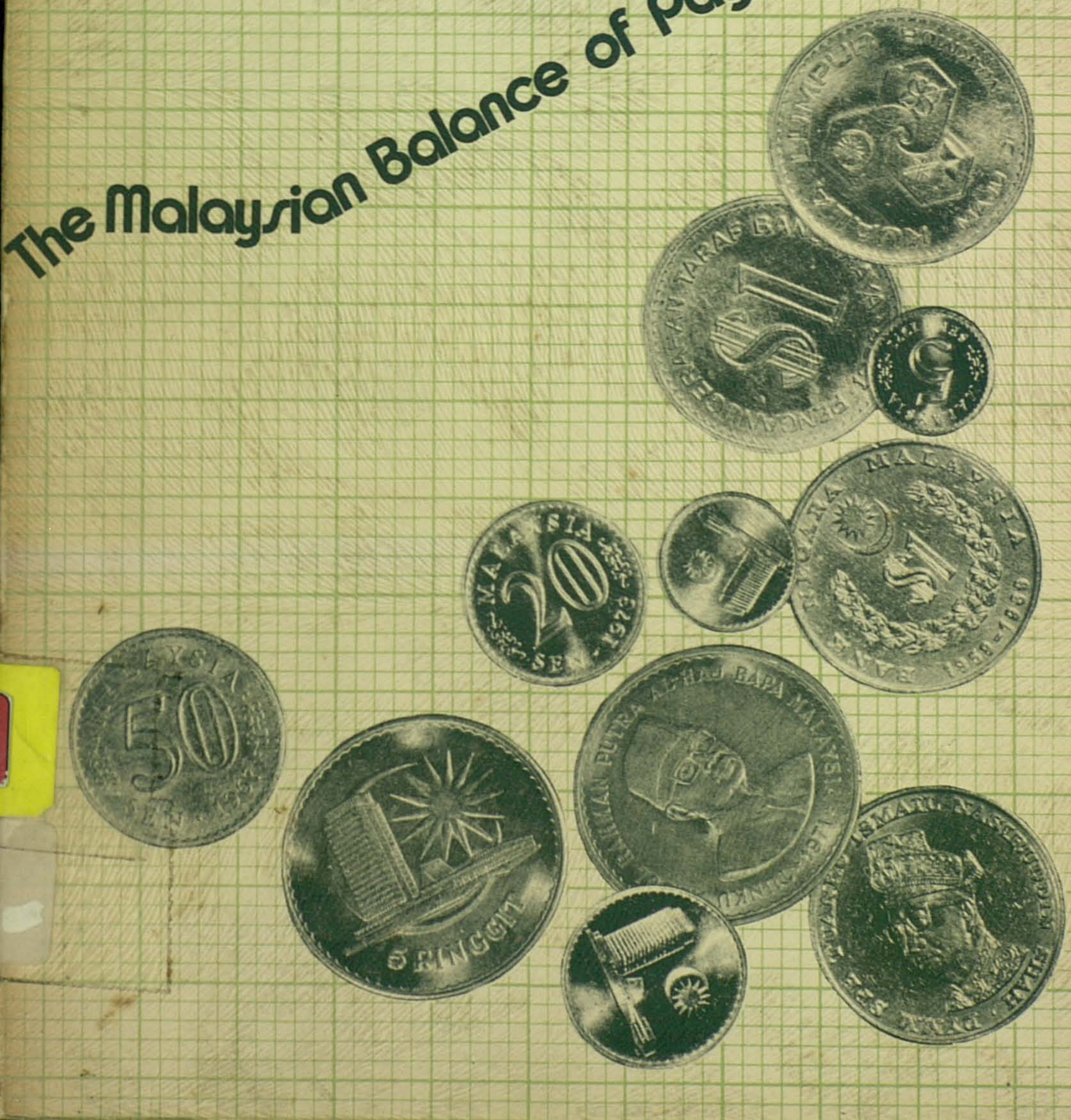
Alan Chew

The Malaysian Balance of Payments: 1960-1970



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THE MALAYSIAN BALANCE OF PAYMENTS

PERPUSTAKAAN NEGARA MALAYSIA
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THE MALAYSIAN BALANCE OF PAYMENTS 1960–1970

CHEW FOOK YEW, ALAN

PENERBIT UNIVERSITI MALAYA
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1975

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Dicetak oleh Penerbit Universiti Malaya

for Elaine

PREFACE

This book studies the Malaysian balance of payments during the sixties, and covers a number of aspects of this topic.

First, the methodological approach and official presentations of the Statistics Department are studied, and then the rationale for these presentations is discussed. Alternative presentations are suggested.

These are followed by an analysis of both the current and capital accounts. For the former, an analysis of the separate states of Malaysia – Peninsular Malaysia, Sabah and Sarawak – is given.

Changes in the balance of payments of a country result in changes in the level of foreign exchange reserves. Malaysia, being a developing country and committed to a development programme, is particularly anxious about the adequacy of its foreign exchange reserves with respect to a number of criteria. An assessment is made as to whether Malaysia has adequate foreign exchange reserves. The Malaysian foreign exchange rate policy and the case for not devaluing the new Malaysian dollar with the pound devaluation in 1967 are also examined. As a consequence, it is suggested that the effects of devaluation in a developing country may have to be studied in the light of a dual economy.

Traditionally, countries have used monetary policies as balance of payments adjustment mechanisms. It is within this context that the development of financial institution and financial instrument is studied. The possibility of using traditional monetary policies including open market operations in Malaysia is questioned.

Non-monetary policies are also seen as balance of payments mechanisms particularly with regard to generating and saving foreign exchange.

Import substitution in both the agricultural and manufacturing sectors has widespread effects on an economy. Of late, developing countries have accepted import substitution policies as part of their development plans, and Malaysia is no exception. The effects of import substitution on the Malaysian balance of payments require serious consideration.

Besides import substitution, other specific policies such as restrictions on transfer payments, the viability of a national shipping line, separate trade policies for manufactured and primary exports and the potentials of the tourist industry are considered.

Finally, the Malaysian balance of payments characteristics and policies are seen within the context of developing countries.

ACKNOWLEDGEMENT

A large part of the material in this book came originally from my doctoral thesis submitted to the University of Hull in early 1972. My study at the Centre for Southeast Asian Studies, University of Hull, was financed by the Inter-University Council of Great Britain channelled through the University of Malaya-Hull exchange scholarship scheme. I was also granted a three-year leave of absence from the University of Malaya. The Department of Statistics, Kuala Lumpur, has been most co-operative in providing me with the Balance of Payments statistics. To all these institutions, I am grateful.

Special thanks also go to the Director, professors, fellows and staff of the Centre for Southeast Asian Studies and the Department of Economics at Hull University for an enjoyable and profitable experience, both socially and academically.

My expression of gratitude is also directed to all those who have helped and enouraged me in numerous ways. I would like particularly to mention my supervisors Dr. Ingrid Palmer and later Mr. B. Parkinson for their constant guidance and help.

Finally, I wish to record my debt to my wife, Elaine, and daughter, Aileen. Their patience is the most important contribution by far.

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ABBREVIATIONS

ECAFE:	Economic Council of Asia and Far East
FAMA:	Federal Agricultural Marketing Authority
IMF:	International Monetary Fund
IBRD:	International Bank of Reconstruction and Development
MIDPL:	Malaysian Industrial Development Finance Limited

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CHAPTER I
THE MALAYSIAN BALANCE OF PAYMENTS: SOME METHODOLOGICAL, AND CONCEPTUAL CONSIDERATIONS WITH ALTERNATIVE PRESENTATIONS

The methodological approach of the Malaysian Statistics Department needs consideration because a study of the methodology adds to an understanding of the statistics which are used in following chapters. It also indicates that by their nature some of the statistics in the balance of payments present problems of identification. This is to point out that for some statistics (e.g. capital movements), it will be difficult to identify a cause and effect relationship. In addition, this study also highlights certain statistical weaknesses which may have given rise to the item errors and omissions including short term capital.[1] This latter item is of particular importance because in 1966 and 1967 it formed about 25% of the total foreign exchange reserves of Malaysia.

The rationale and justification for defining 'surpluses' and 'deficits' in three different ways, namely, the 'current balance', the 'basic balance and the 'over-all balance' will be examined. As a result of different presentations of the Malaysian balance of payments, it is worthwhile to examine briefly Fritz Machlup's three concepts of balance of payments within the Malaysian context. Finally, two alternative presentations are considered.

The Malayan Statistics Department began to compile balance of payments statistics for the Federation of Malaya in 1960. Sarawak's estimates were first compiled in 1961 but the balance of payments statistics were not on a regular basis. No figures for Sabah were available until 1964.

In 1961, the Statistics Department and the Central Bank of Malaya introduced the 'ticket system'[2], a statistical check system to record foreign exchange passing through commercial banks. This was in addition to the Foreign Exchange Control which imposes restrictions on transactions of a capital nature with non-sterling-area countries. There are no restrictions on transactions with sterling-area countries. The statistics from the 'ticket system' were introduced as a means of helping the compilation of the 'invisible account' of the balance of payments.

In 1963, the Central Government Authorities felt the need for a Malaysian balance of payments incorporating the figures of Sabah, Sarawak and Peninsular

[1] A further discussion of 'errors and omissions including short term capital' is given in Chapter III. The study in Chapter III attempts to link the large negative 'errors and omissions including short term capital' with non-statistical causes such as political conditions, smuggling, outflow of funds by immigrants and interest rates changes.

[2] A brief study of the 'ticket system' is given in Appendix 1,

Malaysia. Prior to 1963, these states were separate political entities. Two main problems were involved in compiling a Malaysian balance of payments.

Firstly, there were hardly any data on invisible transactions for either Sabah or Sarawak. Secondly, intra-regional trade could not be consolidated due to the different procedure for recording trade data. Peninsular Malaysia uses the 'General Trade' system while Sabah and Sarawak use the 'Special Trade' system.[3]

However in 1966 the first series of balance of payments statistics, 1961-5 for Sabah, Sarawak, Peninsular Malaysia and Malaysia were compiled and submitted as part of the data for the IMF compilation of balance of payments.[4] The series for Malaysia has been continued since 1966.

The balance of payments may be defined as a record of transactions between residents of a country and foreigners.[5] It covers 1) transactions in goods and services, 2) transfer payments, and 3) movements of capital and gold.

It will be apparent from the above definition that the types and sources of statistics are very diverse. The sources of statistics in Malaysia are from the foreign trade statistics, returns to the comptroller of foreign exchange, the 'ticket system', shipping, airline, film-rental and financial surveys, survey of 'transactions of insurance companies with non-residents' as well as other questionnaires which are returned direct to the Statistics Department from the various government departments, embassies, and quasi-government institutions.

These diverse sources of statistics can be classified into two groups, the 'linked' and 'non-linked' debit and credit source entries.[6] The 'linked' system is one where both the credit and debit entries for the given transaction of the balance of payments are derived from the same individual or group of source of documents. The 'ticket system' is an example of the linked system.

The non-linked system is one where the debits and credits for the same transactions are found in separate and often unrelated documents. The rest of the

[3] 'In the 'General Trade' system the foreign trade statistics refer to total imports and total exports, while in the 'Special Trade' system the figures refer to imports for domestic use only and to exports of domestic origin only.' Saw Swee Hock, *Malayan Economic Statistics*, Kum Printers, Kuala Lumpur, 1968, p. 159.

[4] Department of Statistics, *Data for the IMF Consultations, 1966*, Kuala Lumpur, 1966, pp. 56-69.

[5] Residents are defined to include all legal citizens. An important exception to the rule refers to the 110,000 Indians working in the estate and plantation sectors. The Statistics Department has classified them as 'residents' on the basis that their 'centre of interest' lies in Malaysia. If these people had been regarded as foreigners, they would have presented problems for statistical recording. This exception also applies to some unknown proportion of the Chinese and European population in Malaysia.

[6] Max J. Waserman, Ray M. Ware, The *Balance of Payments*, Simmon-Boardman Publishing Corporation, New York, 1965, p. 189.

above-mentioned sources of statistics comes under this category. It is partly because of this 'non-linked system' that the identification of causes and effects of changes in the statistics is difficult. It may also be responsible for statistical errors.

The Malaysian trade statistics provide the basic data for the visible balance (or the merchandise account). The trade data however contain certain items which are not considered as exports or imports for balance of payments purposes and, conversely, they may omit items that should be included. The trade statistics can be examined under the following headings – coverage, valuation and timing.[7]

COVERAGE

The trade statistics of Malaysia include goods imported and exported on public accounts, i.e. government, municipalities, etc., as well as on account of enterprises and persons, but exclude:

a. gold and issued currency and coins;
b. goods imported and exported on account of naval, military and air forces of the Commonwealth;
c. goods imported or exported on behalf of diplomatic services;
d. exposed cinematograph films imported or exported on a rental basis;
e. personal effects of passengers, other than emigrants, for their own private use;
f. stores and fuels supplied to Federation ships and aircraft.[8]

The Statistics Department's rationale for the exclusion of gold from the visible balance is that it is not part of normal trade and that the production of gold is insignificant in Malaysia. However, for balance of payments accounting, transactions in gold between residents and foreigners have to be included. The Statistics Department includes part of this transaction in 'non-monetary gold' in the current balance and the other part in 'monetary gold' in the foreign exchange reserves account.[9] The Department believes that there is some under-statement of the total value of transactions in gold.[10]

[7]A modified version of this has appeared in my article, "The Malaysian merchandise trade in the Balance of Payments,' *Ekonomi*, 1969, Vol. 10, pp. 17-21.

[8]Department of Statistics, *Malayan Annual Statistics of External Trade*, Kuala Lumpur, December 1966, p. 2.

[9]Physically, there is no intrinsic difference between 'monetary' and 'non-monetary' gold. The importance of the distinction lies in the fact that gold plays the role of an international medium of exchange and monetary reserves above serve a different economic function from gold as a commodity or in private hoards, and therefore it is desirable to divide them into two distinct categories in the balance of payments.

[10]Department of Statistics, 'The Invisible Account: A methodological note', paper submitted to the sixth Conference of Commonwealth Statisticians, 1965, p. 2, unpublished.

The exclusion of goods imported/exported on account of foreign armed forces and diplomatic services is an extension of the intra-territorial principle. This coincides with the balance of payments principle of recording on a resident-foreigner basis.

Exposed cinematograph films entering or leaving a country could be treated as 'temporary trade' or such trade could be considered as no different from ordinary merchandise trade. The Statistics Department has adopted the first criterion – the films were not bought but their services were rented. Such a transaction is a resident-foreigner transaction and should be included in 'other services' in the service balance.

Personal effects of passengers are excluded from the trade statistics because they present statistical recording difficulties. People travelling abroad purchase goods, a portion of which they consume on the spot and the rest they bring back. The travellers are residents of their home countries. They should be included for a complete balance of payments coverage. An estimate which could be used for such a purpose would be the amount brought in or taken out by tourists. This estimate can be obtained from the 'ticket system'.[11]

The exclusion of stores and fuels supplied to Malaysian ships and aircraft is justifiable since it is on a resident to resident basis.

The overall adjustments to the foreign trade statistics to make them compatible with balance of payments concepts for coverage for exports and imports include the following:

a. deduct from imports, 'goods returned to Malaysia', i.e. returned Malaysian exports;
b. deduct from exports 'goods returned to foreign countries whence exported', i.e. returned imports;
c. add exports of treated water to Singapore;
d. add military imports;
e. deduct oil valuation adjustments;
f. adjustments of 'special transactions' such as personal effects of travellers, samples and other articles temporarily exported or imported;
g. add value of 'rental services';
h. adjustments of intra-regional trade between Sabah, Sarawak and Peninsular Malaysia.

The rationale for the first two adjustments is apparent, as returned exports have to be deducted from the total exports while returned imports have to be adjusted in the total import figures.

The addition of sales of water to Singapore is an international transaction. The Johore State government also exports untreated water to Singapore.

[11] See Table A1 in Appendix I.

Malaysia's military imports have to be accounted for since they are not included in the normal trade data for security reasons.

The Statistics Department has found that imports of crude petroleum and associated products shown in the trade statistics were always higher than reported in the returned questionnaires by the five oil companies operating in Malaysia.[12] As a result of this noted difference, adjustments to total imports are made by taking the difference between the import figures in the trade data and those reported by the oil companies.[13]

Adjustments of 'special transactions' include personal effects of travellers, temporarily imported articles such as display equipment for trade fairs, exhibition and animals for breeding and racing. These items have to be deducted.

The adjustment for 'rental services' has already been discussed.

The last adjustment of intra-regional trade is necessary for a pan-Malaysian balance of payments, since the Malaysian presentation is the sum total of the individual balance of payments of Sabah, Sarawak and Peninsular Malaysia. This is to conform to the principle of recording transactions on a resident-foreigner basis.

When one compares one state's trade statistics with those of another state, one may discover that the intra-regional transactions do not cancel each other. Table 1-1 illustrates this point.

There are two reasons for this non-coincidence between the trade figures. Firstly, the exports are recorded on a f.o.b. (free on board) basis while imports are on a c.i.f. (cost including freight and insurance) basis. Freight and insurance have to be deducted from the import figures to make them comparable.

Secondly, all three states in Malaysia define the countries to which exports are sent as 'countries of ultimate consumption' and the countries from which imports are received as 'countries of original production'.[14] The definitions work against the equating of exports and imports. When Peninsular Malaysia exports British manufactured goods to Sarawak, the country of ultimate consumption for her exports would be Sarawak. However, when Sarawak records these imports, the recording of imports would be according to the country of original production, Britain. This will give rise to some discrepancy. The Statistics Department has taken the export figure of each state to be correct and adjusts the import figure of the other partner in the same transaction to make it equal to the export figure. The difference between the two figures is regarded as

[12] The five oil companies in Malaysia are Shell Company, Esso, Caltex, Mobil and British Petroleum Company.

[13] Information obtained from the Statistics Department.

[14] Department of Statistics, *External Trade Statistics, Exports and Re-exports*, Vol. 1, 1967, notes.

TABLE 1-1 Malaysia – Trade between Peninsular Malaysia, Sabah and Sarawak, 1968, ($m)

Peninsular Malaysia's exports to Sabah		51.4
Sabah's imports from Peninsular Malaysia		57.0
	Difference	5.6
Peninsular Malaysia's exports to Sarawak		18.2
Sarawak's imports from Peninsular Malaysia		59.5
	Difference	11.3
Sabah's exports to Peninsular Malaysia		3.3
Peninsular Malaysia's imports from Sabah		0.8
	Difference	2.5
Sabah's exports to Sarawak		3.7
Sarawak's imports from Sabah		1.0
	Difference	2.7
Sarawak's exports to Sabah		14.5
Sabah's imports from Sarawak		5.4
	Difference	9.1
Sarawak's exports to Peninsular Malaysia		10.4
Peninsular Malaysia's imports from Sarawak		15.8
	Difference	5.4

Source: Department of Statistics, Kuala Lumpur, unpublished.

transactions between that state and the rest of the world.[15]

The adjustments to the trade accounts giving imports and exports on balance of payments basis for the years 1962-7 are given in table 1-2.

VALUATION

Errors and unrecorded capital movement can arise in valuation when the values of exports and/or imports recorded differ from the true market value. The use of actual transaction value is far from being a universal practice in the customs record and it is extremely difficult to obtain the necessary data to correct differences between recorded values and transaction values. In Malaysia, this discrepancy between market price and recorded price may assume significant proportions because of the large number of foreign-owned rubber estates, oil palm plantations and tin mines. The recording of primary exports is at either a nominal or gazetted price and no adjustments have been made to convert it to market value.

[15] Lee Sing Guan, The *Balance of Payments Statistics of Malaysia*, Graduation Exercise, Faculty of Economics and Administration, University of Malaya, 1969, p. 21, unpublished.

TABLE 1-2 Malaysia – Adjustments for Coverage, Freight and Insurance in the Visible Balance, 1962-7, ($ m)

	1962	1963	1964	1965	1966	1967
Exports in trade returns (f.o.b.)	3,260	3,330	3,382	3,383	3,846	3,722
Adjustment for coverage	−28	−34	−36	−31	−38	−43
Item I Credit	3,232	3,296	3,346	3.352	3,808	3,679
Imports in trade returns (c.i.f.)	2,073	3,193	3,205	3,356	3,379	3,333
Adjustment for coverage	−31	−23	26	38	45	−9
Item I Debit	2,042	3,170	3,231	3,394	3,424	3,324
Adjustment for freight and insurance	−150	−160	−160	−168	−170	−175
Imports (f.o.b.)	1,892	3,010	3,071	3,226	3,254	3,149

Source: IMF, *Balance of Payments Yearbooks*,
Vol. 19, Malaysia, June 1968, p. 3.
Vol. 20, Malaysia, June 1969, p. 2.

In addition, many of the foreign-owned estates and plantations in the primary export sector form part of the 'agency house system',[16] In other words, the same foreign-owned enterprise is both an importer of goods into Malaysia as well as an exporter of primary exports. This structural set-up may be partly responsible for unrecorded short-term capital movements. It is possible that the valuation of both exports and imports can be recorded in a manner which benefits the firm. This is because the export/import firm operates a system of set-off accounts. The accounts of the Malaysian branch are credited with the value of produce consigned from Malaysia and debited with the value of goods despatched to Malaysia.[17]

[16] The agency house system includes, 1) firms that specialize in imports or exports and 2) firms that specialize in managing enterprises belonging to foreign investors, see J.J. Puthucheary, *Ownership and Control in the Malayan Economy*, Eastern University Press, Singapore, 1960. p. 23. In Chapter II of his book, Puthucheary explains the role of agency houses but does not deal with their financial arrangements.

[17] P.J. Drake, 'The Developing Capital Market in Malaya', Unpublished Ph.D. thesis, A.N.U., Canberra, 1966, pp. 363-4.

The system of set-off accounts may give rise to the 'classical example of over-invoicing and under-billing'.[18] The procedure of recording exports at either nominal or gazetted prices further facilitates such under-valuation of exports and over-valuation of imports.

TIMING

The balance of payments seeks to record economic transactions at the time they occur. This is the moment when a financial claim arises although the claim need not be settled in cash immediately. In the Malaysian case, the Statistics Department uses the date of trade documents received from various departments in any month as the basis of the trade figures for that month. This invariably gives rise to a time-lag of varying lengths between the date of receiving the documents and the actual date imports or exports are affected. It has been argued that on a yearly basis the error is not substantial since the early/late recordings tend to balance each other out.[19] In any case, this time-lag problem does not apply to rubber and tin statistics as the data for these two important commodities relate to the actual quantities imported and exported during the month.

A more important source of error arising from timing is that the entries for visible trade may not correspond with movements in the balance of monetary accounts as the timing of settlements may be different from the change of physical ownership.

STATISTICS FOR THE 'INVISIBLE BALANCE'

The sources of statistics for the invisible balance will be discussed item by item in accordance with their order of presentation in the Malaysian balance of payments. The balance of payments, 1963, given in Table 1-3 is for illustrative purposes.

The first item 'non-monetary gold' in the invisible balance has already been dealt with.

The recording of import trade is on a basis which includes freight and insurance but not customs duty and other import charges payable in Malaysia. Freight and insurance is treated as a separate item in the balance of payments presentation. It is part of the invisible trade.

The IMF recommends that the valuation of exports and imports should be on an f.o.b. basis. This is to achieve symmetry of balance of payments between countries. By recording the value of visible trade on an f.o.b. basis the value of visible trade recorded by the importing country will be equal to the value of the exports recorded by the exporting country.

[18] V. Kanapathy, 'Foreign Investment in Malaysia: Experience and prospects', *UMBC Economic Review*, Vol. VI, No. 2, 1970, p. 12

[19] Saw Swee Hock, *op. cit.*, p. 159.

TABLE 1–3 Malaysia – Balance of Payments, 1963, ($ m)

Exports (f.o.b.)	3,296	
Imports (f.o.b.)	3,010	
Visible Balance		286
Non-monetary gold (net)	–3	
Freight and insurance (net)	–155	
Other transportation (net)	3	
Travel (net)	–69	
Investment income (net)	–195	
Government not included elsewhere (net)	150	
Other services (net)	–55	
Service Balance (net)		–324
Balance of goods and services (net)		–38
Private transfers (net)	–206	
Government transfers (net)	25	
Transfer payments (net)		–181
(Balance on goods, service and transfer payments) *Current Balance*		–219
Private long-term capital (net)	270	
Official long-term capital (net)	87	
Long-term capital inflow (net)		357
(Balance on current and long-term capital) *Basic Balance*		138
Official short-term capital	–5	
Errors and omissions including private short-term capital	–210	
Errors and omissions including all short-term capital	–215	
(Balance on current, long-term and errors and omissions including short-term capital) *Over-all Balance*		–77
Official Reserves (net)	18	
Commercial banks net foreign assets	59	
Net monetary movements		77

Source: Bank Negara Malaysia, *Quarterly Economic Bulletin*, Vol. 2, March 1969, No. 1, pp. 35–47.

Since Malaysia's import trade figures are on a c.i.f. basis, the insurance and freight have to be separated from the value of imports. There would be no problem if separate data were available. Unfortunately, they are not.

The Statistics Department assumes that 8.9% of foreign imports (c.i.f.) from non-sterling countries is due to freight and insurance. For imports from sterling area countries an assumed percentage of 6.5 is used.

The rationale for the assumed percentages of 8.9% and 6.5% is based on sample data received from the various shipping conferences in respect of different categories of cargo.[20]

It may be noted that the estimated percentages of the Statistics Department differed from that of the IMF. Table 1-2 show that the yearly freight and insurance as a percentage of imports (c.i.f.) for 1962-7 was about 5%. This difference may represent another source of errors and omissions.

A further source for errors and omissions relates to imports of Singapore origin. For imports from Singapore into Peninsular Malaysia, freight and insurance has been assumed to be negligible as these two countries have a common land border.

In arriving at the apparent imports from Singapore the following procedure was adopted.

Apparent total imports Singapore origin = Imports of Singapore origin + Imports from foreign countries via Singapore

Imports from foreign countries via Singapore = Imports by rail and road via Singapore + Trans-shipments (goods unloaded from ships in Singapore into smaller boats and brought into Peninsular Malaysia).

The Statistics Department assumes that 85% of the imports by road and rail is of Singapore origin while the remaining 15% is treated as direct foreign imports. These percentage figures are estimates and may be a further source of errors or omissions.

The freight and insurance calculations for Sabah and Sarawak were basically the same as the one employed for Peninsular Malaysia. However, the overall percentage used was 9%. In the case of Sarawak, this excluded oil piped from Brunei to Lutong in Sarawak for refining.

The item 'other transportation' covers passenger fares, port disbursement, ship's crews expenditures and coastal services. Data for these sub-items are from questionnaires mailed to all travel agents, shipping and airlines, Department of Civil Aviation, the various port commissions, Malayan Railways and oil companies.

[20] Information from Statistics Department

'Travel' statistics are from the 'ticket system'; immigrant records and the Ministry of Education.

'Investment income' is subdivided into 1) Income on direct investment and 2) other income. Details of category 1) are from 'financial surveys of limited companies in Malaysia'.[21] 'Other income' includes interest earnings from Malaysian-owned foreign assets and earned incomes by Malaysians working overseas. The government, its agencies and public corporations provide the necessary information on interest earnings. The commercial banks provide similar data to the Central Bank through a mail questionnaire. The private sector's portfolio earnings are estimated. The earned income of Malaysians who work and live in Singapore and those who live in Malaysia but work in Singapore is also an estimated figure. The Statistics Department admits that there are no accurate figures for the amount of earned income from Singapore and has used an assumed figure of $5m. as personal income in favour of Malaysia.[22] This figure may now be lower because of the political split between Singapore and Malaysia in 1965.

STATISTICS FOR 'TRANSFER PAYMENTS

Transfer payments include both private and governmental transfers.[23] For private transfers, two categories are noted, namely, transfers to and from Malaysia on account of taxes, pensions and indemnities, and transfers to or by foreign private institutions and individuals.

Private remittances by former immigrants as well as present foreigners are of significant proportions in Malaysia. On average, remittances have been about $200m. annually. It should also be noted that neither the exchange control nor other sources such as the post office or banking system completely covers all transactions. The 'ticket system' and the financial surveys provide collaborative information especially on payments of pensions and compensations.

From 1967, the 'ticket system' has excluded foreign transactions which were less than $500. The rationale given by the Central Bank is that these transactions are insignificant from the viewpoint of balance of payments compilation. This rationale is weak, as the aggregation of a large number of small remittances may be large, and is another area where the outflow of funds is unrecorded.

Finally, it should be noted that the amount of funds which by-pass these sources are unknown. In any case, the present figures are pure estimates.[24]

[21] A brief study of the financial surveys is given in Appendix II.

[22] Department of Statistics, *Annual Trade Statistics*, 1963, Kuala Lumpur, p. 12.

[23] This institutional classification is significant in that the separate items behave differently. Government transfers are usually to support economic development while private transfers are motivated by personal reasons.

[24] Department of Statistics, *Annual Trade Statistics*, State of Malaya, 1963, p. 8.

The statistics on government transfers are from the Treasury and the Economic Planning Unit. Receipts in this item represent grants in cash and kind to the central government for defence purposes as well as economic aid. Payments are compensations and pensions to retired civil servants now living abroad.

The Statistics Department's qualitative assessment of the reliability of the data in current balance is given in Table 1-4.

TABLE 1–4 Malaysia – Assessment of Reliability of Statistics used in the Current Balance.

	Peninsular Malaysia	Sarawak	Sabah
Trade statistics	g	g	g
Non-monetary gold	f	f	f
Freight and insurance	f	f	f
Other transportation	f	r	v.r.
Travel	f	r	r
Investment income	g	r	r
Government not included elsewhere	g	g	g
Other services	f	r	g
Private transfer payments	r	v.r.	v.r.
Government transfers	g	f	f

good = good f = fair r = rough v.r = very rough

Source: Department of Statistics, 'The Invisible Account: a methodological note', 1965, unpublished.

STATISTICS FOR THE CAPITAL ACCOUNT

The capital account of the Malaysian balance of payments is classified into 1) sectors of the economy, i.e. the monetary sector and the non-monetary sector, 2) private and government capital and 3) long-term and short-term capital.

The monetary sector consists of financial dealings of the Central Bank and commercial banks while the non-monetary sector includes transactions of non-bank business enterprises and the government.

Information on the private sector regarding capital movements of companies is from the financial surveys. The Central Bank also obtains information through the financial returns sent in by the commercial banks.[25]

[25] The monthly statement of assets and liabilities of commercial banks is required under section 12(1)(a) of the banking ordinance, 1958.

The Statistics Department encounters little difficulty in obtaining the necessary information from the government sector. The sources are from the Treasury, central and state government, government agencies and quasi-government institutions.

The distinction between long and short-term capital is arbitrary. Long-term capital covers obligations with a maturity of one year or more while short-term capital obligations are those with a maturity of less than a year.[26]

There are no accurate and separate figures for short-term capital movements. Short-term movements are included in the residual item 'errors and omissions'.

SOME CONCEPTUAL CONSIDERATIONS: 'THE CURRENT BALANCE'

The consolidation of the visible balance, service balance and transfer accounts gives the current balance of the Malaysian balance of payments. (See Table 1-3). The current balance includes capital transfers as distinct from current transfers in the transfer account, but this is technically incorrect. Capital transfers should be included in the capital accounts. No adjustments have been made because no satisfactory and practical criteria have been formulated to facilitate a distinction between capital and current transfers.

This presentation of the current balance has been used by the Department of Statistics,[27] Bank Negara,[28] and the Economic Planning Unit.[29] The rationale for the current balance is that a country which can avoid a deficit in this account can 'stand on its own feet'. A favourable balance is an indication of fundamental strength of the economy.

This rationale need not necessarily be correct, especially for developing countries, because most of them are heavy importers of capital goods. Malaysia can have a deficit in the current balance but this deficit may be financed by an equivalent inflow of foreign exchange or alternatively the inflow of capital as reflected by the capital accounts may be larger than the current balance deficits. This means that unless one can compare the current balance with the capital accounts, there is the possibility of misinterpreting this summarized figure. To date, the current balances of Sabah and Sarawak are given by the Statistics Department without an accompanying capital account.

[26] Department of Statistics, Form X – Financial Survey of Limited Companies incorporated in Malaysia, 1968, p. 3, footnote 4.

[27] In all publications of the *Annual Trade Statistics* and 'Data for IMF consultations'; 1966, 1969, 1970.

[28] All Bank Negara Annual Reports.

[29] *First Malaysia Plan, 1966-1970, Mid-term Review of the First Malaysia Plan, and Second Malaysia Plan, 1971-1975.*

THE BASIC BALANCE

A consolidation of the current balance and the long-term capital account give the Basic Balance or Basic Transactions. (See Table 1-3). The concept which arises from this presentation distinguishes between the basic transactions (the items 'above the line') and 'those sensitive to monetary policies' (items 'below the line') as a means of classifying international transactions and is the legacy of Hal B. Lary.[30]

The Economic Planning Unit uses this presentation for its projections in the programme balance of payments[31] in the First and Second Malaysia Plans.

The justification given by the Central Bank in support of the Economic Planning Unit in the use of the basic balance is that it 'excludes short-term distortions and some of the volatile items as a guide for short term policies'.[32] This justification is acceptable because the size of short-term capital movements of the private sector of the Malaysian economy is unknown and has been included in the residual item 'errors and omission including short-term movements'. It is logical that this item should be excluded from the programme balance of payments.

However, it would be difficult to justify the Malaysian presentation when Lary's criterion is considered. According to Lary, the items 'below the line' are sensitive to monetary policies. 'The concept of sensitivity to monetary policy as applied to international transaction includes the notion of certainty of response, the idea being that certain transactions are likely to be generally more responsive than others ....'[33]

Within the Malaysian context, the financial dealings of the commercial banks and the short-term capital movements are not likely to be as sensitive to monetary policies. It will be shown in Chapter V that traditional monetary policies which can be used by the Central Bank are not likely to bring about the desired results because of the undeveloped money market, the importance of foreign-owned commercial banks and their links with overseas head-offices and the time-lag before the effects of monetary policies can be felt. In Chapter III, it will be shown that though interest rates may have influenced 'errors and omissions including short-term capital' the evidence is less than conclusive.

Finally, the division of international transactions into basic transactions and those sensitive to monetary policies can be objected to on theoretical grounds.

[30] Hal B. Lary, *Problems of the United States as world trader and banker*, Princeton University Press for the National Bureau of Economic Research, 1966, Appendix A, p. 137.

[31] This concept will be discussed on page 19.

[32] Bank Negara Malaysia, *Quarterly Economic Bulletin*, March, 1969, No. 1, p. 48.

[33] Hal B. Lary, *ibid.*, p. 143.

Cooper argued that '... unfortunately, the sensitivity of various international transactions to monetary policies varies along a continuum so any dichotomy into "policy sensitive" and "not policy sensitive" is unnecessarily artificial and over time both the sensitivity of transactions to policy and the policy instrument themselves are likely to change so that aptness of any particular dichotomy will probably be short lived.'[34]

THE OVERALL BALANCE

The sum total of the current balance, long-term capital and 'errors and omissions including short-term capital' (items 'above the line') gives the overall balance of payments. (See Table 1-3). The items 'below the line' are items which measure changes in net international liquidity'. International liquidity consists essentially of the resources available to national monetary authorities to finance potential balance of payments deficits. Typical items entering into international liquidity are holdings of gold and convertible foreign exchange, but claims on international institutions or entitlements to borrow from international institutions, from foreign government or even from private sources abroad, may be included in the concept.[35]

In the Malaysian presentation, international liquidity consists of official reserves and net commercial bank foreign assets. The inclusion of changes in the assets by banks is debatable. In some countries, such as the United States, Germany and Japan, the assets of commercial banks are placed 'above the line', while in other industrial countries they are 'below the line'. The IMF does not show a specific surplus or deficit position but shows separately the changes in foreign assets and liabilities of the monetary authorities and of the commercial banks.

The rationale for placing the changes of assets of commercial banks 'below the line' is that their assets are available to the authorities for defence of the national currency. The commercial banks in Malaysia, especially foreign-owned banks, hold foreign exchange in their own right and they therefore assume responsibility individually for converting their dollars deposits into foreign currency and in the aggregate for financing any deficits in foreign trade. For these purposes they have their own foreign exchange plus what they can borrow abroad, particularly from their head-offices.

For this reason, it seems legitimate for the Central Bank to place the net assets of commercial banks 'below the line' and consider it as part of international liquidity.

[34] Richard N. Cooper, 'The Balance of Payments in Review,' *Journal of Political Economy*, Vol. LXXIV, 1966, pp. 384-5.

[35] J. Marcus Fleming, 'The Fund and International Liquidity,' *IMF Staff Papers*, Washington, D.C. Vol. 11, p. 177.

In addition, it has been suggested by Drake[36] that should the necessity arise, it would always be possible to enact a system (as in Australia) where the commercial banks (as a condition of their licence) are not allowed to hold more than relatively small working balances of foreign currencies. In this event, proceeds of export sales and other inward remittances would be acquired by the Central Bank (the commercial banks receiving balances at the Central Bank in exchange). Outward remittances would be funded by commercial banks purchasing foreign exchange from the Central Bank. In the overall surplus or deficit presentation of foreign accounts, only fluctuations in the Central Bank's foreign assets would be 'below the line'.

Since surpluses and deficits in the balance of payments are not terms which have a unique meaning and their use frequently leads to misunderstanding, one needs to examine the Malaysian balance of payments in relation to Machlup's three concepts of balance of payments, namely, the 'market balance of payments,' the 'accounting balance,' and the 'programme balance of payments'.[37]

THE 'MARKET BALANCE OF PAYMENTS'

As defined '... the market balance of payments is a model of a given situation in the foreign exchange market, characterised by the effective demand and supply of foreign exchange at the given exchange rate and at alternative hypothetical rates'.[38] A dollar deficit in a country's market balance of payment may be taken as an excess of dollar amounts effectively demanded at the given exchange rate by would-be purchasers (who are not restricted by specially adopted or discretionary government control measures) over dollar amounts supplied at that exchange rate by the would-be sellers (who are not motivated by a desire to support the exchange rate).

This is an ex-ante concept for use in the analysis of the foreign exchange market with major emphasis on the effect which changes of the exchange rate might have upon the amount of foreign exchange effectively demanded and supplied.

Prior to June 1967, the external value of the Malayan dollar was tied to sterling. The exchange rate between the dollar and sterling had remained at 2s. 4d. to a dollar since 1906. After 1967, the par value of the Malayan dollar was expressed in terms of gold. The mechanism of the foreign exchange is such that the market rate of exchange 'is never allowed to fall below a maximum of 1% of its par value or climb more than 1% above it. During the sixties, the leading

[36] P.J. Drake, personal correspondence.

[37] Fritz Machlup, 'Three concepts of the Balance of Payments and the so-called dollar shortage,' *The Economic Journal*, Vol. LX, No. 237, March 1950, p. 46.

[38] *Ibid.*, p. 46.

industrial countries have generally accepted even narrower limits of around ¾%. For instance, around the sterling/US. dollar parity, the permitted market range has been two cents in either direction, i.e. between November 1967 and December 1971, 2.38-2.42 dollars around the parity of 2.40 dollars. Pressure on sterling would result in the British authorities running down their foreign reserves, gold and funds from IMF to prevent sterling from falling below 2.38. When all this has failed, a 'forced devaluation' of the currency arises. Policing the upper limits of one's currency is easier, as the authorities have to be prepared to hand over claims in their national currency to foreigners, in return for foreign exchange or gold. A fall in the market exchange rate necessitating official support purchases will often be the first sign of budding payments deficit. The same situation applies to Malaysia.

THE PROGRAMME BALANCE OF PAYMENTS

Machlup defines '...a dollar deficit in a country's programme balance of payments as an excess of dollar amounts needed or desired for some specific purposes (assumed to be important with reference to some accepted standards) over the dollar amounts expected to become available from regular sources'.[39]

The phrase 'needed or desired' refers to the requirements computed by planners and based on what they regard as the nation's needs or desires. Such requirements could be imports from abroad needed to sustain certain levels of domestic consumption and capital formation. The phrase 'with reference to some accepted standards' is a matter of political judgement while 'expected to become available from regular sources' refers to the amount to be received as proceeds from exports of goods and services and from loans and investments by foreign capital if such are safely expected. However, funds from emergency sources are to be excluded. Not all countries compute and use this concept. The concept originated as a supplement to mechanisms developed for national planning of the domestic economy. It is most useful to countries in developing areas as it indicates the amount of foreign financial assistance needed to sustain certain levels of home consumption and capital formation. Today, its use is mainly confined to developing countries.

It should be noted that the programme deficit is not an ex-post deficit but rather it is a deficit which is programmed when there is a chance to finance it. There is no sense in drawing up a programme balance with a deficit when there is no hope of financing it. The concept of programme balance appears to be identical with forecasts of deficits in the balance of payments estimates in the development plans of Malaya and Malaysia. The projections of deficits were for the Second Five-Year Plan, 1961-1965, the First Malaysia Plan, 1966-1970 and

[39] *Ibid.*, p. 55.

the Second Malaysia Plan, 1971-1975. The projections were based on the current balance and the basic balance. It is clear why the net liquidity concept was not used for the programme balance. The policy makers were not so much interested in the liquidity problems but in the regular sources of international finance in terms of grants, foreign aid and sources coming from trade.

The deficits budgetted for those plans mentioned above were $1,230m. and $1,686m. dollars. The deficit in the Second Five-Year Plan was to be financed by the combination of foreign grant assistance, borrowing from foreign balances of the government and in the private capital account, net inflow of re-invested and new foreign capital.[40]

For 1966-70, Malaysia envisaged a potentially serious programmed balance unless the targets for output growth; foreign aid and foreign investment are met and the level of public savings maintained. The balance of payments problems arise mainly from imports exceeding exports as well as deficits in the service balance. Considerable demands are also placed on Malaysia's foreign exchange resources by private remittances although the ties linking one-time immigrants to Malaysia with countries of origin gradually weakens.

The programme balance deficit is expected to be financed through some combination of receipts from official grants, net foreign private investments in Malaysia, official loans, use of foreign exchange reserves and other short-term capital movements.[41]

The forecast prepared in Malaysia appears to differ from Machlup's concept of a deficit in one respect. Machlup uses the words 'needed or desired'. No such terminology exists in the Malaysian case, but if such terminology is to be added then it would be appropriate to use 'expected to be required'. This is because the needs and desires for funds are almost limitless for developing countries.[42]

The ex-ante character of the programme balance is self-evident. The extent to which hopes are fulfilled and targets attained depends on the ex-post record of international transactions tallying with the programme balance. To expect the ex-ante figures to tally with the ex-post is wrong, but what matters seems to be the extent of the deviation. In terms of achieving the required target, as set out in the policy, the severity of the deviation would be greater when the ex-post deficit is greater than the ex-ante deficit. The problem is not so great when the ex-post and ex-ante surpluses differ, except to the extent that deviation represents a loss of opportunity.

[40] *Second Five-year Plan, 1961-1965*, Table XI, p. 66, *First Malaysia Plan, 1966-1970*, Malaysia, Table 3-11, p. 59.

[41] *First Malaysia Plan, 1966-1970*, p. 66.

[42] A.G. Irvine, *The Balance of Payments of Rhodesia and Nyasaland, 1945-1954*. Oxford University Press, London, 1959, p. 27.

The programme balance and ex-post balance of payments of Malaysia are given in Table 1-5.

TABLE 1–5 Malaysia – Programme and Actual Balance of Payments, 1965 and 1970, ($ m)

	Programme Balance		Actual Balance	
	1965	1970	1965	1970
Exports of goods and services	4,115	4,233	4,264	5,636
Imports of goods and services	3,956	4,724	4,133	5,239
Balance on goods and services	159	–491	131	397
Transfers (net)	–126	21	–71	–180
Current balance	33	–470	60	217
Long-term capital inflow (net)	367	450	290	229
Basic balance	400	–20	350	446

Source: Bank Negara Malaysia, *Quarterly Bulletin*, Vol. 2, March 1969, No. 1, pp. 36, 37, 40, 44.
Bank Negara Malaysia, *Annual Report, 1970*, p. 99.
First Malaysia Plan, 1966-1970, p. 63.

THE ACCOUNTING BALANCE OF PAYMENTS

The accounting balance of payments is a record of all transactions, real and financial, which have taken place over the past one or more years between the country's residents and residents of other countries and the records being kept in the form of a double-entry book-keeping with each credit entry balance by an off-setting debit entry and vice-versa. Where there are, in fact, discrepancies between the debits and credits, the item 'errors and omissions' acts as a balancing item. Barring this, it is accepted that the accounting balance of payments must necessarily balance. This concept presents difficulties of definition when it comes to defining a surplus or deficit in some meaningful sense.

Machlup defines 'a dollar deficit in a country's accounting balance of payments as an excess of dollar amounts entered on the debit side of certain accounts in the annual record of its international transactions over the dollar amounts entered on the credit side of the same accounts, the accounts being selected from the full, necessarily balancing statement in order to throw light upon problems connected with market or programme balance of payments'.[43]

[43] Fritz Machlup, *op. cit.*, p. 60

The accounting balance does provide the authorities with a complete statistical record of the country's international economic relations. A time-series of the balance of payments in this form can help to identify changes in the trade position and financial status, and hence pinpoint areas of strength and weakness. Its chief use is in the description of past development and perhaps also in the appraisal of the present position of one nation in relation to another.

A further argument in favour of a record of international transactions and an accounting balance of payments is that these are objective measures. If rejected, resort must be based entirely on mere qualitative statements.[44]

Donald Badger goes further by suggesting that '...while the accounting balance may be seriously inadequate for some purposes, it does, when properly interpreted throw considerable light on the market balance of payments. In the typical case today, when the country's exchange rate has been stable and the other underlying conditions have been reasonably constant, the surplus of deficit may be taken as a reasonable indication of the gap between market supply under these conditions'.[45]

For Malaysia, the exchange rate remained constant over the period 1961-8 (see Table 3-7 in Chapter III). this means that if one can assume the 'other underlying conditions' to remain constant then the accounting balance would approximate to the market balance. If 'other underlying conditions' is taken to mean no drastic changes in economic structure then the above conclusion is valid. In the short run, that is from year to year, this is true. This means that given political stability, a comparative study of changes from year to year can be made with respect to the market balance. For instance, in 1961 to 1962 the accounting balance indicated a change in the market surplus from $78m, to $21m. given the exchange rate of 3.05 to 3.06.

PRESENTATION BY SECTORS[46]

To understand fully how the balance of payments behaves in a developing country, it is important to look not only at the national aggregates but also at what happens in the separate economic sectors. An attempt is made to classify transactions according to the domestic sectors to which the transactor belongs.

Three main sectors can normally be distinguished – public, banking and private. The public sector illustrates the distinctive nature of external trans-

[44] A.G. Irvine, *op. cit.*, p. 21.

[45] Donald G. Badger, 'The Balance of Payments; A Tool of Economic Analysis', *IMF Staff Papers*, Washington, D.C., Vol. II, 1951-2, p. 156.

[46] This section appeared as part of my article, 'The Malaysian Balance of Payments – Existing and Alternative Presentations', *Kajian Ekonomi Malaysia*, Vol. IX, No. 1, June 1972.

actions performed by the government sector of a developing country. Since the banking sector enters into current transactions almost entirely as an intermediary for the payments and receipts of the other two sectors, the presentation simplifies to a division into government and the remaining sector, here described as private. This approach assumes that the banking system does not invest or play an active role in foreign trade on its own accord, and if it does, the financial amount is insignificant. This assumption seems reasonable as the banking sector usually does not directly invest in foreign trade but rather provides the finance for either the public sector or private individuals.

It should also be noted that the private sector includes the quasi-government sector, namely public authorities and statutory bodies such as the National Electricity Board. This is in accordance with international practice. Besides, the activities of public authorities such as the National Electricity Board, etc. may be more applicable in an economic sense to the private sector than to the government sector.

There are some practical as well as theoretical problems in this type of categorization.

Firstly, when a foreigner buys a Malaysian government security from a private resident of this country, the transaction belong to the private sector if attributed to the sector to which the seller belongs. But the foreigner acquires a claim on the Malaysian government, and in this sense the transaction involves the government sector. However, when new issues are concerned or where government departments provide the stock which foreigners buy in the market, the government sector enters into the transactions both as seller and debtor. The relative importance of this theoretical possibility and other transactions of a similar nature is unknown.

Secondly, statistical and security reasons make it impracticable to identify government imports for defense purposes. Thus the total import and freight and insurance figures would contain some portion which belongs to the government sector.

Thirdly, a classification by sectors tends to cut across economic categories. The treatment of interest on government debts paid abroad is included in the balance of payments table as a single figure of interest paid abroad, regardless of who pays it, the government or the private sector. Even more significant than the interest payments are the receipts and payments of direct investment. The item 'investment income' in the Malaysian balance of payments has been classified in the private sector but it is without doubt that some portion of this has been incurred or earned by the government sector.[47] Unfortunately, no statistics are available for identifying net government and private investment income.

[47] An example of this, prior to 1967, was the Malaysian share of the income earned by the Currency Board.

Finally, it must be noted that the two halves of the table are not independent of each other but have important interactions. This is in spite of the situation that government expenditure may be incurred with the aim of promoting as well as sustaining the growth of the private sector, while profit maximization is the primary motive of the private sector.

From these limitations, it is clear that it is difficult to draw inferences about the adequacy of the contributions of either sector to the Malaysian balance of payments. Nevertheless, with the present statistics available, and keeping in mind the above-mentioned limitations, it does provide some indication of the divergence between what the public sector spends, receives as grants and loans, and what the private sector earns, and vice versa.

An example of the end result of such a sectoral presentation of the Malaysian balance of payments is given in Table 1-6.

Levine[48] has suggested an even more detailed sectoral categorization of the balance of payments presentation. It is suggested that there should be two sectors, namely, the export and the import sector. The export sector consists of the following, the growers or producers of the export product, the intermediary processors or trader, official or semi-official marketing boards or grower federations or association and the government. The import sector consists of those who are involved in importing.

To quote him, 'a sectoral examination of balance of payments developments in a country, therefore, can contribute a great deal to the policy maker's understanding of how this adjustment process actually works, and what reconciliation may be necessary between sectoral and national policies'.[49] The usefulness of such a balance of payments presentation is beyond doubt but as Levine himself admits, the empirical research is tremendous and with the lack of adequate statistical data and especially in the detail form required, it is doubtful whether such a sectoral presentation is a practical possibility for Malaysia in the near future.

A FURTHER ALTERNATIVE PRESENTATION

For a developing country, the first balance might be the net total of all current transactions and short-term capital movements, (A+B+C) other than economic aid and monetary movements. This is followed by balances showing receipts of official grants and loans and capital movements. Such a presentation for Malaysia, 1961-71 is given in Table 1-7.

This presentation appears to be useful for a developing country as it highlights the position developing countries would be in when official grants and loans are

[48] Jonathan Levine, 'A Sectoral Approach to Balance of Payments Analysis', *Finance and Development*, Quarterly, No. 1, 1969, pp. 57-61.

[49] *Ibid.*, p. 61.

TABLE 1-6 Malaysia – Balance of Payments by Sectors, 1961-71 ($m).

	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970	1971
Private											
Current Account											
Merchandise (f.o.b.)	540	340	286	275	526	559	477	643	1,481	931	807
Non-monetary gold	−29	−3	−3	−3	−5	−5	−2	−6	−18	−11	−10
Freight and insurance	−133	−145	−155	−154	−162	−165	−170	−186	−187	−231	−242
Other transportation	−8	−8	−9	−15	−16	−11	−9	−12	−11	−16	−34
Travel	−67	−70	−69	−74	−80	−78	−69	−73	−96	−105	−102
Investment income	−231	−177	−195	−230	−255	−288	−144	−154	−308	−213	−213
Other services	−40	−41	−43	−50	−53	−74	−91	−100	−91	−118	−115
Private transfers	−205	−207	−206	−201	−195	−196	−185	−180	−209	−199	−188
Sub-total	−173	−311	−391	−452	−240	−239	−193	−68	460	38	−97
Capital Account											
Company long-term capital (net)	180	235	270	165	150	170	130	93	140	160	160
Public authorities and statutory bodies	10	28	41	27	35	10	53	50	19	2	41
Sub-total	190	263	311	192	185	230	183	143	159	162	201
Short-Term Capital Account											
Net errors and business	−101	−107	−207	−275	−351	−385	−296	−276	−452	−206	−307
Total Private Sector	−84	−155	−287	−535	−406	−394	−306	−201	167	−6	−203
Government											
Current Account											
Transactions n.i.e.	145	131	150	197	225	189	132	125	97	61	34
Transfers	12	13	25	127	137	90	43	37	30	16	15
Sub-total	167	144	175	324	362	379	175	162	127	77	49
Long-Term Capital Account											
Official borrowings	13	22	48	−7	70	−9	81	63	147	−3	270
Others	−8	−3	−2	7	−5	−29	−23	−50	−7	−8	23
Sub-total	5	19	46	0	65	−38	58	13	140	−11	293
Short-Term Capital Account	–	12	−5	71	116	−11	−183	–	–	–	–
Total Government Sector	162	175	216	395	543	230	50	175	267	66	342

Source: Compiled from various issues, *Statistical Bulletin*, Department of Statistics, Kuala Lumpur.

TABLE 1-7 Malaysia — An Alternative Presentation, 1961-71 ($ m)

	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970	1971
A. Current Transactions											
Merchandise account (f.o.b.)	540	340	286	275	526	559	477	643	1,481	931	807
Non-monetary gold	−29	−3	−3	−3	−5	−6	−2	−6	−18	−11	10
Visible trade balance	511	337	283	272	521	553	475	637	1,463	920	797
B. Services and Private Transfers	−539	−517	−527	−527	−536	−603	−536	−580	−810	−821	−860
A + B	−28	−180	−244	−255	−15	−50	−61	57	653	99	−63
C. Short-Term Capital (Errors and Omissions)	−101	−107	−207	−275	−351	−385	−296	−276	−452	−206	−307
A + B + C	−129	−287	−451	−530	−367	−435	−357	−219	201	−107	−370
D. Official Grants and Loans	25	217	68	191	323	70	−59	100	177	13	285
E. Capital Movements	182	260	309	199	180	201	160	93	152	218*	285*
F. Monetary Movements (increase in reserves −)	−78	−20	74	140	−137	164	256	26	−530	−124	−200

Source: Compiled from various issues, *Statistical Bulletin*, Department of Statistics.

*Includes allocation of special drawing rights.

not forthcoming. This point has been illustrated by the table above where the Malaysian balance on current transactions, services and private transfers and short-term capital (excluding official loans and grants) has been in deficit for most years. The results of this presentation also emphasize the theory that adjustment policies of developed countries may result in unfavourable repercussions in developing countries.[50] This means that a developing country can be maintaining its growth of exports and experiencing favourable terms of trade but if official loans and grants are withdrawn or not forthcoming, the developing country can have liquidity problems. The reasons for a shortage of official loans and grants are manifold. Firstly, the donor country may be facing balance of payments problems herself. Secondly, the nature of grants and official loans is such that it arises from bilateral agreements between countries, and the size and certainty of grants and loans can depend on political reasons rather than on economic criteria. Thirdly, official loans may not be of the right size and kind. Package loans with all their conditions may not be acceptable to a debtor developing country.[51]

The other feature of the above presentation is that short-term capital and net errors and omissions (including unrecorded short-term capital) have been included in the total. This inclusion again highlights the unfavourable condition which exists in developing countries where this item has continously been negative, indicating outflows of unrecorded capital. A possible objection to this presentation is when net errors and omissions are taken to be more of a balancing item than a figure indicating capital outflow. If this is true, then a case can be made that the deficit as given does not reflect the true causes for the deficit and that the weakness of the economy has been over-emphasized. However, there are reasons to suspect that in Malaysia's case a significant proportion of errors and omissions are short-term capital movements and not only due to statistical errors.[52]

The balancing groups, official grants and loans, capital movements and monetary movements can then be taken as the sources of finance, viz: gold and foreign assets of the monetary institutions, foreign exchange reserves of the government, and loans and grants from international institutions and private individuals and countries.

The added advantage of keeping the last three groups separate is that individual accounts indicate the extent to which the finance of deficit is through the use of foreign assets of monetary institutions, through official loans and grants or through capital funds of private individuals.

[50] See Robert C. West, 'The Impact of Adjustment on Developing Countries', in *Maintaining and Restoring Balance of Payments*, Fellner, Machlup, Triffin, and others, Princeton, New Jersey, Princeton University Press, 1966, pp. 223-41.

[51] Sulaiman bin Abdullah, 'Why Aid to Malaysia', *Development Forum*, Vol. II, No. 1, June 1969, pp. 30-31.

[52] See my article, 'A note on Errors and Omissions in the Malaysian Balance of Payments Estimates', *Kajian Ekonomi Malaysia*, Vol. VI, No. 1, June 1969 and parts of Chapter III.

CHAPTER II
THE CURRENT BALANCE

The primary aim of this chapter is to provide an analysis of the current balance of Malaysia during the sixties. Some general comments will be presented first, and these will be followed by a more detailed study of the major component parts of the current balance. Finally, a brief discussion of the current accounts[1] of the component states of Malaysia – Peninsular Malaysia, Sarawak and Sabah – will be given. The inclusion of the last section is thought to be worthwhile because the individual current accounts indicate the extent of the contributions these states make to the overall Malaysia current balance.

The current balance, that is, the balance of goods, services and transfers of Malaysia (Table 2-1) has fluctuated not only in size but also from surplus to deficits. In 1960, there was a current balance surplus of $433m., the second largest during the sixties. This was mainly due to the very high average rubber price of 108 cents per pound, which was the highest reached during the sixties, (see Table 2-3). After 1960, a sharp deterioration in the current balance was experienced until a reversal in 1965. The deficits in 1962 and 1963 were $164m. and $219m. respectively. In 1964, there was some improvement in the current balance although a deficit persisted. There were two main causes for the unfavourable current balances during this period.

Firstly, Indonesian Confrontation resulted in a cessation of trade between Malaysia (including Singapore until 1965) and Indonesia. Of equal importance was the fall in price of Malaysia's main primary exports – rubber, palm oil and iron ore. On the other hand, it is important to note that the price of timber, the third largest foreign exchange earner for Malaysia showed an increasing trend throughout the sixties. The smaller deficit of the current account in 1964 compared to that of 1963 was probably due to a favourable average price for palm oil.

1965 marked a change in the current balance situation of Malaysia. Since 1965, it has been in surplus. The current balances of 1965, 1968 and 1969 deserve some comment. In 1965, the average prices of all Malaysia's primary exports increased. The price of palm oil reached a peak of $842 per ton. The very large surplus in the current balance in 1968, in spite of falling average export prices for rubber, tin, palm oil and iron ore, reflects a significant change in the export situation in Malaysia. 1968 may be considered as a watershed in that it

[1] There is a difference between current balance and current account.

