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**THE IMPACT OF THE GLOBAL FINANCIAL CRISIS:
THE CASE OF MALAYSIA**

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Impact of the Global Financial Crisis: The Case of Malaysia

By

Goh Soo Khoon and Lim Mah Hui¹

1. Introduction

The present financial crisis is very different from the one Malaysia experienced in 1998. In 1998, Malaysia suffered a contraction in Gross Domestic Product (GDP) growth due to the Asian financial crisis which originated from Thailand. On the contrary, the present crisis did not start with Asia or Malaysia but is due to the weaknesses in the U.S. financial industry which escalated into a severe international financial crisis and deep slump in global trade and global recession by late 2008. The world's major economies, in particular the US, the European countries and Japan, are experiencing the worst economic contraction since the Great Depression of the 1930s.

Being a small open and export-dependant economy, Malaysia has not been spared from this external shock. The negative shock was transmitted to the Malaysian economy in the fourth quarter of 2008. Exports and industrial output's deteriorated and investments declined. Consumer sentiment was also adversely affected. As a result, GDP growth in the fourth quarter of 2008 was significantly lower at 0.1% compared with an average of 6% in the first nine months of the year. It is fortunate that today Malaysian banks have negligible exposure to securities linked to US subprime loans, and Malaysia's financial institutions and banks are in a better shape than they were during the Asian financial crisis in 1997.² However, prominent local economists forecast that though Malaysia may

¹ The authors wish to thank the following for their helpful insights and comments: Dr. Chang Huan Chiang, Dr. Cheong Kee Cheok, Dr. Rajah Rasiah and Dr. R. Thillainathan; and Ms. Rosliza Musa for the graphic presentations in this paper. The usual disclaimers apply.

² Bank Negara Annual Report 2008

not witness sharp downturns as compared with that of 1998, this may be a longer recession than the recession of 1998.³

This paper intends to examine the impact of this global financial crisis on the Malaysian real economy sector and discuss the policy implications to this economy. Section 2 presents an overview of the Malaysian economy after the Asian Financial Crisis (“AFC”). This section shows that after the AFC, Malaysia became more export dependant with the external sector overtaking private investments as the main driver of growth in GDP. Private investments, both domestic and foreign, declined, in the aftermath of the AFC. Despite the government’s continued efforts to provide new investment incentives to a broad range of industries, investments as a percentage of GDP had not returned to its pre-crisis level. Section 3 identifies the channels through which this global crisis affected Malaysia. There are two key channels through which the US financial crisis is transmitted to Malaysia, namely, the trade channel and the finance channel. This section also shows how the global crisis is then transmitted to the Malaysian real economy that led to a fall in consumer spending, job losses and a fall in the country’s income. Section 4 describes the government policies in response to this global crisis. Section 5 provides concluding remarks and policy implications.

2. Macroeconomic Performance Prior to the Global Financial Crisis, 2008

The impact of the AFC on Malaysia in 1997/98 was huge. The stock market and the currency market nearly collapsed during the crisis. Real GDP growth rate declined from 7.3% in 1997 to negative 7.4% in 1998, the worst downturn since independence. But the economy began its recovery in 1999. Exports of manufactured products contributed to the V-shaped recovery. The upturn in the global electronics cycle in 1999-2000 enabled Malaysia to export its way out of the crisis. In 1997, export of manufactured goods

³ StarBizWeek, A roundtable discussion on the impact of the global crisis on Malaysia”, 28th February, 2009. Panelists are Tan Sri Lin See Yan (former Bank Negara Deputy Governor), Professor Datuk Mohamed Ariff Kareem (MIER Executive Director), and Ms Tan Beng Ling (Meridian Asset Management Sdn Bhd chief Investment officer)

contributed 81% of total exports, with electronic and electrical exports constituting 66% of total Malaysian merchandise exports.

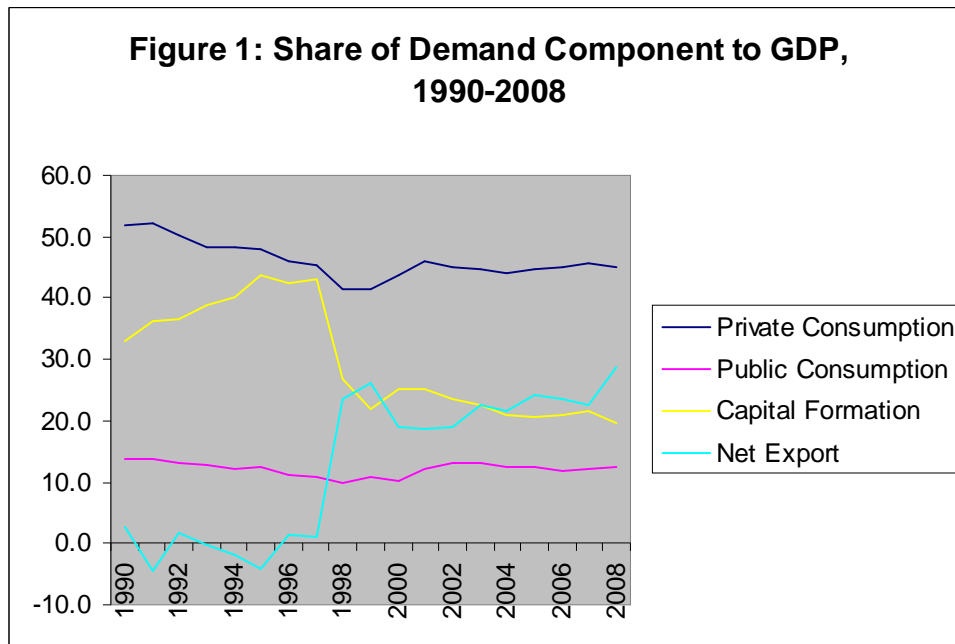
One of the lessons learned from the AFC was that the input-driven growth model that relied on natural resources, cheap labor and primary production was not able to sustain long-term economic growth (EPU, 2002). The Knowledge-based Economy Master Plan was introduced in 2002 with the aim of transforming the economy into an innovation-based driven economy with improved efficiency and productivity to enable Malaysia to achieve 'high-income country' status by 2020, a mission set in 1991 by the then Prime Minister, Dr Mahathir. Malaysia's economy has continued to grow since 2000, with the exception of 2001 where the bursting of the dotcom bubble adversely affected its growth. Its GDP growth rate contracted from 8.9% in 2000 to 0.3% in 2001. After 2001, Malaysia returned to a steady path of GDP growth averaging 5.3% annually from 2002 till 2007. However, this growth rate was lower than the average rate of 8.1% from 1990 -1997. Malaysia's economy recovered and grew, but it was not restructured fast enough to achieve a high level of growth (Mahani, 2009). There were disturbing structural issues facing the economy before the 2008 global financial crisis as discussed below:

a. Export Dependant Economy after the Asian Financial Crisis

Figure 1 shows the share of GDP for the demand components of GDP, from 1990 to 2008. The main components of GDP from the demand side before 1997 were private consumption and investment with net exports occupying a very marginal role. In 1991 and 1994/95, total imports were greater than total exports and in 1997 net exports was barely 1% of GDP. This changed dramatically after 1997 with net exports consistently accounting for about 20% of GDP making Malaysia one of the most open economies, dependent on international trade. Malaysia is the second most trade-dependent country after Singapore in the Asean region. Exports form 100% of GDP compared to Singapore with exports at 185% of GDP.

Manufactured exports played a leading role in the expansion of the export sector and the main source of this export expansion came from the electronics sector, dominated by foreign investors. The upsurge in the world electronic cycle, the big depreciation of the Ringgit against most major currencies, especially the US\$, and strong external demand from the G3 - United States, Europe and Japan - were among the factors accounting for the expansion of output in the export-oriented manufacturing sector (Athukorala, 2001).

Manufactured products accounted for more than 80% of the country's total gross exports. Of the manufactured products, more than 65% are electronics and electrical components, the bulk of which are highly import dependent for intermediate products and therefore with little domestic value-added contribution.⁴ Furthermore, the export market is not well diversified geographically with the G3 making up 40% of the country's total gross exports.⁵ Even substantial parts of exports to other Asian countries like China and Taiwan are meant for assembly and exported to the G3 countries.



