THE BEHAVIOUR OF THE CURRENT ACCOUNT BALANCES OF ASEAN-5 MEMBERS

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By

HAMIZUN BIN ISMAIL

Thesis Submitted to the School of Graduate Studies, Universiti Putra Malaysia, in Fulfilment of the Requirement for the Degree of Doctor of Philosophy

June 2007
DEDICATION

To my beloved mother, Zainab.
Abstract of thesis presented to the Senate of Universiti Putra Malaysia in fulfilment of the requirement for the degree of Doctor of Philosophy

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By

HAMIZUN BIN ISMAIL

June 2007

Chairman:  Ahmad Zubaidi Baharumshah, PhD

Faculty:    Economics and Management

Current account conveys information about the actions and expectations of all market participants in an open economy; it reflects the stance of macroeconomic policies and provides information about the behaviour of economic agents. Therefore, the needs for greater understanding about the behaviour of the current account are becoming increasingly vital, as institutional structures dealing with macroeconomic policies cannot simply be copied from one country to another. This dissertation empirically examined the movement of the current account balances for the ASEAN-5 countries, namely Indonesia, Malaysia, Philippines, Singapore and Thailand, under four main issues: the intertemporal optimization approach to the current account, the twin-deficits hypothesis, the relationship between current account and investment, and the temporary and permanent
shocks of the current account balance and the real exchange rate. Several important results emerged from this study. First, the present value model effectively captures the magnitudes and directions of the current account balances for four out of five ASEAN-5 countries over the period of the study, thus favored the proposition that the countries’ expectations about future movement in net output are reflected by today’s current account. Second, the data supported the twin deficit hypothesis for the ASEAN-5 countries except Indonesia, and that the budget deficit plays a weakly exogenous role with respect to the current account deficit. This is an important finding because it implies that fiscal policy is effective in influencing current account balance. Third, our finding indicated that the ASEAN-5 have relied on domestic savings to finance their investment, thus agreeing with the proposition that developing countries only participate partially in the world’s capital market, as a result of the lack of sophisticated domestic capital market in the developing countries. Forth, our finding suggested that the temporary shock depreciates the currency so much that the current account improves over the short term, while over the longer term, the current account effect fades away as the exchange rates stabilize.
Abstrak tesis yang dikemukakan kepada Senat Universiti Putra sebagai memenuhi keperluan untuk ijazah Doktor Falsafah

GELAGAT IMBANGAN AKAUN SEMASA NEGARA-NEGARA ASEAN-5

Oleh

HAMIZUN BIN ISMAIL

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Akaun semasa negara mengandungi maklumat tentang kelakuan serta jangkaan agen-agen pasaran dalam ekonomi terbuka; ia memberi gambaran tentang pendekatan polisi makroekonomi dan kelakuan agen-agen ekonomi. Justeru itu, kefahaman tentang gelagat akaun semasa menjadi semakin penting sebab struktur-struktur institusi yang berkaitan dengan polisi-polisi makroekonomi sesebuah negara tidak boleh berlaksana dengan semata-mata meniru struktur-struktur institusi negara-negara lain. Tesis ini meneliti pergerakan baki akaun semasa negara-negara ASEAN-5, iaitu Indonesia, Malaysia, Philippines, Singapore dan Thailand, di bawah empat isu besar: pendekatan pengoptimuman inter-temporal, hipotesis defisit berkembar, hubungan antara akaun semasa dengan pelaburan, dan kejutan-kejutan kekal serta kejutan-kejutan sementara
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Last but not least, I am forever indebted to my wife and children who have been patient and supportive throughout my professional development. In many ways, the unfailing encouragement, tolerance and support rendered from my wife and family inspired me to make it through the mist of anxiety and struggle.
I certify that an Examination Committee has met on 15th June 2007 to conduct the final examination of Hamizun bin Ismail on his Doctor of Philosophy thesis entitled "The Behaviour of the Current Account Balances of ASEAN Five Members" in accordance with Universiti Pertanian Malaysia (Higher Degree) Act 1980 and Universiti Pertanian Malaysia (Higher Degree) Regulations 1981. The Committee recommends that the student be awarded the degree of Doctor of Philosophy.

