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Can Malaysia's Economy Beat the Odds in 2013?

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INTRODUCTION

The Malaysian economy performed well in the first three quarters and exceptionally well in the fourth quarter of 2012 and grew by 5.6% for that year. The projection is that it will grow by about 5% in 2013 provided there are no external shocks. This relatively high growth rate is expected despite weakening demand from the USA and Europe for Malaysia's main export, that is, manufactured goods. The prospects also look good next year because of the aggressive expansionary investment drive by Japan into Southeast Asia led by Prime Minister Abe (The Jakarta Post, January 19, 2013). The relatively high growth rate achieved in 2012, which is many shades below the super high growth rates achieved in the early 1990s, has been attributed to domestic demand being fuelled partly by Prime Minister Najib's generous election year handouts to the public, especially the lower classes. These "ang pow" (gifts given during Chinese New Year) packets from Prime Minister Najib have gone largely into consumption and hence have helped fuel headline inflation. The Central Bank, Bank Negara Malaysia, claims that inflation is well under control though, and moderated to 1.3% in the fourth quarter of 2012, "reflecting lower inflation in the food and non-alcoholic beverages category" (Bank Negara Malaysia, 2013: 133).

INFLATION

There is obviously a gap between what Bank Negara measures as inflation and what the people experience as inflation. Prepared food prices have generally gone up by at least 10 % in the last quarter and especially during and after the Chinese New Year festival. The handouts given out by the government to boost private consumption and domestic demand is transitory income or windfall gains but the prepared food price increases are permanent. The setting up of BR1M shops selling lunch for RM1, and 1Malaysia Health Clinics has not contributed much towards abetting inflation as they too are spread out and hard to reach. The rental market has also been active and house and office space rents have gone up. As food and rents make a large proportion of the income of lower income groups, their hardship may be reflected in the upcoming polls. Hence the generous temporary handouts, which at the same time increase private consumption and domestic demand to compensate for weakening external demand.

DOMESTIC DEMAND

However, it should be pointed that the cash handouts were well intentioned to increase domestic demand in the face of falling external demand. There have even been calls by the American Federal Reserve chairman Ben Shalom Bernanke (Bernanke, November 19, 2010) to rebalance the world economy whereby developing countries should spend more so that domestic demand can influence economic growth especially. Although this is a laudable goal, the reality is that the Malaysian economy is too small to be dependent on domestic demand. The people cannot be expected to save less and spend more although Bernanke has eloquently argued that the huge savings from the emerging markets flowing into the United States in search of higher returns and lower risk caused the sub-prime crisis. Malaysians from all walks of life save a relatively high proportion of their income for a variety of reasons including the fact that they do not have social security and health care benefits and a safety net to see them through old age. Malaysia's savings rate is one of the highest in the world, at 34% of GNP despite the very low rate of interest given to savings deposits. Even periods of negative real interest rates have not been able to dampen the relatively high propensity to save among Malaysians.

SOURCES OF DOMESTIC DEMAND

Domestic demand has come from both increased public and private consumption and investment. Private consumption has been strong because of a tight job market, Najib's cash transfers and higher wages, especially public sector wages. Public consumption has in-

creased through purchase of supplies and services and increased wages. However, there are limits to increasing private consumption through government cash transfers and handouts as the public debt is already high. The New Straits Times of Malaysia reported the Managing Director of the IMF, Ms Christine Lagarde as having commented that "Malaysia's public finances were among the weakest in the region, due to its high level of indebtedness and dependence on commodity-linked revenues for financing, where prices are highly volatile" and "urged Malaysia to overhaul its tax and subsidy regimes to achieve inclusive growth" (New Straits Times, 14 January 2013).

Domestic investments have also contributed positively to increases in gross fixed capital formation. According to the World Bank, "gross fixed capital formation surged in the first three quarters of 2012, taking the share of investment in GDP to the highest level since 1997, spurred by high-value private and public projects in oil and gas, real estate and infrastructure" (World Bank, 2012). The Central Bank of Malaysia endorses this view in its latest Quarterly Economic Report for Quarter 4, 2012 where it states that "investment will be led by capital spending in the domestic-oriented sectors, the oil and gas industry and the on-going implementation of infrastructure projects" (BNM, Monetary Policy Statement, January 31, 2013). However, what was not noted is that the ratio of Gross Fixed Capital Formation (GFCF) to GDP is still about half what it used to be before the 1997 Asian Financial Crisis. The risk of investing in Malaysia is still pretty high because of the experience of the 1997 Asian Financial Crisis when the sudden reversal of capital flows increased defaults (Radelet and Sachs, 1998). However, the recent surge in investments in the Iskandar Development Region and in oil and gas and ongoing infrastructure projects are expected to continue.

