The Malaysian Economy: Performance, Uncertainties and Challenges

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Introduction

The Malaysian economy is one of the most open economies in the world. Malaysia's economic openness has increased over the years. The ratio of exports to gross national product (GNP) has risen from 48.2 per cent in 1965 to 100.3 per cent in 1996. The trade dependence of the Malaysian economy is manifest, as the total value of exports and imports is twice as large the country's national income. Structural changes in the economy since political independence in 1957 have rendered the Malaysian economy increasingly outward-looking.

The outward-looking development strategy has paid handsome dividends. The economy has been growing at over 8.5 per cent per annum since1987. The country's per capita income has risen sharply from US$304 in 1965 to US$4,465 in 1996. Rapid economic growth has been accompanied by a more equitable distribution of income and wealth. What is more, Malaysia has been quite successful in maintaining domestic price stability without inflationary pressures.

Economic openness, however, has rendered the Malaysian economy susceptible to external fluctuations, although the vulnerability of the domestic economy to external influences has been to some extent ameliorated by domestic policies. It is noteworthy that Malaysia has been adopting fairly sound macroeconomic policies since mid-1980s with budgetary discipline and monetary prudence.

Understandably, Malaysia has been regarded as showcase by the World Bank and the International Monetary Fund and as a model by many developing countries in the region and beyond. However, the sharp depreciation of the Ringgit since July 1997 has cast some doubts about the continuity of Malaysia's impressive track record. An attempt is made in this paper to analyse the current currency crisis and to draw some policy inferences.

Track Record

The Malaysian economy has undergone rapid transformation during the last three decades, as reflected by the dramatic changes in the sectoral contributions to the gross domestic product (Table 1). The share of the agriculture sector in gross domestic product (GDP) has declined over the years from 30.8 per cent in 1970 to 12.8 per cent in 1996, notwithstanding considerable agricultural diversification which introduced several commercial crops including pepper and cocoa. The share of the manufacturing sector in GDP has increased rapidly from 14.5 per cent to 34.3 per cent between 1970 and 1996, with a particular focus on the electrical and electronic (E&E) products. The share of the mining sector would have been much smaller, had it not been for the fortuitous discovery of petroleum.

It is the manufacturing sector that has played a key role in transforming the Malaysian economy. Significant industrial restructuring has taken place within the manufacturing sector. In particular, the share of E&E and chemical products in total manufacturing value-added has increased sharply. Industrialisation began in the late 1950s with import substitution. There was a radical shift from import substitution to export promotion in the late 1960s when it became obvious that the domestic market was too small for the industrialisation drive. The 1970s witnessed the establishment of many exports processing zones in which multinational corporations (MNCs) have played a pivotal role. In the 1980s, Malaysia opted for a second round of import substitution on account of its ambitious heavy industrialisation programme. The heavy industries which the government has vigorously promoted include petrochemicals, iron and steel and automobile manufacturing. These are among the most heavily protected industries in the country.

Despite the fact that Malaysia is a resource-rich country, primary production has declined in importance over time. The share of agriculture and mining in GDP has fallen from 44.1 per cent in 1970 to 20.0 per cent in 1996. The share of primary exports (SITC 0-4) in total exports has also declined from 72 per cent to 22 per cent between 1970 and 1996. By contrast, the share of manufacturing in total exports has risen sharply from 11.1 per cent to 80.6 per cent during the same period.

Surprisingly, resource-based manufacturing has assumed a relatively low profile. Its share of total manufactured exports remains relatively small at 23.8 per cent as at the end of 1996. Non-resourced-based manufactures account for the bulk of total exports. As a matter of fact, the Malaysian manufacturing sector is dominated by the electrical and electronics (E&E) subsector which accounted for 43 per cent of total manufacturing output and 66 per cent of total manufactured exports in 1996.

Foreign direct investment (FDI) has played a crucial role in the development of the Malaysian economy. Indeed, trade and investment are closely interrelated. Much of the manufactured exports are associated with FDI activities in the country. Japan, Singapore, the US and the EC have long been the major sources of FDI for Malaysia. More recently, Taiwan and Korea have emerged as important investors in Malaysia. FDI has gone into a wide spectrum of manufacturing activities, ranging from food processing to the production of scientific and precision instruments. Nonetheless, electronics, chemicals, textiles and wood products account for the bulk of FDI interests in the country.

Malaysia's track record in terms of economic performance is very impressive. Its per capita income has increased by nearly fourteen times between 1970 and 1996. The incidence of poverty (in terms of percentage of poor households) in the country has declined from 49.3 per

cent in 1970 to 8.9 per cent in 1995. The significant strides in economic development that Malaysia has accomplished are also amply reflected in the key socio-economic indicators. For example, the infant mortality rate has decline from 40.8 per cent in 1970 to 9.8 per cent in 1996, while life expectancy has improved significantly from 65.8 to 71.7 years between 1970 and 1996.

The Malaysian economy has been registering high growth rates. In the 1970s, the economy posted an average real GDP growth of 7.8 per cent. Economic growth in the 1980s was also quite impressive, despite the recession in the mid-1980s with the economy registering a negative growth rate for the first time in 1985. The economy has been growing at rates averaging over 8 per cent since 1987, with growth peaking at 9.5 per cent in 1995.

It is also noteworthy that the unemployment rate has declined shapely from 8.3 per cent in 1986 to 2.5 per cent in 1996. In fact, the economy has suffered severe labour shortage, especially in the plantation, construction and manufacturing sectors which has been filled by immigrant workforce. There are some 2 million foreign workers in the country of which one-half are illegal. It thus appears that Malaysia is experiencing an over-full employment, given the large ratio of guest workers to the local labour force of 9 million.