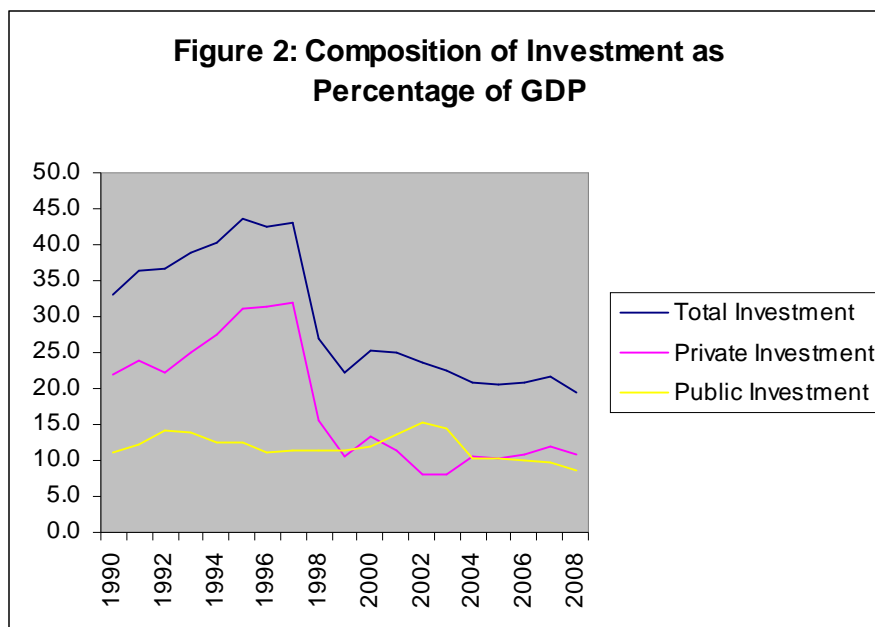
Source: Monthly Statistics Bulletin, BNM

⁴ StarBizWeek, “Search for a new growth model”, 25 April, 2009. Interview with three economists, Professor Datuk Dr Mohamed Ariff of Malaysian Institute of Economic Research, Nor Zahidi Alias of MARC, and Dr Yeah Kim Leng of RAM Holding

⁵ ibid

b) Inadequate Investments after the Asian Financial Crisis

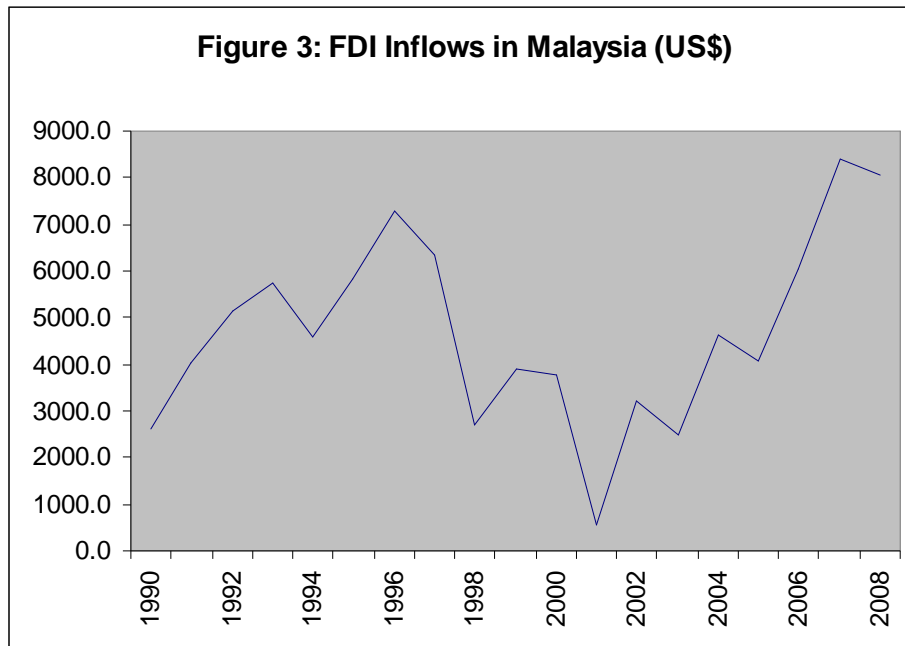
Figure 2 shows that investments as percentage of GDP halved after the AFC and never recovered to its pre-crisis level. Its gross domestic investments dropped from a peak of 43.6% in 1995 to 19.6% in 2008. Most of this decline came in the private sector that declined from 31.2% to 10.9% in the same period, whereas public investments only slowed moderately from 12.4% to 8.7%.



Source: Monthly Statistics Bulletin, BNM

Several reasons contributed to low investments after 1997. First is the decline in foreign direct investments (“FDI”) inflow into Malaysia compared to other countries after the AFC. Figure 3 shows FDI inflows have moderated compared to pre-crisis periods. FDI flows into Malaysia averaged US\$5.2 billion between 1990 and 1997, but declined to an average of US\$4.3 billion between 1998 and 2008. China, India, Vietnam and Cambodia absorbed most of the FDIs going to emerging market countries in Asia after 1997 (Kamer, 2004). United Nations Conference on Trade and Development reported that in

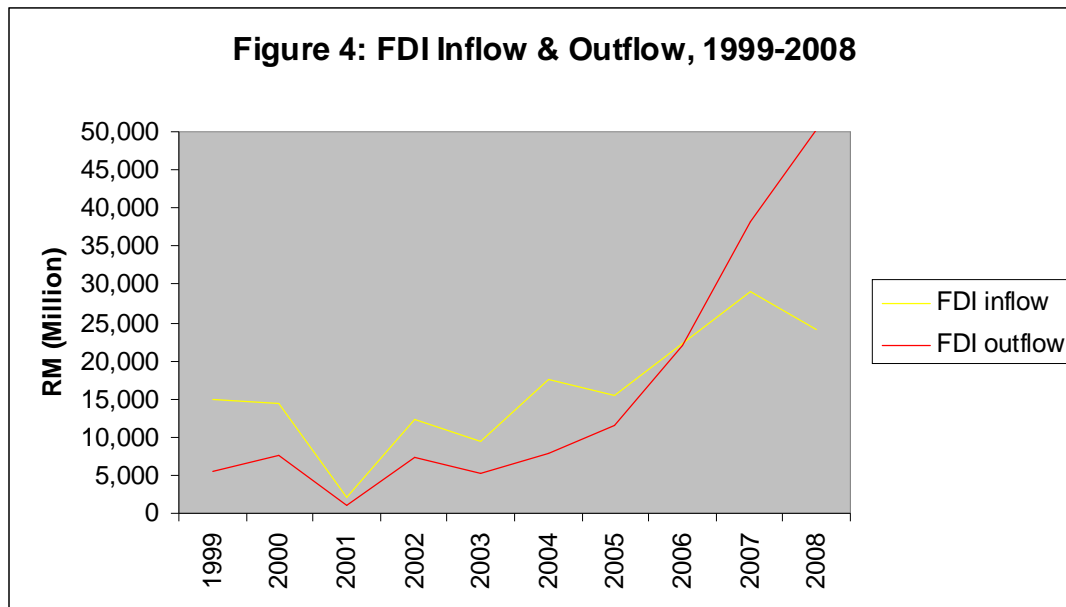
2007 Malaysia accounted for only 2.6% of the total FDI inflows to Asia in 2007, compared to 8% in the mid 1990s and 10% in the 1980s (UNCTAD,2007).



Source: UNCTAD

Secondly, there were fewer mega projects in the post crisis period compared to the pre-crisis period. When Abdullah took over as prime minister in 2003, the government scaled down, postponed or abandoned several large mega projects to reduce its budget deficit (Narayan, 2008). Thirdly, there is evidence that prolonged over-investment that led to the AFC contributed to sluggish domestic investments in Malaysia after the crisis. Using a long time series of aggregate domestic investment, Guimaraes and Unteroberdoerster (2006) found there was overinvestment (exceeding over 10% of GDP) for about four years prior to 1998. Fourthly, investors have become more cautious after the AFC despite the government's efforts to provide new investment incentives to a broad range of industries. Lack of fair and healthy competition discouraged investments in both new and existing firms. A survey by the World Bank in 2005 showed shortage of skilled workers and bureaucratic burdens as adverse features for investment climate. Difficulty in hiring local workers, restrictive regulations for hiring foreign workers and

skill shortages are the reasons why firms are understaffed. Firms often face uncertainty regarding the length of time required to fulfill the entire bureaucratic procedures (World Bank, 2005). Lastly, a small domestic market of only 27 million people has driven local firms to venture into new markets overseas. In fact, since 2000 onwards, there has been a surge in direct investments abroad by Malaysian firms. For the years 2007 and 2008, the direct investment outflows by Malaysians exceeded the inflow of FDI (Figure 4).



Source: Monthly Statistics Bulletin, Bank Negara Malaysia.

c) Gross National Savings, Gross Capital Formation and Current Account Balance

Malaysia has always maintained a high level of savings. From 1960 -1990, the country saved an average of 24% of GNP (Lin, 1996). With rapid income growth since the 1990s, the average saving rate rose to 35% a year (Table 1). Private sector has been a consistent net saver with mandatory contributions from the working population in the form of Employees Provident Fund (EPF) (Lin, 1996).

Table 1 shows the saving-investment gap (the mirror image of current account balance) in Malaysia. The saving-investment gap went from negative to positive before and after

the AFC. During the pre crisis period (1990-1997), the saving-investment gap reached a deficit of -10.2% of GNP, with most of the financing requirements met by foreign capital inflows. Since the start of the AFC, investments plunged but the savings rate remained high. With domestic savings in excess of the investment, current account turned from negative to positive balance from 1998 to 2008. In 2008, current accounts reached a surplus of 18% of GNP.

A current account surplus implies that there is limited capacity in the economy to generate sufficient investment opportunities to absorb domestic savings. And persistent current account surplus after 1997 indicates that though the Malaysian economy was being driven by the export sector the domestic economy remained weak, with an excess of savings over investments (Ariff, 2007). The fact that national savings is not used to finance gross investment reveals growth is not sustainable in the long term. Private investments need to rise to sustain high economic growth.

