



## Malaysia: An Economic analysis

International Financial Policy

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## **Introduction**

As an emerging market, Malaysia is a clear success story. In the past three decades, Malaysia implemented many development plans to increase Malaysian quality of life and to modernize its agrarian economy towards manufacturing. In particular, state policy encouraged investment in export industries such as electronics and non-tradable sectors, real estate sector and capital-intensive infrastructure. From 1970 to about 1995, Malaysian investment ranked quite high in the region. However, in the early 1990's, the public sector financed this investment, increasing budget deficits to unsustainable levels. Financial standardization, economic diversification, deregulation and financial liberalization all helped to correct this problem, transforming the country into a middle-income emerging market.

Since these adjustments and until the 1997 crisis, Malaysia exhibited strong economic performance, real GDP growth averaged 8.5% a year, unemployment was below 3%, prices and the exchange rate remained stable and international reserves remained high. Nevertheless, some signs of stress already had surfaced.

## **Asian Financial Crisis**

Before 1997, a managed float determined the ringgit exchange rate; and the capital account remained positive. Due to high offshore interest rates, foreigners had large ringgit holdings, establishing liabilities for the Malaysian banking system. Thus, potential offshore speculators had sufficient currency to destabilize the Malaysian banking system.

Once the 1997 Asian financial crisis began, intense speculative pressures surfaced in Malaysia. Speculation typically leads to an increase in the demand for ringgit credit, raising short-term interest rates, and putting forward pressure on the currency. Speculation also produces large capital outflows. In the case of Malaysia by September 1997, 10 billion dollars were gone.

In response, the Negara Bank imposed a \$2 million limit on swaps to non-residents. However, other speculative activities continued and produced a further wedge between domestic and offshore interest rates. Offshore interest rates for ringgits soared to more than 20% while in Malaysian banks the rates remained around 11.4%.

## **Temporary Policy Response**

In September 1998, after the exchange rate started appreciating, Malaysia implemented capital controls (See Appendix B) and a pegged exchange rate to the dollar. These temporary policies helped to eliminate transactions not related to trade and foreign direct investment, thus closing the offshore market, suspending ringgit credit to foreigners and reducing outflows.<sup>1</sup> Most importantly, the temporary policies eliminated speculative pressures and the related fluctuations in domestic interest rates and exchange rates. Malaysia also began a fiscal stimulus effort to increase capital spending.

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<sup>1</sup> Ron Hood, *Malaysian Capital Controls*. World Bank Policy Research Working Paper. January 2001,2-9

Before restricting capital outflow, monetary contraction policies increased interest rate. By the end of 1999, capital controls had dismantled the offshore market, reducing interest rates to 3.15% and inflation to 2.5%. Meanwhile, international reserves rose. Current account continued to strengthen. Additionally the capital controls gave Malaysia space to implement needed corporate and financial reform including consolidation programs and tight regulations.

Capital controls, however, certainly inhibited foreign investment. Meanwhile, Malaysia's credit rating fell shortly after the imposition of capital controls.<sup>2</sup> For this reason, the capital controls had gradually ease.

## **Recent Macroeconomic Performance and Problems**

Malaysia is currently undergoing fiscal expansion policies to help increase domestic income and hence spending. The global recession – especially in the US – has reduced electronics exports, a primary Malaysia revenue sources. Malaysia is continuing with its pegged exchange rate, holding at 3.80 ringgit/US dollar, helping maintain stable interest rates and keeping inflation low.

Fortunately, recent global growth – especially in silicon-based products – help the Malay economy. Current account still maintains a large surplus. Short-term foreign debt remains low. Reserves remain adequate. Low inflation persists. Early May 2001 authorities levied the 10% exit tax on repatriated profits from less than a year and eased the rules of the purchase of property by foreigners. In addition, political stability has enabled the Malaysia bounce back after the crisis.

Unfortunately, the Malaysian economy remains heavily dependent on electronic exports (\$60.2 billion or 62% of total exports<sup>3</sup>). Thus, it responded quickly to the global slowdown in information technology. Furthermore, the Malaysian economy also responded quickly to the depreciation of the yen and other regional currencies, resulting in ringgit appreciations, short-term capital outflows and reserve losses. Domestic investment has not recovered to prior 1998-level.

## **Policy Recommendations**

Malaysia's economy has remained healthy and vibrant since moving to a pegged exchange rate system. The benefits of a fixed system include highly effective fiscal policies, which can result in high domestic income and output with fiscal expansion.

Although the fixed system is working well for Malaysia currently, we recommend that it return to a floating system in the next two to five years. The reasons behind this recommendation are many. First, there is a possibility that the ringgit could appreciate or not be truly representative of its current market valuation. Furthermore, a currency crisis could occur if combined with regional economic instability and market expectations of overvaluation.

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<sup>2</sup> <http://www.bradynet.com/e870.html>

<sup>3</sup> Economist Intelligence Unit: Country Profiles: Malaysia, March 26, 2002

This change in expectations could lead to unsustainably high interest rates putting pressure on the Malaysian government to devalue the ringgit. To maintain the pegged rate, the Central Bank would have to contract money supply. Contracting the money supply leads to higher interest rates and depreciated currency. The move to a floating exchange rate system should be made carefully and after necessary banking and corporate reforms are fulfilled.

Policy recommendations must also be followed with other improvements within the economy. A high priority should be placed on diversification. Malaysia's export markets concentrated in the electronics and technology sector are vulnerable to global slumps in demand, especially in the US who is the main exporter of Malaysian goods.

