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Macroeconomic Instability Index and Malaysia Economic Performance

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Abstract

The economic performance of Malaysia was affected by a series of financial crises that had induced macroeconomic instability in the country, which in turn had immensely dampened the nation’s economic growth rate. No doubt Malaysia needs an indicator to monitor the nation’s economic performance from time to time. This study attempts to construct such indicator known as Macroeconomic Instability Index (MII). The constructed MII shows two significant spikes at 1998 and 2008, which correspond to the Asian Financial Crisis and US Subprime Mortgage respectively, that had resulted in negative growth rate for GDP of Malaysia in 1999 and 2010. Results obtained from further analysis by the ARDL technique show that MII has negative and significance effects on economic performance. Moreover, MII has predictive power against economic performance as early as two periods in advance. The constructed MII could serve as end-product for policy purposes or intermediate-product for other economic and finance studies.

Keywords: macroeconomic instability index, Malaysia, economic performance

1. Introduction

The economic performance of Malaysia was affected by a series of financial crises that had induced macroeconomic instability in the country, which in turn had immensely dampened the nation’s economic growth rate. For instance, the negative effect of 1997 Asian Financial Crisis and the 2007 US Subprime Mortgage Crisis (which turned into a fully-blown Global Financial Crisis in September 2008) caused Malaysian economy to perform poorly. These crises reduced Malaysia’s exports as well as national aggregate demand. Many businesses failed and the non-performing loan of commercial banks escalated to 22.4% in November 1998 from 6.5% in 1997, just for an instance. In 1998, the output of the real economy declined plunging the country into its first recession for many years. During that year, the ringgit plunged below 4.7 and the KLSE fell below 270 points. Foreign direct investment inflow to Malaysia in 1998 also reduced by 59% compared to 1997. As a result, the country's gross domestic product plunged 6.2% in 1998. On the other hand, after the Global Financial Crisis, the contraction in manufacturing was steepest in export-oriented sectors that are facing the full brunt of the collapse in demand in developed markets. Overall, exports fell by -7.5% in the fourth quarter of 2008 and -20% in the first quarter of 2009. Electronics exports, which was badly affected, declined by -44.0% in the first quarter and -34.6% in the second quarter of 2009. Moreover, the construction sector contracted 23.5%, manufacturing shrunk 9% and the agriculture sector 5.9%. The unemployment rate rose from 3.2% in 2007 to 3.7 % in 2008 (Zainal Abidin and Rasiah, 2009). Stock market in Malaysia also fell from a closing index of 1445.03 in 2007 to 876.75 in 2008, amounting to fall of 39.3%. Hence, it is obvious that Malaysia needs an indicator to monitor the nation’s economic performance from time to time. In this conjunction, Macroeconomic Instability Index (MII) is an important indicator of a country’s economic condition. This study aims to construct MII for Malaysia and analyses its impact on economic performance.

Macroeconomic instability was ambiguously defined back in those days, however, World Bank (1993) emphasized that budget deficit, foreign debt and the instability of exchange rates as influential factors in macroeconomics instability. In addition to this, World Bank (1993) made it clear that the foundation of macroeconomic stability in one’s country is to have a constant growth rate, moderate or low inflation rate, and taking control of external debt and currency management. Since then, studies between macroeconomic instability and growth nexus became widely explored by economists and policymakers to formulate a perfect measurement for macroeconomic instability index (MII).