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DECLARATION

I hereby declare that the thesis is based on my original work except for quotations and citations which have been duly acknowledged. I also declare that it has not been previously or concurrently submitted for any other degree at UPM or other institutions.

HAMIZUN BIN ISMAIL

Date: 13 August 2007
# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>DEDICATION</td>
<td>2</td>
</tr>
<tr>
<td>ABSTRACT</td>
<td>3</td>
</tr>
<tr>
<td>ABSTRAK</td>
<td>5</td>
</tr>
<tr>
<td>ACKNOWLEDGEMENTS</td>
<td>7</td>
</tr>
<tr>
<td>APPROVAL</td>
<td>8</td>
</tr>
<tr>
<td>DECLARATION</td>
<td>10</td>
</tr>
<tr>
<td>LIST OF TABLES</td>
<td>13</td>
</tr>
<tr>
<td>LIST OF FIGURES</td>
<td>16</td>
</tr>
</tbody>
</table>

## CHAPTER

I INTRODUCTION

- Background of the Research
- An Overview of the ASEAN-5 Economies
- Lessons From the Asian Crisis
- Statement of the Problem
- Research Objectives
- Research Hypothesis
- Organization of the Thesis

II REVIEWS OF LITERATURE

- Introduction
- The Intertemporal Approach to the Current Account
- Current Account and the Twin-Deficits Relation
- Current Account, Investment and Capital Mobility
- The Current Account, Exchange Rate and Monetary Shocks
- Summary and Conclusion

III METHODOLOGY AND DATA

- Introduction
- The Unit Root Test
- Intertemporal Optimization Approach to Current Account
- The Tri-variate Vector Error-Correction Models of the Current Account Deficit, the Budget Deficit and Investment
- The Identification of Temporary and Permanent Shocks from the Current Account Balance and the Real Exchange Rate
- Sources of Data
- Summary and Conclusion
IV EMPIRICAL RESULTS ON THE INTERTEMPORAL OPTIMIZATION APPROACH TO CURRENT ACCOUNT
- Introduction 119
- Determination of the Parameter Values 122
- Tests for Stationarity 128
- Estimation of the Model 135
- Evaluation of the Estimated Models 142
- Summary and Conclusion 153

V EMPIRICAL RESULTS ON THE TRI-VARIATE VECTOR ERROR-CORRECTION MODELS OF THE CURRENT ACCOUNT DEFICIT, THE BUDGET DEFICIT AND INVESTMENT
- Introduction 155
- The unit-root tests 157
- The Cointegration Tests 159
- The Estimation of the VECMs and Their Interpretations 162
- Summary and Conclusion 171

VI EMPIRICAL RESULTS ON THE TEMPORARY AND PERMANENT SHOCKS OF THE CURRENT ACCOUNT AND THE REAL EXCHANGE RATE
- Introduction 174
- Tests for stationarity 175
- The Estimation of the VAR and the Bivariate MA Models 179
- Further Analyses on the Results of Estimation 185
- Summary and Conclusion 193

VII CONCLUSION AND POLICY IMPLICATIONS
- Introduction 194
- The Intertemporal Optimization Approach to the Current Account 195
- Current Account, Budget Deficit and the Twin Deficits Hypothesis 200
- Current Account and Investment 205
- Temporary and Permanent Shocks of the Current Account Balance and the Real Exchange Rate 208
- Policy Implications 213
- Limitations of the Study 220
- Implications for Future Research 222

