Financial Liberalization and Its Impact on Domestic Stabilization Policies: Singapore and Malaysia

By

Emil-Maria Claassen

I. Introduction: Real Appreciation as an Outcome of Financial Liberalization

Financial liberalization means that domestic interest rates get aligned to international ones, that credit constraints become looser in the case of a deficit of expenditures over receipts and that the menu of portfolio allocation becomes richer. From the point of view of the international economy, financial liberalization profits from the international specialization of savings and investment. A "young" country which is usually a deficit country with a higher investment than savings ratio is able to borrow from "mature" countries being in surplus.

Domestic stabilization policies become by far less autonomous under an open capital account. A monetary-fiscal policy mix which is divergent from that of the outside world may have immediate repercussion on the balance of payments (for fixed exchange rates), on the foreign exchange rate (under floating exchange rates) or on both (managed float). These repercussions may be unwarranted such that they exercise the famous external constraints on domestic stabilization policies.

Remark: The present report is an abridged version of a paper on the Singaporean and Malaysian economy I have written in June–August 1991 when I was Senior Fellow at the Institute of Southeast Asian Studies of Singapore.
Another unfavourable impact of financial liberalization concerns the possibility that it produces a real appreciation of the domestic currency with the adverse effect on the domestic supply and demand of tradable goods and, by this, on the trade balance. It is this issue on which the present study pays most attention. In particular, we ask the question whether the real appreciation could be avoided by a proper mix of domestic stabilization policies. We are dealing with two case studies, namely, Singapore and Malaysia, which both are fast growing economies, which were monetarily linked together until the early 1970s and which underwent afterwards different paths of financial liberalization. Among the various differences between both economies, a particular one is retained which is concerned with Singapore as an international financial centre what Kuala Lumpur is not.

Before we start with the empirical analysis of both countries, we illustrate our basic question within a simple theoretical framework of the Australian model (Figure 1a). The $TT$- and $NN$-lines are the partial equilibrium schedules of the markets for tradable and nontradable goods, respectively. Both categories of goods are assumed to be gross substitutes. The slope of each schedule depends on the relative price between both types of goods. Any point which is situated right to the $NN$-line ($TT$-line) represents an excess supply of nontradables (excess demand for tradables being equal to the trade balance deficit). The $MM$-line describes the equilibrium of the money market. For a given money supply, the latter determines the general price level which is compatible with different combinations of the price levels of tradable and nontradable goods, $P_T$ and $P_N$. Internal and external equilibrium exists at the intersection point $A$. The nominal equilibrium exchange rate is at the level $E_0$. The real equilibrium exchange rate ($q = P_T/P_N$) is indicated by the slope of the $Oq_0$-ray.

Assume that the concerned country implements external financial liberalization. By neglecting the impact on the domestic interest rate, we shall look only at the effect of net capital imports as a possible outcome of financial liberalization. To the extent that net capital imports are used for an additional demand of tradable and nontradable goods, the $TT$- and $NN$-lines of Figure 1a shift to $TT_1$ and $NN_1$ in Figure 1b. The new real exchange rate equilibrating the market for nontradable goods is indicated by the slope of the $Oq_1$-ray (real appreciation). Under floating exchange rates, the real appreciation is brought about by a mix of nominal appreciation ($E_1$) and of a rise in the price level of nontradables, while the general price level remains constant (point $B$). In a regime of fixed exchange rates ($E_0$), the overall