It is remarkable that Malaysia has been able to register high GDP growth without inflationary pressures, except during the mid-1970s when double-digit inflation was experienced. During the high growth period of 1978-1996, inflation was kept at low levels at 3-4 per cent. In 1996, inflation stood at below 3.0 per cent.

The only sign of overheating for the Malaysian economy has been the growing deficit in the current account of the country's Balance of Payments (BOP). Malaysia has traditionally enjoyed trade surpluses, experiencing current account deficits sporadically due to huge deficits in

the service account. Fortunately, the overall balance has been in Malaysia's favour, thanks mainly to the substantial FDI inflows. There have been growing BOP concerns more recently, as the country began to face deficits not only in the services account but also on the merchandise trade account in the wake of sluggish inflow of FDI.

The government has been adopting fairly liberal economic policies, especially since the mid-1980s. Under the New Economic Policy (NEP) during 1970-90 -- which was designed essentially to increase the stake of the Bumiputras (indigenous people) in the economy in an attempt to reduce inter-ethnic economic disparities -- the government kept a high profile in the economy by establishing a number of state-owned enterprises. Affirmative action had also called for state interventions of sorts. In the aftermath of the recession in 1985-86, the government adopted pragmatic measures that led to considerable deregulation and decontrol, recognising the prowess of the private sector. Since the mid-1980s, the government policy has been highly pro-business, with the private sector steering the course and the public sector taking the back seat.

Economic reforms since the mid-1980s have called for conservative budgetary measures and prudent monetary policy. Malaysia has opted for nothing less than a balanced budget. In fact, Malaysia has been posting budget surpluses for several years. Conservative fiscal policy has been accompanied by a fairly prudent monetary policy, with the Central Bank pursuing realistic interest rates. However, there have been considerable central bank interventions in the foreign exchange markets.

Economic Turmoil

While Malaysia has accomplished much in a short period of time, there have been considerable ups and downs. The first major economic

crisis experienced by the country was in the mid-1980s when the economy suffered a severe recession which was attributed to the poor performance of many state-owned enterprises, heavy external debts, overvalued exchange rate of the Ringgit and depressed commodity markets. The Malaysian economy, however, rebounded remarkably, responding positively to the various economic reforms that were introduced by the government. These reforms included privatisation of many public enterprises, debureaucratisation, deregulation, decontrol and the devaluation of the Ringgit. The Malaysian economy has been growing at rapid rates since 1987.

Economic success has brought with it new challenges. The task of managing such success has proved to be more daunting than that of creating it. Although the Malaysian economy has been fairly resilient, it remained susceptible to the external fluctuations, the price all open economies have to pay. The currency turbulence since July 1997 experienced by the Malaysian economy is an interesting case in point. The Malaysian Ringgit has depreciated by about 30 per cent, causing shock waves throughout the system. The Malaysian stock market has also tumbled badly with the Kuala Lumpur Stock Exchange plunging by about 50 per cent.

The Ringgit debacle has taken many by surprise, although one could understand the contagion effect arising from the fall of the Thai Bhat that has spread to neighbouring countries including Indonesia, Philippines, Hong Kong and Singapore and more recently South Korea. However, the contagion effect could only provide a partial explanation for the sharp fall in the external value of the Ringgit. For the rest of the explanation one has to look elsewhere.

It appeared that fundamentals were strong and solid relative to that of Thailand, Philippines and Indonesia. On many counts Malaysia is very different from these countries. External debt accounts for only

30 per cent of GNP. Short-term external debts form only a small proportion of the total. Malaysia's savings-GNP ratio is nearly 40 per cent. International reserves until mid-July 1997 were large enough to finance four months of retained imports. In the banking sector, loans to property and security markets accounted for less than one-third of the total, while the ratio of non-performing loans stood at less than 4 per cent. At the macro level, Malaysia has been registering budget surpluses for several years consecutively. How can we then explain the currency turmoil?

While fundamentals determine the long-term exchange rates, it is market sentiments that drive the short-term prices of currencies. These sentiments are, more often than not, are based on perceptions rather than facts and figures. The interpretations of facts and figures are also often tainted by perceptions. Be that as it may, one must not ignore a major flaw, namely the huge current account deficits in the country's balance of payments. The perception was that the BOP current account deficit would get worse, not better in the near term.

In 1995, the ratio of BOP current account deficit to GNP was 10.8 per cent. In 1996, the situation seemed to have improved significantly, as this ratio was reduced to 5.6 per cent. Nonetheless, the perception remained that it would worsen in 1997 and the next few years. This perception was based on the expectation that the government would implement several mega projects which would cause a dent in the balance of payments given the high import content of these projects and the possible diversion of resources from the traded to the nontraded sector. This fear was compounded by the RM2.1 billion trade deficits reported for the January-June 1997 period.

Although the BOP situation had improved in 1996, there were concerns about the way in which the deficit was financed. Not only was there a RM13 billion current account deficit, there was also an outflow of

long-term capital in the form of "reverse investments" by the Malaysian companies to the tune of RM6.6 billion. The Central Bank could also increase its external reserves by about RM6.2 billion, despite the current account deficit. FDI inflows could cover only a part of all these. The rest of the finance came in the form of short-term capital inflows, estimated at RM11.2 billion. Herein lay the seeds of the currency crisis that was to unfold in July 1997. The short-term capital has always been notoriously volatile. It could move out as fast as it moves in. Any crack in the confidence, perceived or real, could trigger a massive outflow of such short-term funds.