TABLE 2-1 Malaysia – Current and Visible Balance, 1960-70 ($ m)

	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970
Current Balance	433	−18	−164	−219	−159	90	40	2	117	687	217
Visible Balance	1009	539	340	286	275	526	559	477	643	1481	1034

Source: Bank Negara Malaysia, *10th Commemorative Issue, 1969.*
Bank Negara Malaysia, *Annual Report, 1971,* Vol. 4, p. 66

TABLE 2-2 Malaysia – Year to Year Changes in the Current Balance and the Visible Balance, 1960-70, ($ m)

	60/61	61/62	62/63	63/64	64/65	65/66	66/67	67/68	68/69	69/70
Current Balance	−451	−146	−55	60	249	−50	−38	115	570	−470
Visible Balance	−470	−199	−54	−11	251	33	−32	166	838	−447

Source: Computed from Table 2-1.

TABLE 2-3 Malaysia — Average Prices of Selected Export Commodities, 1958-70.

	Rubber RSS 1. ct. per lb.	Tin Straits ex-works $ per picul	Palm Oil $ per ton	Iron Ore $ per ton	Sawn Logs Timber $ per ton of 50 cu. ft.	Sawn Timber $ per ton of 50 cu. ft.
1958	80.21	369.35	695.0			
1959	101.56	396.56	724.8			
1960	108.08	393.68	690.1			
1961	83.54	446.85	707.0	25	74	159
1962	78.20	447.79	659.0	26	78	148
1963	72.41	455.40	654.7	27	80	168
1964	68.14	619.42	730.2	26	72	181
1965	70.02	702.80	841.6	24	78	183
1966	65.36	645.23	732.7	24	85	164
1967	54.68	600.10	690.6	23	94	177
1968	53.13	565.56	523.0	22	94	190
1969	69.88	626.56	544.6	22	98	200
1970	56.40	646.77	810.0	22	102	209

Source: Bank Negara Malaysia, *Quarterly Economic Bulletin*, Vol. 4, 1971, p. 61.

marked the year when rubber output was expanded by an increasing proportion of high-yielding trees reaching the productive stage. This was the result of re-planting and new planting with higher-yielding clones in both small-holdings and estates during the late fifties and early sixties.

The favourable current balance in spite of falling average export prices meant that the supply of exports had increased significantly. In 1968, rubber production exceeded the million ton level for the first time and was 11.4% higher than production in 1967. The production of palm oil and palm kernel had also shown substantial increases in 1968, an increase of 25% over the production level of 1967. Production of sawn logs increased by 11.4% and sawn timber by 15.7%.

In spite of the May racial riots in the Federal capital, the current balance surplus of $687 m in 1969 was the largest during the sixties. This resulted primarily from the upsurge in earnings from primary exports, particularly rubber. The average prices for all primary commodities showed a marked increase over 1968.

A general feature of the current balance is that the movements or fluctuations appeared to have been in the same direction as those of the visible balance. This can be seen from Table 2-2. For the year 1960/1, 1964/5, 1968/9 and 1969/70 when the year to year changes in the visible balances were largest, the current balance year to year changes behaved in a similar manner. In addition, the direction of year to year changes for both series moved in the same direction for most years with the exception of 1963/4 and 1965/6. This close correlation between the two series was closely associated with fluctuations in the prices of primary exports. It also indicated the heavy reliance of the current balance on the visible balance.

The visible balance (including non-monetary gold) in the current balance had consistently been favourable but fluccuating in size. This feature is not unique to Malaysia but occurs in most developing countries whose economies are geared to the production of a few primary commodities. It is also the legacy of a former colonial economy in which there was a heavy reliance on primary exports with volatile prices.

The extent of fluctuations in the prices of the main primary exports can be seen from Table 2-3. Rubber prices fluctuated from 53 cents per pound to 108 cents per pound. Tin prices ranged from a low of $369 per picul to $665 per picul. Palm oil prices changed from $523 per ton to a peak of $841 per ton. Sawn timber prices fluctated from $148 per ton of 50 cubic feet to $209 per ton.

Although Malaysia has embarked on an industrialization programme, it is unlikely that the present heavy reliance of the visible balance on primary exports can be changed. It should also be noted that there is no *a priori* reason why Malaysia's balance of payments should not continue to depend on this sector.

On the other hand, the invisible balance has traditionally been in deficit, In recent years, the invisible balance has become progressively unfavourable, partly on account of larger payments in the investment income, insurance and

freight and lower foreign military expenditure following the phased withdrawal of British military forces from the country in 1971. Having a persistent deficit in the invisible balance implies that whether the current balance is favourable or unfavourable is dependent on whether the surplus in the visible balance is sufficient to offset the invisibles.

THE VISIBLE BALANCE

The agricultural character of the Malaysian economy determines the pattern of its international trade. The country also possesses some mineral resources, namely, tin and iron ore, which are also exported. In terms of value, rubber, tin, timber, palm oil and canned pineapples accounted for about 78% of the total value of exports. (see Table 2-9).

Some general trends of the visible balance by commodity sections are indicated by Table 2-4. Section 2 – Crude Materials Inedible – and Section 4 – Animal and Vegetable Oils and Fats, were in surplus throughout the decade. The main primary exports are included in Section 2 while palm oil is in Section 4. The surpluses of Section 2 fluctuated during this period and were caused by fluctuating export prices. The surpluses of Section 4 reflected an increasing trend in value.

On the other hand, Malaysia is an importer of food, manufactured goods, machinery and transport equipment. During the sixties, these three categories in descending order of importance were machinery and transport equipment, food and manufactured goods. They formed on average about 54% of the total import bill.

The Table also indicates that the balance of trade in Section 0 – Food – has been fairly stable. This was due to the effects of import substitution of rice, especially after 1965. On the other hand, Section 7 – Machinery and Transport Equipment – reflects an increasing trend with the exception of 1967 when the level of economic activity slowed down because of very low rubber prices. The price of rubber in August 1967 dropped to 48.6 cents per pound. Until 1970, this was the lowest level recorded for the last nineteen years. The trend of the import bill for manufactured goods was also an increasing one. Finally, it is worthwhile to note that there was a decreasing trend in the value of imports for Beverages and Tobacco. This decreasing trend was the result of greater import substitution in these industries.

Having indicated the general trends of the visible trade by commodity sections, some of the more pronounced characteristics may be studied in greater detail.

Firstly, a study of the year to year changes in the level of total exports from, and total imports into, Malaysia (see Table 2-6) indicates that the export percentage changes fluctuated to a greater extent than those of imports percentage changes. The export percentage changes ranged from - 11.4% in 1961 to 22.5% in 1969, while the import percentage changes fluctuated from -1.4% to a maximum of 15.8% in 1970.

TABLE 2-4 Malaysia – Visible Trade: Analysis by Commodity Sections, 1960-70, ($m)

	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970
Section 0 – Food											
Exports	129.5	148.0	151.8	146.9	163.5	198.8	203.7	207.5	220.5	233.7	283.4
Imports	651.9	665.2	670.1	783.1	835.4	749.6	748.0	762.1	766.2	727.5	757.8
Balance	−552.4	−517.2	−518.3	−636.2	−671.9	−550.8	−544.3	−554.6	−545.7	−493.8	−474.4
Section 1 – Beverages and Tobacco											
Exports	13.6	21.3	34.4	43.7	27.3	41.5	19.2	21.5	11.0	16.9	21.3
Imports	109.3	127.4	125.6	130.5	114.3	123.5	90.6	90.2	77.9	87.0	96.1
Balance	−95.7	−106.1	−91.2	−86.8	−87.0	−82.0	−71.4	−68.7	−66.9	−70.1	−74.8
Section 2 – Crude Materials Inedible											
Exports*	2968.0	2621.5	2561.2	2637.9	2644.0	3531.8	2956.7	2804.9	3090.0	3936.5	3780.2
Imports	378.7	310.9	361.2	307.3	241.4	237.7	163.7	165.8	282.2	302.6	314.6
Balance	2589.3	2310.6	2200.0	2275.6	2402.6	2694.1	2793.0	2639.1	2805.8	3633.9	3465.6
Section 3 – Mineral Fuels											
Exports	290.1	225.2	237.2	209.8	235.7	244.1	275.5	395.5	351.0	339.4	364.6
Imports	416.2	358.6	376.0	355.5	364.8	388.5	437.2	446.6	500.7	485.7	516.0
Balance	−126.1	−133.4	−138.8	−145.7	−129.1	−144.4	−161.7	−51.1	−149.7	146.3	−151.4
Section 4 – Animal and Vegetable Oils and Fats											
Exports	87.1	91.3	90.2	93.0	95.2	125.7	142.2	141.7	165.4	177.6	330.4
Imports	15.4	15.7	15.7	14.4	15.3	18.2	15.2	15.2	21.9	19.2	23.9
Balance	71.7	75.6	74.5	78.6	79.9	107.5	127.0	126.5	143.5	158.4	306.5

TABLE 2-4 continued .....

	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970
Section 5 – Chemicals											
Exports	18.5	20.8	21.6	28.9	35.1	37.1	35.2	34.3	37.5	38.7	35.6
Imports	164.9	181.9	173.3	189.9	201.3	233.9	252.0	248.2	239.5	274.7	312.8
Balance	−146.4	−161.1	−151.7	−160.0	−166.2	−196.8	−216.8	−213.9	−202.0	−236.0	−277.2
Section 6 – Manufactured Goods											
Exports	41.1	63.3	53.1	48.4	56.2	66.6	74.9	83.5	98.0	138.9	176.0
Imports	423.7	473.2	534.8	545.3	544.2	597.6	608.4	592.5	613.5	624.2	766.0
Balance	−382.6	−409.9	−481.7	−496.9	−488.0	−531.0	−533.5	−509.0	−515.5	−485.3	−590.0
Section 7 Machinery and Transport Equipment											
Exports	34.2	44.4	53.4	53.6	57.8	65.7	67.4	56.5	73.6	83.7	84.4
Imports	395.8	458.0	561.4	613.0	631.3	728.6	799.7	735.8	792.7	840.9	1207.2
Balance	−361.6	−413.6	−508.0	−559.4	−573.5	−662.9	−732.3	−679.3	−719.1	−757.2	−1122.8
Section 8 – Miscellaneous Manufactured Articles											
Exports	17.9	20.9	32.2	25.9	27.0	26.9	24.1	29.6	31.3	33.8	43.1
Imports	150.1	160.7	171.7	187.4	191.3	206.3	188.9	193.5	188.4	132.8	201.9
Balance	−132.2	139.8	−139.5	−161.5	−164.3	−179.4	−164.8	−163.9	−157.1	−149.0	−158.8

* Includes tin metal from section 6.

Source: Bank Negara Malaysia, *Quarterly Economic Bulletin*, Vol. 4, No. 2, June 1971, pp. 62-63.

TABLE 2-5 Malaysia: Total Exports (f.o.b.) and Imports (f.o.b.), 1960-70, ($m)

	Gross Exports (F.O.B.)	Gross Imports (F.O.B.)	Visible Balance
1960	3,622	2,613	1,009
1961	3,208	2,669	539
1962	3,232	2,892	340
1963	3,296	3,010	286
1964	3,346	3,071	275
1965	3,752	3,226	526
1966	3,808	3,249	559
1967	3,679	3,202	477
1968	4,070	3,427	643
1969	4,986	3,505	1,481
1970	5,089	4,055	1,034

Source: Bank Negara Malaysia, *Quarterly Economic Bulletin*, Vol. 4, No. 2, June 1971, p. 66.

A priori one might be tempted to argue that greater export incomes would result in an increase of consumption of imported goods. This is because of higher per capita income. Similarly, greater export incomes may generate greater confidence in the economy and this may stimulate an increase in private investment. This again may increase the volume of imported goods. To some extent the arguments seem reasonable.

However, an important implication of the results of Table 2-6 is that to some extent the level of consumption of imports is not, and never has been, entirely dependent upon the level of exports. For instance, in 1962 there was a large expansion of imports when compared to the low level of exports. The percentage change in imports was 8.3% while the percentage change for exports was only 0.8%. This was the case because '...a remarkable momentum was given to the country's Second Five-Year Development Plan, 1961-1965, after the slow start in the first year of the plan-development expenditure to the public sector achieved a remarkable increase of about 50% over the performance of the previous year.'[2]

Another indicator which supports the conclusion that the level of consumption of imports did not rigidly follow the level of exports was the movement of

[2] Bank Negara Malaysia, *Annual Report, 1962*, p. 1.

TABLE 2–6 Malaysia – Year to Year Changes of Exports and Imports, 1960-70.

	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970	Average
Export %											
Change	−11.4	0.8	1.9	1.7	12.1	1.5	−3.4	10.9	22.5	2.0	3.9
Import %											
Change	2.1	8.3	4.0	2.0	5.0	0.7	−1.4	7.0	2.3	15.8	4.6

Source: Computed from Table 2-5.

the volume indices of exports and imports. The indices are given in Table 2-7. This conclusion also holds if a time-lag of a year is allowed for. Again, the import volume indices do not rigidly follow the export volume indices.

TABLE 2-7 Peninsular Malaysia – Price and Volume Indices, 1961-67.

	Exports		Imports	
	Price Index 1964=100	Volume Index 1964=100	Price Index 1964=100	Volume Index 1964=100
1961	101	94	93	96
1962	97	97	90	104
1963	94	103	94	105
1964	100	100	100	100
1965	105	107	95	102
1966	99	111	94	98
1967	90	113	94	95

Source: Department of Statistics, *Data for the IMF Consultations*, 1969, Malaysia, 28, July 1969, p. 14

For the period 1964-7, the volume index of exports reflected an increasing trend. For the same period, the volume index of imports indicated a decreasing trend. This partial independent movement of imports may or may not be desirable.

Such a movement of imports is desirable when a period of large export earnings is matched by a comparatively lower level of import consumption. To some extent, this reflects some saving of foreign exchange which may be used during periods when export earnings fall. It is also very probable that with a high level of profits, the gain in foreign exchange is partially offset by a higher outflow of foreign reserves as remittances of profits and dividends. On the other hand, during a period of low export earnings, the comparatively stable level of consumption and investment imports is one of the main causes for a deficit in the overall balance of payments.

Another significant feature of the visible balance during the sixties was that rubber continued to be the largest foreign exchange earner. The average contributions of rubber to the total export earnings for the sixties (see Table 2-9) was 41%. The other main contributions to the visible balance were tin (19%), timber (11%), iron ore (4%) and palm oil (3%). The contribution from manufactured and processed products was 12%.

This heavy reliance on one export commodity has been one of the main causes for balance of payments deficits or surpluses in Malaysia. A deficit arises

when exports earnings are below their usual level while imports are at approximately the level that would ordinarily be expected. Within the Malaysian context, the level of imports for consumption and investments are more predictable and stable because they consist mainly of Sections 0, 6 and 7.

Bernstein terms such a cause of balance of payments deficits as a 'structural-change' in the competitive position of certain export industries.[3] In the case of rubber, the development of synthetic rubber has been the basic cause of this 'structural change'. It can be argued that Bernstein's theory is only partially true for Malaysia. The introduction of synthetic had brought about a 'structural change' and had affected the price of rubber. However, fluctations in rubber prices are almost certainly not caused only by the introduction of synthetics. This is because change in the demand for rubber is not solely determined by the supply of synthetic. The price for rubber is a function of other variables, that is the supply of rubber natural and synthetic as well as certain events such as military build-ups, potential wars or other random events.

However, in spite of the dominant position of rubber in the visible balance, it is important to note the decline in the export values, absolutely as well as relatively. Rubber as a percentage of total exports showed a declining trend. (See Table 2-9). The importance of rubber declined from 55% of the total earnings in 1960 to about 33% in 1970. 1969 represented a year when the increase in rubber prices pushed the percentage contributions to 40%. On the other hand, there was a rising trend in the contribution of timber to the visible balance. Timber currently represents the third largest foreign exchange earner for Malaysia. The contribution of tin has remained fairly stable at about 20% of total export earnings. This is also true for manufactured and processed products which form, and have formed, about 12% of the export earnings. The palm oil trend has also been increasing though at a very slow rate. Iron ore production has been decreasing, and its future is bleak because of the depletion of resources as well as the reduced foreign demand. Japan is practically the sole foreign market for Malaysian iron ore, and in recent years she has been diversifying the sources of supply and entering into long-term contracts to buy from Australia, India and countries in South America. This has resulted in a progressive decline in the demand for Malaysia's iron ore.[4] The main iron ore mine – Rompin in Pahang – has now closed.

The export values of canned pineapples (including pineapple juice) has been around M$44m. from 1966 to 1970. The prospects of the pineapple industry are poor because of Britain's possible entry into the Common Market. The United

[3] E.M. Bernstein, 'Strategic Factors in Balance of Payments Adjustment,' *IMF Staff Papers*, 1956-7, Vol. 5, Washington, D.C., p. 158.

[4] Bank Negara Malaysia, *Annual Report, 1965*, p. 28.

TABLE 2-8 Malaysia – Gross Exports by Major Products, 1960-70, ($m)

	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970
Rubber	1000	1567	1477	1476	1396	1462	1474	1275	1353	2031	1724
Tin	503	553	630	642	728	872	793	756	830	940	1013
Timber	194	185	210	267	294	358	468	583	699	769	831
Palm oil	61	61	65	69	81	107	129	125	140	166	269
Iron ore	140	164	166	176	163	161	136	122	111	116	107
Pineapple, canned	26	24	27	28	33	40	44	43	48	44	43
Manufactured goods	–	–	–	–	–	–	475	488	521	561	630

Source: Bank Negara Malaysia, *Annual Report, 1970*, pp. 113, 114.
Bank Negara Malaysia, *Quarterly Economic Bulletin*, Vol. 4, No. 2, 1971, p. 57.
First Malaysia Plan, 1966-1970, p. 23
Department of Statistics, *Data for the IMF Consultations, 1969*, Kuala Lumpur, p. 15.

TABLE 2-9 Malaysia – Selected Commodities as percentage of Total Exports, 1960-70

	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970	Average
Rubber	55.1	48.3	45.3	44.3	41.3	38.6	38.3	34.2	32.8	40.2	33.6	41.1
Tin	14.0	17.0	19.0	19.3	21.5	23.0	20.6	20.3	20.1	18.6	19.7	19.4
Timber	5.3	5.7	6.4	8.0	8.7	9.5	12.3	15.7	16.9	15.2	16.2	10.9
Palm oil	1.7	1.9	2.0	2.0	2.4	2.8	3.3	3.3	3.4	3.2	5.2	2.8
Iron ore	3.9	5.0	5.0	5.3	4.8	4.3	4.5	3.3	2.7	2.3	2.1	3.8
Pineapple	–	–	–	–	–	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Manufactured goods	–	–	–	–	–	–	12.4	13.1	12.7	11.1	12.3	12.3

Source: As Table 2-8.

Kingdom provided the main market and absorbed about 40% of Malaysia's total exports in 1970. Malaysian canned pineapples now enjoy duty free entry into the British market. The entry of Britain to the Common Market would adversely affect the industry unless the present substantial import duty of 24% applicable in Common Market countries is greatly reduced.[5]

The fact that rubber has declined in relative importance with respect to the visible balance leads to the important conclusion that the position of the visible balance is no longer so vulnerable to fluctuations in export prices of rubber. This is true of downward movement in rubber price though less true of upward movement. At least, this is what appears to have happened in the 1960s, on average, though without doubt rubber has been and still is the main support of the Malaysian economy. However, it is important to note that there is now a certain amount of built-in stabilization. The increasing importance of timber, palm oil and the fairly stable but significant contributions of tin and manufactured and processed products can provide a compensating effect on the visible balance.

When the price of rubber falls, the prices of other primary exports may rise. This is because the changes in prices of other primary exports are not related to changes in the price of rubber. This would to some extent offset the adverse effects falling prices would have on the visible balance. However, whether this compensating effect would be sufficient to overcome the loss due to lower rubber prices would naturally depend on individual price movements. This important feature can be seen from Table 2-3. For instance, in 1970, when the average price of rubber fell, the prices of tin, palm oil and timber rose. On the other hand, it is also possible for a situation to arise when the average price of rubber increases while that of palm oil and tin falls. Such was the situation in 1960 for instance. There would still be some compensating effect in this case. However, there would be no compensation effect when the average prices of all primary commodities fell, which happened in 1966 and 1967.

In any case, the important conclusion is that with the decreasing relative importance of rubber, the increasing relative importance of timber and palm oil and the fairly stable contributions of pineapples, tin and manufactured and processed products, the visible balance has become less vulnerable to fluctuations in rubber prices. This situation does not seem to have reflected any deliberate government policy even though a diversification programme has been one of the main priorities in the Second Development Plan, 1961-1965.

It seems more likely that this situation has been brought about by the action of private individuals – especially in palm oil and timber. Government commitment to diversifying crops was very slow during the sixties.

The possible long-run implication of this situation is that for the visible balance

[5] Bank Negara Malaysia, *Annual Report, 1970*, p. 114.

to be adversely affected either of two situations must arise. The first would be when decreases in rubber prices are not sufficiently compensated by rises in prices of other primary exports. The second would be when the prices of all primary exports might fall simultaneously. Since the probability for all prices of primary commodities to fall simultaneously is less than the probability of of one commodity's price falling, it can be concluded that the first situation is more likely to be the cause of an adverse visible balance. And this is why, probably, the upward movements in rubber prices seem to have had more effect on the balance of trade than downward movements.

The other factor affecting the visible trade is imports. In general, the increasing trend in the absolute value of imports (see Table 2-11) into Malaysia during the sixties, reflects four basic economic changes.

Firstly, it reflects rising per capita income of the Malaysian population. The per capita gross national product for the period 1960 to 1970 is given in Table 2-10. Rising per capita incomes tend to increase demand for imports.

Secondly, with a high population growth rate of about 3% per annum for the sixties, a rise in import consumption is to be expected.

Thirdly, the sixties witnessed the Second Development Plan, 1961-1965 and the First Malaysia Plan, 1966-1970. As a result of the government's commitment to economic development, there was a substantial increase in public investment and expenditure. Public development expenditure averaged about $620m. annually during the 1961-5 period. The level of government expenditure was stepped up during the 1966-70 period to about $830m. annually.

Finally, and of greater importance in terms of magnitude, was the level of private investment during this period. During 1961-5, the annual average private investment was $900m. During the 1966-70 period yearly private expenditure was increased to $1,000m. The main sectors of private investment expenditure were in perennial crops, construction, machinery and transport equipment.

A significant feature of Malaysian imports by commodity section has been the dominant position of Section 0 – Food (See Tables 2-11 and 2-12). On average, food has formed about 22% of the total imports into Malaysia. It is significant to note that from 1965 food as a percentage of total imports showed a declining trend. Since rice formed about 25% of Section 0, it seems reasonable to suggest that the main cause for the declining trend was the increased local production of rice, especially after 1965. The declared policy of the government with regard to rice is to encourage and foster the conditions for increasing production was to be achieved in two main ways: by increasing the acreage under rice (as well as double-cropping) and through the use of better seeds such as *Malinja, Mahsuri, Ria* and *Bahagia.* As a result of this policy, the level of self-sufficiency of rice has increased to 84% in Peninsular Malaysia in 1970. In 1969,

TABLE 2-10 Malaysia – Per Capita Gross National Product, 1960-70, ($ m)

1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970
820	798	815	843	869	932	961	967	986	1060	1080

Source: Computed from Bank Negara Malaysia, *10th Commemorative Issue, 1969*, p. 56. *Annual Report, 1970*, p. 66.

TABLE 2-11 Malaysia – Gross Imports by Commodity Sections, 1961-70, ($m)

Commodity Section	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970
Section 0 – Food	665	670	783	835	750	748	761	766	728	757
Section 1 – Beverages + Tobacco	127	126	131	114	124	91	90	78	87	96
Section 2 – Inedible crude material	311	361	307	241	238	164	166	284	301	310
Section 3 – Mineral fuels	359	376	356	365	389	437	447	501	486	516
Section 5 – Chemicals	182	173	190	201	234	252	248	240	275	313
Section 6 – Manufactured goods	473	535	535	544	589	608	593	614	624	763
Section 7 – Machinery + Transport equipment	458	561	613	631	729	800	736	793	841	1200
Section 8 – Miscellaneous manufactured goods	160	172	187	191	206	189	194	188	183	201
Section 9 + 4 – Miscellaneous transactions + Vegetable oils	70	83	81	81	90	91	90	88	80	92
Total	2816	3056	3193	3205	3356	3380	3325	3552	3606	4248

Source: Bank Negara Malaysia, *Annual Report, 1970*, p. 116, *10th Commemorative Issue, 1969*, p. 63.

TABLE 2-12 Malaysia – Commodity Sections as percentage of Total Imports, 1961-70.

	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970	Average
Section 0	23.6	21.9	24.5	26.0	22.3	22.1	22.9	21.6	20.2	17.8	22.3
Section 1	4.5	4.1	4.1	3.6	3.7	2.7	2.7	2.2	2.4	2.3	3.2
Section 2	11.0	11.8	9.6	7.5	7.0	4.8	5.0	8.0	8.4	7.3	8.0
Section 3	12.5	12.3	11.1	11.4	11.6	12.9	13.4	14.1	13.5	12.1	12.5
Section 5	6.5	5.7	5.6	6.3	7.0	7.5	7.5	6.7	7.6	7.4	6.8
Section 6	16.8	17.5	16.8	17.0	17.8	18.0	17.8	17.3	17.3	17.9	17.4
Section 7	16.3	18.4	19.2	19.7	21.8	23.0	22.1	22.3	23.3	28.2	20.4
Section 8	5.7	5.6	5.9	6.0	6.1	5.6	5.8	5.3	5.1	4.7	5.6
Section 9 + 4	2.5	2.7	2.5	2.5	2.7	2.7	2.8	2.5	2.2	2.3	2.5

Source: Computed from Table 2-11.

the levels of self-sufficiency for Sarawak and Sabah were 64% and 66% respectively. During the sixties, the average annual change in terms of value of Section 0 – Food was only 2% and this can be considered as a very favourable rate when compared with the population growth rate of nearly 3% per annum. This lower average annual change in food indicates that import-substitution of food, especially rice, has been achieved to a great extent. The implication of this on the visible balance is that food as percentage of total imports will remain at around 20% or possibly decline marginally. However, whether the government has been justified on balance of payments grounds in promoting import-substitution of rice through extensive investment and reallocation of resources is questionable.[6] This problem will be dealt with in greater detail in Chapter VI. It might be worthwhile to mention here, however, that although there are some minor gains through a scheme of import-substitution of rice, the opportunity costs far outweigh such gains. The Federal Agricultural Marketing Authority stated that '...despite the introduction of double-cropping in recent years, returns from padi farming are still low compared to other commercial crops. A preliminary estimate is that at farm level prices of 47 cents per pound for rubber, $700m. per ton for oil palm, $14 per picul for padi, returns to padi farmers per acre of cultivated land would barely be 50% of returns to farmers from the other two products'.[7]

Another feature of Malaysia's imports has been the growing importance of Section 7 – Machinery and Transport Equipment. For the period 1961-70, the absolute import value of Section 7 showed an increasing trend. This increasing trend is also reflected if Section 7 is taken as a percentage of total imports. This should be expected because Malaysia is still at an early stage of industrial development and the needs and demand for capital investment goods are great. Since Malaysia includes industrialization as part of her economic development programme, it seems reasonable to suggest that the relative importance of Section 7, both in absolute values and percentage terms with respect to the total import payments will continue to increase.

The very large increase in the import value of Section 7 in 1970 as compared to that of 1969 reflects two factors. Firstly, it reflects an upsurge in consumption and investment activity. This larger than usual increase in consumption and investment may have been the result of a postponement of expenditure during the racial disturbances in 1969. Secondly, to some extent, the increase in the

[6] Chai Doan's cost/benefit study of the Muda Irrigation Scheme indicates that the cost/benefit ratio is 1:1.6. The low cost/benefit further supports the view that the Government's rice policy may be unjustified. For a detailed discussion see Chew Chai Doan, 'Resource Allocation in West Malaysia with special reference to the River Muda Project', M.A. thesis, Chapter VI, University of Hull, 1972.

[7] Federal Agricultural Marketing Authority, *Annual Report and Statements of Accounts*, 1965 and 1966, p. 30.

value of imports was due to higher import prices as a result of price inflation in many industrial countries, and to a lesser extent, the higher prices of goods from the Federal Republic of Germany as a result of the revaluation of the Deutsche mark in 1969.[8]

When a distinction can be made between imports for consumption and imports for investments or capital formation some important inferences can be drawn. The statistics for imports and end-use are in Table 2-13. The significant feature of this table is that the percentage growth per annum for 1961-7 of imports for consumption was 2.8% while that of investment imports was 8.5%. These statistics further support the view that as industrialization gathers momentum, the import bill due to Sections 7 and 3 increases. It is unlikely that changes in the level of export earnings affect the level of investment imports. The absolute levels of imports for capital formation during 1963 and 1964 did not decline in spite of the fact that the balance of payments was in deficit. It might possibly be argued that had there been no balance of payments deficits, the level of import investments might have been higher. It is difficult to prove this but the important point is that the level of investment imports did not fall below those of 1961 and 1962. One important inference which might be drawn from this is that this part of the import bill is fairly inflexible downwards. An indication of the relative importance of investment imports is that, on average, they have formed about 26% of the total imports into Malaysia.

The other major form of imports classified by sections was Section 6 – Manufactured Goods (not elsewhere classified). Manufactured goods during the sixties formed about 17% of total imports. It is significant that the yearly percentage figures remained fairly constant. It mainly reflected the increasing substitution of imports by local manufacturers.

To a great extent, the import values of Section 3 – Mineral Fuels – can be correlated with those of Section 7. This is because Malaysia has no mineral fuel resources of her own. Mineral fuel formed about 13% of the total import bill.

When the percentage contributions of Sections 0, 3, 6 and 7 are taken together, they have represented on average about 74% of the total import bill. Since these four sections have consisted of food, mineral fuels, manufactured goods and machinery and transport equipment, it is unlikely that any of these sections can be reduced to any significant extent in the short run. Although there is every possibility that the production of local rice can be increased, the margin for further substitution is only 16% in 1970 for Peninsular Malaysia. The present rate of population growth of nearly 3% per annum can contribute to some expansion in the scope for import-substitution. However, the long run implication

[8] Bank Negara Malaysia, *Annual Report, 1970*, p. 115.

TABLE 2-13 Malaysia – Imports by End-Use, 961-7

	1961	1962	1963	1964	1965	1966	1967
Gross Imports $m	2816	3057	3193	3205	3356	3379	3325
Imports for re-exports and exports processing	425	479	419	333	345	250	260
Total retained imports	2391	2578	2774	2872	3011	3129	3065
Imports destined for consumption	1864	1902	2059	2171	2195	2227	2203
Imports destined for capital formation	527	676	715	701	816	902	862
Investment imports as % to total retained imports	22.0	26.2	25.8	24.4	27.1	28.8	28.1
Consumption imports as % of total retained imports	78.0	73.8	74.2	75.6	72.9	71.2	71.9

Source: Unpublished report, IBRD *Economic Mission to Malaysia,* July/August 1968, p. 51.

is that these four sections represent the hard core of Malaysian imports and it is not likely that they can be reduced to any considerable extent. Thus, the future of Malaysia can only be ensured by an aggressive and correct export policy. A recommendation for two export policies, one for manufactured goods to other developing countries and the other to advanced countries is given in Chapter VII:

The relationship between the current balance, visible balance and the terms of trade can be seen from Table 2-14. The reason why two categories of terms of trade are given, namely, the net barter terms of trade and the income terms of trade is because the former reflects price changes only without any consideration being given to the volume of exports. The latter index takes into account both volume and prices.[9]

A feature of Table 2-14 is that there appears to have been a closer relationship between visible balance and the terms of trade. The net barter terms of trade had been favourable for all years except 1967. For the same period, the visible balance has also been in surplus. On the other hand, the current balance was in deficit from 1961-4. The same conclusion was true in this period for the correlation between the income terms of trade, the visible balance and the current balance.

Another feature of Table 2-14 is that, prior to 1964, the impact of the net barter terms of trade on the visible balance was greater than that of the income terms of trade. On the other hand, after 1964, the income terms of trade has had a greater effect on the visible balance.

A summary of the main conclusions of the visible balance would include the following:

1. A main conclusion of this study of the visible balance is that it was in surplus throughout the sixties. However, the visible surplus varied from year to year,

[9]Since it is especially important for a country to take its volume of exports into account, one may want to connect the movements in net barter terms of trade to changes in export volume. The income terms of trade do this, and are expressed as $L = N.Q_x$ where Q_x is the export volume index and N the net barter terms of trade. A rise in L indicates that the country can obtain a larger volume of imports from the sale of its exports: its export based capacity to import has increased. The export based capacity to import should be distinguished from the total capacity to import which depends not only on exports but also capital inflow, other invisible exchange receipts and foreign exchange reserves. Nor should a change in the income terms of trade be interpreted as an indicator of welfare, it should be used simply as a measure of the quantity of imports bought by exports. The income terms of trade is useful because with deteriorating net barter terms of trade, that is, falling prices, an increasing volume of exports is sold in order to maintain the level of imports or to indicate that the country has the capacity to import more because of increased production. This may be typical for Malaysia where goods should be regarded as something given and fixed to this economy because the demand for imports as a whole is rather inelastic because many of the imported manufactured consumer's goods, machinery and equipment, and fuels are essential for the industrialization progress. The indices for the computation for terms of trade were the price and volume indices of exports and imports for Peninsular Malaysia. It is assumed

TABLE 2-14 Malaysia – Current Balance, Visible Balance and Terms of Trade, 1960-70

	Current Balance $m.	Visible Balance $m.	Net Barter Terms of Trade (1964=100)	Annual Change	Income Terms of Trade (1964=100)	Annual Change
1960	433	1009				
1961	–13	539	109		102	
1962	–164	340	108	–1	105	3
1963	–219	286	100	–8	103	–2
1964	–159	275	100	0	100	–3
1965	90	526	109	9	117	17
1966	40	554	105	–4	116	–1
1967	2	477	96	–9	108	–8
1968	117	643				
1969	687	1481				
1970	217	1034				

Source: Prices and Volume indices from Table 2-7.

Net Barter Terms of Trade = Export price index/Import price index

Income Terms of Trade = $N.Q_x$ where N is the net barter terms of trade and Q_x is the export volume index.

from a high level of $1,480m. in 1969 to $247m. in 1963. This fluctuation in the level of surplus was due to changes in export prices of primary commodities. As a result, the fluctuations in the year to year changes in the level of exports was greater than those of the year to year changes in the level of imports. This implies that a certain minimum level of imports would have to be maintained irrespective of the level of export earnings. These imports tend to consist largely of machinery and transport equipment, mineral fuels and manufactured products.

2. A second conclusion is that a certain degree of built-in stabilization against fluctuations in export prices of rubber has evolved over the 1960s. This has occurred due to the decreasing importance of rubber as a percentage of total exports. The growing importance of timber and palm oil provided the compensating effect. The relative importance of tin and pineapples remained fairly stable during this period.
3. Another conclusion is that there has been a significant reduction in the imports of Section 2 – Beverages and Tobacco. On the other hand, the absolute value of imported food had remained fairly stable in spite of population growth rate of nearly 3% per annum. This means that the import-substitution of Section 0 and 2 has been successful to some extent.
4. Finally, the terms of trade of Malaysia have not been unfavourable but it is apparent that since 1965, the income terms of trade have had a greater impact on the visible balance than the net barter terms of trade.

INVISIBLE BALANCE

The invisible balance can be considered as consisting of two main sections. These sections are the service balance and the transfer balance. The former account consists of payments and receipts arising from the provision of some facilities or services such as insurance, shipping facilities, banking services, etc. On the other hand, the transfer balance consists of pure transfers without a current corresponding provision of services. These two sections will be dealt with separately.

In general, Malaysia's service balance was persistently in deficit during the sixties. This can be seen from Table 2-15. The size of the persistent deficits varied from year to year and their main causes were the payments for freight and insurance and investment income.[10] Both these items were in turn largely determined by the volume and value of trade. This was especially true for freight and insurance as this latter factor by its nature represented the trading service overheads.

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that these indices would reflect with fair accuracy the terms of trade for the whole of Malaysia. The need for making such an assumption has arisen from a lack of statistics for either Sabah or Sarawak.

[10] Investment income refers to remittances of profits, dividends and interest payments.

TABLE 2-15 Malaysia – Invisible Balance, 1961-9, ($m)

	1961	1962	1963	1964	1965	1966	1967	1968	1969
Freight and insurance (net)	−133	−145	−156	−154	−162	−165	−170	−177	−195
Other transport (net)	4	3	3	3	2	2	5	5	−38
Travel (net)	−67	−70	−69	−74	−80	−78	−69	−73	−96
Investment income (net)	−231	−177	−195	−252	−303	−313	−257	−342	−315
Government transactions (net)	145	131	151	184	227	185	135	102	90
Other services (net)	−54	−49	−55	−64	−74	−78	−80	−81	−96
Total	−336	−307	−321	−357	−390	−447	−436	−566	−650

Source: IMF *Balance of Payments Yearbook*, 1963-1970.

Since 95% of shipping was owned by foreigners during the sixties, the large annual payments are to be expected. However, since 1968, the Malaysian government has formed the Malaysian International Shipping Corporation, although on a modest scale. A detailed consideration of the impact of a Malaysian shipping fleet on the balance of payments is given in Chapter VII. The main conclusion is that although there ought to be some gains to the Malaysian balance of payments, the government should not channel capital into it without some comparative cost-benefit studies of alternative projects. The accompanying propensities to import of these alternative projects need to be taken into account as well.

Insurance in Malaysia is also dominated by foreigners.[11] Out of a total of seventy general insurance companies in 1969, sixty-nine were foreign-owned. In the case of general and life insurance companies, six out of nine were foreign-owned.[12] As can be seen from Table 2-15, the payments for freight and insurance indicate an increasing trend. This increasing trend reflects both a higher freight rate of the Conference system as well as a higher level of trade. It might also be possible that some goods were bulkier or more risk-prone per unit of value.

The net travel account has also been negative. On average, the net outflow was about $75m. annually. This to some extent reflects the greater than unitary income elasticities for travel and only limited success in expanding tourism in Malaysia. The ratio of travellers going abroad to foreigners coming into Malaysia in 1968 was 2:1. This was an improvement compared to ten years ago when the ratio was 9:1.[13] Presently, the government has embarked on a programme of promoting tourism in Malaysia, and an assessment of its policy and the possible impact on the Malaysian balance of payments will be made in Chapter VII.

The most important item contributing to the service balance deficit was the net investment income account which was principally made up of profits, dividends and interest payments and receipts. The net figures indicate that the deficits were persistent though fluctuating in size. This deficit is to be expected since about 60% of rubber, tin, banking, insurance and wholesale trade continue to be owned or controlled by foreigners.[14] It has been estimated that about 62% of the share capital of limited companies in 1969 was foreign-owned or foreign-controlled.[15]

[11] Change Sow Khong, 'The Insurance Industry in Malaysia', *Malaysian Management Review*, Vol. 3, No. 1, December 1968, pp. 41-49.

[12] Statistics obtained from *UMBC Economic Review*, Vol. VI, No. 2, 1970, p. 68.

[13] *Malay Mail*, January 70.

[14] V. Kanapathy, 'The Issue of local and foreign investments and the place of multinational corporations in our developing ecnomy', in *The Great Economic Debate*, University of Malay Economic Society, 1971, p. 12.

[15] Bank Negara Malaysia, *Quarterly Economic Bulletin*, Vol. 4, No. 2, June 1971, p. 95.

Detailed information about investment income is scanty and where supplementary statistics are available they have been included below for a better understanding of this important account.

Among the major sources of investment income receipts was Malaysia's share of the distributed income of the Currency Board, which was in existence until 1967. When the Currency Board was terminated, this source of investment income was ended but this loss has been offset by gains from investment of foreign reserves elsewhere. The receipts from the Currency Board for the period 1961-7 were $27m., $39m., $51m., $46m., $36m., $40m., and $72m., respectively. The other main sources of receipts have been income from foreign assets of the Central Bank, the Government, Government Agencies and Malaysia's share of the profits of the Buffer Stock of the International Tin Council.

Data on interest, profits and dividends are only available for 1967-9. A conclusion which can be drawn from the statistics of Table 2-16 is that the main outflow has been payments of profits and dividends rather than interest. Although the data referred only to 1967-9, it is likely that the situation is similar to previous years, since it is unlikely that the investment patterns of foreigners during the early sixties would have been different.

TABLE 2-16 Malaysia – Investment Income, 1967-9, ($m)

	1967	1968	1969
Profits, Dividends (net)	−330.5	−391.4	−458.0
Interest (net)	74.5	86.4	93.0
Total	−256.0	−305.0	−365.0

Source: Department of Statistics, Malaysia, *Data for IMF Consultations, 1969*, p. 4.

The position of outstanding government debt from 1964 to 1970 is given in Table 2-17. The statistics indicate that government debt was increasing. This was also true for the debt servicing burden.

A more detailed study of the level of debt servicing in Malaysia is necessary because this is a factor which often creates balance of payments problems for developing countries.

One of the elements considered when assessing a country's debt position is the debt service ratio: the ratio of amortization and interest payments to the value of exports of goods and services. The debt service ratio is a convenient indicator of actual and potential pressure imposed on the balance of payments as the debt service is a continuing charge against total exports. The proportion

TABLE 2-17 Malaysia – Estimated External Public Debt, 1964-70, (US $ 000)

	1964	1965	1966	1967	1968	1969	1970
Debt outstanding	259,639	230,639	312,257	349,666	418,090	411,685	384,293
Interest	8,681	9,635	9,995	10,968	12,377	15,751	17,239
Amortization	7,419	7,344	9,205	17,360	17,512	25,990	28,214

Source: Unpublished paper of the Economic Planning Unit.

of exports absorbed by the debt service reflects the pressure to which a debtor country would be exposed and the effort it would have to make if capital inflow were to cease. The debt service ratio of Malaysia is given in Table 2-18.

TABLE 2-18 Malaysia – Debt Service as a percentage of Exports of Goods and Services, 1962-9.

1962	1963	1964	1965	1966	1967	1968	1969
0.8	0.9	1.3	1.2	1.4	2.1	2.1	2.2

Source: World Bank, *Annual Reports*, 1963-1970.

The figures clearly indicate that Malaysia does not have a debt servicing problem. The debt service in 1967 was 2%. Compared with other developing countries such as Pakistan (15% in 1967) and Argentina (27% in 1967), the debt service ratio in Malaysia might even be called insignificant.

However, it can be argued that the debt service ratio may have been underestimated. There are two main reasons for suggesting this.

Firstly, the servicing of the government's treasury bills and securities which are owned by foreigners and foreign commercial banks operating in Malaysia have not been included in the debt service ratio. From 1966-70, about 45% of total treasury bills (see Table V-17) are owned by foreign commercial banks. Similarly, foreign insurance companies in Malaysia hold some proportion of the Malaysian treasury bills. Both these institutions are equired by law to hold part of their assets in the form of domestically issued Federal government treasury bills and securities.[16]

In addition, it seems reasonable to suggest that the Malaysian government treats these as sources of funds for financing development projects rather than monetary instruments for open market operations.

In view of these two factors, the servicing of treasury bills and securities should be part of the debt service ratio. The usual distinction between internal and external debts does not allow for this. For example, a foreign firm operating in Malaysia lends money (Malaysian dollars) to the government as a form of investment (or as required by legislation). The firm will receive Malaysian dollars as interest and then as capital repayments. But, given the convertibility between the Malaysian dollar and other currencies, especially the pound sterling, the

[16] The effects of this on the possible use of open market operation by the Central Bank will be dealt in Chapter V.

foreign firm may well transfer pounds to a foreign account. Whilst the process may not be the same, there is still a loss of foreign exchange.

The second reason for suggesting that the debt service results in underestimation within the Malaysian context hinges upon the denominator – exports – of the ratio. It has already been indicated that about 60% of the rubber and tin sectors are foreign-owned. This means that a significant proportion of foreign exchange earnings are not available for debt servicing.

In view of the above arguments, another ratio, net investment income to exports may be more relevant. Table 2-19 indicates net investment income as a percentage of total exports for the period 1961-9.

TABLE 2-19 Malaysia – Net Investment Income as percentage of Exports, 1961-9

1961	1962	1963	1964	1965	1966	1967	1968	1969
7	5	6	7	8	8	7	8	6

Source: Computed from table 2-5 and 2-15.

The main feature of the ratio of investment income to total exports is that it has been larger than the debt service ratio. It is also significant that the ratio has been stable. However, both ratios are still low, showing that Malaysia did not have a debt servicing problem during the sixties.

This conclusion means that Malaysia does not have a liquidity crisis in the balance of payments. Fixed debt service liabilities, if they are large, introduce a serious element of rigidity into the debtors economy. Since developing countries are usually dependent on primary export commodities, the foreign exchange receipts are likely to fluctuate while debt servicing obligations remain contractually fixed. This means that the impact of downward fluctuations must be borne by a reduction of imports or the country must use its foreign exchange reserves or continue to borrow in order to finance the balance of payments deficit as well as the debt service.

The burden of contractual debt service obligation may be further strengthened by the inflexibility of the import sector especially if the industrialization programme in the developing country is in its early stages. The early stages of industrialization usually manifest themselves in an import pattern where the imports of fuel, food and machinery and transport equipment are not substitutable or when it cannot be curtailed without the industrial development programme being retarded.

Although Malaysia has no contractual debt servicing problem, it has already been noted that there has been a certain degree of inflexibility in the import sector, especially for commodities of Sections 0, 3, 6 and 7.

Further, Wheelwright has expressed concern about the problem of servicing foreign debts in Malaysia. He has argued that in the past this problem had not arisen because foreign investment had been in the export sector and profit remittances had been taken care of simply by allowing foreign currency export proceeds to remain abroad. If future foreign investment is concentrated in the non-foreign trade sector, that is, where the investment is neither export-earning nor import-substituing, there may be some difficulty in finding foreign exchange to cover profit remittances as well as servicing debts.[17]

One may consider this as a very pessimistic assessment. It is probable that the present pattern of foreign investment in the export and import-replacing sectors will remain significantly unchanged in the seventies.

Even though Malaysia may have no debt servicing problems, it is still worthwhile to determine the reasons for the Malaysian government's need to borrow. The basic reason to borrow during the 1960s was that government revenue was insufficient to finance development expenditure. Loans are preferred to foreign private, institutional and/or governmental investments in national development programmes because there is no foreign equity claim on the economy. Table 2-20 shows the central government's finance for 1960-70.

There are two justifications for large government development expenditure. In the long run, development expenditure on infrastructure can be seen as an attempt to ensure that the pattern as well as the rate of growth is such that a time will come when Malaysia is no longer dependent on foreign supplementation to domestic sources. In the short run, foreign borrowing is an attempt to secure a pattern of growth that at least allows the transfer problem of foreign exchange to be met.[18] This is in addition to the government's policy of containing the unemployment problem and, more important, in Malaysia's case, of bridging the income gap between the various income and ethnic groups.

Another reason for borrowing has been that the government has already taxed domestic sources considerably. Table 2-21 shows this. The government's domestic debt for the sixties has for most years been at least four times larger ıan foreign borrowing.

The government's domestic debtors were principally from a 'captive' market such as quasi-government institutions, Employee Provident Fund, Post Office Savings Bank, Insurance Companies, Borrowing Companies and the Commercial Banks. A detailed study of the capital and money market is in Chapter V. This considers whether monetary policies can be effective in a dual economy such as Malaysia's.

[17] E.L. Wheelwright, *Industrialization in Malaysia*, Melbourne University Press, Melbourne, 1965, pp. 109-10.

[18] E.K. Hawkins, *The Principle of Development Aid*, Penguin Modern Economics, 1970, p. 59.

TABLE 2-20 Malaysia – Central Government Finance, 1960-79, ($m)

	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970
Current Surplus/Deficit	236	195	145	93	56	17	−7	−30	−75	164	55
Development Expenditure	141	264	415	455	509	590	651	625	630	504	550
Special Expenditure/Receipt	1	1	5	5	60	54	84	51	40	−100	−84
Overall Surplus/Deficit	96	−68	−265	−357	−393	−519	−574	−604	−665	−4	−579

Source: Bank Negara Malaysia, *10th Commemorative Issue, 1969*, p. 51. *Annual Report, 1970*, p. 60.

TABLE 2-21 Malaysia – Source of Government Debt, 1960-70, ($m)

	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970
Gross Domestic Borrowing	168	125	148	210	212	412	400	529	524	459	376
Gross Foreign Borrowing	44	31	38	60	6	83	6	116	103	188	90
Total	212	156	186	270	218	495	406	645	627	647	466
Official External Reserves	2254	2406	2458	2440	2301	2334	2196	1910	1998	2405	2513

Source: As in Table 2-10.

Table 2-21 also indicates that the official external reserves of Malaysia have been much larger than government debts. As a result of this, it may be argued that the government should use her own foreign exchange reserves rather than borrow from abroad. However, it should be noted that the foreign exchange reserves of Malaysia serve a number of functions such as currency backing, a pool of funds to finance temporary balance of payments deficits and to enable the monetary authorities to maintain a certain 'degree of balance of payments ease'.[19] In addition, a high level of reserves affects the quality of balance of payments adjustment policies. A study of the adequacy of foreign exchange reserves with respect to the various criteria within the Malaysia context is given in Chapter IV. One of the conclusions of Chapter IV is that the foreign exchange reserves of Malaysia could be profitably run down to 81% of the present level.

Finally, it is pertinent to explain Malaysia's relatively small foreign debt. There are four possible reasons. The first two are fairly obvious. Firstly, the domestic sector has provided the greater part of the Malaysian government's needs. Secondly, Malaysia has large foreign exchange reserves. Thirdly, the government, and especially the Central Bank, has always adopted a very conservative monetary policy throughout the sixties.[20] Finally, and perhaps more important, is the strong possibility that Malaysia has not been able to absorb a larger volume of foreign debts even though such foreign loans have been available. This has two aspects. Firstly, a lack of local manpower to plan and implement other development projects. The reasons for this suggestion will be discussed in detail in the next Chapter.

Secondly, some foreign aid was not of the right kind and so was unacceptable. For example, American aid offered under PL. 480 imposed the condition that Malaysia stop imports of like commodities from Communist China which were normally cheaper and could be more easily afforded by the lower income groups. In other instances, project loans covered only the direct foreign exchange requirements of a project and made no provisions for the indirect foreign exchange costs. Foreign loans were also on a package basis.[21] These unsuitable conditions for foreign loans were a further cause for Malaysia's small foreign debt.

Apart from the freight and insurance and the investment income accounts, the other main feature of the invisible balance has been continuous inflow of funds through 'government not included elsewhere' account. The bulk of 'government

[19] J.M. Fleming, *Towards assessing the need for international reserves,* International Finance Series, Princeton University, Princeton, New Jersey, February 1967, p. 5.

[20] This policy will become apparent in Chapters IV and V.

[21] Sulaiman bin Abdullah, 'Why Aid to Malaysia', *Development Forum,* Vol. 11, No. 1, June 1969, pp. 30-31.

n.i.e.' has arisen from the expenditure of Commonwealth forces in Malaysia. Table 2-22 shows that estimated size of the annual sum of foreign exchange involved.

TABLE 2-22 Singapore and Malaysia – Estimated Amount spent by the Commonwealth Forces, 1960-5, ($m)

	Singapore and Malaya	Malaya
1960	400	100
1961	400	100
1962	410	103
1963	450	113
1964	550	138
1965	600	150

Source: P.J. Drake, The Developing Capital Market of Malaysia, Australian National University, unpublished Ph.D. thesis, p. 361.

These receipts have been an important prop to the Malaysian balance of payments. The Malaysian economy may not have benefited by the full amount of these inflows. There were leakages in so far as the troops consumed imported goods or made remittances abroad. But to the extent that the troops consumed local products and services or made deposits in local banks there were benefits in the bank's liquidity as well as in the foreign reserves.[22] These consequences were in addition to the multiplier effects on income and employment.

With the phased withdrawal of the British forces from Malaysia in 1971, one can expect this gain of foreign exchange virtually to cease. There have been attempts to reduce the impact of this loss. Special aid of £25m. was agreed after negotiations between the British and Malaysian governments for commitment over a period of five years up to 31 March 1972, to help deal with economic effects of the British Forces run-down. Three quarters of the total 'aid' is an interest free loan repayable over twenty-five years with a grace period for seven years for capital repayments. One quarter is an outright grant. It was also decided that between April 1968 and March 1969 up to 30% of the total aid may be allocated as agreed.[23] In the seventies one can expect this item of the Malaysian

[22] P.J. Drake, The Developing Capital Market of Malaysia, unpublished Ph.D. thesis, A.N.U. Canberra, 1966, p. 362.

[23] *World Banking Survey 1968/1969*, London, p. 225.

balance of payments to be less favourable unless there is a reversal in British foreign policies in South-East Asia.

Finally, so far, the only positive step taken by the monetary authorities which can be interpreted as an attempt to reduce service payments is a procedural change in the handling of foreign exchange to non-sterling countries. Under a new exchange central procedure introduced from 1 June 1968, banks in Singapore are no longer empowered to certify receipts of the foreign exchange proceeds of exports from Malaysia. All proceeds of Malaysian exports to non-sterling area countries have to be sold to Malaysian banks. The volume of Malaysian rubber and tin exports to such countries passing through the Singapore banking system was stated by the Finance Minister to have amounted to M$544m. in 1966, so that Malaysian banks stood to gain business to about this extent. Britain has also acted as intermediary for Malaysian exports to non-sterling area countries: Malaysian exports of rubber and tin affected under this arrangement accounted to about $380m. in 1968 and an unknown proportion of the proceeds also would have had to be accounted for through the sale of foreign exchange to banks in Malaysia.[24] This means that, in future, payments of commissions for foreign exchange to Singapore and British banks are expected to decrease. This should make the 'other services' account in the invisible balance more favourable.

TRANSFER PAYMENTS

In addition to the continuous deficit in the service balance, very considerable demands have been placed on the Malaysian balance of payments by transfer payments, especially private foreign transfers. Table 2-23 shows the direction and magnitude of such transfers.

The private transfers were payments by immigrants as well as gifts and pensions and other payments by Malaysian firms to former employees. They have amounted to more than $200m. a year in recent years excluding profit remittances which are regarded as factor incomes in the service balance. From 1966-70, it was anticipated in the Malaysian development plan that there would be some tendency for these transfer payments to decline as the ties linking one-time immigrants to Malaysia to their countries of origin gradually weakens.[25]

However, after the implementation of the Employment Restriction Act, 1969, the estimate in the plan may be inaccurate. This is because non-citizens working in Malaysia will have to obtain renewals of their permits either on a three-month or six-month basis. During the early part of 1970, there were 46,000 workers on the former and 66,000 on the latter.[26]

[24] 'Malaysia – Project-Commitments involving U.K. Co-operation'. *Far East Trade and development*, Vol. 23, No. 9, September 1968, p. 708.

[25] *First Malaysia Plan, 1966-1970*, p. 58.

[26] *Straits Times*, 9 January 70.

TABLE 2-23 Malaysia – Transfer Payments, 1961-9, ($m)

	1961	1962	1963	1964	1965	1966	1967	1968	1969
Private (net)	−205	−207	−206	−201	−195	−196	−185	−180	−209
Central Government (net)	10	3	25	127	103	104	87	37	31
Total (−deficit)	−195	−204	−131	−74	−92	−92	−98	−143	−178

Source: IMF, *Balance of Payments Yearbook*, 1963-1970.

The majority of these were plantation workers. The renewal of permits was dependent on the condition that the same job was not required by a Malaysian citizen. During 1970, it appeared that there were few citizens who wanted to work in plantations and/or estates. This meant that the possibilities for the renewal of work permits were better. The implication of this situation on the private transfer account might be that, in the future, the volume of transfer payments might increase, or at least not reduce, in size because of the greater insecurity of retaining a job in Malaysia. The impact on the private transfer account would be significant because of the very large number of people affected. There are about 110,000 workers on short-term permits of six months or less. It is known that labour empoyed directly in rubber estates in 1970 numbered 163,750 workers.[27] Foreign workers in rubber estates formed about 35% of the total plantation labour force.

Information and statistics on private transfers are difficult to obtain and the figures are given by the banking system. However, there is reason to believe that a considerable number of Asian remittances do not go through the official or banking system.[28] Drake's estimate of the outflow of capital of Chinese families from West Malaysia for the years 1960-3 were $4.3m., $2.5m., $1.7m., and $5.5m., respectively. Indians, Pakistanis and Ceylonese in Peninsular Malaysia also make remittances to their home countries. Despite the fact that these populations were smaller in number than the Chinese and a relatively smaller number of these people were in the entrepreneurial class, the homeward remittances were comparable in amounts with those of the Chinese.[29]

Using Drake's estimate it means that the transfer payments by Asians, that is the Chinese, Indians, Pakistanis and Ceylonese, were about $17.2m., $10m., $6.8m., and $14.0m. approximately for the years 1960-3. When these figures are compared with the actual recorded private transfer payments for the same period (see Table 2-23) they formed less than 10% of the total net transfers for each individual year. This indirectly implies that the remittances by Asians on a private basis has not been the main cause for the large private transfer. By a process of elimination it means that the major share of private transfer payments has been in the form of pensions and payments by Malaysian firms to former employees as well as private transfers by other foreigners especially, one suspects, Europeans.

[27] Bank Negara Malaysia, *Annual Report, 1970,* p. 91.

[28] The way in which Indians remit funds to India without going through the banking system will be briefly discussed in Chapter III. This is in relation to unrecorded short-term capital.

[29] P.J. Drake, *op. cit.*, p. 360.

However, the statistics of private transfer payments from Peninsular Malaysia[30] (see Table 2-24) indicate that the estimates have been understated. As such the above implied conclusion is incorrect. It can be seen from Table 2-24 that for all years, that is, 1961-4, net payments to the 'Other Sterling Area' were the largest. India, Pakistan, Ceylon and Hongkong are in this category. In addition, it seems reasonable to suggest that part of the remittances by the Chinese to relations in China go through Hongkong. Given the fact that the net private payments to the 'Other Sterling Area' were larger than payments to United Kingdom and 'all others' it shows that Drake's estimates were understated. In addition, the private transfer payments by Asians from the Asian Commonwealth countries were larger than Drake's estimates

Finally, the most important component of central government transfers has been grants in kind and cash from foreign governments. The very significant increases since 1964-5 were contributions from Singapore to the Federal Budget. In developing countries it is unquestionable, from an economic viewpoint, that current government transfers are the best means of financing development expenditure. This is because a grant leaves no liability behind it for replacement. They create no future strains on the balance of payments and contribute to the progress of economic development not only through the impact of the investment they finance but also through the freedom they give for future gains from exports which may have arisen from such investment.

A conclusion of the study of transfer payments is that the annual net payments have been large. Due to the introduction of the Employment Restrictions Act, 1969, it is unlikely that remittances from the Asian population will decrease in the near future. Whether these net private transfers could be reduced by prohibition and whether it is worthwhile implementing such a policy will be considered in Chapter VII.

Six main conclusions arise from this study of thc invisible balance.

