Malaysia

Financial turbulence reduced economic growth in 1997 and a more marked decline is likely in 1998. The potentially favorable impact of the depreciation of the ringgit on exports requires complementary measures, and stronger and broader responses to the financial crisis may be necessary.

RECENT TRENDS AND PROSPECTS

Currency instability and asset market disruption buffeted Malaysia's financial and corporate sectors in 1997. A massive depreciation of the ringgit, combined with plunging stock market values, seriously eroded the financial standing of many Malaysian businesses. After some initial hesitancy, the Malaysian government responded to these events by paring back public expenditures on prestige projects, tightening monetary policy, and taking measures to strengthen the financial system. Although asset values plummeted in 1997, the effects of the crisis have yet to register fully on incomes.

The financial crisis that unfolded during the second half of 1997 took its toll on economic performance. Economic growth for the year slowed to 7.5 percent from 8.6 percent in 1996. All components of aggregate demand grew more slowly, largely because of diminished confidence in markets and the loss of purchasing power associated with large reductions in the capital value of assets. The fiscal and monetary measures introduced in the latter part of the year in response to the crisis held back growth still further.

Notwithstanding difficulties in other sectors, agriculture performed well. Output grew by a strong 3.5 percent in 1997. The growth in output was broadly based, with palm oil, sawlogs, and livestock output all growing. However, rubber and cocoa production declined, largely because of the conversion of land to other uses and labor shortages.

Manufacturing output growth eased, particularly because of the weak performance of the electrical and electronics industry. This industry dominates Malaysian manufacturing and has been hard hit by the slowdown in the growth of global demand in this sector. Growth in the construction sector also slowed. Measures taken to limit lending to the property sector and a general slackening in demand for office space, condominiums, and retail outlets affected construction activity. The service sector was comparatively buoyant based on strong performance of the transportation, storage, and communications subsectors. However, finance, insurance, real estate, and business services, as well as wholesale and retail trade, and hotel and restaurant services, recorded lower growth. This was attributable to the instability in the financial markets and to the haze problem that resulted from the Southeast Asian forest fires caused by the drought associated with El Niño. This led to a downturn in tourism.

Despite the moderation in economic growth, Malaysia's unemployment rate remained low at 2.5 percent in 1997. This was the sixth year in a row that the economy was virtually at full employment. As a result, upward pressure on wages grew, and wage increases again outpaced productivity gains. Unskilled foreign workers continue to provide

Table 2.8 Major Economic Indicators: Malaysia, 1995-1999
(percent)

Item	1995	1996	1997	1998	1999
Gross domestic product growth	9.5	8.6	7.5	3.5	4.5
Gross domestic investment/GDP	43.5	41.5	42.0	40.5	41.5
Gross domestic savings/GDP	39.5	42.6	43.8	42.0	42.5
Inflation rate (consumer price index)	3.4	3.5	4.0	5.0	4.5
Money supply (M2) growth	24.0	20.9	18.5	18.0	20.0
Fiscal balance/GDP	0.9	0.7	1.8	0.9	1.4
Merchandise exports growth	26.6	7.3	6.0	8.0	10.0
Merchandise imports growth	30.4	1.7	7.0	6.0	7.0
Current account balance/GDP	-8.4	-5.0	-5.3	-4.9	-3.8
Debt-service/exports	6.2	na	na	na	na

na Not available.

Sources: Ministry of Finance (1997), International Monetary Fund (1998), and staff estimates.

an important reservoir of labor that is used to meet local demands. Estimates indicate the presence of more than a million documented foreign workers in 1997 and another million undocumented migrants.

Malaysia continued to finance its development expenditure through public savings to avoid borrowing and tried to minimize increases in both operating and development expenditures. Although public sector operating and development expenditures increased, so did public sector revenues. The government maintained the overall public sector surplus at 2.1 percent of GNP.

Inflation picked up slightly during 1997. Consumer prices increased by 4 percent during the year. Strong credit growth in the first half of 1997 helps explain some of the acceleration.

The direction of monetary policy in the second part of 1997 was tentative as Malaysia struggled to find a way to stop the hemorrhaging of the ringgit and the collapse of its stock market. Foreign exchange controls, which were introduced in August, quickly proved counterproductive, as they led to an exodus of investors from the stock market and further weakened the ringgit. As a consequence, the government abandoned these measures. Interest rate policy also lacked clear direction. The government relaxed an initial tightening of interest rates as equity prices declined, but comparatively low interest rates made stemming the tide of the ringgit's depreciation more difficult. Subsequently, the government tightened monetary policy again as part of an overall policy response to the crisis.