Concerns about BOP, referred, to above were exacerbated by the fact that FDI inflows into country in the first 6 months of 1997 declined by about 45 per cent. This led to fears about Malaysia's ability to finance the deficits. Many fund-managers and stock-brocking firms were worried that Malaysia will have to run down its external reserves and/or resort to external borrowing.

In the domestic sector, a cause of concern has lately been the rapid growth of overall money supply (M3) at rates exceeding 20 per cent per annum. What is more, bank loans have been growing even faster at rates surpassing 30 per cent per annum. Apparently, the Central Bank was injecting liquidity to prevent increases in interest rates. The base lending rate (BLR) of commercial banks, hovering at 9.6 per cent, was considered high. At the margin, real interest rates have risen sharply, given the low rate of inflation in the economy. Loans given to the "unproductive" property and security sectors have been growing at a much faster pace than that extended to the manufacturing sector. There have also been concerns about property prices which many analysts tended to view unfavourably, given the anticipated oversupply conditions. All these must have also contributed to the currency crunch.

Some policy pronouncements, made in the midst of the looming uncertainties, seem to have backfired due to wrong timing. For example, the decision by the Central Bank to limit bank loans for property, stocks and shares, designed to divert resources from "unproductive" speculative activities to productive sector, although well-intentioned, unfortunately came at a time when the local stock market was already under sedation. Such pre-emptive measures were, however, seen as warning signals by the market operators.

The 1998 Budget unveiled in October 1997 could not prevent a deepening of the currency crisis. The Budget introduced several fiscal measures to increase exports and to reduce imports. The carrots offered in the Budget included export allowances, reinvestment incentives and reduction in the corporate tax rate from 30 per cent to 28 per cent. Budget tightening took mainly the form of increases in import duties on consumer durables, cutbacks in government expenditure and shelving of several mega projects valued at RM65.5 billion. Later in December 1997, the Finance Minister announced several austerity measures which included an 18 per cent government expenditure cut, freezing of reverse investments, reduction of targeted growth rate for 1998 from 7 per cent down to 4-5 per cent and postponement more infrastructure projects.

To be sure, the currency crisis represents a temporary setback, as the real sector is in a fairly good shape. The recovery process will, however, depend critically on the policy measures that the government will adopt. It is unfortunate that there has been too much rhetoric and too little substance in terms of immediate policy response.

Systemic Problems

It is important that the policy makers recognise that all is not well with the domestic economy and that one cannot blame it all on

external factors. There is certainly a need for the policy makers to come to terms with the new realities and to set the house in order.

The Malaysian economy has been growing too fast at rates averaging 8.5 per cent per annum during the last 10 years. Growing current account BOP deficits are a sure sign of overheating, although inflationary pressures have been defused, thanks mainly to the presence of foreign workers. The latter have helped prevent a wage-push inflation by depressing wages and a demand-pull inflation by repatriating their earnings. There is certainly a need to rein in on growth. A run-away growth has serious cost implications, as it could strain the country's balance of payments and financial system. The actual real GDP growth rates have exceeded the "potential" growth rate (Chart 1), where the latter is defined as one that would not exert upward pressure on wages and prices. It is thus important to bring the growth rate down to what is considered potential or optimal.

It is also disturbing to note that the high GDP growth rates experienced in recent years have been largely input-driven, with more and more capital and labour, and not productivity-driven, as indicated by the declining Total Factor Productivity (TPF) (Chart 2). That capital has not been used very efficiently may be inferred from the fact that incremental capital output ratio (ICOR) has been rising sharply (Chart 3). However, the sharp increase in ICOR may be partly due to heavy investments in infrastructure with a long gestation period. Labour productivity has been lagging behind wage increases with rising unit labour costs, although it has been rising at a decreasing rate in recent years (Chart 4). Nevertheless, there are significant inter-industry variations, with the transport equipment industry registering the sharpest increase in unit labour costs and the textile industry experiencing the least, the only exception being the chemical and plastic industry where unit labour cost has fallen markedly during January-

July 1997 (Table 2). There were also indications of an exchange rate overvaluation of the Malaysian currency from 1992 onward, with the real effective exchange rate diverging from the nominal exchange rate (Chart 5).

Shortage of capital and labour has been overcome through importing foreign capital and labour. This is a dangerous receipe, as there are limits to the importation of capital and labour. Foreign short-term capital is highly volatile and sensitive, while long-term capital is hard to come by as many countries compete to attract FDI. Foreign labour is really not as cheap as it may appear, as the social costs far exceed the wages paid by the employers. Malaysia should learn to produce more with less capital and less labour by improving the productivity of capital and labour.

Malaysia invests nearly 45 per cent of GNP, while its savings amount to about 39 per cent of GNP. There is a need to close the domestic resource gap by using capital more carefully and by increasing national savings. Nonetheless, FDI must continue to play an important role, even if the domestic resource gap is eliminated. For domestic capital is no substitute for FDI. It is incorrect to view the latter purely as financial flows, as they bring with them new technology, marketing know-how and new managerial skills, all of which have a powerful demonstration effect on local investors. To put it differently, the external economies associated with FDI are far more significant than that of domestic investments.

