FUNDAMENTALS STILL STRONG DESPITE STRAINS

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The Malaysian macroeconomic fundamentals are still fairly strong, although there are signs of strains, exacerbated by the slowdown in the US economy. After putting up an impressive double-digit growth in the first half of 2000, the economy began to decelerate in the second half of the year, with gross domestic product (GDP) growth rate trending down to 7.8 per cent in the third quarter and 6.5 per cent in the fourth.

Growth forecasts for this year range from a low of 3.5 per cent to a high of 7.0 per cent, while MIER has projected a growth rate of 5.0 per cent. A higher growth rate through stronger government pump-priming is possible but not advisable, as it would cause undesirable side effects in terms of difficulties in the realms of public finance and balance of payments (BOP). It is in this sense that a slower pace of growth at times such as these is not undesirable.

The key macroeconomic indicators do reflect the inherent strength of the Malaysian economy. Despite 8.5 per cent GDP growth last year, inflation remained at 1.6 per cent. Employment figures also look good with the number of job seekers registered with the Manpower Department falling to 27,820 at end-December 2000 from 36,067 at end-September 2000. Trade surplus for the year amounted to RM60.9 billion, with a current account BOP surplus of RM26.2 billion for the first nine months. External debt – GDP ratio has declined from 57.8 per cent at end-1999 to 50.5 per cent at end-2000. In particular, the decline in short-term debt to US$4.6 billion, which now forms only 11 per cent of total external debt, is significant as it serves to reduce the vulnerability of the economy.

The risk-weighted capital adequacy ratio of the system remains high at 12.4 per cent, above the 8 per cent international threshold, with a relatively low non-performing loans (NPL) ratio of 6.3 per cent. It is noteworthy that bank loans grew at 5.4 per cent in 2000, the highest annual growth rate since August 1998.
There was a sharp increase in the value of both applications and approvals of manufacturing investment in the fourth quarter to RM10.5 billion and RM8.2 billion, respectively, while bank loans dispersed also increased markedly to RM98.8 billion during the quarter. As at 15 February 2001, the net international reserves of Bank Negara

Malaysia stood at RM110.9 billion (US$29.2 billion) which is 6.3 times the short-term external debt.

Increased public expenditure has continued to play a critical role by providing a strong fiscal stimulus. It is comforting to note that the Federal Government budget deficit has been financed largely by drawing down the Government's realizable assets, with domestic borrowing playing a smaller role. So far so good.

The near-term prospects, however, are less rosy, to put it mildly. As noted, the economy has been decelerating during the last two quarters. This downtrend is expected to continue, given the sluggish demand for Malaysian exports associated with the economic slowdown in the United States and the stagnation in the Japanese economy. This time around, depressed commodity prices unfortunately coincide with falling demand for electronics manufactures. This is not to underestimate the resilience of the Malaysian economy. A 5.0 per cent growth under the present conditions will not be a mean accomplishment.

To be sure, there are areas of growing concerns. One such concern relates to recent trends in external reserves. The importance of adequate reserves can hardly be exaggerated. Capital controls and currency peg could not have worked in the absence of sizeable reserves. It is remarkable that Malaysia's reserves rose sharply since September 1998 when capital and exchange controls were introduced. However, external reserves have been shrinking slowly after reaching a peak in April 2000. Since May 2000, net reserves have been falling, despite substantial current account surpluses in BOP. It has fallen from US$34.5 billion in April 2000 to US$29.9 billion in December 2000. By end-mid-March 2001, net reserves declined further to US$28.7 billion.

Obviously, capital account trends are somewhat unnerving. A large proportion of the outflow in the capital account was due to repayment of long-term external debt totaling US$4.2 billion (RM15.8 billion). Another US$2.3 billion (RM8.8 billion) outflow was attributed to repayment of short-term external debt. Reverse investments by the Malaysian corporate sector, to the tune of US$2 billion (RM7.7 billion), also caused a big dent in the country's capital account last year. In addition, the flow of portfolio funds reversed since June 2000 with large net outflows of portfolio capital amounting to US$3.2 billion (RM12.3 billion) during the last seven months of the year. Reference must also be made to the US$1.4 billion ((RM5.3 billion) foreign exchange revaluation losses, due to the appreciation of the US dollars against other major currencies held as reserves.