Merchandise exports increased by only 6 percent in 1997. While this is only slightly less than the increase in 1996, it is far below the double-digit export growth that Malaysia has routinely posted in the past. The dominance of electronic and electrical goods production has left Malaysia particularly prone to the vagaries of global demand in this sector. Unfortunately, exports of textiles, clothing, and footwear—traditionally the second largest foreign exchange earner among manufactured goods—have also been languishing. Stiffer competition from lower cost countries is now adversely affecting growth in these sectors. The performance of other exports was mixed. Commodity exports increased by slightly less than 1 percent, led by higher export volumes of palm oil and palm kernel oil. However, export earnings from crude petroleum declined by 1.7 percent as global prices softened. Led by exports of liquefied natural gas, "mining" exports registered strong growth.

Capital goods imports accounted for much of the 7 percent expansion in merchandise imports in

1997. Some of these imports, particularly ships and commercial aircraft, are needed to offset Malaysia's long-standing service account deficit. Imports of intermediate and consumption goods grew more moderately because of the ringgit's depreciation. The faster growth of imports relative to exports caused Malaysia's trade surplus to contract in 1997. Together with the deficit on the income and service account, this contributed to a widening of the current account deficit to 5.5 percent of GNP.

Projections indicate that growth will slow abruptly in 1998. The growth of GDP will be somewhere between 3 and 4 percent, the slowest growth in more than a decade. As a result of the depreciation of the ringgit, the collapse in asset values, and the tighter fiscal and monetary policies, domestic demand will fall markedly. In 1999, as the government eases its restrictive policies somewhat and net exports respond favorably to the currency depreciation, growth may pick up to about 4 to 5 percent. However, private investment is likely to remain subdued for some time.

On the production side, slower growth is anticipated in all sectors. Agricultural output is expected to grow by only 2 percent in 1998 because of anticipated weakness in international commodity prices and competition from lower cost countries. Short-term growth in the manufacturing sector is likely to be weak. Intermediate goods will cost more, foreign direct investment (FDI) may falter, and global demand conditions in the electronic and electrical goods sector are not expected to strengthen much. Some firms may find obtaining new credit difficult. The construction sector will also experience lower growth in the face of excess capacity in residential and office space, high interest rates, and the measures introduced to dampen speculation in the property market. Beyond 1998, manufacturing growth should recover as restocking of inventories occurs and manufacturers begin to feel the benefits of the ringgit's depreciation. A favorable supply response depends, however, on the containment of domestic inflationary pressures, as well as on external market conditions.

Service activity will also be badly hit in 1998. The finance, real estate, and business service sector will bear the brunt of asset and currency market dislocation. Consumer services will also suffer as real income growth slows. The hosting of the Commonwealth Games in September 1998 should help buoy services and, provided the haze does not return, tourism may pick up as a consequence of the currency depreciation.

Inflationary pressures emanating from a weaker ringgit will put upward pressure on consumer prices. Despite sluggish domestic demand, consumer price inflation could accelerate to about 5 percent in 1998. As the economy adjusts to the new exchange rate regime and labor constraints loosen, continued fiscal and monetary discipline should succeed in easing price increases in the latter part of 1999.

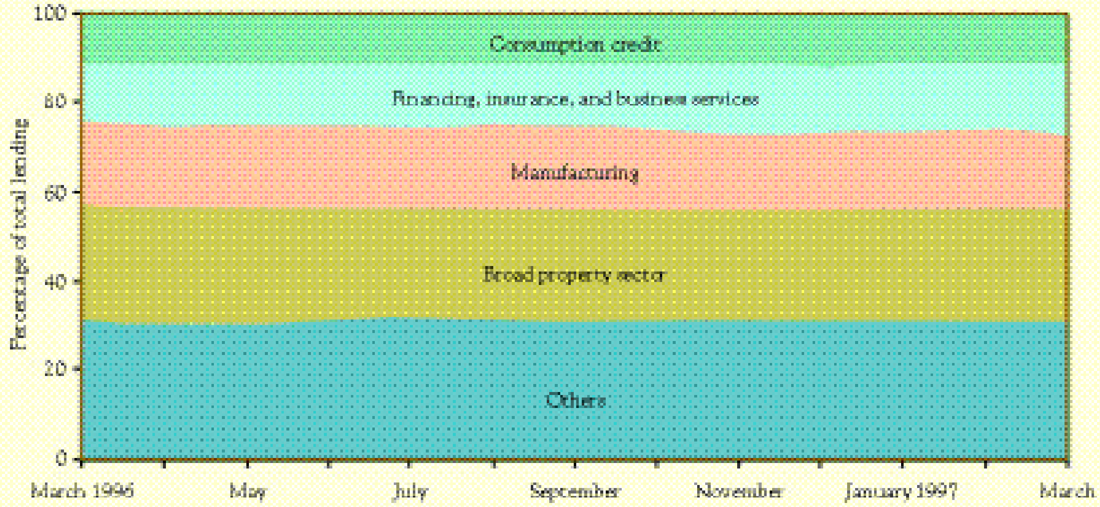
Exports are expected to pick up in 1998 as a result of the ringgit's depreciation. Subdued import growth will lead to a larger trade surplus. To moderate import growth, the government is planning to establish a RM1 billion ($250 million) fund for small and medium-scale manufacturers to spur local production. Companies with paid-up capital of less than RM50 million will be able to avail themselves of this fund. With service payments for freight and insurance and FDI income repatriation growing more slowly, the service account deficit is projected to narrow somewhat. Thus the current account deficit is expected to decline to 5 percent of GNP in 1998.