Table 1: The Saving-Investment Gap, 1990-2008

Year	Gross National Saving	Gross Capital Formation	Current Account balance
(% of GNP)			
1990	31.6	33.8	-2.2
1991	30.7	39.8	-9.1
1992	33.4	37.3	-3.9
1993	36.3	41.1	-4.8
1994	35.3	43.3	-7.9
1995	35.5	45.7	-10.2
1996	38.8	43.5	- 4.6
1997	39.1	45.4	-6.3
1998	42.1	28.2	13.9
1999	41.1	24.1	17.1
2000	39.1	29.2	9.8
2001	34.8	26.3	8.5
2002	35.0	26.5	8.5
2003	36.8	24.0	12.7
2004	37.1	24.3	12.7
2005	36.6	20.9	15.7
2006	38.3	21.2	17.2
2007	38.2	22.2	16.0
2008	37.7	19.8	18.1

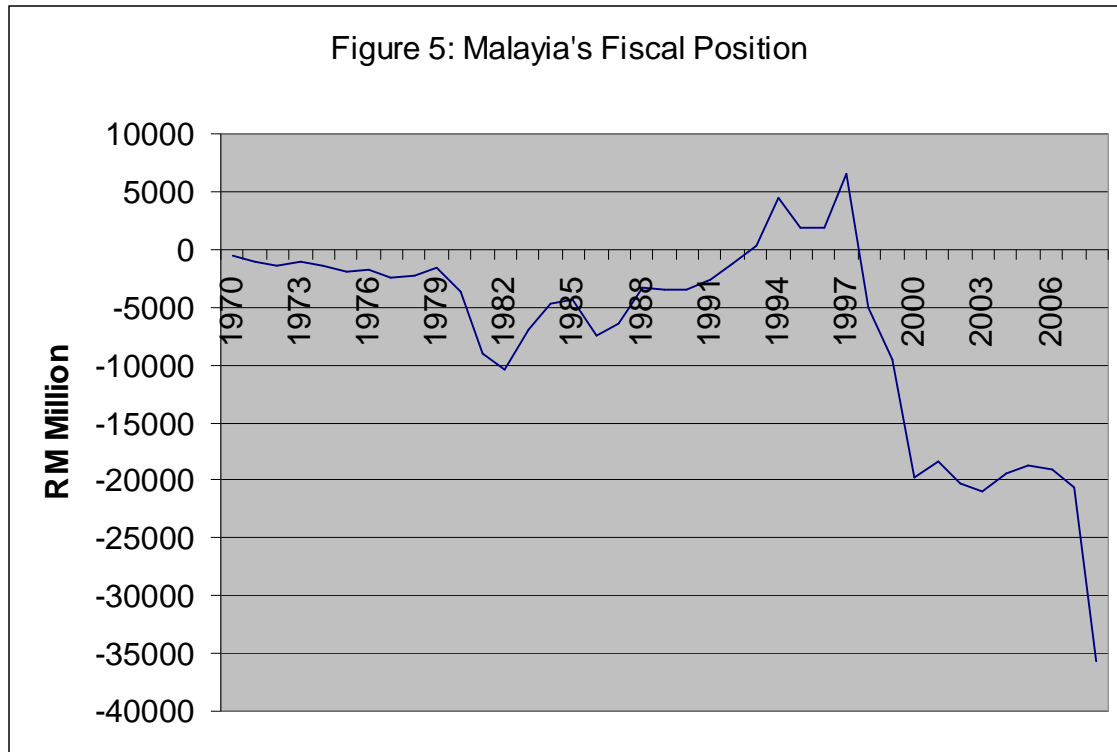
Source: Bank Negara Malaysia, Monthly Statistics Bulletin

d) Persistent Fiscal Deficits

Malaysia has never gotten out of its fiscal deficit since independence except for brief periods (See Figure 5). In the early 80s, budget deficit as a percentage of GDP swelled to double digit levels. In 1982, budget deficit was 16 per cent of GDP. Fiscal deficit was then progressively reduced and eventually reversed to fiscal surplus from 1993 to 1997 when the country recorded rapid economic growth during this period (Ariff, 2009).

With the onset of the AFC, the government budget reversed to a fiscal deficit to stimulate the economy. Even after the economy recovered, the government has been running on a persistent fiscal deficit. Though the fiscal deficit eased slightly from 2005-2007, it widened again in 2008 with the onset of the global financial crisis. For the medium term till 2010, the fiscal deficit level is expected to remain high due to lower revenue collection from slower GDP growth and lower commodity prices.

There are two main reasons for fiscal deficit since 1998. First is the enormous burden placed on fiscal policy rather than monetary policy to stimulate the domestic economy. Since the Ringgit was pegged to the US\$ from 1998 to 2005, monetary policy shifted to maintaining a fixed exchange rate by keeping the inflation differential and interest rate differential to the anchor nation stable (Masih, 2005). Secondly, the government's operating expenditure has been rising more sharply than its tax revenue since 2000. Malaysia has a narrow tax base. Only a small segment of the Malaysian working group pays income tax as the majority of the working population are low wage earners. Besides, 40% of the government tax revenue is derived from the oil and gas sector which is unsustainable as oil reserves will eventually be depleted.



Source: Bank Negara Malaysia, Monthly Statistics Bulletin

A deficit finance is not sustainable if it is financed through external borrowings or printing money. But in Malaysia, the high savings rate and excess liquidity in the system made it possible for the bulk of the fiscal deficit to be financed through non-inflationary domestic sources in the form of Malaysian government securities. Table 2 shows 80% of the fiscal deficits is largely financed through domestic borrowings. The domestic composition of debt insulated the government from exchange rate risks.

Table 2: Federal Debt, 1999 – 2008 (RM Billion)

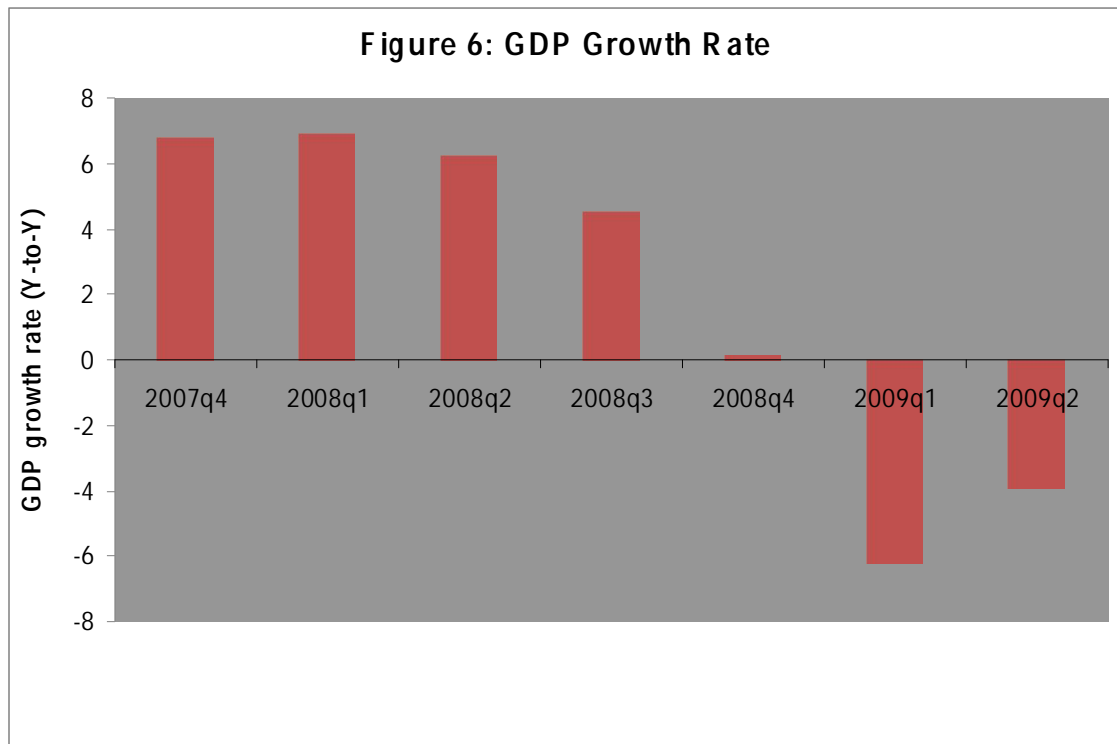
Year	Domestic Debt*	External Debt*	Total Federal Debt	% of GDP
1999	93.7 (83.7%)	18.3 (16.3%)	112	37.3
2000	106.8 (85%)	18.8 (15%)	125.6	35.2
2001	121.4 (83.3%)	24.3 (16.7%)	145.7	41.3
2002	128.7 (78%)	36.3 (22%)	165.0	43.1
2003	142.3 (79.3%)	37.2 (10.7%)	179.5	42.9
2004	182 (84%)	34.7 (16%)	216.7	45.7
2005	198.7 (86.9%)	30.0 (13.1%)	228.7	43.8
2006	217.2 (89.7%)	25.0 (10.3%)	242.2	42.2
2007	247.1 (92.7%)	19.6 (7.3%)	266.7	38.4
2008	286.1 (93.4%)	20.3 (6.6%)	306.4	41.5

Source: Bank Negara Malaysia, Monthly Statistics Bulletin. Note: * brackets in the domestic debt and external debt refer to the percentage of domestic debt to GDP and the percentage of external debt to GDP respectively.

Although the government's debt level is still at a manageable level, fiscal discipline should be implemented to ensure macroeconomic stability. Persistent fiscal deficit will increase risk premiums, pushing up bond yields due to concerns over fiscal sustainability and the government's credit solvency (CIMB, 2009).