Firstly, net payments for freight and insurance indicate an increasing trend over the period 1960-70. This increasing trend has been due to increasing Conference freight rates as well as increased volume of trade. As a consequence of this the government's policy of establishing a viable Malaysian shipping corporation merits serious considerations.

Secondly, Malaysia does not have a debt servicing problem. This conclusion is based on a study of both the debt service ratio as well as the ratio of investment income to total exports.

Thirdly, very few alternatives are available to the government to reduce the large annual outflow of foreign exchange through the remittances of profits,

[30] About 90% of private transfer payments from Malaysia were by people living in Peninsular Malaysia.

TABLE 2-24 Peninsular Malaysia — Transfer Payments 1961-4

	1961			1962			1963			1964		
	U.K.	'Other Sterling Area'	Others	U.K.	'Other Sterling Area'	Others	U.K.	'Other Sterling Area'	Others	U.K.	'Other Sterling Area'	Others
Gifts and Maintenance Allowances	−54.0	−129.3	−18.9	−19.0	−100.0	−20.0	−61.5	−67.5	−47.5	−59.2	−69.6	−40.0
Pensions and Compensations	−20.5	−2.5	−	−22.0	−3.0	−	−17.5	−4.5	−3.0	−18.0	−4.5	−3.5
Sub-total	−74.5	−131.8	−18.9	−71.0	−103.0	−20.0	−79.0	−72.0	−50.5	−77.2	−74.1	−43.5
Total	−225.2			−194.0			−201.5			−194.8		

Source: Department of Statistics, *External Trade, West [Peninsular] Malaysia*, 1962-1965, Malaysia.

dividends and interest This is because some 60% of Malaysia's productive sector is either foreign-owned or foreign-controlled.

Fourthly, the withdrawal of the Commonwealth Forces from Malaysia will result in the loss of one important source of invisible earnings.

A fifth conclusion is that one of the main weaknesses of the Malaysian invisible balance has been private transfer payments. It appears unlikely that these will be reduced in the near future.

Finally, the invisible balance has traditionally been in deficit and there is little prospect that this situation will change in the foreseeable future.

CURRENT ACCOUNTS[31] OF MALAYSIA: PENINSULAR MALAYSIA, SARAWAK AND SABAH

It needs to be emphasized that the purpose of this sub-section is to indicate in a general manner the contributions of the component states to the overall Malaysian current balance and is not a detailed study of the international trade of the component states.

The statistics of the current accounts of Sarawak and Sabah for the period 1965-9 were given by the Statistics Department and are unpublished.[32]

One of the main features of Table 2-25 is that Peninsular Malaysia has been the main contributor to the Malaysian visible balance. This means that changes in the visible balance of Malaysia have been mainly determined by changes in the visible balance of Peninsular Malaysia. The latter was in surplus throughout the period under study. However, the size of the surplus fluctuated from year to year. On the other hand, the current account of Sarawak was in deficit from 1963-7. This was also true for Sabah from 1963-5. This means that during this period, the Malaysian visible balance was adversely affected by the unfavourable balances of Sabah and Sarawak.

The main cause for these negative contributions was the Indonesian Confrontation, 1963-6. It should also be noted that the high average rubber price in 1965 did not benefit either Sabah or Sarawak sufficiently to result in a favourable visible balance, because rubber was not the main export of these states. The main exports of Sarawak were those of Section 3 – Mineral Fuels and Timber. Mineral fuels referred to refined re-exports of mineral fuels from Brunei. Rubber formed 13% of the total exports in 1965 (see Table 2-31) and has been declining.

[31] The current account is defined as the difference between the visible balance and the service balance. On the other hand, the current balance was defined as the difference between the visible balance and the invisible balance which was composed of the service balance and transfer payments.

[32] The detailed current accounts of Sabah, Sarawak and Peninsular Malaysia are given in Appendix III.

TABLE 2-25 Malaysia – Current Accounts of Peninsular Malaysia, Sarawak and Sabah, 1961-8, ($m)

	1961	1962	1963	1964	1965	1966	1967	1968
Peninsular Malaysia	221.0	58.4	44.1	90.0	163.1	96.2	14.9	62.0
Sarawak	−19.1	2.7	−31.1	−48.8	−32.9	−71.8	−58.8	−11.6
Sabah	5.5	−2.1	−28.0	−31.3	−15.4	23.5	73.4	74.7
Total	207.4	59.0	−15.0	9.9	114.8	47.9	29.5	125.1

Source: As Tables 2.41, 2-42, 2-43 in Appendix III.

TABLE 2-26 Malaysia – Visible Balance of Peninsular Malaysia, Sarawak and Sabah, 1961-8, ($m)

	1961	1962	1963	1964	1965	1966	1967	1968
Peninsular Malaysia	506	308	306	362	580	570	451	562
Sarawak	35	29	−7	−35	−39	−45	−6	57
Sabah	20	13	−11	−19	−13	34	94	98
Total	561	350	288	308	528	559	539	717

Source: As Tables 2-41, 2-42, 2-43 in Appendix III.

TABLE 2-27 Malaysia – Service Balance of Peninsular Malaysia, Sarawak and Sabah, 1961-8, ($m)

	1961	1962	1963	1964	1965	1966	1967	1968
Peninsular Malaysia	−285.2	−249.8	−262.1	−272.2	−417.1	−473.8	−436.1	−497.3
Sarawak	−25.5	−23.1	−21.5	−10.4	9.4	−25.5	−51.8	−68.0
Sabah	−14.5	−15.1	−17.0	−12.3	−0.7	−6.3	−19.2	−21.4
Total	−325.2	−288.0	−300.6	294.9	−408.4	−505.6	−507.1	−586.7

Source: As tables 2-41, 2-42, 2-43 in Appendix III

TABLE 2-28 Peninsular Malaysia – Gross Exports by Major Products, 1962-8.

	1962	1963	1964	1965	1966	1967	1968
Rubber	1368	1374	1303	1368	1396	1216	1301
Tin	616	638	723	865	779	744	820
Iron ore	166	176	163	161	136	122	110
Palm oil	72	76	88	115	127	119	131
Timber	43	65	87	92	99	129	182
Total of all exports	2626	2705	2778	3099	3117	2919	3204

Source: Department of Statistics *Data for the IMF Consultations*, 1966, p. 32.
Data for the IMF Consultations, 1969, p. 15.

TABLE 2-29 Peninsular Malaysia – Selected Exports as percentage of Total Exports, 1962-3.

	1962	1963	1964	1965	1966	1967	1968
Rubber	52	50	46	44	44	41	40
Tin	23	23	26	27	24	25	25
Iron ore	6	6	5	5	4	4	3
Palm oil	2	2	3	3	4	4	4
Timber	1	2	3	2	3	4	5
Total	84	83	83	81	79	73	77

Source: As Table 2-28.

In the case of Sabah, the main export is timber. Rubber formed only 11% of total export in 1965 (see Table 2-33).

However, it is significant to note that both Sarawak and Sabah made positive contributions to the Malaysian visible balance in 1968. Sabah's contribution was 18%, while that of Sarawak was 12%. The favourable visible balances of Sarawak and Sabah in 1968 were due to the higher timber prices as well as increased timber production. There was an improvement of 13 cents per ton over the 1967 price. It might be concluded that the contributions of Sabah and Sarawak will continue to increase in the near future because of the rising timber prices (see Table 2-3).

The service balances of all the three states were in deficit from 1961-8, with the exception of Sarawak in 1965. The favourable service balance in 1965 was due to a once and for all large government transfer to Sarawak. It may also be noted that the Peninsular Malaysian deficit was the largest.

TABLE 2-30 Sarawak — Gross Exports by Major Products, 1961-8, ($000)

	1961	1962	1963	1964	1965	1966	1967	1968
Rubber	83,257	72,597,	69,575	60,133	59,453	46,192	32,363	26,314
Round timber	18,401	23,777	30,761	30,356	47,290	82,475	99,797	138,692
Sawn timber	23,196	17,058	22,956	31,856	35,184	26,343	36,222	42,374
White pepper	19,635	16,100	17,664	16,288	19,193	20,422	22,489	19,089
Black pepper	9,011	7,787	4,726	7,376	12,539	12,574	12,980	15,575
Sago flour	3,298	4,170	5,593	8,083	5,813	4,734	4,809	4,946
Section 3 (Mineral fuels) ($m)	214.6	226.2	201.3	200.8	218.5	241.5	264.0	298.7
Total of all exports ($m)	397.2	407.2	373.8	381.0	433.7	463.6	503.0	604.3

Source: Department of Statistics *Data for the IMF Consultations*, 1966, p. 37.
Data for the IMF Consultations, 1969, p. 20.

TABLE 2-31 Sarawak – Selected Exports as percentage of Total Exports, 1961-8.

	1961	1962	1963	1964	1965	1966	1967	1968
Rubber	20	17	18	15	13	9	6	4
Round timber	4	5	8	7	10	17	19	22
Sawn timber	5	4	3	8	8	5	7	7
White pepper	4	3	4	4	4	4	4	3
Black pepper	2	1	1	1	5	2	2	2
Sago flour	1	1	1	2	1	1	1	1
Section 3	54	53	52	50	50	52	52	49
Total	90	86	88	89	91	90	90	88

Source: As in Table 2-30.

Finally, the pattern of the contributions of the current accounts for the states was different. The visible account of Peninsular Malaysia was in surplus from 1961-8. However, the size of the surpluses fluctuated with changes in the political conditions with Indonesia as well as changes in rubber prices.

On the other hand, the current accounts of Sarawak were in deficit throughout 1961 to 1968 with the exception of 1962 when there was a marginal surplus. It is significant to note that in spite of a sizeable surplus in the visible balance in 1961 and 1962, the negative service balance was greater. The relatively large service deficits in the Sarawak current account were due to the relatively large payments on the 'other services' account especially after 1966. These large net payments were mainly due to the payments to the relatively large number of expatriates in Sarawak.

The contributions of Sabah were less consistent in the sense that the visible balances were in deficit from 1962 to 1965 and in surplus from 1966. It is important to note that the positive contributions of Sabah to the overall Malaysia's current account in 1967 and 1968 were larger than those of Peninsular Malaysia.

One possible conclusion from the above discussion is that since the formation of Malaysia in 1963, Peninsular Malaysia had been assisting both Sabah and Sarawak on the current account from 1963 to 1965. In a sense, it could be argued that the level of consumption and investment of Sarawak and Sabah have been maintained by Peninsular Malaysia without a corresponding foreign exchange problem arising in both Sarawak and Sabah.

TABLE 2-32 Sabah – Gross Exports by Major Products, 1961-8, ($000)

	1961	1962	1963	1964	1965	1966	1967	1968
Round timber	102,791.6	122,104.8	150,640.2	148,559.8	185,437.4	259,755.1	317,337.1	335,358.4
Rubber	41,208.0	36,709.0	32,063.0	32,243.0	34,039.0	31,890.0	26,310.0	25,991.0
Copra	27,084.4	18,485.1	17,585.7	15,900.3	13,527.4	11,295.5	5,624.9	6,582.8
Hemp	4,813	3,208.2	3,772.4	4,510.2	2,737.7	2,841.4	2,390.9	2,307.8
Fish, fresh, dried or salted.	1,928.5	1,961.0	2,039.3	1,789.6	3,576.8	6,010.9	6,508.7	8,043.9
Total of all exports ($m.)	220.3	234.7	274.8	259.9	305.0	358.3	409.6	433.2

Source: Department of Statistics *Data for the IMF Consultations*, 1966, p. 43.

Data for the IMF Consultations, 1966, p. 43.

TABLE 2-33 Sabah – Selected Exports as percentage of Total Exports, 1961-8

	1961	1962	1963	1964	1965	1966	1967	1968
Round timber	46	52	54	57	60	72	77	77
Rubber	18	15	11	12	11	8	6	6
Copra	12	7	6	6	4	3	1	2
Hemp	2	1	1	1	1	1	1	1
Fish, fresh, dried or salted	1	1	1	1	1	1	1	1
Total	79	76	73	77	77	85	86	87

Source: As in Table 2-33.

Two important features about the export sections of the individual states may be noted.

Firstly, the composition of the major exports of Sabah and Sarawak indicate that the main contribution of both Sabah and Sarawak to the Malaysian export earnings has been through timber. Timber is Malaysia's third largest foreign exchange earner after rubber and tin. It can be seen from Tables 2-32 and 2-33 that timber was the main export of Sabah. It is also important to note that timber exports of Sabah reflected an increasing trend. This increasing trend in exports earnings was the result of both increasing prices of timber as well as increased output. The same increasing trend was also true for Sarawak. Timber formed 29% of the total export earnings of Sarawak in 1968. In the case of Sabah, timber exports formed 77% of the total export earnings for the same years.

It has already been urgued earlier that there was some degree of built-in stabilization in the export earnings of Malaysia. This protection against low rubber prices was due to the increasing importance of other exports like timber and palm oil with the relative contributions of tin remaining fairly stable. Timber exports from East Malaysia formed on the average about 75% of the total timber exports of Malaysia. This means that, to a significant extent, the recent built-in stabilisation of the export sector against low rubber prices was due to the contributions of East Malaysia.

The second important feature of the export sectors was that the main primary exports of all the three Malaysian states were fairly similar. Tables 2-23, 2-30, and 2-32 show that rubber and timber have been the main exports. However, in Malaysia as a whole, tin is the second largest source of foreign exchange. In the case of Sarawak, it is important to note that exports of Section 3 – Mineral fuels – represent the re-exported refined mineral fuels from Brunei. The addition to

TABLE 2-34 Peninsular Malaysia – Gross Imports by Commodity Sections, 1962-8, ($m)

	1962	1963	1964	1965	1966	1967	1968
Section 0 – Food	563	657	695	614	611	623	630
Section 1 – Beverages and tobacco	72	61	58	61	56	56	56
Section 2 – Inedible crude materials	340	292	228	229	161	166	281
Section 3 – Mineral fuels	151	153	167	174	195	203	210
Section 5 – Chemicals	152	168	177	208	225	222	212
Section 6 – Manufactured goods	613	621	617	676	671	672	686
Section 7 – Machinery and transport equipment	482	495	516	580	644	575	624
Others (Sections 4,8,9)	73	70	63	66	70	69	70
Total	2449	2517	2521	2608	2633	2586	2769

Source: Department of Statistics *Data for the IMF Consultations,* 1966, p. 33.
Data for the IMF Consultations, 1969, p. 16.

TABLE 2-35 Peninsular Malaysia – Gross Imports by Commodity Sections as percentage of Total Imports, 1962-8.

Commodity Sections	1962	1963	1964	1965	1966	1967	1968
Section 0 – Food	24	26	27	23	23	24	22
Section 1 – Beverages and tobacco	3	3	3	3	3	3	3
Section 2 – Inedible crude materials	13	11	9	9	8	7	10
Section 3 – Mineral fuels	6	6	6	6	7	7	7
Section 5 – Chemicals	7	7	7	8	8	8	8
Section 6 – Manufactured goods	25	24	24	25	25	25	24
Section 7 – Machinery and transport equipment	19	19	20	22	24	22	22
Others (Sections, 4,8,9)	3	3	3	3	3	3	3
Total	99	99	99	98	98	99	99

*Includes the value of crude oil piped from Brunei to Sarawak for refining.

Source: As in Table 2-34.

TABLE 2-36 Sarawak – Gross Imports by Commodity Sections, 1961-9, ($m)

Commodity Sections	1961	1962	1963	1964	1965	1966	1967	1968	1969
Section 0 – Food	66.2	68.3	77.3	86.1	89.3	93.3	95.0	88.6	75.5
Section 1 – Beverages and tobacco	9.5	9.5	12.2	15.7	12.6	11.4	11.6	16.2	4.2
Section 2 – Inedible crude materials	8.2	9.2	5.3	5.3	7.2	7.0	6.7	5.7	5.4
Section 3 – Mineral fuels*	201.6	207.2	186.8	191.7	212.4	237.8	252.9	287.0	269.1
Section 4 – Animal and vegetable oils	0.4	0.5	0.7	0.7	0.7	0.7	0.5	0.7	0.6
Section 5 – Chemicals	15.8	14.6	14.9	16.6	19.6	23.6	22.8	24.4	17.1
Section 6 – Manufactured goods	31.9	32.5	35.7	37.0	45.6	53.3	48.9	53.5	36.5
Section 7 – Machinery and transport equipment	28.6	33.9	39.7	49.6	68.0	68.7	70.8	70.3	68.9
Section 8 – Miscellaneous manufactured goods	14.4	14.9	14.9	15.7	18.8	19.8	17.4	18.5	11.9
Section 9 – Transactions,.n.i.e.	35.1	10.1	9.0	11.4	10.6	10.1	10.1	9.9	6.9
Total	411.7	400.7	396.5	429.8	484.8	525.7	536.7	574.8	496.1

*Includes the value of crude oil piped from Brunei to Sarawak for refining.

Source: Department of Statistics *Data for the IMF Consultations*, 1966, p. 39.
Data for the IMF Consultations, 1969, p. 22.

TABLE 2-37 Sarawak – Gross imports by Commodity Sections as percentage of Total Imports, 1961-9.

Commodity Sections	1961	1962	1963	1964	1965	1966	1967	1968	1969
Section 0 – Food	16	17	19	20	18	17	17	16	15
Section 1 – Beverages and tobacco	3	3	4	4	3	3	3	3	1
Section 2 – Inedible crude materials	2	2	2	1	1	1	1	1	1
Section 3 – Mineral fuels	48	51	48	44	44	45	47	49	54
Section 4 – Animal and vegetable oils	–	–	–	–	–	–	–	–	–
Section 5 – Chemicals	3	3	3	3	4	4	4	4	2
Section 6 – Manufactured goods	7	8	9	9	9	10	9	9	7
Section 7 – Machinery and transport equipment	6	8	11	11	14	13	13	12	14
Section 8 – Miscellaneous manufactured goods	4	3	3	4	4	4	4	3	2
Section 9 – Transactions, n.i.e.	9	3	2	2	2	2	2	2	2
Total	99	98	99	98	98	99	99	98	98

Source: As in Table 2-36.

TABLE 2-38 Sabah – Gross Imports by Commodity Sections, 1961-9, ($m)

Commodity Sections	1961	1962	1963	1964	1965	1966	1967	1968	1969
Section 0 – Food	28.8	40.8	51.0	57.7	57.4	63.7	68.2	67.4	60.9
Section 1 – Beverages	29.7	44.3	57.4	41.2	50.8	26.6	29.6	23.6	18.7
Section 2 – Inedible crude materials	21.2	14.3	13.2	12.2	10.1	9.4	8.4	5.7	4.6
Section 3 – Mineral fuels	14.5	18.6	21.0	26.7	29.1	37.0	24.1	27.8	20.8
Section 4 – Animal and vegetable oils	1.7	1.7	2.0	2.2	2.7	2.5	2.8	2.8	2.6
Section 5 – Chemicals	9.4	9.1	11.4	13.5	13.6	16.3	16.9	19.4	13.4
Section 6 – Manufactured goods	34.0	32.3	41.7	45.5	48.2	50.0	46.4	52.9	41.1
Section 7 – Machinery and transport equipment	41.2	53.4	74.1	70.6	86.7	100.0	94.6	105.7	138.6
Section 8 – Miscellaneous manufactured goods	17.3	19.0	25.7	25.5	24.7	27.0	29.0	30.1	21.3
Section 9 – Transactions, n.i.e.	7.2	6.4	7.2	7.4	12.9	14.3	12.2	8.6	5.6
Total	215.0	238.9	304.7	302.5	336.2	346.8	330.2	344.0	327.6

Source: Department of Statistics *Data for the IMF Consultations,* 1966, p. 45.
Data for the IMF Consultations, 1969, p. 28.

TABLE 2-39 Sabah – Gross Imports by Commodity Sections as percentage of Total Imports, 1961-9.

Commodity Sections	1961	1962	1963	1964	1965	1966	1967	1968	1969
Section 0 – Food	18	17	17	19	17	18	20	19	19
Section 1 – Beverages and tobacco	13	18	18	13	15	8	9	6	6
Section 2 – Inedible crude materials	9	6	4	4	4	3	3	2	2
Section 3 – Mineral fuels	6	7	7	8	8	10	7	8	6
Section 4 – Animal and vegetable oils	1	1	1	1	1	1	1	1	1
Section 5 – Chemicals	4	4	4	4	4	4	5	5	4
Section 6 – Manufactured goods	15	13	13	15	14	14	14	15	13
Section 7 – Machinery and transport equipment	19	22	24	23	25	28	29	30	40
Section 8 – Miscellaneous manufactured goods	8	8	8	8	8	8	9	8	7
Section 9 – Transactions, n.i.e.	4	3	3	3	3	4	3	3	2
Total	98	99	98	98	99	98	99	99	100

Source: As in Table 2-38.

TABLE 2-40 Malaysia – Crude Estimates of Consumption of Rice, 1965-9.

	Production (tons)			Net Imports (tons)			Apparent Consumption			1 as % of 3		
	P.Malaysia	Sarawak	Sabah	P.Malaysia	Sarawak	Sabah	P.Malaysia	Sarawak	Sabah	P.Malaysia	Sarawak	Sabah
1965	677,390	66,891	52,700	257,352	58,811	29,932	934,742	125,702	82,632	72	53	64
1966	666,900	71,104	46,718	207,606	59,222	31,653	374,506	131,026	78,371	76	54	60
1967	659,110	57,065	46,285	285,941	60,991	30,389	945,051	118,059	76,674	70	48	60
1968	780,000	76,392	56,604	238,467	44,311	26,052	1018,467	120,703	82,656	77	63	68
1969	866,840	95,738	55,037	220,691	54,615	28,790	1087,531	150,343	83,827	88	64	66

Source: Department of Statistics *Data for the IMF Consultations,* 1970, pp. 20-22.

earned foreign exchange has been the amount of the value added rather than the value indicated by the export figures.

In the case of imports, the similarities of the consumption and investment pattern have been equally pronounced.

Imports into the separate states of Malaysia for 1961-3 exhibit a common pattern (see Tables 2-34, 2-36, 2-38). The main imports by con modity sections into Peninsular Malaysia and Sabah and Sarawak were Section 0 – Food, Section 6 – Manufactured Goods and Section 7 – Machinery and Transport Equipment. In the case of Peninsular Malaysia, Section 6 formed 25%, Section 0, 24% and Section 7, 21% of the total import bill. For Sabah, Section 7 formed 25%, Section 0, 18% and Section 6, 14%. In the case of Sarawak, Section 0 formed 17%. Section 7, 11% and Section 6, 9%. The dominance of these three sections was also reflected by the pan-Malaysian trend. The implications of this have already been discussed earlier.

The component of imports in Section 0 – Food, consisted of rice. Table 2-40 indicates the extent of reliance on imported rice by the separate states. On average Malaysia's production of rice formed about two thirds of her annual consumption. In addition, it can also be seen that the extent of import substitution of imported rice has been more successful in Peninsular Malaysia than in either Sarawak or Sabah. On the other hand, Sabah was less dependent on imported rice than Sarawak.

It has already been indicated on balance of payments grounds that the policy of import substitution of rice is not justified. However, since the government has already committed itself especially in Peninsular Malaysia in the Kemubu and Muda schemes, there are some possibilities of maximizing a second-best situation. Should Peninsular Malaysia succeed in becoming self-sufficient in rice production in the seventies, any surplus could be marketed in East Malaysia.

Two main conclusions arise from this brief general study of the economic impact which the separate states have on Malaysia.

Firstly, the exports of Sabah and Sarawak have contributed to a greater degree of built-in stabilization in Malaysia's foreign exchange earnings against low rubber prices. For instance in 1967 and 1968, the positive contributions of Sabah to the current account of Malaysia were greater than that of Peninsular Malaysia. Although the contributions of Sabah and Sarawak to the overall current account were negative during the period of the Indonesian Confrontation, there are indications that the present timber boom will continue.

Secondly, the pattern of import consumption and investments of these three states were similar. This means that there is little scope for reducing the import bill of these states except in the case of rice. Sabah and Sarawak may provide

the market for Peninsular Malaysia's rice in the near future. However, if the Kemubu and Muda Schemes go according to plan with respect to increasing production Malaysia may produce a sizeable export surplus. If this is the case, the problem of finding an export market would present itself.[33]

[33] Brien K. Parkinson, *Economic Development Policies in Independent Malaysia and Singapore*, Chapter IV, forthcoming.

CHAPTER III
THE CAPITAL ACCOUNT

The capital accounts indicate the volume of capital movements into and out of a country. Although a part of the movement is caused by the transactions in the current account, the other part is capital movements resulting from new investments, inflows arising from the floating of securities, loans received from international institutions and from long-term and short-term private capital movements.

Since there is no single reason for capital movements, a study of individual items might throw some light on the nature of such funds regarding their stability in terms of whether they fluctuate with the terms of trade or other socio-economic factors. Apart from this, one can derive benefit from such a study to see whether individual capital items represent an area of weakness or strength in the overall Malaysian balance of payments. The long-term trends of each individual capital item will to some extent indicate the strength or weakness of these items.

It must be stressed at the outset that the theoretical framework needed for a casual interpretation of changes in the international flow of private capital contains concepts for which no statistical counterpart exists in the accounting balance of payments. The theoretical distinctions required to interpret a change in the international flow of capital – official or private, foreign or domestic, long term or short term, recorded or unrecorded are 1) an autonomous disturbance, 2) an official or semi-official settlement, 4) a market-induced counterflow or 4) a policy-induced corrective. These distinctions can serve the purposes of explanation and prediction, but only if one can identify actual capital movements according to these categories correctly and only if one can obtain supplementary information not contained in the statistical balance of payments.[1] In the Malaysian case, attempts to derive the theoretical distinctions for capital movements are all too frequently frustrated by scanty supplementary information.

The sections in the Malaysian capital accounts are official long-term, official short-term, private long-term and 'errors and omissions including other short-term capital'.

Official long-term capital is an aggregated figure of capital movements of both local and federal government transactions since separate statistics are not

[1] Fritz Machlup, 'Capital Account in the Balance of Payments', in *Maintaining and Restoring International Payments,* Fellner, Machlup, Triffin, etc., Princeton University Press, 1966, p. 167.

available. The capital accounts of local and federal government are given in Table 3-1.

A few features of the accounts may be noted. Firstly, 'Loans Received by the government appeared to be greatest in 1961, 1962, 1967 and 1968. A further breakdown of the 'Loans Received' account is given in Table 3-2. It is apparent that there is no particular trend in government loans and that Malaysia's chief creditor is the U.S.

The second feature of significance is that the floating of securities in foreign capital markets has formed an important source of government funds. Securities issued abroad covered a £5m. bond issue in London in 1963, A US$25m. bond issue in New York in 1965 and a £7½m. issue in London in 1967. The frequency of the successful floating of securities abroad indicates foreign confidence in the Malaysian economy, and one conclusion which might be reached is that this source of finance may be a reliable standby for fund-raising in the future.

Finally, the item 'Other Liabilities' is most important in terms of size after 1963. The changes in this item 'Other Liabilities' involve mainly changes in Singapore commercial banks' holdings of Malaysian treasury bills, changes in foreign holdings of domestically issued bonds and changes in Malaysian liabilities to international monetary institutions resulting from payments of subscriptions in national currency by the Federal government to the IBRD, the International Development Association and the Asian Development Bank. The most important change in 'Other Liabilities' involves the changes in Singapore's commercial banks' holdings of Malaysian treasury bills, especially after the political split in 1965 and the currency split in 1967. After 1966, short-term liabilities of the government declined. In 1967, there was a $183m. outflow following the withdrawal of Malaysian treasury bills from banks in Malaysia to their officies in Singapore as a consequence of the introduction of the new liquidity requirements in Singapore which became effective in July 1967. This outflow is not likely to be repeated and as long as the Malaysian economy remains prosperous, this capital outflow must be regarded as something less than the usual outflow of capital.

The details of the private long-term capital accounts are given in Table 3-4.

'Loans Received' cover drawings mainly in IBRD loans to the National Electricity Board and the MIDFL and loans from United Kingdom Commonwealth Development Corporation and International Finance corporation. 'Other Liabilities and Assets' represent the estimates of net foreign direct and portfolio investments in Malaysia. From Table 3-4 it is clear that foreign direct and portfolio investments are more important than loans. For the years 1966 and 1967, it is known that the volume of direct investments was larger than the volume of portfolio investments. The volume of direct investments (net) for 1966 and 1967 were $98m. and $96m. respectively. On the other hand, the

TABLE 3-1 Malaysia – Local and Central Government Capital Accounts, 1961-9, ($m)

	1961	1962	1963	1964	1965	1966	1967	1968	1969
Loans received (net)	20	22	9	–7	–6	–1	33	62	n.a.
Securities issued abroad (net)	–	–	43	–	76	–8	48	–	n.a.
Other liabilities (net)		10	–6	79	139	–34	–180	1	–2
Capital subscriptions (net)	–3	–1	–1	–1	–26	4	–86	–	n.a.
Other assets (net)	–	–3	4	5	1	1	1	–50	–7
Total	17	28	49	76	184	–38	–184	13	130

Source: IMF *Balance of Payments Yearbook*, 1963-1970.

TABLE 3-4 Malaysia – Private Long-Term Capital Account, 1961-8, ($m)

	1961	1962	1963	1964	1965	1966	1967	1968
Loans received (net)	8	29	22	24	35	60	78	48
Other liabilities and assets (net)	180	235	270	205	190	137	127	202
Total	188	264	292	229	225	197	205	250

Source: IMF, *Balance of Payments Yearbook*, 1963-1970.

TABLE 3-2 Malaysia – Loans Received by the Central Government, 1961-8, ($m)

Drawings from	1961	1962	1963	1964	1965	1966	1967	1968
Canada	–	–	–	–	–	2	16	14
Brunei	20	–	–	–	–	–	–	–
Germany	–	–	–	1	2	3	12	6
IBRD	–	–	–	–	–	4	15	27
Japan	–	–	–	–	–	–	–	3
U.K. (ECGD)	6	7	3	1	1	–	–	7
CDC	5	–	–	–	–	–	–	–
U.S.	6	32	14	3	4	–	11	27
Others	–	–	4	–	–	–	–	–
Total	37	39	21	5	7	9	54	84

Source: IMF *Balance of Payments Yearbook, 1961-1962,* vol. 18, p. 3, Malaysia; *1963-1967*, vol. 20, p. 3, Malaysia; *1967-1968,* vol. 21, p. 3, Malaysia.

TABLE 3-3 Malaysia – Repayments made by the Central Government, 1961-8, ($m)

Repayments to	1961	1962	1963	1964	1965	1966	1967	1968
Singapore	10	10	–	–	–	–	–	–
U.K. (CDC)	1	1	–	–	–	–	–	–
ECGD	–	–	3	3	3	3	4	2
Other Official	6	4	5	5	5	–	9	4
U.S.	–	2	4	4	4	5	6	14
Others	–	–	–		1	2	2	2
Total	17	17	12	12	13	10	21	22

Source: As for Table 3-2.

volume of portfolio investments was $59m. and $14m. respectively.[2] Although no data are available for the 1961-5 period, it seems reasonable to suggest that

[2] Figures were obtained from *Report on the Financial Survey of Limited Companies, 1967,* Department of Statistics, Malaysia.

the volume of direct investments was greater than portfolio investments. This is because Malaysia's export economy is and was dominated by rubber and tin. A large part of this is and was foreign-owned with Britain as the main investor. Agricultural diversification to palm oil has also resulted in direct investments as well as re-investments. In addition, during the early sixties the Malaysian Stock Exchange was not well developed. An undeveloped Stock Exchange means that there is little activity in shares of companies. Therefore most investments would be direct investments rather than portfolio investments.

At this stage, it is pertinent to draw a significant distinction between government loans and private long-term capital in Malaysia. Foreign capital inflows through the government are either direct loans or investments in government securities and treasury bills. These items represent fixed interest loans. Private long-term capital on the other hand represents direct equity investments. Although a portion of private long-term capital in Malaysia represents portfolio investments, the latter could be considered as direct foreign investments. This is because it is likely that the foreign owners of such portfolio investments are not passive shareholders.

It may be argued, therefore, that direct investments are preferable to loans because the former represent entrepreneurial activity with technical and managerial skills and marketing channels accompanying it. Within the Malaysian context the primary exports sector continues to benefit from new technology and training of manpower. Though some natural rubber technology has been developed by the local Rubber Research Institute, big rubber firms have contributed just as much. Oil palm research is entirely carried out by foreign firms inside and outside Malaysia. A similar case could be made for tin mining. It appears that the argument for the benefits of technology and training of manpower also applies to the manufacturing sector. On the other hand, loans are basically a financial transaction providing supplementary funds. However, it should be noted that the gain from direct investment is offset to some extent by repatriation of capital. Retained earnings in turn create substantial investment income liabilities which may in the long term reach significant proportions.[3]

Another argument in favour of direct investment is that the profits from which earnings are remitted will tend to vary with the level of activity in the country, which in turn will reflect to some extent the strength or weakness of the balance of payments. Hence the balance of payments, burden of transferring payments for the services of foreign capital will tend to adjust itself automatically to the volume of earned foreign exchange. The burden of fixed charges on borrowed capital is inflexibile.

A simple correlation between the time-series for rubber, tin and palm oil

[3]This point will be returned to on pg. 86.

prices and investment payments, from 1960 to 1969, indicates that the correlation co-efficients were 0.08, 0.58 and 0.18 respectively. These co-efficients do not support the above argument that the payments for the services of foreign capital will adjust themselves automatically to the volume of earned foreign exchange. However, if a time-lag of a year is allowed for, that is for instance 1960 prices and 1961 investment payments, the correlation co-efficients are 0.61, and 0.78 and 0.38 for rubber, tin and palm oil respectively.

The co-efficients of rubber and tin support the above hypothesis and it is probable that there is a time-lag of a year before foreign owners of estates or tin-mines decide on the amount to be remitted. The low correlation co-efficient for palm oil could be due to the fact that the oil palm industry is still in its infancy and remittances are likely to be small.

The above argument for direct foreign investment is only true as long as the direct investment is relevant to foreign exchange earnings. However, if direct foreign investment is in production specially geared towards the Malaysian domestic economy, this may no longer be true. If it is in import-substituting industries, there may be some savings of foreign exchange.[4] If not, then the full impact of remittances of foreign exchange without any offsetting inflows of foreign exchange will be felt in the balance of payments. In addition, if the country gets into balance of payments difficulties, devaluation will lighten the burden of income transfers on direct investments but will not affect the foreign exchange burden of fixed interest obligations. If a foreign loan is expressed in terms of a foreign currency, and the stated currency is not devalued or is not devalued to the same extent, the devaluation would in fact increase the foreign exchange burden.

As a result of the above discussion, a quantitative indication of the time profiles of the direct balance of payments costs of loans versus equity under certain assumptions would be helpful. The statistics which are given are taken from two tables, balance of payments cost of loan arrangements and balance of payments cost of equity investment by S. Tarapore.[5]

The basic assumptions used in the computations were that the initial loan amount and the initial foreign investment were the same, that is 100. Within the Malaysian context, the interest rate for the loan was taken to be 7%. This seems to be a reasonable rate as the interest rate on government securities (16-20 years maturity) is 6¼%. Other forms of inter-government loans would probably be slightly higher. The rate of return of net profits is taken to be 10%. This figure

[4]The effect of import substitution on the Malaysian balance of payments will be considered in Chapter VI.

[5]S.S. Tarapore, 'Some Aspects of Foreign Investments Policy', *Reserve Bank of India Bulletin*, May 1966, pp. 508-17.

is much lower than the average rates of return of direct British investment in Malaysia (see Table 3-8). The average rates of return of investment for the period 1960-5 varied from 14.5% to 17.8%. The reason for adhering to 10% is that the average rate of returns for Commonwealth developing countries was 9.5%. In addition, the high rate of returns of British investment in Malaysia may be pushed up by British interest in rubber and tin. The returns to industries in Malaysia are unknown. The calculation for balance of payments cost of equity investment also assumes that 5% of profits were retained while 5% were remitted and that there were no returns to investments for the first three years.[6]

Given these assumptions, the direct balance of payments cost of a 25-year loan at 7% interest, with equal annual repayments of the loan would be 191% of the loan amount by the end of the loan period and the cost at the end of the 20th, 15th, 10th and 5th year would be 167.5%, 135.5%, 97.5% and 52.5% respectively. An equity investment with the assumption of a 10% net profit equally distributed between retained profits and remittances abroad, would over 25 years create a balance of payments drain of 192% at the end of the 25 years, in addition to raising the investment liabilities to 292%. However, the balance of payments drain at the end of the 20th, 15th, 10th and 5th year would be 129%, 79.5%, 40.7% and 10.3% respectively with increases in the investment as well.

It is clear that the balance of payments profile of the equity investments appear to be more favourable as far as the drain on the balance of payments is concerned. However, at the same time, the equity value of foreign investment in the host country has increased to 292% of the initial investment. A direct loan does not introduce the latter problem at all.

Another aspect of foreign equity investment is the possibility that local people will purchase some part of the equity over time either as a direct result of government policy or as a result of market forces. The mere existence of this possibility supports the view that investment might be better than loans.

Although a direct loan may appear more favourable than foreign direct investment when one includes the increasing equity assets of a foreign investor, the option available to Malaysia is not one or the other but rather in deciding upon different proportions of loans and equities. If industrialization in Malaysia is to continue, Malaysia needs foreign investors with the accompanying managerial and technical skills. In spite of this, there may be a very small margin of manoeuvre.[7] In any case, it is significant that the net volume of government loans in Malaysia is smaller than private long-term capital. On the other hand, the

[6]The results for other varying assumptions in interest rates, rates of returns, percentage of remittances and percentage of retained profits can be obtained from the previously mentioned table.

[7]See page 100.

loans received in the private sector show an increasing trend. If the present trend continues the inflexible interest payments on loans may cause the Malaysian balance of payments situation to deteriorate especially when this coincides with low export prices of the primary commodities. On the other hand, the net foreign direct investment in the private sector decreased from 1963, that is from $270m. to $127m. in 1967. In view of the importance of private capital to Malaysia's growth and balance of payments, it is worthwhile examining the likely causes for this decline. The factors of export prices, political stability, inflation, exchange rate stability, exchange control, rate of return of investment and the investment incentives will be examined.

The years of greatest inflow of net investment by private individuals occurred during the period 1962-4 with the largest amount of $235m in 1963. This period witnessed substantial foreign investment in the industrial area especially in oil refineries, food industries and plant for manufacturing tyres, chemical products and concrete products, electrical and consumer goods. This period may represent the first flush of optimism in the formation of Malaysia, which at the time included Singapore and represented a larger domestic market. In addition, international investment may also have been made in a belief that a rival, local or foreign, might preempt the market by building a stronghold for themselves and thereby obtain greater tariff protection and establishing a brand loyalty.

The decline in the volume of capital from 1965 to 1966 may be influenced by the Indonesian Confrontation which lasted from the end of 1963 to 1966. In 1965, Singapore withdrew from Malaysia. These factors could have dampened the initial expectations of investors.

Since 1966, the Malaysian government's policy has been to discourage companies which are wholly owned by foreigners and to require them to provide at least 50% of their equity capital for local participation.

1967 represents the year when capital inflow was lowest and this coincides with the period of depressed export prices for rubber. Table 2-3 shows the export prices of the main export commodities of Malaysia. In comparing the export prices with the fall in capital inflow into Malaysia one might be tempted to explain this by stating that there is a close relationship between export prices and private capital movements in the form of re-investment.

Helm[8] has found that when a time-lag of one year between rubber prices and replanting in rubber estates was allowed for, the correlation coefficient was about 0.8. The time series used was for 1950-66. The 1951 price and 1952 acreage of replanting were omitted on the basis that the 1951 price was exceptionally high.

[8]A.R. Helm, Some Aspects of post-war Agricultural Policy in West Malaysia, M.Sc. thesis, University of Hull. August 1969, unpublished, pp. 41 and VI (Appendix to Chapter II).

The positive correlation may be spurious. It is unlikely that the decision to replant is based on yearly rubber prices, since it is a well-known fact that they fluctuate. To replant according to price changes means that replanting will be intermittent. In addition, rubber trees take between 5-7 years to mature and the productive lifespan is about 25 years. This further supports the view that the policy of replanting especially by estates is preplanned and unlikely to be determinde by short-run changes in rubber prices. An estate's policy of re-investment is more likely to be determined by the long-run prospects rather than the year to year changes in export prices.

Macbean's study of twenty underdeveloped countries indicated '...that there is no clear association between the magnitude of fluctuations in investment and in the importing power of exports'.[9] In addition; '...there may be relatively little connection between the year to year receipts from exports of these companies and their current expenditures within the countries in which they operate'.[10] The 1968 figures of both capital inflow and export prices strongly support the argument that a downward movement of export prices does not determine the level of movement into Malaysia. The volume of capital inflow in 1968 was $200m. as compared to $127m. in 1967. This was in spite of the fact that the prices of the three exports (rubber, tin and palm oil) were all lower than prices in 1967. The conclusion is that export prices of primary products may not have affected the levels of private long-term capital significantly.

A further reason for the decline in capital inflow is that the rate of re-investment of foreign manufacturing firms is low, lower than locally owned or multiple ownership industries. Hirschman[11] has shown from Table 3-5 that the rates of re-investment for the two categories of foreign companies were only 4% and 11%. Column 5 of Table 3-5 shows the ratios for investment and profits in 1967. The pattern is basically the same with a much higher rate of re-investment by locally controlled firms as compared to foreign-controlled companies and branch plants of foreign companies. The very high net investments of locally owned companies in 1966 was due to new issued share capital.

In general, private capital movements are likely to respond to changes or expected changes in domestic prices and costs, foreign exchange rates and political stability given the other factors which influence the incentive to invest in a particular country. The arguments which follow indicate that there are no inflationary conditions in Malaysia, that the external value of the currency is

[9] A.I. Macbean, 'The Short-Term Consequences of Export Instability', in *Economic Policy for Development*, edited by I. Livingstone, Penguin, 1971, p. 224.

[10] *Ibid.*, p. 228.

[11] Charles Hirschman, 'Ownership and Control in the Manufacturing Sector of West Malaysia', *UMBC Economic Review*, Vol. VII, No. 1, 1971, p. 26.

TABLE 3-5 Peninsular Malaysia – Profit and Net Investment for Local and Foreign-Controlled Companies in Manufacturing, 1966-7, ($m)

	Profit before Taxes – 1966 ($'000)	Profit before Taxes – 1966 ($'000)	Net Investment 1967 ($'000)	Net Investment 1967 Profit-1966	Net Investment 1967 Profit-1966
Limited companies incorporated in Malaysia (locally controlled)	30,930	49,335	44,095	142.6%	89.4%
Limited companies incorporated in Malaysia (foreign-controlled)	57,008	57,218	2,775	4.9%	4.8%
Malaysian branches of limited companies incorporated abroad	28,828	32,704	3,350	11.6%	10.2%
Total	116,766	139,257	50,220	43.0%	36.1%

Source: Charles Hirschman 'Ownership and Control in the Manufacturing Sector in West Malaysia', *UMBC Economic Review,* Vol. VII, No. 1, 1971, p. 30.

TABLE 3-6 Malaysia – Retail Price Index (1959=100), 1960-70

	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970
Retail price index	99.8	99.6	99.7	102.8	102.4	102.3	103.7	108.0	108.2	107.1	108.6
Private capital		180	235	270	205	190	137	126	202	n.a.	n.a.

Source: IMF *International Financial Statistics, December 1969.* 4, 1971, p. 52.

stable, there that are minimum restrictions on payments and transfers for current international transactions, that Malaysia has been practising a unitary exchange rate, that investment incentives are attractive and that the returns of investments are high. This shows that in spite of these favourable conditions the amount of private foreign capital shows a decreasing trend form 1963 to 1967. This implies that the reasons for decreasing trend in private foreign investment after 1963 may be exogenous in nature and or that the Malaysian economy had temporarily reached a point where it could not absorb any more foreign capital. It could also be due to a combination of both these factors.

The relationship between private direct and portfolio capital movements and the retail price index (as an indication of inflation or non-inflation) is indicated in the Table 3-6.

The retail price index was stable from 1960 to 1970 with an indication of cost of living going up by 8% in 1970. It can be concluded that the economy was not suffering from inflation.

However, it might be noted that the retail price index might understate the extent of inflation slightly. Inaccuracy of the index is due to a number of factors. Firstly, prices used for the computation of the index differ from those paid by householders. This difference in prices was most obvious during the Indonesian Confrontation. Another reason for questioning the accuracy of the index lies in the area of information coverage. The data collected on consumption expenditure in the *1957-58 Household Survey* is to a certain extent unreliable because of wrong inclusion and exclusion of certain commodities. Items which were wrongly included cover 'losses on gambling', 'loans repayments' and 'life insurance premiums'.

Another limitation is the weighting system. The weighting system is based on the consumption pattern of the income group $1-$300. As a result of this, the index coverage is confined to this particular group. The price rises of commodities which are not consumed by this group are not included in the index. As standards and costs of living rise, both in the rural and urban areas, more and more households become concerned with items previously confined to a relatively higher income group. Following this trend, it can be argued on both theoretical and practical grounds that the list of commodities included in the index should be revised to include such commodities as television and scooters, as well as the increasing cost of education.

Other limitations include 'treatment of rents', 'outlet samples' and a lack of quality changes.[12]

[12] For a detailed discussion of the limitations of the Retail Price Index in West Malaysia, see my M.Ec. thesis, Index Numbers in West Malaysia, University of Malaya, April 1968, pp. 38-55, unpublished. See also my article, 'Quality Changes in Index-numbers Construction', in *Kajian Ekonomi Malaysia'*, 1970.

In spite of these limitations, the retail price index is the only objective indication of the extent of inflation in Malaysia.

The second important variable which can affect capital inflow is the external value of the Malaysian dollar or the foreign exchange rate. Table 3-7 shows the exchange rate of the Malaysian dollar to the US dollar from 1961 to 1968.

TABLE 3-7 Malaysia – Exchange Rate, Malaysian dollar to United States dollar, 1961-8.

	1961	1962	1963	1964	1965	1966	1967	1968
Exchange rate	3.05	3.06	3.06	3.07	3.08	3.08	3.07	3.08
Exchange rate Index (1962 = 100)	99.6	100.0	100.0	100.3	100.3	100.3	100.3	100.3

Source: IMF *International Financial Statistics, December 1969.*

The table indicates that the exchange rate has been very stable with minor variations from $3.05 to $3.08 per US dollar, the par value being 3.0622. In terms of percentage fluctuations from the official par value the variation is -0.4 to 0.3 percent. The advantage of having a stable exchange rate is that it is likely to encourage capital inflow and investment. If the exchange rate is unstable, especially if devaluation of the exchange rate is more likely, then the investment climate is unhealthy. It is possible that a foreign investor can with business acumen generate a profit in terms of local currency from his venture but if the exchange rate depreciates the investment may turn out to be a loss rather than a gain.

Another feature of the foreign situation in Malaysia is that there is minimum exchange control. Foreign exchange control is only applied to the non-sterling area. However, it should be noted that several important investors are from non-sterling countries. For instance, by the end of 1967, the major foreign investors were United States, United Kingdom, Hongkong, Canada and Japan in that order of importance.[13]

Malaysia has also been operating a unitary exchange rate. This is in contrast to

[13] Federal Industrial Development Authority, *Malaysia Industrial Digest*, Vol. 1, No. 4, Fourth Quarter, 1968, p. 13.

several other developing countries where multiple exchange rates systems exist.[14] In a multiple exchange rate system, it is necessary for the investors to form a view not only of the future strength or weakness of the balance of payments, but also of the probable relative changes of exchange applicable to various transactions. For instance, in some circumstances, experience may lead investors to expect that whereas the basic export rate would remain unchanged for some time, the rate applicable to capital transactions and the repatriation of earnings would tend to depreciate. This is particularly so when, during an inflationary period, foreign exchange of capital and earnings transactions are bought and sold at a free or relatively uncontrolled exchange rate while the export rate remains constant or is depreciated by less than the free rate.

Table 3-8 shows the returns on direct British investment in Malaysia and the rates compare favourably with other developing countries in the Commonwealth. The average rate of return for the period 1960-5 is 16% and is above the average of 9.5% for the Commonwealth developing countries taken as a whole.

TABLE 3-8 Averages Rates of Returns on Direct Investment by Countries, 1960-5.

	1960	1961	1962	1963	1964	1965
Commonwealth developing countries	10.8	9.8	9.2	9.2	9.7	9.0
Ceylon	6.7	5.6	4.4	5.5	3.3	5.2
Hongkong	22.4	20.7	20.7	13.7	14.6	21.5
India	3.4	8.3	8.4	6.7	6.9	7.6
Malaysia	17.8	17.1	14.8	15.3	15.8	14.5
Pakistan	8.0	8.0	10.2	6.8	9.4	8.4
Singapore	30.7	32.7	26.7	n.a.	n.a.	14.8

Source: H.M.S.O. *Board of Trade Journal,* Vol. 196, 9 May 1969, p. xv. Table 12.

The statistics for returns to investment thus show that Malaysia does offer some opportunities for a comparable level of profits to be made

A favourable investment climate acts as an attraction for foreign investment. However, it needs to be emphasized that a favourable climate must be thought of

[14] According to the IMF, an effective buying and selling rate which as a result of official action differs from parity by more than 1% constitutes a multiple exchange rate.

as being necessary but not as a sufficient condition for attracting foreign capital. A summary of the investment incentives in Malaysia is given in figure 3-1. However, it is often argued that one of the obstacles to foreign investment is the Malaysian government's insistence on local participation. At present, joint venture companies which have been granted pioneer status are required to provide 51% equity capital for local participation. Non-pioneer companies are required to provide 50%. It is argued that foreign firms have a preference for sole ownership of their subsidiaries. The explanation given for this preference is that sole ownership allows for effective decision making and that it facilitates management in the planning of operations internationally without having to account separately to their shareholders or to a third party – for the current profitability of each of their subsidiaries in overseas markets.[15] Kanapathy argues that this is not true because if a foreign firm is genuinely interested in investing it would welcome local participation for several reasons – it builds immediate goodwill, establishes contacts and markets, and is generally beneficial in the company's long term interest.[16] Both arguments are true. This is because whether a foreign investor prefers or disapproves of joint ownership depends on individual psychology, the type of business ventures and past experience (if any). It is significant to note that the Malaysian government has recently recognized this problem and has agreed to a flexible policy especially if the companies are more export-oriented and do not wholly need the domestic market support.[17]

In any case, if foreign firms are bent on sole ownership rather than joint ventures, it is known that this obstacle could be overcome in Malaysia. There is nothing at present to prevent a foreigner from buying shares of a firm when the ordinary shares of such a concern are transacted on the Stock Exchange of Malaysia and Singapore. Furthermore, there is nothing in law which prevents manipulation of purchases in the names of nominees or even citizens at a premium held in trust and with permanent proxy forms signed in advance for voting purposes over to the foreign investor concerned.[18]

This view is also held by Parkinson. He believes that '...a business venture which begins life as a joint venture may become one whose share distribution

[15] H. Hughes and You Poh Seng, *Foreign Investments and Industrialization in Singapore*, A.N.U. Press, 1971, p. 51.

[16] V. Kanapathy, 'Foreign Investments in Malaysia: Experience and Prospects', *UMBC, Economic Review*, Vol. VI, No. 2, 1970, p. 10.

[17] *Straits Times, 25* September 69.

[18] Siew Nim Chee, 'The Issue of Local and Foreign Investments and the Place of Multi-National Corporations in our Developing economy', *The Great Economic Debate*, University of Malaya, Economic Society, 8-12 June 1971, p. 28.

is foreign dominated'.[19]

Furthermore, the supposed supremacy of shareholders' votes at an Annual General Meeting or an Extra-Ordinary General Meeting which form the basis of the 51% is invalid as the attendance at many such meetings of some of the largest companies in Malaysia seldom exceeds a dozen or more members. More often than not, any bloc holding in excess of 25% to 30% of shareholders votes would constitute a majority unless very contentious issues are at stake.[20]

Any conclusion about whether tax concessions and pioneer status were responsible for inducing foreign investments in Malaysia is generally inconclusive. However, Parkinson argues that '...even if tax concessions could be shown to be relatively unpersuasive in themselves, they do form part of a "package" which helps to show businessmen that this government is willing to play its part in industrialization'.[21] In addition, it may have considerable psychological impact. A further point is that it is certainly quite possible that tax concessions altered the timing of investments into Malaysia.[22] Foreign firms might have invested earlier than they actually did.

Finally, as a summary of the general investment climate in Malaysia during the period under review, one might adopt a rating scale which has been used by US multinational firms.[23] Table 3-9 shows the variables and the rating scale used for assessing the investment climate. In addition, an attempt has been made to award points for each variable within the Malaysian context. Some of these variables have already been discussed earlier.
The rating given in this table indicates that the investment climate in Malaysia is favourable.

In theory, it is safe to assume that inflation and an unfavourable investment climate (defined to take into account the variable discussed above) discourage capital inflows and encourage capital outflows. On the other hand, if the country does not face continuous exchange rate depreciation and if inflation is non-existent, then assuming other things constant one would expect capital inflow. As has been shown, Malaysia has had a favourable investment climate. Yet, for the period 1963-7 there is a decreasing trend in direct private capital inflow. To be sure, capital movements respond to a large number of factors which affect the

[19] Brien K. Parkinson, *op. cit.*, Chapter VI.

[20] Siew Nim Chee, *op. cit.*, p. 28

[21] Brien K. Parkinson, *op. cit.*,Chapter VI.

[22] *Ibid.*

[23] See R.B. Stobaugh, Jr., 'Where in the world should we put that plant', and 'How to analyze foreign investment climates', in *Harvard Business Review*, Vol. 47, January/February 1969, p. 129-36 and September/October 1969, pp. 100-8.

INVESTMENT INCENTIVES ACT 1968

(a summary)

I. PIONEER STATUS

(a) Procedure for granting Pioneer Status remains the same.

(b) Scope extended to non-manufacturing industries.

TAX HOLIDAY

- CAPITAL INVESTMENTS
  - Less than $250,000 = 2 years
  - $250,000 plus = 3 years
  - $500,000 plus = 4 years
  - $1 million plus = 5 years
- ADDITIONAL YEAR
  - (a) Development Area, or
  - (b) Priority Products, or
  - (c) Specified Local Content

CAPITAL ALLOWANCES

Where losses incurred every year throughout tax relief period allowed to be notionally calculated and aggregated as deducation in post-pioneer period

DIVIDENDS

Now exempted in hands of shareholders of companies receiving tax-free dividends from pioneer companies

PAYROLL TAX

Present exemption from payroll tax continues.

II. INVESTMENT TAX CREDIT

(a) Given once for year of assessment in which capital expenditure is incurred.

(b) Capital expenditure must be incurred within 5 years from beginning of basis period in which project is approved.

Granted to companies not considered qualified or deserving pioneer status or as choice by companies

Amount not less than 25% of capital expenditure incurred on factory, plant or machinery for approval project.

- Additional 5%
  - (a) Development Area, or
  - (b) Priority Products, or
  - (c) Specified Local Content

Tax Relief equals amount of credit and credit can be carried forward in case of loss or insufficiency of income until fully utilised against subsequent profits.

Dividends exempted also in hands of shareholders in pioneer companies.

III. EXPORT INCENTIVES

DEDUCTIONS FOR PROMOTION OVERSEAS	**Expenses Qualified** (a) Overseas advertising. (b) Supply of free samples overseas. (c) Export market reserach. (d) Preparation for overseas tenders. (e) Negotiation and conclusion of contracts overseas. (f) Supply of technical information overseas.
ACCELERATED DEPRECIATION ALLOWANCE	Only resident companies qualified Must export 20% by value. Given only in respect of capital expenditure incurred for modernization. Rate – 40% per annum.
EXPORT ALLOWANCE	Non-resident companies and exports of primary commodities excluded. Allowance related to increase in (a) Exports; (b) wages paid in respect of employees with less than $500 basic wage per month; (c) amount of Malaysian materials used (50% of which by value provided in Malaysia). Scheme allows deduction for income tax purposes of 20 cents for every dollar incurred on wages and Malaysian materials used in basic period. Formula used:– $\frac{(VE) - (AV\ 3)}{GS} \times 20$ cents VE = value of export sales in basis period. AV 3 = average of export sales for 3 preceding years. GS = gross sales for basis period.
PAYROLL TAX	Granted to registered companies exporting more than 20% of the total production of registered products. Refund based on the proportion of export turnover to the value of the total turnover of company for the year.

Source: *Malaysia: Investment Incentives Act*, 1968, pp. 13-14.

TABLE 3-9 Indication of the Investment Climate in Malaysia

	Number of Points	
	Malaysia	Maximum
1. Capital repatriation (no restrictions)	12	12
2. Foreign ownership allowed (joint ownership on a 50% basis)	6	12
3. Discrimination and control, foreign versus domestic business. (no discrimination, certain amount of bottle-neck in administration and processing of applications)	8	12
4. Currency stability (no devaluation since 1949)	20	20
5. Political stability (Indonesian Confrontation 1963-6, Singapore split in 1965, racial disturbance in 1969 and Communism)	4	12
6. Willingness to grant tariff protection (see Figure 3-1)	6	8
7. Availability of local capital (open stock exchange, fair amount of local capital in terms of bank deposits and government reserves)	8	10
8. Amount of inflation for last five years. (change of 8% since 1959)	12	14
Total	76	100

yield expected by investors. For 1963-7, there was a short fall in private long-term capital and this reflected in part the continuing decline in the acreage of European rubber estates, a decline which was not fully offset by increases in their oil palm acreages. Investment in the traditional rubber and tin industries has declined with the slowing down of rubber replanting and new planting (about 90% of rubber estates in Peninsular Malaysia were already planted with high-yielding material by the end of 1968) and the gradual exhaustion of tin-bearing land.[24] There has been some disinvestment in British estates since 1966,

[24] Bank Negara Malaysia, 'An introduction to the Malaysian balance of payments', *Quarterly Economic Bulletin*, Vol. 2, March 1969, p. 44.

particularly as a result of the introduction in the United Kingdom of the Corporation Tax on overseas trading companies in 1965. More generally, the period 1965-7, was also one of relative capital scarcity abroad, where balance of payments problems were felt, a tight money market developed in the U.S. and Europe, and economic difficulties affected the United Kingdom.

One conclusion which can be drawn is that the cause for the decline of direct foreign capital was exogenous in character and that this rendered largely ineffective any domestic policies to attract capital.

This hypothesis supports West's view that the adjustment process in industrialized countries, especially those in the Group of Ten, have a pronounced effect in the developing countries. During periods of low and declining activity in industrialized countries, the effect on developing economies is: export prices decline more than import prices and more important sources of private foreign capital dry up and public capital is at harder terms and less readily available.[25]

Another possible explanation is that the Malaysian economy may have been unable to absorb foreign investments because of the initial large flow of foreign capital during the early sixties. Since the investment climate is and was favourable this seems a reasonable alternative. Although it is difficult to prove the above assertion conclusively, a recent comment by the Prime Minister may lend some support to it. He commented that 'Malaysia is not able to absorb large amount of bilateral credits which are tied to the exports of goods from donor countries because of her "limited" need to direct importation of foreign goods.'[26]

A third possible explanation for Malaysia's inability to absorb investment is likely to be due to skilled manpower shortages. The main difference between foreign investments and loans is that foreign skills accompany the former but rarely the latter.