Malaysia's dependence on foreign labour is a different story. There are some 2 million guest workers in the country. It is estimated that nearly one-half of them are illegal workers. The number is too large, given the small local workforce of 9 million. While the overpresence of foreign workers has kept wages low, thereby maintaining the competitiveness of Malaysian exports, it has impeded

structural adjustments that might have otherwise taken place. Higher wages would have forced firms to adopt labour-saving production methods and raise labour productivity, thereby taking the economy up the technology ladder. The heavy dependence on foreign workers seems to have adversely affected technology transfers, as firms are unwilling to invest in guest workers who may not stay long enough. Malaysia is thus risking the danger of being trapped in a low-level technology equilibrium.

Besides, foreign labour is not as cheap as it might appear, as the social costs clearly exceed the private costs to the employers. High social costs, which take such forms as strains on medical amenities, introduction of new diseases and increase in crime rates, imply that society is subsidising the firms that employ such workers. What is more, the large presence of guest workers has also dented the current account of the country's balance of payments through income remittances. Assuming that each guest workers sends home RM250 a month, 2 million of them would be remitting some RM6 billion a year, which is probably a gross underestimate.

This is not to deny the positive contributions of foreign workers. In their absence, the economy would have grown more slowly and wages would have climbed more steeply and inflation would have risen more rapidly. The point made here is that all this is not without high costs to the economy. To put it differently, Malaysia may have forgone long-term gains for short-term benefits by resorting to the importation of foreign workers too early.

Another serious problem faced by the Malaysian economy is the recent phenomenon of reverse investment flows. In 1995-96, reverse investments by Malaysian companies amounted to about RM13 billion. In the first seven months of 1997, reverse investments exceeded RM7 billion. It is not difficult to craft a case in favour of such investments,

as they help not only to establish equity linkages but also to penetrate into the host country markets. The main difficulty however arises from the fact that these investments have strained the capital account without easing the current account of the balance of payments. In other words, while the massive outflows have weakened the capital account, there has been very little inflow in the form of investment incomes in the current account. Perhaps, it is too early for these investments to bring home profits. But, the fact remains that it is unwise to increase such investments at a time when the country is experiencing severe BOP deficits. A country must generate enough surpluses to effect the "real transfer" associated with capital exports. The difficulties are compounded by the fact that the bulk of the reverse investments have gone largely into the development of infrastructure development and tourism-related activities which have a longer gestation period before harvests.

The services account of Malaysia's balance of payments has always been in deficit. In an attempt to reduce this deficit, the government has been promoting local shipping and insurance for many years without much result. Apparently, Malaysia does not have a potential comparative or competitive advantage in shipping and insurance, as the local ventures have failed to grow up over time. This does not mean that nothing can be done about the services account deficit. To be sure there are several other services areas in which Malaysia can develop its own niches. Tourism is a clear candidate. Malaysia has been quite successful in attracting tourists in recent years, but it is a late comer compared with Thailand or Indonesia. Educational services represent yet another potential area, and it was only recently that the government has begun to look seriously at the prospects of exporting educational services by turning Malaysia into a regional centre for higher education. Financial services are also viewed in

similar lights for transforming Malaysia into a regional financial centre. The fact, however, remains that the services sector is over-regulated and over-protected and that they cannot compete internationally.

The manufacturing sector now accounts for about 35 per cent of the country's GDP. The manufacturing share is likely to level off after reaching the 38 per cent mark. It will plateau for a while before it begins to decline, as it has happened in many industrialised countries. In other words, the manufacturing sector cannot be the "engine of growth" for long. The Malaysian economy needs a new "locomotive" to propel the economy. The services sector is thus seen as the new engine, but it is by no means ready to play this role. This sector has been protected for too long. This sector is too inward-looking. There is a need to reorientate the services sector by exposing them to greater foreign competition, which calls for a gradual and orderly liberalisation and deregulation of the services sector.

The importance of a sound banking system can hardly be exaggerated. Without a doubt, Malaysia's financial system has been resting on solid grounds. The central bank has always been a good watchdog. It has adopted a fairly prudent monetary policy. However, there are signs that there is too much liquidity in the system. Broad money supply, M3, has been growing at over 20 per cent per annum in recent years. More alarming is the rapid expansion of banking loans which have grown at the rate of over 30 per cent per annum. It appears that bank credit for speculative and property sectors and non-traded sector activities has grown more than that for the manufacturing and other traded sector activities. Interest rate differential between deposit and lending rates have widened over the years. Lack of transparency has often led to rumours that undermine the faith in the banking system during uncertainties. There are also concerns about growing non-performing loans. Tough actions taken by the central bank during

difficult times can force even firms with sound fundamentals to fold up. Tough measures during bad times may just as imprudent as the lack of them during good times.

Rapid economic growth since 1987 did cause strains on the country's infrastructure. Malaysia has always prided itself as one of the few developing countries with good infrastructure facilities. Indeed, one of the main attractions of Malaysia for FDI has been its good infrastructure. There were concerns in the early nineties that Malaysia's infrastructure was lagging behind economic growth. Hence the renewed importance attached to infrastructure development projects. It appears that Malaysia was overzealous in its infrastructure development drive in recent times. The clustering of many multi-billion dollar projects seems to have strained the economy by diverting resources away from traded-sector activities and by increasing imports. The 1998 Budget, unveiled in October 1997, postponed or shelved several mega projects valued at over RM65 billion. More projects were shelved later in December in 1997 as part of the emergency measures, as the currency crisis deepened. The message is loud and clear: while infrastructure development must keep pace with economic growth, it must also be kept within manageable limits.