MONETARY POLICY

Monetary Policy has been cautious as Bank Negara Malaysia has been reluctant to either increase or decrease the interest rate through its Overnight Policy Rate, which it has not changed since May 2011 (Business Times, March 1, 2013). The Central Bank in January 2013 maintained the Overnight Policy Rate, which passes as bank interest rates, at 3% on the grounds that the Monetary Policy Committee (MPC) of Bank Negara considers "the current stance of monetary policy to be supportive of the economy while inflation remains contained" (Bank Negara Malaysia, 2013a). In March 2013, Bank Negara Malaysia reiterated its commitment to maintain the Overnight Policy Rate at 3% because the "MPC considers the current stance of monetary policy to be appropriate given the outlook for inflation and growth" (Bank Negara Malaysia, 2013b).

An increase in the interest rate will attract more short-term capital flows as 'carry trade', whereas a decrease in the interest rate may lead to outflows of capital and cause stock prices to fall. But at the same time, domestic investors may invest in the stock market

as the cost of funds falls. An increase in the interest rate may also discourage long-term investments as the cost of funds rises. Rising interest rates may also help to break the housing price bubble, which the government has reluctantly admitted to. The implementation of a new capital gains tax regime and loan to value ratios together with raising interest rates may make housing more affordable but the government and Bank Negara Malaysia has been hesitant in increasing the interest rate.

The World Bank has summarized the lack of action on the part of Bank Negara Malaysia as follows: "on one hand, strength in domestic demand, rising real estate prices and a positive output gap call for a resumption of the normalization of interest rates while declining inflation rates and heightened external risks call for easing. Given these opposing forces, Bank Negara Malaysia (BNM) has decided to keep its benchmark interest rate (the Overnight Policy Rate, OPR) unchanged throughout 2012" (World Bank,2012:13). In other words, the Central Bank of Malaysia appears crippled as it is unable to increase interest rates because of the need to increase domestic demand in a small open economy when external demand is low, constant and perhaps falling.

FALLING EXTERNAL DEMAND

Malaysia is not only helpless in using interest rate policy to stimulate growth, it is also unable to generate external demand for Malaysia's goods and services to cover for falling external demand for its traditional manufactured exports, which constituted about 76% of its exports when the Global Financial Crisis erupted in 2008 (Ministry of Finance, Malaysia, 2009: 69). The demand for its manufactured goods has been falling since the beginning of the Global Financial Crisis, especially for electrical and electronics goods. The trade balance or net exports of Malaysia is positive but although it has deteriorated since the last quarter of 2011 till the third quarter of 2012, it has registered a larger surplus in the fourth quarter of 2012. It has declined from $32.2 billion in Q4 2011 to $17.2 billion in Q3 2012. Although the expectation was that net exports will decline further as prices of commodities decline and imports of capital goods increase, the surprise is that the trade surplus increased to RM 26.6 billion in the fourth quarter of 2012 (BNM,2013:145) on the back of higher commodity prices. However, on an annual basis, net exports of goods declined by about 24% from 2011 to 2012.

Malaysia is now dependent on the export of oil, palm oil and rubber and the prices of these commodities are expected to decline given the expected lower rate of growth in China and the continuing gloomy prospects of a global economic recovery. Malaysia's manufactured exports, on which the country was dependent to produce more than 7% growth in the past, has declined since the beginning of the Global Financial Crisis in 2008 and is not expected to show a recovery in 2013. Malaysia's imports have been sustained at about 82% of total exports between 2011 and 2012 (Ministry of Finance, 2013: Table 2.4)

and they constitute mainly imports of capital and intermediate goods (Ministry of Finance, 2013:99) for the manufacturing and oil and gas industries. The import of consumption goods only constituted on the average about 7% of total imports in 2011 and 2012 (Ministry of Finance, 2013: 99).

THE CURRENT ACCOUNT BALANCE

The declining trend of net exports or the trade balance between 2011 and 2012 is not brightened by the increase in the services account deficit that had occurred since 2011. The services account deficit increased from RM8 billion to RM13.4 billion or by more than 67.5% between the end of 2011 and the end of 2012. The services account is usually a summary of payments for transportation and insurance services incurred in the import and exports of goods. It is usual for the payment of transportation and insurance services to vary with the value of shipments. However, the service account also includes payment for personal, cultural, recreational, construction, computer and information services and travel including tourism.

The current account balance is also influenced by income earned by Malaysians overseas and income earned by foreigners in Malaysia. The outflow of funds from Malaysia in the form of income earned by foreigners as dividends, investment income or payment for labour services has increased quite significantly from RM22 billion in 2011 to RM33.7 billion in 2012 (Bank Negara Malaysia, 2013:144). It is estimated that about 90% of the outflow as income has been in the form of investment income or repatriation of dividends and profits possibly of multinationals operating in Malaysia.

Current Transfers or “government to government” payments and private transfers made at the initiative of the individual has declined from RM21 billion in 2011 to RM18.2 billion in 2012 (Bank Negara Malaysia, 2013:144). The data on current transfers is not broken down into government and private transfers. One possible reason for the decline in current transfers may be because the slower economic growth rate is making it difficult for Malaysian parents to support their children’s education overseas. However, current transfers may also include workers’ remittances, donations, aids and grants, official assistance and pensions.

