

Malaysia

Malaysia has made an impressive recovery from economic recession in 1998. Although capital controls enabled the authorities to pursue expansionary fiscal and monetary policies without precipitating capital flight, greater market orientation in several areas will support a more sustainable recovery. Enhancing the skill level of the Malaysian labor force remains a key challenge for improving economic competitiveness and long-term development prospects.

RECENT TRENDS AND PROSPECTS

The economy achieved a robust recovery in 1999, with real GDP expanding by 5.4 percent after having contracted by 7.5 percent in 1998. Stronger economic growth also led to a decline in the rate of unemployment to 3 percent of the labor force in 1999 from 3.2 percent in 1998. Most of the positive signs of economic growth came from greater external demand for manufactured goods and a rise in consumer confidence, as reflected in increased passenger car sales, sales tax receipts, and imports of consumer goods.

All major production sectors, with the exception of construction and mining, recorded higher growth in 1999. The manufacturing sector expanded by 13.6 percent, spearheaded by strong external demand for electronic equipment and components. A significant increase in crude palm oil production pushed agriculture sector growth to 3.8 percent, while increased manufacturing activity and stronger export growth led to a recovery in service subsectors such as transportation, storage, and communications.

Although a large surplus of high-rise commercial buildings and higher-end condominium units continued to depress construction activity, output contraction lessened in 1999. Despite the strong rebound in overall economic activity in 1999, the recovery was uneven, and private investment activity continued to contract because of inadequate credit expansion and excess industrial capacity.

After averaging 5.3 percent in 1998, consumer price inflation decreased steadily during 1999, averaging 2.8 percent. The slowdown reflected continued excess capacity, greater exchange rate stability, and a slower increase in food prices. The strong economic rebound, the relaxation of restrictions on the repatriation of portfolio investment, and the consequent decision of several credit rating agencies to readmit Malaysia to their global benchmark equity indices led to a recovery in share prices. Share prices were, however, somewhat volatile, owing in part to uncertainty over US interest rates and a strengthening yen. Overall equity prices, as measured by the Kuala Lumpur Composite Index, rose by 39 percent in 1999.

Table 2.10 Major Economic Indicators, Malaysia, 1997-2001
(percent)

Item	1997	1998	1999	2000	2001
GDP growth	7.5	-7.5	5.4	6.0	6.1
Gross domestic investment/GDP	42.9	26.7	23.7	24.1	25.0
Gross national savings/GDP	37.3	39.6	37.7	35.4	35.0
Inflation rate (consumer price index)	2.7	5.3	2.8	3.3	3.5
Money supply (M2) growth	18.5	2.7	8.3	12.0	14.5
Fiscal balance/GNP	2.5	-1.9	-4.9	-2.0	0.5
Merchandise exports growth	1.2	-7.5	10.1	8.0	8.0
Merchandise imports growth	1.4	-26.5	10.0	12.6	13.0
Current account balance/GDP	-5.0	12.9	14.0	11.3	8.1
Debt-service ratio	6.5	6.6	6.2	5.3	5.0

Sources: IMF (2000); Bank Negara Malaysia; staff estimates.