The Way Forward

Economic crises are sometimes blessings in disguise, as it tends to have a humbling effect on people at the helm and forces them to take a hard look at themselves, get their bearings right, shift gears and change directions. Economic crises compel policy makers to be pragmatic and down-to-earth. Thus, the currency crisis may be seen essentially as a market correction in the face of an overheating economy with an overvalued currency. However, the market is by no means perfect, as it tends to overshoot, causing excessive depreciation with the pendulum

swingging to the other extreme where the Ringgit is grossly undervalued. It will take a while before the dusts settle and things normalise. Things will probably have to get worse before it can get better.

There might have been an implosion in the Malaysian economy, if the Ringgit did not depreciate along with the currencies of other East Asian countries. Malaysia would have lost its export competitiveness, causing the export sector to contract with severe unemployment consequences. It is in this sense that the currency crisis has averted a bigger real sector crisis. This does not necessarily mean that the real sector of the economy is now safe. Far from it. To be sure, the financial sector crisis will impact on the real sector as well sooner or later through rising costs in general and interest rates in particular.

The recovery will be delayed by the lack of confidence in the currency and the financial system. Capital flight in search of safer havens would exacerbate the difficulties, causing the Ringgit to spiral downward and interest rates to soar upward. It is not easy to restore confidence, especially when transparency is lacking. There are important lessons of governance in all these not only for the government sector but also for the corporate sector.

All these notwithstanding, one must not overlook or underestimate the positive side of the Ringgit depreciation. It will stimulate exports, even though some of the advantage of the weak Ringgit may be offset by rising cost of imports and other costs. It will also stimulate the domestic sector, as demand gets diverted from expensive imports towards cheaper local substitutes. This, however, may not be sufficient to prevent a major slowdown in the country's economic growth in 1998 and 1999, as the government and the corporate sector must tighten the belt and bite the bullet.

The fundamentals of the Malaysian economy remain strong. Be that as it may, strong fundamentals can assert themselves only in the long run. It does appear that the Malaysian economy is still the strongest among the ailing ones in the region. But, then, it is not good enough if Malaysia puts its own house in order and others do not. Malaysia's economic recovery will depend also on that of the neighbouring countries, as foreign investors tend to look at the region as a whole.

The medium- and long-term prospects seem bright, provided that Malaysia has the will to address the challenges discussed above. If the Malaysian experience of the mid-1980s is anything to go by, one can be very confident about Malaysia's future prospects.

Table 1

Sectoral Contributions to GDP (%)

Sector	1957	1967	1977	1987	1997*
Agriculture	40	30	25	23	11
Mining	7	9	7	10	7
Manufacturing	8	14	18	24	35
Construction	3	5	4	3	4
Services	42	43	44	40	45

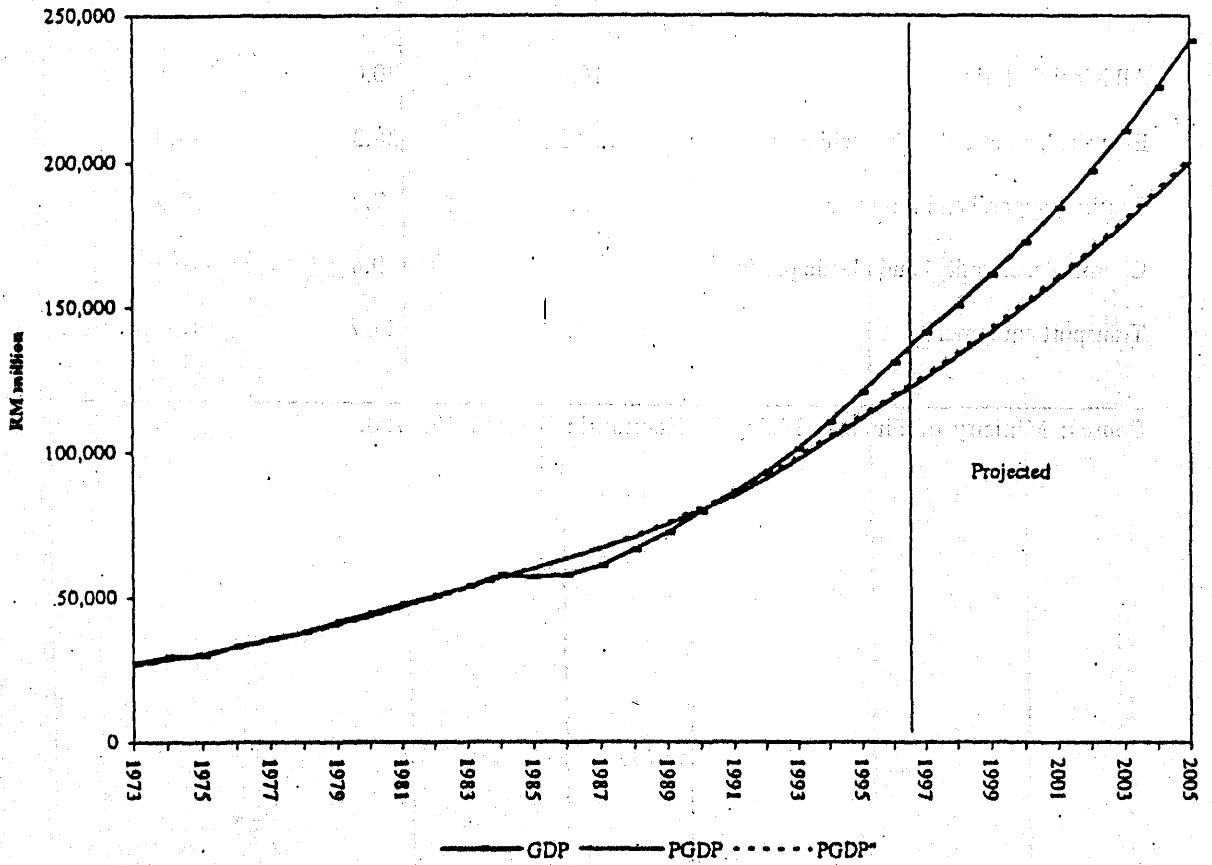
** Estimate*
Source: Economic Reports (various) and Malaysia Plans