3. Impact of the global crisis

Up to the first half of 2008 Malaysia was relatively unaffected by the financial turmoil. The financial and economic environment worsened in the second half of 2008 and first quarter of 2009. Real GDP grew only 0.1% yoy in the fourth quarter of 2008 compared to a 4.7% yoy growth in the third quarter of the same year (see Figure 6). The average GDP growth was 5.9% in the first nine months of 2008. Real GDP fell by 6.2% yoy in the first quarter of 2009, the first time in negative territory since 2001. The depressing performance in the first quarter of 2009 confirmed the expectation that Malaysia faces a full-blown recession for the year 2009. The decline was mainly due to the drastic contraction in export value of 27.9% yoy in January 2009. The fall in exports adversely affected economic growth, particularly in the manufacturing sector, which contracted 19.1% in the first quarter 2009 (yoy).



Source: Bank Negara Malaysia, Monthly Statistics Bulletin

The global financial crisis is transmitted to Malaysia mainly through the financial and trade channels (James et al.2008).

Impact on Finance

Capital Flows

Like other Asian countries, Malaysia suffered capital flight since the second quarter of 2008. Banks and financial institutions in the United States and the West reduced their international businesses and focused on their home markets. There was a big drop in funds flowing into Malaysia (see Table 3) with net financial and capital flows falling from negative RM37.8 billion in 2007 to negative RM123.9 billion in 2008.

Portfolio Flows

Of these capital flows, portfolio investments are the most volatile and recorded the largest net outflow of RM92.4 billion in 2008, compared to a positive net inflow of RM18.4 billion in 2007 (see Table 3 and Figure 7). Malaysia is one of the countries affected by portfolio investment outflows in 2008 (Khor,2009). There is a high level of foreign participation in the Malaysian stock market. The trading volume attributable to non-resident participants is more than 30% since 2004 (see Figure 8). The reversal of the portfolio capital flows due to the repatriation by foreign participants affected the stock market significantly with the KLCI falling from 1393 points in January 2008 to 876 points in December 2008. There is a strong correlation between changes in net portfolio equity flows and stock prices in Malaysia.

Direct Investments

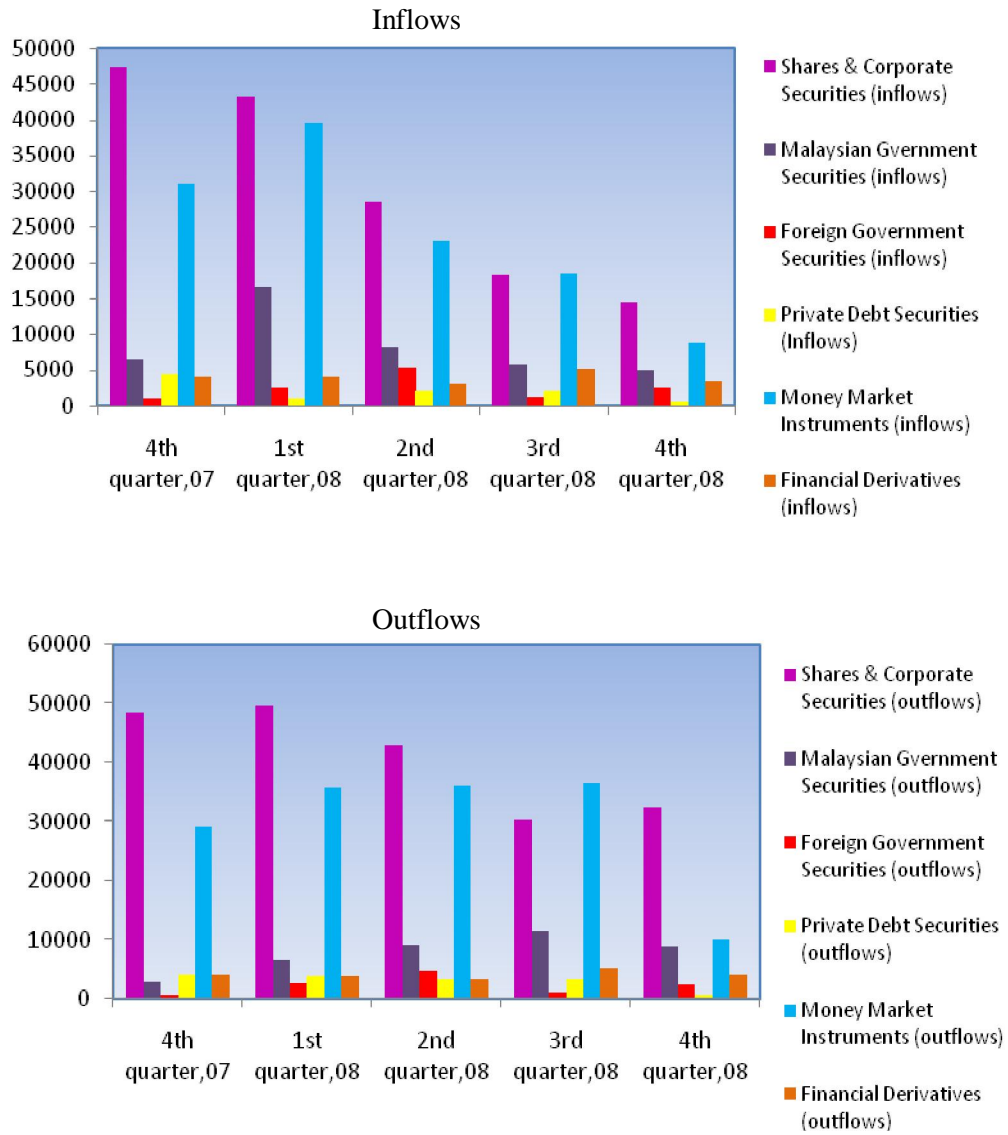
Foreign direct investments into Malaysia plunged 95% from RM17.4 billion in the second quarter of 2008 to RM0.9 billion in the third quarter. For the full year, foreign direct investment fell 9% in 2008. Direct investments abroad by Malaysian companies increased to RM47.1 billion in 2008. The Other Investment account recorded a lower net outflow of RM11 billion in 2008 compared to a net outflow of RM46.9 billion a year earlier, due to lower net external debt repayments by both the official sectors and private sectors (BNM,2008).

Table 3: Financial Account in the Malaysia Balance of Payment, 2007-2008

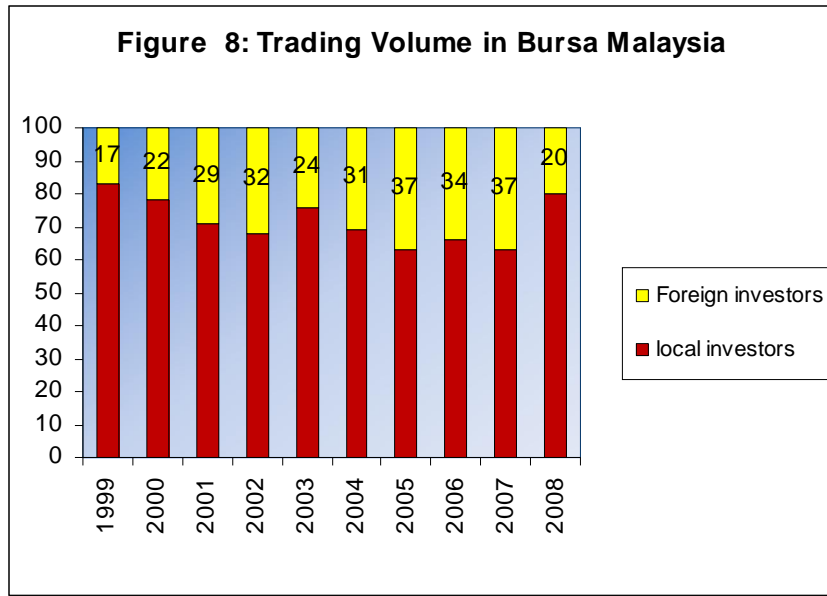
	2007	2008	2008Q1	2008Q2	2008Q3	2008Q4	2009Q1
Financial Account	-37.81	-123.90	26.45	-12.31	-61.48	-76.57	-29.7
Direct Investment	-9.14	-20.50	-2.98	2.91	-18.97	-4.36	3.19
Abroad	-38.22	-47.10	-6.33	-14.48	-19.5	6.43	0.43
In Malaysia	29.08	26.70	3.36	17.39	0.88	5.07	2.76
Portfolio Investment (net)	18.36	-92.40	21.07	-24.02	-56.18	-33.27	-12.15
Other Investment (net)	-46.92	-11.00	7.56	8.84	13.79	-41.19	-20.8
Official Sector	-5.79	-2.70	-0.71	1.61	-2.74	-0.86	-0.97
Private Sector	-41.14	-8.30	8.28	7.24	16.53	-40.34	-19.8

Note: * this category covers financial transactions in trade credits, long and short term loan and other transactions that are not recorded under direct investment, portfolio investment, and reserve assets.
Source: Bank Negara Malaysia, Monthly Statistics Bulletin

