CHAPTER 14
MALAYSIA

Introduction. The Malaysian economy is rapidly slowing down and may already be in a recession.

- After about a robust 8.3% GDP growth in 2000, GDP grew at about 1% in 2001.
- Given the U.S. downturn and the anti-U.S. terrorism on 11 September, the future growth numbers will almost certainly be worse than the early IMF forecasts that expected a rebound in 2002.

Rising Jobless Numbers. Socially, a painful Malaysian recession is already here.

- The evaporation of the U.S. appetite for imports translates into a sharp downturn in Malaysia's manufactured exports.
- As a result, more than 30,000 people were laid off between January 2001 and September 2001.
- Most the lay-offs are from factories producing electronics products.
- And things will get worse.
- By the end of the year, the government expects more than 390,000 people to be out of work.
- That would mean unemployment is rising from 3.1% in 2000 to 3.9% for 2001.

Confidence Problem. In essence, Malaysians have a confidence problem and are concerned about their economic future.

- Almost 60% of respondents surveyed in September 2001 feel it will be difficult to get a job—the lowest level since the survey began after the Asian Crisis in 1997.
- Even those who are clinging to their job are fearful of losing their job.
- And that means people are reluctant to spend money.

Fiscal Stimulus. In essence, therefore, Malaysia's businesses and consumers have lost the ability or confidence to spend money.

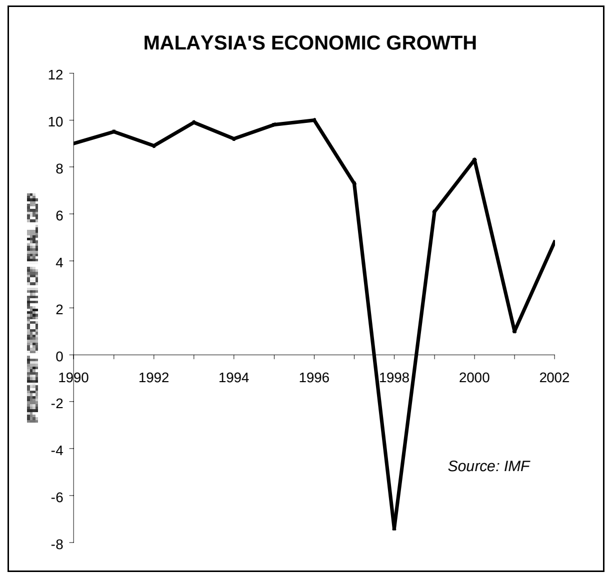
- In response, Prime Minister (and Finance Minister) Mahathir has decided to fight off recession with the Keynesian medicine of more government spending.

Figure 14-A. Selected Historical Data

$ Billions (or %)	**'97**	**'98**	**'99**	**'00**
Gross National Income	98.2	79.8	77.3	89.3
Purchasing Power	168.0	155.0	180.8	212.4
Real Growth (%)	7.3	-7.4	6.1	8.3
Inflation (%)	2.6	5.1	2.8	1.5
Exports	78.5	73.0	84.6	98.2
To U.S.	18.5	19.5	21.8	26.0
Imports	78.5	58.1	65.4	82.2
From U.S.	10.8	9.0	8.8	10.8
FDI from U.S.	5.6	6.2	5.8	6.0
In U.S.	0.3	0.2	0.1	0.0
Cur Account /GDP %	-5.2	13.5	15.9	9.4
Fiscal Balance /GDP %	2.4	-1.8	-3.2	-5.8
External Debt /GDP %	42.1	52.7	45.0	39.8

Sources: IMF, ADB, World Bank, U.S. Commerce

Figure 14-B



- So in October 2001 Mahathir announced a further round of pump priming.
- A further 4.3B ringgit ($1.1B) will be spent by the government on infrastructure works, in addition to the 3B ringgit spending program announced by Mahathir in March.
- On 21 October, Mahathir increased Malaysia's budget expenditure for 2002 by 10% to just over 100B ringgit.
- Mahathir has also:
  - Cut income taxes
  - Slashed import duties and
  - Handed out bonuses and a 10% salary hike to 800,000 civil servants.

Looser Monetary Policy. Monetary policy has also been eased in hopes of stimulating growth.