It is most probable that the decline in capital inflows for the period 1963-7 is the result of all three explanations.

In 1968 private capital inflow showed a very marked increase. It is difficult to be sure why there is a sudden influx in any one year. It could be argued that it is merely a random event, or possibly a number of events may have led up to it. Firstly, the New Incentives Act, 1968, was implemented. This reason seems unlikely because of the time-lag between the introduction of the Incentives Act and the movement of foreign capital. Secondly, there was a change in the lending policies of the MIDFL as from 1968. It is only since 1968 that there has been a reduction in MIDFL's overall liquidity position and any substantial increases in

[25] Robert L. West, 'The Impact of Adjustment on Developing Countries', in *Maintaining and Restoring balance of payments*, Fellner, Machlup, Triffin etc, pp. 223-41.

[26] *Malay Mail*, 17 November 69.

the amount of industrial lending.[27] Before 1968, Drake[28] is of the opinion that the lending policies of MIDFL were over-cautious, and their relaxation may have encouraged an inflow of foreign investments. Thirdly, there may have been some increased investment in the palm oil and timber industries. Finally, there may have been a re-assessment of the economic situation of Malaysia after the Singapore-Malaysia political split and the ending of the Indonesian Confrontation in 1966. There is certainly a time-lag between the decision to invest and the actual investment – even if it is only administrative – and this might explain why political changes in 1966 did not result in increased investments till 1968.

The crux of the problem about long-term capital movement in Malaysia is not that there is no inflow but rather that it is decreasing and whether the present volume of inflow is sufficient for the objectives of economic development. The adequacy of private capital inflow is relative to the needs of economic development and for offsetting balance of payments deficits. In comparing capital inflow with the current balance in the Malaysian balance of payments, it is significant to note that the inflow of net private capital has been more than sufficient to offset the current accounts deficits. If one can ignore the unrecorded short-term capital, the conclusion can be drawn that balance of payments problems do not exist. A balance of payments problem here is taken to mean a shortage of foreign exchange. On the other hand, in comparing the cumulative total of private capital inflow from 1966-8 with the development plan cumulative for the same period, (i.e. private capital inflow in the Malaysian programme balance of payments) it is clear that the inflow was inadequate. The realized inflow was $455m. while the planned cumulative total was $600m. In the long run, it is further inadequate because the strength of the balance of payments is dependent on the rate of economic growth and hence the implementation of the development plans. Since the volume of realized private long-term capital fell short of what was needed to implement fully the Second Five-Year Plan, it may be probable that the same rate of economic growth may not be maintained. This may affect the long run balance of payments situation adversely.

Finally, in view of the current emphasis on foreign investments, it is pertinent to consider the long-run impact of direct foreign investments on the Malaysian balance of payments. Initially, foreign investment results in an increase in the foreign exchange of a country. The eventual remittances of profits would not seriously affect the balance of payments so long as the inflow of foreign capital is larger than the outflow. There is a situation which can arise and is undesirable. The established foreign-owned or controlled firm may increase its assets position

[27] Brien K. Parkinson, *op. cit.*, Chapter VI.

[28] P.J. Drake, *Financial Development in Malaya and Singapore*, A.N.U. Press, Canberra, 1968, pp. 162-96.

from the company's net income. Thus the increased investment by the foreign firm may be out of local savings and local resources. If this is on a large scale, the withdrawal of the profits due to this new investment will have a net negative effect on the balance of payments. This kind of investment does not produce any transfer of foreign exchange into Malaysia at any stage.

Closely akin to this problem is the possible growth of mergers and/or take-overs, which would result in foreign firms taking over domestic firms or having controlling interests in them. This in turn could increase the repatriation problem as the firms become completely foreign-owned. Singapore is getting worried about this and is trying to think of ways to prevent it.

A further argument against foreign investment is the extent to which foreign firms usurp investment opportunities, with the result that entrepreneurs have no opportunities, or less profitable ones, to exploit than would be the case were there no foreign investment.[29]

As a result of these arguments, there is a further case against foreign investments as a means of industrialization. In spite of this, there are few practical alternatives for a government bent on achieving a rapid rate of industrial growth.[30] This is because there are industries which may require a level of finance, technology or managerial expertise which local businessmen cannot yet produce in adequate amounts.

However, even though the practical alternatives of industrialization without foreign capital are limited, there are two possible partial solutions.

Firstly, the government and/or the state government can actively participate in the Malaysian industrialization programme by direct investments. The government has ample foreign exchange[31] which it can use. Foreign technical expertise and skilled manpower could be employed. The amount of foreign exchange spent on wages on these groups of personnel generally, is much less than repatriation of profits of foreign firms. This proposal would represent a change from the past government policy of non-direct participation in the private sector of the economy. Parkinson has argued that although government ventures have failed in other South-East Asian countries, there is no *a priori* reason why they should fail in Malaysia. In addition, the fear in private businesses that the government may use unfair business tactics against them can be dispelled by the Malaysian government assuring them that such tactics would not be used. The

[29] Henry J. Bruton, 'The Issue of local and foreign investments and the place of multinational corporations in our developing economy', in *The Great Economic Debate*, University of Malaya Economics, June 1971, p.33.

[30] Brien K. Parkinson, *op. cit.*, Chapter VI.

[31] This statement will be analyzed in Chapter IV.

Singapore government has shown that it is capable of entering into the manufacturing field without resorting to such tactics.[32]

Another possibility is for the government to set up some institution to demarcate industries where foreign expertise or capital is not necessary. These industries could then be reserved for local industrialists, or where capital is lacking the government could set up such industries on a joint ownership basis with local businessmen. This alternative is possible but difficult to achieve.

So far the discussion has been on long-term private capital movements. One of the main strains on foreign reserves is the movement of short-term capital. This is particularly true for developed countries in recent years like the U.S. and West Germany. In the case of Malaysia, there are no separate figures for recorded short-term capital movements. In fact, all short-term capital movements have been treated as a residue in the balancing item 'net errors and omissions'. In general, irrespective of the method of presenting the balance of payments the items 'errors and omissions' is present. 'Net errors and omissions' represents a gap in the analysis of the balance of payments. This implies that the monetary movements of the balance of payments in the given period reflects not only the net total of known estimated transactions but also some transactions which have not been identified.

It is possible to give reasons for the causes on a general basis but it is impossible to pin-point the specific areas of errors. It seems probable that errors can arise from the following: visible trade in the trade accounts, invisible trade, timing errors in the transactions, time-lags between receipts and payments, problems of valuation and methods of collection of data. A detailed discussion of these factors as a source of errors has been given in Chapter I.

What is more difficult to explain is the magnitude of the item and its changes from time to time. Since 'errors and omissions' is a net figure the fact that it may be large or small does not necessarily indicate how accurate and inaccurate the balance of payments statement is. If a transaction is omitted entirely, this omission would have no effect on net 'errors and omissions' account, since equal amounts of credit and debits will have been left out. The account is affected when a) a credit entry and its contra-debit both have been incorrectly recorded but the errors do not offset each other, b) a credit entry correctly entered but its contra-debit is partly or completely omitted or a debit is entered in its proper place and its contra-credit partly or completely omitted. Since large debit omissions may be offset by equal credit omission and since errors can offset each other, a high or low 'errors and omissions' may not normally be significant but if it is large, it is clear evidence that something is wrong.

[32] Brien K. Parkinson, *op. cit.*, Chapter VI.

TABLE 3-10 Malaysia – Errors and Omissions, 1961-70.

1961	1962	1963	1964	1965	1966	1967	1968	1969	1970
–99	–104	–210	–274	–326	–385	–316	–391	–470	–386

Source: Bank Negara Malaysia, *Annual Reports*, 1969 and 1970.

These figures indicate that the magnitude has changed from year to year but what is significant is that it has always been negative or an outflow. One explanation is that the individual items in the net 'errors and omissions' is of a random nature. However, this argument may not be completely plausible. More likely there are other reasons for it. The period 1963-6 shows an increasing trend when compared to 1962. This period coincides with the period of Indonesian confrontation, and with political uncertainties outflow of short-term capital is expected. 1965 was also the year of Singapore's withdrawal from Malaysia. Unrecorded outflows declined in 1967. It may be that capital outflow resulting from the sale to nationals of foreign-owned estates declined this year because depressed rubber prices depressed offers and owners decided to hang on in hopes of better future prices.[33]

In 1969, the merchandise balance was at $1,481m., the largest since 1960. If the size of 'errors and omissions' is rigidly correlated with export surpluses, then the 'errors and omissions' should also be one of the largest. The 'errors and omissions' in 1969 was $470m., the largest outflow during the sixties. This lends support to the view that 'errors and omissions' contain a large part of unrecorded capital movements and trade due to the agency house system.[34] However, it should also be noted that 1969 represents a year of political instability in Malaysia. The racial riots in May could have triggered off an outflow of capital. Although the size of outflow is unknown, it is widely believed that there was capital flight during this period. The extremely large outflow reflected by 'errors and omissions' may to some extent substantiate this belief. In any case the conclusion is that political uncertainties and to a lesser extent, the balance of trade do affect the magnitude of 'errors and omissions'. The elasticity of response of outflow of short-term capital to certain crises, like the Indonesian Confrontation, the Singapore-Malaysia split and the racial troubles appear to be positive.

Another possible source of 'errors and omissions' would be the smuggling activities around the Thailand-Malaysian border. It is known that large quantities of rice are smuggled into Malaysia. The payments for such activities would not be recorded. Smuggling across the seas from Indonesia to the coast of Malaysia

[33] IBRD, *Economic Mission to Malaysia, 1970*, p. 54, unpublished.

[34] The agency house system has already been discussed in Chapter I.

especially Penang is also fairly common.[35]

A further possible source of omission refers to the manner in which Indians remit part of their wages and savings to India. The principle behind this system is that immigrants pay into a 'pool' in Malaysia the money they wish to send home. Their relatives are then able to withdraw rupees from the syndicate at the other end of the link. At this point, no money actually leaves Malaysia.

Instead money is kept here for Indian businessmen who want to buy goods but are limited by the amount of foreign exchange available in India. It is at this stage that the balance of payments would be affected. There should under normal circumstances be an inflow of foreign exchange for goods sold by Malaysians to Indian businessmen but since funds are withdrawn from the 'pool' in Malaysia, there would be an under-recording of foreign exchange.

The main direction of Indian illegal currency flows has undergone a change as well. Formerly, most of it was going to West Asia, particularly to Iran and the Persian gulf ports. Now it goes to South-East Asian countries, mainly Hongkong and Singapore for nylon yarns.[36] This may have resulted in movement of funds from Malaysia to Singapore.

The reason for the popularity of this system is that immigrants may get as much as 60% or more above the official rate. It is known that the prevailing unofficial rates are Rs3.50 or Rs4 for a Malaysian dollar as against the official rate of Rs.2.50[37]

Whether interest rates differential is a factor influencing the movements of unrecorded short-term capital in Malaysia is open to speculation. In the US, attempts have been made to link a credit or debit balance with the existing interest rates or investment returns. Supporting such an interpretation is the fact that during the post-war years when the US was an attractive haven for investment funds, the 'errors and omissions' figure was posted on the credit side of the ledger every year but 1950. Then, in 1960, when new strength of several currency in combination with prevalence of higher interest rates in money centres abroad created incentives for funds to move overseas, 'errors and omissions' became a debit entry for the first time in ten years.[38]

[35] Angus Maddison, 'The Balance of Payments of Developing Countries', *Banca Nazionale del Lavoro*, Vol. 19, 1966, p. 153. Maddison of the O.E.C.D. Development Centre believes that smuggling is important in Malaysia and that smuggling may well amount to more than 5% of recorded trade.

[36] B.V. Kumar, 'Foreign Exchange Racket', *The Illustrated Weekly of India*, 17 October 1971, p. 16. See also 'Black Money: India's parallel Economy', by Dr. Hannan Ezekial, in the same magazine, pp. 9-13, and *The Times*, 30 November 1971.

[37] *Ibid.*, p. 14.

[38] The Morgan Guarantee Survey, 'The Book-Keeping on the balance of payments', in

In the case of Malaysia, changes in the interest rates for the period 1960-8 are shown in Table 3-11. Changes in the level of interest rates occurred in all years except 1963, 1965 and 1966 since the establishment of the Central Bank. In 1960, 1961, 1964 and 1967 all upward adjustments to both the deposit and advance rates followed the rise in interest rates abroad. The main consideration was to stem any possible outflow of funds abroad in view of the close financial links in Malaysia with other monetary centres, particularly London, as well as the virtual absence of exchange control. In 1962 interest rates were reduced, partly to conform with international trends and partly in the interest of facilitating productive investments in the economy.

An examination of the changes in the interest rates structure and 'errors and omissions' indicate a fairly close correlation. When interest rates went up from 4% in 1960 to 5% in 1961, 'errors and omissions' were reduced to $99m. as compared to $204m. in 1960. A reduction of the interest rate in 1962 resulted in a marginal increase in 'errors and omissions'. The year 1963-6 represented years of political uncertainty and short-term capital movements may have been more influenced by the latter factor than changes in interest rates. In 1967 and 1968, with upward adjustments of interest rates, 'errors and omissions' declined in magnitude.

The Malaysian Statistics Department also believes that interest rate is a factor, although an indirect one. It is claimed that one source of such an effect would be changes in the timing pattern between payments for imports and exports and their physical arrival. Such changes are part of the normal pattern that ensues whenever there are changes in interest rate differentials between countries.[39]

The above arguments suggest that there may be a loose link between 'errors and omissions' and changes in interest rates in Malaysia but the evidence is less than conclusive.

From the discussion so far, it seems reasonable to suggest that 'errors and omissions' do reflect largely unrecorded private short-term capital and it is very significant to note that total private capital (difference between private long-term capital and 'errors and omissions')[40] has been of an adverse nature because the outflow of private capital has been larger than the inflow.

Changing Patterns in Foreign Trade and Payments, by Bela Balassa and N.W. Norton, New York, 1964, p. 15.

[39] Department of Statistics, *Balance of Payments Estimates, 1967, 1968 and first half 1969*, Appendix.

[40] Malaysia – Difference between private long-term and 'errors and omissions', 1961-8, $m.

1961	1962	1963	1964	1965	1966	1967	1968
81	126	60	−69	−96	−154	−112	−141

TABLE 3-11 Malaysia – Interest Rates, 1960-8

	Treasury Bills Discount Rate[1]					Commercial Banks Interest Rates. (per annum) fixed deposits.			
	3 mths.	6 mths.	9 mths.	12 mths.		1 mth.	3 mths.	6 mths.	9 mths.
1960									
April 19	3	3	32/3	3¼	1960	–	3	4	4
1961	4	4	4	4					
August 10	5	5	5	5	1961	–	5	5	5
1962					1962				
February 15	4½	4½	4½	4½	Feb. 2	–	4½	4½	4½
August 30	4	4	4	4	Aug. 30	–	4	4	4
1963	4	4	4	4	1963		4	4	4
1964					1964				
November 25	5	5	5	5	Jan. 1	2	4	4	4
					Nov. 25	2½	5	5	5
1965	5	5	5	5	1965	2½	5	5	5
1966	5	5	5	5	1966	2½	5	5	5
1967					1967				
November 20	5½	5½	5½	5½	Nov. 20	2	5½	5¾	6
1968					1968				
June 10	4½	4½	4½	5½	May 1	3	5½	5¾	6
August 1	4½	4½	5	5½					

Source: Bank Negara Malaysia, *10th Anniversary Report, 1969*, Table IV. 2. p. 50
IV. 1. p. 49

1. Dates refer to dates of changes

Table 3-12 shows the difference between 'errors and omissions' and the overall balance of payments for the period 1961-70. It is very significant to note that there has been an outflow of capital for all years with the exception of 1969. What is alarming is that when the outflow in 1966 or 1967 is compared to the total foreign exchange reserves of Malaysia, the outflow represents one quarter of the total reserves of the country.

TABLE 3-12 Malaysia – Difference between the Overall Balance of Payments and 'Errors and Omissions', 1961-70. ($m)

1961	1962	1963	1964	1965	1966	1967	1968	1969	1970
–21	–83	–287	–112	–193	–552	–558	–411	60	–326

Finally, an interesting fact that emerges from a comparison of the residuals in various countries is that most of the primary producing countries show negative 'errors and omissions' year after year, while the majority of the industrialized countries have positive 'errors and omissions'. It does not seem likely that the negative residuals in the primary producing countries and the corresponding positive residuals in the primary producing countries are solely the result of unregistered capital movements from the primary producers to the industrialized countries. Theoretically, there may be reasons for suspecting the occurrence of of systematic 'errors and omissions' in the trade statistics of the various countries – errors which can help to explain the tendency towards a negative residual in the primary producing countries, and positive residuals in the industrialized countries. For fiscal reasons, there would be strong incentives to undervalue the imports of certain primary producing countries. The extent to which systematic errors are present in the trade statistics of the industrialized countries is unknown but it is likely that there are tax motives for undervaluing export incomes.[41]

[41] Sven Grassman, 'The Balance of Payments Residual', *Skandinaviska Banken, Quarterly Review*, 2, 1967, p. 44.

CHAPTER IV
FOREIGN EXCHANGE RESERVES AND FOREIGN EXCHANGE RATE POLICIES

This chapter examines the use of 'offsetting adjustment'[1] policy, that is, the use of foreign reserves to cushion balance of payments disturbances. Within this context, an assessment of whether the present volume of foreign exchange reserves is adequate in relation to various objectives will be attempted. A second aim is to study the foreign exchange rate policy of Malaysia for the period 1960-70 and in the light of the British devaluation in 1967, to examine Malaysia's decision to devalue the old Malayan dollar with the pound sterling but not the new Malaysian dollar.

USE OF FOREIGN RESERVES AS AN 'OFFSETTING ADJUSTMENT' POLICY

The balance of payments of any country is constantly exposed to innumerable disturbances. As a result, countries have always relied upon their foreign exchange reserves to even out vicissitudes in the balance of payments. Malaysia is no exception and, in fact, has been relying constantly on external reserves to act as a cushion against temporary fluctuations in the balance of payments. This is to enable Malaysia to overcome the difficult years which may arise from poor commodity prices, high level of imports or insufficient capital inflows with respect to development expenditure without significant adverse effects in the rate of development.

The size and composition of foreign reserves of Malaysia will be determined first and this will be followed by a study of the appropriate policy with respect to the reserves. The monetary reserves[2] of Malaysia can be taken as the assets which the financial authorities have available to meet payments to other countries. The total gold and foreign exchange reserves or international liquidity position of a country may be classified as primary, subsidiary and *ad hoc* liquidity. In estimating the total quantum of international liquidity, particularly from the viewpoint of developing countries, *ad hoc* liquidity should be excluded.[3]

[1] S.B. Linder and B.J. Cohen, 'Balance of Payments Adjustment in a disequilibrium system', *Kyklos* Vol. 17, 1964, pp. 83-88.

[2] The two tests before an item can be considered as reserves or near reserves are first its availability to the monetary authorities of the country and second its acceptability by potential creditors.

[3] Rajendra Kumar, 'The problem of international liquidity of developing countries especially

Primary reserves refer to the gold and foreign reserves which belong to the country and so their use is unconditional. Malaysia's official external assets and commercial banks' foreign assets are made up of gold and foreign exchange reserves and these constitute Malaysia's primary international liquidity. The inclusion of commercial banks' foreign assets implies that the financial authorities assume that should the necessity arise such resources could be used to overcome the balance of payments difficulties. In other words the 'overall' concept of the balance of payments has been used. (The validity of the inclusion of commercial banks' assets has been discussed in Chapter 1.) The Total external foreign assets of Malaysia and the year to year changes in reserves are given in Table 4-1. This table reflects generally the overall favourable position of Malaysia's gold and foreign exchange. The reserves have remained well over $2,000m. for most years with the exception of 1958, 1967 and 1968. The overall deficit was $418m. for 1966 and 1967 ($171m. for 1966 and $247m. in 1967). The loss consists of treasury bills of $183m. being discounted for the commercial banks of Singapore and the loss due to the British devaluation of sterling in 1967. Neither of these factors, which resulted in the loss of reserves, were related to economic deterioration in the economy but rather to conditions not related to the economic performance of Malaysia.

Subsidiary reserves are provided by the I.M.F. to any of its member countries for meeting current balance of payments difficulties. As a rule, a member country's access to international liquidity through the Fund falls into two parts: gold tranche and the credit tranches. The gold tranche is equivalent to a member's gold contribution to the I.M.F., an amount which is normally 25% of its quota. The other facilities for drawing funds from the I.M.F. refer to the Stand-By Arrangements, Compensatory Financing of Export Fluctuations and Special Drawing Rights. The first facility refers to a situation in which members enter into Stand-By Arrangements to ensure that drawings may be made up to specified limits and within an agreed period if the members observe the conditions, e.g. specific policies which the member has indicated its intention to pursue in the field of exchange, monetary and fiscal matters. Malaysia has not entered into any Stand-By Arrangements with the I.M.F. Compensatory Financing of Export Fluctuations may result in an increase of funds up to 50% of the member's quota provided that the Fund is satisfied, first, that the short-fall is of a short-term nature and is largely attributable to circumstances beyond the control of the member and, second, that the members will co-operate with the Fund in an effort to find, where required, appropriate solutions for balance of payments difficulties. This facility was introduced particularly for primary exporters encountering payments difficulties produced by temporary export shortfalls. The essence of the Special Drawing Rights scheme is the creation by the Fund

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India', *The Developing Economics*, Vol. XIII, September 1965, No. 3, p. 343.

TABLE 4-1 Malaysia – Gold and Foreign Exchange Reserves, 1958-70, ($m)

	At cost as at end of period												
	1958	1959	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970
Reserve position in IMF[a]	–	–	–	–	10.4	22.0	22.6	42.1	61.9	97.0	101.1	109.0	227.3*
Central Bank[1]	737.4	1020.0	1089.0	1068.4	1149.4	1181.9	1242.8	1332.5	1377.8	1302.0	1475.9	1973.7	2008.2
Govt.[3] and agencies[2]	624.8	809.2	1164.5	1338.0	1298.5	1236.5	1035.8	958.9	755.8	510.8	420.9	322.6	278.4
Official external reserves	1412.2	1829.2	2253.5	2406.4	2458.3	2440.4	2301.2	2333.5	2195.5	1909.5	1997.9	2405.3	2512.9
Comm. Bk. foreign liabilities	61.9	69.7	95.1	108.6	166.4	201.2	322.7	236.7	276.0	211.3	355.2	339.0	287.2
Comm. Bk. foreign assets (net)	321.8	333.1	335.4	258.3	235.0	176.3	176.5	278.8	246.2	55.3	–59.7	66.0	82.2
Total external reserves	1734.0	2162.3	2588.9	2664.7	2693.3	2616.7	2477.7	2612.3	2441.7	1964.8	1938.2	2471.3	2595.1
Year to year changes		428.3	426.6	75.8	28.6	–78.6	–139.0	134.6	–170.6	–247.9	–26.6	533.1	123.8

1. Include Malaysia's estimated share of the foreign assets of the Board of Commissioners of Currency, Malaya and North Borneo
2. Central Government and State Governments of Sabah and Sarawak

a. Refers to primary reserves, i.e. gold.

3. Government
4. Commercial Banks

Source: Bank Negara Malaysia, *10th Anniversary Commemorative Issue*, Table VII. 6, p. 65.

*Includes as from 1970 – Special Drawing Rights which were activated on 1 January 1970. [$71.6m.] 1969-70 – Computed from Table 39, p. 119. Bank Negara Malaysia, *Annual Report, 1970.*

to supplement the world's monetary reserves without any deposits of gold or currencies by the participating countries. Every member of the Fund may participate and allocations of Special Drawing Rights will be made in proportion to their quotas to the Fund. Participating countries can use these new drawing rights unconditionally, transferring them in the books of the Fund to another participant (designated by the Fund) which will be obliged to supply its own currencies or another currency in exchange. There are, however, provisions for reconstitution which require that participating countries should, on the average for a five year period, hold drawing rights to the amount of 30% of the average of their net cumulative allocations over the period.[4]

In essence, *ad hoc* liquidity resources refer to those resources available only to those Article VIII countries whose currencies are susceptible to speculative transfer of funds and the arrangements governing them are an outcome of the various first-aid devices that have cropped up on a regional basis since 1961 under stress of sudden and massive capital flight. Although Malaysia has recently adopted Article VIII status, the *ad hoc* resources arrangement does not apply to her. The countries to whom this source of funds is available are 'members of the so-called Paris Club – namely: Belgium, Canada, France, West Germany, Italy, Japan, Netherlands, Sweden, the United Kingdom, the United States and Switzerland.'[5]

The reserve position of Malaysia in the I.M.F. refers to the automatic drawing rights and other related 'credits' potentially available from the Fund, sometimes known as second-line reserves. Malaysia's present quota in 1970 with the I.M.F. is $367.2m.

In addition to its reserve position in the Fund which it can mobilize automatically, Malaysia may draw a maximum of another $367.2m in four credit tranches from the Fund to meet balance of payments needs. Separate and additional drawing rights amounting to $183m are also available to Malaysia in the event of a temporary shortfall in export receipts under the I.M.F. facilities for Compensatory Financing of Export Fluctuations. It is clear that this category of reserves refers to subsidiary international liquidity. Malaysia's position in the Fund for the period 1962 to 1970 is given in Tables 4-2, 4-3, 4-4.

Having indicated the size and composition of Malaysia's foreign reserves it is pertinent to examine Malaysia's need to hold such reserves and whether their volume is adequate. Whether they are adequate depends on the purposes for which they are needed.

[4]National Westminster Bank, 'Special Drawing Rights', *Quarterly Review*, November 1968, p. 72.

[5]Rajendra Kumar, *op. cit.*, pp. 31-35.

TABLE 4-2 Malaysia – Fund Gold Tranche Position 1962-8, (US $m)

1962	1963	1964	1965	1966	1967	1968	1969	1970
3	7	7	14	20	32	33	36	51

Source: IMF *International Financial Statistics,* Vol. XXI, No. 2, December 1968, p. 208. Vol. XXII, No. 2, December 1969, p. 209.

TABLE 4-3 Malaysia – Credit Tranche position, 1962-8, (US $m)

1962	1963	1964	1965	1966	1967	1968	1969	1970
35	38	38	58	84	110	115	125	186

Source: As Table 4-2.

TABLE 4-4 Malaysia – Gross Fund Position, 1962-8, (US $m)

1962	1963	1964	1965	1966	1967	1968	1969	1970
38	45	45	72	104	142	148	161	237

Source: As Table 4-2.

TABLE 4-5 Malaysia – Quota to IMF, 1962-8, (US $m)

1962	1963	1964	1965	1966	1967	1968	1969	1970
35	38	38	58	84	110	115	125	186

Source: As Table 4-2.

It is claimed by the Central Bank that, on average, the external reserves amounted to more than eight months imports for the period 1960-8.[6] The assured rationale for using this ratio is that imports represent a potential exchange drain and so affect the balance of payments adversely. The use of this ratio by the Central Bank to indicate the need for monetary reserves raises a fundamental question. Does the relationship expressed in the ratio between re-

[6] Bank Negara Malaysia, *10th Anniversary Commemorative Issue,* p. 9. Bank Negara Malaysia, *Annual Report,* 1970, p. 4. 'This level of reserves was sufficient to finance about 8 months of retained imports in 1970.'

serves and imports have any real significance? Machlup argues that '...there is neither theoretical or statistical support for attaching any real significance to the ratio of reserves to imports'.[7] This is because the theory that an increased volume of international trade requires proportionally increased international reserves implies that there must be something like a minimum or an optimum ratio of reserves to trade or to imports. Machlup's study of the available statistics of various countries has indicated that variations of the ratios between countries have been large. One can surmise that some of the ratios in particular countries at certain times were uncomfortably low and there is little empirical evidence pointing to a right ratio of foreign reserves to imports, either in individual countries or in all countries together.[8] At the same time, one should not overlook the fact that international payments are not always payments for goods and services. Payments in capital accounts may either offset payments on current account or be in addition to them. Furthermore, any comparisons of ratios of reserves to imports between countries and/or between different time periods have the unfortunate effect of focussing discussion on the merits of different base years. This in fact constitutes an index number approach to measurement and as with all index numbers construction in general is subject to severe limitations when underlying circumstances change significantly.[9] The changing circumstances which might affect the validity of the index are the exchange rate policy, monetary policies and trade restrictions.

It is clear from the discussion that the other functions of the Malaysian foreign exchange reserves need to be considered. Another function that the foreign exchange reserves serve is the currency backing for the Malaysian dollar. The legal minimum backing of the Malaysian dollar is about 81%.

In other words for every dollar, 81 cents is fully backed by foreign currency and/or gold. The implication of this, is that 81% of the Malaysian foreign reserves cannot be used if the currency component of the money supply is to remain unchanged. The relationship of the official external reserves (excluding the commercial banks' external assets) and the currency in circulation as well as the money supply is given in Table 4-6.

It is clear from the statistics in Table 4-6 that the ratios of reserves to currency are at least two times larger than the required legal backing. The ratios

[7]F. Machlup, 'The need for Monetary Reserves', *Banca Nazional de Lavoro*, Vol. CIC, No. 78, 1966, p. 185.

[8]F. Machlup, 'The Demand for Foreign Reserves', in *International Payments, Debts and Gold*, Charles Scribber & Sons, New York, 1964, pp. 265-6.

[9]R.F. Gemmill, 'Notes on the measurement of International Liquidity', *The Journal of Finance*, Vol. XV, March 1960, No. 3 p. 415.

TABLE 4-6 Malaysia – Official Reserves as percentage of Currency, Money Supply and Imports, 1959-70.

	1959	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970
Reserves to Currency	235	297	317	308	294	261	245	215	222	222	224	217
Reserves to Money Supply	107	197	201	196	182	163	155	134	126	118	125	122
Reserves to Annual Imports			85	80	76	71	70	65	57	56	67	59

Source: Compiled from Table 1.1, 1.3, VII. 6 of Bank Negara Malaysia, *10th Commemorative Issue*, 1969 and 1970 figures are from the *Annual Report* of 1970.

of reserves to money supply (i.e. currency and demand deposits) are also above 100%. Thus, even if the criterion of foreign reserves to money supply is used, the volume of reserves is too large. In addition, international reserves are necessary if countries are to withstand the adverse pressures of speculative capital flights and arbitrage transactions.[10] All convertible currencies are to some extent susceptible to these pressures. Malaysia is no exception with respect to speculative flights of capital especially when political conditions appear unstable. This was proved during the Indonesian Confrontation.[11] Whether or not there were any capital flights during the racial riots of 1969 is uncertain but it is generally thought that there were. However, it is unlikely that arbitrage transactions are significant in Malaysia. Commercial banks occasionally go through arbitrage to effect their exchange transactions out of necessity rather than to benefit from interest rate differentials and exchange rate differentials.[12] One important reason for this is that the forward exchange market is very inactive in Malaysia. For example, the Central Bank does not as a rule buy or sell in the forward market and commercial banks in Malaysia go into forward buying or selling only to cover the trading needs of their customers.[13] This implies that there is unlikely to be any pressure on foreign exchange reserves as a result of arbitrage transactions.

Another criterion which has often been used to indicate Malaysia's strong position is a comparison between the level of reserves and the corresponding deficits in the balance of payments. The figures in Table 4-1 (last two rows) clearly show that the volume of reserves has been more than adequate to offset the balance of payments deficits in the years 1963, 1964, 1966, 1967 and 1968. In 1967 with the balance of payments deficit at its largest figure of $247m., the foreign exchange reserves was about eight times greater than the deficit. The use of this ratio of reserves in relation to past deficits is a more valid measure than the relationship between reserves and imports. Reserves are held so that a country may not be compelled to take unpopular measures such as devaluation, deflation or direct controls merely to correct temporary deficits. However, it should be noted that the actual volume of reserves compared to actual deficits

[10] M.O. Clement, 'A Functional approach to the concept of international reserves', *Kyklos*, Vol. XVI, No. 3, p. 415.

[11] There was heavy buying of pound sterling in 1964 as a result of the Indonesian Confrontation. Details discussed in the section on Foreign Exchange Policy.

[12] For a brief but lucid account of the 'interest parity theory' see B.J. Cohen, *Balance of Payments Policy*, Penguin, 1969, pp. 66-67.

[13] Information obtained from correspondence with the Assistant Manager of a large foreign-owned commercial bank in Kuala Lumpur.

(or surpluses) has been more than adequate.[14] This can be seen from Table 4-7.

TABLE 4-7 Malaysia – Ratio of Total Foreign Exchange Reserves to the Overall Balance of Payments, 1959-70.

1959	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970
5.1	6.1	35.2	94.2	22.2	17.8	19.4	14.3	7.9	72.9	4.7	21.0

Source: Computed from Table 4-1.

Based on this criterion, it is evident that foreign exchange reserves of Malaysia are more than adequate to meet present balance of payments disturbances, and the implication for policy is whether the present level is necessary in view of development needs as well as the need to borrow from external sources. It has been argued that the need to borrow is not solely determined by financial needs but rather by the domestic shortage of technical expertize. Foreign technical expertize tends to accompany foreign capital. At the same time foreign funds were borrowed purely for liquidity purposes. For example, the government successfully floated securities in the United States and the United Kingdom in 1963, 1965 and 1967.

It can be argued that it is a luxury for a developing country like Malaysia to have such a high level of reserves when there is a need of funds for development purposes. It is too often overlooked that the accumulation of monetary reserves by a nation represents a formation of capital that remains less productive in its present form and becomes more productive only through its eventual use in emergency. The marginal productivity of capital invested in domestic productive activities may be 10 or 15% per annum (or even higher in some of the capital-poor countries) whereas the current yield of foreign reserves invested in liquid dollar securities or bank balances would be very much lower.[15] Although it could be argued that the holdings of foreign reserves is a form of insurance and a country like Malaysia which is so dependent on a few primary commodity exports has a special need of this insurance to tide her over a period of low export prices. This may be true but, at the same time, one can over-insure.[16]

[14] Machlup objects to the use of this ratio to indicate the need to hold a large volume of foreign reserves because '.....can anybody seriously contend that the central bank hold reserves only for the purpose of meeting deficits if the reserves are between 900 and 1500%'. However, it should be noted that the Malaysian Central Bank may hold reserves for a number of purposes. For instance, to finance deficits for currency backing and to allow for a 'degree of balance payments ease'.

[15] F. Machlup, *op. cit.*, pp. 261-2.

[16] W.M. Corden, 'The Malayan Balance of Payments Problem', in *The Political Economy of*

Furthermore, for those developing countries which have accumulated sizeable foreign reserves before embarking upon planned development, the cushioning effect of such reserves reduces the anxiety of impending crises during periods of adverse trade balance. Such a state of anxiety often prevails in countries which are living from hand to mouth on foreign exchange earnings. Such anxieties exist because of the dislike for devaluation as well as the possibility that foreign loans or investments may not be forthcoming in lieu of monetary crises.

The strongest argument in favour of having large reserves in Malaysia is that '... reserves creation ought also to govern the rate at which a country corrects its imbalance once it has decided to do so'.[17]

In other words, a store of reserves is not only an alternative to adjustment but it can serve as a complement to the adjustment process. This latter function is important because the volume of reserves is apt to affect the quality of the restoration of balance, not just its timing and phase. Countries that are forced to correct imbalance rapidly because they do not have sufficient means or access to reserves may do so by controls on trade and investments. The above argument can be accepted if the monetary authorities can legitimately anticipate eventually an endogenous response to the initial balance of payments deficit. In other words, some endogenous mechanism or policy is set in motion to correct the disequilibrium while foreign exchange reserves are temporarily offsetting the deficit. In the Malaysian case, it could be argued that by having a currency backing of 81% by foreign reserves ensures this, provided the commercial banks curb their advances and loans either of their own accord or because of central bank imposition. However, the commercial banks' advances and loans during the period 1960-70 were not curbed or adjusted in the same direction as the balance of payments disturbance.[18] The Central Bank had relied on the currency backing factor to act as an endogenous restraint on expenditure. This is opposed to a situation when a government tends to rely on the foreign exchange reserves to offset balance of payments deficits even when there are no endogenous offsetting disturbances to be expected. This dependence on the emergence of random exogenous disturbances has been referred to as a policy of 'breath-holding'.[19]

Closely akin to the concept of the use of foreign reserves as an alternative and/

Independent Malaya: ed. by T.H. Silcock and E.K. Fisk, Eastern University Press, Singapore, 1963, p. 122.

[17] P.B. Kenen, 'Financing and Adjustment: The Carrot and the Stick', in *Maintaining and Restoring the Balance of Payments,* by Feilner, Machlup, Triffin and others, Princeton University, p. 151.

[18] This statement will be substantiated in the next chapter when the relationship between money supply and balance of payments is examined.

[19] W.R. Allen, 'The IMF and the Balance of Payments Adjustments', *Oxford Economic Papers,* June 1961, p. 150.

or a supplement to other forms of adjustment processes, is the concept of 'degree of balance of payments ease'.[20] The sense of balance of payments ease concerns the confidence of the authorities in their ability to meet payments deficits. The degree of balance of payments ease is affected by both the stock and the rate of growth of the country's reserves. The higher the reserve stock the greater is the degree of balance of payments ease, that is, in the country's ability to meet current or future deficits. On the other hand, the faster the rate of growth of reserves, the greater is the degree of balance of payments ease provided that the rate in the growth of reserves is not brought about by massive inflationary capital inflow or speculative capital. It would appear that the Malaysian Central Bank subscribes to this belief of balance of payments ease.[21]

A further function of the level of the foreign exchange reserves is to indicate the creditworthiness of a country. The more credit-worthy Malaysia is in the eyes of the financial world, the easier it is for her to borrow. To quote the Finance Minister on the practical function of the volume of foreign exchange reserves, '...the time to borrow is when you have plenty of it [foreign exchange]. It is most difficult to get a loan when you are really in need of it. In the same way, it is far easier for a millionaire to get a bank overdraft than it would be for one who is poor. As it is with individuals, so it is with nations.'[22]

A conclusion of Chapter II was that the debt service ratio was negligible. The ratio of net investment income to exports was also low. These two ratios can also be taken as indicators of Malaysia's creditworthiness. The comparatively small foreign debt of Malaysia may be part of a conservative monetary policy.

The conclusion is that the foreign exchange reserves of Malaysia serve a number of functions. Whether or not the volume of foreign exchange is adequate should be assessed in the light of the various functions it has to perform.

It has already been indicated that, in Malaysia's case, the level of foreign exchange reserves maintained to act as a buffer for balance of payments deficits has been too high. It has been shown that the ratio of the foreign exchange reserves to balance of payments deficits has been positive. During the years of balance of payments deficits, that is 1963, 1964, 1966, 1967 and 1968, the

[20] J.M. Fleming, 'Towards assessing the need for International Reserves', *International Finance Series*, Princeton University, Princeton, New Jersey, February 1967, p. 5.

[21] Bank Negara Malaysia, *10th Anniversary Commemorative Issue*, p. 6 Text of speech of the governor of the Bank Negara Malaysia, '...This level of reserves is of course satisfactory, to put it mildly. I should add, however, that to a Central Bank Governor, who is always concerned with margins of safety, no levels of reserves can be considered adequate and the higher it is the better will it be for his peace of mind.'

[22] Tan Siew Sin, 'Speech by the Hon'ble Tun Tan Siew Sin to the Economic Association in Kuala Lumpur', *Kajian Ekonomi Malaysia*, Vol. IV, No. 1, June 1967, p. 4.

volume of foreign exchange reserves were more than adequate to cover such deficits. In 1967, when the deficit was largest, the foreign exchange reserves were seven times larger than the deficit. This supports the view that the volume of Malaysia's foreign exchange has been more than adequate, and equally so with respect to the currency backing and the money supply.

Thus, though it is absolutely true that the high level of reserves affects the quality of the policy which is used for the restoration of the Malaysian balance of payments, it appears that there is again justification for running down the level of reserves of Malaysia should the need arise. Foreign reserves are also needed for a 'degree of balance of payments ease'. However, the volume of foreign exchange reserves needed for some particular degree of balance of payments ease is open to subjective evaluation and, because of this, it is difficult, if not impossible, to assess the needed volume of foreign exchange reserves.

Finally, foreign exchange reserves (the debt servicing ratio and net investment to export ratio) serve as an indicator to creditworthiness. To a great extent, this criterion is again subjective.

In terms of a change in the present policy, a part of the reserves could reasonably be used for development purposes. It has to be borne in mind that the returns of such investments as indicated earlier would be much higher than returns from investments in foreign securities or in foreign bank balances. In addition, the running down of reserves is better than foreign 'aid' or foreign loans. The remittances of interest payments of such loans can be avoided. The difficult task is to determine the level to which the Malaysian foreign reserves should be run down. According to Kanapathy, '...about 50% of the total foreign exchange holdings are presently sizeable enough to meet even a large programme'.[23] This is true. However, to allow the Central Bank to maintain some degree of balance of payments ease, to be on the safe side and to be in keeping with its very conservative attitude, the foreign exchange reserves could possibly be run down to the level required for the currency backing of the Malaysian currency. For example, this in practice means that, in 1968, a total of about $650m. could have been released for development purposes.

FOREIGN EXCHANGE RATE POLICY DURING THE SIXTIES

The high degree of monetary stability in Malaysia during this period has pushed into the background the fundamental economic relationships between monetary and fiscal policies, exchange policies and balance of payments problems. In those less developing countries where monetary stability is lacking and where balance of payments crises frequently occur, foreign exchange rate policies are often

[23] V. Kanapathy, 'Commercial Banking in South East Asia', *UMBC Economic Review*, Vol. 1, No. 1, 1969, p. 9.

highlighted as a means of balance of payments adjustment or even as a cause of balance of payments disequilibrium. The usual concentration on monetary policies and fiscal matters for balance of payments adjustments is justified. However, since the balance of payments position of a country depends equally on exchange rate policy, the latter policy in Malaysia should be studied. Developments in the field of exchange restrictions or inter-government arrangements can have direct and indirect balance of payments implications.

The principal feature of Malaysia's foreign exchange policy during the sixties is that minimum restrictions have been imposed on any transaction in the current account of the balance of payments. Imports and import payments are permitted freely under 'an open general licence', under 'specific licence' or without licence, depending on the nature and origin of the goods. An open general licence indicates an arrangement whereby certain imports or other international transactions are exempt from the restrictive application of licencing requirements in contrast to an individual licence which may be given freely or restricted in its issue according to administrative decisions. There are no restrictions on capital transfers to and from other countries in the sterling area. Inward and outward capital transfers between Malaysia and countries outside the sterling area require exchange control approval: such approval is freely given for inward transfers but the subsequent utilization of non-resident-owned funds in Malaysia in most cases is subject to individual exchange control approval. Investments in new industrial and development projects that have been approved by the Ministry of Commerce and Industry are not restricted. The transfers to residents of countries outside the sterling area of capital held or accruing in Malaysia are generally permitted but require prior exchange control approval. Investments by Malaysian nationals in countries outside the sterling area may be made upon approval of the exchange control authorities. This is given only when such investments are considered to contribute to the economic interest of the country.[24]

Malaysia accepted Article VIII status of the IMF agreement in November 1968.[25] Among the reasons given by the Central Bank for adopting Article VIII were.

1. Such a decision would assist the country's development effort in creating a more conducive environment particularly in enhancing its international financial standing and in producing a favourable psychological impact on foreign investors.

[24] IMF, *21st Annual Report, Exchange Restrictions*, Washington, DC., 1970, p. 323.

[25] Out of a total of 111 countries, thirty-four Fund members have assumed these obligations. Other developing countries are Argentina, Bolivia, Costa Rica, Dominican Republic, El Salvador, Guatemala, Guyana, Haiti, Honduras, Hongkong, Jamaica, Kuwait, Mexico, Nicaragua, Panama, Peru, Saudi Arabia, Singapore and Surinam.

2. Through the pursuit of sound financial policies in the past, Malaysia's exchange system was already free from restrictions and that a move to Article VIII status was merely formalising a position that has prevailed for many years.[26]

Prior to this, like most developing countries, Malaysia's policy was defined by Article XIV. There are economic implications in accepting Article VIII. Briefly, sections 2, 3 and 4 of Article VIII state that a member country may not without prior approval of the Fund, impose restrictions on making payments or transfers for current international transactions. In addition, a member country may not engage in discriminating currency arrangements or multiple exchange rates. This means in practice that there is a unitary effective rate without restrictive measures such as special rates for some or all invisibles or the imports rate being different from the export rates, or more than one rate for either exports or imports. Furthermore, the member country's monetary authority will have to provide for the free convertibility of foreign-held balances of its currency into either the currency of the member country making the request, or gold, except in specified circumstances. Lastly, restrictions on the exchange system may be introduced by a member country only if the Fund is convinced after close examination of that member's economic position and of possible alternative corrective measures, that the proposed restrictive measures will apply for only a temporary period and that conditions exist or are likely to be developed to enable these restrictions to be removed within a reasonable period of time. Article VIII status does not conflict with exchange control over outflows of capital either within the sterling area or outside because adherence to Article VIII permits restrictions of movements in the capital account which does not arise from international trade.

According to Kawata, with the acceptance of Article VIII, an economy becomes an 'open economy' in the sense that it becomes an economic unit in which transactions in goods and services and capital may be concluded with foreign countries in principle freely and without restrictions.[27] From this, it is clear that the foreign exchange policy of Malaysia is designed to encourage exports and create a conducive investment climate in the hope that the balance of payments would be strengthened by an increase in the inflow of foreign investments.

One of the conclusions of Chapter III is that a conducive investment climate is a necessary but not a sufficient condition for attracting foreign capital. It should also be noted that the mere existence of minimum exchange control in

[26] Bank Negara Malaysia, *Quarterly Economic Bulletin*, Vol. 1, September 1968, No. 3, p. 34.

[27] Fukuo Kawata, 'Preserving Japan's Balance of Payments Position in an Open Economy', *The Developing Economies*, Vol. 111, No. 1, March 1965, p. 106.

Malaysia can also result in eventual outflows. In the long run, capital outflows in the form of remittances and profits may turn out to be greater than an initial once and for all foreign capital investment. This is an important fact which must be recognized and accepted as a price for encouraging the inflow of foreign capital. The share of foreign ownership of the Malaysian economy may also be increased.

On the other hand, Article XIV permits countries to impose, and alter as necessary, payments restrictions on current transactions and to regulate exchange control (including changes in the exchange rates) on capital transfers so that current deficits are limited to the net inflow of capital plus the available foreign exchange reserves plus the permissible IMF drawing rights. Rajendra Kumar[28] argues that breaking away from Article XIV status could lead to economic progress and lasting balance of payments improvements. He argues that, in general, the balance of payments problems of developing countries are heightened by the relative shortage of gold and foreign exchange reserves. In addition, their import requirements for purposes of rapid economic development are so enormous that they are constantly confronted by the danger of foreign exchange instability. In consequence, these countries are forced to maintain foreign trade and payments restrictions under Article XIV of the IMF. This adherence to restrictions and controls works, in effect, as a vicious circle of economic under-development. The absence of economic development or the existing structural economic imbalance and national efforts to remove it speedily, force those countries into balance of payments difficulties, which in turn necessitate the continuance of foreign exchange restrictions. These barriers to free foreign trade and the resulting complex of physical control and licensing machinery at home inhibit significantly the pace of economic development progress in developing countries particularly those with deficient administration. This prolongs economic under-development. In other words, the existing system of foreign trade controls could act as a constraint on the pace of economic development. Malaysia's foreign exchange policy of adopting Article VIII represents a step in the right direction, but whether the full benefits accruing to such a policy will result will depend among other things on the reactions of her trading partners.

Throughout the period under study, Malaysia's exchange rates remained very stable and there was only one instance when the Central Bank had to support strongly the exchange rate of the Malaysian dollar. In 1964, there was strong buying pressure for sterling in the Malaysian market and the Central Bank supported the dollar with continued sales of sterling. The Bank kept the exchange rate very close to 2s 4d. (its par value at the time) with its selling and buying

[28]Rajendra Kumar, 'To amend the IMF', in *The Banker*, Vol. CXCVI, November 1963, p. 315.

rates within the 2s $3^1/_8$d – 2s $4^1/_8$d limits. But, for this action by the Central Bank, the exchange rate would have slid downwards and the banks would eventually have had to sell notes to the Currency Commissioners at 2s $3^7/_8$d.[29] This sudden increase in demand for sterling could have been due to the uncertain economic and political conditions created by the Indonesian Confrontation. However, to what extent this unusually large increase in demand was generated by a fear or anticipation of a fall in the future exchange rate of the Malaysian dollar is debatable. It could be that there was quite a sizeable portion of 'flight' capital involved. In any case, what is important is that this is the first reported instance of heavy Central Bank support for the exchange rate of the Malaysian dollar.

NON-DEVALUATION OF THE NEW MALAYSIAN DOLLAR IN 1967

The most severe test that the Central Bank had to face with respect to a possible change in the exchange rate occurred when the sterling devaluation took place in November 1967. The pound sterling was devalued by 14.3% from US $2.80 to US$2.40. The monetary policy alternatives available to the Malaysian Central Bank were: to devalue the Malaysian dollar with the pound sterling thus maintaining the exchange rate with pound sterling (and all those countries which devalued to the same extent) but devaluing *vis-à-vis* the rest of the world; not to devalue with pound sterling resulting in an appreciation in the exchange rate with sterling (and with all countries which devalued) but with the exchange remaining at par with the rest of the world.

The goal of either policy should have been to ensure that the Malaysian balance of payments position did not deteriorate. It must be recognized that alternative policies existed because other major countries like the US, France, Germany and Japan maintained their exchange rate parity. If these countries had decided to follow the British devaluation, Malaysia would have had to follow suit. Otherwise, the Malaysian currency would have been an over-valued currency.

In the event, Malaysia decided not to devalue her new Malaysian dollar. On the other hand, the old Malayan dollar (which was issued by the Currency Board from 1906-67) was devalued to the same extent as the pound sterling. This meant that the old Malayan dollar was now worth only 85.7 cents of the new Malaysian dollar. This situation arose because the process of replacing the old Malayan dollar by the new currency had not been completed before the British devaluation. The motives for and effects of devaluing the old Malayan dollar will be dealt with separately in the next sub-section.

Before examining the reasons given by the Central Bank for not devaluing

[29] P.J. Drake, *Financial Development in Malaya and Singapore*, A.N.U. Press, Canberra, 1963, p. 204.

the new Malaysian dollar, it might be helpful to review the meaning and purpose of devaluation. Devaluation occurs when the exchange rate of a currency is over-valued to such an extent that the balance of payments is persistently in deficit. Devaluation results in a country devaluing its currency sufficiently to transform it from an over-valued currency to an under-valued currency or perhaps to its true value. This makes the currencies of other countries over-valued relatively. The consequence of this is to discourage imports and encourage exports. This is possible as long as devaluation is not immediately followed by corresponding increases in domestic prices. If domestic price increases accompany the devaluation process, the expected advantage of devaluation would not occur. This means that devaluation by itself may not be a sufficient policy. Other economic measures are needed to ensure that the cost differentials of exports are not wiped out by rising domestic prices and that resources are not diverted from the export sector to the domestic sector. The end result of such policies is to bring about an improvement in the balance of payments position. It must also be recognized that devaluation leads to an unfavourable change in the terms of trade. Assuming no change in domestic prices, devaluation of 14.3% in this case would mean that one unit of imports would now require 1.143 units of exports instead of one. This is because, by devaluing, exports become cheaper while prices of imports remain the same.

The official reasons given by the Central Bank of Malaysia for not devaluing the new Malaysian dollar were as follows:

1. 'A devaluation of the Malaysian currency would not improve Malaysia's competitive position in the international market as its major exports consist of primary commodities whose prices are determined by supply and demand conditions in world markets. Countries which devalued with Britain accounted for only about 10% of Malaysian merchandise exports. It is therefore unlikely that the country's export position would be adversely affected by devaluation of the currencies of these countries.'[30]
2. On the other hand, imports from U.K. (15.6%) and Hongkong (2.5%) and other countries formed about 20% of Malaysia's total imports. This means that about 20% of Malaysia's imports would consequently have become relatively cheaper as a result of Malaysia's exchange rate remaining unchanged. A devaluation of the Malaysian dollar would necessarily have meant higher prices for imports from countries which did not devalue since imports of food and manufactured goods from such countries accounted for about 85% and 75% respectively of Malaysia's total imports of these products. This is turn would have resulted in an increase in the cost of living and would have been likely to lead to a demand for higher wages and salaries in the country.

[30] Bank Negara Malaysia, *Annual Report, 1967*, pp. 3-4.

3. The economy was strong without any persistent balance of payments problems and the country had adequate gold and foreign exchange reserves to maintain the stability of the Malaysian dollar.[31]

For these reasons the Malaysian government felt that it was justified in maintaining the existing parity of the Malaysian dollar. The essence of the first two reasons for not devaluing is based on the terms of trade effect of devaluation. Since countries which devalued their currency accounted for 10% of Malaysia's exports (i.e. $499m in terms of 1967 trade figures) and 20% of imports (i.e. $710m.) it was assumed that Malaysia would gain financially by not devaluing.

Other arguments could be cited for not devaluing, though these have not been given by the Central Bank. In practice, the total effect of devaluation on an economy is in fact the sum total of the direct and indirect effects on income and absorption.[32]

The effects of devaluation upon income and via income are the idle-resource effect and the terms of trade effect. The latter effect has already been considered Theoretically, if a devaluing country has idle-resources, employment can be increased by additional consumption, investment and government expenditure or exports. An increment in the export industries will result in an income increment which in turn increases consumption leading to the creation of consumers goods industries. If the combined marginal propensities to consume, to invest and to spend in the public sector are greater than one, the trade balance could become worse. If improving the trade balance is the policy objective, the government must hope that these combined marginal propensities that is in aggregate, the marginal propensity to absorb, is less than one or that the other effects of devaluation will improve the trade balance and are stronger than the idle-resource effect.

[31] *Ibid.*, p. 4.

[32] The theory used in this section is largely based on articles by F. Machlup, 'Relative prices and aggregate spending', and 'The Terms of Trade Effects of Devaluation upon real Income and the Balance of Trade', in *International Monetary Economics*, George Allen and Unwin London, 1969, pp. 171-94, and pp. 195-222, and also Sidney S. Alexander, 'Effects of a devaluation on a Trade Balance', *IMF Staff Papers*, Vol. 2, 1951-1952, pp. 263-78.

One of the ways of analyzing the probable effectiveness of a devaluation undertaken to remove or reduce an existing excess demand for foreign exchange is the 'Aggregate-Spending' or 'Income-Absorption approach'. The total income of a nation can be divided or classified into consumption plus investment plus government contribution plus exports minus imports ie

$Y=C+I+G+X-M$

Trade Balance is $B=X-M$

Absorption is $A=C+I+G$ and $Y=A+B$. Therefore $B=Y-A$

Although Malaysia does possess unused or unalienated land of good quality, it is unlikely that land will be legally made available for use as a direct result of devaluation. Land alienation is a function of administrative policy and efficiency in Malaysia, not of change in exchange rates. It needs to be noted that before any Federal land development project can be implemented, there is the need for lengthy discussion both at state level and between state and federal officials.[33] There is a fairly long time-lapse before such land development schemes materialize.

On the other hand, even after such discussions, more land may not be made available at all. The point that needs to be emphasized is that although Malaysia does possess idle-resources in the form of available land, these are not likely to be made available for production of primary products as a direct result of devaluation.

However, even if it is assumed that land could be made available for the production of primary exports, there is a time-lag problem. There is usually a time-lag between investment and the returns to investment. This is likely to be longer in the production of primary products such as rubber, palm oil or coconuts since it takes a number of years before these trees reach maturity.[34] As a result of this long time-lag between investment and production in the primary export sector, the initial benefits of lower export prices as a result of devaluation may no longer exist. The time-lag element also exists in the manufacturing sector but generally it is shorter than in the primary export sector.

In the case of the manufacturing sector, Drake argues '...that had there been devaluation the local manufactures would not have incurred the immediate initial price disadvantages relative to Britain, Hongkong and Israeli industries and they would have gained price advantages over producers elsewhere. This would have permitted Malaysian industrialists to expand production and employment and perhaps would have resulted in some increase in manufactured exports. In the home market, local manufactured goods would have been able to increase sales at the expense of imported products. The imports (about 20% of the total import trade between Malaysia and foreigners) originating from Britian and other devaluing countries would have had their advantage wiped out and imports from non-devaluing countries would have been at a disadvantage. In foreign currency terms, the total value of imports would have fallen and so far as the balance of trade accounts were concerned, there would have been a beneficial effect."[35]

Drake's argument first and foremost assumes that there are some idle-resources

[33] Brien K. Parkinson, *op. cit.*, Chapter IV.

[34] Rubber and coconuts take about six to seven years before they mature. Palm oil takes about three to four years.

[35] P.J. Drake, *op. cit.*, pp. 230-1.

available for a possible expansion in production and employment. The most important factors needed for an expansion in the manufacturing sector are capital, labour and various factor inputs. Each of these resources will be dealt with separately.

It is true that there is locally-owned capital available either in the form of deposit savings in the banks or in the form of foreign reserves of the government. However, it was unlikely that a devaluation would have activated government investments in the private sector. The government's industrial policy has been primarily to encourage the growth of the private industrial sector but not actively to invest in it. It is only since 1969 that there has been any real hint of possible direct government investment in the industrial sector.[36] In addition, it is unlikely that fresh capital would have been attracted into Malaysia had there been a devaluation.[37]

Nevertheless, it seems reasonable to suggest that some existing foreign-owned firms in Malaysia may have increased their investments in certain specific areas rather than repatriate their profit remittances. This is because greater profit opportunities would have existed had Malaysia devalued. All imports would have become expensive, and this might have increased the demand for import substitutes. This is an area where investments are likely to have been increased by some firms. Another area might have been in locally manufactured exports where the factor inputs were of domestic origin. Malaysia's manufactured exports would become cheaper, and so more competitive.

The second factor input is labour. The high unemployment rate in Malaysia indicates a potentially available labour force. However, it is difficult to ascertain whether the required type of labour would have been abundantly available. Probably, some small part of this large unemployed labour force could have been utilized in the expansion of the manufacturing sector.

Finally, if the needed factor inputs were imported factors, a devaluation in Malaysia in 1967 would have pushed up the costs of such imported inputs. In spite of this, there might have still been some gains in such industries which used imported input industries. These industries are likely to have been import substituting ones.

The above discussion about the idle-resource effect in Malaysia indicates that there would have been some gain in the manufacturing sector had Malaysia devalued in 1967. But it is unlikely that the primary export sector would have benefited because there is not likely to have been any significant expansion in production. Since the main source of Malaysia's foreign exchange comes from primary exports, a devaluation in 1967 would have resulted in a greater loss of

[36] Brien K. Parkinson, *op. cit.*, Chapter V.