Figure 7: Portfolio Investment by Type, 4th quarter 2007-08



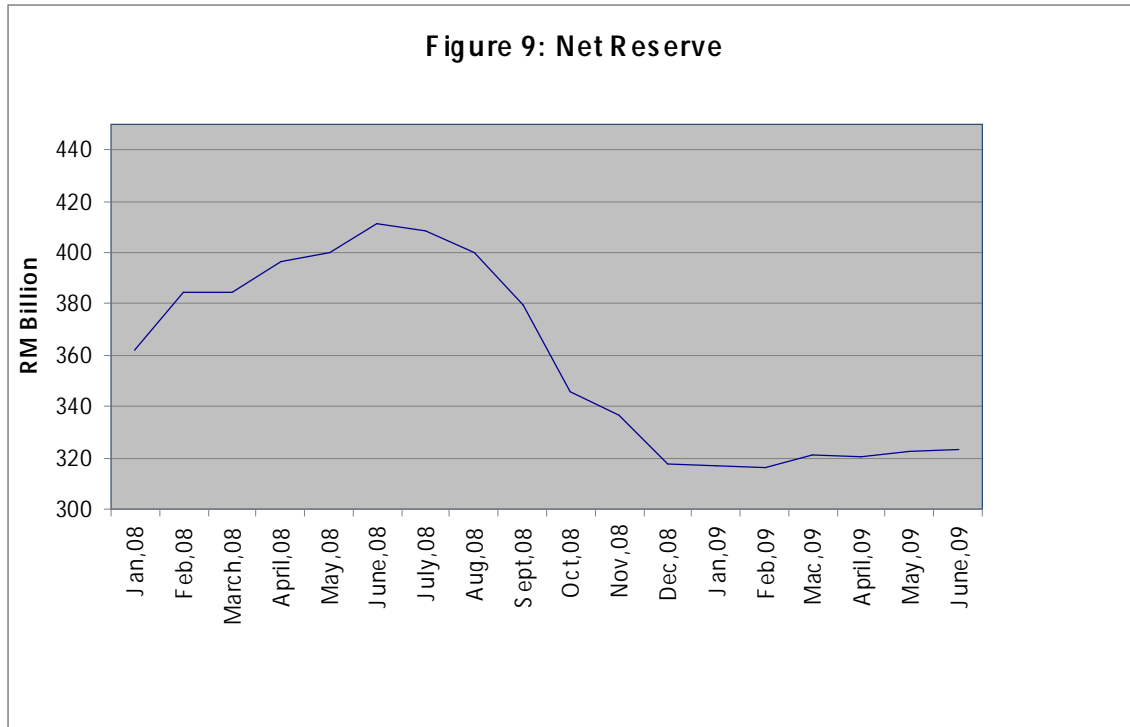
Source: Bank Negara Monthly Statistic Bulletin



Source: Bursa Malaysia

The combination of the rise in capital account deficits and the fall in current account surplus⁶ led to the deterioration in its balance of payments and its stock of foreign reserves (see Figure 9). The big reversal of portfolio capital flows due to divestments by foreign financial institutions with the onset of the global financial crisis led to a decline in reserves in the second half of 2008. Malaysia's high level of reserves has acted as a buffer during periods of large reversals in short-term flows.

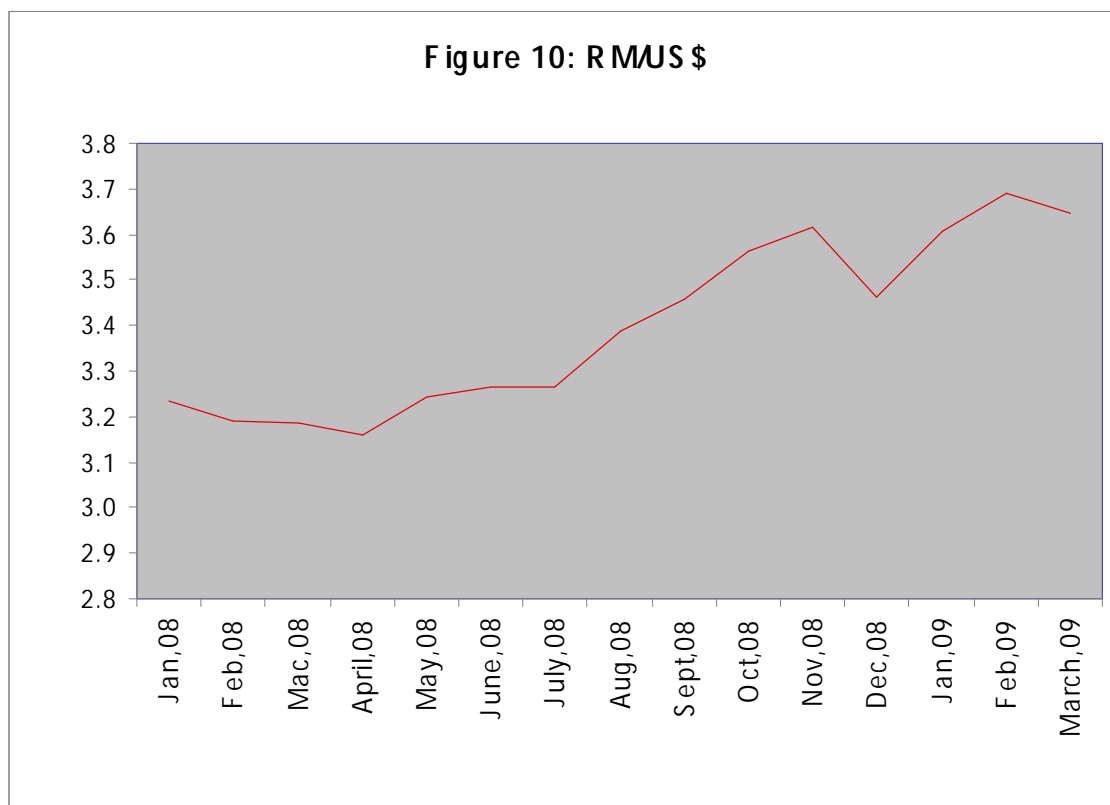
⁶ The fall in exports of goods and services is explained in the following section - impact of trade



Source: Bank Negara Malaysia, Monthly Statistics Bulletin

Foreign Exchange Rate

Since the de-pegging of the Ringgit from the US dollar in 2005, capital flows have had a significant impact on the Ringgit (Ooi,2008). Generally, capital outflows depress the price of the Ringgit; since the beginning of the year 2009, the Ringgit has lost almost 6% of its value against the US dollar, from RM 3.464 to RM3.693 currently (see Figure 10). This decline in the value of the Ringgit is primarily due to the declining demand in exports and portfolio outflows. The depreciation of the Ringgit may help to improve its export performance of the country, limiting the negative impact from the global recession. However, the study by Jongwanich (2007) for a group of 9 Asian countries (including Malaysia) found that there is a very weak link between the real exchange rate and export performance in these countries. On the contrary, world demand and production capacity play a more important role in determining exports of these groups of Asian economies.



Source: Bank Negara Malaysia, Monthly Statistics Bulletin

The Banking System

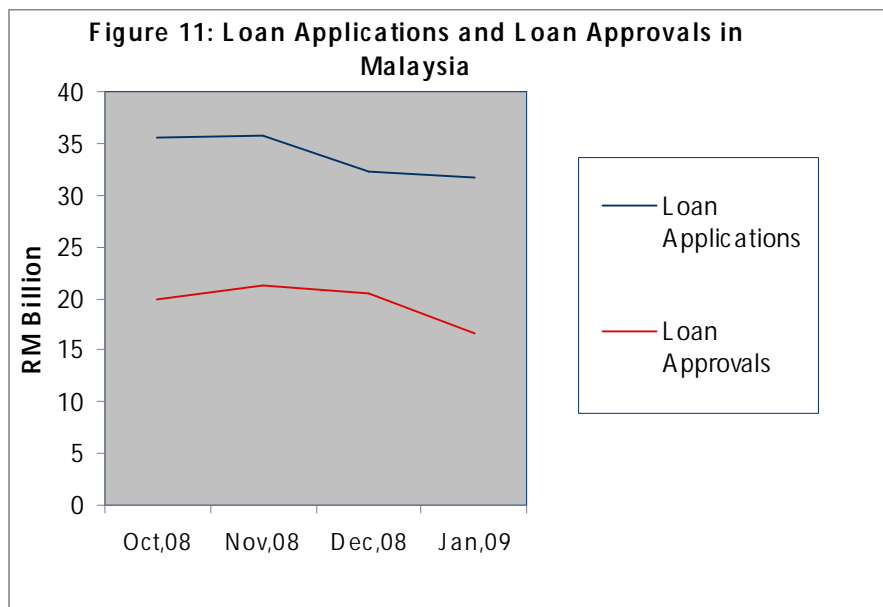
The impact on the banking system was relatively modest as domestic banks had negligible exposure to U.S. sub prime loan products. Also domestic banks have strengthened and built significant buffers during the decade after the AFC. At year end 2008, the banking system's risk-weighted capital ratio (RWCR) and core capital ratio (CCR) were maintained at high levels of 131% and 10.6% respectively (See Table 4). Non-performing loans were at healthy levels. They peaked during the Asian financial crisis at 18.5%; since then the ratio has declined to 2.6% in 2008. Nevertheless, given the weak business environment and an expected rise in unemployment, the banking systems' non-performing loans are expected to rise.

Table 4: Banking System Health Indicators

	2001	2002	2003	2004	2005	2006	2007	2008
Nonperforming Loans – 3 month classification (% of net total loans)	11.5	10.2	8.9	7.5	5.8	4.8	3.2	2.6
Risk-Weighted Capital Adequacy Ratio (RWCR)*	13.0	13.2	13.8	14.4	13.7	13.5	13.2	13.1
Core Capital Ratio (CCR)	11.1	11.1	11.1	11.4	10.7	10.7	10.2	10.6

Note: * RWCR is an indication of how much losses or bad asset write-offs a financial institution can take.
 Source: BNM Monthly Statistics Bulletin February 2009

With the slowdown of domestic economic activities, the overall loan applications in the country showed a declining trend. Loan applications slowed down for both the business and household sectors; however, loan applications from the transport, storage, communication, finance, insurance and business services sectors were sustained. Loan approvals also fell in tandem with the fall in overall loan applications (see Figure 11).