Table 2
Manufacturing Sector: Labour Productivity, Real Average Wage and Real Unit Labour Cost by Industry
(Annualised % Rate of Change During January-July 1997)

Industry	Labour Productivity	Real Average Wage	Real Unit Labour Cost
All Manufacturing	10.8	20.0	8.3
Electrical, electronics & machinery	12.5	28.3	14.0
Textiles, apparel and footwear	5.3	7.4	1.9
Chemicals, chemical and plastic products	22	9.4	-10.3
Transport equipment	-5.5	11.7	18.2

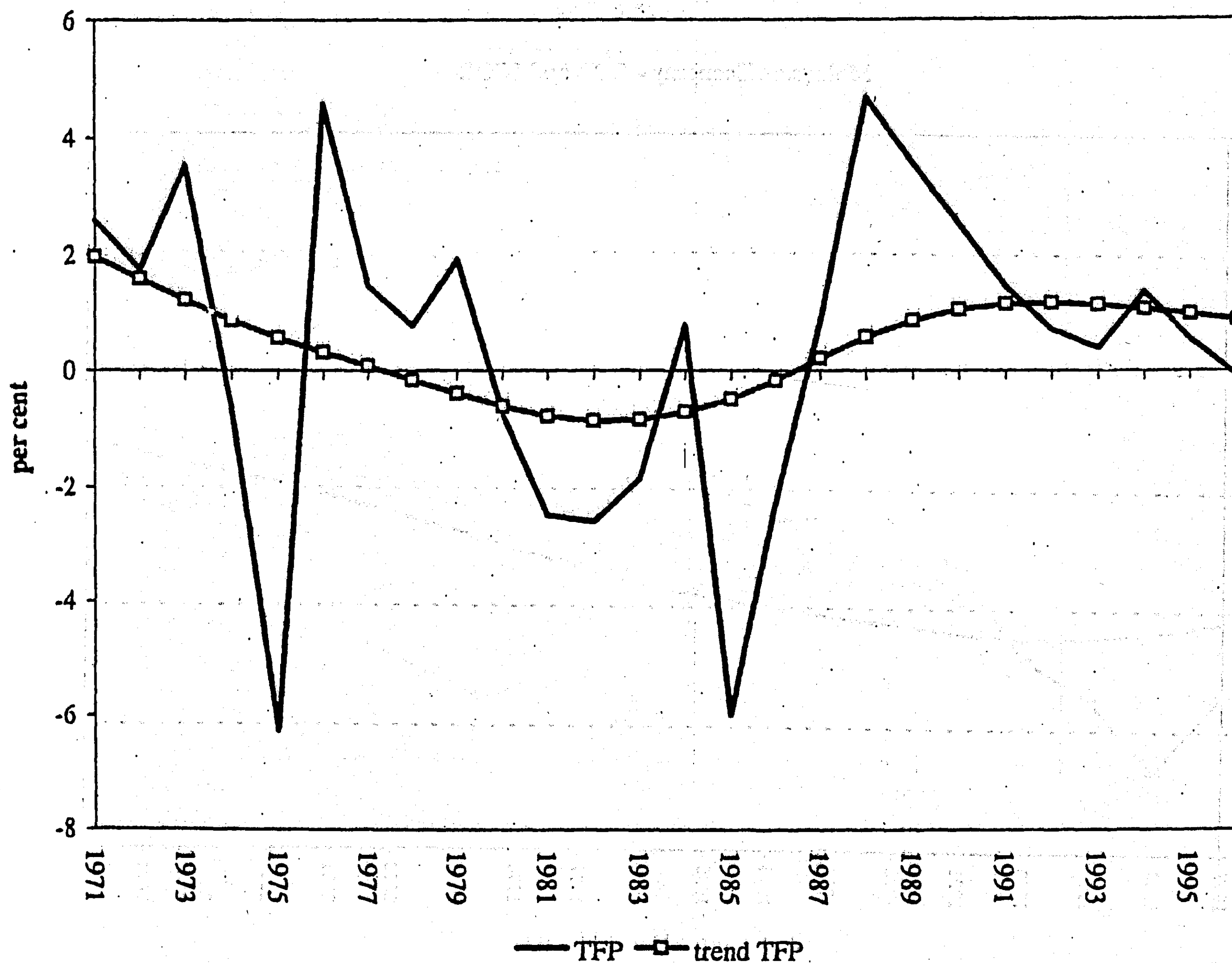
Source: Ministry of Finance, Malaysia, **Economic Report 1997/98.**