REFERENCES 225
BIODATA OF THE AUTHOR 236
## LIST OF TABLES

<table>
<thead>
<tr>
<th>Table</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Average annual real GDP growth for the 1960s to 1990s, including the years 2000 and 2001 (% of GDP)</td>
<td>29</td>
</tr>
<tr>
<td>2</td>
<td>Total exports and investment to GDP ratio of the ASEAN-5 Countries</td>
<td>30</td>
</tr>
<tr>
<td>3</td>
<td>The GDP and export growth rates of the ASEAN-5 countries (%)</td>
<td>31</td>
</tr>
<tr>
<td>4</td>
<td>The average annual gross domestic saving of the ASEAN-5 countries (% of GDP)</td>
<td>32</td>
</tr>
<tr>
<td>5</td>
<td>The average annual domestic investment of the ASEAN-5 countries (% of GDP)</td>
<td>32</td>
</tr>
<tr>
<td>6</td>
<td>The average annual current-account balances of ASEAN-5 countries (% of GDP)</td>
<td>34</td>
</tr>
<tr>
<td>7</td>
<td>The current account balances of ASEAN-5 countries from 1990 to 1997 (% of GDP)</td>
<td>40</td>
</tr>
<tr>
<td>8</td>
<td>The average market rates indices of the exchange rates of the ASEAN-5 countries from 1995 to 2002 (local currency per USD, 1995=100)</td>
<td>41</td>
</tr>
<tr>
<td>9</td>
<td>Shares of Services-to-GDP of the ASEAN-5 Countries, 1980-1999: Five-Year Averages and Overall Averages (%)</td>
<td>125</td>
</tr>
<tr>
<td>10</td>
<td>Change in net output ($\Delta no$) of the ASEAN-5 countries</td>
<td>130</td>
</tr>
<tr>
<td>11</td>
<td>Current account ($CA^*$) of the ASEAN-5 countries</td>
<td>131</td>
</tr>
<tr>
<td>12</td>
<td>Interest rate ($r^*$) for the ASEAN-5 countries</td>
<td>132</td>
</tr>
<tr>
<td>13</td>
<td>Results of unit-root tests on change in net output ($\Delta no$), current account ($CA^<em>$) and interest rate ($r^</em>$)</td>
<td>133</td>
</tr>
<tr>
<td>14</td>
<td>The coefficients of the estimated VAR of the primary model for the ASEAN-5 countries (with standard errors and t-values in parentheses)</td>
<td>137</td>
</tr>
</tbody>
</table>
The coefficients of the estimated VAR model for alternative model for the ASEAN-5 countries (with standard errors and t-values in parentheses)

The vectors k and their associated $\chi^2$-statistics that are used to test the consistency between the predicted model and the data.

Results on estimations of the present value model with varying values of $a$ and $\gamma$.

Results on testing the null hypothesis that current account does not Granger-cause net output.

Measures of fit for primary and alternative models and serial correlations between the actual and the predicted series of current account ($CA^*$).

The unit-root tests.

The Akaike’s information criterion (AIC) or the Schwartz’s criterion (SC) of the estimated VAR.

The Johansen’s trace test and maximum eigenvalue test.

Repeated cointegration tests at different other lags.

Cointegrating equations and the Wald test on the significance of the error-correction term.

The Wald test on the short-run causality among the variables in the system.

Variance decompositions of current account deficits, budget deficits and investment.

Unit-root tests on real exchange rate and current account-GDP ratio.
<table>
<thead>
<tr>
<th>Page</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>28</td>
<td>Akaike information criterion (AIC) and Schwartz information criterion (SIC) of the bivariate VAR model for ( q_t ) and ( ca_t )</td>
</tr>
<tr>
<td>29</td>
<td>The coefficients of the estimated VAR model for alternative model for ( q_t ) and ( ca_t )</td>
</tr>
<tr>
<td>30</td>
<td>The variance-covariance matrix ( \psi ) estimated from the VAR model for ( q_t ) and ( ca_t )</td>
</tr>
<tr>
<td>31</td>
<td>The bivariate moving average representation, estimated from each of the VAR model for for ( q_t ) and ( ca_t )</td>
</tr>
<tr>
<td>32</td>
<td>The bivariate moving average representation associated with permanent shocks and temporary shocks</td>
</tr>
</tbody>
</table>
**LIST OF FIGURES**

<table>
<thead>
<tr>
<th>Figure</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>The world’s real interest rates from 1960 to 2000</td>
<td>124</td>
</tr>
<tr>
<td>2</td>
<td>Indonesia’s actual path of the current account variable and its predicted path</td>
<td>149</td>
</tr>
<tr>
<td>3</td>
<td>Malaysia’s actual path of the current account variable and its predicted path</td>
<td>150</td>
</tr>
<tr>
<td>4</td>
<td>The Philippines’ actual path of the current account variable and its predicted path</td>
<td>151</td>
</tr>
<tr>
<td>5</td>
<td>Thailand’s actual path of the current account variable and its predicted path</td>
<td>152</td>
</tr>
<tr>
<td>6</td>
<td>Impulse responses of the real exchange rates</td>
<td>188</td>
</tr>
<tr>
<td>7</td>
<td>Impulse responses of the current account</td>
<td>189</td>
</tr>
<tr>
<td>8</td>
<td>Decomposition of the real exchange rates: Contribution by permanent shocks</td>
<td>190</td>
</tr>
<tr>
<td>9</td>
<td>Decomposition of the current account: Contribution by permanent shocks</td>
<td>191</td>
</tr>
<tr>
<td>10</td>
<td>Decomposition of the current account: Contribution by temporary shocks</td>
<td>192</td>
</tr>
</tbody>
</table>
CHAPTER I