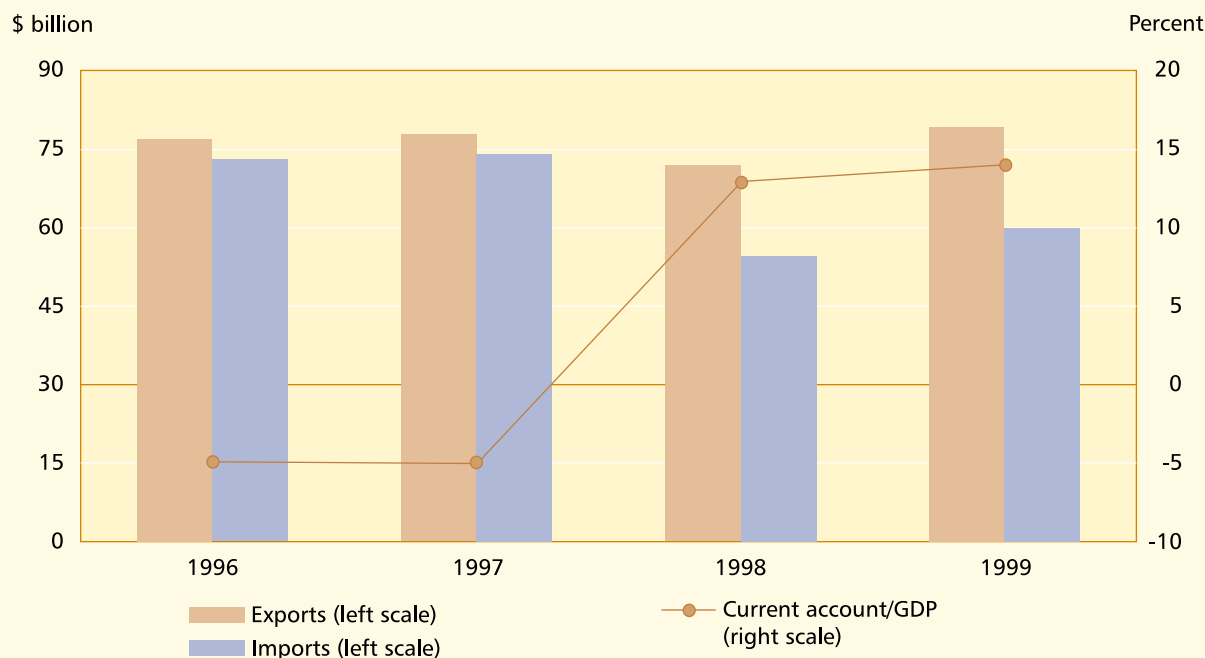
The appreciation of the currencies of Malaysia's main trading partners in 1999—following their precipitous declines in the latter half of 1997 and into 1998—left the ringgit relatively undervalued. This, in turn, helped improve the price competitiveness of Malaysian exports. However, any cost advantage from currency undervaluation is likely to be temporary. Countries such as People's Republic of China, India, and Viet Nam, which have a huge cost advantage in relatively unskilled labor, are increasingly moving into producing the lower value-added goods currently exported by Malaysia.

The balance of payments strengthened further in 1999, following a substantial improvement in the trade surplus and higher net inflows of long-term capital. The trade surplus in 1998 was driven by import compression, as imports declined much more sharply than exports (see figure 2.9). The 1999 surplus, however, resulted from a higher initial level of exports as exports and imports expanded at similar rates. Export growth was buoyed by the real depreciation of the ringgit and stronger demand for electronic goods, both within the region and by the United States. Import growth was stimulated by renewed consumer confi-

dence and the need to replenish depleted stocks of raw materials. Imports of capital goods, however, remained subdued because of excess capacity in several production sectors. The significantly larger trade surplus more than offset an increase in the services and transfers deficit and led to a higher current account surplus. Higher net inflows of official long-term capital boosted the capital account. This included a \$1 billion global bond issued by the government after a lapse of nine years, and concessional loans from the Japanese government under the New Miyazawa Initiative. Because of these developments, the overall balance of payments was substantially in surplus, and net international reserves increased to \$30.9 billion (six months of import equivalent). The external debt position improved in 1999 because of higher repayments and less borrowing by the private sector. Because of the lower incidence of debt and the improved export situation, the debt-service ratio declined to 6.2 percent in 1999 from 6.6 percent the previous year.