Since Malaysia has the ringgit pegged to the dollar it has to reconsider whether it is about time to abandon the fixed exchange rate. Therefore, it is necessary to revise the pros and cons of implementing either system.

First, the openness to trade of an economy is an important factor to decide what kind of exchange rate system is desirable. If the country relies heavily on trade a fixed exchange rate may be better because it provides stability. However, having the exchange rate fixed does not allow the economy to remain competitive in foreign trade when other countries are facing inflation. This leads to the second element, inflation rates.

The domestic inflation rate, as well as the inflation rate of the trade partners is another relevant factor. In this case, the strategy is not straightforward. If the country remains with the fixed rate it can stop the inflationary tendencies in the economy.

Third, labor market flexibility is also relevant to decide which exchange rate system is better in a given period. In general, if the labor market is pretty flexible, a fixed exchange rate system seems to work better. Conversely, if the labor market is rather inflexible, the exchange rate should be flexible, to avoid unemployment due to output shocks. This means that if the exchange rate were fixed, to maintain the level of the spot rate output has to shrink, thus unemployment would rise.

A fourth important factor is the degree of financial development of the country. If the country tends to be underdeveloped financially, a fixed exchange rate may be better to avoid large effects of foreign speculation.

A fifth relevant factor is the credibility of policymakers. If policymakers are pretty credible in the country, a flexible exchange rate may be better. Conversely, if the policy institutions are weak, a fixed exchange rate would be better.

A last consideration when deciding which exchange rate system is better is the mobility of capital. If the capital mobility is high, then it is more convenient that the exchange rate to be flexible. As we can observe, Malaysia's decision to peg its currency to the dollar seems adequate. However, once financial institutions are solid and policymakers are credible, it would be adequate, as well, to consider changing to a flexible exchange rate system. This will

also require labor and capital mobility, but will allow Malaysia not to lose competitiveness in foreign trade, which is an important source of income for the nation.

Therefore, to ease the transition Malaysia will need to continue to implement consistent macroeconomic policies to maintain financial stability and sustainable fiscal and external positions. Also, it needs to carry on current structural reforms to achieve healthy balance sheets of the banking and corporate sectors. Another economic problem in Malaysia is the negative consequence of a heavy dependency on electronic exports. Therefore, it needs to diversify its exports to include other sectors, like the service and financial sector. Examples include establishing corporate bond market especially to foster private domestic investments—to offset their current account surplus due to high foreign investments (we believe that more domestic investments should occur).

Last, but not least, now is the best time, economic indicators are improving (2002) and forecasts are optimistic, to further financial (financial services) and trade (services, telecommunications, automotive) deregulation to promote competition and efficiency.

## **Conclusion**

Malaysia's economy rebounded considerably well from the 1997 Asian crisis without incurring in IMF loans and hence future debt. Economic forecasts are optimistic even though there was a deceleration in the economy due to a slowdown in the market for information technology. Also, macroeconomic numbers remain stable and there is a strong confidence in the country's future performance. Therefore, we find Malaysia capable of revitalizing its economy to become one of the few strong economies in Southeast Asia. This can be attributed to its well-sounded financial and monetary policies as well as the confidence the Malaysian people and surrounding country governments have in the Malaysian administration. Nonetheless, some policy changes have to be implemented to guarantee results, including: changing the exchange rate system, diversifying its export base, furthering financial and trade deregulation and continuing to reform the financial and corporate sectors.

## Appendix A

	1995	1996	1997	1998	1999	2000
<b>CA/GDP</b>	<b>14.83%</b>	<b>15.59%</b>	<b>20.23%</b>	<b>23.61%</b>	<b>31.95%</b>	<b>27.27%</b>
<b>G/GDP</b>	<b>12.37%</b>	<b>11.11%</b>	<b>10.88%</b>	<b>10.00%</b>	<b>11.17%</b>	<b>10.66%</b>
<b>GR F Cap For/GDP</b>	<b>43.59%</b>	<b>42.50%</b>	<b>43.06%</b>	<b>26.81%</b>	<b>22.24%</b>	<b>25.67%</b>
<b>Govt. Def/GDP</b>	<b>0.84%</b>	<b>0.72%</b>	<b>2.35%</b>	<b>-1.76%</b>	<b>-3.17%</b>	<b>0.00%</b>
<b>GDP growth</b>		<b>14%</b>	<b>11%</b>	<b>1%</b>	<b>5%</b>	<b>13%</b>

	1997	1998	1999	2000	2001
Real GDP growth	7.3	-7.4	6.1	8.3	
Exchange rate (ringgit/US)	2.8	3.9	3.8	3.8	
Current Account Balance	-5.9	13.2	15.9	9.4	
Gross official reserves (US\$ billion)	21.7	26.2	30.9	29.9	
Gross domestic investment (% of GDP)	43.0	26.7	22.3	26.8	
Export value	0.7	-7.3	16.9	17.0	
Import value	1.2	-26.6	13.0	26.2	
CPI inflation	2.7	5.3	2.7	1.5	

## Appendix B

### Capital Control Regulations:

- 1-year minimum waiting period for repatriating Malaysian securities held abroad. [On Feb 15, 1999 the one-year waiting period was replaced with graduated exit taxes.]
- Mandatory ringgit repatriation.
- Restriction on funds transfers between external accounts
- Limits on ringgit transport by travelers
- Prohibition of resident-nonresident credit arrangements
- Prohibition of trade settlement in ringgits
- Prohibition of resident-nonresident offer side swaps and similar hedge transactions
- Freezing of CLOB share transactions
- Restriction of overseas ringgit and ringgit asset trade to prevent speculation from outside the country
- Restrictions of residents' abroad currency and investment movement