[37] The attraction of foreign capital as a result of non-devaluation is debatable. This point has already been discussed in Chapter III.

foreign exchange from the primary export sector than that gained from the expanded manufacturing sector.

In addition, had devaluation been undertaken purely for the sake of the industrial sector, there would have been, and still are, other alternatives which can give the same results as a devaluation without affecting the primary export sector. The effects of devaluation are the same as imposing a uniform tariff on all imports and giving a uniform subsidy to all exports. To foster the growth of the manufacturing industries and increase the extent of local production, a specific tariff system could have been introduced to stimulate local industries. Higher import duties could have been imposed on goods coming from countries which devalued. On the other hand, export subsidies could have been applied to those manufacturing industries which were producing for the export market. Such specific tariffs and subsidies would have been more advantageous for the Malaysian economy than a devaluation of the currency. The advantage of the duty-cum-subsidy system is that it is reversible, that it can be administered in small doses as required or in varying doses to different industries and that it does not subject the economy to a sudden and unsettling jolt which devaluation invariably implies, especially if there is no fundamental disequilibrium in the economy. It may be worthwhile to note that Malaysia has one of the lowest degrees of tariff protection in South-East Asia.[38]

On the whole, it appears that had Malaysia devalued in 1967, the terms of trade effect would have been negative because imports would have become more expensive. Since Malaysia is committed to industrialization, it would have found it difficult to cut down on imports. One of the conclusions of Chapter II was that Sections 0, 3, 6 and 7 formed the hard-core of Malaysian imports and it was not likely that their volume could be reduced to any appreciable extent. Since the prices of Malaysia's imports are determined by world demand and supply it is unlikely that there would be any substantial gain from devaluation. It was also unlikely that the supply of these primary products could have been increased to any appreciable extent in the short-run to benefit from devaluation. There was the possibility that small rubber holders might increase their supply of rubber by slaughter-tapping but this is not to be encouraged, because in the long run the productivity and life-span of rubber trees would be adversely affected. The conclusion is that the idle-resources effect would also have been negative.

The direct effect on absorption are the cash-balance effect, income-redistribution effect and the money-illusion effect.

In theory, devaluation raises the domestic prices of imports and eventually factors of production. The increase in the prices of factors of production will

[38] IBRD Current Economic Position and Prospects of Malaysia, 24 December 1968, Unpublished. See also Chapter VIII, pp.

tend to raise the prices of import substitutes, of potential imports and of intermediate goods required for production. The elevated price level will imply a reduction in the real value of total cash balances. This reduction in the real value of total cash balances will have the effect of cutting down investment expenditure of businesses and consumption expenditure of households.

In Malaysia, where a dual economy exists, the theoretical cash balance effect on consumption expenditure of households may no longer be completely true. The dual economy in Malaysia consists of the peasant sector and urban commercial sector. The cash-balance effect would be different for the different sectors.

The peasant sector would probably remain largely unaffected by a devaluation whereas the impact of devaluation would have been felt by the urban middle class. This is because the level of monthly cash income in the peasant sector is low. E.K. Fisk's survey of 334 families in Kuala Trengganu indicated an average monthly income of $38.20 while in Batang Kali, Selangor, the average household income was $92 per month.[39]

These figures may be under-estimated because these families may consume part of the crops which they themselves produce. The *Household Budget Survey 1957-1958*, indicates that the average monthly consumption expenditure of rural households was about $160.[40] This figure appears to be on the high side when compared to those given earlier. Probably an average of the two, that is, about $130 may present a fairly reasonable estimate. As a result of this comparatively low level of income, the consumption expenditure of peasant households generally does not include imported consumer goods especially durables or semi-durables. This means that even had Malaysia devalued in 1967, there may have been very little reduction in the real value of total cash balances in the peasant sector.

On the other hand, middle-class households in the urban sector would have been affected. This is because their consumption patterns include imported commodities. There are three courses open to middle-class households when the prices of imports rises with devaluation. They may sustain their former level of consumption by drawing on their past savings or perhaps save less out of their present income. In this case, there is no reduction in the consumption expenditure in the short run. Secondly, they may cut down on imported goods and consume more import substitutes. On the other hand, they may continue to maintain the same level of consumption of imported commodities but cut down on local products. Both these cases are expenditure-switching rather than expenditure-reducing. Finally, households may cut down on their expendi-

[39] Quoted in Brien K. Parkinson's book, Chapter II.

[40] Federation of Malaya, Department of Statistics, *Household Budget Survey, 1957-58*, p. 5.

ture of imported goods resulting in a reduction in imports. In any case, it is likely that a devaluation would have only affected the consumption expenditure of the middle-class households. The rural or peasant households in the rural sector would probably have been unaffected. This situation differs from the usual theoretical cash-balance effect on household expenditures.

The second theoretical cash-balance effect resulting in a reduction of business investments may again not be completely true. This is because the prices of the factors of production in the primary export sector are unlikely to be affected by devaluation. As indicated earlier, the factor inputs whose prices would have been affected are imported factor inputs. However, even with increases in the cost of imported factor inputs, there was unlikely to have been any cut-back in investments in the import substituting industries because imports would have become even more expensive. The demand for import substitutes may have increased. It is probable that the level of investment would have been increased or sustained rather than reduced had Malaysia devalued in 1967.

S. Alexander mentions three kinds of shifts of real income in the income redistribution effect, viz:

a. shifts from fixed-income recipients to the rest of the economy (export and manufacturing sectors);
b. shifts from wage recipients to profit recipients;
c. shifts from taxpayers to government.

A shift from fixed-income recipients to the export sector would have resulted in a reduction of aggregate absorption if the corresponding gains in real income accrued largely to people richer and more thrifty than renters, fixed-income salary workers and pensioners. In the Malaysian export sector, especially in rubber, the effect on aggregate absorption is not so clear cut. Smallholders in rubber production would have benefited in terms of increases in real income and it is likely that little would have been saved. There might have been a temporary small-scale boom resulting in an increase in aggregate absorption. In the case of the rubber estate workers, there would have been no gain at all in terms of increased income. Although there was, and still is, a wage agreement which links wages to rubber prices, wages would only have increased when rubber prices reached 67 cents a pound. With devaluation, prices of rubber fall rather than rise. Since the supply of Malaysia's primary exports from the estate and plantation sector are fairly inelastic, there would probably have been no financial gains at all.[41] Rather, the primary export sector might have lost financially as a result of devaluation.

The import-substituting industries might have been given a boost. However, since the import substituting industries are to a large extent foreign-dominated,

[41] The supply of tin for exports in fixed by the International Tin Council.

the financial gains might not have increased absorption to the same extent. It is likely that the amount of profits remitted abroad as a result of increased profits would have dampened the absorption effect.

In theory, a shift of real income from tax-payers to the government will cut down aggregate spending, if government expenditure is fixed. However, it is known that the government's budget is not inflexible. There are numerous cases where development expenditure exceeded that planned. However, had Malaysia devalued in 1967, it is uncertain whether government revenue would have been increased or decreased. The volume of export duties in terms of foreign exchange would have decreased when export prices fell. The increase in import duties may or may not have offset the loss from export duties.

The money-illusion effect may contribute a favourable effect to a devaluation if higher prices lead people to consume less even though their money-income has increased in proportion. In the Malaysian case, it has previously been pointed out that devaluation would probably have had its main impact on the middle-class. It is unlikely that a money-illusion effect would have deterred people from this income group from consuming imported commodities.

Finally, there is an indirect effect which needs consideration. It has already been argued that investments in existing import-substituting industries would probably have increased. But it is unlikely that fresh foreign investment would have been encouraged had Malaysia devalued in 1967. It has been indicated by Stobaugh's study of US multi-national firms that they shy away from making investments in countries where the currencies are prone to devaluation.[42] The relevance of Stobaugh's study to Malaysia is that American companies were the second largest investors in Malaysian pioneer manufacturing industries.

The overall conclusion from the above discussions is that a Malaysian devaluation in 1967 would not have resulted in a favourable balance of trade in the short run, though it has been indicated that beneficial results might have been achieved by a well-designed tariff system. Therefore, the Central Bank's decision not to devalue the Malaysian currency was correct.

A further argument in support of this conclusion is that given by Brian Johns.[43] It is argued that the market price of foreign exchange in Malaysia does reflect the shadow price reasonably well. The shadow price of foreign exchange can be defined as that price which preserves an appropriate balance between overseas payments and receipts including capital flows in the absence of import restrictions, tariffs, etc.

[42] Robert B. Stobaugh, 'How to analyse foreign Investment Climates', *Harvard Business Review*, September/October 1969, pp. 100-8.

[43] Brian L. Johns, Import Substitution and Industrial Development in West Malaysia, Criteria for the identification of suitable manufacturing Industries, Part 2, Economic Planning Unit, Malaysia, unpublished.

As import duties in Malaysia apply to most imported consumer goods it might be argued that the shadow price of foreign exchange in terms of domestic currency is higher than the present price of $3.06122 = US$1. Even if this is true, the present shadow price could not possibly exceed the present market price by the average percentage rate of import duty as there are still some imports which are not dutiable. Johns further argues that Malaysian import duties are a major source of public revenue and this is a more important function of import duties than protection of the manufacturing sector. Hence, the shadow price of the Malaysian foreign exchange differs little from the market price of foreign exchange. This means that the Malaysian dollar is not sufficiently over-valued to warrant a devaluation.

However, there is a school of thought in Malaysia which is of the opinion that the new Malaysian dollar should have been devalued in line with the pound sterling on balance-of-payments grounds. It is pertinent to examine some of the main pro-devaluation arguments[44] and assess their validity. The main arguments of the pro-devaluation school were:

1. Britain had written off large sums of money (the sterling reserves) that were invested or held in trust in London by the Central Bank, commercial banks and other institutions. In the accounting books no loss would have been made in so far as these sterling reserves held in London were concerned had the new Malaysian dollar been devalued. Similarly, the commercial banks and other institutions which had balances in London would also not have had to sustain any losses. Avoidance of such losses had a tremendous psychological effect on those who held balances in London. A counter-argument against such losses in terms of the Malaysian balance of payments situation is that debts of the Malaysian government expressed in terms of sterling had been reduced because of the sterling devaluation. To arrive at any definite conclusion, the volume of total reserves held in London have to be compared with government debts denominated in sterling.

2) By not devaluing, more pounds sterling would be needed as foreign exchange reserves for a given volume of Malaysian dollars. This is because the value of each sterling pound received from abroad is reduced. 'Devaluation would not only have avoided these difficulties but also would have permitted some definite expansion of the currency supply to the extent that (a) any existing currency reserves were held in gold or non-sterling curriences and (b) the devaluation would have improved the balance of payments.'[45] Part (a) of this argument given favours devaluation.

[44] Devaluation of the Pound Sterling', *UMBC Economic Review*, Vol. III, No. 2, 1967, pp. 22-25.

[45] P.J. Drake, *op. cit.*, p. 231.

3. The necessity to have two internal values (the old Malayan dollar and the new Malaysian dollar) would not have arisen and the consequences which followed would have been avoided.[46]

Finally, an inconclusive argument for devaluation is that a change in an exchange rate would have affected the balance of payments through the capital accounts. It was claimed that, by not devaluing, the Malaysian currency demonstrated a strength that could have continued to attract an inflow of foreign capital. It has been shown in the last chapter that, despite a unitary exchange rate, a non-inflationary economy as exhibited by the retail price index and stable exchange rate, the inflow of foreign capital was not increasing as fast as was desired or envisaged in the programme balance of payments. Thus the argument that an unchanged exchange rate is likely to encourage the foreign inflow of capital in Malaysia is debatable. In the short run, it may be true that the decision not to devalue may have impressed some overseas investors with the Malaysian government's confidence in the strength of the Malaysian balance of payments but, in the long run, it is hard to see how capital inflow can be favourably affected by this consideration, for the crucial issue is whether the balance of payments turns out to be strong.[47]

The conclusion to be drawn from this analysis of the pro-devaluation school standpoint is that the only strong point is argument 2a (page 134). Thus, it appears that the decision not to devalue was correct.

DEVALUATION OF THE OLD MALAYAN DOLLAR IN 1967

Normally, devaluation is one of the those monetary measures which is liable to undermine the prestige of the government and damage its political image and prospects because it can be regarded as a sign of weakness or an admission of having pursued mistaken policies.

It was highly probable that this was one of the reasons for the Malaysian authorities not devaluing the new Malaysian dollar, though the devaluation of the old Malayan dollar contradicts such an argument. Nevertheless, the official reason given by the Central Bank was as follows:

'...Unlike the new Malaysian dollar which is defined in terms of gold, the exchange rate of the old Malayan dollar is legally fixed in the Currency Agreement between Malaysia, Singapore and Brunei at 2s. 4d. sterling for a dollar so that any devaluation of the sterling automatically devalues the Malayan dollar to the same extent unless the law is immediately changed in the three countries. In terms of what was practicable at the time the Malaysian government was unable to change the parity of the money, a change which required concurrence

[46] The political consequence of devaluation of the old Malayan dollar led to a racial riot in the island state of Penang.

[47] J.O.N. Perkins, 'Australia's non-devaluation', *The Bankers Magazine*, May 1968, No, 1490, p. 259.

of the other two governments participating in the Currency Agreement governing the issue of that currency and the immediate introduction of legislative measures in the three respective countries. With circumstances of the situation given, these legal and time restrictions, it was not possible to take a decision on the Malayan dollar even if it was desired that it should not be devalued.'[48]

This is the only reason given for devaluing the Malayan dollar and the strength of the argument is based on the legal and legislative difficulty of changing the exchange rate.

This rationale is suspect because the government could, after consultation with Singapore and Brunei, have maintained the value of the Malayan dollar. In addition, the Central Bank has stated that the Malaysian economy was strong and the country had adequate gold and foreign exchange reserves to maintain the stability of the Malaysian dollar. If this is valid for the Malaysian dollar, it should also have applied to the old Malayan dollar, and it appears that there was no monetary justification for the devaluation of the old Malayan dollar.

In view of the above, the Finance Minister was accused by local politicians of trying to recoup the losses (arising from sterling reserves) by allowing the old dollar to remain pegged to sterling. It was estimated that of Malaysia's $2,400m in gold and foreign assets, some $1,000m were held in sterling, so that Malaysia lost about $150m. About a third of the total reserves, about $600m, was circulating in the rural areas, so that the three governments concerned stood to gain about $90m. In addition, it is thought that a substantial amount of Malayan currency – perhaps 10% – was circulating in the other countries, particularly Indonesia.

Fryer is in agreement with this line of argument. He calls it '...a shabby trick of devaluing the old currency commission notes and coins,[49] still circulating in both countries alongside their new monetary units. Little of the latter had in fact reached the hands of the public and the devaluation of the old units in the face of tacit promises by both governments to redeem such money at par ...'.[50]

In view of the above, it seems reasonable to suggest that the government probably took this opportunity to speed up the withdrawal of the old currency so that conversion to the use of the new currency would be complete.

Irrespective of the motive of the government, the economic effect is a

[48] Bank Negara Malaysia, *op. cit.*, p. 4.

[49] Coins were not devalued.

[50] Donald W. Fryer, *Emerging Southeast Asia*, George Philip and Sons Ltd., London, 1970, p. 286.

deflationary one. By allowing a devaluation of 14.3% while total money supply was about $1,500m in 1967, a reduction in the money supply by about 6% resulted.

A policy of deflation can be adopted as a means of reducing successive payments deficits, the theory being that by moderating the rise in aggregate demand, the rise in imports is checked and resources are redirected to exports.[51] Thus by devaluing the old Malayan dollar, the first result was achieved, that is, there was a reduction in aggregate demand. However, since about $600m was circulating in the rural areas, the reduction in consumption of imports would not have been in proportion, since the reduction in aggregate demand of imports would have been rather ineffective.

There is reason to doubt the second part of the deflationary argument within the Malaysian context. The factors of production for the primary sector are not generally short in supply. The domestic sector of the economy does not generally siphon away such factors of production. In addition, a reduction in aggregate demand of imports as a result of deflation is unlikely to divert resources to the primary export sector.

The main conclusions from this study of the Malaysian foreign exchange rate policy are that the Malaysian experience of pegged exchange rate policies with a non-inflationary situation and a low level of restrictions on international trade is not a common feature of developing countries. However, the Malaysian reaction is the typical one of restricting certain international transactions to foster the growth of import-substituting industries. It is difficult to assess or quantify the effects of the adoption of Article VIII status of the IMF agreement. This is because the foreign exchange policy before this was *de facto* along the same liberal lines. If the foreign exchange policy had been more restrictive or on a multiple exchange-rate system, the favourable effects on the balance of payments as a result of a switch to Article VIII would have been more apparent.

The study of the Central Bank's decision not to devalue in 1967 indicates that devaluation was unnecessary and not the instrument to be used in order to strengthen the balance of payments situation. However, this does not preclude its possible use in future if circumstances change. For instance, if natural rubber cannot compete with synthetic rubber because of cost differentials then there may be a case for using this traditional balance of payments adjustment mechanism. Devaluation must be seriously considered if the balance of payments of Malaysia is continuously in deficit as a result of her primary exports ceasing to be price-competitive.

[51] David T. Llewellyn, 'A Budget for Devaluation', *Westminster Bank Review*, August 1968, p. 68

CHAPTER V
MONETARY POLICIES AND THE BALANCE OF PAYMENTS

This chapter has three objectives. The first is to determine the relationship between the Malaysian money supply and the balance of payments, and then to discuss the implications arising from the relationship between the two mentioned variables. The second is to decide whether various monetary instruments have been directly used for balance of payments adjustments, and if not, whether there have been any repercussions. The third is to consider the possibility of using traditional open market operations within the Malaysian context. This is because open market operations can be used to neutralise or postpone movements in the balance of payments.

THE MONEY SUPPLY AND THE BALANCE OF PAYMENTS

The money supply of Malaysia as defined by the Central Bank consists of two components, namely, active currency in circulation and the demand deposits of the private sector.[1] We will now examine the relationship between the money supply, its individual components with the current account (pre-1959 period) and the overall surplus or deficit in the balance of payments (post-1959 period). The division of the time-span, pre- and post-1959 is to take into account that the Central Bank of Malaya existed from 1959, and of Malaysia from 1963. Although the Central Bank has existed since 1959, it did not assume the authority of note issue until 12 June 1967. This means that the Currency Board co-existed with the Central Bank until that date. This implies that the mechanics and control of the currency component of the money supply remained the same as before, that currency issue must be 81% backed by sterling and other foreign reserves. The less than 100% backing of the currency was due to the provision for a fiduciary issue.

The statistics in Table 5-1 indicate that, prior to 1959, changes in the money supply, active currency in circulation and the demand deposits of the private sector moved in the same direction as changes in the current account of the balance of payments. It can be seen that when there was a surplus in the current account, money supply and its components, currency and demand deposits

[1] The holdings of the public sector are excluded on the grounds that they are akin to inventories and have little influence on the expenditure of the government. 'Near money or quasi-money' that is fixed and savings deposits, are also excluded in that they are instruments of savings or investment – a store of value. This is in keeping with the criterion used by the IMF.

TABLE 5-1 Malaysia – Current Account, Balance of Payments and Money Supply, 1950-70

Year	Current Account	Currency in Circulation	Annual Change	Demand Deposits of Private Sector	Annual Change	Money Supply*	Annual Change	Balance of Payments
1950	648	517.9	203.9	864.9	300.9	1382.8	503.9	
1951	714	622.6	104.7	1054.3	189.4	1676.9	294.1	
1952	−105	574.9	−47.7	967.2	−87.1	1542.1	−134.8	
1953	−244	567.8	−7.1	835.0	−132.2	1402.8	−139.3	
1954	45	610.4	42.6	852.2	17.2	1462.6	59.8	
1955	447	752.3	141.9	935.4	83.2	1687.7	225.1	
1956	−49	756.4	4.1	913.8	−21.6	1670.2	−17.5	
1957	−273	742.3	−14.1	839.9	−73.9	1582.2	−88.0	
1958	−400	730.1	−12.2	856.2	16.3	1586.3	4.1	
1959	234	820.2	90.1	879.3	23.1	1699.5	113.2	
1960	433	682.1	−138.1	485.7	−393.6	1167.8	−531.7	429
1961	−18	690.7	8.6	503.5	17.8	1194.2	26.4	78
1962	164	716.4	25.7	532.8	29.3	1249.2	45.0	21
1963	−219	748.6	32.2	587.4	54.6	1336.0	86.8	−77
1964	−159	797.1	48.5	613.9	26.5	1411.0	75.0	−138
1965	60	846.2	49.1	655.6	41.7	1501.8	90.8	134
1966	−8	908.6	62.4	733.6	78.0	1642.2	−140.4	−171
1967	−54	771.6	−137.0	742.6	9.0	1514.2	−128.0	−247
1968	−35	805.2	33.6	881.4	138.8	1686.6	172.4	−27
1969	687	970.0	164.8	941.0	59.6	1911.0	224.4	530
1970	217	1039.1	69.1	1018.7	77.7	2057.8	146.8	124

*Money Supply is defined as currency in circulation and demand deposits.

Source: 1950 from S.Y. Lee, 'The Balance of Payments of the States of Malaya and Singapore', 1947-64, *Kajian Ekonomi Malaysia*, Vol. IV, June 1967.
1960-8 Bank Negara Malaysia, *10th Commemorative Issue*, p. 37.
1969-70 Bank Negara Malaysia, *Annual Report, 1970*, pp. 17, 99.

increased. When there was a deficit, money supply decreased. So did the individual component items. The main reason for this 'classical link'[2] between the balance of payments and the money supply can be attributed to the Currency Board System, the activities of the commercial banks as well as a lack of any kind of deliberate monetary policies by the government to offset changes in the balance of payments. The main factors which determined the volume of money supply during the pre-1959 period were the balance of trade, the inflow of capital for investments and the movement of government funds. The first-mentioned factor was the most important.[3] When there was a balance of trade surplus, available sterling would be exchanged for Malayan dollars, resulting in an increase in the currency component. During a period of balance of trade surplus, demand deposits were likely to be expanded to meet the increase in demand to finance more trade. This was matched by the increase in supply of funds due to the increased liquidity of the banking system. The inflow of capital for investments was of less significance. On the other hand, a balance of trade deficit would result in a contraction of the currency component as well as contraction in the demand deposits of the commercial banks.

An important effect of this system is that an external imbalance, that is, a balance of payments deficit, would not result in pressure on the exchange rate since there would be no shortage of sterling cover. Instead, the balance of payments difficulties or surplus would be reflected in the physical shortage or increase of Malaysian currency in circulation. This ensured an automatic adjustment in the Malaysian balance of payments, and for this reason it is often said that Malaysia did not face a balance of payments problem. A close correlation between the current account of the balance of payments and the demand deposits of the commercial banks means that, prior to 1959, inflationary conditions and depressions arising from fluctuations from international trade were not cushioned by commercial bank lending.

During a period of favourable balance of trade, the currency component of the money supply increased. With increased liquidity, commercial banks extended their credit facilities to meet the demand for credit from the business sector. Business expansion was a direct result of increased household expenditure. This expansion of the money supply reinforced the initial inflationary tendencies caused by the favourable balance of trade. When the balance of trade was unfavourable, the process was reversed.

The effect of having the local money supply, particularly the currency component, as a function of the balance of payments imposes some restraints on the economy.

[2] P.J. Drake, *op. cit.*, p. 43.

[3] S.Y. Lee, *Kajian Ekonomi Malaysia, op. cit.*, p. 9.

The first restraint is that in the short run, the rigid relationship between balance of payments and the currency component makes anti-cyclical policy on the part of the government difficult but not impossible.[4] The rigidity in the money supply can be overcome by various devices available to the monetary authority and the government. In times of balance of payments surpluses, fiscal policies to reduce inflation could be used. For instance, the graduated tax on rubber has been used to mop up inflationary tendencies. The effective use of this policy instrument is dependent on the size of such taxes. Government can also affect the level of aggregate demand by budgetary policy, containing or reducing inflationary trends by spending less than the total current revenue receipts and loans. The attempt to reduce money supply can be achieved if such accumulation of reserves is invested abroad. Commercial banks' liquidity could also be varied independently of the budgetary position. The government's alteration of the money supply could be achieved by moving government funds from commercial banks to the Central Bank or out of the country. This assumes that government funds are already deposited with commercial banks. Withdrawals of such government funds will have multiple effects on the credit creation capacity of commercial banks.

In view of these arguments, the government can implement anti-cyclical policies under a Currency Board System where the backing of a currency is by foreign reserves and where the balance of payments affects the currency component of the money supply directly.

Although anti-cyclical policies could be used, it is unlikely that their impact would be significant. The anti-inflationary cess in rubber since June 1955 only operates when the gazetted price of rubber exceeds $1.00 per month.[5] During the sixties, 1960 was the only year when rubber prices exceeded the one dollar mark. It is unlikely that rubber prices will pass this mark in the future. The government has never used the budget as a deflationary policy[6] and is not likely to do so in the near future. Finally, in practice, government reserves are deposited with the Central Bank or abroad. Therefore the last mentioned policy is only a theoretical possibility. However, it has been noted[7] that there was a positive correlation between rubber and tin prices with net investment payments. To some extent, this acts as an automatic anti-inflationary mechanism.

The second objection to the former sterling exchange standard is that when a

[4] P.J. Drake, *op. cit.*, p. 56.

[5] The duty being calculated according to the formula, $\frac{[2.5(p) - 250]}{10}$ where p is the weekly price.

[6] Government budgetary policy is examined later in this chapter.

[7] Chapter III, p. 85.

larger quantity of local output comes on the home market it has to be bought by the same quantity of money and unless the velocity of circulation of money increases the result will be deflationary.[8] This objection assumes that the extra output is not exported and income is not consumed but saved. It is then argued that the system has a 'deflationary bias' which can in the long run put the brakes on development. A problem of insufficient elasticity of money supply occurs whenever the output of the economy expands without a simultaneous improvement in the balance of payments. The gravity of this situation depends on the method of finance of increased home production. If the financial resources result from importation of foreign capital either through loans or foreign investments or the creation of deposits by commercial banks, an increase of the local money supply is clearly involved. If the system allows for fiduciary issue (as from 1960) and if the government is aware of the effects of varying bank liquidity either independently of or through budgetary policy (even under a 100% sterling exchange standard), the 'deflationary bias' no longer holds. In addition, the validity of the deflationary criticism is centred on a constant velocity of circulation. In practice, there is no reason to expect the velocity of circulation to be constant.

Since the velocity of circulation is unlikely to be constant and the income of rural households (these are the people whose output is not likely to be exported) is not likely to be saved, the 'deflationary bias' argument is not valid.

It is clear that although a Currency Board System introduces restraints on the money supply, these restraints can be overcome by the methods already discussed. The significant point is that the government and/or the Central Bank must assume the responsibility for initiating the use of such measures. During the pre-1959 period, a central bank did not exist in Malaya. Malaya obtained her political independence in 1957. The then colonial government may not have felt the need to implement additional anti-cyclical policies during an export boom or deficit budgetary during a period of balance of payments deficits but rather considered the automatic adjustment in the money supply as adequate. Since the then colonial government was not involved in deficit development expenditure, this was in fact true.

Since 1959, the relationship between currency in active circulation (excluding cash holdings of commercial banks and the treasury), demand deposits, money supply and the overall balance of payments has changed, in spite of the existence of the Currency Board over much of this period. In theory, the external backing has been reduced as the 1960 Currency Act provided for a maximum fiduciary issue of M$300m. or about 25% of the currency in cir-

[8] Analyst 'Currency and Banking in Jamaica', *Social and Economic Studies*, Vol. 1.1, No. 4, August 1953, p. 47.

culation at the end of 1960. By this provision, the Currency Board arrangement did provide some funds for the financing of economic development or for balance of payments adjustments in times of deficits. The $300m. fiduciary issue has never been utilized. The same amount of fiduciary issue was retained by the Central Bank in 1967. This means that the new Malaysian dollar is now 81% backed by sterling and other foreign reserves. Although the currency supply of the Malaysian dollar is partially dependent upon the supply of foreign reserves, the influence of the trade balance and the balance of payments on demand deposits, and so the money supply, may no longer be as strong as during the pre-1959 period

From Table 5-1, it could be concluded that changes in both the currency component and the demand deposits have not moved in the same direction as changes in the overall balance of payments. This is because both components have increased, irrespective of the changes of the balance of payments. This conclusion also holds when a time-lag of a year is allowed for, i.e. for instance, 1960 overall balance and 1961 changes in the currency component. One of the reasons for the non-correlation between the currency component and overall balance of payments is that the data do not include cash-holdings of the commercial banks and the Treasury. More significantly from 1960, bank lending has in fact sustained economic activity in the face of deficits in the balance of payments.

Table 5-2 indicates the changes in the Malaysian money supply and the factors influencing the changes for the period 1959-68. The factors affecting changes in the Malaysian money supply can be classified as: money of external origin (that is, foreign assets of the banking system excluding the foreign assets holdings of the government) and money of internal origin.[9] Changes in the foreign assets component, item 11a, is the result of changes in the balance of payments which includes the transfers of foreign assets of the government. Changes in money of internal origin results from changes in the transactions of the banking system with the government or the private sector or both.

For the period 1959-68, the money supply increased by $579.2m. This was an increase of 52%. On the other hand, the foreign assets component increased by $164.2m or 28% of the change in the total money supply for the same period. This, in general, indicates the relatively smaller influence of the external sector on the money supply. This important point is more clearly shown by a study of the annual changes of the money supply and its components. It is clear from annual changes of foreign assets (item 11a), that is, money of external origin,

[9] Bank Negara Malaysia, 'The Concept and Development of Money Supply in Malaysia, 1960-1968', *Quarterly Economic Bulletin*, June 1969, Vol. 2, No. 2, pp. 122-30.

TABLE 5-2 Malaysia – Money Supply by Origin, 1959-68.

Item	1959	1960	1961	1962	1963	1964	1965	1966	1967	1968	Rate of change 1960-1968 (%)
	($ million)										
	As at end of year										
1. Money supply	1,107.4	1,167.8	1,194.2	1,249.2	1,336.0	1,411.0	1,501.8	1,642.2	1,514.2	1,686.6	+ 4.3
Currency	646.4	682.1	670.7	716.4	748.6	797.1	846.2	908.6	771.6	805.2	+ 2.5
Demand deposits	461.0	485.7	503.5	532.8	587.4	613.9	655.6	733.6	742.6	881.4	+ 7.5
1a. Of external origin (Foreign assets)	1,353.1	1,424.4	1,326.7	1,394.8	1,380.2	1,441.9	1,653.4	1,685.9	1,454.3	1,517.3	+ 1.3
1b. Of internal origin (net of (i) through (vi))	−245.7	−256.6	−132.5	−145.6	−44.2	−30.9	−151.6	−43.7	59.9	169.3	+ 6.0
(i) Claims on Government	75.8	101.5	104.7	106.2	174.6	146.9	250.0	393.3	719.7	956.4	+32.5
(ii) Claims on private sector	412.6	522.6	690.9	776.9	918.8	1,062.9	1,121.9	1,269.8	1,405.1	1,689.9	+17.0
(iii) Other assets	167.3	208.6	243.9	322.4	204.7	244.9	319.9	562.4	689.1	707.0	+17.4
(iv) Less quasi-money	366.3	478.2	558.8	606.4	699.5	790.7	927.3	1,075.1	1,288.9	1,542.4	+17.3
(v) Other liabilities	359.1	402.5	441.6	541.6	442.2	455.8	603.3	872.7	932.6	1,030.4	+12.4
(vi) Government deposits	176.0	208.6	171.6	203.1	200.6	239.1	312.8	321.4	523.5	610.9	+14.8

TABLE 5-2 (continued from page 141)

	Item	Annual changes								
II	Money supply	+60.4	+26.4	+55.0	+86.8	+75.0	+90.8	+140.4	−128.0	+172.4
	Currency	+35.7	+8.6	+25.7	+32.2	+48.5	+49.1	+62.4	−137.0	+33.6
	Demand deposits	+24.7	+17.8	+29.3	+54.6	+26.5	+41.7	+78.0	+9.0	+138.8
IIa.	Of external origin (Foreign assets)	+71.3	−97.7	+68.1	−14.6	+61.7	+211.5	+32.5	−231.6	+63.0
IIb.	Of internal origin (net of (i) through (vi))	−10.9	+124.1	−13.1	+101.4	+13.3	−120.7	+107.9	+103.6	+109.4
	(i) Claims on Government	+25.7	+3.2	+1.5	+68.4	−27.7	+103.1	+143.3	+326.4	+236.4
	(ii) Claims on private sector	+110.0	+168.3	+86.0	+141.9	+144.1	+59.0	+147.9	+135.3	+284.8
	(iii) Other assets	+41.3	+25.3	+78.5	−117.7	+40.2	+75.0	+242.5	+117.7	+26.9
	(iv) Less quasi-money	+111.9	+80.6	+47.6	+93.1	+91.2	+136.6	+147.8	+213.8	+253.5
	(v) Other liabilities	+43.4	+39.1	+100.0	−99.4	+13.6	+147.5	+269.4	+59.9	+97.8
	(vi) Government deposits	+32.6	−37.0	+31.5	−2.5	+38.5	+37.7	+8.6	+202.1	+87.4

Bank Negara Malaysia, 'The Concept and Development of Money Supply in Malaysia, 1960-1968', *Quarterly Economic Bulletin*, June 1969, Vol. 2, No. 2, p. 126.

have not always been positive. 1961 and 1963 were years when the foreign assets of the backing system decreased. This shows that the influence of the external sector has been diminished. Furthermore, when changes in money supply are compared with the overall balance of payments (see Table 5-1) it can be seen that changes in these two variables have not been in the same direction. The same conclusion applies when a comparison is made between changes in money supply, its component parts and changes in the current account of the balance of payments.

It is clear that although the balance of payments still influences the money supply, it is no longer the main source of influence. Since 1960, changes in the money supply have been to a large extent influenced by the growth of domestic credit. Although the growth of credit to the government has been uneven, there appear to have been two distinct phases in its rate of growth. In 1965-8, there was a distinct jump in the annual increases. The increased liquidity of the banking system may be partly due to the 1965 export boom. More important was the increased lending in the form of investments in treasury bills and other government securities.[10] The increased lending to the government in the form of treasury bills and government securities represent earning assets and, of greater significance, represent eligible assets for the statutory liquidity requirements. The introduction in 1968 of a new liquidity regulation which required banks to maintain at least 50% of their savings liabilities in the form of either housing loans or long-term government securities may have accelerated the holdings of such securities.

Several features should be noted about the credit of the banking system to the private sector. Firstly, there have been annual increases throughout the period. For the same period, the balance of payments was in deficit in 1963, 1964, 1966, 1967 and 1968. This clearly shows that loans and advances of the banking system do act as a buffer during periods of balance of payments deficit and that the Malaysian money supply is no longer solely or strongly dependent on the state of the balance of payments. Secondly, after 1965, the impact of credit to the government sector on the money supply has been as significant as that of credit to the private sector. This was not so before 1965.

Table 5-3 shows that except for 1965, in spite of a decline in net external assets of the commercial banks, local earning assets – that is loans, advances and investments – have not only been maintained but greatly increased. This demonstrates that bank credit is the main offsetting factor in addition to export earnings. In other words, commercial banks have been providing the foreign ex-

[10]The changes in the volume of treasury bills indicate a similar pattern as from 1965. (See Table 5-14, p. 199.) The volume of treasury bills held by commercial banks also increased drastically from 1965. (See Table 5-15, p. 199.)

TABLE 5-3 Malaysia – Selected Assets and Liabilities of Commercial Banks, 1958-69

Year	(1) Demand Deposits	(2) Net External Assets	2 as % of 1	(3) Liquid Assets	Annual Change	(4) Local Earning Assets	Annual Change	3 as % of 4
1958	493.9	321.8	65	384.9	+	462.5	+	83
1959	512.4	333.1	65	394.5	+	561.2	+	70
1960	527.9	335.4	64	399.9	+	702.8	+	56
1961	550.3	258.3	47	316.1	–	880.2	+	35
1962	576.4	235.0	41	305.6	–	972.7	+	31
1963	626.9	176.3	28	242.5	–	1,177.4	+	20
1964	664.7	176.5	27	245.0	+	1,304.7	+	18
1965	713.8	292.2	40	393.6	+	1,334.6	+	29
1966	795.0	261.6	32	379.8	–	1,697.4	+	22
1967	791.8	55.3	6	193.8	–	2,335.7	+	8
1968	920.7	–59.6	–6	81.4	–	2,703.8	+	3
1969	991.4	67.5	6	205.0	+	2,940.0	+	6

Source: 1958-64 Bank Negara Malaysia, *10th Anniversary Commemorative Issue*, p. 40
1965-69 *Annual Bulletin of Statistics*, Malaysia, 1969, Table 3.5, p. 47.

Local Earning Assets = Loans + Advances + Local investments + Treasury bills + Central and state government securities + Other Malaysian securities + Loans to customers other than banks + Trade bills payable in Malaysia.

Net Earning Assets = Balance with banks outside Malaysia + Balances of trade bills payable outside Malaysia + Balances of other assets outside Malaysia.

Liquid Assets + Net External Assets + Local cash (including cash balances but not reserves with Central Bank)

change to meet excess import demands as reflected by the balance of payments deficits.

A further breakdown of bank lending in terms of local and foreign-owned commercial banks shows that it is the foreign-owned banks which are boosting the money supply and the economy in the face of balance of payments deficits. From Tables 5-4 and 5-5[11] the creation of demand deposits of foreign commercial banks are at least twice those of the local commercial banks for the period 1964-8. The net foreign assets of foreign banks have declined and, for 1967 and 1968, were in deficit, indicating that these banks have been prepared to draw from headquarters abroad. Drake[12] argues that these banks have generally been able to provide credit with little regard for liquidity considerations. The utlimate decisions about the level of credit availability in Malaysia therefore rested largely with the head offices of the foreign banks. He believes that the current trend is unlikely to continue due to the decline in relative importance of foreign banks and the fact that they have already committed large amounts and are unlikely to further their commitments. If this is true, the impact of balance of payments disturbances in future might be similar to the pre-1959 period.

Certain implications arise from the above discussion.

Firstly, has the credit creation of the banking system been so excessive as to cause balance of payments difficulties? If credit creation has not been excessive are there other ways of supporting the increase in demand deposits in view of the fact that the foreign-owned commercial banks are already committed? In the first instance, it is pertinent to show that the maintenance of import demand has not been excessive.

In theory, the maintenance of excess import demand could be taken as a signal-warning of a possible balance of payments deficit. In the expansion of aggregate demand, the creation of money is not the sole, but probably the most important factor. In a growing economy, the money supply may be expected to increase more or less continuously. If excess demand leading to increased imports and increased prices is to be avoided, the money supply should not grow at a faster rate than the real gross national product. Table 5-6 shows the relationship between money supply, gross national product and money creation. Money supply grew at an average rate of 5.8%, while gross national product grew at 6.0% per annum for the period 1960-70. This implies that there was no excessive creation of aggregate demand during the period. However, for individual years, money supply grew at a faster rate, namely, during 1966, 1968, 1969 and 1970.

[11] Statistics available for the years 1964-8 only. Statistics for 1969-70 are not comparable.

[12] P.J. Drake, *op. cit.*, p. 53.

TABLE 5-4 Malaysia – Selected Assets and Liabilities of Locally-owned Commercial Banks, 1964-8.

Year	Demand Deposits ($m)	Net External Assets ($m)	2 as % of 1	Liquid Assets ($m)	Annual Change	Local earning Assets ($m)	Annual Change	3 as % of 4
1964	154.6	78.8	50	104.8		357.4	+	29
1965	170.1	101.0	59	132.6	+	445.2	+	29
1966	203.1	138.0	68	175.4	–	599.4	+	29
1967	236.1	100.0	24	140.7	+	795.0	+	17
1968	300.7	114.9	39	157.6	+	978.5	+	16

Source: Computed from Bank Negara Malaysia, *10th Anniversary Commemorative Issue*, pp. 40-42.

TABLE 5-5 Malaysia – Selected Assets and Liabilities of Foreign-owned Commercial Banks, 1964-8

1964	510.1	97.7	19	122.2		248.1	+	13
1965	543.7	177.8	33	228.8	+	969.8	+	23
1966	591.2	108.2	18	155.1	–	1,248.1	+	12
1967	555.7	–45.3	–8	–1.3	–	1,540.7	+	0
1968	619.6	–174.6	–28	–125.1	–	1,888.1	+	–6

Source: As Table 5-4.

TABLE 5-6 Malaysia – Growth Rates of Money Supply, Gross National Product and Money Creation, 1961-70

	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970	Average
Money Supply	2.2	4.3	6.9	5.6	6.4	7.9	−7.8	11.4	13.3	7.7	5.8
Gross National Product	0.5	5.5	6.6	5.9	10.3	6.5	3.9	5.0	9.7	6.3	6.0
Money Creation	3.8	5.7	10.1	4.7	11.6	11.9	1.2	18.5	6.8	8.2	8.2

Source: Computed from Bank Negara Malaysia, *10th Commemorative Issue*, pp.37, 56
Bank Negara Malaysia, *Annual Report, 1970*, pp. 17, 67.

In addition, the existence of an excess of money creation over gross national product growth may with qualifications be regarded as an early-warning signal which need not be taken too seriously if there are indications of compensatory changes. Among such compensating changes may be reductions in the velocity of circulation, substantial improvements in the current account or the long-run balance of capital movements, the existence of excessive capacity and of unemployment that is gradually being absorbed in the production process.[13] The current balance in Malaysia was in deficit for all years with the exception of 1960, 1965, 1969 and 1970, which were years of high export prices. The deficits in the balance of payments were to some extent offset by a continuous surplus in the long-run capital accounts and a continuing growth of the gross national product (though the growth rates varied from year to year). The rate of money creation on average was 8.2% per annum as compared to the average growth rate of 6% for the gross national product. This indicates that there was some excess creation of demand but, at the present level, it is unlikely to lead to any balance of payments crises. It should be noted that some level of money creation is needed to sustain the rate of economic development which in the long run brings about improvements in the balance of payments.

The second implication is that since the foreign-owned commercial banks appear to be fully committed, it is likely that their future expansion of demand deposits may not be as large. Since credit creation has not been excessive, there may be a need to sustain the present level of credit expansion in order to generate the present rate of national product. A number of policies can be used either singly or collectively. Local commercial banks must be induced to assume part of the responsibility of increasing demand deposits as a matter of policy, the Central Bank can utilize its powers of fiduciary issue, or reduce the statutory reserve ratio of commercial banks or the government can continue to use deficit budgetting. Currently, local banks are being urged by the Central Bank to change their attitudes and methods of lending in order to become more development-orientated. In addition, some commercial banks have begun to take an interest in forming consortia to provide for the larger industrial projects in co-operation with the MIDF. An investment of $26m. in six industrial projects was made in 1970 as a result of such a consortium.[14]

The main conclusions from this study of relationship between money supply and the balance of payments are as follows. The currency component of the money supply is determined by the balance of payments with a margin of manoeuvre, because the Malaysian currency is, in fact, 100% or more backed by

[13] F. Machlup, 'The search of guides for policy', in *Maintaining and Restoring International Payments,* Fellner, Triffin, Machlup and others, p. 37.

[14] Bank Negara Malaysia, *Annual Report, 1970,* p. 15.

foreign reserves. The Central Bank and the government have yet to make use of the fiduciary issue. What is difficult to understand is the apparent contradiction in policy that although a minimum legal backing of currency is practised, legislation permits the government, through the Minister of Finance or the Monarch, to change the backing ratio unconditionally without approval of parliament. This is a radical policy, because most developing countries either allow the ratio to be altered only after parliamentary approval or, in the case of India, Pakistan and Burma, the central bank can suspend the minimum ratio requirements for a specified period.[15] The implication of the Malaysian policy is that the Finance Minister can change the backing requirements at any time. The justification for not going to parliament to effect the required amendments would be that debates in parliament would set in train a wave of exchange speculations which cause untold damage to the economy and might even wreck it beyond repair.[16] This justification is suspect.

The other component of the money supply, that is bank lending, has not always moved in the same direction as the balance of payments since 1959. Expansion of bank lending has been more significant in the foreign-owned banks. As the foreign-owned banks are already heavily committed – their net external assets already in deficit – the burden of future expansion of credit facilities in times of balance of payments deficits lies with the Central Bank and its policies, the government and the voluntary or induced activities of the locally-owned commercial banks. Currently, it appears that the Central Bank has taken the initiative to persuade local commercial banks to increase credit to the private sector, especially in areas which coincide with the overall development plans of the country. Probably the Central Bank's motive is to get local banks interested in industrial finance for the sake of increasing industrial finance. It is unlikely that there are any 'banking' or 'monetary' reasons for it. Nevertheless, the effects may be the same. Finally, the objection that the present currency system is an obstacle to anti-cyclical policy in the short run still holds. However, the 'deflationary bias' argument is no longer valid.

EXISTING MONETARY POLICIES AND THE BALANCE OF PAYMENTS

This second section is confined to determining whether financial policies are used for balance of payments adjustment in Malaysia. The method of investigation follows that used by Michael Michaely.[17] Each policy variable will be examined

[15] Lim Chong Yah, 'Monetary Policies and the New Malaysian and Singapore Dollars', in *Money and Monetary Policy*, Eastern Universities Press Sdn. Bhd. Singapore, 1969, p. 31.

[16] Tan Siew Sin, 'Speech by the Hon'ble Tun Tan Siew Sin to the Economic Association of Malaysia in K.L.,' April 1967, *Kajian Ekonomi Malaysia* Vol. IV, June 1967, p. 2.

[17] Michael Michaely, *Balance of Payments Adjustment Policies, Japan, Germany and the*

separately to see whether or not by itself it reveals any consistent adjusting behaviour. Thus, when there is a downward disturbance – balance of payments deficit – any change in the monetary instruments of the Central Bank which tend to reduce aggregate demand or lower prices is an adjusting change. The variables in Malaysia would include changes in Central Bank lending to the government, changes in the government budget, changes in the statutory reserve ratio, changes in the liquidity ratio, changes in the interest rates and Central Bank loans to commercial banks. Terming such changes in the variables as 'adjusting' implies that the entire process of which a change is a part will have an adjusting effect. For instance, the discount rate may be raised, but the demand for commercial credit may continue to increase, thus augmenting the balance of payments disturbance. However, without a change in the discount rate, the deterioration would have been stronger and this is therefore an 'adjusting' change in the discount rate.[18] In using this approach, it may appear that a policy variable may have been changed or implemented for motives other than a balance of payments adjustment. Any repercussions on the balance of payments situation may appear secondary or incidental. This may be true but a policy implies deliberate decisions. An extreme example may clarify this point. '... If a government embarks on large scale spending on rearmament or social services without taking into consideration the inflationary effects of its action, it does not mean that the government can disclaim the pursuit of a deliberate inflationary monetary policy. If inflation is merely an unwanted incidental result of the policy pursued, the decision to risk such an effect, or even an ostrich-like attitude of ignoring it, constitutes a monetary policy decision.'[19]

The selection of policy instruments for study was based on the criterion that the policy instrument can be quantified even though the quantification might be crude. A brief discussion of each of the policy variables is necessary for an understanding of the policy mechanism in Malaysia.

CENTRAL BANK LENDING TO THE GOVERNMENT

The Central Bank by law can provide temporary advances known as 'ways and means' advances to the government. The advances cannot exceed 12.5% of the budget revenue of the government and the advances have to be repaid not later than three months after the end of the government's financial year in which it is granted. The Bank has discretion in the determination of the interest rate and no further loans can be made until all previous advances have been cleared.

Netherlands, Occasional Papers 10, National Bureau of Economic Research, New York, 1968.

[18] *Ibid.*, p. 13.

[19] Paul Einzig, *Monetary Policy: Ends and Means*, Pelican Book, 1967, p. 54.

The Central Bank has also been very cautious in investments in treasury bills and other government securities. Such investments are another form of advance to the government. Although statutory regulations govern such investments of the Central Bank, its investments in treasury bills and other securities (see Table 5-7) represented less than 10% of its assets from 1960-70 despite an almost ten-fold increase in its resources over the same period. In general, the government has not taken advantage of the credit facilities despite their increasing commitment to a deficit budget.

TABLE 5-7 Bank Negara Malaysia – Government Securities as percentage of Central Bank's Total Assets, 1959-70.

1959	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970
0	0	1	1	2	3	5	6	12	7	6	6

Source: Computed from Bank Negara Malaysia, *Annual Report*, various issues.

The Central Bank's holdings of central and state governemnt securities show a fairly even increasing trend for the period 1960-70, with the exception of 1967 when the percentage figures jumped to 12%. 1967 was the year when Malaysia experienced her largest balance of payments deficit of $247m. from 1960-70. This may indicate that in this instance this particular policy variable was used.

THE GOVERNMENT BUDGET BALANCE

In the fiscal sphere, the major policy tool which might be expected to be used for purposes of balance of payments adjustment is probably an overall surplus or deficit balance of the budget. A deficit budget by the government could be interpreted as an excess government demand for goods and services. An increase in the government's excess demand whether it is an increase in a deficit or a reduction in a surplus or a shift from a surplus to a deficit is a contribution to the economy's aggregate demand and thus an inflationary measure: and a reduction of excess demand is the opposite.

The overall budget of the government has been in deficit for all years except 1960. A study of the component parts of the government budget would indicate that the reason for a continuous deficit budget has been the government's involvement in economic development (see Table 5-8).

Another feature of development expenditure is that there appears to have been an increasing trend up to 1966. Development expenditure remained around the 1966 peak of $651m. for the next two years. 1969 and 1970 showed a decline

TABLE 5-8 Malaysia – Government Budget Balance, 1959-70, ($ million)

	1959	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970
Current surplus/deficit	23	236	195	145	93	56	17	−7	−30	−75	164	55
Development expenditure	142	141	264	415	455	509	590	651	625	630	604	634
Overall budget	−59	96	−68	−265	−357	−393	−519	−574	−604	−665	−440	−579
Overall balance of payments	–	429	78	−21	−77	−138	−134	−171	−247	−27	530	124

Source: Bank Negara Malaysia, *10th Commemorative Issue*, p. 51, and *Annual Report, 1970*. p. 60.

in development expenditure. For this there may be some explanations. Firstly, there was an economy drive in the government sector from 1968. This was an attempt to cut down on administrative costs rather than on development projects, and its effects may be felt from 1969 onwards. Of greater significance may be the fact that Malaysia may have reached a stage where she was unable to maintain the same rate of development expenditure because of the shortage of skilled manpower. Finally, the racial riots in May 1969 may have forced a slowing down of the rate of economic development. Normal working conditions were not restored in the Federal capital until the later part of 1969. This may or may not have affected the pace of development projects.

It is clear that the government has had a deficit budget from 1961. An examination of the changes in the total reserves of the country, that is the overall surplus or deficit in the balance of payments in relation to the overall budget of the government, would indicate that the government budget has not been used as an adjusting mechanism. Rather, the government deficit budget is one of the main causes for balance of payments deficits. Irrespective of the state of the balance of payments, the government budget has continuously been in deficit.

STATUTORY RESERVE RATIO

Commercial banks in Malaysia are required by law to maintain minimum reserve requirements. Since the introduction in December 1959, when the minimum reserve ratio was 4% of their total deposit liabilities, it has been adjusted twice — to 3.5% in February 1965, and in 1969 to 5%. The earlier reduction was not an indication of an easier monetary situation but was implemented in order to facilitate the introduction of uniform banking legislation to the whole of Malaysia. One feature of the Malaysian case deserves some comment and that is the Central Bank's preference for a variable minimum ratio as opposed to a fixed ratio. A distinct advantage of adhering to a variable ratio is that adjustments to the ratio can be made quickly and simply during times of balance of payments disturbances. The assumption that the variable reserve ratio will be effective presupposes two conditions, namely, that banks determine their lending policy on the basis of their cash reserves and that banks are in the habit of maintaining reasonably fixed ratios between their cash balances and deposits.[20] In Malaysia, the assumption of the second condition of a fairly fixed ratio between cash and deposits is acceptable.[21] The assumption of the first condition is debatable. Commercial banks' lending policies are not likely to be determined solely by the level of their cash reserves. Other factors such as profit opportuni-

[20] A.W.F. Plumptre, *Central Banking in the British Dominions*, University of Toronto Press, Toronto, 1947, p. 278.

[21] The maintenance or adherence to a fairly fixed ratio will be dealt with later.

ties, the level of foreign reserves – their own or foreign reserves which they have access to – and their volume of liquid assets are equally important.

In other words, commercial banks' lending policy is determined by the totality of their liquid position and the demand for credit. However, though cash reserves are not the only factor, they are nevertheless one of the most important. Therefore it is likely that changes in the cash reserve ratios will have some effects on the lending policy of banks.

Another defect in the use of reserve ratio is that its effects are limited to commercial banks only. The degree of impact of counter-inflationary measure depends on whether the commercial banks are the main purveyors of finance and credit. In Malaysia, the other main sources of credit are the borrowing companies, insurance companies, building societies and quasi-government organizations, like the Malaysian Industrial Development Finance Limited. In terms of loans and advances to the general public, borrowing companies may be the next most important after the commercial banks, since their main activities are for hire purchase loans for consumer durables. In terms of total capital funds, the commercial banks had a total of $3,400m. and the borrowing companies a total deposit of $436m. at the end of 1970. Any change in the variable reserve ratio will not directly affect the lending activities of the borrowing companies. The mechanics of this instrument when there is a balance of payments deficit, is that the ratio can be raised to curb the lending capacity of the commercial banks and thus a contractionary monetary policy. The process is reversed when there is a balance of payments surplus.

It could be argued theoretically that the statutory ratio may not be an effective tool if the banking system is dominated by foreign banks which have access to funds through their head offices. Foreign commercial banks may bring in foreign exchange and so increase their cash reserves. This, in the short run, would not aggravate the balance of payments disturbance. In fact, this inflow of foreign funds may be desirable if the balance of payments difficulties are temporary in nature, as this is an adjustment mechanism. However, if the balance of payments difficulties are not temporary but deep rooted the maintenance of money levels is not desirable. In the Malaysian case, it has already been shown that foreign-owned commercial banks have in fact been responsible for the bulk of advances and loans to the general public. This could indicate that so long as foreign banks believe that profit-making opportunities exist, the variable ratio may be unsuccessful unless the increase in the ratio is substantial. However, if a large increase in the variable reserve ratio is implemented by the Central Bank, it would mean that the locally-owned commercial banks could be drastically affected. One solution is to have two sets of ratios for different commercial banks according to ownership. Sherwood holds a similar but more extreme view. In addition to discriminating variable reserve ratio for banks of different owner. ship, he suggested '...high reserve ratios, if necessary as high as 100% in respect

of any increase in a commercial bank's deposit liabilities of any particular class after a given date'.[22]

The main objection to the Central Bank having different ratios for different banks is that such practices may lead to unjust discrimination. Since discriminating variable reserve ratios are not used, the Central Bank would have to rely on qualitative and persuasive measure.

The effects on the balance of payments of a reduction in the minimum reserve ratio and those of an increase in the foreign reserves of a foreign-owned commercial bank appear to be similar at first glance. Both steps postpone the operation of the self-adjusting mechanism of balance of payments adjustments which otherwise would be, in consequence of the reduction of the liquid reserves of the banks, expected to cause contractions in bank lending, local incomes and import demands. Both alternatives allow the maintenance of imports at a level above that which would have been the case if the self-correcting mechanism had been in use. Up to this stage, the effects from either a reduction of the ratio or an increase in the foreign reserves of a foreign owned bank are identical.

However, the net effect on the balance of payments will be less severe and may even be favourable when the decline in the commercial banks' reserves is offset by loans from overseas banks, for the overseas banks provide a short-term capital inflow into Malaysia which does not happen when the Central Bank releases statutory reserves deposits.[23] In terms of policy, it follows that when Malaysia desires to maintain domestic activity and imports in face of a deterioration in the balance of payments, the Central Bank should not immediately alter the variable minimum reserve ratio but first see whether the foreign banks are prepared to increase their investments in Malaysia.[24] So far the situation when this policy can be tested has not arisen because, as has already been pointed out, the commercial banks both local-and foreign-owned do, in practice, maintain a higher ratio than the required minimum requirements.

In practice, there can be limitations to the extent to which changes of reserve ratios may be used as a monetary policy instrument especially if it is a contractionary policy. The total deposits of the commercial banks in Malaysia are about $3,000m. Therefore, even a 1½% increase (change from 3.5 to 5% in 1969) of the required reserve ratio would only correspond to increased deposits of about $50m., an amount too small to cope effectively with the excess liquidity

[22] P.W. Sherwood, 'The Watson-Caine Report on the establishment of a Central Bank in Malaya', in *Money and Banking in Malaya and Singapore,* edited by P.J. Drake, University Handbook Series, No. 2, Singapore, Malaysia Printers, 1966.

[23] P.J. Drake, *op. cit.*, p. 79.

[24] *Ibid.*, p. 80.

problem.[25] But if the reserve ratio is substantially increased still further a likely complaint of the banks on such occasions would undoubtedly be that they are forced to acquire assets which yield no interest rate and hence to accept a reduction of earnings. This may become more difficult for the government to neglect.[26] Nevertheless, in times of balance of payments crises the Central Bank is justified in implementing a high reserve ratio if the aim is to have a contraction in bank lending. This is because when a monetary system has been allowed to get out of control firm measures are required to restore financial stability. Dorrance argues '...under these circumstances a general raising of reserve requirements may be the most effective means of putting a general contractionary pressure on the monetary situation'.[27] However, foreign-owned commercial banks could partially avoid this if they chose to do so.

In addition, for its more efficient use, the variable minimum reserve ratio has also to influence other liquid assets of the commercial banks. If this is not done, banks might meet the additional cash requirements on any change in reserve ratios by adjusting their portfolio of liquid assets.[28] For this reason, if the variable minimum ratio is used it should be used simultaneously with the liquid assets ratio and when these instruments are used the changes in the ratio must be large if the instruments are to succeed in under-developed countries. This is because the level of excess liquidity of the commercial banks is high. In any case, it is clear that the minimum reserve ratio has not been used as a policy variable for balance of payments adjustments in Malaysia.

THE LIQUIDITY RATIO

At present, commercial banks have to maintain liquid assets equal to 20% of their total deposit liabilities, excluding savings deposits. Since its introduction in 1959, the liquidity ratio has been adjusted twice, first in January 1962 when

[25] Snyder holds a similar view. He argues that changes in the reserve ratios of developing countries need to be large before money supply can be significantly affected. This is because currency as a percentage of money supply is large in developing countries. Similarly, the reserve ratio is also high. Together these two factors produce a low money multiplier. The money multiplier is expressed as $\frac{1}{c+r(1-c)}$ where $c = \frac{\text{currency}}{\text{money supply}}$ and $r = \frac{\text{reserves}}{\text{demand deposits}}$. See Wayne W. Snyder, 'Managing Money and Credit in a developing economy', *Malaysian Economic Review*, Vol. XVI, No. 1, April 1971, pp. 4-6.