GDP growth is likely to accelerate in 2000 as private consumption strengthens, reducing excess industrial capacity and providing more incentives for fixed investment. Purchasing power will recover

Figure 2.9 Levels of Exports and Imports and Current Account, Malaysia, 1996-1999



Sources: IMF (2000); Bank Negara Malaysia.

further as asset values increase and unemployment eases, while fixed investment will pick up because of increased bank lending. These positive trends will, however, be partially offset as public consumption expands more slowly to bring down the level of fiscal deficit. The rate of increase in real GDP growth is likely to moderate in 2001 as the recovery from recession ends. Inflation is likely to pick up slightly because of stronger domestic demand, rising real wages, and a recovery in non-oil commodity prices, but it will remain substantially below its 1998 level. The trade surplus is likely to narrow, as an expected improvement in export performance on the back of stronger world trade growth is offset by faster import growth, because of the import-dependent nature of exports and a higher demand for capital goods. Malaysia's dependence on trade-related service imports and increased outflows of profits and dividend payments will likely widen services and income deficits, in turn causing the current account surplus to narrow. The exter-

nal debt position is expected to remain manageable, and Malaysia should not experience any problems in meeting its debt obligations.

Although stronger economic growth is likely to increase the demand for workers, various factors may limit how much unemployment decreases. These include ongoing restructuring activities in the construction, manufacturing, and financial sectors; the tendency for private companies to employ migrant workers as wage pressures begin to mount; and a loss of competitiveness in labor-intensive, low-value-added goods because of increased competition from countries with cheaper unskilled labor.

ISSUES IN ECONOMIC MANAGEMENT

With capital controls in place, the government pursued expansionary fiscal and monetary policies to stimulate the economy in 1999. While expansionary fiscal policies have undoubtedly helped to revive the

economy, lower interest rates have been less effective in stimulating loan growth. The central bank's three-month intervention rate—the rate used by banks to fix the base lending rate—reached a low of 5.5 percent in 1999, falling from a high of 11 percent in 1998. Correspondingly, base lending rates declined to less than 7 percent from more than 12 percent in July 1998, although total loans extended by the banking system contracted 4 percent during the year.

The ratio of nonperforming loans (NPLs) on a three-month arrears basis decreased only gradually—from 18.9 percent at the end of 1998 to 16.7 percent at the end of December 1999—and corporate debt restructuring proceeded slowly. Hence banks were reluctant to lend for fear of increasing their risk exposure. With domestic demand still subdued, fiscal and monetary policies probably will remain expansionary in the short term to boost private consumption and investment. To encourage investment and loan growth, the government is likely to capitalize on the current low inflation to further reduce interest rates. Loan growth is also likely to increase and NPLs decrease as the economy continues to recover.

The government has, however, made considerable progress in cleaning up the banking sector by NPL purchases and capital injections. Danaharta, the agency set up to purchase and rehabilitate the banking sector's bad debt, acquired around 35 percent of NPLs and began disposing of these assets. Danamodal, the special-purpose organization for recapitalizing and strengthening banks, initially injected RM6.4 billion into ten banks. The amount involved decreased to RM4.6 billion following repayments by five banking institutions. The government also attempted to consolidate the banking sector to create domestic financial institutions that can withstand international competition. This competition is expected to intensify in 2003 when the government liberalizes the sector to conform to its World Trade Organization commitments. The plan initially called for the consolidation of the country's 58 financial institutions by the end of March 2000 into six anchor banks to be selected by the authorities. However, following strong objections to some parts of the plan, the central bank allowed commercial banks to choose their own merger partners—which they have now done—and extended the deadline to December 2000.

Some observers are concerned over the need for greater transparency and a proper balancing of creditor and borrower interests in the voluntary corporate debt workout program. However, notable progress has been achieved in restructuring corporate debt. By the end of September 1999, Malaysia's Corporate Debt Restructuring Committee, which oversees the voluntary program, had received 63 applications for debt restructuring that totalled RM35 billion. Of these, 15 restructuring schemes involving debts of RM12.7 billion were completed or were in various stages of implementation, while a further 15 cases involving debts worth RM3.5 billion were rejected. A program for reforming corporate governance, created in 1998, was enacted. It requires publicly listed companies to file quarterly financial statements, restricts the number of directorships an individual may hold, enhances disclosure requirements for publicly listed companies relating to takeovers and mergers, and requires more stringent listing requirements and capital adequacy ratios for publicly listed financial companies.