Malaysia’s current account balance has declined from RM97.1 billion in 2011 to RM60 billion in 2012 or by more than 38% (Bank Negara Malaysia, 2013:144). This is no doubt due to a declining trade balance; an increasing services deficit; increasing income outflows and outflows in the form of current transfers. Although the balance on current account has declined it has been positive for all the quarters between Q4 2010 to Q4 2012. This is quite unlike the situation just before the Asian Financial Crisis in 1997 when the current account was in deficit for several years (Asian Development Bank, 2000).

THE FINANCIAL ACCOUNT BALANCE

The overall balance in the Balance of Payments, which has been positive in 2011 and 2012, is largely influenced by the current account and the financial account. While the current account has been positive between 2011 and 2012, the financial account had turned negative in 2012 after being positive in 2011 (Bank Negara Malaysia, 2013: 144). The balance in the financial account had been above RM22.3 billion at the end of 2011 but moved to below RM22.5 billion at the end of 2012 (Bank Negara Malaysia, 2013:144). The Financial Account of the Balance of Payments is made up of Malaysia's Direct Investments Abroad, Foreign Direct Investments, Foreign Portfolio Investments and Financial Derivatives and other Investments, which include private and public investments.

The sudden and large reversal in the financial account in 2012 does not augur well for Malaysia as it reflects the large outflow of Malaysia's savings in the form of Direct Investments Abroad and other investments made overseas by the private and public sectors. Together they amounted to more than RM111 billion, which was nearly 1.9 times the inflow of Foreign Portfolio Investments (FPI) into Malaysia in 2012. It is indicative that Malaysian corporations were investing in a substantial manner overseas. Besides the outflow of direct investments by Malaysian corporations such as the government-owned Malayan Banking (or Maybank) and partly government-owned Commerce International Merchant Bank (CIMB), there were also substantial outflows of "other investments" amounting to RM60 billion in 2012. The outflow of "other investments" indicates that Malaysians were not confident of the investment environment in Malaysia or the risk-adjusted returns of investing overseas were much higher than investing in Malaysia.

The Financial Account deficit would have been much larger or severe in 2012 if not for the massive inflow of volatile short-term FPI amounting to RM 59.2 billion (Bank Negara Malaysia, 2013:144). The inflow of FPI more than doubled between the end of 2011 and the end of 2012, moving from RM27.6 billion to RM59.2 billion. These large FPIs flowed into the capital markets including the stock and bond markets. They could explain the spectacular and volatile behaviour of share prices and the sharp rise in the value of bonds traded including Islamic Bonds or Sukuks.

The Financial Account deficit would also have been worse if not for the positive inflow of long-term stable Foreign Direct Investments (FDI) in 2012. However, Malaysia performed relatively poorly as a host to FDI as total FDI inflows into Malaysia declined from RM36.6 billion at the end of 2011 to RM29.1 billion at the end of 2012, a fall of nearly 21% (Bank Negara Malaysia, 2013: 144).

The Malaysian Balance of Payments was in surplus in 2011 and 2012 although the amount of the surplus declined from RM94.9 billion in 2011 to RM3.9 billion in 2012 (Bank Negara Malaysia, 2013: 144). Malaysia's reserves were RM428 billion (USD 139.7 billion) in January 2013 which is sufficient to finance 9.5 months of imports and is about 4.6 times

its short-term debt. International reserves have also gone up by about 4.5% in US dollars between 2011 and 2012 (Bank Negara Malaysia, 2012:135; Bank Negara Malaysia, 2013:147).

PROBLEMS AND PROSPECTS OF THE ECONOMY

The Malaysian economy has several fundamental problems that have to be confronted. It is too dependent on commodity exports whose prices are volatile and on a downward trend. It is also too dependent on FPI to bolster its capital market including the stock and bond markets. A sudden reversal of volatile FPI flows may hurt the capital markets, cause prices to crash, and lead to currency, banking and balance of payments crises. The economy is also vulnerable because there is massive capital flight in the form of "other investments." The flight of "other investments" is quite substantial and increased from RM6.6 billion to RM60.7 billion between December 2011 and December 2012. Although the current account surplus in 2012 was substantial, the overall balance of the balance of payments was only about RM4 billion because a substantial amount was drained out as Direct Investments Abroad and "other investments." The outflow of funds as Direct Investments Abroad increased from RM46.7 billion in 2011 to RM51.0 billion in 2012 (Bank Negara Malaysia, 2013:144). If this trend continues then the balance of payments may become negative especially if commodity prices decline and the prospects for manufactured exports continue to be bleak.

The year, however, started off quite brightly as Malaysian "shipments to China rose 8.6 percent year-on-year, driven by demand for Malaysian crude oil, rubber, and electronic and chemical products" (Agence France-Presse, 3.11.2013).

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