[26] Anders Olgaard, 'Monetary Policy in Malaysia as part of Policies towards Economic Development', *UMBC, Economic Review*, Vol. V, No. 2, 1969, p. 26.

[27] Graeme Dorrance, "The Instruments of Monetary Policy in countries without highly developed Capital Markets', *IMF Staff Papers*, Vol. 12, 1965, p. 276.

[28] D.R. Khatkhate, 'Instruments of Monetary Control in Developing Economies', *The Banker*, Vol. 117; No. 502, December 1967, p. 1064.

it was increased to 25% and second in February 1965 when it was returned to the former level of 20%. The first upward adjustment was '...intended as a preventive measure, that is to prevent bank lending being over-extended as the rate of bank advances was far out-pacing the rate of increase of bank deposits'.[29] This might be taken as an 'adjusting' change to prevent the balance of payments from deteriorating although 1961 was a year of balance of payments surplus. It might be viewed from the angle that the Central Bank felt that if such a measure was not taken the balance of payments situation would have deteriorated. The 1965 downward adjustment was to facilitate the introduction of uniform banking legislation to the whole of Malaysia. This lack of consistency in the direction of changes in the liquidity ratio, suggests that the Central Bank has not changed the liquidity ratio for balance of payments purposes.

The definition of liquid assets is of extreme importance because an instrument which the Central Bank could have used, but has not, is the local assets ratio. The implementation of a local assets ratio has important implications for the free movement of bank funds between Malaysia and overseas financial centres. It could mean a '...de facto mobilization of some of the overseas funds of the commercial banks into the hands of the Central Bank'.[30] Don Mckenna commented that the local asset ratio 'could be used effectively to bring about the transfer to the central bank of as much of the commercial banks' overseas reserves as happened to be required at that time (when the occasion demanded) for the relief of balance of payments or other purposes including local economic development'.[31] The local assets ratio has never been formally enforced in Malaysia although with effect from 31 July 1967, assets eligible for inclusion in the computation of the liquidity ratio were mainly local assets. This indirectly implies that commercial banks have to hold the bulk of their assets in the form of local assets to satisfy the liquidity ratio. It could be argued that the liquidity ratio of 20% is not large enough if the purpose of the Central Bank is to make commercial banks hold the bulk of their assets in Malaysia. However, it is fortunate that commercial banks of their own accord were holding about 92% of their total assets in Malaysia in 1968 as compared to 65% in 1965.

INTEREST RATE STRUCTURE

Changes in the level of interest rates on advances and deposits is another form of policy instrument which the Central Bank uses to influence the level of bank

[29] Bank Negara Malaysia, *10th Commemorative Issue*, p. 22.

[30] P.J. Drake, *op. cit.*, p. 77.

[31] Don Mckenna, 'Financial Developments since Independence', in *The Political Economy of Independent Malaya*, edited by T.H. Silcock and E.K. Fish, Eastern Universities Press, 1963, pp. 197-8.

liquidity and the volume of bank credit. Since the establishment of the Central Bank, the level of interest rate has been changed for all years except 1963. In making these changes, the Central Bank has been influenced by many factors. One of the main causes for upward adjustments of interest rates has been attempts to stem any possible outflow of funds abroad in view of the close financial ties with London as well as the virtual absence of exchange controls. These upward adjustments were made in 1960, 1961, 1964 and 1967. For two of these four years, namely 1960 and 1961, the balance of payments were in surplus while, for 1964 and 1967, the balance of payments were in deficit. This lack of consistency between the movements of interest rates and the balance of payments disturbances could be taken to mean that there is no consistent policy of using interest rates as an instrument for balance of payments adjustments. This inconsistency in policy by the Central Bank is further shown when there were no changes in the interest rates when the balance of payments was in deficit in 1963, 1966 and 1968.

In 1962, interest rates were reduced partly to conform with international trends and partly in the interest of facilitating productive investments in the economy. The central bank in a developing country usually faces a dilemma in controlling levels of interest. This arises because of the need on the one hand to have low interest rates for development expenditure, and on the other, if interest rates are low, the difficulty of attracting an inflow of foreign funds.

An attempt to simplify the Malaysian system and yet continue with a differential interest rate structure was made in 1966 when the structure of the minimum rates of interest for advances was adjusted. In place of differential minimum rates of interest for various categories of advances, a single minimum rate of 7.5% was introduced for all categories of advances other than those to government and public authorities. Advances against government and muncipal securities, and advances against local agricultural produce had a preferential rate of 7% per annum. Lastly, considerations to encourage savings and to induce savings in long term deposits and thus stabilize the volatility of deposit funds resulted in upward changes in the rate of saving deposits from 2.5% to 3% in 1965 and subsequently 3.5% (in the case of commercial banks) and 4% (in the case of Post Office Savings Banks) in the same year. To encourage long-term savings and to help stabilise deposits, differential rates on fixed deposits according to their maturities were introduced in 1967 and in 1968. As from August 1968, the discount rate for treasury bills was fixed at 4% per annum for bills of 91 days, at 4.5% per annum for bills of 182 days, at 5% for bills of 273 days and at 5.5% per annum for bills of 365 days.

CENTRAL BANK LOANS TO COMMERCIAL BANKS

Another traditional instrument – control of commercial bank borrowing from the Central Bank – can be an important and effective instrument. Unlike

variations in the statutory reserve ratio, controlling the amount of commercial bank indebtedness to the Central Bank is similar to an open market operation, because individual banks are free to increase or decrease their borrowing and hence the multiplier powers of total bank reserves.

If this is to be an effective instrument, at least one condition must be met: the quantity of commercial banks' borrowing from the Central Bank must be large enough so that variations can produce the desired change in commercial bank reserves.

Table 5-9 shows the Central Bank's volume of advances[32] to commercial banks.

It is clear from Table 5-9 that Central Bank advances to commercial banks have been insignificant. As such it is unlikely that this instrument can be effective as a means of monetary control either directly through variations in the interest rates charged by the Central Bank or by direct quantitative controls. It also appears that this traditional monetary instrument has not been used to offset balance of payments changes.

A general conclusion which can be drawn from this study of the various policy variables used by the Central Bank is that none of the monetary instruments have been consistently used for balance of payments purposes. This could possibly be explained by the fact that in spite of balance of payments deficits, Malaysia has not experienced any balance of payments crises. This fortunate situation is probably due to the very large foreign exchange reserves, the very conservative monetary policies of the Central Bank, the advantages of having been on the Currency Board System and, from 1967, having had the currency backed by at least 81% of foreign exchange reserves in theory and, in practice, by greater than 81% and lastly, by the movements of capital funds between foreign-owned commercial banks and their head offices.

Another reason, perhaps the most important, is that the Malaysian economy has been basically sound and that, as yet, all the balance of payments deficits have been purely temporary and have arisen from short-term fluctuations in export prices. Since the deficits have been purely temporary and since they have corrected themselves as prices have risen and diversification has taken effect, there has been as yet no need for the Central Bank to pursue active contractionary monetary policies.

In the light of the fact that Malaysia's balance of payments 'problems' do follow export prices and that export prices do fluctuate from year to year or even from week to week, it is pertinent to ask whether and when these monetary policies can be of use for balance of payments adjustments.

[32]The figure 'Others' includes Central Bank advances to commercial banks. This means the volume of advances given in the table over-states the amount of loans to commercial banks.

TABLE 5-9 Malaysia – Central Bank Advances including Advances to Commercial Banks, 1960-70

	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970
a) 'Others' including advances to commercial banks ($m)	33.2	37.4	36.4	56.5	25.7	50.5	94.8	85.8	78.4	66.0	53.3
b) Commercial banks' liquid assets[1] ($m)	648.1	569.5	606.4	612.5	720.0	907.0	1203.7	1253.2	1468.4	1644.3	1610.6
a) as percentage of b)	5	6	6	8	3	5	7	6	5	4	3

1. Liquid assets = Cash + Balances with banks + treasury bills + trade bills payable, loans and advances to banks, money at call + cheques payable in Malaysia.

Source: Bank Negara Malaysia: *10th Anniversary Commemorative Issue*, pp. 38-40. *Quarterly Economic Bulletin*, Vol. 4, No. 2, June 1971, pp. 8, 11.

Due to the unpredictability of the frequencies and magnitude of export price fluctuations, it would appear that monetary policies cannot be of much use if they are to offset the effects that price fluctuations have on the Malaysian balance of payments.

In addition, the time-lag before the effects of a change in monetary policy can be felt might cause even more confusion once prices change. Given the fact that Malaysia's money-market is not well integrated, the time-lag must necessarily be long. In other words, the conditions which dictate that a particular monetary policy be used may well have changed drastically by the time the policy takes effect.

These severe limitations to the use of monetary policies in Malaysia may perhaps be partially responsible for the Central Bank's passive policy during the sixties.

Although the use of monetary policies is limited with respect to export price fluctuations, a stabilization policy can be used to offset downward price movements. In 1967, rubber prices reached their lowest level of 48.6 cents per pound during the sixties. In an attempt to prevent any further fall in prices, the Malaysian government began buying rubber from the market. Its intervention had some immediate favourable effects on market sentiment and helped to maintain the price above the 50 cent level.[33] It should be noted that such a policy can be sustained for only a limited period of time because of the amount of money involved. In addition, a stabilization policy merely treats the symptoms of the deficit rather than the cause.

It should also be emphasized that monetary policies are useful for influencing international capital movements, and here the Malaysian balance of payments could be affected by monetary policy changes.

Finally, attempts at policies directed at preserving and improving the balance of payments situation in Malaysia have been in such areas as import substitution, both in the agricultural and manufacturing sectors, as well as export-promotion. In other words, the Malaysian authorities have either not found it necessary to use or are unable to use what Linden and Cohen call 'forced adjustment through the traditional mechanism' but have rather relied more upon an 'offsetting' disequilibrium in the balance of payments – and upon 'new adjustments methods' – that is, import substitution and economic diversification.

In the light of the above analysis, it is appropriate to ask what is the balance of payments policy in Malaysia? It appears that Malaysia shows some concern when the balance of payments is in deficit, while a surplus is to be encouraged and desired. This implies that a deficit has been considered as an undesirable disturbance and a surplus as the opposite. Given that Malaysia is a developing

[33] Bank Negara Malaysia, *Annual Report* 1967, p. 31.

country, with priority given to development and higher growth rates, accumulation of foreign reserves is the target. It is extremely unlikely that adjustments will be pursued should Malaysia's balance of payments show a consistent and continuous surplus. In this respect Malaysia is no different from other developing countries in its attitude towards its balance of payments situation. However, it should be noted that a consistent and continuous surplus can create inflationary problems as well unless there is a revaluation of the Malaysia currency.

OPEN MARKET OPERATIONS

Let us examine the possibility of using open market operations within the context of the Malaysian money-market. To do this, the common claim that it is undeveloped and too narrow[34] needs critical appraisal, and the possibility of widening it must also be considered.

Theoretically, open market operations can be used as a balance of payments adjustment policy. In times of balance of payments difficulties, contraction of effective aggregate demand can be brought about by the monetary authority selling treasury bills and securities to the general public and the commercial banks. The Central Bank can also allow bills to mature without replacing them by the purchase of new bills. These actions would result in a reduction in the cash or near cash reserves of the commercial banks which consequently leads to a several-fold reduction in the total money supply. When there is a need for an expansion of the money supply, that is, increasing effective aggregate demand, the reserve process is necessary.

Open market operations are transactions conducted in an organized money-market. Such transactions can be conducted only if there is a satisfactory market for the assets normally bought and sold by the Central Bank – usually treasury bills, commercial bills of exchange and short-dated government securities. The degree to which a central bank may rely on open market operations to make interest rates and the credit policies of financial institutions conform to its purposes depend primarily upon three factors:[35]

[34] A number of writers have stated that the Malaysian money-market is undeveloped and narrow without indicating why this is so. For instance, see V.Kanapathy, 'The Role of Financial Institutions in Malaysia's Economic Development', in *The Malaysian Economy: Problems and Prospects,* Asia Pacific Press, 1970, p. 177, 'In view of the underdeveloped nature of the money and capital markets in Malaysia...'. See also Bank Negara Malaysia, *10th Commemorative Issue,* p. 22, 'It does not use the classical instruments of the Bank rate and Open Market Operations to control credit in view of the underdeveloped nature of Malaysian money and capital market'. However David Williams has argued that it may not be so. See David Williams, 'Money-Markets in S.E. Asia', *The Banker,* June 1963, Vol. CXIII, No. 449, pp. 486-91.

[35] A.W.F. Plumptre, op. cit., p. 230 (Plumptre only states the first two conditions). See also

1. The success of the Central Bank in maintaining a highly stable cash reserve ratio on the part of the commercial banks because this ensures that these banks will re-enforce by several fold the expansive or restrictive operations of the Central Bank;
2. The level of development of the money market;
3. The degree to which commercial banks refrain from rediscounting bills or borrowing from the Central Bank to replenish their cash balances that are reduced by the Central Bank's action.

Nevertheless, it should be noted that neither condition 1 or 3 is absolutely necessary for the success of open market operations. If the money-market is broad[36] and active, that is well developed, open market operations can be undertaken effectively. Alternatively, even if the money-market is narrow, open market operations may still succeed if banks follow a stable ratio policy. The point to note is that the environment becomes ideal for a successful open market policy when all three conditions are satisfied.

The first two conditions can now be discussed within the Malaysian context. Since July 1969, the legal variable minimum reserve ratio in Malaysia has been 5% although, as already stated, the ratio was 4% for the period 1959 to February 1965 and 3.5% till 1969. Table 5-10 shows that the minimum reserve ratio maintained by commercial banks in Peninsular Malaysia has varied from 7% to 13%. For the years 1959-66, the actual minimum reserve ratio was higher, in fact, at least twice as high as the legal minimum. There would seem to be three possible explanations for this. Commercial banks may have wanted to safeguard against shortage of cash should the Central Bank change the legal variable minimum reserve ratio. Secondly, the fractional reserve model assumes that the general public has a demand for cash which increases proportionately as bank deposits increase. However, it seems likely that this assumption may not have been rigidly true from 1959-66. Less cash may have been held by the public with increases in deposits which means that the actual ratios of commercial banks were greater than the legal minimum. Thirdly, up to 1964, the volume of local liquid assets in the form of treasury bills and short-term government securities was small. This means it may have been considered prudent to hold a larger volume of cash instead of liquid assets.

Since 1965, for Malaysia as a whole (see Table 5-11) the cash ratio of commercial banks has been kept nearer to the required legal minimum.[37] This

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Hirandra Nath Roy, *The Role of Monetary Policy in Economic Development*, The World Press Private Limited, 1962, p. 97. S.N. Sen, *Central Banking in undeveloped money markets*, Bookland Private Limited, 1967, p. 52.

[36] See p. 171.

[37] The implications of the commercial banks adhering to cash ratios very close to the legal variable minimum, i.e. economizing in the use of cash for indicating the degree of develop-

TABLE 5-10 Peninsular Malaysia – Commercial Banks' Cash Ratio, 1959-66.

Period		Deposit Liabilities $ m.	Cash on Hand and in Central Bank	Cash Ratio
1959	1	798.6	101.0	.1264
	2	820.8	98.0	.1193
	3	888.9	106.0	.1192
	4	928.2	105.2	.1133
1960	1	1,031.5	103.0	.0998
	2	1,059.3	105.0	.0991
	3	1,066.8	101.0	.0946
	4	1,075.8	110.0	.1023
1961	1	1,095.8	121.0	.1104
	2	1,128.9	107.0	.0947
	3	1,199.0	97.0	.0809
	4	1,185.8	116.0	.0978
1962	1	1,203.0	135.8	.1124
	2	1,230.2	114.9	.0933
	3	1,247.8	138.6	.1110
	4	1,255.3	131.0	.1043
1963	1	1,296.1	144.6	.1115
	2	1,314.6	128.8	.0979
	3	1,373.3	132.6	.0965
	4	1,397.6	141.0	.1022
1964	1	1,441.0	130.0	.0902
	2	1,465.1	122.0	.0832
	3	1,496.7	119.0	.0795
	4	1,531.7	133.0	.0868
1965	1	1,556.5	136.0	.0873
	2	1,610.4	132.6	.0859
	3	1,662.6	128.0	.0769
	4	1,144.3	151.0	.0865
1966	1	1,759.4	138.0	.0755
	2	1,825.1	141.0	.0772
	3	1,879.0	140.0	.0745
	4	1,982.0	166.0	.0837

Source: Rais Sanimann, Determinants and Behaviour of the Money Supply in Malaysia, Unpublished Ph.D. thesis, George Washington University, pp. 129-30.

TABLE 5-11 Malaysia — Liquid Assets of Commercial Banks. 1965-70.

As at end of	Total	Cash	Balances with Central Bank	Net Balances with banks & money at call	Treasury Bills	Government Securities[3]	Bills discounted or purchased & bills receivable	Cheques purchased payable in Malaysia	Others	Liquidity Ratio	Cash Ratio[2]
1	2	3	4	5	6	7	8	9	10	11	12
				$ million						Per cent	
1965	984	113	24	47	322	165	239	53	21	33.2	4.6
1966	1152	114	38	38	442	168	271	59	22	22.9	4.5
1967	859	88	19	28	438	141	69	53	23	38.3	4.8
1968	913	92	16	27	604	45	71	58	—	41.7	4.0
1969	876	90	11	26	613	68	68	—	—	35.2	3.3
1970	845	96	21	31	536	76	85	—	—	30.1	3.5
				Per cent of Total						Change (Per cent)	
1965	100	11.5	2.4	4.8	32.7	16.8	24.3	5.4	2.1	n.a.	−0.7
1966	100	9.9	3.3	3.3	38.4	14.6	23.5	5.1	1.9	+0.7	−0.1
1967	100	10.2	2.2	3.3	51.0	16.4	8.0	6.2	2.7	+4.4	+0.3
1968	100	10.1	1.7	2.9	66.2	4.9	7.8	6.4	—	+3.4	−0.8
1969	100	10.3	1.3	2.9	70.0	7.8	7.7	—	—	−6.5	−0.7
1970	100	11.4	2.5	3.7	63.4	9.0	10.0	—	—	−5.1	+0.2

[1] With effect from the end of October 1968, commercial banks were required to maintain a statutory minimum liqiudity ratio of 20% against total deposits, except savings deposits. Originally, the liquidity requirement applied to total deposit liabilities. Prior to 31 July 1967, the calculation of the statutory minimum liquidity requirement was based on the overall position of banks operating in both Malaysia and Singapore and liquid assets in Malaysia and Singapore were eligible for inclusion in the computation. As from 31 August 1969, cheques purchased drawn on other banks in Malaysia were excluded from the computation of the liquidity ratio.

[2] Cash in hand and balances with the Central Bank to total deposits.

[3] Exclude government securities required to satisfy the 50% ratio of longer-term government securities and/or housing loans to saving deposits.

Source: Bank Negara Malaysia, *Annual Report*, 1970, Table 13, p. 32.

change in attitude of the commercial banks may have been due to the large volume of local assets, especially bills, that the banks now hold either voluntarily for profit motives or because of the statutory liquidity ratio imposed by the Central Bank. Closely related to the change in the commercial banks attitude towards holding a larger volume of treasury bills may be the increased confidence in the Central Bank to act as lender of last resort as well as in the activities of the Discount House which was set up in 1963. Another feature of Table 5-10 is that the cash ratios of commercial banks do not appear to have been seasonally affected. A more significant point to note is that the commercial banks do adhere to a stable and low reserve ratio, especially after 1965. This means that the first condition for open market operations to be effective in Malaysia is satisfied.

The determination of whether the Malaysian money-market is developed or underdeveloped is less definitive. It may be more appropriate to try to indicate the degree to which it has developed rather than have a rigid dichotomy between a developed and underdeveloped money-market.

The term money-market may be taken to refer to the organization for the impersonal borrowing and lending of short-term funds through the use of financial assets which are relatively liquid. The definition emphasizes three essential characteristics of a money-market:

a. The assets that are bought and sold are relatively liquid;
b. that such activities tend to be concentrated in some centre which serves a region or area; and
c. that competition in the market is impersonal in character.[38]

Williams' 1963 study of the money market in Malaysia[39] indicated that the assets that were traded were principally call money and that the money-market was purely an inter-bank market. Three separate but connected inter-bank markets have been distinguished, the market for sterling which formed the core of the money-market, the market for dollar loans and the market for 'same day' dollars for the purpose of clearing balances at the Central Bank.[40] Both the financial centres of Singapore and Kuala Lumpur in 1963 had restricted dealings in treasury bills since such bills were considered as investments or considered necessary as part of the statutory capital requirements. In addition, the volume of treasury bills was small. Coupled with this was the attitude of the Central

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ment of the money-market will be dealt with on p. 191 and pp. 195-196.

[38] J.S.G. Wilson, The Structure of Money Markets', in *Monetary Policy and The Development of Money Markets*, George Allen and Unwin Ltd., 1966, p. 218. See also J.S.G. Wilson, 'The Role of a Money Market in a developing Country', *Yorkshire Bulletin of Economic and Social Studies*, Vol. 16, No. 2, November 1964, pp. 76-87.

[39] David Williams, *op. cit.*, pp. 486-91.

[40] P.J. Drake, *op. cit.*, p. 198.

Bank to discourage rediscounting such bills, arguing that it lacked the resources to provide such facilities. Commercial bills seldom appeared on the open market and were rarely traded between banks locally.[41] After 1965 (see Table 5-12), the change in the attitude of the Central Bank towards rediscounting treasury bills changed significantly indicating the presence of a more active bill market although it appears that treasury bills have played a more dominant role than commercial bills. This change in attitude was the result of the increase in government funding through treasury bills and government securities as well as the Central Bank's aim to develop the Malaysian money market. In any case, the assets which were traded in the money market were relatively liquid since these consisted primarily of the first line reserves of commercial banks, treasury bills of the government and to a lesser extent commercial bills.

Prior to 1965, the financial centres of Malaysia were Kuala Lumpur and Singapore, The political split in late 1965 resulted in Kuala Lumpur being the main financial centre for Malaysia. The money-market in Kuala Lumpur has more or less direct connections with other financial centres of the world as evidenced by the need for the Central Bank to adjust its interest rates in sympathy with changes elsewhere. For instance, in April 1970, the Central Bank had an upward revision in the discount rates for treasury bills. 'The upward adjustments were made to bring the rate more in line with rates abroad...'.[42]

In a well developed money-market, borrower-lender relationships are likely to be relatively impersonal in character so that the price is solely determined by supply and demand. However, in the case of Malaysia in 1963, the situation in both Singapore and Kuala Lumpur, '...the personal element especially in "call money" transactions, is alleged to be the main determinant both of availability and of rates'.[43] It is difficult to know for certain whether the same conditions continue to exist and it is likely that personal influences prevail, but is is unlikely that personal contacts will show themselves in pronounced differential rates. This is because of the increased volume of business of the Discount House as well as the fact that treasury bills dominate the bills market.

The above discussion shows that the Malaysian money-market to some degree possesses the essential characteristics of a developed money-market. Whether open market operations will be effective or not will depend on whether the effects are localized in the financial centre itself or become more widespread. For the effects to be widespread a well integrated structure of markets and institutions needs to be in existence. In addition, commercial banks should be geared to

[41] David Williams, 'Commercial Banking in the Far East', *The Banker*, Vol. CXIII, No. 448, June 1963, p. 422

[42] Bank Negara Malaysia, *Annual Report*, 1970, p. 14.

[43] J.S.G. Wilson, 'The Role of a Money Market in a developing country', *op.cit.*, p. 77.

TABLE 5-12 Malaysia – Central Bank's Transactions in Treasury Bills, 1961-70, $m.

	Sales to Commercial Banks	Others	Rediscount for Commercial Banks	Others	Total Sales	Total Rediscount	Bought
1961	50.3	3.0	17.1	3.8	53.3	20.9	55.5
1962	29.0	n.a.	7.2	–	29.0	7.2	61.0
1963	71.8	9.0	43.8	2.0	80.8	45.8	93.9
1964	90.9	63.5	97.2	35.0	154.4	132.2	97.6
1965	121.5	112.2	171.3	114.6	233.7	285.9	–
1966	61.5	256.8	402.7	169.7	318.3	527.4	18.7
1967	80.8	262.7	469.6	240.8	343.5	710.4	89.0
1968	229.2	151.6	499.8	330.4	380.8	830.2	101.1
1969	100.0	202.0	443.0	171.0	302.0	613.9	n.a.
1970	211.0	117.0	377.6	96.5	328.0	474.1	n.a.

Source: Bank Negara *Annual Reports*, various issues.

having fairly stable cash ratios which are at or near the minimum reserve ratios. This implies that commercial banks are prepared to use 'other liquid assets' to cushion or absorb the impact of any sharp drop in bank cash.[44] Finally, the money-market needs to be broad rather than narrow. The integration of structure of markets and institutions has two aspects, the central money-market itself and the overall network of Malaysia's financial institution.

In the central money-market, that is Kuala Lumpur, the degree of integration between financial institutions is well developed. The Central Bank has the power to purchase, sell, discount, rediscount; inland bills of exchange and promissory notes arising out of bona fide commercial transactions maturing within three months; inland bills of financing of agricultural operations or the marketing of crops maturing within six months, treasury bills maturing within three months, and government securities of not more than twenty years maturity which have been publicly offered for sale. It can make advances for fixed periods against treasury bills and certain other types of government securities.[45] The Central Bank also provides the facilities of lender of last resort should the necessity arise. The provision of lender of last-resort facilities is an essential condition in the development of a money-market. Unless this facility is available, dealers in the market will not be able to turn their assets into cash when all other sources of liquidity fail and such assets can no longer be regarded as truly liquid in the sense of being marketable without risk of substantial loss. In recognition of this factor, the Central Bank has offered rediscounting facilities to enable banks as well as the Discount House to turn their treasury bills into cash whenever the need arises. Since 1961, the Central Bank has offered rediscount facilities to the commercial banks and certain other institutions at 1/8% above the ruling interest rate on treasury bills issues. The Central Bank's transactions in treasury bills from 1961-70 is given in Table 5-12.

The intermediate link between the commercial banks and the Central Bank is the Discount House which appears to have been fairly active, as indicated by the volume of total turnover of investments (purchases of treasury bills and government securities) of about $305m. in 1970. Total deposits with the Discount House including amounts borrowed from the Central Bank as lender of last resort stood at about $40m. The amount of call money accepted by the Discount House from the commercial banks was $6,544m. in 1970. If integration of structure is taken in a limited sense as to mean the close market relationships between the commercial banks and the Discount House which had direct access to the Central Bank, it may seem reasonable to suggest that the money-market

[44] J.S.G. Wilson, 'The Structure of Money Markets', *op. cit.*, p. 220.

[45] Siew Nim Chee, 'Central Banking in Malaya', in *Central Banking in South and East Asia*, edited by S. Gethyn Davies, Hongkong University Press, 1960, p. 116.

in Malaysia is fairly well integrated. However, when one considers the overall structure of Malaysia's financial institutions the degree of integration is less. These two aspects will result in differing degrees of impact on the economy when open-market operations are practised by the Central Bank. This point will be considered in greater detail later.

The total number of banking offices in Malaysia at the end of 1970 was 336, with the concentration in the main trading centres in Selangor (86), Perak (45), Penang (38) and Johore (32). The total number of banks was 38 of which 16 were domestic banks with a total of 177 banking offices and the remaining 22 were foreign incorporated banks with 159 banking offices. The volume of deposits held in the banking system at the end of 1970 amounted to $3,400m. of which 61.4% was with foreign banks. The above distribution of concentration of banking offices, that is, nearly two-thirds in four states, does indicate to some extent the lack of banking facilities in the other states of Malaysia. The other financial institutions of importance to the money-market as well as the capital market are the Discount House, the borrowing companies, the insurance companies, quasi-government financial corporations like MIDF, the Employees Provident Fund and the Post Office Savings Bank. The criterion for whether the money-market was developed or underdeveloped should not however be in the presence or absence of any particular financial institutions but rather the lack of integration between them.

In Malaysia, there appear to be two distinct markets, the organized market – that is, the central money-market – and the unofficial money-market. It is in the breakdown of direct links between these two markets that one is often led to the conclusion that the Malaysian money-market is narrow and undeveloped. The unorganized money-market is prevalent in both the rural and urban sectors of the economy. There is substantial volume of agricultural production financed on short-term by money-lenders, shop-keepers and other small scale businessmen. Even in the urban areas the existence of the 'tontine' system, now illegal, and the 'chit fund' system[46] which allow groups of individuals access to fairly short-term funds at rates which bear no resemblance to the rates in the official money markets. However, it would be wrong to think that there is no link at all between the lenders and borrowers of funds in the rural and urban areas. 'In Malaya the chettiars extend credit to Chinese and Indian businessmen against

[46]The 'tontine' and 'chit fund' refer to an arrangement whereby a group of individuals contribute to a pool a fixed amount of funds less the interest rates for the opportunity of using the funds earlier. Any participant of the fund can tender for the use of such funds. The individual who offers the highest rate of discount secures the use of such funds. Usually, there is a minimum interest rate for tender but the system varies in terms of the amount of contribution, the frequencies of bidding either weekly or monthly, the number and type of participants and in the level of interest rate.

mortages and especially promissory notes. The chettiars in turn place themselves in funds by discounting these notes with the western banks or by obtaining overdrafts or the security bills or title-deeds to property.'[47] This link, though it exists, is weak in the sense that the benefits derived from an organized market are not likely to be completely passed on to the rural consumer. It is likely to stop when it reaches the middlemen, the chettiars. To the extent that the unorganized money-market exists in Malaysia, the conclusion would be that complete integration of financial institutions does not exist in Malaysia. The theoretical importance of having a completely integrated structure is that the influences operating in one market or affecting one financial institution will be transmitted fairly readily to all related institutions. This in turn implies that if open market operations are undertaken by the Central Bank, the effects of such operations will be widespread rather than be localized in a financial centre. Since the conclusion is that the money-market in Malaysia is not fully integrated in a broad sense, the question is whether open market operations can be effective nationally and so be used as a monetary policy to control the volume of the money supply? This question will be dealt with later.

For the time being, it is necessary to indicate that the conditions of fairly stable cash ratio for commercial banks do exist. Table 5-10 clearly shows that this is true and, in addition, it also shows that the commercial banks employ their cash reserves very economically. These characteristics suggest that commercial banks might be responsive to action taken by the Central Bank. Table 5-10 also shows that the liquidity ratios of commercial banks are in excess of the legal required minimum of 20%. This in turn means that the commercial banks still maintain a fairly safe margin of at least 10% above the minimum, which implies that open market operations by the Central Bank would have to be on a fairly large scale to be effective.

A further criterion often used to classify whether a money-market is developed or undeveloped is the degree of institutional specialization. The greater the proliferation of financial intermediaries, the more developed the money-market is said to be. This criterion however, is not necessary. Specialization of function is not a prerequisite of integration.[48] Specialization is a function of growth in the financial system.

Generally, it is accepted that the attributes of a narrow as opposed to a broad security market are as follows: first, that the absolute number of buyers and sellers is few: second, that there is not a wide spectrum of owners and ownership motives; and third, that 'position-takers' are few in number.[49]

[47] P.J. Drake, *op. cit.*, p. 114.

[48] J.s.G. Wilson, 'The Role of Money Market in a developing Economy', *op. cit.*, p. 79.

[49] R.C. Porter, 'Narrow security market and monetary policy – Lessons from Pakistan', in

From Table 5-13, it is clear that the Malaysian market has been a 'captive' market in which the ownership of treasury bills and securities has been in the hands of three institutions which are, and have been, required by statute to invest a specified portion of their assets in government and other 'approved' securities. The Employees Provident Fund has been the main investor. It is significant to note that commercial banks since 1965 have shown increased ownership of treasury bills and this has been brought about by a change in the definition of assets which could be included in the liquidity ratio. Since 1965, eligible assets have included treasury bills, government securities, bills discounted, bills receivable, cheques purchased payable in Malaysia and cash in hand at the Central Bank. Apart from the Employees Provident Fund, Post Office Savings Bank, commercial banks and the Central Bank, the bulk of the remaining government debt has been taken up by the Discount House, the insurance companies and the borrowing companies.[50] The situation just described seems to correspond with the characteristics of a narrow-money market. In addition, it is also probable that institutional investors other than commercial banks have held their treasury bills until maturity.

Table 5-14 shows that prior to 1965, treasury bills have on average formed about 10% of government debts. Since 1965, the volume of treasury bills has increased to 20%.

Is is significant to note that commercial banks in Malaysia continued to be the major holders of treasury bills and accounted for about 71% of the treasury market for the period 1967-70 (see Table 5-15). This point is important because commercial banks are responsible for the size of the demand deposits of money supply. Table 5-17 shows that the foreign-owned commercial banks have held the bulk of the treasury bills. Besides this, the existence of dealers who are prepared to hold or sell the assets of the money market is important. The Discount House in Malaysia accepts short term funds from banks and other financial institutions for periods less than three months and re-invests them for somewhat longer periods in treasury bills and short-and medium-term government securities.

The main conclusions are that the money-market is fairly well developed at the financial centre, and that when a broader concept of integration is applied, it lacks complete integration. Given these conditions, would open market operations give the required results when used as a monetary policy to control the money supply in the economy?

Economic Development and Cultural Change, October 1965, p. 48.

[50] Borrowing Companies Act, 1969, A minimum of 10% of Malaysian liquid assets against local total deposits liabilities is required. The Amendment to the Insurance Act, 1963, requires insurance companies to hold by the end of 1970 at least 10% of total assets of their insurance funds in the form of domestically issued federal government securities.

TABLE 5-13 Peninsular Malaysia – Distribution of Government Debts, 1958-70

Year	Total Government Debt Treasury Bills and Securities	Employee Provident Fund Holdings		Post Office Saving Bank Holdings		Commercial Bank		Central Bank		Total
	$m	$m	%	$	%	$	%	$	%	%
1958	649.0	386.0	59	26.7	4	55.9	3			71
1959	839.0	469.7	55	41.8	4	73.3	8	2.5		67
1960	957.0	558.0	58	59.2	6	93.1	9	8.4		73
1961	1,071.0	655.5	61	79.5	7	93.2	8	11.5	1	77
1962	1,267.0	762.2	60	86.0	6	93.0	7	13.2	1	74
1963	1,529.0	370.6	56	100.7	6	139.5	9	33.2	2	73
1965	1,665.0	998.4	59	110.1	6	109.3	6	43.2	2	73
1965	2,171.0	1,148.4	52	133.8	6	132.6	3	67.6	3	69
1966	2,496.0	1,312.1	52	151.3	6	310.2	13	83.1	3	73
1967	2,933.0	1,494.4	50	172.5	5	578.6	19	141.1	4	78
1968	3,479.0	1,639.8	47	212.2	6	853.6	24	102.5	2	79
1969	3,893.0	1,831.2	47	240.3	6	808.0	21	122.5	3	77
1970	4,258.0	2,038.0	48	260.7	6	833.0	20	123.8	3	77

Source: Bank Negara Malaysia, *Annual Reports*, various issues.

TABLE 5-14 Malaysia – Central Government Debt by Length of Maturity, 1958-70, End of Period, ($m)

Domestic Debt	1958	1959	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970
Treasury bills	71	95	113	106	109	148	222	450	578	644	779	815	792
2 years security					15	51	54	32	14				
3 years security								13	54	54	100	152	183
5 years security		20	28	32	74	107	98	97	97	155	225	278	303
7 years security										24	24	24	24
Long term security	578	724	816	933	1069	1223	1365	1579	1753	2108	2351	2623	2956
TOTAL	649	839	957	1071	1267	1529	1665	2171	2496	2953	3479	3893	4258
Percentage of treasury bills to total debt	10	11	11	9	8	9	13	20	23	21	22	20	18

Source: Bank Negara Malaysia, *10th Anniversary Commemorative Issue*, p. 55, *Annual Report*, 1970, p.63.

TABLE 5-15 Malaysia – Commercial Banks, Distribution of Malaysian Government Securities, 1958-70, ($m)

Malaysian Government Securities	1958	1959	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970
Treasury bills	9.0	20.5	33.9	32.1	17.6	41.2	29.0	105.7	225.6	437.8	603.9	613.0	536.0
Central & state government securities	46.9	52.8	59.2	61.1	75.4	98.3	80.3	76.9	84.6	140.8	249.7	295.0	297.0
TOTAL	55.9	73.3	93.1	93.2	93.0	139.3	109.3	182.6	310.2	578.6	853.6	808.0	833.0
Commercial banks treasury bills as % of total													
Treasury bills	10	11	30	30	16	27	12	23	38	67	76	75	68

Source: Bank Negara Malaysia, *10th Anniversary Commemorative Issue*, pp. 40-11. *Annual Report, 1970*, p. 28.

TABLE 5-16 Malaysia – Locally-owned Commercial Banks' Holding of Government Securities, 1964-70, ($m).

Malaysian Government Securities	1964	1965	1966	1967	1968	1969	1970
Treasury bills (A)	7.1	64.5	59.2	139.6	198.9	241.0	198.0
(A) as % of total treasury bills	3	14	10	21	25	30	25
central & state securities (B)	15.1	15.4	14.3	32.7	80.1	118.0	118.0
(B) as % of total central government & state securities	1	–	–	1	3	4	3

Source: Bank Negara Malaysia, *10th Anniversary Commemorative Issue*, pp. 40-41. *Annual Report*, 1970, pp. 29, 63.

Table 5-17 Malaysia – Foreign-owned Commercial Banks' Holding of Government Securities, 1964-70, ($m).

Malaysian Government Securities	1964	1965	1966	1967	1968	1969	1970
Treasury bills (A)	21.1	41.2	166.4	298.2	405.0	372.0	338.0
(A) as % of total treasury bills	9	9	28	46	51	46	43
central & state securities (B)	18.2	61.5	70.3	108.1	169.6	177.0	179.0
(B) as % of total central and state government securities	4	3	3	4	6	6	5

Source: As in Table 5-16.

Firstly, it might be argued that, in one sense, the narrowness of the security market will contribute to the effectiveness of Central Bank credit control. The absence of liquidity in a narrow market acts as a deterrent to commercial bank sales of securities, while the Central Bank could, even with minor interventions, be able to affect changes in the interest rate patterns. Secondly, Table 5-11 (columns 6-8) clearly shows that for the years 1967-70, the volume of treasury bills held by commercial banks was at least seven times larger than commercial bills. Two implications arise from this. In the first instance, it is unlikely that the Discount House or the Central Bank can refuse to rediscount treasury bills if commercial banks want to increase their cash holdings. Any refusal to absorb treasury bills in the money-market would affect the credibility and liquidity of government short-term debts. This would means that there is no lack of liquidity if the commercial banks decide to get rid of their holdings of treasury bills. It could be argued that to make open market operations effective and at the same time overcome the stated problem, the Central Bank can increase either its variable reserve ratio or liquidity ratio or both simultaneously. However, this would mean that there is a resort to direct means of control by the Central Bank rather than through the sole use of open market operations. There is no reason why direct controls cannot be used to supplement open market operations but the main point of argument here is that the sole use of open market operations cannot be effective in a narrow market especially if the money market is dominated by a larger volume of treasury bills.

It has already been noted that the liquidity ratios of commercial banks from 1965 to 1970 were at least 10% higher than the required legal minimum. For open market operations to be effective, the volume of sales by the Central Bank must be very large.

Another consequence of a market dominated by treasury bills is that if the Central Bank allows its treasury bills to mature, the burden of finding funds to meet them falls on the government which may have to borrow by 'ways and means' advances from the Central Bank. Even if the Central Bank engages in open market operations, this can be countered by commercial banks allowing their treasury bills to mature, thus compelling the government to borrow from the Central Bank.[51] Thus it is unlikely that commercial banks would be short of cash if the Central Bank relied solely on open market operations.

Another feature of a narrow market with few buyers and sellers is that open market operations result in rapid movements in the prices of securities bought and sold. The disadvantage arising from rapid movements of changes in the price of treasury bills may conflict with the purpose of the monetary authorities in

[51] J. Obasanmi Olakanpo, *Central Banking in the Commonwealth*, Bookland Private Ltd., Calcutta, 1965, pp. 60-61.

setting up a money-market. A more fundamental issue is whether developing countries consider open market operations as a pure instrument of monetary control, divorced from budgetary considerations. The creation of a market for treasury bills and government securities in Malaysia is not so much primarily to enable monetary control through open market operations, but rather to manage the public funds or debt. The rationale of such a policy in economies with partial planning is that the financing of public investments acquires crucial significance.[52] In view of this, the government may have been more concerned about the creation of an appropriate climate for smooth absorption of the sale of government securities and treasury bills by institutional investors and commercial banks.

Secondly, any policy to widen the base of the money-market must ensure that a policy of reasonable stable prices for treasury bills exists. The concern of the Central Bank to avoid rapid fluctuations in the money-market becomes acceptable as an aspect of building up investors' confidence and broadening the base of the market.

Finally, since there is a lack of complete integration between the organized and unorganized money-markets, it is likely that whatever impact open market operations have on the central market will have been considerably dissipated by the time it reaches the unofficial money-market. It does not mean, however, that there are no spill-over effects from the official market, but such leakages or effects into the unorganized money-market would probably be very weak. It is also likely that there would be a long time-lag between the time of open market operations and the time the effects are felt. This means that open market operations cannot be effective nationally.

The main conclusion is that open market operations cannot be fully effective in controlling the cash reserves of commercial banks. The ineffectiveness of open market operations was due to the nature of the bills market especially the dominance of treasury bills over commercial bills. In addition, the commercial banks maintained a liquidity ratio which was well above the required minimum legal liquidity ratio. The narrowness of the money-market in terms of ownership of government securities and treasury bills was another restrictive factor. A further obstacle to effective control over the money supply was the lack of complete integration between the organized and unorganized money-market. There was also lack of integration between rural and urban monetary institutions.

The most severe limitation to the use of monetary policies, including open market operations, in Malaysia is the fact that the main cause for balance of payments deficits are fluctuating primary export prices. Any attempt to use open

[52] D.K. Khatkhate, *op. cit.*, p. 1062.

market operations to offset such price fluctuations would be futile.

Although open market operations are of limited use presently, it may be pertinent to consider the possibility of widening the Malaysian money-market. It is doubtful whether the narrowness of the security market can be overcome in the near future. In a situation like that prevailing in Malaysia, the rural household sector's savings (if there are many) are more likely to be attracted to small savings schemes tailored to meet their individual needs. On the other hand, the urban household sector may in fact invest in securities where returns of yields are expected to be very high. It has been suggested by Porter[53] that a means for attracting widespread ownership of government securities in developing countries is to increase the interest rates for such securities. The implicit assumption of such a suggestion is that the cause of non-participation in the government security market is the yield elasticity of the individual. This may be true in Malaysia for when anticipated yield returns are extremely large, the general public show no hesitation in subscribing to the market. It is known that subscriptions to newly issued corporate shares have been heavily over-subscribed in Malaysia. Substantial contributions came from the lower income groups in both Malaysia and Singapore.[54] It is not practical for government securities to have such extremely high returns because of the cost of servicing government debts. Another objection to Porter's proposal is that, in any event, it is not the level of the yield of the government securities or treasury bills market alone that is relevant but also the spread between these securities yields and those of the private sector[55] such as debentures, ordinary and preferential shares. It is unlikely that there would be any narrowing of the spread of the yields between government securities and issued shares and debentures of the private sector.

Another significant form of saving both in the rural and urban areas, though non-institutional in character in Malaysia, is the 'tontine' and 'chit fund' system already mentioned. This form of saving is mainly for the short-term and middle-term money-market and where interest rates are very high and with a minimum guarantee rate. Due to the existence of such saving or fund-raising schemes, it is unlikely that the government security market could compete or sufficiently attract the general public to subscribe to it. In view of this, it may be difficult to expect a widening of ownership base of the government securities and treasury bills.

[53] B.C. Porter, *op. cit.*, p. 53.

[54] P.J. Drake, 'The new issue booms in Malaya and Singapore , 1961-1964', in *Economic Development and Cultural Change,* Vol. 18, No. 1, October 1969.

[55] M. Narasimham, 'Narrow Security market and monetary policy – Lessons from Pakistan: A Comment', in *Economic Development and Cultural Change,* Vol. 15, 1966-7, p. 470.

Another aspect of broadening the bills market in Malaysia is the need to reduce the dominance of treasury bills over commercial bills. One possible solution, though not practical from the government's point of view, is to slow down the rate of issue of treasury bills. The other possible alternative is to encourage the growth of a local commercial bills market, a suggestion made by Silcock in 1959.[56] One of the obstacles to the growth of such a market would be that '...there seems to be the complete lack of tradition in dealing with bills locally. Bills are generally regarded as short term investments and are held to security.'[57] This particular difficulty could be slowly overcome with time and proper encouragement from the Central Bank. Other difficulties are that local commercial bills may be used for financing transactions which are not self-liquidating and that domestic credit requirements tend to run over six months, a period longer than usual in bill financing.[58] Here again, if the Central Bank and/or government is to provide the initiative in guaranteeing and endorsing local commercial bills, the growth of a local bill market may be expected.

[56] T.H. Silcock, 'Merdeka in the Money Market', in *Readings in Malayan Economics*, edited by T.H. Silcock, Eastern Universities Press Ltd., Singapore, 1961, pp. 488-9.

[57] David Williams, 'Money Markets in S.E. Asia', p. 491.

[58] P.J. Drake, *op. cit.*, p. 206.

CHAPTER VI
THE EFFECTS OF IMPORT SUBSTITUTION ON THE BALANCE OF PAYMENTS

In Chapter V it was indicated that import substitution has been recognized as a 'new adjustment method' to help cushion the effects of disequilibrium in the balance of payments. An import substitution policy is popular in developing countries because of its visible effects. The impracticability of specific traditional monetary policies may be a further reason for this popularity.

In Malaysia, import substitution includes import replacement in both agricultural and manufacturing sectors. In agriculture, rice growing has been a specific government import substitution policy, but there has been none in the manufacturing sector. This is because the government has not actively encouraged investment in specific import substituting industries by foreign firms or local entrepreneurs. It has encouraged foreign and local investment in the manufacturing sector to create an industrial sector. That some of these investments have been in import substituting industries is because foreign and local businessmen have themselves chosen to invest in them. In spite of this lack of a specific policy, import substitution has been extensive and the effects on the Malaysian balance of payments cannot be ignored.

In general, the four motives behind import substitution are the strategic considerations, the balance of payments difficulties, the official development policy and the growth of the domestic market as a result of export growth.[1] Although the balance of payments consideration is the main theme, a brief discussion of other motives is necessary for a better understanding of the import substitution policy in Malaysia. In any case, it appears that the implementation of an import substitution policy in Malaysia has been based on all four motives rather than on one.

The strategic motive for import substitution has been especially pronounced in the case of import substitution of rice. Though the strategic motive has been predominant, economic motives have been attached to the policy of self-sufficiency in rice. These aspects of the import substitution policy will be dealt with in greater detail later in this chapter.

Although Malaysia does not yet face balance of payments difficulties, it was realized in the First Malaysia Plan, 1966-1970, that one possible solution to

[1] Albert O. Hirschman, 'The Political Economy of Import Substitution Industrialization in Latin America', *Quarterly Journal of Economics*, February 1968, Vol. LXXXII, No. 1, p. 5.

the balance of payments investment finance problem or 'foreign exchange gap',[2] should be the import substitution of manufactured goods. The government considered import substitution to be necessary if investment and gross national product growth targets were to be attained. It will undoubtedly be necessary that intermediate and investment goods should take up a larger share of total imports in the future than they do at present.[3]

Import substitution as a result of growth of the domestic market because of export growth and/or population growth has not often been emphasized. As incomes and market expand in a country some new lines of domestic production can be expected to become profitable and new industries to come into being.

The process of industrialization, including import substitution, in Malaysia has been to a great extent encouraged by the government through the various tax incentives given, in addition to the provision of suitable industrial sites. However, Helen Hughes' study of industrialization in Singapore indicates that foreign businessmen would have invested in the island even in the absence of such favourable incentives.[4] This implies that the same situation may also be true for Malaysia, which means that with the larger domestic market as a result of the formation of Malaysia, with rising per capita income and with a high population growth rate, the production and import substitution of manufactured goods for the domestic market might have been inevitable.

In the First Malaysia Plan, an import substitution policy was seen as a method of long-run economic diversification including both agricultural diversification.[5]

It should also be noted that to some extent the first three motives for import substitution were part of the official development policy.

The development motive also incorporates the aim of reducing the relatively high rate of unemployment among the younger age groups in the large towns (namely 20% among young men aged 15-24). Diversification of the domestic economy through import substitution has been an attempt to reduce this unemployment. Industrialization, it was hoped, would absorb some part of the urban unemployed while agricultural diversification would help to reduce both the rural-urban drift of young migrant labour and the level of unemployment and under-employment in the rural areas. The employment goal of the First Malaysia Plan was to provide 460,000 additional jobs, thus generating employ-

[2] Brian L. Johns, *Planning the Development of Private Manufacturing Industry in West Malaysia*, presented at the DAS Conference, Sorrento, Italy, September 1968, p. 6.

[3] *First Malaysia Plan, 1966-1970*, p. 63.

[4] See Chapter III, p. 93.

[5] *First Malaysia Plan, 1966-1970*, pp. 15-16.

ment for the entire estimated increase in the country's labour force. The 460,000 additional workers represented a growth of 2.7% per year in the number of workers, slightly less than the rate of population growth.[6]

IMPORT REPLACEMENT IN AGRICULTURE

From 1960-70, about 22% of Malaysia's total gross imports consisted of food.[7] The largest single item in imported food has been rice. Rice on average formed about 5% of gross total imports and 25% of Section 0 for this period.

It was one of the aims of the First Development Plan to make Malaysia self-sufficient in the production of rice. The implementation of the import substitution policy towards self-sufficiency was to be implemented in four main ways.

Investment in the irrigation system for increased locally-grown rice was to be expanded. It was estimated that investment in rice formed about 35% of the total investment for agricultural development.[8] This included the cost for the establishment of the River Muda scheme in 1966 and the Kemubu scheme in 1968. The former cost about $300m. while the latter cost about $40m.

The encouragement and implementation of double-dropping as well as the introduction of better strains of padi – *Malinja* in 1964, *Mahsuri* in 1965, *padi Ria* in 1966 and *Bahagia* in 1968 – were manifestations of the efforts to bring about higher production. For instance, *padi Bahagia* has yielded 7,500 lbs/acre of paddy per crop under ideal conditions though not by local rice growers in *kampongs*. This is twice the output for the former variety, *Pebifum*.[9]

The government supports the rice growing sector through subsidies in the form of a minimum guaranteed price of $16 per picul.

With respect to Peninsular Malaysia, imports of rice from any country are conditional on the importer purchasing one ton of domestic rice for every one and a half tons imported, the ratio varying from time to time depending on the turnover of official stock. For instance, in 1964 there was a large increase in imported rice, which was primarily due to a very poor paddy crops in Malaysia during the 1963/4 season. Bad weather conditions resulted in a significant drop

[6] *First Malaysia Plan, 1966-1970*, p. 60.

[7] See Chapter II, Table 2-11 p. 40.

[8] Public development expenditure for agricultural development during 1966-70 was about $900m or 24% of total expenditure in the First Malaysian Plan. $320m. has been allotted for drainage and irrigation which will increase the area that can be double-cropped with rice. A further $35m. was allotted as crop subsidies and since rice has a minimum guaranteed price of $16 per picul it is likely that a significant proportion of the last mentioned allotment went to rice.

[9] G.R. Elliston, 'Problems associated with the introduction of high yielding hybrid rice', unpublished paper, p. 4.

in production, and this in turn resulted in a change in the above import ratio. Importers were required to purchase one ton of rice from the official stock for every ton imported instead of every two tons imported.[10]

The imposition of trade controls on rice formed an attempt to affect the structure of agricultural production in the economy.[11] Trade controls on rice have the overall effect of favouring the balance of payments as well as encouraging domestic production, thus further reducing the import bill for food.

As indicated earlier, the motives for import replacement of rice were both strategic and economic in nature. The 'strategic' motive for self-sufficiency may have had two aspects.

Firstly, the 'external strategic' motive, that is the insurance against shortage of rice in the eventuality of wars in exporting countries. The danger of depending on other countries for essential commodities became very apparent during the later years of the Second World War.

Secondly, the 'internal strategic' motive, which may be taken as a very strong political pressure for the existing predominantly Malay government to increase the well-being of the rice producers. This is because the majority of rice farmers are Malaysians of indigenous stock and, more important, because they are one of the poorest sections of Malaysian society. Since it is part of the government's declared policy to narrow the income gap between the various ethnic groups and between the different sectors of the economy, ' ...it makes political sense to help the rice farmers become more efficient and more prosperous".[12]

One of the main economic motives behind the government's rice policy is to increase the income level of rice growers. Although it is generally accepted that the present policy of double-cropping, higher productivity through the use of better seeds, trade controls of imported rice and a minimum guaranteed price do increase the income levels of rice growers, it is unlikely that the income gap between the different sectors of the economy can be significantly reduced in the long run.[13]

If the government wants to narrow and continue to maintain a small income gap between rice growers and the other sectors in the economy, there is a need of rice in the eventuality of wars in exporting countries. The danger of depending

[10] IMF, *16th Annual Report, Exchange Restrictions*, 1965, Washington, DC, p. 350.

[11] Any trade control system and any change in it affects the economy in four principal areas: balance of payments, the government budget, the structure of production and the domestic price level. See Herman E. Daly, 'A Brief analysis of recent Uruguayan Trade', *Economic Development and Cultural Change*, Vol. 15, 1966-7, p. 286.

[12] B.K. Parkinson, *op. cit.*, Chapter V.

[13] For those interested in this issue see B.K. Parkinson, *op. cit.*, Chapters IV and VIII.

encourage rural farmers to concentrate on rubber or palm oil where the returns to investment are higher. The possibility of encouraging market-gardening should also be seriously considered, as the returns are higher than in rice.[14] There is need for such an import substitution policy because the volume of imported vegetables form a significant proportion of Section 0 – Food. Fruit and vegetables are imported at the rate of about $100m. yearly, half of which is for vegetables. A further advantage of market gardening is that the crops require high labour inputs per acre, and also they enjoy a comparative advantage from being produced in close proximity to the consumer.

The strongest argument against such a policy of import substitution as a means of saving foreign exchange and thus possibly improving the balance of payments situation is 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 costs – and if alternative crops to rubber have to be considered payments situation is that it pays Malaysia '... to export rubber and import rice, tunities.'[15]

This argument is valid. As an indication of the rate of return from rice, it has already been quoted from FAMA's annual report that the returns to rice farmers per acre of cultivated land would barely be 50% of rubber or oil palm. This 50% was thought to be an over-assessment as the estimate was derived from income per acre. Most rice farms tend to be of a smaller size. This means that the incomes of the rice farmers may be lower than 50% of the income of other farmers.

It may be concluded that the government's import substitution policy of rice cannot be justified on balance of payments grounds. Even though it can be argued that the government has not implemented this policy on balance of payments considerations nevertheless, its implementation has an opportunity cost. The alternative use of such investment funds would probably have been in rubber or palm oil or market-gardening, which would have had a more favourable effect on the balance of payments.

IMPORT REPLACEMENT ON THE MANUFACTURING SECTOR

The effects of import substitution in the manufacturing sector upon the balance of payments may be studied through the effect upon the balance of merchandise trade, the effect upon capital movements and a long-term effect on the balance of payments.

[14] Whilst the figures used for his calculations were estimates, Robert Ho's conclusion was that multiple and mixed cropping systems appear to possess an economic potential from two to ten times larger than rubber, rice or coconut. See Robert Ho, 'Mixed farming and multiple-cropping in Malaysia', *The Journal of Tropical Geography*, Vol. XVI, October 1962, pp. 1-17.

[15] W.M. Corden, *op. cit.*, pp. 13-14.

EFFECT ON THE MERCHANDISE TRADE

The effect of import substitution on the balance of trade can be categorized into direct initial effect, direct year to year effect and subsequent income and price effect. The first group consists of original investment in capital equipment. In the short run, net saving on the balance of trade would probably be negative as the returns from the replacement of imports in the initial stages are unlikely to be larger than the cost of imported plant and equipment at that stage.

The direct year to year effect is more complicated in that some saving in foreign exchange is expected after the initial stages. The year to year effect would have to include the value of replaced imports, the import content of these import substitutes, any further import of direct capital goods after the initial instalments of plant and equipment and, lastly, any remittances of interest, dividends and profits if the investment in import substitution is completely or partially foreign-owned.

At the present stage of development in the Malaysian economy, the immediate opportunity is to be found principally in the domestic production of those consumer goods which are presently imported. The magnitude of these possibilities may be seen from the estimate that only about 40% of total Malaysian domestic demand for manufactured goods or roughly $2,000m. is presently met from local production while 60% is imported.[16]

The extra year to year foreign exchange earnings accruing from net exports and from import replacement can be quantified. Maizels follows Chenery in defining gross import substitution in manufacturing over some time period as the reduction in manufactured imports at the end of the period relative to what these imports would have been if they had grown proportionately to the output of domestically manufactured goods.[17]

An attempt has been made to quantify the amount of foreign exchange saved as a result of import substitution. The data which have been used for this exercise have been taken from the inter-industry accounts of domestic production and primary factors and imports by sectors origin, 1960 and 1965.[18]

[16] First Malaysia Plan, *op. cit.*, pp. 129-30.

[17] Alfred Maizels, *Growth and Trade*, Cambridge University Press, 1970, p. 148. Import substitution which was due to industrialization, to changes in relative importance of exports in the national product or to any other causes is termed as gross import substitution. This is in contrast to a net concept of import substitution resulting from industrialization alone.

[18] Department of Statistics, West Malaysia Inter-Industry Accounts, 1965, pp. 10-12. *Sixth Conference of Commonwealth Statisticians*, Vol. II, Dominion Bureau of Statistics, Ottawa, 1966, p. 574-5.

Define the coefficient of import reliance in an industry as

$$u^i = \frac{\text{imports of i}}{\text{total supply of i}}$$

$$u^i = \frac{\text{imports of i}}{\text{imports of i + local production of i}}$$

$$u^i = \frac{\text{imports of i}}{\text{imports of i + intermediate use of locally produced i + domestic final use of locally produced i}}$$ [19]

Expressed in algebraic form

$$u^i_o = \frac{m^i_o}{m^i_o + k^i_o + h^i_o}$$

where m = imports

k = intermediate use of locally produced item
h = final domestic use of locally produced item
subscript o = time period o
superscript i = item i

A difference between the coefficients of import reliance that is $(u^i_0 - u^i_1)$ in two time periods would indicate the degree of import substitution as it measures the incidence of dependence upon imports in total supplies.