Source: Bank Negara Malaysia, Monthly Statistics Bulletin

Impact on Trade

This crisis exposed the vulnerability of Malaysia's export dependent growth on the world market. Malaysia suffered its biggest drop in exports since 1982 in January 2009 when exports dropped 28% year-on-year terms.

The most worrying fall has been in manufactured exports, particularly electronics, electrical machinery and appliances, that together account for 40% of Malaysia's exports. In the fourth quarter of 2008, total manufactured exports declined 20% quarter to quarter led by semi-conductors and electronics. Agricultural and natural resource exports also fell as commodity prices tumbled. In the same period palm oil exports dropped 32% and crude oil by 33% quarter to quarter (Table 5).

Table 5: Gross Export of Manufactured Goods, Agricultural and Mining Commodities

	2007	2008	2008Q1	2008Q2	2008Q3	2008Q4
RM Million						
Manufactures	474,714	491,930	111,474	131,367	138,711	110,376
Electronics	288,326	277,282	61,588	75,108	78,217	62,367
Semiconductors	96,471	89,819	17,251	26,659	26,375	19,532
Electronic equipment and parts	116,978	106,113	26,651	27,632	28,220	23,609
Electrical products	46,159	52,476	10,332	13,222	16,358	12,562
Resource-based products	110,619	132,529	31,011	35,426	37,985	28,104
Commodities						
Agriculture						
Palm oil	31,983	45,955	10,587	12,592	13,504	9,271
Rubber	7,335	8,112	2,165	2,107	2,501	1,338
Minerals						
Crude oil and condensates	31,880	43,040	10,371	11,822	12,462	8,385
Liquefied natural gas	26,157	40,732	8,235	8,459	9,312	14,726

Source: Bank Negara Malaysia, Monthly Statistics Bulletin

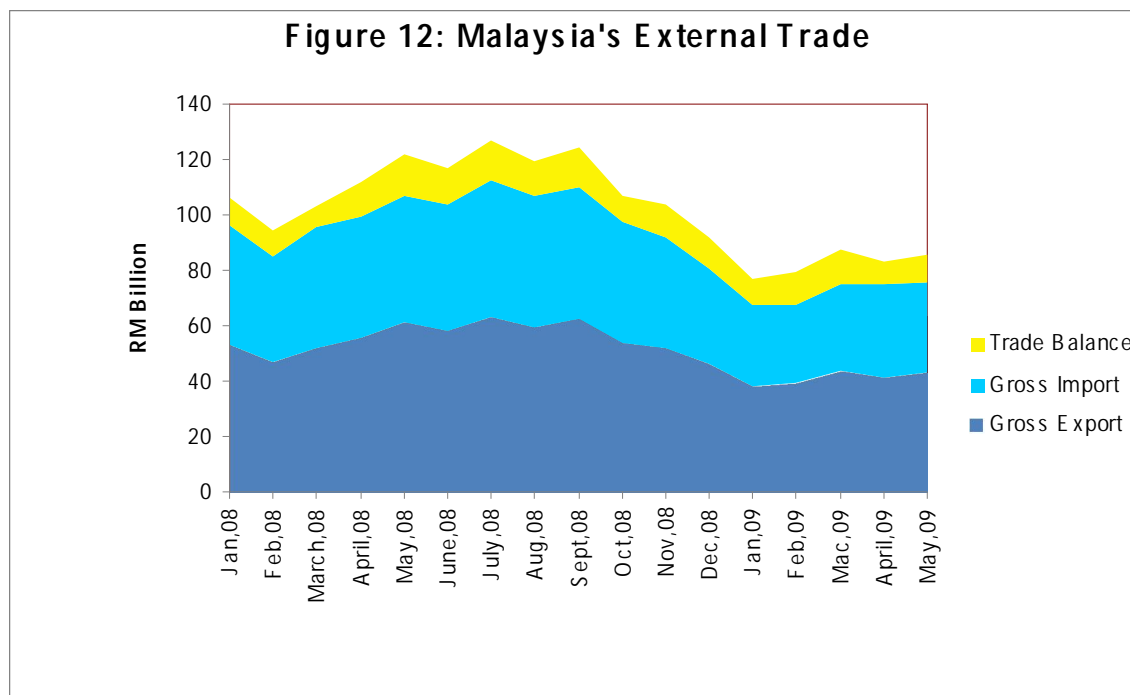
Significantly, the improvement in the export sector was as rapid as its deterioration. By March 2009, the rate of decline in exports slowed on a year-on-year basis to 15.6%, and in fact rose on a month-on-month basis by 13.8% (Table 6). Much of this initial improvement was driven by the need to restock inventory that had run to very low levels. By the second half of 2009, the continuation in the improvement of exports was due to the effect of the massive fiscal and monetary stimulus programs worldwide.

Table 6: Export,s YoY and MoM change, Sept 2008- Mac 2009

	2008				2009		
	Sept	Oct	Nov	Dec	Jan	Feb	Mar
Y-o-Y % change	15.0	-2.6	-4.9	-14.9	-27.9	-15.9	-15.6
M-o-M%	4.5	-14.2	-3.1	-11.0	-16.9	3.4	13.8

Source: Department of Statistics, Malaysia

Malaysia's exports contain a high import component of intermediate goods. Therefore when exports fell, imports also dropped concomitantly, and, in fact, by a greater amount. Hence, Malaysia was able to maintain positive trade balance during this crisis, though the surplus is smaller compared to 2008, because import of intermediate goods fell faster than exports (see Figure 12).



Source: Bank Negara Malaysia, Monthly Statistics Bulletin

Malaysia's exports trend is not different from that of other countries in the Asian region. More than 40% of its exports are channeled to the G3 countries of the United States, Japan and Europe⁷ (See Table 7). Furthermore, even part of its exports to China is destined for the G3 as China acts as the assembler of components in the global supply chain.

Table 7: Direction of Trade in Malaysia

	2008	%	2008q1	2008q2	2008q3	2008q4
Export in RM (Millions)						
To US	82,741	12	19,567	22,840	22,097	18,238
EU	74,868	11	18,118	18,714	20,479	17,556
Japan	71,793	11	15,519	17,001	17,909	21,364
China	63,211	10	12,592	8,853	19,751	12,676
Singapore	97,765	15	23,328	25,915	27,197	21,328
Other Countries	273,136	41	62,674	81,846	77,801	60,151
Total	663,514	100	151,798	175,169	185,234	151,313

Source: Bank Negara Malaysia, Monthly Statistics Bulletin

⁷ AmResearch senior economist Manokoran Mottan, the Star, Sat, 21 March, 2009

Impact on the Real Economy

Industrial Production Index (IPI)

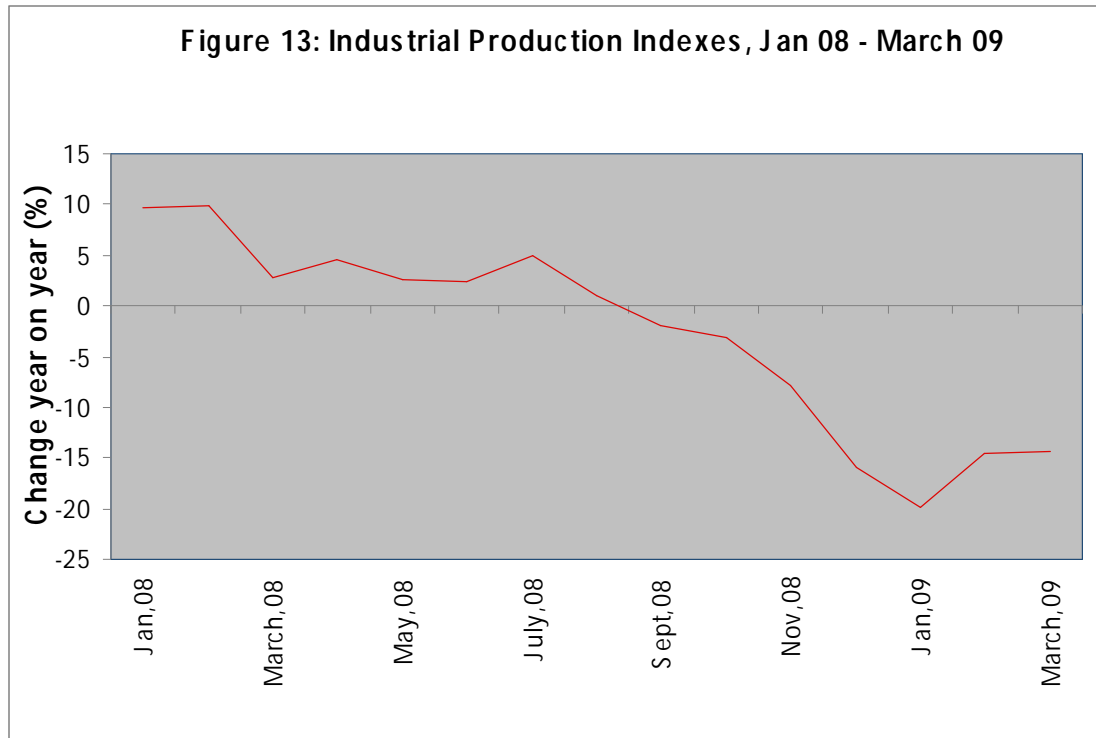
The impact of the crisis on the financial and trade routes is working its way through to the real economy in terms of loss in output, trade and jobs. Recent data released by the Department of Statistics showed that Malaysia's industrial production index (IPI) for January 2009 fell 19.8% yoy basis, and 4.0% mom basis. The contraction in January was due to the drop in three indices, namely, manufacturing (26.3%), mining (5.8%) and electricity (12.5%). Contraction in manufacturing output was due to decreases in sub-sectors such as the electrical and electronic products, petroleum, chemical, rubber and plastic products, see Table 8.