By 1999, exports should respond strongly to a more favorable exchange rate and should outpace import growth even more. While the trade account surplus will continue to increase, this will likely be more than offset by a persistent deficit on the service account. Consequently, the current account will remain in deficit, although it is projected to ease somewhat. External borrowing by public enterprises is expected to be less in 1998 than in 1997. Malaysia should maintain a relatively comfortable international reserves position, although some short-term capital outflows are likely to persist.

CRITICAL ISSUES IN SHORT-TERM ECONOMIC MANAGEMENT

Malaysia is exposed to a number of short-run economic risks, of which the most immediate is its current account position, which remains fragile. There is no prospect for anything other than marginal improvement in 1998. Indeed, the deficit may even widen because of lumpy imports (for instance, for aircraft, ships, and infrastructure projects), lower export growth, and continued increases in net service payments. At the same time, financing the

Figure 2.6 Banking System Loans to Major Sectors: Malaysia, March 1996-March 1997



Source: Bank Negara Malaysia data.

deficit could become a problem if FDI flows decline, particularly in the electrical and electronics industry as a result of excess capacity. While lower FDI would also reduce capital imports, the net effect on the balance of payments will be negative. To mitigate risks, Malaysia should focus on re-evaluating the economic returns of planned large infrastructure projects, maintaining a restrictive monetary stance, and encouraging long-run capital inflows whenever possible.

Malaysia also faces the difficult challenge of reining in its overheated property sector. Although the growth of the broad construction sector appears to be slowing, the banking system's exposure to the property market remains high at nearly 26 percent of total loans in early 1997. Bringing this exposure down to the target limit of 20 percent or less will require a strong and resolute effort. While the authorities have instituted measures to restrict the supply of credit to the sector, the momentum of credit growth and activity in the construction sector cannot be halted overnight.

Malaysia's financial sector would benefit from more prudent supervision and tighter regulation. In this regard, the government's plan to undertake a broad review of the supervisory and regulatory system is appropriate, and should result in long-term benefits if follow through on the outcome of the review is appropriate. A stronger regulatory and supervisory framework should improve loan quality and standards of asset management, leading to a more healthy and robust financial sector. Fuller and more timely disclosure of information would be a critical component of improved regulation. In this connection, the Bank Negara's recent initiatives to increase transparency in the conduct of monetary policy are a welcome move.

POLICY AND DEVELOPMENT ISSUES

To promote a solid platform for long-term growth, Malaysia must devote more resources to investing in the development of relevant skills for its labor force. Secondary education and curricula need to be strengthened further, as do tertiary-level technical and vocational education programs. Indeed, the need to invest in the domestic provision of education has become more urgent as the foreign exchange costs of educating Malaysians overseas have now risen sharply. The development of a modern and responsive education system is an objective worthy of consistent support, even during troubled times.

The need to upgrade Malaysia's industrial base in a way that is responsive to its shifting comparative advantage raises broader questions. While, as part of its strategy to deal with the current crisis, the government has put the recruitment of foreign workers on hold, it needs to work out a longer term vision that is not only sensitive to the needs of immigrant workers, but also meets national economic objectives. Given the structure of migrant flows to Malaysia, these issues could perhaps be usefully considered within the broader framework of the Association of Southeast Asian Nations.

Malaysia's New Economic Policy has helped lift many from poverty. For some time the policy also seemed to succeed in reducing income inequality; however, income distribution appears to have worsened since the mid-1980s, both between and within ethnic groups, and especially within the Malay group. At the same time, regional inequalities seem to be on the rise. East Malaysia and the eastern states of Peninsular Malaysia have not benefited from growth to the same extent as parts of west Peninsular Malaysia. To the extent that poor and comparatively uneducated Malays are disproportionately concentrated in those regions that are lagging, regional and ethnic inequality are related. For distributional reasons, and with a view to easing congestion and related costs, especially in the Klang Valley, Malaysia might consider policies to promote more balanced growth across its regions, for example, by supporting existing initiatives on growth areas with a more balanced spatial apportionment of resources for education, and for infrastructure more generally.