INTRODUCTION

Background of the Research

Current account is a variable that is both a broad reflection of the stance of macroeconomic policies and a source of information about the behaviour of economic agents. It reflects not only changes in a country’s trade flows, but also the difference between a country’s saving and investment. Furthermore, the current-account balance can also be described as the addition to a country’s claims on the rest of the world. Hence, movements in current account convey information about the actions and expectations of all market participants in an open economy.

More generally, the current account balance can also be viewed as a barometer of a country’s economic performance. There are numerous studies which emphasize on the link between the current-account balances and main macroeconomic aggregates such as domestic growth, public savings, aid flows, currency depreciation, and terms of trade (Calderon et al, 2001). In particular, current account deficits have been considered to be one of the important variables used in predicting crises. The potential role of current-account deficits as a source of disruptive tensions in the financial markets has been repeatedly emphasized in
the literature. For instance, a ‘fundamentals’ approach proposes that a crisis occurs when the economy is in a state of distress with a deteriorating current account, a growth slowdown, the bursting of stock and real estate price bubble, and short-term foreign debt reaching dangerous levels (Kaminsky and Schmukler, 1999). Miyakoshi (2000) and Ryan (2000), among others, found that current account deficits were one of the main causes that had triggered the Asian currency crisis of 1997. Similar conclusion is made by Bustelo (2000) who suggested that large current account deficits for the year 1993 and 1994 was an important indicator prior to the Mexican crisis of 1994. In contrast, Puri et al. (2002) provided evidences of current account balance having no direct relationship with the currency crisis in South Korea. Moreover, Bustelo (2000) surveyed nine important empirical studies on indicator of financial or currency crises published from 1996 to 2000, and noted that the current-account deficits turned out to be a significant variable only in three of the studies. In a more comprehensive study, Edwards (2001) concluded that large current-account deficits increase the probability of a currency crisis, but not necessarily that every large deficit leads to a crisis.

A current account deficit is a normal phenomenon in open economies as temporary current account deficit reflects reallocation of capital to the country where capital is most productive. Therefore, a current account deficit can possibly bring along the benefits of the associated foreign capital inflow. To elaborate this,
consider a country who is facing an investment boom. An investment boom occurs as a result of either the discovery of new natural resources, or the technological progress leading to new products that can be profitably developed and produced. It can also occur due to structural economic reforms such as trade liberalization or capital market liberalization, and macroeconomic stabilization policies that lead to expectation of high future economic growth and high profitability of new investments. Regardless of the causes, an investment boom has to be financed with some savings. If the national savings of the country are not sufficient to finance all new profitable investment projects, then it is optimal for the country to run a current account deficit, i.e. to rely on foreign savings to finance the excess of investment over national savings. Such a current account deficit will imply the accumulation of new foreign debt, i.e. a capital inflow as foreign funds will be borrowed to finance domestic investment. Over time, the goods produced by the new capital will lead to increased country exports that will generate the trade and current account surpluses that are necessary to eventually repay the foreign debt and interest on it. Thus in general a persistent current account deficit and foreign debt accumulation generated by a boom in investment should not be considered with too much concern and it might actually increase the rate of growth of an economy where domestic savings are not sufficient to finance all profitable investment projects. For example, Fountas and Wu (1999) pointed out that the U.S. current account deficits have been increasing in the 1990s, and the inflow of foreign capital to the U.S. has helped finance its investment boom,
with interest rates below what they otherwise might have been. To the extent that this investment increase supports a higher standard of living, the U.S. will be able to service its international debts without reducing consumption.