Table 8: Industrial Production Index (IPI) and Sector Indices (2005=100)

	2008 January	2009 January	Percentage of Change (%)
IPI	115.8	92.9	-19.8
Mining	105.4	99.3	-5.8
Manufacturing	120.9	89.1	-26.3
Electricity	114.3	100.0	-12.5

Source: Department of Statistics, Malaysia

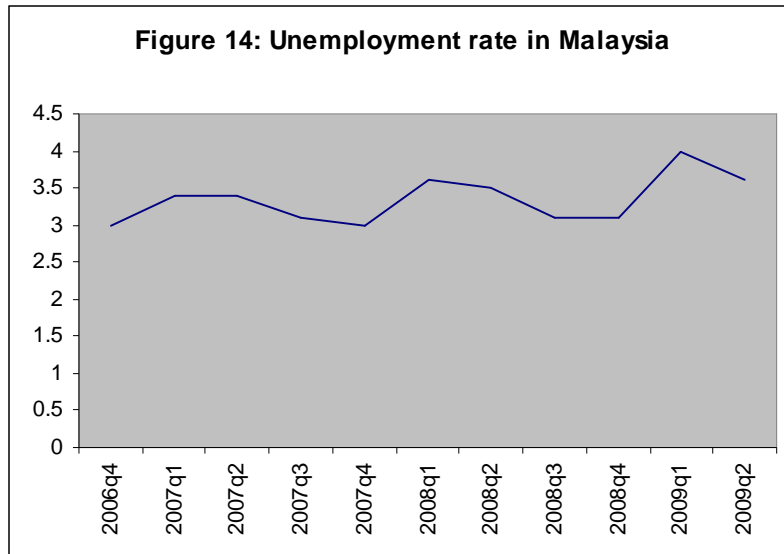
The IPI in February and March 2009 continued to fall 14.7% and 14.4% respectively, on a yoy basis due to decline in manufacturing, mining and electrical industries. Figure 13 shows the IPI was declining since September 2008 till March,09, with the biggest figure recorded in January, 09 (-19.8%). However, the declining rate was much smaller in February and in March,09.



Source: Department of Statistics, Malaysia

Labor and Employment

The impact of the crisis on unemployment in Malaysia is not quite as alarming as compared to that of the other countries. Unemployment rate was relatively stable and low during the crisis. Even during the depths of the crisis in the first quarter of 2009, the unemployment rate increased by 0.9% to 4.0% in the first quarter of 2009 as compared to 3.1% in the fourth quarter of 2008 (See Figure 14). The unemployment rate then declined to 3.6% in the second quarter of 2009 reflecting the slow down in economic deterioration and the implementation of the two stimulus packages by the government.



Source: Department of Statistics Malaysia

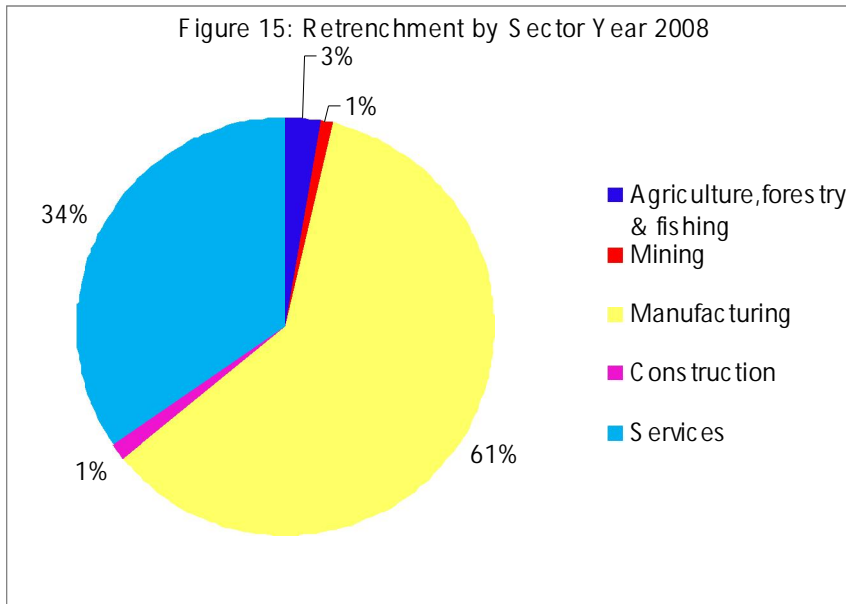
Statistics compiled by the Ministry of Human Resources showed a cumulative figure of 40,000 workers retrenched during this crisis,⁸ with 60% of the retrenchment coming from the manufacturing sector (see Figure 15).⁹ Job cuts in the current downturn are not as severe as that during the 1997/98 Asian Financial Crisis when Malaysia lost 84,000 jobs.¹⁰ Unlike what happened during the Asian Crisis, most employers are eliminating shift work and overtime and reducing work days or salaries instead of retrenchment or laying off workers¹¹, in order to retain the pool of workers when the economy revives. A recent World Bank report on Malaysia cited that 120,000 workers or 8% of manufacturing jobs were lost, accounted mostly by retrenchment of foreign workers (World Bank, 2009).

⁸ This figure does not include illegal workers in industries ranging from plantations to constructions.

⁹ “Malaysia’s unemployment rate may rise to 4.5% by year-end”, The Star,

¹⁰ “Malaysia sees up to 50,000 job losses this year”, The Star, 18 March 2009

¹¹ IMF, 2009



Source: Bank Negara Malaysia, Monthly Statistics Malaysia

The current economic slowdown has affected foreign workers in Malaysia most severely as they are the most unprotected and vulnerable segment of the working population. Many have been sent home as unemployment in the country rises. The government has frozen the hiring of foreign laborers, doubled the levies to engage foreign workers for all sectors except for construction, plantation and domestic maids, and offered incentives for hiring local workers.¹²

4. National Response to the crisis

Like any other country, to counter the recession, the Malaysian government introduced economic stimulus packages to revive the economy. Domestic demand is expected to provide the main support to the economy with public sector expenditure as the main driver of domestic demand.

¹² ibid

On 4 November 2008, the Government announced the first economic stimulus package amounting to RM7 billion. The government claimed that the funds would be allocated to projects with high and immediate multiplier impact on the economy. These included:

- 1) RM1.2billion to build more low and medium cost houses;
- 2) RM500million to upgrade, repair and maintain police stations and living quarters, and army camps and quarters;
- 3) RM600million for minor projects like village roads, community halls and small bridges;
- 4) RM500million for public amenities such as roads, schools and hospitals;
- 5) RM500million to build and improve roads in East Malaysia
- 6) RM200 million for schools, with equal parts going to religious schools, “mission schools” and Chinese and Tamil Vernacular schools
- 7) RM500 million to improve public transport in major cities
- 8) RM1.5 billion to set up an Investment Fund to attract more private sector investment
- 9) RM400 million to expedite the execution of the High Speed Broadband project

Several measures to directly support private consumption were also introduced, such as reduction of EPF contributions from 11% to 8% and higher vehicle loan eligibility for civil servants.

The RM7billion stimulus package which accounted for approximately 1% of Malaysia’s GDP has been criticized as too small. As the global economic conditions deteriorated into the fourth quarter of 2008 and early 2009, the Malaysian economy faced the prospect of a deep recession. The worse than expected global trade slowdown and the sharper plunge in trade in January 2009 prompted the government to introduce a second stimulus package that was bigger and more comprehensive totaling RM60 billion in March 2009. This package was almost 9% of Malaysia’s GDP. Of this amount, RM15 billion was fiscal injection, RM25 billion for government guarantee of private loans and bonds, RM10 billion for government investment company Khazanah Nasional to invest equity

stakes in local projects with high multiplier effects, RM7 billion private finance initiatives (PFI) and off-budget projects, and RM3 billion in tax incentives. This is the largest stimulus package in the country’s economic history and will be implemented over 2009 and 2010. The two packages together are equivalent to 10% of Malaysia’s GDP. This makes Malaysia the second most aggressive country in its “policy-induced recovery” programs among the Asean countries after Singapore (see Table 9).