There is little that one can say about repayments of external debt upon maturity, while prepayment of external debt makes considerable sense where it leads to significant savings in cost. However, there is a need to keep tabs on reverse investment, especially where such outflows have serious implications for external reserves. Those overseas investments with long gestation period and no prospects of 'early harvest' deserve lower priority. Conversely, overseas investments that generate trade flows would have a better claim on scarce foreign exchange. There is also a need to find out why foreign capital flows into the country are held up and to remove the obstacles or impediments, if any.

Current account surplus has also been declining since the third quarter of 1999 when it exceeded RM14 billion. It has fallen to just RM7.6 billion in the third quarter of 2000. Will it continue to fall? One view is that trade surplus and current account surplus will not be adversely affected by the slowdown, as intermediate imports will fall with exports, while services account deficits will decline with reduced volume of trade. Another view is that imports may grow due to increased capital goods imports arising from the implementation of so many new investment projects approved by MIDA. Imports may also be expedited, if there are concerns about the current currency peg.

If the current account surplus continues to fall, it will lead to a faster erosion of external reserves, given the present trends in the capital account. This is not to deny that the current reserve position is fairly sound. There is no doubt that reserves are still substantial, useable and unencumbered. It is further erosion that is worrisome. The reserve level is sufficient to finance 4.3 months of retained imports, down from 7.0 months equivalent that the country had enjoyed previously.

All these have implications for the external value of the ringgit. To be sure, there is no suggestion that the ringgit peg is facing imminent threat of any kind. Nonetheless, it is necessary to have large reserves for the peg to stay. A big drop in reserves may cause the peg to brake. Rising trade surpluses and external reserves were attributed partly to the perceived undervaluation of the ringgit which made exports competitive. Now that the trade surplus and reserves are falling, it can be surmised that the ringgit is no longer undervalued. Some would even use these observations to argue that the ringgit is already overvalued. The fact remains that the ringgit has strengthened against almost every currency, simply because it is tied to the US dollar which has appreciated enormously. The authorities cannot ignore the fact that Malaysia's rivals will become more competitive by default, if the US dollar and hence the ringgit were to further strengthen. Besides, according to industry sources, production cost in the electronics sector is 10 per cent higher in Malaysia compared with the Philippines or Thailand.

Changes in reserves tend to reflect changes in demand and supply for foreign exchange, especially where the exchange rate is fixed. Thus, rising reserves would suggest that supply exceeds demand, at the given the exchange rate, which in turn would imply that the national currency is undervalued. Conversely, falling reserves could mean demand for foreign exchange exceeding supply, at the given exchange rate, which would imply that the domestic currency is overvalued. Hence the importance of stable reserves for maintaining a given peg.

Another area of concern revolves around the scope for monetary and fiscal instruments under the present circumstances. The central bank can easily reduce interest rates by some percentage points, now that inflation is a non-issue. But, it is uncertain if this will matter much under the current excess liquidity conditions. It cannot be denied that government pump priming has played a pivotal role in stimulating the economy in recent years. Increased development expenditure has injected more money into the system at the cost of increased budget deficits. While the wisdom of the authorities in resorting to pump priming is not questioned, the fact remains that there are limits to deficit financing. Pump priming makes sense only as an emergency measure. There are lessons to be learned from the Japanese experience where a decade of continuous pump priming has brought about fiscal fatigue.

Budget deficits would raise eyebrows, especially if government revenue is not sufficient to cover even operating expenditure, let alone development expenditure, as was the case in the last quarter of last year with a current deficit of RM2.78 billion. Overall budget deficit for the year as a whole stood at RM19.74 billion or 5.8 per cent of GDP. The shortfall would have been larger, had it not been for the windfall gains thanks to higher prices of oil.

The exchange rate instrument may have to be activated. If the ringgit gets overvalued at the current exchange rate, Malaysian exports will become uncompetitive unless offset by a fall in domestic prices with deflationary implications. The authorities will then have to make a difficult choice between lower growth and currency re-peg. Meanwhile, stimulus packages, such as the one announced lately by the Government, can provide some relief by encouraging domestic consumption and investment, even if the question of external disequilibrium remains unresolved.