Chart 1



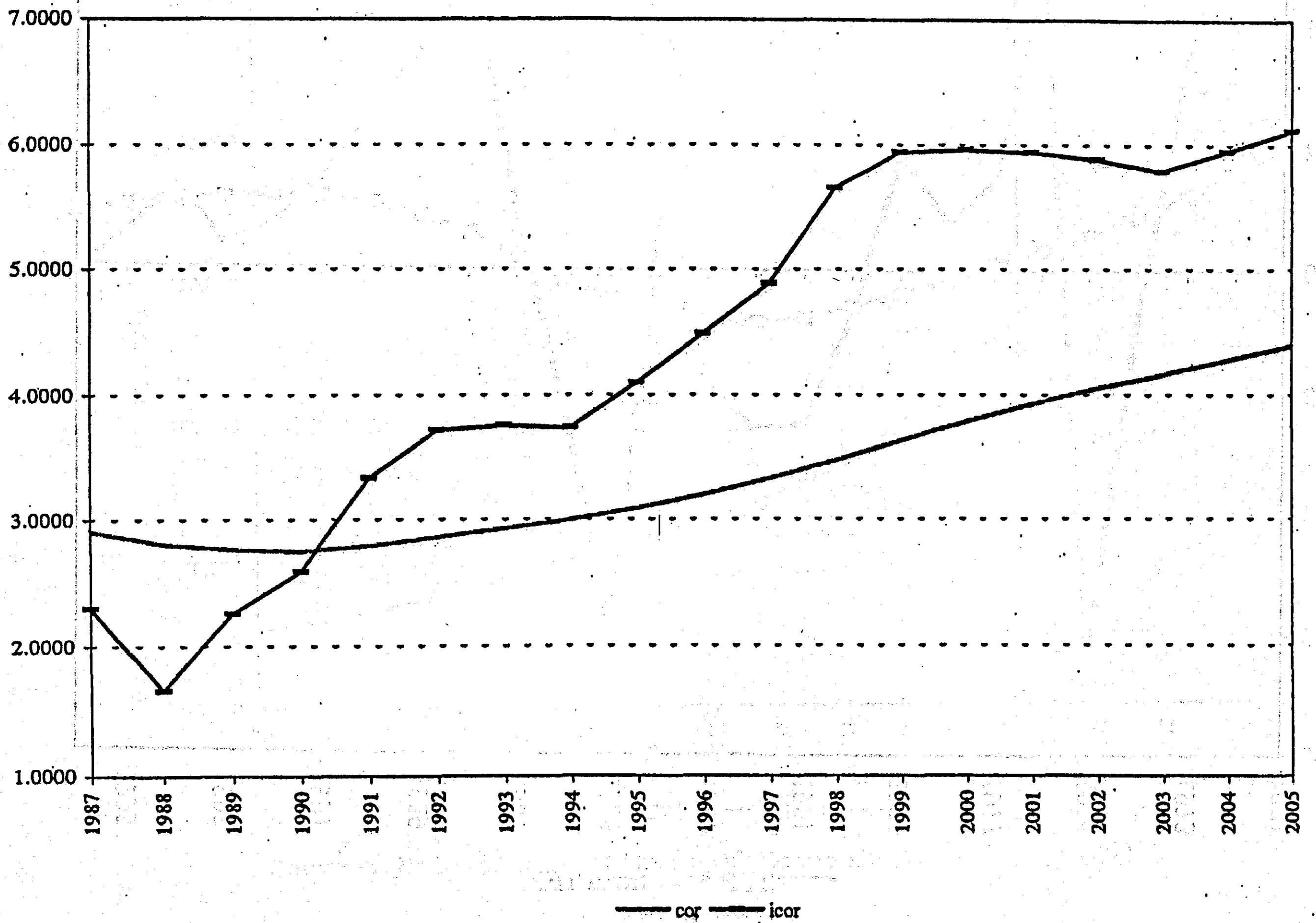
Source: Malaysian Institute Of Economic Research (MIER)