Table 9: Proportion of Stimulus package to GDP

Country	Stimulus Package(US\$, Billion)	Proportion to GDP
Singapore	13.8	10.7
Malaysia	18.1	10.0
Philippines	6.1	4.0
Thailand	8.3	3.3
Vietnam	7.0	1.1
Indonesia	4.5	0.9

Source: CIMB Research House

It should be noted that in the second stimulus package, the government will not inject all RM60 billion into the economy. The direct stimulus package is only RM18 billion comprising RM15 billion direct fiscal stimulus and RM3 billion tax incentives. The remaining RM42 billion are in the form of guaranteed funds, equity interests and private finance initiatives and off-budget initiatives. Furthermore, the implementation of the two economic stimulus packages appears to be very slow. Of the RM7 billion (the first economic stimulus package), 97% has been distributed to the Ministries and government agencies as of 26 June 2009, but only RM2.3 billion or 32% was actually spent. For the second economic stimulus package, RM14.5 billion has been disbursed but only RM1.6 billion or 2.6% was actually spent.¹³ However, the Prime Minister said a total of RM7.9 billion has been paid to contractors for the completion of 41,176 projects under the first and second stimulus packages.¹⁴ Construction industry was one of the biggest beneficiaries because of the strong political support contractors provide to the ruling

¹³ Project Management Unit (PMU), <http://www.rangsangekonomy.treasury.gov.my>

¹⁴ The Star, “Stimulus takes effect”, 22 September, 2009

party and the putative multiplier effects on domestic economy.¹⁵ However, most of the workers in the construction sector are foreign workers and remittances made by them create leakages in the domestic economy, hence, the multiplier effect from the stimulus spending may be subdued (Quah, 2009).

Corruption and fiscal mismanagement contribute to further leakages (Narayana, 2008). Every year, the Auditor General in his report detects federal and state government's weaknesses in financial management but no stern actions are taken against the wrong doers.¹⁶

Recovery should not just be confined to the stimulus package. With the slowdown of inflation,¹⁷ there is more room for monetary policy to drive the economy by lowering interest rates. Bank Negara Malaysia has reduced the Overnight Policy Rate (OPR) three times by a total of 150 basis points between November 2008 and February 2009. The OPR is currently 2%, while the Statutory Reserve Requirement (SRR) has been reduced by 200 basis points to 1.0%.¹⁸

5. Conclusions and Policy Implications

This global financial crisis has hit Malaysia hard but in ways that are slightly different from the AFC. It is neither a currency crisis, nor a financial crisis. It is essentially an export crisis (mainly manufactured exports) with direct impact on the real economy. The shocks in this crisis are transmitted through the financial and trade sectors. In the financial sector, the big impact was felt primarily in the stock markets with rapid outflow of portfolio investments sending the stock markets down by over 50%. But the fall-out to

¹⁵ Like the political relationship between the construction industry and the LDP in Japan, Malaysia has over 67,000 contractors, mostly small time Bumiputra contractors who form a strong political base for the UMNO, the dominant component of the ruling party. Hence much of construction projects are for satisfying this constituency.

¹⁶ For example, a set of RM32 of screwdrivers was purchase for RM224. RM1,146 for a set of pens costing RM160, two bicycles worth RM 19,800 could not be traced as there were no written records their use elsewhere, a consultant was overpaid for the RM4.25mil for a community hall project that was completed in 2005 which is now in need of repair and is under utilized.

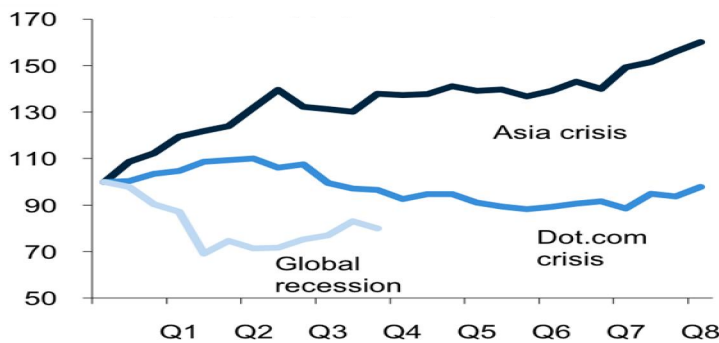
¹⁷ Inflation has decelerated from 8.5% in August 2008 to 3.5% in March 2009

¹⁸ Bank Negara Malaysia Annual Report, 2008, p.99 and Monetary Policy Statement, announced by Bank Negara on 24 February,2009

other parts of the financial sector was limited as the banking sector was sound and healthy and there was no huge build up of a property asset bubble. Also Malaysian banks were not highly exposed to toxic financial assets

The major impact on Malaysia's economy came through trade channels. Malaysia after the AFC became even more dependent on exports for growth. The collapse of external demand led to the biggest drop in exports in January 2009 (27%) the country has experienced since 1981. Figure 16 shows the different impact of the AFC, the dotcom recession and the present global financial crisis on Malaysia's export performance. In the AFC, exports actually climbed and lifted the economy out of the crisis. In the dot.com crisis, exports declined slowly and moderated for five quarters before recovering. In the present crisis, exports plunged sharply for two quarters and picked up equally fast by the third quarter. Whether the rebound is sustainable is highly dependent on a strong recovery in the G3 countries.

Figure 16: Export Index Comparing three recent crisis episodes



Source: World Bank, 2009.

The second important feature of this crisis is Malaysia, like most Asian countries after the AFC, repaired its national, corporate and household balance sheets and that helped it absorb the shocks of this crisis relatively well. The country accumulated large foreign exchange reserves from running current account surplus and not from capital account surplus. This earned, rather than borrowed, reserves helped the country cushion the

impact of this crisis on its currency. In the corporate sector, leverage was reduced to manageable levels and hence did not lead to major defaults or threaten the banking system. Household savings rates remained high and enabled personal consumption level to be maintained at almost the same levels, aided by government monetary and fiscal stimuli.

Third, the crisis exposed serious structural weaknesses in the Malaysian economy, namely, behind the rosy current account surplus story is the troubling decline in investments accounting for its positive savings investment gap. In other words, it is not the rise in savings but the drop in investments that led to current account surplus. Total investments halved and never recovered to its pre-crisis levels, led by the drop in private investments from 32.7% in 1995 to 11.8% in 2008 while public investments held relatively steady (from 13% to 10.5% in the same period).

Private investments fell not only because of the outflow of direct investments by Malaysian companies abroad but equally significant is the decline in foreign direct investments into Malaysia. In other countries such as Singapore and Korea, while domestic investments flow abroad, they also continued to attract substantial foreign direct investments in critical areas that accelerated moving up the technological ladder. Such is not the case in Malaysia. The reason for the drastic drop in private investments, both domestic and foreign, is the poor investment climate created by distortions and inefficiencies associated with the implementation of the country's New Economic Policy, the bureaucratic red tape and high level of corruption at all levels faced by investors and the public, distrust over the impartiality of its judiciary and police institutions, decline in the standards of education, shortage of skilled labor, lack of meritocracy in the public sector, and the continuous and increasing brain drain from Malaysia.¹⁹ Malaysia is stuck in the middle-income trap, losing its competitive edge as a low-cost producer to neighbors like Vietnam, Indonesia and Thailand; at the same time it is unable to climb up the technological ladder to become a high-end producer (World Bank, 2009).

¹⁹ Malaysia has some 785,000 of its citizens working abroad, two thirds are professionals, while it has only 38,000 expatriates working in Malaysia, with Singapore sucking up most of Malaysia's talents. (Lee, 2009).

Another structural weakness facing Malaysia is its persistent fiscal deficit since the AFC. As noted earlier, investments in the country has been supported by public investments funded through fiscal deficits. Malaysia has an unhealthy public revenue structure with a very narrow and low tax base and high level of government revenue (over 40%) derived from oil and gas revenues. It is estimated Malaysia will run out of oil in another decade or so. Unless the revenue base is broadened and strengthened, this weak fiscal system acting as a pillar supporting total investments in the economy is not sustainable.

This crisis has exposed serious structural flaws in the U.S. and global economy as well as in Malaysia's economy. All countries, including Malaysia, have injected massive monetary and fiscal stimuli to their economies. The question is have they addressed the structural weaknesses or is it more of the same panacea?

There is little doubt that the United States has to readjust its savings investment gap, i.e. reduce its current account deficits. As it seeks to do that how will it impact on countries like Malaysia and how will Malaysia respond? What are the options available to Malaysia? On the one hand, U.S. readjustments will put pressure on Malaysian exports to G3 countries and consequently lead to lower growth; on the other hand, a weaker dollar will not only hurt Malaysia's exports but also the value of its dollar reserves.

According to a World Bank economist, Malaysia has three options. First, to accept the situation passively and adjust to a lower-growth trend that is led more by domestic demand. Second, to aggressively build on its comparative advantage in manufactured exports and become more competitive. Third, to climb the technological ladder and diversify into new products and services where it might have a niche or better productivity and export prospects.²⁰

²⁰ Public lecture by Dr. Shahid Yusuf, "Tiger Economies Under Threat" at Wawasan Open University, Penang, November 20 2009.

While Malaysia's domestic market can be strengthened, with the right policies to increase productivity, to return of a significant portion of the productivity increase to labor by raising wage, and provision of better social services and safety nets, it is still limited in size. Hence, export markets will remain an important driver of growth. The challenge is to reduce export dependence on G3 markets and reorientate it to Asian intra-regional markets. This means Malaysia together with other Asian countries must redouble efforts to promote regional cooperation and integration on all fronts – currency arrangements, monetary policies, trade policies etc.

The massive fiscal stimulus package, equivalent to 10% of Malaysia's GDP, does not address any of the major structural weaknesses identified earlier. It is essentially substituting private spending with public spending, with leakages in the implementation process. The government under the new Prime Minister Najib is trying to address the structural issues and in the process of producing a blue-print for Malaysia to achieve a high-income country status by 2020. It has taken a few initial small steps to liberalize some restrictions and distortions associated with the New Economic Policy. But burdened with a political base that has benefited so much from rent-seeking activities for decades, it remains to be seen whether there is enough political will to carry through any meaningful structural changes and removal of the barriers identified earlier.

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