During 1999, some of the capital control measures that had been introduced in September 1998 to support economic recovery were significantly relaxed. In February 1999, an exit levy replaced the previous moratorium on the repatriation of portfolio capital. This allowed foreign investors to repatriate the principal and profits upon payment of a graduated levy that varied from 10-30 percent, depending on the duration of investment in Malaysia. In September 1999, a uniform levy of 10 percent on capital gains replaced the graduated levy.

Malaysia has survived the dire predictions made by many analysts when it imposed selective capital controls in September 1998. At a time when international investors had yet to regain confidence in the region, capital controls gave the authorities sufficient flexibility to pursue expansionary fiscal and monetary policies that would stimulate domestic demand without precipitating capital flight. Using capital controls to accelerate corporate and financial sector reforms and replacing the quantitative restrictions on repatriating portfolio investment with an exit levy also helped restore international confidence and reestablish portfolio capital inflows.

In the short term, however, greater market orientation in several areas will help bring about a more

robust and sustainable recovery. For instance, setting a minimum loan growth target for banks (as was the policy in 1998 and 1999) is likely to lessen the quality of credit appraisal and jeopardize the asset quality of banks. Loan growth more likely will be stimulated if banks are allowed to set lending rates consistent with underlying risks, rather than the current practice of setting a cap on lending rate using an administratively determined, fixed markup on the base rate.

Reverting to a three-month NPL classification standard and reducing the current six-month disclosure requirement for banks to three months also will strengthen prudential norms and provide a stricter assessment of the banking system's health. This will also reinforce market discipline and be consistent with the direction of current financial sector and corporate sector reforms. Bank exposure limits to certain risky sectors (such as real estate and share transactions) that were relaxed in 1998 must be reviewed to strengthen overall risk management by individual banks. Coping with these issues will reduce the vulnerabilities that characterized the financial sector when the crisis struck in 1997.

POLICY AND DEVELOPMENT ISSUES

In the longer term, the retention of capital controls and the fixed exchange rate probably will increase inefficiency in resource allocation. This, in turn, is likely to have negative implications for economic growth. The number of foreign investment applications has fallen steadily since the imposition of capital controls in September 1998. This suggests continued investor unease over these measures, which has serious implications for a country that wants to shift from producing low-cost, labor-intensive manufactured goods to high-technology, knowledge-based high value-added products.

Malaysia has made impressive gains in increasing the educational levels of its population, especially at the primary and secondary levels. Concern is, however, growing about educational quality considering the shortage of skilled labor for the high-technology and knowledge-based industries that the country

hopes to build, and the perceived lack of labor competitiveness compared with most Association of Southeast Asian Nations countries. While the effects of the economic crisis on existing levels of primary and secondary education are believed to be mild, the effect on tertiary education is more severe. The steep rise in the cost of tertiary education abroad has led to increased demand for public tertiary education within Malaysia, both from new school leavers and returning overseas students who cannot afford to complete their studies abroad. Estimates indicate that in 1998 there were 112,000 applications for the 40,222 places available at the country's ten public universities. Under these circumstances, local tertiary education costs have reportedly increased about 30 percent, beyond the reach of many lower middle-income families.

In the initial stages of the crisis, the government decreased its education budget as part of an across-the-board cut of 18 percent in all categories of expenditure to restore international confidence and stabilize the economy. Expenditure cuts in the school construction program in rural areas, teacher training programs, and educational management information systems undoubtedly adversely affected educational access, quality, and efficiency. Following the abandonment of the government's restrictive demand management program in mid-1998, these budget reductions were restored in 1999 and allocations for education were increased in real terms.

However, given the shortage of skilled labor and the bottlenecks in tertiary education, efforts must be redoubled to encourage greater private sector participation in providing higher education and appropriate skills development programs. Private sector employers also need to be involved in providing vocational training. This will not only increase the likelihood that the skills gained by trainees are relevant to employer needs, but would shift the financial burden of providing such courses to employers, away from the public sector. The opportunity cost of not doing so is high, because private provision of education not only increases access to education at little or no cost to the government, but also introduces competition that could improve standards.