Chart 2



Source: MIER

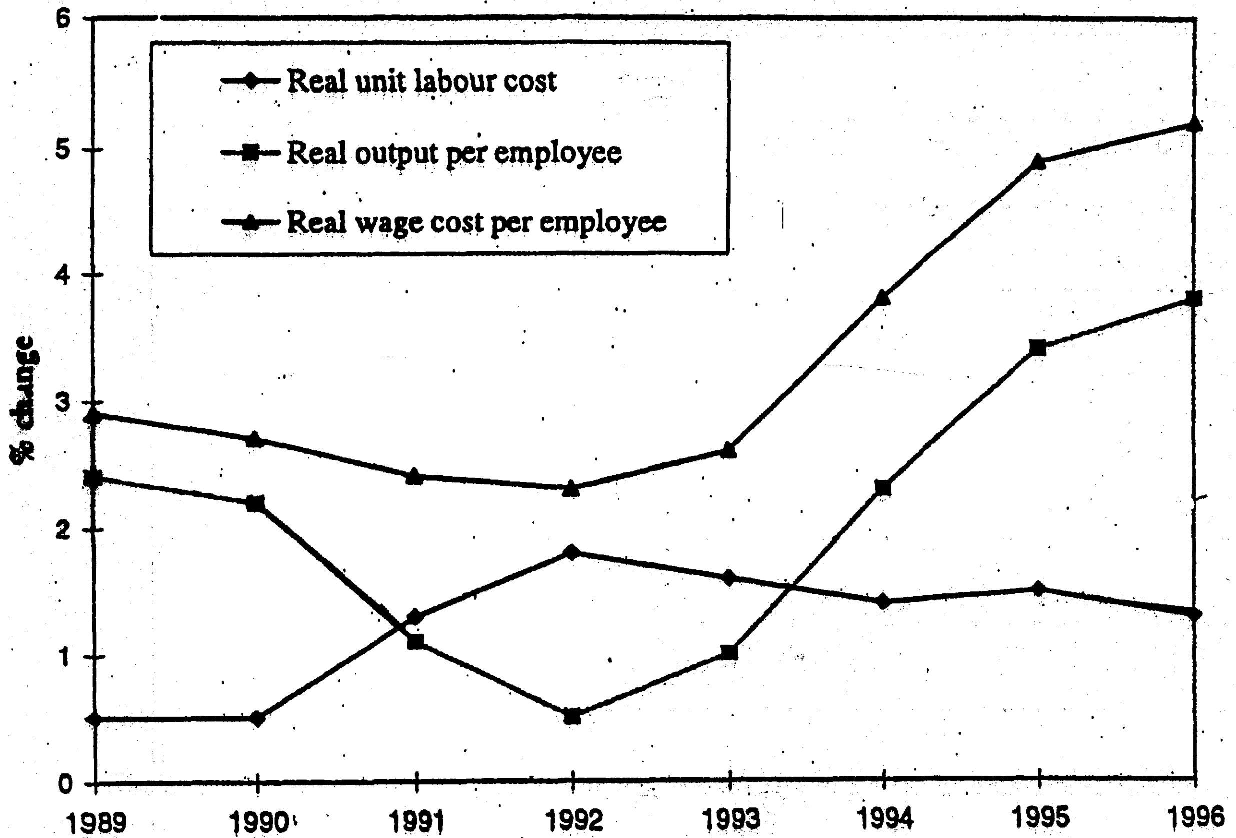
Chart 3



Source: MIER

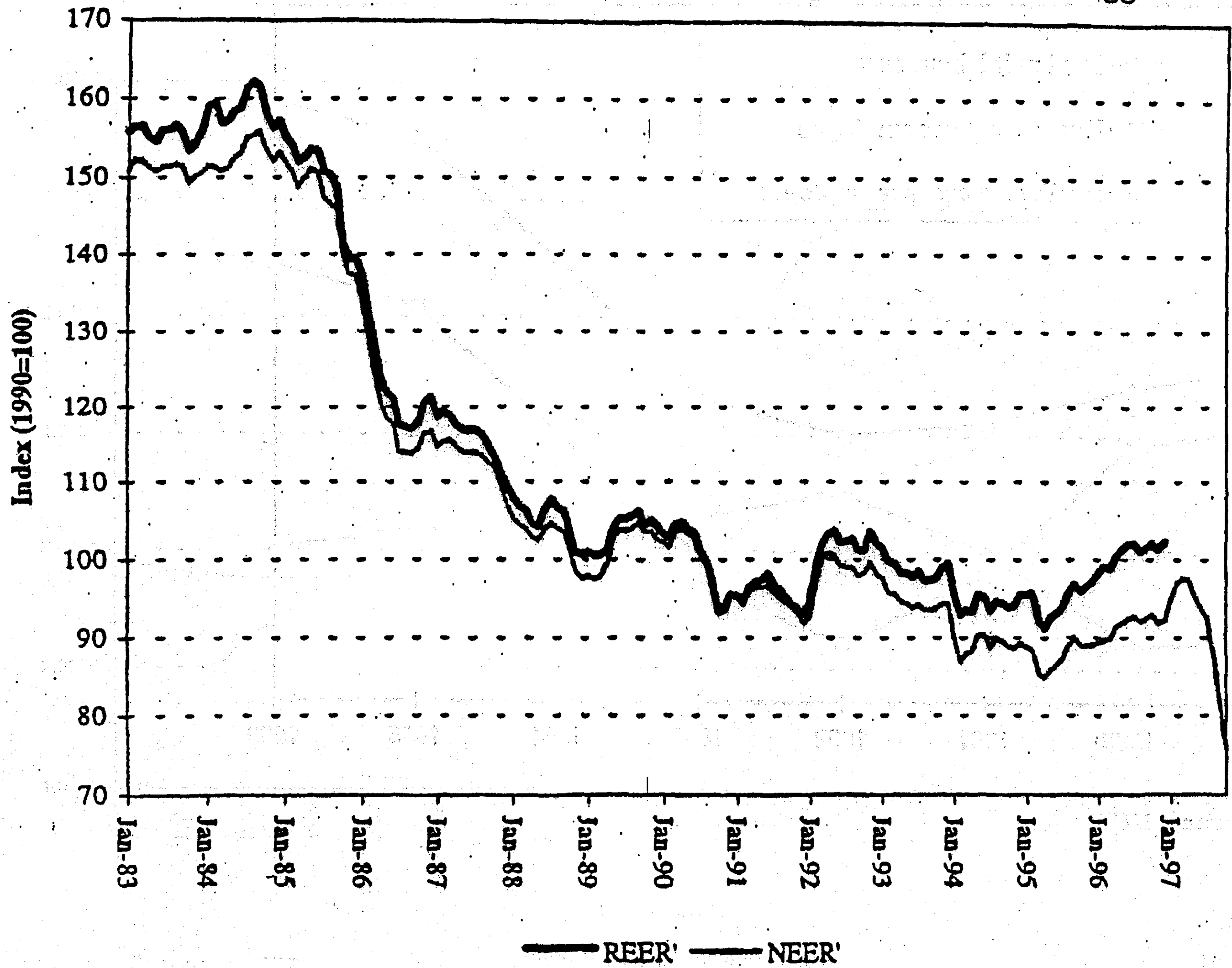
Chart 4

Manufacturing Sector - Real Unit Labour Cost, Real Output per Employee and Real Wage Cost per Employee



Source: MIER

Chart 5



Source: MIER