If $u^i_o \rangle u^i_1$, successful import substitution

$u^i_o \langle u^i_1$, unsuccessful import substitution

Let Q^i_1 be the total supply of local production of i consumed locally.

$$Q^i_1 = k^i_1 + h^i_1$$

Then, the amount of production which is due to successful import substitution

[19] Final domestic use refers to the commodities being consumed by householders and government, as fixed assets and unspecified. It is important to note that exports of these manufactured goods have been excluded from the total supply. By definition exports are not import substituting.

is given by $(u_o^i - u_1^i)\ Q_1^i$. But the amount of reduced imports as a result of import substitution may or may not include imported materials in the production process. If it does, then the amount of foreign exchange saved as a result of import substitution is the amount of production which replaced imports less the remaining imported content.

Let z_1^i be the average import content in per unit of domestic output, that is

$$z_1^i = \frac{n_I^i}{Q_1^i}$$

where n = total import content

The amount of foreign exchange saved is given by

$$(u_o^i - u_1^i)\ Q_1^i - z_1^i\ (u_o^i - u_1^i)\ Q_1^i$$

$$[(u_o^i - u_1^i)\ Q_1^i]\ \ [(1 - z_1^i)]$$

This foreign exchange saved for all industries, both agriculture and manufacturing is the summation for all the individual units, that is

$$\sum_{i=1}^{i=n} [(u_o^i - u_1^i)\ Q_1^i]\ \ [(1 - z_1^i)]$$

It must be emphasized that the method used for estimating the amount of foreign exchange saved is a partial equilibrium approach.

The method thus used might result in some over-estimation of the foreign exchange saved as a consequence of import substitution in the manufacturing sector.

For instance, when one considers the fact that the Malaysian import substituting industry is a protected one and when the import substitute is an intermediate product, the cost of these intermediate products might be higher than they would be in a free market. Since no quantitative adjustments have been provided for this, the amount of foreign exchange saved is likely to have been over -estimated.

It should also be noted that the higher prices of intermediate import substitutes may have an adverse long run effect on the Malaysian balance of payments. The high prices of intermediate import substitutes may cause lower profit margins for some local firms and, in the extreme cases, may cause some to close down.

Such an event would result in an unfavourable effect on the Malaysian balance of payments.

Since the values of inputs and outputs were obtained from the inter-industry accounts for the period 1960 and 1965, some of the following features may be noted.

The imported inputs into the various industries are inclusive of import duties.[20] As these were aggregated figures, it is not possible to extract the amount of import duties imposed. In any case, it is likely that the prevailing import duties on imported inputs were low. This is because many of the import substituting industries were pioneer manufacturing industries and so protected. In addition, a significant proportion of the import duties would have been paid by foreign-owned manufacturing firms. This represented a resident-foreign transaction and so should be included as part of the effect on the balance of payments.

It may therefore be argued that the end result derived for the amount of foreign exchange saved is not grossly over-estimated. Alternatively it could be said that the true amount of foreign exchange saved cannot exceed the figures obtained.

A second and more important limitation in the method used is the assumption that an increase in local output represents import substitution, since, in its absence, imports would have been necessary to maintain the same availabilities. This may not be completely true. If in the process of import substitution, the output of a consumption commodity becomes so great that 'normal' domestic consumption is exceeded, it can be said that part of the domestic consumption of the commodity has been due to increased demand. The latter effect is known as the 'consumption liberalization effect'.[21] As a result of changes in supply, the change in domestic consumption is the sum of changes in normal and liberalized consumption. The liberalization effect may not have been significant because the manufacturing sector did not exist until 1960. In any case, no adjustment has been allowed in this chapter.

This is because the existing data from the input-output tables does not permit one to calculate this effect. Theoretically, it is possible to estimate the liberalization effect though the use of extraneous data. This is again not possible for Malaysia due to the lack of such statistical data.

All the relationships are expressed in the prices for that year, in this case, 1960 and 1965 respectively. The advantage of using the current year prices is

[20] Sixth Conference of Commonwealth Statisticians, *ibid.*, p. 370.

[21] Azizur Rahman Khan, 'Import Substitution, Export Expansion and Consumption Liberalisation', *Pakistan Development Review*, Vol. III, No. 2, 1963, pp. 208-23.

that the amount of foreign exchange saved or lost is for that year. As price is one of the determinants of value, this procedure is preferable to constant prices. Constant prices detract from market realism for, in fact, price changes will to some extent influence the technical coefficients of production and possibly capital-output ratios. Private consumption of different sector products will also be influenced by price changes.

In calculating the costs of import input content, the average cost per unit (z) for 1965 has been used. Since the amount of imports saved is the incremental output, that is, 1965 output over the 1960 output level, the incremental cost per unit is the correct measure to use. In practice, it is likely that the average cost per unit of production is the same as the incremental cost. The cost per unit of production is not likely to change from one unit of production to another.

A number of industries have been excluded because of the lack of data. These industries are construction, electricity, transport and communications, wholesale and retail trade, banking and insurance, etc., dwellings and other services industries. Rubber processing and basic metals are excluded because the bulk of their output is exported and cannot be categorized as import substitution.[22]

The use of 1960 as the bench-mark year and 1965 as the current year was determined by the availability of data. The 1965 inter-industry statistics were at the time the latest available from the Statistics Department. It is debatable whether a five-year gap is desirable for computing the degree of import substitution or whether a gap of one year is preferable. In a sense, the latter is better because it reflects the changes in a year but it is arguable that since Malaysia started its industrialization and agricultural diversification in the late fifties, the result of import substitution can be more readily seen from this five year gap.

This method of measurement of Peninsular Malaysia's gains in foreign exchange as a result of import replacement of manufactured goods consumed locally quantities the value of extra imports that Malaysia can afford to purchase each year through incomes generated.[23] Finally, the net gains in foreign exchange would be the difference between the calculated figure of $107m. in 1965 and the amount

[22] For instance, in 1965 the total output of rubber processing and basic metals were $1,438m and $520m. respectively. The value of exports for these two industries were $1,407m and $506m. respectively.

[23] It needs to be emphasized that the computed foreign exchange saving due to import substitution is implicitly based on the assumption of *ceteris paribus*. Theoretically, it is possible that in the absence of import substitution the resources could have been used for export orientated industries so that export earnings could have risen. Thus on the whole it is possible that net foreign exchange savings is negative. However, in reality, import substitution has taken place. Since this is so the exercise is to attempt to estimate the amount of

TABLE 6-1 Peninsular Malaysia – Estimated Amount of Foreign Exchange saved as a result of Import Substitution, 1960-5 ($ million)

Industry	Amount Saved $m.	Coefficient of import reliance in 1960(u_0)	Coefficient of import reliance in 1965(u_1)	Degree of import substitution $u_0 - u_1$
	(1)	(2)	(3)	(4)
Chemical products	49.43	0.80	0.60	0.20
Food industries	38.77	0.62	0.52	0.10
Tobacco	25.60	0.47	0.14	0.33
Rubber products	18.34	0.47	0.19	0.28
Non-metallic mineral products	11.05	0.53	0.37	0.16
Beverages	5.39	0.79	0.61	0.18
Furniture and fixtures	3.88	0.15	0.13	0.02
Printing and publishing	3.21	0.37	0.31	0.06
Textile	1.13	0.96	0.86	0.10
Forestry	1.07	0.07	0.06	0.01
Miscellaneous manufacturing	0.93	0.59	0.57	0.02
Metal products and machinery	0.64	0.83	0.78	0.05
Paper and paper products	0.56	0.91	0.83	0.08
Clothing and footwear	0.04	0.90	0.89	0.01
Agriculture and livestock		0.20	0.20	–
Fishing		0.07	0.10	–0.03
Leather and leather products		0.67	0.67	–
Wood and cork		0.08	0.14	–0.06

Source: Computed.

that remitted overseas in the form of interest, profits or even transfer payments.

Table 6-1 summarizes the results of the computation. The industries which were not successful as import substitution industries in terms of the definition used were agriculture and livestock, fishing, leather and leather products and wood and cork. This was indicated by the fact that the ratios of import reliance in 1965 were the same as or larger than the ratios in 1960.

The case for agriculture being unsuccessful as an import substitution industry may seem contradictory to the results of the previous section, that is, the case of rice. The proportion of imported rice into Peninsular Malaysia as a percentage of total consumption of rice for 1960 and 1965 was 43 and 37% respectively, which represented a reduction in imports by only 6%. Although rice is the most important single sub-section, 25% of the Section 0 – Agriculture, the growth rates of imports from other sub-sections could have overshadowed the import or rice replacement.

The estimated total amount of foreign exchange saved is $107m. and the contributions of each of the individual industries can be seen from Table 6-1.

The importance of the various industries in terms of the estimated amount of foreign exchange saved are arranged in descending order of importance. (See column 1.) The main industries were chemical products, food industries, tobacco, rubber products and non-metallic mineral products. Together they contributed about 90% of the estimated total amount of foreign exchange saved.

The table also indicates that tobacco, rubber products, chemical products and beverages seem to have achieved the greatest degree of import substitution. (See column 4.)

A study of the coefficients of import reliance in column 3 for 1965 indicates which industries had the highest coefficients. In terms of import substitution, these industries require further inroads if import substitution to be successful. In descending order of magnitude of coefficients they are clothing and footwear, textiles, paper and paper products, metal products and machinery, beverages chemical products, miscellaneous manufacturing and food industries.

It may be concluded from this study of import substitution as a balance of payments policy for Malaysia that import substitution might have other beneficial effects which are non-quantifiable.

For instance, a point in favour of a programme of import substitution is that usually, calculated costs figures do not take into account favourable externalities to the rest of the economy. One of Maizels' conclusions in his study of 'Growth and Trade' is that the level of productivity in the rest of the economy may be raised as a result of industrialization by increasing the supplies of fertilizers to

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foreign exchange saved.

agriculture, by improving transport facilities, educational levels, etc.[24] In Malaysia, import substitution in the manufacturing sector is part of the policy of industrialization,[25] therefore, Maizels' argument may be valid for Malaysia.

In addition, there would be beneficial learning effects as well as backward and forward linkage effects. Though the external benefits argument is reasonable, the same rationale can be extended to all manner of alternative projects. However, since the alternative projects in Malaysia are predominantly in rubber and tin the learning effects would not be as great.

It might be further argued that import substitution in the manufacturing sector also produces fairly quick results by permitting local entrepreneurs to exploit already existing markets without any need to develop new markets for domestically produced goods. However, this argument may only be partially true because one of the 'peculiar' things about domestic demand in less developing countries is 'brand loyalty' and a tendency to believe that imported goods are 'better'.

Although it has been argued that there probably would have been some non-quantifiable advantages and although it has been shown that some foreign exchange has been saved as a result of import substitution in manufactured goods, it must be noted that there may be various disadvantages. B.L. Johns in his study of the manufacturing sector in Peninsular Malaysia argues that there are adverse effects on gross export receipts due to the diversion of local capital from the primary sector into the manufacturing sector.[26] Since adverse effects on gross exports receipts in the primary sector will not show up in the short run because of the long gestation period of rubber and oil palm, this effect is ignored. The case for import substitution cannot be sustained wholly by the argument that the long run prospects of primary exports are unsatisfactory. It is likely that marginal investment opportunities in the primary export sector are not exhausted or limited, especially in palm oil and timber, or even in rubber. It is therefore likely that import substitution in manufactured goods, though it represents some saving in foreign exchange, is only a second best policy.

There are two points to note about the above argument. The first refers to possible returns to investments and the second to the flow of local capital.

[24] Alfred Maizels, *op. cit.*, p. 9.

[25] This concept of the manufacturing sector being part of industrialization coincides with Myint's definition. 'Industrialization in the broader sense relevant for economic development should therefore include not only manufacturing industry but also the creation of social overhead capital such as transport and communications, irrigation, power, etc. and, above all, the "industrialization" of agriculture in the sense of applying modern science and technology to raise argricultural productivity.' See H. Myint, 'Trade, Education and Economic Development', *UMBC Economic Review*, Vol. VI, No. 1, 1970, p. 24.

[26] Brian L. Johns, *op. cit.*, p. 3.

In the first instance, the argument is acceptable if the returns of investments from rubber or palm oil are higher than the returns from import substituting industries in the manufacturing sector. Given the present government's policy of tax incentives and concessions, it is questionable whether the returns from the primary sector are in fact higher than the returns from the manufacturing sector.

Secondly, if local capital had not been diverted into the manufacturing sector these industries might have been financed solely by foreign capital. The repatriation of profits, interest, etc., would have been a further burden on the balance of payments.

This leads to the use of tax concessions or protection. The cost of import substitution of the economy is the excess of the cost of domestic production of import substitutes over the cost of importing the same goods or, alternatively, it can be taken as the subsidy given to the domestic production of import substitutes.[27] In Malaysia, the Pioneer Incentives Act allows for tax concessions, that is income tax relief, for pioneer industries, and initial income tax allowances for capital investment by all business enterprises. A tax concession to firms producing import substitutes is a subsidy at the expense of the community.

In addition, there are protective tariffs on 214 items.[28] This also amounts to an extra budgetary tax on consumers and a subsidy to producers. Professor Johnson argues that a production subsidy by making domestic prices to producers different from prices facing foreign producers induces a socially non-optimal production pattern, reducing the real output of the community (valued at world prices) below the maximum attainable if producers were free to allocate resources to production at world market prices. This reduction in real output measures the amount of protection.[29] However, within the Malaysian context, it is arguable whether the production pattern is a socially non-optimal one. This is because without import substitution and without protection, employment levels in the manufacturing sector would certainly be lower than at present. The social and political costs of unemployment are high. In addition, tax incentives are a fairly cheap way of attracting foreign capital and, with it, technology. Without tariffs some of the existing manufacturing industries might not have been established at all.

Finally, Corden[30] has argued that the objectives of external balance (balance

[27] Harry G. Johnson, 'Fiscal Policy and the Balance of Payments in a growing Economy', *Malayan Economic Review*, Vol. 9, p. 11.

[28] *First Malaysia Plan*, p. 132.

[29] Harry G. Johnson, 'The Cost of protection and self-sufficiency', *Quarterly Journal of Economics*, Vol. LXXXIX, 1965, p. 356-72.

[30] W.M. Corden, 'The Geometric Representation of Policies to attain Internal and External

of payments equilibrium) and internal balance (full employment without inflation) can be attained through the uses of deflation of expenditure and import restrictions. Import restrictions would divert demand from imports to home-produced goods (including import substitutes). An increase in demand of locally-produced goods would help to reduce the unemployment levels. This further supports the view that protection of import substitutes through some form of import restrictions need not necessarily result in a socially non-optimal production pattern.

As a result, it appears that both advantages and disadvantages accrue to import substitution in the manufacturing sector. In most instances, the arguments are non-quantifiable. Since it is not possible definitely to conclude that the disadvantages outweigh the gains, since the government is committed to the creation of an industrial sector and since some foreign exchange has been saved, it might be concluded that the impact of import substitution in the manufacturing sector has not been totally unfavourable to the Malaysian balance of payments.

EFFECTS OF IMPORT SUBSTITUTION ON CAPITAL MOVEMENTS

Depres (IBRD Report on Malaysia, 1963) stated that the net private capital inflow into Peninsular Malaysia may be a positive function of the rate of domestic investment. This is because of the government's policy of joint ownership. However, this link cannot be conclusively proved. It is also suspected that the additional net inflow would arise mainly from a reduction in the short-term private capital movement outflow. Some part of the investment in import substituting industries in the manufacturing sector may be financed by locally-owned capital which would otherwise have been invested overseas, or which is withdrawn from overseas balances.[31] This view is supported by the situation in the pioneer industries where joint foreign and local ownership is insisted upon by the government. About 45% of equity shares in all pioneer status industries are locally owned. However, it would be dangerous to rely completely on the preposition that long-term equity capital inflow is bound to be improved by an economically sound programme of import substitution.[32] A further reason is that a significant proportion of the most likely areas of investment which attract foreign capital as well as encourage local capital to remain are the motor vehicle industries, petroleum industries, transport equipment, timber industries, food and beverages industries, chemicals and other branches of heavy industries. But it should be noted that these industries are already established in Malaysia. For

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Balance', in *International Finance*, edited by R.N. Cooper, Penguin Modern Economics, 1969, pp. 256-9.

[31] W.M. Corden, *op. cit.*, p. 116.

[32] This was one of the conclusions of Chapter III.

instance, there are already six approved motor vehicle assemblers, two scooter assemblers and a motor-cycle plant already in production. Petroleum refineries for Esso and Shell are already well established. This situation does not mean that there are no investment opportunities left. There is potential in the petroleum derivatives, pharmaceuticals, etc., and even in timber industries. However, since the main areas for investment have already been taken up, the inflow of new capital may be slower.

An unfavourable effect of the inflow of foreign capital for import substitution industries is that such investment does not represent a complete gain of foreign exchange for Malaysia. Large investment in heavy capital equipment and plant in the initial stages of development offsets the inflow of capital. In the long run, the remittances of profits, etc., would have to be considered. It follows that, in the short run, a rapid process of import substitution through foreign investment in the manufacturing sector would probably not improve the Malaysian balance of payments. However, this does not mean that such development should not take place as in the long run there may be gains in foreign exchange through import substitution and finally through export promotion.

LONG-TERM EFFECTS OF IMPORT SUBSTITUTION

The long-term effects of import substitution can be examined from the potentialities of the Malaysian market structure. It may be argued that the Malaysian market is not large enough to absorb the bulk of locally-produced import substitution and this results in excess capacity in import substituting industries which use mechanised plant such as motor assembly. Currently, this may be true for the motor industry. However, one must not under-estimate the size of the Malaysian market. Some of the indicators of market size are given in Table 6-2.

A crude indicator of market size is the per capita income. Though the population is only twelve million, Malaysia had a relatively high income of about $1,030 in 1970. Excluding Japan, Malaysia comes after Singapore and Hongkong in the level of per capita incomes in Asia.

By Asian standards, it is a surprising fact that Malaysia's total imports of goods in 1968 were about the same as either Indonesia, the Philippines or Thailand. This means that the market size of Malaysia is larger than indicated by the population size. In other words, import substitution has a long way to go before the market is saturated.

Finally, Professor Myint argues that, '...outward-looking Southeast Asian countries can continue to expand their exports by increasing productivity in the existing lines of primary exports and by creating a favourable economic climate which might enable them to strike into new lines of primary exports, they may be able to expand the size of the domestic market quickly enough to keep on adding further stages of import substitution without being held back by a foreign

TABLE 6-2 Indicators of Market Size for Asian Countries, ($ U.S.)

	Indonesia	Malaysia	Philippines	Singapore	Thailand
Population					
Total 1968 (millions)	112.8	10.3	35.9	2.0	33.7
Gross domestic product					
Total 1968 ($ billions)	10.0	3.5	8.0	1.3	5.0
Gross domestic product per capita ($)	88	318	230	655	140
Manufacturing as % of domestic product 1968	12.6	12.0	17.0	13.0	15.0
Average hourly earnings in manufacturing					
Current 1968 ($)	—	0.35	0.22	0.35	0.16
Total Exports at 1960 prices 1968 (billions)	1.27	1.51	0.97	0.80	0.83
Total Imports at 1960 prices 1968 ($ billions)	1.42	1.38	1.78	0.92	1.02
Private consumption expenditure, 1968 (billions)	8.30	2.05	6.69	0.94	3.26

Source: V. Kanapathy, 'Foreign Investment in Malaysia: Experience and Prospects', *UMBC Economic Review,* Vol. VI, No. 2, 1970, pp. 19-20.

exchange shortage. Without this possibility, it is difficult to see how Scandinavian countries managed to launch themselves into economic development in the past without the benefits of large regional common markets or colonies.'[33]

The problem of Malaysia may be more difficult by virtue of being a 'late-comer' and with increasing competition from India, Hongkong, Pakistan and Singapore. However, it should be noted that Singapore was a 'late-comer' as well, which supports the view that the task is not impossible.

Thus, the possibility exists, and it will be shown in Chapter VII that a significant portion of Malaysia's manufactured goods are in fact bought by advanced countries. As a result of this, it is clear that some of Malaysia's manufactured goods can compete with manufactured exports from other less developing countries and that the size of Peninsular Malaysia's domestic market need not necessarily be a once-and-for-all limiting factor with respect to Malaysia's industrialization policy, which includes import substitution.

[33]Hla Myint, 'The Inward and Outward Looking Countries of Southeast Asia', *Malayan Economic Review,* April 1967, Vol. XII, No. 1, p. 11.

CHAPTER VII
A CONSIDERATION OF ALTERNATIVE POLICIES

The analysis of the Malaysian balance of payments has shown that Peninsular Malaysia has not suffered from any balance of payments crises. Rather, it is to be expected that there would be years of deficits punctuated by years of surpluses, because of fluctuating export prices around a decreasing trend, especially in rubber. The Indonesian Confrontation was another influence. As a result, it could be said that the need for alternative policies for adjustment does not arise as long as the Malaysian balance of payments remains as it has for this decade or, alternatively, so long as the volume of foreign exchange reserves remains adequate to offset temporary deficits. This might be called a 'passive' policy. However, what has not been emphasized is that since the balance of payments affects both the multiplier and the multiplicand (the volume of spontaneous investment in the multiplier model)[1], the need to have a favourable balance of payments is great.

This is because Peninsular Malaysia is a dependent economy and her position is in some respects quite different from what may be called a dominant economy. In the latter, the pace of activities is set mainly by domestic factors, that is, investment activities at home, though these may be re-enforced by the position of the balance of payments. In a dependent economy, however, the pace of activities is usually set by the state of foreign trade, especially the level of export prices.

An exception occurs when there is an upward phase in the trade cycle of a dependent economy, brought about by an increase in domestic investments as a result of deficit government financing. Since it has already been shown that the government has more than adequate foreign exchange reserves, this is one of the policies that could be implemented during a balance of payments deficits.

Nevertheless, the state of the balance of payments acts as a constraint on the level of investment. A favourable balance of payments allows for the potential of an increase in the multiplicand because of an increase in the volume of foreign exchange. Nevertheless, it should be emphasized that a surplus in the balance of payments merely increases the volume of potential investment. There need not necessarily be an actual increase in the incentives for investment. However, what might be affected is ease for borrowing funds. It is unlikely that a favourable balance of payments will bring about a reduction in interest rates. The level

[1] Wolfgang F. Stopler, 'The Multiplier if imports are for investments', in *Trade, Growth and The Balance of Payments*, R.E. Baldwin, etc., Rand Mcnally and Co., Chicago, 1965, pp. 126-39.

of interest rates in the Malaysian capital market appears to be more affected by the level of interest rates in international money markets, especially that of London. It is likely that the effect of a surplus balance of payments would lead to an ease of borrowing because of a larger volume of capital available.

As a result, there is a need for alternative policies, which will be considered in this chapter, to help prevent the balance of payments from turning into a deficit and, where possible, to secure an improvement. An improvement in the balance of payments is defined to mean a movement towards a balance of payments surplus or a reduction in a balance of payments deficit.

Basically, the policy alternatives differ in their nature as well as in their importance. The first policy measure considers the possibility of directly checking the outflow of foreign exchange in terms of pure transfer payments. The second considers the government's commitments to the development of a national shipping line and its effect on the Malaysian balance of payments. The third and fourth are primarily export promotion policies, though the former is a recommendation for having separate trade policies for manufactured exports. The export markets for manufactured goods are divided into exports to developing and developed countries, which implies that there is a need for different trade policies. The fourth policy measure considers the potential of the invisible export sector – the tourist industry.

It needs to be emphasized that one possible shortcoming of the policies considered here is that they merely emphasize the potential gain in foreign exchange and do not consider the real social costs and benefits of their implementation. In other words, no account has been taken of possible conflict with the other stated policy objectives of the Malaysian government.

For instance, one of the over-riding policy objectives of current government policy in Malaysia is to reduce the high level of unemployment and underemployment prevailing in both rural and urban sectors. Almost inevitably, it seems, this involves a discussion of the relative labour or capital intensity of development projects. Whilst, on the one hand, a capital intensive project might result in a favourable effect on the balance of payments, a relatively labour-intensive project would help to absorb labour though it might be less favourable on balance of payments grounds. Before any project is undertaken, detailed cost-benefit studies should be carried out to determine which of various alternative projects is the most appropriate. In the case of the policies considered here, no such cost-benefit studies (which includes social costs) were carried out, owing to the lack of relevant data.

Quite apart from the absence of relevant data concerning the relative labour or capital intensity of inputs into these projects, another difficulty is the choice of an appropriate shadow-wage for labour. One is tempted to suggest when unemployment is widespread that the shadow-wage is zero, or near to it, and that, since the contribution of unskilled labour to the agricultural sector is thought to

be less than that of unskilled labour in the industrial sector,[2] there should be a differential between the shadow-wages used for urban unemployed and the rural unemployed. In practice, a shadow-wage of greater than zero but not higher than the lowest wages of unskilled industrial labour could be used.

Notwithstanding the various statistical and conceptual difficulties associated with this kind of cost-benefit study, it must be emphasized that they are necessary so that a project, acceptable on balance of payments criteria, need not necessarily by undertaken if it conflicts with one of the government's other prime objectives – in this case, labour absorption.

Finally, it should also be noted that the balance of payments situation of a country does affect the criterion for project selection. It affects the appropriate rate of interest by which future costs and benefits are discounted, that is, the rate of discount.[3] For instance, a weak balance of payments position will affect the accounting price used in project selection so as to encourage the use of domestic resources.

FOREIGN EXCHANGE RESTRICTIONS

In Chapter II we saw that the outflow of foreign exchange in terms of net transfer payments is about $200m. annually, a part of which is due to the transfer of funds by former Chinese and Indian immigrants. Legally, each Chinese family is permitted to remit about $600 per annum to mainland China through licensed remittance shops, but additional amounts may be transferred through the banking system.[4] There appear to be no regulations regarding the amount of pure transfers which can be made by the immigrant Indian population to India. This may be because India is a part of the sterling area. It might be suggested that this outflow of about $10m a year could be checked or reduced by a change of government policy to prohibit or further limit such transfers of foreign exchange, and that the present political situation present an opportunity for implementing such a policy. Such a change could be viewed as part of the government's attempt to forge a new Malaysian society following the racial riots of 1969. The degree of its success would to some extent depend on the administrative machinery available to prevent the outflow of funds by-passing both the banking and legal systems. However, it is unlikely that the amount of foreign exchange saved through this kind of restrictive measure would be substantial, and it may not be worthwhile for the government to implement this measure.

[2] I.M.D. Little and J.A. Mirrlees, *Manual of Industrial Project Analysis in Developing Countries*, Vol. II, Development Centre of the Organization for Economic Co-operation and Development, p. 94.

[3] *Ibid.*, p. 38.

[4] I.M.F., *21st Annual Report, Exchange Restrictions, 1970.* Washington, D.C., p. 322.

POLICY FOR A SHIPPING LINE

In Chapter II another conclusion was that a main cause of an outflow of foreign exchange was large annual payments for freight and insurance. The net cost of freight and insurance averaged around $170m. annually for the period 1961-8, and it is probable that this item will continue to increase, as higher payments for freight and insurance arise from the combined effects of a higher level of trade and higher freight charges. The latter factor will be felt after 1971 '...when the majority of shipping conferences operating throughout the world raise the freight rates by between 10% and 15% in order to cover recent increases in operating costs such as bunker charges, wages and salaries, etc. The Far Eastern Freight Conference decided that from February 1st, 1971, most of the existing freight rates from Singapore, East and West Malaysia and Brunei to all conference destinations would be raised by approximately 10%. Its decision to impose a further increase of 5% in July, however, was reversed in the face of strong opposition from exporters of primary commodities.'[5] The First Malaysia Plan, 1966-1970, indicated an awareness of the need for development in this area by the formation of the Malaysian International Shipping Corporation (MISC) designated as the National Shipping Line in late 1968 with 30% government equity participation in paid-up capital of $7m. 'The Prime Minister, Tun Abdul Razak, has already forecast that Malaysia will be a maritime nation ...'.[6] It is worthwhile considering whether the establishment of a national shipping line is the appropriate policy to implement in order to reduce this particular weakness in the Malaysian balance of payments.

The Malaysian International Shipping Corporation purchased two second-hand steamers in the latter part of 1969 and has ordered ten vessels comprising six cargo lines, two woodclip carriers, a bulk carrier and an ore/oil combination carrier.[7] In addition, the MISC will be operating, on charter from the government, two new cargo liners acquired under the Japanese goodwill payments for the Second World War. Of the total twelve new vessels the national shipping line has already taken delivery of three and these are in service in the Far East-Europe run. Ten ships will ply between Japan, Peninsular Malaysia and the Sabah ports of Kota Kinabalu, Sandakan and Tawau. The Second Malaysia Plan also caters for the improvement of the two major ports, Port Swettenham and Penang, which handle three quarters of the country's international trade. These ports are to be modified for container traffic. The extension of ports in Sibu, Sandakan, Kota Kinabalu and Kuching is also provided for.

Two approaches can be used to help ease the burden of net payments of

[5] Bank Negara Malaysia, *Annual Report and Statement of Accounts, 1970*, p. 100.

[6] *The Times*, 'Malaysia: A Special Report', 31 August 1971, p. VI.

[7] Allocation of $46m. for them in the *Second Malaysia Plan, 1971-1975*, p. 179.

freight and insurance. The first is to have consultations between shippers and carriers regarding shipping rates and services either to prevent an increase in rates or to negotiate for a decrease in existing rates. The second is in the development of a national shipping line, with or without the eventual hope of replacing foreign ships.

In practice, it is more likely for consultation to slow down increases in rates than to secure actual reductions. Consultation is a measure which has been used by Malaysia with only partial success. In 1964/5, there were consultations with the Far East Freight Conference lines about the high cost of freight charges. It was pointed out that the rates charged by the Conference lines were higher than non-Conference lines. For instance, in 1964, the Straits New York Conference raised the conference rate on rubber from Singapore to New York from US$45.75 to US$50 a ton. As a result, Singapore rubber exporters and foreign exporters refused to sign contracts with the Conference lines since rubber shipments through non-Conference lines cost US$42 a ton.[8] Thus, one way of reducing costs is to use non-Conference lines whenever the rates are lower. However, the Conference lines have certain advantages in that they ensure the regularity and reliability of shipping services, frequent sailings, unrestricted coverage of shipments and stability of rates to enable planning of production and marketing. To the producers, of course, these advantages are of no great importance. However, from the viewpoint of the importers and exporters, the regular sailings, speed. efficient handling of commodities are of very considerable importance. Malaysia is a primary producer and also an importer and exporter. This means that the use of Conference lines cannot be wholly substituted by non-Conference ships. Other measures to reduce freight charges can include the strengthening of existing machinery for negotiating with conferences. The establishment of a national shipping council which would include all representatives for both Malaysia and Singapore was proposed in the Singapore International Chamber of Commerce in 1969

Other forms of *ad hoc* measures on a negotiation basis can include the introduction of government surveillance as proposed in the recent amendment to the Trade Practices Act, the chartering of tramp tonnage by shippers themselves at peak period for certain cargoes, and suitable encouragement from time to time of independent liner companies to carry cargoes at cut rates.[9] A regional government co-operation scheme to back up local producers exporters and importers in negotiating for better rates is another possibility. Consultations between shippers and carriers are measures to prevent rates from rising, but they

[8] *Far East Trade and Development*, Vol. 2, No. 7, July, 1967, pp. 657-88.

[9] Alex Hunter, 'Some Notes on National Shipping Lines: The Australian Case', *The Economic Record*, March 1967, p. 43.

do not solve the problem of net payments for freight and insurance and so reduce or remove the adverse effect on the balance of payments.

Another aspect of regional co-operation can help to reduce freight payments, and in this the Malaysian government has taken the initiative. The Economic Commission for Asia and the Far East has been asked – and it has decided to accord high priority to the Malaysian request – to find ways of utilizing to full capacity the national shipping lines of member countries to serve regional needs and thus to improve their system and facilities.[10]

A further Malaysian measure is to approach the major maritime powers to agree that one-half of the tax on profits of shipping enterprises should accrue to Malaysia. The first maritime nation to agree to this is Norway which signed a new agreement on the avoidance of double taxation with Malaysia in December 1970. Under Malaysia's old tax treaties, profits from shipping enterprises were taxable only by the country in which the place of effective management of the enterprise was situated.[11]

What is often considered as a long-run solution by less developing countries as well as by the more developed is that investment in a national shipping line will improve the balance of payments. In considering such a policy it is important to stress that the net gain of foreign exchange to the Malaysian balance of payments is not the former net foreign exchange payments, even if there is a complete displacement of foreign shipping lines. R.O. Goss[12] has established the principle that before one comes to any conclusion with respect to the gains to the balance of payments from investment in a national shipping line one needs to analyze the operating costs of the ship's account for the type of international carrier in question, in order to discover what is a typical distribution of foreign exchange earnings as between any ship's home country and abroad.

Table 7-1 provides what might be termed a typical distribution of foreign exchange earnings and expenditure in the operations of a liner. Whether the distribution of operating costs as given in the Table would also apply to a liner company in a developing country like Malaysia is uncertain, although the annual report of an Indian liner company revealed much the same distribution of operating cost items as that in Europe.[13] The purpose of presenting the Table is to indicate the type of statistics that are needed in order to provide a quantitative

[10] *Malaysian Digest*, 31 December 1970, p. 8. ECAFE accepted the proposed ratio of 40:40:20 for carriage. Ships of the exporting and importing countries were each to be allowed to carry 40% of the cargo. Other ships could carry the remaining 20%.

[11] *Ibid.*, p. 8.

[12] R.O. Goss, 'Investment in shipping and the Balance of Payments', A Case-Study of Import Substitution Policy, '*Journal of Industrial Economics*, Vol. 13, 1964/5 No. 2, pp. 103-15.

[13] UNCTAD, *Report (Final Act and Report)* Annex F, Vol. 1. New York, 1964, p. 223.

TABLE 7-1 Allocation of Liner Freight to Items of Operating Costs

A. Liner Freight Expenditures (Gross freight less rebates and freight paid to co-transporters under through bills of lading.)			100.0%
B. Operating Costs			
i.	Cost of loading discharge, port dues (including canal fees) agency fees, pilotage	51.3%	
ii.	Bunkers	7.8%	
iii.	Lubricating oil	0.9%	
iv.	Deck and engine stores	2.5%	
v.	Repairs and maintenance, surveys	5.9%	
vi.	Insurance: marine, war, others.	3.5%	
vii.	Provisions	1.9%	
viii.	Wages for sea-going personnel	10.6%	
ix.	Other costs for crew (social, insurance, travel)	1.4%	
x.	Administrative costs	2.1%	87.9%
C. Gross Profits (before interest depreciation and national taxes)			12.1%
D. Total Receipts			100.0%

Source: Balance of Payments Aspects of Cargo Liner Freights and Expenditure', UNCTAD (E/Conf. 46/C. 3/5) 29 April 1964.

Notes: The figures are based on all Norwegian cargo liners over 7,000 tons with maximum twelve passengers which operated during the whole of 1962. The majority of the ships operated between developed and developing countries. The ships numbered 169, had an average size of 9,376 tons, and belonged to fifteen different companies: 145 ships were less than 15 years old; 16 were between 15 and 20 years and 8 more than 20 years. For different breakdowns of operating costs see United Nations document (ECN. 11/715).

conclusion for the Malaysian case. However, an analysis of the individual items will indicate that the gains to the Malaysian balance of payments is not the total former net payments of freight and insurance – that is, about $170m. annually – but some small percentage of it, if the enterprise is successful.

The source of revenue which will accrue to a Malaysian ship is freight charges. Since Malaysia has practically no merchant fleet at present, foreign exchange in terms of freight revenue can arise in two forms. Firstly, there are the former freight payments to foreign ships. Normally, resident to resident transactions do not appear in the balance of payments, therefore, a monetary amount will not be *added* to any outflow of funds but it will show as a *decrease*, namely, the amount of foreign exchange actually saved. The other possible source of income is the freight formerly earned by foreign ships from non-Malaysian customers

and now paid by foreigners to national ships. This would represent earned foreign exchange as the result of provision of carriage services to foreigners.

If the setting up of a national shipping line results in any form of protection which affects the freight rates, the correct amount of foreign exchange saved or earned should be the free market freight rate. Protection may be given in the form of income tax relief or tax concessions.

To summarize, the effect on the Malaysian balance of payments when national ships replace foreign ships is the amount of foreign exchange saved through the displacement of foreign ships and the foreign exchange earned by providing carriage services. Against this revenue must be deducted some of the operating costs in the normal operations of a ship, irrespective of its nationality. It is likely that items (i-viii) in Table 7-1 represent such costs. Of course, it is true that item B(i) would be incurred in the home port in which case there are no payments in terms of foreign exchange to foreigners. However, if a national ship had not replaced a foreign ship, the home port would have earned the equivalent amount of foreign exchange. Items B (ii - iv) are items where there is little scope for substitution by local resources. Items B(v) and (vi) – that is, repairs and maintenance, and insurance – are areas in which some substitution from foreign to local facilities may be possible in the long run but at present they are costs which have to be incurred. Currently, Malaysia lacks repair facilities. Singapore provides such facilities around South-East Asia, while shipping insurance is high specialized, and this is why most ships are either insured or re-insured in London or New York. The proportion of freight revenue which could be allocated to provisions, wages for sea-going personnel, other costs to crew, administrative costs and profits (Items B vii and C) would be a contribution to the Malaysian balance of payments. It is likely that the majority of the crew will be Malaysians. Some key personnel may be foreigners because of the present lack of expertise, and their wages must be deducted.

In the case study presented in Table 7-1, assuming that items B vii-x and gross profits accrue to the national ship, then the margin or returns to investments cannot exceed 28%. In the case of a developing country setting up a shipping line, there may be a further cost which needs to be accounted for. The main factor which will reduce the contribution to the balance of payments is remittance of profits by foreigners. It is likely that a shipping line in Malaysia will be partially foreign-owned. Japanese business firms have suggested to the Malaysian government that there should be joint ownership in the development of shipping and construction of shipyards.[14] The contribution to the Malaysian balance of payments is therefore likely to be smaller.

However, in Malaysia there is a probability that the shipping line can be locally

[14] *Straits Times*, December 69.

owned, either privately or by the government or jointly. This is because Malaysia is not short of foreign exchange. Foreign individuals with the necessary expertise can be employed. If this is so then a few factors must be considered. In the first instance, since Malaysia does not build her own ships,[15] there will be a once-and-for-all payment of foreign exchange which in turn will make the balance of payments worse than before, at least in the short run. If she attempts to build the ships herself it is likely that the cost will be higher than for ships built by Japan.

It is possible that capital may be borrowed for financing the shipping line, in which case the balance of payments would not be adversely affected in the short run. In the long run the continual repayments of principal and interest will be felt. The payments of interest for the use of foreign capital will have to be considered as part of operating costs, thus making the margin of returns to investment even smaller.

As a result, it seems reasonable to suggest that the margin or returns to investment in national shipping in Malaysia would be less than 20% rather than 28%. This allows for wages to key personnel who are likely to be foreigners, and also assumes that the shipping line is locally owned. This means that the volume of capital needed to build up a fleet would also have to be considered. Capital outlay will differ with type, age and size of ships.

In spite of the large amount of capital needed, it is probable that investment in a national shipping line will help to improve the Malaysian balance of payments in the long run. The important question is whether returns to capital investment will be higher in alternative projects. In other words, as the use of foreign exchange should be optimized, the objective of policy makers is to maximize such uses. It is not possible to indicate in general whether other forms of development project will bring about a higher return to investment in a shipping line, unless specific feasibility projects are compared with that of shipping. The correct policy for the authorities is to conduct such studies before committing foreign exchange to the building of a shipping line. However, from the above analysis, it appears that a national shipping line is a viable project and merits serious consideration.

If Malaysia decides to expand her shipping fleet in the seventies, she could find herself in a buyer's market. The proliferation of large container ships on the major sea routes is likely to force a large number of modern, handy-sized ships ranging from 10,000 to 15,000 tons, on to the second-hand market by the mid-1970s.[16]

[15] The MARA shipyard in Kuala Trengganu is capable of building vessels up to 100 feet but not large ships.

[16] *National and Grindlays Review*, February 1972, p. 10.

A. Hunter[17] has indicated that a further argument, which has often been used in an attempt to strengthen the case for a national shipping line in terms of reducing the effect of payments of freight on the balance of payments, is that the existence of a national shipping line could be used as a countervailing power against rate-fixing proposals of foreign conference lines, or to secure rate structures more advantageously geared to the export movements. It is arguable that national shipping lines are cumbersome and expensive instruments to devise for the purpose of controlling freight rates and do not even hold out the compensating advantage of certainty of success.

Finally, it should also be noted that there would be favourable employment effects domestically if a large shipping line is set up. There would also be linkage effects leading to ship building in future. It might be argued that investments in alternative projects would also provide employment opportunities and linkage effects. This is true, but it should be noted that a shipping industry can be very labour intensive. Firstly, there is employment on board ship. At a later stage, though substantial gains in production have been achieved by incorporating modern technological innovations much of the ship-building process still depends largely on manual labour.[18] The success of Singapore's ship-building and ship-repairing industries has illustrated the extent to which the creation of employment opportunities can be achieved.

An implication arising from a study of the breakdown of costs of operation is that any improvement made to the present port facilities would help to improve the balance of payments, in the sense that better port facilities may attract foreign ships or divert Malaysian export traffic through Malaysian ports rather than through Singapore. The diversion in sea traffic to Malaysian ports would reduce the net payments of freight due to an increase in invisible savings as well as possibly an increase in earnings. Thus it seems that a complementary policy to investment in a national shipping line for overseas run is investment in her port facilities. However, before extending existing works the authorities should be convinced that the use of existing facilities is close to the maximum capacity. It is also important to make allowance for reserve capacity to handle peak traffic periods, because of the customary practice of shipping rubber on end-of month contracts. Delays in the expansion of port facilities can result in a higher cost of freights in the long run. The cost of shipping delays may be put at roughly $1.00 per ton carrying capacity of ship per day.[19]

[17] Alex Hunter, *op. cit.*, p. 43.

[18] *Far East Trade and Development*, July 1970, Vol. 25, No. 7, p. 330.

[19] The IBRD in a study *'Economic Aspects of Malaysia'*, 1963, estimated that the cost of delays was $0.75 per ton per day. Since freight charges have gone up by 10-20%, the figure of $1.00 is used.

In the case of Port Swettenham, the shortage of wharves is currently being remedied as two deep-water berths are presently under construction to supplement the seven wharves in operation.

However, this is not the case in Sabah and Sarawak. The ports of Kota Kinabalu and Sandakan have been the subject of no fewer than six separate studies in seven years. Each of these six separate studies is believed to have come to the conclusion that the port of Kota Kinabalu and the port of Sandakan, or both, are inadequate. Each study is believed to have recommended either substantial extension of the existing ports or the construction of completely new ports. This means that port services in Sabah and Sarawak should be given priority.[20]

The conclusion from the analysis about the possible effects of a national shipping line on the Malaysia balance of payments indicates that there would likely be some gains, but the opportunity cost of the use of capital for investment in shipping has to be evaluated. It is recommended that the development of ports throughout Malaysia has priority over other projects.

TRADE POLICIES FOR MANUFACTURED EXPORTS

Another policy alternative to help improve the balance of payments is directed at a modified policy for manufactured exports of Malaysia. The general recommendation is that there should be two trade policies for manufactured exports, one directed at other developing countries and the other directed at advanced countries. This is opposed to a common trade policy for both types of export markets for Malaysia's manufactured goods. In the Development Plans, 1960-1965 (Second Malaya Plan), First Malaysia Plan, 1966-1970,[21] and the Second Malaysia Plan, 1971-1975[22] there is an awareness to expand the manufacturing export sector but there is no recognition of the two different export markets.

A study of the characteristic of the manufacturing export sector is necessary to support the policy recommendations. Table 7-2 shows that contribution of manufactured exports to the total export earnings from 1963-9. Table 7-3 shows the relative share of Malaysia's manufactured exports excluding non-ferrous metals in group 6 (sub-section 68, S.I.T.C.) This is the sub-group which consists mainly of tin and so cannot be considered as manufactured exports. The statistics in Table 7-3 indicate that manufactured exports form a significant part

[20] *Straits Times*, 5 March 70. Letter by A.H. Postlethwait, Director, Straits Steamship Co. Ltd., Singapore.

[21] *First Malaysia Plan, 1966-1970*, See pp. 123-4 and 129-30 for discussions on manufactured exports.

[22] *Second Malaysia Plan, 1971-1975*, See pp. 174-8 for discussion on manufactured exports.

TABLE 7-2 Peninsular Malaysia – Manufactured Exports, 1963–9, ($ million)

	Total Exports	Manufactured Exports	Chemicals	Basic Manufacture	Machinery and Equipment	Miscellaneous Manufactured Goods
1963	2,705	737	32	881	52	22
1964	2,781	894	40	771	57	26
1965	3,103	1,063	40	926	66	27
1966	3,120	1,002	44	857	71	28
1967	2,919	973	47	828	61	37
1968	3,203	1,083	55	919	70	38
1969	4,061	1,353	58	1,038	67	50

Souce: Department of Statistics, *West Malaysia, Annual Statistics, External Trade*, 1963-9.

of total exports and that the exports in percentage terms have remained fairly stable at about 32%.

TABLE 7-3 Peninsular Malaysia – Relative Share of Manufactured Exports, 1963-9.

	Total %	Chemicals	Basic Manufacture	Machinery and Equipment	Miscellaneous Manufactured Goods
1963	27	1	25	1	–
1964	30	1	27	2	–
1965	32	1	29	2	1
1966	32	1	28	2	1
1967	32	1	28	2	1
1968	32	1	28	2	1
1969	32	1	28	2	1

Source: Computed from *West Malaysia, Annual Statistics, External Trade*, 1962-9

The pattern of the export market for manufactured goods is shown in Table 7-4 where the export market is divided into two categories, namely, that of the advanced countries (group 1) and that of the developing countries (group 11). The statistics indicate that Malaysia depends chiefly on the developing countries for her exports of manufactured goods. The percentage share averaged nearly 90% of the exported manufactured goods from the years 1962 to 1969. However, there is now a clearly decreasing trend ranging from 95% in 1962 to 31% in 1969. This means that the share of the exported manufactured goods to the advanced countries has increased from 5% in 1962 to 19% in 1969, a 14% increase in eight years.

TABLE 7-4 Peninsular Malaysia – Export Markets of Manufactured Goods 1962-9.

Year	Total %		Chemicals		Basic Manufacture		Machinery and Equipment		Miscellaneous Manufactured Goods	
	1	*11*	*1*	*11*	*1*	*11*	*1*	*11*	*1*	*11*
1962	5	95	13	87	6	94	2	98	3	97
1963	8	92	10	90	15	85	2	98	3	97
1964	7	93	5	95	18	82	2	98	3	97
1965	9	91	3	97	19	81	3	97	10	90
1966	13	87	3	97	21	79	6	94	23	77
1967	16	34	8	92	21	79	6	94	29	71
1968	18	82	5	95	30	70	4	96	29	71
1969	19	31	5	95	30	70	4	96	29	71

Source: Computed from *West Malaysia, Annual Statistics, External Trade,* 962-1962-9

This trend may have two explanations. Since other developing countries are also developing themselves it is likely that they are producing for themselves similar manufactured items that Malaysia is exporting. If this is true, one would expect a further decline in such trade in the future. The most dramatic declines are in basic manufacturers from 94% in 1962 to 70% in 1969 and in miscellaneous manufactured goods from 97% in 1962 to 71% in 1969.

Another possible explanation for the trend is that some of Malaysia's manufactured exports to advanced countries are becoming more competitive. This is particularly true for commodities such as rubber manufactures, wood and cork, textile and clothing, and implies that two trade policies for Malaysia's manu-

factured exports are necessary in order to ensure that Malaysia's balance of trade will not be adversely affected in the future. Some kind of integrated trade policy among developing countries would ensure that developing countries do not build up barriers against each other which in the long run would be detrimental to all concerned.[23]

On the other hand, resources should be directed into areas where the export market potential in advanced countries is greatest rather than in a diversified manner. Table 7-5 shows the Malaysian export market by commodities to advanced countries in terms of the two-digit code. The percentage figures indicate the share of the exported manufactured goods. It seems worthwhile to classify further the exports into four groups A-D according to their relative importance in terms of percentage sales.

Group A (62) Rubber manufactures n.e.s.
(63) Wood and cork manufactures
(65) Textile manufactures
(34) Clothing

This group of commodities is the most important since it has averaged about 41% of the total manufactured exports to advanced countries. The reason is that comparative advantage exists in these lines because of resources content, especially for the commodities in groups 62 and 63. Thus this group represents the area with the greatest market potential.

Group B (51) Chemicals
(55) Perfume toilet preparations
(58) Plastic materials
(85) Footwear
(86) Scientific instruments
(89) Miscellaneous manufactured articles n.e.s.

Group B consists of manufactured products which are called light manufactured goods. Sales for the period 1962-9 averaged about 12%. Another feature of these exports is that they are comprised of commodities which are relative newcomers to the industrialization process.

Group C (71) Machinery non-electric
(72) Electric machinery
(73) Transport equipment

Group C consists of machinery and transport equipment and it is likely that it is difficult to find an expanding market in advanced countries because of Malaysia's inability to compete against similar products made by them. These

[23] Professor Murakami holds a similar view. See Atsuhi Murakami, '2 aspects of the export manufactured goods', in *The Developing Economics*, Vol. VI, September 1968, No. 3, pp. 261-83.

TABLE 7-5 Peninsular Malaysia – Percentage of Manufactured Exports to Advanced Countries, 1962-9

Code	Commodities	1962	1963	1964	1965	1966	1967	1968	1969
51	Chemical compounds	25	41	42	13	3	22	9	9
52	Mineral tar	–	–	–	–	–	–	–	–
53	Dyes and colour	–	1	–	–	–	–	1	1
54	Medicinal products	–	1	–	–	–	2	2	2
55	Perfume toilet preps.	20	11	5	4	4	11	9	9
56	Fertilizers	–	–	–	–	–	–	–	–
57	Explosives	–	–	–	–	–	–	–	–
58	Plastic materials	14	8	6	11	–	2	–	1
59	Chemical products n.e.s.	–	–	2	2	–	1	–	1
61	Leather products n.e.s.	–	–	–	–	1	–	–	–
62	Rubber mfs. n.e.s.	35	31	31	34	32	25	27	28
63	Wood and cork mfs.	–	–	–	18	33	49	60	65
64	Paper manufacture	–	–	–	–	–	–	1	1
65	Textile manufacture	–	24	46	39	40	44	55	51
66	Non-metal mineral mfs.	–	4	–	–	1	–	1	1
67	Iron and steel	–	–	–	–	–	–	–	–
69	Metal manufacture	1	2	2	1	2	1	2	3
71	Machinery non-electric	–	–	–	–	3	5	3	3
72	Electric machinery	–	–	–	–	3	4	2	2
73	Transport equipment	3	5	3	6	9	9	7	8
81	Sanitary lights mfs.	–	2	–	–	–	–	–	–
82	Furniture	–	–	–	–	–	–	–	1
83	Travel goods	–	–	–	–	–	–	–	1
84	Clothing	–	–	–	38	63	56	63	47
85	Footwear	6	4	2	7	15	23	25	30
86	Scientific instrument	–	12	3	25	15	12	9	7
89	Misc. manufactured articles n.e.s.	3	3	6	9	12	23	10	14

Source: Computed from *West Malaysia, Annual Statistics, External Trade*, 1962-9.

exports, are commodities which have a high transport cost and, more important, they are not technologically advanced enough to be demanded by consumers in advanced countries.

Group D (54) Medicinal products
(59) Chemical products n.e.s.
(69) Metal manufactures

Exports of commodities from this group to advanced countries are insignificant.

The conclusion is that Malaysia should have two trade policies with respect to the manufactured export sector instead of a common trade policy for the two different export markets. As the bulk of Malaysia's manufactured exports, especially those of groups B, C and D, are consumed by other developing countries, an integrated trade policy with them presents the best prospects for continuing improvement in Malaysia's balance of payments. The need for integration of trading policies is urgent because of the fast-decreasing trend in the consumption of commodities indicated in section 6 (Basic manufactures) and section 8 (Miscellaneous manufactured goods). The second trade policy in terms of intensive marketing campaigns, better quality products and greater orientation of products towards the type of demand in advanced countries should centre itself around the commodities in group A.

TOURIST POLICY

The importance of tourism as a factor in economic development is now widely accepted. Developing countries which possess the two basic attractions of sunshine and ocean tend to see in tourism a potential source of foreign exchange. It is also recognized that tourism is labour intensive. In addition to direct employment in the tourist sector, the benefits of tourist development are diffused widely throughout the economy, affecting all part of the service sector and construction, while considerable additional demand is generated for local products. An example of the potentials of labour intensity in tourism is given by Oshima. He estimated that one-sixth of Singapore's unemployed labour force will be engaged in the tourist industry by 1977.[24] A further advantage is that the industry stimulates investment and it is generally accepted that tourist investment projects do not have a long gestation period. It is also an industry whose overall material capital-output ratio is probably low (perhaps around 2).[25] Tourism can also help to mitigate regional disequilibrium.

Finally, the Zinder report on 'The future of tourism in the eastern Carib-

[24] Harry T. Oshima, 'Growth and Unemployment in Singapore', *Malayan Economic Review*, Vol. XII, No. 2, October 1967, p. 44.

[25] *Ibid.*, p. 44.

TABLE 7-6 Peninsular Malaysia — Tourists by Air and Sea and Purpose of Visit, 1966-70

	Tourist	Purpose of Visit									
		Business	%	Holiday/Social	%	Transit	Pass %	Education	%	Special	Pass %
1966	45,914	6,370	14	28,396	62	9,460	20	602	1	587	1
1967	42,602	745	1	32,233	75	9,253	21	203	—	168	—
1968	50,588	817	1	36,621	72	12,371	25	189	—	126	—
1969	53,071	357	1	38,070	71	13,818	26	982	1	342	—
1970	76,374	212	—	60,144	78	15,006	20	826	1	186	—

Source: Department of Statistics, *Tourist Statistics, West Malaysia*, 1970, p. 1.

bean'[26] has calculated the income multiplier effects of tourist spending on incomes, jobs, wages and tax revenue. This report is relevant for Peninsular Malaysia because it stated that '...comparable multiplier of tourist spending are 8.4 in a centrally controlled developing economy (Yugoslavia) and 3.2 in typical underdeveloped economics (Southeast Asia including Singapore, Malaya, Thailand Cambodia and Vietnam)'.[27]

However, Levitt, Gulati, Bryden and Faber[28] have conclusively shown that Zinder's multipliers are wrong because of repeated over-counting. Bryden and Faber believe that Zinder's income-multiplier has been over-estimated by some two-and-a-half times.

Thus, though it is generally agreed that there would be some beneficial income multiplier effects of tourist spending, it should be noted that the Malaysian income-multiplier effect is not as large as given in the Zinder Report.

For these reasons, it is therefore not surprising that the Malaysian government has started, especially in the late sixties, to promote and expand the tourist industry. It is pertinent to examine the government's tourist policy, as this is an export policy. The potential effects on the balance of payments can be pronounced.

In general, four stages may be distinguished in the development of tourism.[29] The first refers to a situation where the number of tourists is small and where there is little hope of increasing it at present. The second is where there are few tourists but where there are opportunities for immediate increase. The third occurs where the tourist trade has been expanding at a fair rate and where there are prospects, given proper action, of large-scale tourism. Finally, the fourth stage, where large-scale tourism already exists but where the authorities are interested in increasing their tourist traffic still further.

Table 7-7 shows the annual growth rates of tourists (defined as foreigners who are in Peninsular Malaysia for vacational purposes or in transit) in Peninsular Malaysia, 1966-70.[30] From these it seems reasonable to suggest that the develop-

[26] This report was prepared in May 1969, by H. Zinder and Associates Inc. under contract with the Agency for International Development and was sponsored by The Regional Development Agency.

[27] Quoted in John Bryden and Mike Faber, 'Multiplying the Tourist Multiplier', *Social and Economic Studies*, No. 1, March 1971, Vol. 20, p. 66.

[28] Kavi Levitt and Iqbal Gulati, 'Income Effect of tourist spending: Mystification Multiplied: A Critical Comment on the Zinder Report', *Social and Economic Studies*, No. 3, September 1970, Vol 19, pp. 326-43, See also J. Bryden and M. Faber, *ibid.*, pp. 61-82. J. Bryden and M. Faber, *op. cit.*, p. 74.

[29] H. David Davis, 'Investing in Tourism', *Finance and Development*' Vol. IV No. 1, March 1967, pp. 1-2.

[30] No statistics of tourists (mainly Thais and Singaporeans) who arrive by road and rail are

TABLE 7-7 Peninsular Malaysia – Annual Growth Rates of Tourists by Air and Sea and Purpose of Visit, 1966-70

	Tourist	Holiday and Transit Pass
1966/7	–7	9
1967/8	19	19
1968/9	5	4
1969/70	43	44

Source: Computed from Table 7-6.

ment of tourism in Malaysia is probably between stages 2 and 3.

It is important to indicate the reason for not adhering strictly to the Statistics Department's definition of a tourist, which includes all visitors, whose purpose of visit were categorized as business, education, special reasons, in transit and holiday.[31] In terms of studying the growth of tourism, it seems reasonable to suggest that the first three categories are not important because the majority of such visitors would visit Peninsular Malaysia even in the absence of tourist attractions. In addition, visitors on vacation and in transit formed about 95% of the total number of tourists from 1966-70.

The very low growth rate of 4% in 1969 was due to the racial disturbances in the Federal capital. The very high growth rate of 44% in 1970 was due to 'EXPO 70' in Japan. Malaysia was used as a stop-over point.

Since 1969 and 1970 were exceptional years, the growth rates of 9% in 1967 and 19% in 1968 may be taken to reflect normal conditions. These growth rates compare very favourably with the rate of increase of 10-12% annually in other underdeveloped countries.[32]

The statistics from Tables 7-8 and 7-9 show that the favourable growth rates of tourist numbers were not solely due to American soldiers from Vietnam, even though, as Table 7-8 shows, American tourists were quantitatively the most important. It might be argued from this that the Malaysian tourist inflow has been boosted by American soldiers who were on 'rest and recuperation' from Vietnam.

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available. It is only since August 1971 that these persons have had to fill in special immigration cards, enabling an accurate headcount. The annual arrivals given by PATA for 1962-5 were, 22,931, 26,865, 24,754 and 25,000 respectively. There was no breakdown into tourists by air and sea, or purpose of visit.

[31] The United Nations defines tourists as non-residents stopping for more than twenty-four hours.

[32] H. David Davis, *op. cit.*, p. 8.