- Interest rates are at their lowest in a decade.
- The base-lending rate is now just 6.2%.

Fiscal Elbow Room. Some might argue that Malaysia's budget deficit—at 5% of GDP—is far above the Maastricht criterion for financial stability (budget deficits at no higher than 3% of GDP).

- In normal times this is true. But these are not normal times.
- The global downturn and the 9-11 anti-U.S. terrorism have devastated global demand for most Malaysian exports.
- Equally important, Malaysia has a low national debt—only 40% of GDP.
- This figure is well under the Maastricht criterion for financial stability—a national debt that is below 60% of GDP.
- In short, Malaysia has lots of fiscal elbow room to press the Keynesian button to inject more short-term demand into the economy.
- Mahathir therefore hopes loose fiscal and monetary policies will start to close the gap between potential GDP and actual GDP.

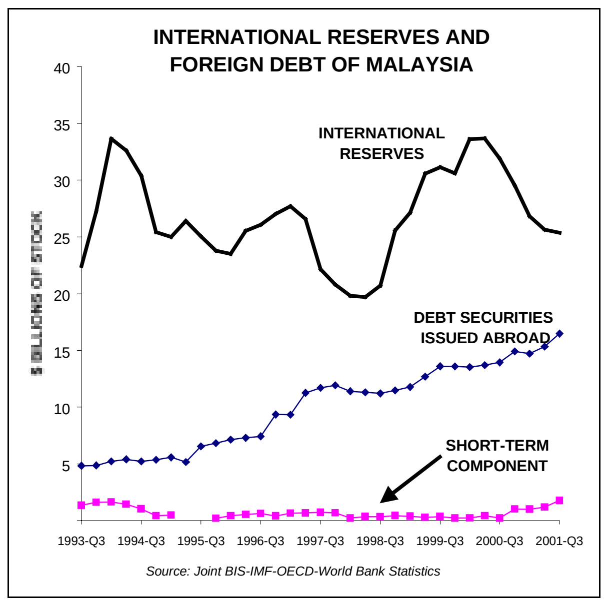
Falling Currency Reserves. Another area of concern for Malaysia has been the state of its currency reserves. (See Figure 14-B.)

- On 15 May the currency reserves fell for the 13th straight month—reaching a 29-month low of $26.1B.
- That was a 13% fall from their peak of $30B in September 2000.
- This sharp fall in the currency reserves is often a good indicator of capital flight. When an economy gets shaky, we often see capital flight as investors bail out of the local currency and buy U.S. dollars.
- While these negative indicators are not yet compelling or reason for alarm—since Malaysia still had over 3 months of import cover—there was initially some cause for concern since trends were moving in the wrong direction.

Currency Reserves Stabilize in 3Q01. But since June 2001 the Malaysian currency reserve situation has stabilized—and even improved a bit.

- The reserves have actually registered a net increase.
- Currency reserves have risen by RM1.2B or 1.1% to RM106.5B at mid- September from RM105.3B two weeks earlier.
- Why the improvement in currency reserves?
- Up through most of 3Q01, Malaysia's balance of payments benefited from an economy that is more broad-based than Singapore and other Asian states.
- Petroleum, gas and palm oil all contribute significant export earnings.
- And in an ironic twist to the global tale of woe, exports of sterile rubber gloves, of which Malaysia is the world's largest producer, have been boosted by almost 50% as a result of the global anthrax scare.

Figure 14-C



Export Downturn Likely. That said, the trade performance of Malaysia is taking a hit.

- The 9-11 terrorist attacks in the United States have sharply illustrated Malaysia's dependence on external flows of trade and capital, albeit not as much as Singapore.
- Palm-oil stockpiles have begun rising because of a reluctance by shippers to go anywhere near Pakistan—one of Malaysia's big markets.

- War risks amid a slowing global economy are putting downward pressure on palm-oil prices.
- Meanwhile, revenues from tourism, the country's second-largest foreign-exchange earner after palm oil, have fallen by 30% since mid-September.
- Against such a backdrop, there is little the government can do apart from making sure the fundamentals are right to capitalize on a global recovery.
- Are the fundamentals right?
- To address this question, let's assess the foreign exchange rate regime, and the foreign investment climate.