However, large and persistent current account deficits are detrimental to economic welfare, thus raise the issue of sustainability of the deficits. A country that continually runs a current-account deficit will become ever more indebted to foreigners. The sustainability of the current account deficits depends on certain characteristics such as measures of determining when a deficit is a large deficit, the financing of a deficit, and whether the deficits are used for investment or for consumption (Edwards, 2001). So long as these borrowings are invested wisely the deficits need not be a problem, since future economic growth should allow the debt to be serviced. On the other hand, if the foreign resources are badly employed, or if the current-account deficit grows too fast, a country may not be able to meet its obligations to foreign creditors. Hence, a large current-account deficit that fuels consumption or a property-price bubble may be a problem.

How do we judge that a country’s current account deficit remains sustainable? Under the least restrictive interpretation the current-account deficit is sustainable if the country is solvent in the sense that it must be able to generate sufficient trade surpluses in the future to repay its debt (Guest and McDonald, 1999). In other words, a country is solvent to the extent that the discounted value of the
expected stock of its foreign debt in the infinitely distant future is non-positive. Corsetti et al. (1999) argued that in practice, the solvency criterion is not particularly stringent, because the intertemporal budget constraint of a country imposes only very mild restrictions on the evolution of a country’s current account and foreign debt. Any path of the current account such that the present discounted value of the current and future trade surpluses is equal to the current external debt position is consistent with solvency. A country could run very large and persistent current-account deficits and remain solvent, as long as it can generate trade surpluses of the appropriate size at some time in the future. As an alternative, they suggested that the issue of sustainable current account deficit to be evaluated by analyzing the path of the current account balance to see whether it fairly closely follows certain path that is considered optimum. Generally, the optimal path is obtained from a model that is suited to the actual current account data.

One of the approaches to estimate such model is the consumption-smoothing approach, which focuses on the long-run savings and investment decisions of private agents. Under this approach, the current-account position of a country is determined by its savings-investment gap, which ultimately depends on the willingness of foreigners to hold its liabilities (Knight and Scacciavillani, 1998). Countries with a higher savings ratio will tend to be net capital exporters and run sustained current account surpluses, while countries with a lower savings ratio
will tend to import capital and therefore run current-account deficits. For this reason, current account can also be looked from the perspective of saving and investment.

The relationship between saving and investment has been sharply enthusiastically debated following the controversial finding of Feldstein and Horioka (1980). In this study, they proposed the perfect capital mobility hypothesis which stipulates that the capital mobility is perfect across national boundaries when investment and saving are uncorrelated. The controversy arose when they tested this hypothesis on 21 OECD countries (for the period from 1960 to 1974) and found that investment and saving are highly correlated. The conclusion that capital might not be internationally mobile in highly open economies such as the OECD countries remained to be known as the Feldstein-Horioka puzzle. Consequently, Feldstein-Horioka findings have been extensively challenged from both technical and theoretical grounds.

One of the alternative view in explaining the Feldstein-Horioka puzzle is the intertemporal current-account solvency argument, as highlighted in numerous studies such as Taylor (2002), Liu and Tanner (2001), Jansen (2000), Coiteux and Olivier (2000), Levy (1999), Coakley et al. (1999), and Coakley and Kulasi (1997). The main idea behind their arguments is that the solvency constraint requires that the current account balances be stationary since debt cannot explode.
Since current account balance equals saving minus investment, cointegrating relationship between saving and investment will imply that the current account balance is stationary, and hence the non-violation of budget constraint. In other words, a high saving-investment correlation may simply result from the fact that a country is in intertemporal balance externally and domestically. As long as the intertemporal budget constraint is not violated, the long-run saving and investment would be correlated, regardless of the degree of capital mobility. A good example supporting this view is the study by Coakley et al. (1996) who tested the hypothesis that current account balances are non-stationary for 23 OECD countries. Their results strongly rejected the hypothesis, thus implied that saving and investment cointegrate irrespective of the degree of capital mobility. In other words, the high saving-investment correlation from the Feldstein-Horioka’s regression should be interpreted as a manifestation of the intertemporal budget constraint rather than evidence of low capital mobility.

In short, the behaviour of the current account movements is one of the most widely debated topics not only among economists but also among policymakers in developed and developing countries. Essentially, the topic has been in the economic spotlight because of its important policy implications concerning the long-term viability of a country’s economic progress. For instance, in an open market economy, where the goal of macroeconomic policy is to maintain the internal and external balance of the macroeconomic system through a