TABLE 7-8 Peninsular Malaysia – Tourists by Air and Sea, Citizenship and Purpose of Visit, 1969-70

	Tourist		Purpose of Visit									
			Business		Holiday/Social		Transit Pass		Education		Special Pass	
	1969	1970	1969	1970	1969	1970	1969	1970	1969	1970	1969	1970
United States of America	9601	13327	16	12	8539	12671	974	538	39	83	33	23
Indonesia	6033	10498	8	2	4717	9170	1023	988	202	315	12	13
United Kingdom	5445	7497	22	15	4572	6360	814	1058	13	36	24	38
Japan	4582	6137	37	10	3688	5031	831	1131	3	1	23	14
Australia	2772	5154	7	4	2322	4403	423	728	12	3	8	16
India	6163	7401	28	32	2317	3665	3800	3683	5	4	13	17
Singapore	4826	5516	7	9	1434	1868	3374	3633	2	–	9	6
Thailand	1742	2279	6	2	1401	1784	186	211	141	278	8	4
Germany	1131	1811	6	1	939	1671	181	136	–	–	5	3
China (mainland and Taiwan)	1280	1890	61	32	870	1508	328	338	2	2	19	10
Canada	881	1513	–	5	774	1406	96	93	6	8	5	1
France	671	1026	–	–	555	903	111	123	–	–	4	–

Source: Department of Statistics, *Tourist Statistics, West Malaysia*, 1969, p. 12.
Tourist Statistics, West Malaysia, 1970, p. 13.

TABLE 7-9 Peninsular Malaysia — Tourists by Air and Sea by Age Groups, 1960-70.

		Age (years)										
	Total	0–4	5–9	10–14	15–19	20–24	25–29	30–39	40–49	50–59	60–69	70 and over
1969	53,071	931	1016	1522	1945	4276	6614	12427	11338	7050	3420	1735
1970	76,374	819	1186	1928	2779	6548	9169	17994	16351	10002	4708	3779

Source: Department of Statistics, *Tourist Statistics, West Malaysia*, 1969, p. 6.
Tourist Statistics, West Malaysia, 1969, p. 7.

To a certain extent this is true. However, Table 7-9 shows the distribution of visitors by age-groups. The most significant groups in terms of number were 30-39, 40-49, 50-59 and 20-24. Soldiers on 'rest and recuperation' would probably be in the last mentioned age group. This implies that the inflow of tourist was not due to the temporary inflow of soldiers, though for a time Penang did benefit from the 'rest and recuperation' programme, but this was stopped in early 1969.

The government's tourist policy can be classified into generic and specific policies. The former policy includes a) a $1m. study by international consultants for a master plan for the overall development of tourism and b) the provision of new incentives for the hotel industry. The new incentives are the following:

a. hotels and motels built in less developed parts of Malaysia will qualify for an abatement of chargeable income ranging from 20 to 30% for twelve years;
b. hotels built in Kuala Lumpur and Penang will qualify for an accelerated depreciation allowance; and
c. hotels in areas designated as tourist potential areas (Pulau Langkawi) will qualify for the depreciation allowance plus 30% abatement of chargeable income and normal industrial building allowance.[33]

A further incentive is duty-free inputs of building and furnishing materials, liquor and cigarettes over a specified period.[34]

The estimates for new construction and modernization of accommodation for 1968-72 for Malaysia compared to selected Asian tourist centres are given in Table 7-10.

Table 7-10 shows that Malaysia has the highest number of new hotels for 1968-72. The main reason for this sudden impetus in Malaysia is the need for more accommodation when Malaysia is the host to the Pacific Area Tourist Travel Association (PATA) conference in 1972.[35]

Another aspect of the government's general tourist policy is that such policy in Malaysia is considered to be part of a regional development programme. The extra incentives for the development of hotels in less developed areas and the proposed holiday resorts in the east coast states of Peninsular Malaysia are manifestations of regional planning. There is justification for such a programme.

However, in the promotion of holiday resorts which are some distance away from the main stream of tourists, the Malaysian government must be absolutely clear as to whether its aim is to develop them as local or international tourist attractions, because these two objectives have different effects on the balance of payments.

[33] *Sunday Mail*, 28 September 69.

[34] *Straits Times*, 20 November 70.

[35] The implication for playing host to the PATA Conference is given on p. 222.

TABLE 7–10 Estimates of New Construction and Modernization of Accommodation for 1968-72 in the Pacific and East-Asian Region.

Units: Accommodation Establishments		Hotels	Motels	Inns	Youth Hostels
Hongkong:	new	4	—	—	—
	modernized	—	—	—	—
Malaysia:	new	21	2	—	—
	modernized	—	—	—	—
Philippines:	new	5	—	—	—
	modernized	—	—	—	—
Singapore:	new	13	—	—	—
	modernized	5	—	—	—
Thailand:	new	10	5	15	20
	modernized	10	10	12	—

Source: *International Union of Official Travel Organisation*

The encouragement of local holiday resorts is likely to result in a less significant gain in foreign exchange when compared to the potential returns of an international tourist centre. Malaysians travelling within their country do not affect the balance of payments situation. The most likely sources of foreign exchange will be from foreigners living in Malaysia, and from Thais and Singaporeans.

The usual argument that there may be substantial savings of foreign exchange because Malaysians are diverted from going abroad due to lower cost of travel within the country is not wholly acceptable. Malaysians who can afford to travel further than either Singapore or Thailand are not likely to be diverted by lower cost. It is also very likely that the Malaysian tourist traffic to Singapore and Thailand will not be significantly diverted. The main attractions these two countries offer are not and will not likely be available in Malaysia. Singapore is a shopping centre because of its lower taxes on consumer goods.[36] It is also an international holiday resort. This latter aspect is also true for Thailand, in addition to its attraction of a significantly different culture.

The Malaysian government must be aware that the use of tourism as part of a regional development policy is likely to have a less beneficial effect on the

[36] *Far East Economic Review*, 4 April 1968, p. 257 'A recent survey by the Singapore Tourism Board revealed that Asian tourists (presumably from Malaysia, Borneo and Indonesia) were the people who shopped in Singapore.

Malaysian balance of payments. A potential problem is the possible clash of interests between the thirteen different states, each wanting to benefit from a tourist policy, and this must be avoided, since each of them is empowerd to enter into tourist development projects, as well as the newly formed Malaysian Tourist Corporation.

The government's specific policy is in the promotion of two islands of Trengganu – Pulau Perhentian and Pulau Redang as tourist resorts. The government is prepared to assist developers to open up the area, grant pioneer status, provide the necessary infrastructure such as an airstrip on either of the islands and even invest in the project itself.[37]

There are two serious objections to this particular policy as a potential source of foreign exchange earnings.

Firstly and more important is the fact that these two islands are too far away from the Federal capital. It needs to be emphasized that most tourists spend only three or four days in Malaysia,[38] and are unlikely to be keen on wasting long hours in internal travel. The Malaysian Singapore Airlines has ruled out the possibility of running an air-service in the immediate future unless there is justifiable tourist traffic.[39] The argument given is enveloped in a vicious circle. The services will not be provided because of insufficient passenger load, and it is likely that because air services are not present the passenger traffic is low.

The other objection is that, apart from the beaches, there are no other amenties which might attract tourists to these islands. This is especially so when their visits to Malaysia are short. It is evident that this policy needs to be re-assessed.

A number of external factors may justify the government's optimism in the tourist industry.

One which favours the development of tourism in Malaysia is that there has been a rapid growth of air charter inclusive vacation travel. Air charter, because of high load factors and low overheads, radically reduces charges for passengers, and thus makes long-distance travel from Europe a practical reality.

The Malaysian government has announced an 'Open Sky' policy giving liberal landing rights to schedules airlines as well as encouraging charter flights into the country.[40] This is a step in the right direction in terms of a tourism policy. This number of passengers on these flights increased by over 150% from 1969 to total about 45,000 in 1970.

[37] *Sunday Mail*, 28 September 69.

[38] See Department of Statistics, *Tourist Statistics, West Malaysia, 1969*, p. 21. *Tourist Statistics, West Malaysia*, 1970, p. 45.

[39] *Sunday Mail*, 28 September 69.

[40] *Second Malaysia Plan, 1971-1975*, p. 167.

In view of this, it is difficult to understand the government's policy of not granting landing rights to BOAC charter flights from Britain to Kuala Lumpur. British tourists are third in importance in terms of numbers (see Table 7-8). If more tourists from Britain and Europe are to be encouraged the present policy needs reconsideration. The government should not overlook the fact that of the world's twelve leading tourist countries ten of them including Britain are from Europe. These twelve leading tourist countries are even more predominant as the source of long distance travellers to developing countries – providing 90% of all travellers to these countries.[41] Table 7-8 shows that besides the United Kingdom, only Germany and France are of any significance. However, the attraction of tourists from Europe to Malaysia should be a primary target. This is because of the Europeans' desire for foreign travel coupled with their financial ability to travel.

The other factor which may be in Malaysia's favour is that while the cost of transport constitutes a large proportion of the total cost of a trip, costs at the destination also have an important influence on demand. Where the cost of transport to two destinations is virtually the same, a competitive advantage can be gained by the one where these other costs are lower.

There is a marked difference in the cost of living, especially in accommodation cost between Johore Bahru and Singapore. They are separated by a causeway. Singapore is one of the leading tourist centres in South-East Asia, but since accommodation and food prices in Singapore for tourists are rising very rapidly, it is possible for Malaysia to exploit this difference in prices to her advantage.

TABLE 7-11 Singapore – Net Balance of Travel Account, 1961-70. ($m)

1961	1962	1963	1964	1965	1966	1967	1968	1969	1970
19	27	44	50	53	72	108	128	200	250

Source: R.P. Kinsella, 'The Development of Tourist Industry in Singapore, 1961-1967', University of Hull, 1968-1970. Private Communication.

Table 7-11 shows the contribution of tourism to Singapore's balance of payments from 1961-70. The net tourist income from 1961-70 supports the view that there are potentials for tourism in this area.

The potential for a spill-over effect into Johore Bahru is there. Tourist psychology of having crossed the frontier into another country should be

[41] H. David Davis, 'Potentials for Tourism in Developing Countries', *Finance and Development*, Vol. 5, No. 4, December 1968, p. 35.

exploited. The city and centre of Singapore is only about fifteen miles from Johore Bahru. Tourists, including Singaporeans, can also be attracted to the better beaches in Johore.

It is suggested that the types of hotel which have the greatest potential are those where accommodation charges are low and/or in the medium price range relative to accommodation charges in Singapore. Tourists who can afford luxury hotels do not usually make any distinction in accommodation prices and so are not likely to be attracted on this basis. This recommended range of hotels has the added advantage that investment is relatively small when compared to investment in luxury hotels. Hotels in this price range are normally used for package tours.

Finally, Malaysia has been selected to be host to the Pacific Area Tourist Travel Association (PATA) Conference in 1972. The importance of this to Malaysia, according to the research director of PATA, is that during the next few years, PATA will regularly promote Malaysia as a tourist country.[42] The five nation Association of South-East Asian Nations is also making joint efforts to boost tourism.

However, it is difficult to be sure about the potentials of the tourist industry. This is because, by its nature, tourism differs from other sectors of the economy, since it is an industry based on movements of people rather than on goods, and is particularly susceptible to subjective considerations quite apart from the play of economic forces. Social and political factors, psychological attitudes, changes of fashion and trends may all influence the course of tourism development markedly and unpredictably.

Apart from the unpredictability, the potentials of the Malaysian tourist industry as a source of foreign exchange earnings may be summed up by quoting the research director of PATA, '...Malaysia occupies a unique position in this region by being centrally located to a number of important tourist-dominated countries such as Australia, United States, Japan and Europe. Malaysia has more than a fighting chance to become an important tourist destination in this part of the world.'[43]

[42]The 1965 PATA conference in South Korea has probably affected the Korean tourist industry. '...A Southern Korean tourist official proclaimed that since his country hosted the 1965 PATA conference tourism in his country had increased 800%, totalling 250,000 last year (1971). *Financial Times*, 21 February 1972, p. 18.

[43]*Malaysian Digest*, 31 October 1970, p. 6.

CHAPTER VIII
PENINSULAR MALAYSIA AND THE DEVELOPING COUNTRIES

This study of Malaysia's balance of payments has been centred upon two main aspects. The first has been an analysis of the causes of balance of payments movements while the second has considered balance of payments policies. In conclusion, the main characteristics of the Malaysian balance of payments and policies are now restated within the framework of developing countries. This is to place Malaysia's balance of payments in perspective with respect to other developing countries.

BALANCE OF PAYMENTS CHARACTERISTICS

Bernstein has defined a proper balance of payments as '...one that enables a country over an average of good years and bad to meet its payments (including ordinary capital outflow) out of its receipts from current transactions and ordinary capital inflow, without compelling it to keep economic activity below a desirable level or to restrict imports merely for the purpose of avoiding a deficit in its balance of payments.' [1]

The average of the cumulative total of the Malaysian balance of payments over a number of years is a more reliable indicator of the state of the balance of payments than yearly changes. Yearly changes in the balance of payments can be due to temporary factors and this has been particularly true for Malaysia.

An average for two five-year periods has been taken. They have been chosen to coincide with the Second Malaya Plan, 1961-5, and the First Malaysia Plan, 1966-70. If considered in this way, the Malaysian balance of payments has been in surplus during the 1960s. The average surpluses for the periods 1961-5 and 1966-70 were $4.3m and $42.4m. respectively. The average of $4.3m. for the first five-year period may seem low but the fact remains that it was positive in spite of the Indonesian Confrontation, 1963-6.

A similar conclusion of Malaysia's favourable situation can also be drawn when a comparative study of Malaysia's average balance of payments is made with respect to developing countries in general.

Table 8-1 shows the average balance of payments summaries for developing countries for the period 1964-9. The average trade balance (column 3) of Malaysia has been in surplus and the same is true for developing countries in

[1] E.M. Bernstein, 'Strategic Factors in Balance of Payments Adjustment', *IMF Staff Papers*, 1956-1957, Vol. 5, Washington, D.C., p. 159.

TABLE 8–1 Primary Producing Countries – Less Developed Areas – Average Balance of Payments Summaries, 1964-9,[1] US. $m.

	Exports (f.o.b)	Imports (f.o.b)	Trade Balance	Services and Private Unrequited Transfers	Goods, Services and Private Unrequited Transfers	Central Govern-ment Capital and Aid	Private Long Term Capital	Basic Balance	Errors and Omissions including short-term Capital	Total
	1	2	3 (1+2)	4	5 (3+4)	6	7	8 (5+6+7)	9	10 (8+9)
Latin America	11,449	−10,289	1,160	−2,616	−1,456	740	1,078	362	209	571
Asia	7,960	−10,893	−2,933	323	−2,610	2,352	565	307	− 51	256
Middle East	5,339	− 4,835	954	−1,553	− 599	672	214	287	−239	48
Africa	4,889	−3,969	920	−1,227	− 307	411	308	412	4	416
Total	29,637	−29,536	101	−5,073	−4,972	4,175	2,165	1,368	− 77	1,291
Malaysia	1,292	− 1,067	225	− 195	30	23	74	127	−112	15

[1]Though balance of payments summaries for 1961-3 are available in IMF Annual Reports, the imports are given on a c.i.f. basis. For this reason, the time-series chosen is from 1964.

Source: Computed from IMF, *Annual Report*, 1964-70.

general. However, for Asia, the average trade balance has been in deficit. Malaysia is classified in this group and so could be said to be atypical of developing countries in Asia.

Another significant feature of Table 8-1 is that the average current balance (column 5) of Malaysia has been in surplus for the period under review. This is in contrast to the deficits for developing countries in general, and highlights Malaysia's strong trading position.

The average overall balances (column 10) of Malaysia and developing countries have been in surplus. However, it can be deduced from Table 8-1 that the favourable overall balances of some developing countries (especially for Asian countries) have been due to the inflow of aid, inter-government funds and private long-term capital. The inflow of capital has more than offset the average deficits in the current balances, whereas in Malaysia the average current balance has been positive;

In general, the four typical causes of deficits in the balance of payments of developing countries are temporary shortfall of export receipts, deficits due to unsatisfactory long-term trends of export receipts, deficits due to excess demand and deficits due to the over-valuation of currency.[2] These causes may affect the balance of payments singly or collectively.

Malaysia's balance of payments deficits were mainly caused by temporary shortfalls in export receipts. In this respect, Malaysia is no different from other developing countries. The shortfalls in export receipts in Malaysia have been due to fluctuation in rubber prices around a decreasing trend. However, Malaysia has been fortunate in that there has been a certain amount of built-in stabilization because of the growing importance of timber and palm oil. The contribution of tin, the second largest export, has been fairly stable.

It could also be argued that deficits in Malaysia have been due to an unsatisfactory long-term trend of export receipts, which has two aspects. First, it may be due to a falling trend in export receipts over a long period due to circumstances beyond the exporting country's control. Second, it may be due to simple stagnation of export receipts or, at least, to increases which are considered inadequate to meet rising imports.

The second aspect is relevant to the Malaysian case. Although the supply of exports has increased in volume, the average annual rate of import growth form 1960-70 has been larger than the average annual rate of export growth for the same period. The average annual import growth rate was 4.6% while the export growth rate was 3.9%. In this respect, Malaysia's deficits have been typical of developing countries in Latin America and Asia, but not of Africa.

[2] Paul Host-Madsen, 'Balance of Payments of Developing Countries, Part II', *Finance and Development*, Vol. IV, No. 4, 1967, pp. 310-7.

The average annual growth rates of exports and imports of developing countries for 1964 to 1969 is given in Table 8-2. The very high growth rate for African countries has been principally due to the export growth of Libya whose principal export is oil.

TABLE 8–2 Developing Countries – Average Annual Growth Rates of Exports (f.o.b.) and Imports (f.o.b.) by Regions, 1964-9.

	Exports	Imports	Difference
Latin America[1]	4.6	7.0	–2.4
Asia[1]	5.4	5.6	–0.2
Middle East[1]	10.4	9.0	1.4
Africa[2]	9.2	3.4	5.8

[1] List of developing countries given in IMF, *Annual Report, 1966*, p. 34.

[2] Consists of Ethiopia, Ghana, Ivory Coast, Libya, Morocco, Nigeria, Sierra Leone, Somalia, Sudan and Tunisia. The choice of these countries was determined by the aim to have a continuous time series from 1964-9.

The third typical cause of deficits in developing economies is deficits due to excess demand. In a sense, all developing countries face this problem. The balance of payments problems of developing countries must be seen against the background of two circumstances that dominate their entire economic being: the endeavour to improve the living standards of their people and the continuing high rate of population growth.

In Malaysia, there is a further political and economic consideration, that is, the income imbalances which coincide with the different ethnic groups as well as the different economic sectors.[3]

[3] In the Second Malaysia Plan, 1971-1975, the average incomes of workers in the five sectors of the economy are given as follows:

Modern Urban Sector – high
Modern Rural Sector)
Government Sector) – medium
Traditional Urban Sector)
Traditional Rural Sector) – low

Besides these differences in the levels of income between the sectors, there are also racial income differences. These arise as a result of the identification of race with economic activity. With the major proportion of working Malays still in the traditional rural sector and with a good portion of working non-Malays in the medium urban sector and the modern sector, Malay incomes are generally lower than non-Malay incomes. Second Malaysia Plan, 1971-1975, pp. 37-38.

As a result of the first two basic circumstances and, more lately, the last mentioned factor as well, the Malaysian Government's budget has persistently been in deficit during the sixties and will continue to be so in the seventies.[4] In this sense, there is some excess demand. Madsen has argued that this type of deficit must be regarded primarily as a problem of development rather than as a balance of payments problem.[5]

Another indicator of excess demand in Malaysia has been the rate of money creation. A conclusion of Chapter V was that it has not been excessive, and the average rate was 8.2% for 1961-70. For the same period, the average growth rate of Gross National Product was 6.0%.

The statistics of Table 8-3 show that only developing countries in Group C do have an inflationary rate of money creation. Countries of Group A have an average rate of money creation which is less than the average growth rate of the Gross National Product.

TABLE 8-3 Developing Countries – Ratio of Average Annual Growth Rate of Demand Deposits to Average Annual Growth Rate of Gross National Product,[1] 1964-70.

Group A – Less than 1	Group B – Almost 1	Group C – Greater than 1	
Ethiopia	Argentina	Malta	Bolivia
Guyana	Brazil	Mexico	Ecuador
Ghana	Ceylon	Pakistan	Honduras
Indonesia	Chile	Paraguay	India
Kuwait	Colombia	Philippines	Kenya
Libya	Cyprus	Portugal	Korea
Nicaragua	El Salvador	Saudi Arabia	Panama
Trinidad and Tobago	Guatemala	Singapore	Turkey
	Iran	Spain	Venezuela
	Iraq	Thailand	Dominican Republic
	Israel	Tunisia	Sudan
	Jordan	Uruguay	
	Malawi	Zambia	
	Malaysia		

[1] For actual average figures, see Table 8 in Appendix 3.

Source: Computed from IMF, *International Financial Statistics*, Vol. XXIV, No. 12, December 1971.

[4] The majority of developing countries have a deficit budget from 1964-70. See Table A-6 Appendix IV.

[5] Paul Host-Madsen, 'Balance of Payments of Developing Countries, Part I', *Finance and*

A further cause for excess demand is inflation which results from the rise in domestic prices, costs and incomes. It was noted that the graduated export tax on rubber and the net investment payments (with a time-lag of a year) have acted as automatic anti-inflationary measures. In Chapter III it has been shown that in spite of the limitations of the Retail Price Index as an indicator of the extent of inflation in Malaysia, there was little or no inflation during the sixties. Malaysia's relative position can be seen from Table 8-4. This examination of the three causes of excess demand indicates that Malaysia was not typical of developing countries.

Finally, deficits in developing countries are caused by over-valuation of currency, but this does not apply to Malaysia (see Chapter IV).

A few main features of Malaysia's balance of payments deserve some comment. The first two are atypical of a developing country. Firstly, Malaysia's debt service ratio was less than 2% from 1961-8. This is an insignificant ratio and must be considered unusual for a developing country. It is substantiated by the statistics of Table 8-5.

In Chapter IV it was shown that the level of Malaysia's foreign exchange reserves has been more than adequate with respect to currency backing, money supply and the balance of payments deficits. No definite conclusion can be drawn about the adequacy of foreign exchange reserves with respect to various qualitative criteria, which were with respect to the 'degree of balance of payments ease', the credit-worthiness of the country and the required volume of reserves needed to affect the quality of restoration of balance, not just the timing.

A conclusion of Chapter III was that 'errors and omissions including short-term capital movements' were large and negative from 1961 to 1969.[6] It appears that most primary producing countries show negative 'errors and omissions' as well.[7] This can also be seen from Table 8-1 (column 9).

It is also worthwhile to note that the average Malaysian 'errors and omissions including short-term capital movements' has been larger than the average for developing countries for the period 1964-9.

The net transfer payment of about $200m. annually for the period 1961-9 is another notable feature of Malaysia's balance of payments. This may or may not apply to developing countries. An indication which suggests that Malaysia's net annual payments are atypical of developing countries in general is the net transfer receipts for developing countries in 1965. (See Table 8-6).

Finally, Malaysia has provided and continues to provide a favourable climate for private foreign investment, not only in the manufacturing sector but also in

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Development, Vol. IV, No. 2, 1967, p. 118.

[6] A IBRD study of Malaysia has estimated that about one-third of 'errors and omissions' is due to short-term capital flight.

[7] Sven Grassman, *op. cit.*, p. 44.

TABLE 8–4 Developing Countries – Changes in the Consumer Price Indices[1] between 1962 and 1968 (1963=100)

Above 201%	101–200%	51–100%	21–50%	11–20%	6–10%	5% and less
Uruguay	Korea	Peru	Spain	Ceylon	Iran	Guatemala
Brazil		Colombia	Turkey	Haiti	Dominican Republic	Malaysia
Vietnam		Ghana	Bolivia	Jamaica	El Salvador	Venezuela
Chile		India	Pakistan	Mexico	Sudan	
Argentina			Somalia	Tanzania	Malta	
Indonesia			United Arabs Republic	Iraq		
			Sierra Leone	China Rep.		
			Israel	Nicaragua		
			Tunisia	Thailand		
			Ecuador	Morocco		
			Philippines	Nigeria		
			Trinidad and Tobago	Kenya		
				Costa Rica		

[1] The term Consumer Price Index is synonymous with Retail Price Index.

Source: Computed from *International Financial Statistics*, December 1969.

TABLE 8-5 Developing Countries – Average Service Payments on Public Debt as percentage of Exports of Goods and Services, 1962-9.

	1962	1963	1964[a]	1965	1966	1967	1968	1969
Africa	4.5	4.5	4.0	4.7	4.6	5.5	6.5	6.7
East Asia	1.7	1.7	1.8	3.8	3.9	4.1	4.4	4.9
South Asia	8.4	9.0	12.4	9.4	11.1	14.9	15.9	18.0
Latin America	15.1	13.5	15.1	8.1	8.4	8.9	10.4	9.7
Southern Europe	6.6	6.7	6.5	7.6	6.4	6.1	6.2	7.1
Middle East	14.0	12.4	23.5	7.9	7.5	6.3	7.5	8.8
Mean Average	8.4	8.0	10.6	6.9	7.0	7.6	8.5	9.2
Malaysia (average 1.5)	0.8	0.9	1.4	1.2	1.4	2.1	2.1	2.2

a) The number of developing countries for all categories until 1964 is less than the same categories after 1965.

Source: Computed from World Bank and International Development Association, *Annual Report, 1966-1967,* pp. 32-33, *Annual Report, 1971,* pp. 64-65.

TABLE 8–6 Developing Countries – Net Transfer Receipts, 1965, (US. $m)

Latin America	Africa	Middle East	South Asia	East Asia	Southern Europe	Total
2	14	125	102	92	710	1,135

Source: Lester B. Pearson, *Partners in Development,* Praeger Publishers, 1969, p. 310.

the primary export sector. This is in addition to maintaining a mainly free market economy as well as pursuing fiscal and monetary policies which ensured a high degree of financial stability.[8]

As a result of these factors, foreign ownership in the primary and commercial sectors of the Malaysian economy has contributed significantly to the balance of

[8]H. Myint, *South East Asia's Economy, Development Policies in the 1970's,* Penguin Books, 1972, p. 29.

payments in generating foreign exchange as well as in causing an outflow of capital. Table 8-7 indicates that the ratio of net investments to exports[9] for Malaysia has been around 8% from 1964 to 1968. Within the context of developing countries, it might be concluded that Malaysia is in a Group (C) where the burden of interest payments, remittances of profits and dividend payments (i.e. investment income) has not been too taxing. Group D consists of countries in which the ratios are in favour of the developing countries.

No further meaningful comparison can be made between developing countries with respect to foreign ownership without a detailed study of the foreign sectors in these other developing countries. The disadvantage of a foreign sector in terms of capital repatriation and the growing equity problem has been noted. A further conclusion was that the complete displacement of foreign investments was not a viable alternative.

BALANCE OF PAYMENTS POLICIES

In principle, the methods available to developing countries for correcting deficits in the balance of payments are the same as those available to developed countries. In practice, however, this may not be so. This is not intended to suggest that economic theory as derived from advanced countries is generally inapplicable to developing countries in the sense suggested by Boeke.[10]

For Malaysia, it has been shown in Chapter IV that monetary policies in terms of changes in interest rates, liquidity ratios, variable statutory ratios and open market operations are not likely to be effective as balance of payments mechanisms. There are a number of reasons for this. The dominance of foreign-owned commercial banks was a significant factor. This means that these banks have easy access to foreign exchange from their head offices. Foreign commercial banks may still see their main functions as the provision of credit for trade (mainly the financing of exports and imports, including plantation agriculture).

A second reason was that interest rate changes were mainly determined by international financial centres. Thirdly, the money-market was not well integrated. The market for treasury bills was a 'captive' market. At this stage of the development of the Malaysian economy, treasury bills may be seen more as a means for raising government funds than as an instrument for influencing the required changes in the money supply, therefore interest rates have to be low. Official

[9] It should be noted that the ratios do not indicate the magnitude of foreign ownership but rather the extent of outflow of funds by foreigners. A high ratio could be the result of a higher volume of profits accruing to a foreign enterprise. The extent of foreign ownership of an economy may be small relatively but the returns to investment may be large.

[10] J.H. Boeke, *Economics and Economic Policies of Dual Societies*, New York, Institute of Pacific Relations, 1953. Boeke believes that a transference of western theory to an eastern society is not applicable, p. 143.

TABLE 8-7 Developing Countries – Ratio of Investment Income to Exports (f.o.b.), 1964-8.

	1964	1965	1966	1967	1968
Group A – Generally above 30% – Ratio of Investment Payments to Exports					
Chile	18	18	22	24	24
Jamaica	18	20	20	22	21
Panama	11	22	22	21	22
Puerto Rico	23	24	24	24	25
Surinam	31	25	17	19	32
Venezuela	27	29	29	28	28
Iran	32	32	32	33	35
Iraq	41	41	41	41	42
Saudi Arabia	36	36	38	37	37
Libyan Arab Republic	32	24	23	23	28
Nigeria	13	20	26	17	26
Group B – Around 10–19% – Ratio of Investment Payments to Exports					
Brazil	13	16	16	18	15
Colombia	19	20	16	12	9
Costa Rica	9	12	11	12	11
Dominican Republic	11	10	14	14	12
Ecuador	12	14	13	12	13
Guyana	17	14	17	13	13
Haiti	16	14	11	13	8
Honduras	7	10	11	13	9
Nicaragua	5	9	11	13	16
Peru	11	13	16	19	17
Trinidad and Tobago	18	15	14	15	14
Israel	15	14	12	13	12
India	12	16	17	17	15
Kenya	12	11	14	18	17
Malawi	18	20	19	20	17
Sierra Leone	10	14	10	16	11
Zambia	17	3	14	11	11
Bolivia	3	3	–	12	15
Group C – Less than 10% – Ratio of Investment Payments to Exports					
Argentina	7	4	10	8	10
El Salvador	4	4	5	3	4
Guatemala	7	6	8	10	12

Mexico	3	3	3	4	4
Paraguay	7	5	7	12	10
Uruguay	9	8	10	16	8
Cyprus	8	1	5	—	1
Syrian Arab Republic	3	2	1	1	1
United Arab Republic	3	3	2	4	4
Ceylon	2	1	2	3	3
Republic of China	—	1	—	—	2
Indonesia	15	15	7	8	9
Korea	2	1	—	+	1
Malaysia	8	8	9	7	8
Pakistan	8	8	9	9	11
Congo	1	1	2	—	2
Ethiopia	4	3	4	7	8
Ghana	6	8	7	8	10
Mali	—	5	5	5	5
Mauritius	—	1	—	1	1
Morocco	4	7	10	8	10
Somalia	—	—	3	—	3
Sudan	3	3	4	4	4
Tanzania	5	7	7	7	3
Togo	—	14	4	6	8
Tunisia	3	7	8	12	14
Uganda	—	—	8	9	9
Group D — Ratio of Investment Receipts to Exports					
Jordan	25	21	31	31	35
Burma	2	—	—	1	1
Singapore	2	2	2	2	2

Source: Computed from IMF, *Balance of Payments Yearbook, 1970*, Vol. 21, pp. 5-15.

control of capital funds was considerably reduced by the existence of the unofficial money-market in the form of the 'chit' and 'tontine' systems. The first three restraints appear to be also generally true for developing countries. Snyder[11] also concluded that until a fully developed tripartite system (the Central Bank, the commercial banks and the non-banking private sector) is created, open market operations will necessarily remain a more limited instru-

[11] W.W. Snyder, *op. cit.*, pp. 6-7.

ment of monetary policy in a developing than in a financially mature economy.

However, the most important reason was that Malaysia's balance of payments deficits were temporary and caused by fluctuating export prices. It is difficult to use any monetary policies because it is not easy to ascertain to what extent a shortfall of export receipts is temporary. The time-lag before the effects of a change in policy can be felt is a far more serious obstacle. This inability to offset temporary price fluctuations through monetary policies is probably true for most developing countries as well. Snyder holds a similar view with respect to the effectiveness of monetary policy in developing countries. His conclusion is that '...the potential effectiveness of monetary policy is more limited in a developing country than in one already financially mature, if reliance is placed on the traditional instruments alone'.[12]

Changes in exchange rates can be used as a balance of payments mechanism and could be applicable to all economies. Devaluation can be an effective tool, but in Malaysia and many developing countries the effects of devaluation may need to be analyzed in terms of a dual economy. The lower income groups of the rural sector have a low marginal propensity to imports. Thus higher prices of imports may not affect this sector.

In terms of an exchange rate policy, Malaysia is not typical of developing countries. Malaysia has assumed Article VIII status, has a unitary exchange rate system and has a very stable currency. On the other hand, most developing countries have accepted Article XIV status,[13] have implemented a multiple exchange rate system and do not, as a rule, have particularly stable currencies. In addition, in Malaysia there is a minimum of restrictions on foreign exchange and capital movements.

Perhaps as a result of the ineffectiveness of monetary policies, non-monetary policies are frequently used by developing countries to offset deficits or to help improve their balance of payments prospects in the long run. The most important non-monetary policies are those of import substitution and import restriction.

An import substitution policy is usually seen as a long-term policy by most developing countries. Malaysia is no exception. It has been noted that balance of payments deficits can at times be directly associated with particular investment decisions, especially in import substituting industries. It is generally admitted that the determination of an optimum investment pattern is not an easy task. Nevertheless, Malaysia's investment in the import substitution of rice cannot be justified on productivity considerations.[14] The study of import substitution in

[12] *Ibid.*, p. 12.

[13] Out of a total 111 member countries, thirty-four countries have accepted Article VIII. Of these, twenty are developing countries.

[14] Apparently, other South-East Asian countries such as Indonesia and the Philippines are

the manufacturing sector was less conclusive on balance of payments grounds.

Import restrictions are generally seen as a short- and medium-term policy to offset balance of payments deficits. An import restriction policy is also used to supplement an import substitution policy. Import restriction either in terms of physical quotas, licensing or in terms of tariffs and taxes or foreign exchange rationing is widely used by developing countries. Malaysia does have some degree of import restriction though foreign exchange rationing has not been used.

Malaysia's import restriction policy during the sixties involved principally the use of some combination of direct controls and taxes on trade.

Direct controls in Malaysia took the form of quantitative restrictions, and the more severe controls have been on rice and the motor industry. The variable ratio of permitted imported rice to local production has already been noted in Chapter VI. The import quotas for the motor industry were as follows: for the period August 1966 – February 1967, the quota for passenger cars was 110% of the average imports for 1961/5 and 80% for commercial vehicles.[15] The quota became more restrictive for the period September 1968-February 1969, when the quota for passenger cars was 1% of 1966 sales, for commercial vehicles, 1% of 1966 sales, or nil, depending on weight, and lastly 50% of 1966 sales for motor cycles, and nil for scooters.[16]

Another form of restriction was that, as from August 1965, Malaysian government agencies were required to purchase locally-made goods whenever their prices did not exceed by more than 10% those of comparable foreign goods. Prior to this, the margin was 5%.

Finally, almost all imports into Malaysia (excluding Penang and Labuan) are subject to a surtax of 2% for re-exports or for exports after processing.[17]

A significant feature of the overall import restriction policy of Malaysia was that the degree of protection has been one of the least restrictive in Asia. An ECAFE study of protection of trade of developing countries in Asia has classified developing countries into three categories namely,

1. Those that apply a minimum of import control;
2. Those which institute a comprehensive import control system through

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also seeking national selt-sufficiency in rice production. For Indonesia, there appear to be somewhat limited opportunities for using the abundant labour supply other than in food production. Myint believes that there seem to be strong economic reasons for Indonesia pushing ahead with her rice expansion programme. However, there may be less justification for the Philippines in pursuing a similar policy. Myint's conclusion is that Malaysia appears to be going against the grain of her most advantageous pattern of economic development by trying to achieve self-sufficiency in rice, See H. Myint, *op. cit.*, pp. 50-52.

[15] IMF, *18th Annual Report, Exchange Restrictions, 1967, pp. 411-2.*

[16] IMF, *20th Annual Report, Exchange Restrictions, 1969*, pp. 303-5.

[17] IMF, *21st Annual Report, Exchange Restrictions, 1970*, p. 324.

quantitative restrictions, foreign exchange budgeting and/or other measures, and

3. Those which aim at achieving complete control over imports through state trading or nationalisation of import trade.[18]

The ECAFE study concluded that three developing countries belonged to group (1) – Malaysia, the Philippines and Thailand.

This view is supported by an IBRD study of Malaysia in 1968.[19] The economy of Malaysia is open and tariff protection has been used sparingly in comparison with other developing countries as illustrated by Table 8-8.

TABLE 8-8 Average Effective Rates of Protection on Manufactured Goods (in per cent of domestic value added)

	Processed Materials	Intermediary Products	Non-durable Consumer Goods	Consumer Durables	Equipment	All Manufactures
Pakistan	138	173	156	510	109	189
Chile	100	195	300	123	89	112
Brazil	96	103	94	132	53	69
Philippines	28	40	40	81	22	48
Malaysia	9	25	20	−5	9	8

Source: IBRD, *Economic Mission to Malaysia*, 1968, unpublished, p. 84.

This study shows that the Malaysian balance of payments has been favourable during the sixties even if an accounting period of longer than a year is adopted. However, the deficits whenever they occured were temporary in nature and due to shortfalls in export receipts. In this respect, Malaysia is no different from the other primary producing countries. Apart from this, the Malaysian balance of payments has exhibited several favourable characteristics which were not typical of developing countries.

This may partly account for the comparatively low degree of import restrictions and the maintenance of a very stable currency during this period. The minimum level of restrictions on foreign exchange and capital movements may be taken as further reflections of the favourable conditions during the sixties.

[18] ECAPE, *The Asian Development Bank and Trade Liberalization*, 1965, p. 110.

[19] IBRD, 1968, *op. cit.* p. 84.

APPENDICES

APPENDIX I

The 'Ticket System' as a Source of Balance of Payments Statistics

The foreign exchange 'ticket system' was established jointly by the Department of Statistics and Bank Negara in 1961 for the sole purpose of compiling balance of payments statistics. Any individual or firm which needs foreign exchange would have to fill in a 'ticket' (form). This is also true when one wants to change foreign currency to Malaysian currency or vice versa. Modifications were made to the system in August 1967 since the data previously collected was not comprehensive enough to enable the invisible account of the balance of payments to be compiled. The main fault was that the system did not attempt to cover transactions with Singapore and Brunei when they shared a common currency. This represented a coverage deficiency, in that expenditure relating to Singapore or vice versa was not covered by the foreign exchange statistics since the same currency was used. It was also known that a substantial number of foreign exchange transactions took place through Singapore and so by-passed the 'ticket system'. It is questionable whether this problem is in fact solved even with the 1967 modifications.

The significant modifications were as follows:

1. Only foreign transactions amounting to an equivalent of 500 dollars or more were to be recorded, unlike previously where all transactions irrespective of the value were recorded. The rationale behind this was that transactions of less than 500 dollars were insignificant from the point of view of balance of payments statistics compilation. However, all transactions in travellers cheques and remittances to Malaysian abroad for educational purposes were included irrespective of their value.
2. Due to the difficulty of obtaining the true nature of transactions, simple and clear cut multiple choice types of 'nature of transactions' were categorized for banks to identify. A further category 'all other transactions' (described in full) was provided for transactions which could not be found in the multiple choice categories.
3. Until 12 June 1967, Singapore and Malaysia shared a common currency issued by the Board of Commissioners of Currency, Malaya, Singapore with British Borneo. With the introduction of the new Malaysian, Singapore and Brunei dollars in June 1967, it is now possible to record such transactions in Singapore and Brunei dollars separately, as for any other foreign currency. The present system does not require separate tickets written for individual transaction in these currencies. Such transactions are covered in the monthly reconciliation statements of banks where the aggregate value of gross receipts and payments in these currencies are reported.

As indicated earlier, the 'ticket system' provides information for balance of payments compilation. The table below is an attempt to show how the data from tickets (forms SA and SB, given after the Appendix) can be used. The attempted

classification of the items into a format based on the standard global balance of payments presentation from the tickets involves a double-entry system. The entries in the receipts/payments are carried out in alphabetical letters which follow the two forms (SA and SB) in the ticket system.

TABLE A.1 Malaysia – Arrangement of Statistics from the Ticket System on a Global Balance of Payments Format.

A. *Goods and Services (1 through 8)*	Receipts of Foreign Exchange	Payments of Foreign Exchange
1. Merchandise (Exports: rubber, tin, timber, other exports, f.o.b.)	a	a
2. Non-monetary gold	—	—
3. Freight and insurance		
Receipt/remittance by shipping, airline companies and agencies	b	b
Receipt/remittance by insurance companies and agencies	c	c
4. Other transportation	—	—
5. Travel – purchases/sales of travellers cheques	d	d
6. Investment income-dividends	e	e
interests and other	f	f
7. Government (n.i.e.)		
8. Other services-remittances of education		
abroad	g	g
commissions, brokerage, agency fees	i	i
films rental, royalties	j	j
advertising, consultation fees, subscription, royalties	k	k
B. *Transfer Payments*		
9. Cash gifts, maintenance allowances and transfers by individuals	h	h
10. *Central Government*	—	—
C. *Capital and Monetary Gold*	—	—
11 & 12 *Private long-term and short-term capital*		

Loans received/extended by individuals and companies	j	m
Loans repayments received/repayments by individual companies	k	n
Receipts from sale or redemption of foreign bonds by individuals and companies	l	–
Payments for purchase of foreign bonds by individuals and companies		o
Receipts from sales of stocks and shares by individuals and companies	m	–
Payments for purchases of stocks and shares by individuals and companies	–	P
Remittances and transfers from/to head office, parent company and associated companies abroad	n	q
Remittances and transfers received by Malaysian company from/to their branches and subsidiaries abroad	o	r
Transfers by companies from/to their bank accounts abroad	p	s
All other transactions receipts/remittances by individuals and private institutions	u	x
13 & 14 Local and Central Government		
Receipts from sales of Malaysian government bonds	i	–
Payments for purchase or redemption of Malaysian government bonds	–	l
Loans received/extended by government and public authorities	j	m
Loans repayments received/repayments by government and public authorities	k	n
Receipts from sale or redemption of foreign bonds by government and public authorities	l	–
Payments for purchase of foreign bonds by government and public authorities	–	o
Receipts from the sale of stocks and shares by government and public authorities	m	–
Payments for purchase of stocks and shares by government and public authorities	–	p
Other transactions receipts/payments by government and public authorities	n	x

15. Central Monetary Institutions		
16. Other Monetary Institutions		
Loans received/extended by banks	j	m
Loans repayments received/repayments by banks	k	n
Receipts from sale or redemption of foreign bonds by banks	l	—
Payments for purchase of foreign bonds by banks	—	o
Receipts from the sale of stocks and shares by banks	m	—
Payments for purchase of stocks and shares by banks	—	p
Transfers to/from Malaysian dollar accounts held for banks outside Malaysia	r	u
Other Financial Flows and Transactions not identifiable		
Repatriation of foreign currency, notes, coins	q	—
Payments for purchases of Malaysian currency notes and coins from abrod		t
Purchases and sales of foreign exchange to banks outside Malaysia	t	w
Purchases and sales of foreign exchange from banks in Malaysia	s	w

Source: Forms SA and SB

SPECIMEN

CONFIDENTIAL

DEPARTMENT OF STATISTICS, MALAYSIA

FORM SA: TICKET SYSTEM – RECEIPTS OF FOREIGN EXCHANGE

The information contained in this return is required under authority of the Statistics Act, 1965, and will be treated as Confidential.

This form need not be completed for receipts of less than M$500 (except for purchases of travellers' cheques) and receipts in Singapore and Brunei dollars.

FOR OFFICIAL USE ONLY

(1) Bank: _____

Head Office/Branch: _____ (2) Date: _____

(3) Amount in Malaysian Dollars: M$ _____

(4) Name of Currency Received (US$, Sterling, Aust.$, etc.): _____

(5) Country of Payer: _____

(6) Nature of Transaction: (Insert X in appropriate ☐)

(a) ☐ Exports ☐ f.o.b. ☐ c.i.f., etc. ☐ not known

- ☐ Rubber
- ☐ Tin
- ☐ Timber
- ☐ Other exports

(b) ☐ Receipts by shipping and airline companies and agencies

(c) ☐ Receipts by insurance companies and agencies

(d) ☐ Purchases of travellers' cheques

(e) ☐ Dividends on stocks and shares

(f) ☐ Interest and other investment income

(g) ☐ Receipts by foreign diplomatic and military missions in Malaysia

(h) ☐ Cash gifts, maintenance allowances and other remittances received by individuals

(i) ☐ Receipts from sales of Malaysian Government bonds

(j) ☐ Loans received by
- ☐ Government and public authorities
- ☐ banks
- ☐ individuals and companies

(k) ☐ Loan repayments received by
- ☐ Government and public authorities
- ☐ banks
- ☐ individuals and companies

(l) ☐ Receipts from sale or redemption of foreign bonds by

(m) ☐ Receipts from the sale of stocks and shares by

(n) ☐ Remittances and transfers from head-office, parent company and associated companies abroad

(o) ☐ Remittances and transfers received by Malaysian companies from their branches and subsidiaries abroad

(p) ☐ Transfers by companies from their bank accounts abroad

(q) ☐ Repatriation of foreign currency notes and coins

(r) ☐ Transfers to Malaysian dollar accounts held for banks outside Malaysia

(s) ☐ Purchases of foreign exchange from banks in Malaysia

(t) ☐ Purchases of foreign exchange from banks outside Malaysia

(u) All other transactions (describe in full)

(i) Nature of transaction: _____

_____

_____

_____

(ii) Receipts by
- ☐ Government and public authorities
- ☐ individuals and private institutions
- ☐ companies (Name: _____

_____

SPECIMEN

CONFIDENTIAL

DEPARTMENT OF STATISTICS, MALAYSIA

FORM SB: TICKET SYSTEM – PAYMENTS OF FOREIGN EXCHANGE

The information contained in this return is required under authority of the Statistics Act, 1965, and will be treated as Confidential.

This form need not be completed for payments of less than M$500 (except for sales of travellers' cheques) and payments in Singapore and Brunei dollars.

FOR OFFICIAL USE ONLY

(1) Bank: _____

Head Office/Branch: _____ (2) Date: _____

(3) Amount in Malaysian Dollars: M$ _____

(4) Name of Currency Paid (US$, Sterling, Aust. $, etc.): _____

(5) Country of Payee: _____

(6) Nature of Transaction: (Insert X in appropriate ☐)

(a) ☐ Imports ☐ f.o.b. ☐ c.i.f., etc. ☐ not known

(b) ☐ Remittances by shipping and airline companies and agencies

(c) ☐ Remittances by insurance companies and agencies

(d) ☐ Sale of travellers' cheques

(e) ☐ Dividends on stocks and shares

(f) ☐ Payment of interest and other investment income by ☐ Government and public authorities ☐ others

(g) ☐ Remittances for education abroad

(h) ☐ Cash gifts, maintenance allowances and transfers by individuals to their bank accounts abroad

(i) ☐ Commissions, brokerage and agency fees

(j) ☐ Film rentals and royalties

(k) ☐ Advertising, consultation fees, subscription and royalties

(l) ☐ Payments for purchases or redemption of Malaysian Government bonds

(m) ☐ Loans extended by ☐ Government and public authorities ☐ banks ☐ individuals and companies

(n) ☐ Loan repayments by

(o) ☐ Payments for purchase of foreign bonds by ☐ Government and public authorities ☐ banks ☐ individuals and companies

(p) ☐ Payments for purchase of stocks and shares by

(q) ☐ Remittances and transfers to head-office, parent company and associated companies abroad

(r) ☐ Remittances and transfers by Malaysian companies to their branches and subsidiaries abroad

(s) ☐ Transfers by companies to their bank accounts abroad

(t) ☐ Payments for purchase of Malaysian currency notes and coins from abroad

(u) ☐ Transfers from Malaysian dollar accounts held for banks outside Malaysia

(v) ☐ Sales of foreign exchange to banks in Malaysia

(w) ☐ Sales of foreign exchange to banks outside Malaysia

(x) All other transactions (describe in full)

(i) Nature of transaction: _____

_____

_____

(ii) Remittances by ☐ Government and public authorities ☐ individuals and private institutions ☐ companies (Name: _____

_____

APPENDIX II
The Financial Survey

The data collected from the financial survey are used for estimating the movement of capital in the private sector. The financial survey was launched in late 1967 and covered about 70% of the total number of companies. Prior to this, the company survey was used but this survey was weak in its coverage as it only included about 10% of the population of limited companies.

The financial survey in 1967 was especially designed to provide material for estimating for the company sector certain items of Malaysia's national income and expenditure, and the balance of overseas payments. The survey covered three categories of companies, namely 1) limited companies incorporated in Malaysia, locally-controlled; 2) limited companies incorporated in Malaysia, foreign-controlled; 3) Malaysian branches of limited companies incorporated abroad.

The criteria for deciding whether a company is locally- or foreign-controlled is the percentage of the voting stock held by residents and non-residents. In most cases, the locally-controlled companies are those for which over 50% of the voting stock is held by residents, whereas foreign-controlled companies are those of which over 50% of the voting stock is held by non-residents.

The questionnaires (forms X, Y, Z, Financial Survey, Department of Statistics, 1968) collected information in two main areas: details of profit and losses, capital accounts and details of transactions with non-residents. In brief, the first part sought information on current profit and loss, amount of capital transferred, details of capital account, specification of investment and disinvestment in fixed assets in Malaysia, company's holding of equity shares and also ownership of company's equity share.

The second part of the questionnaire is intended to cover all transactions of the reporting company with non-residents of Malaysia. It covers information on all settlements of the reporting company with non-residents that take place through banks in Malaysia. In sub-section 1 of part 2, entries are of two types, those of a non-capital nature for balance of payments purposes and those of a capital nature. The first type includes exports, imports, other current accounts, receipts/payments from non-residents, payment made or accruing to non-residents. The second type consists of capital transactions of the reporting company with non-residents and transfers through banks in Malaysia to or form non-resident, parent and affiliated enterprises and other shareholders.

The processing of the 1967 survey for the calendar year 1966 was completed in 1968. A presentation of the results in a balance of payments form is given in Table 1-7 which illustrates the manner in which information could be used for balance of payments purposes.

TABLE A.2 Malaysia – Use of Statistics from the Financial Survey 1966, for Balance of Payments Presentations $m.

Exports (f.o.b.)	2,633
Imports (c.i.f.)	1,659
Invisible receipts (excluding government)	41
Invisible payments (excluding government)	539
Private capital inflow: c+f	258.4
a) Foreign long-term investments in Malaysian companies (decrease –)	216.6
Direct investment	135.1
Portfolio investment	58.6
Long-term loans received	22.9
b) Long-term investment abroad by Malaysian companies (increase –)	–6.2
Direct investment	–4.2
Portfolio investment	–1.3
Long-term investment	–0.7
c) Net inflow of foreign long-term capital: a–b	210.4
d) Foreign short-term investment in Malaysian companies	124.4
e) Malaysian short-term investment abroad (increase –)	–76.4
f) Net inflow of foreign short-term capital: d–e	48.0

Source: Department of Statistics, unpublished.

APPENDIX III

TABLE A.3 Peninsular Malaysia – Balance of Payments, 1961-8 ($m).

Item	1961	1962	1963	1964	1965	1966	1967	1968
1. Exports (f.o.b.)	2609	2608	2678	2748	3079	3095	2889	3177
Imports (f.o.b.)	2093	2300	2372	2386	2499	2525	2438	2615
Visible balance	516	308	306	362	580	570	451	562
2. Non-monetary gold (net)	0.2	0.2	0.2	0.2	0.2			−2.7
3. Freight and insurance (net)	−107.7	−123.1	−129.7	−133.0	−132.7	−135.2	−135.9	−151.2
4. Other transportation (net)	−3.3	−2.1	−1.9	−5.1	−2.5	−3.0	−1.0	−1.5
5. Travel (net)	−64.0	−66.9	−65.3	−69.5	−75.5	−72.5	−63.3	−67.7
6. Investment income (net)	−213.3	−160.2	−172.2	−187.1	−295.7	−311.4	−257.6	−293.8
7. Government n.i.e. (net)	151.7	145.2	155.1	176.1	150.3	112.7	86.9	85.7
8. Other services (net)	−48.6	−42.7	−48.1	−53.6	−61.0	−64.4	−65.2	−66.1
Current account (1 to 8)	221.0	58.4	44.1	90.0	163.1	96.2	14.9	62.0
Service balance (3 to 8)	−285.3	−249.8	−262.1	−272.2	−417.1	−472.8	−436.1	−497.3
9. Private transfers (net)	−201.2	−203.2	−201.3	−194.8	−188.4	−189.0	−178.0	−173.1
Total 1 to 9	9.8	−144.8	−157.2	−104.8	−25.3	−92.8	−153.1	−108.4

Source: 1961-1964 from Department of Statistics, *Data for IMF Consultations, 1966*, pp. 61-69.
1965-1968 from Department of Statistics, *Data for IMF Consultations, 1969*, p. 6.

TABLE A.4 Sarawak – Balance of Payments, 1961-9 ($m)

Item	1961	1962	1963	1964	1965	1966	1967	1968	1969
1. Exports (f.o.b.)	389	399	361	355	426	459	498	597	623
Imports (f.o.b.)	354	370	368	390	465	504	504	540	523
Visible balance	35	29	−7	−35	−39	−45	−6	57	100
2. Non-monetary gold (net)	−28.6	−3.2	−2.6	−3.4	−1.3	−1.3	−1.0	−0.6	–
3. Freight and insurance (net)	−10.2	−10.4	−8.8	−5.6	−10.4	−12.8	−23.6	−25.5	−25.4
4. Other transportation (net)	5.4	3.0	2.5	1.6	1.8	2.0	−1.8	−1.0	−0.7
5. Travel (net)	−1.3	−1.4	−1.5	−1.8	−2.6	−3.1	−3.1	−3.2	−3.3
6. Investment income (net)	−16.1	−10.9	−11.1	−16.0	−14.0	−15.9	−8.7	−8.0	−14.1
7. Government n.i.e. (net)	−0.2	–	1.2	18.0	43.0	26.0	21.0	14.7	17.5
8. Other services (net)	−3.1	−3.4	−3.9	−6.6	−8.4	−21.7	−35.6	−45.0	−49.5
Current account (1 to 8)	−19.1	2.7	−31.1	−48.8	−32.9	−71.8	−58.8	−11.6	24.5
Services balance (3 to 8)	−25.5	−23.1	−21.5	−10.4	9.4	−25.5	−51.8	−68.0	−75.5
9. Private transfers (net)	−2.4	−2.2	−2.4	−3.8	−3.9	−4.0	−4.0	−4.0	−3.9
Total (1 to 9)	16.7	0.5	−33.5	−52.6	−36.8	−75.8	−61.8	7.6	20.6

Source: 1961-4 from Department of Statistics, *Data for IMF Consultations, 1966*, pp. 61-69
1965-9 from Department of Statistics, unpublished.

TABLE A.5 Sabah – Balance of Payments, 1961-9 ($m).

Item	1961	1962	1963	1964	1965	1966	1967	1968	1969
1. Exports (f.o.b.)	214	229	262	249	296	347	397	417	509
Imports (f.o.b.)	194	216	273	268	309	313	303	319	363
Visible Balance	20	13	−11	−19	−13	34	94	98	146
2. Non-monetary gold (net)	–	–	–	–	−1.7	−4.2	−1.4	−1.1	–
3. Freight and insurance (net)	−11.3	−12.0	−14.4	−14.7	−19.4	−17.3	−15.7	−16.5	−19.0
4. Other transportation (net)	1.9	2.3	2.0	2.0	1.6	3.0	−0.5	−0.8	1.0
5. Travel (net)	−1.6	−1.9	−2.4	−2.4	−2.5	−2.6	−2.6	−2.7	−2.8
6. Investment income (net)	−0.9	−1.0	−1.3	−5.0	−4.9	−6.8	−4.7	−4.0	−8.1
7. Government, n.i.e. (net)	0.1	0.1	2.0	12.0	32.0	25.0	12.0	9.8	9.7
8 Other services (net)	−2.7	−2.6	−2.9	−4.2	−7.5	−7.6	−7.7	−8.0	−8.5
Current account (1 to 8)	5.5	−2.1	−28.0	−31.3	−15.4	23.5	73.4	74.7	116.3
Service balance (3 to 8)	−14.5	−15.1	−17.0	−12.3	−0.7	−6.3	−19.2	−21.4	−29.7
9. Private transfers (net)	−1.7	−1.8	−2.0	−2.3	−2.7	−3.0	−3.0	−3.0	−2.9
Total (1 to 9)	3.6	0.3	−27.4	−33.6	−18.1	20.0	70.4	71.7	113.4

Source: As in Table 2-42.

APPENDIX IV

TABLE A.6 Developing Countries – Average Annual Growth Rates of Demand Deposits and Average Growth Rates of Gross National Product, 1964-70.

Group A

	Demand Deposit	Gross National Product
Ethiopia	4	8
Guyana	1	9
Ghana	6	11
Indonesia[1]	245	330
Kuwait[1]	2	10
Libya[1]	24	30
Nicaragua	5	7
Trinidad and Tobago	5	9

[1] These are countries where government budgets are not given in the international financial statistics, and one does not know whether they practise a deficit budget. The rest of the developing countries have practised deficit budgetting from 1961-70.

[2] Singapore had a surplus budget from 1968-70.

Group B

	Demand Deposit	Gross National Product
Argentina[1]	29	28
Brazil	42	45
Ceylon	6	8
Chile	39	38
Cyprus[1]	13	13
Colombia	17	16
El Salvador	6	5
Guatemala	6	6
Iran	16	13
Iraq	9	7
Israel	11	13
Jamaica	8	8
Malawi	12	11
Malaysia	9	8
Malta[1]	13	11
Mexico[1]	12	10
Pakistan	11	10

Paraguay	8	7
Philippines	11	11
Portugal[1]	9	11
Saudi Arabia[1]	8	10
Singapore[2]	9	11
Spain[1]	13	13
Thailand	12	12
Tunisia[1]	8	7
Uruguay	58	68
Zambia[1]	18	21

Group C

	Demand Deposit	Gross National Product
Bolivia	17	11
Costa Rica[1]	14	9
Ecuador	18	9
Honduras	14	7
India	13	8
Kenya[1]	17	10
Korea	41	27
Morocco	9	5
Panama[1]	15	10
Turkey[1]	20	11
Venezuela[1]	9	6
Dominican Republic	16	3
Sudan[1]	10	5

Source: IMF, *International Financial Statistics*, Vol. XXIV, No. 12, December 1971.

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This study of Malaysia's balance of payments during the sixties concentrates upon two main features – first, an analysis of the causes of balance of payments movements, and second, the motivating policies behind them.

Since Malaysia is a developing country, committed to a development programme, it is particularly concerned with the adequacy of its foreign reserves, and the pre-occupation with this particular angle of the balance of payments is a dominant feature of the book. Other developing countries with similar financial problems are compared and contrasted with Malaysia.

Consideration has been given to the methodological approach and official presentations of Malaysian statistics since a study of methodology helps in understanding the statistics quoted, although alternative presentations are suggested.

Import substitution plays an important part in planning the economy of developing countries and Malaysia is no exception in adopting such a policy. Its widespread effects on the balance of payments merit the serious consideration which it receives in this book. Other specific policies, such as the viability of a national shipping line, separate trade policies for manufactured and primary exports, and the potentials of tourism are also dealt with.

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