Overvalued Ringgit? Unlike most of the other ASEAN states, Malaysia has maintained its fixed exchange rate regime. How will the regime fare in the future?

- U.S slowdown means weaker demand for Malaysian exports, which in turn means weaker demand for the ringgit.
- That means the pegged ringgit has not kept up with the depreciation of other Asian currencies and is arguably over-valued against the U.S. dollar today.
- If Mahathir floated the ringgit, it would fall.
- Malaysian domestic investors want to sell ringgit and buy dollars before the unattractive specter of a ringgit devaluation becomes a grim reality.

Falling Foreign Investment. Negative foreign investor perceptions of the Malaysian economy also hurts Malaysian interests.

- Since Malaysia became independent in 1957, Foreign Direct Investment (FDI) has been the largest factor fuelling growth.
- Globalization has been good for Malaysia, with foreign capital funding many of its ambitious infrastructure projects.
- But this foreign investment appears to be drying up.
- For instance, foreign investors' holdings of Malaysia's share market have dwindled to about 3% from almost 30% in early 1997.
- The short-term component of Malaysia's foreign debt is quite small. (See Figure 14-B.) In comparison to foreign participation rates seen in other countries, there appears to be an abnormal fear by foreign investors of short-term investments in Malaysia.

Why Short-term Investors Foreign Investors Stay Away. Short-term investors are largely taking a "wait and see" attitude, indicating that Malaysia needs to do more to address its structural economic reforms necessary for long-run sustainable growth.

- Investors would welcome a more consistent and foreign investor-friendly policy environment.
- How effectively Malaysia addresses the following four investor concerns are likely to have a significant bearing on the extent to which private capital flows into Malaysia are restored, which in turn will help define growth patterns in the future.

1***. Government Involvement in Economy***. Investors concede that Malaysia's interventionist measures, such as capital and currency controls, insulated the economy and contributed to economic growth the past two years.

- However, they would like to see the government focus more on promoting those structural and private sector reforms necessary in developing and strengthening market-oriented institutions and policies.
- Investors also express concern about the prevalent link between business and government and the resulting conflict of interest.
- They note that more consistent policies as well as incentives for foreign investment would help to restore investor confidence.

2***. Application of the Law.*** While investors agree that Malaysia's legal framework is adequate, they are very concerned about what they perceive to be inconsistent application of the law, particularly in civil cases.

- In addition to questioning the independence of the judiciary, investors express concern about the treatment of foreign investors under the Malaysian legal system.

3***. The Banking System.*** Investors share several concerns regarding Malaysia's banking system:

- Investors would like to see bank restructuring completed—especially the bank consolidation process.
- Investors would also welcome a more consistent and minimal government role in the banking system.
- Other concerns include the lack of Central Bank independence.
- Investors concede that government agencies have eased the debt burdens of domestic corporations and banks generally have returned to profitability.
- But they are concerned about the level of non-performing loans.[1]
- About 30% of these restructured debts will need to be rescheduled unless genuine corporate restructuring begins with Malaysia's politically connected corporations.

4***. Conflicts of Interest.*** Investors perceive conflict of interest as a major problem in Malaysia.

- They point out that business and political linkages foster crony capitalism, influence of vested interests, and political patronage.
- They also are concerned about how this will affect Malaysia's long-term competitiveness and growth.
- In this regard, it's important to note that Malaysia's competitiveness is faltering. The World Economic Forum's ranking of Malaysian competitiveness has slipped from 16th to 25th.

Conclusions

The U.S. appetite for Malaysian manufactured exports has fallen. Malaysia's economy is rapidly slowing down and may already be in recession. Unemployment is going up and consumer and business confidence is going down.

In response, the government has opted for lower interest rates and more government spending in hopes of stimulating economic growth. Fortunately, the government has ample fiscal elbow room to boost government spending.

To sustain strong growth, the country must attract more foreign investment. That won't happen unless Malaysia creates a more attractive business climate for foreign investors.

Investors are holding back until their concerns in the following four areas are addressed:

- Too much government involvement in the economy,
- Ineffective application of the law,
- A socialistic banking system, and
- Conflicts of interest.

Endnotes

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1 The government says NPLs are 7% of total assets. Private estimates are much higher.