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Analysis

Malaysia: Ten Years After the Crisis

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A lot of water has flowed under the bridge for the Malaysian economy since the financial crisis hit the region ten years ago. It took more than a year for the Malaysian authorities to develop any substantial policy response to the crisis, but the economy turned around remarkably well.

Yet it is debatable whether normalcy has been restored. Much depends on what one means by 'normalcy'. A return to the pre-crisis state would mean a *déjà vu*, not normalcy. The economy is still wrestling with structural problems of sorts that cannot be fixed as easily as cyclical downturns.

The post-crisis macroeconomic track record has been impressive, with gross domestic product (GDP) expanding at a respectable 5.4 per cent on average between 1999 and 2006 after the 1998 fall of 7.4 per cent. The current 5-6 per cent growth, no doubt, pales in comparison with the 8-9 per cent growth before the crisis but it is clearly not in the interest of the economy to grow at pre-crisis levels.

The private sector, badly bruised by the crisis, still remains the key growth driver, albeit with significant government support. The Malaysian

economy continues to be highly dependent on the external sector, with a trade/GDP ratio of about 200 per cent. The direction of exports has not changed much, except for the rise of China whose export share has increased to 6.7 per cent in 2006 from 2.4 per cent in 1996.

The balance of payments situation has changed 180 degrees since the crisis, with a current account surplus to the tune of 17.1 per cent of GDP in 2006, a far cry from a deficit of 5.9 per cent in 1997. Consequently, Malaysia's reserves increased to US\$98.4 billion by May 2007, up from US\$26.2 billion in 1998. The external debt service ratio, which measures debt servicing as a proportion of export proceeds, has dwindled to 4.7 per cent in 2006, down from 6.5 per cent in 1998.

Export growth, however, has been decelerating in recent times, due mainly to the slowdown in the US economy. In the first quarter of 2007, exports registered a mere 1.9 per cent growth year-on-year, which contributed to a slower GDP growth of 5.3 per cent in the first quarter. Whilst this deceleration is likely to continue into the second quarter, the Malaysian economy is poised for a better performance in the second half of 2007.

Foreign direct investment (FDI) inflows have also shown considerable improvement in recent years. After dropping to a low of RM2.1 billion in 2001, FDI inflows have bounced back, to RM22.2 billion in 2006. The Ringgit has performed

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strongly against all major currencies following its de-pegging on 21 July 2005. It appreciated by about 7.0 per cent against the US dollar in 2006, and reached a new high of RM3.38/\$US at end-May 2007.

All these changes have come with a much healthier financial system. There are fewer banks now than before the crisis, thanks to extensive merger exercises, and they are healthier with sound balance sheets. The acquisition of bad loans and recapitalisation by the special-purpose vehicles (Danaharta and Danamodal), at the cost of RM12.6 billion, has restored balance in the financial sector. The ratio of non-performing loans (NPLs) to total loans has fallen from 13.6 per cent in 1998 to 4.7 per cent in 2006, while the risk-weighted capital adequacy ratio of commercial banks has improved from 10.5 per cent in 1997 to 12.9 per cent in 2006. The Kuala Lumpur bourse is now the second-best performer in the region next only to Shanghai, with the Composite Index touching 1372 in the first week of June 2007, way above the pre-crisis 1200 benchmark.

Not surprisingly, all this is translating into new confidence on the part of the policy makers, if the recent liberalisation moves are any measure. The central bank has further eased its foreign exchange administration policies with effect from 1 April 2007. In a similar vein, the property sector

has received a big shot in the arm in the guise of the removal of real property gains tax and more liberal facilities for foreign ownership of properties.

This is reassuring, but serious concerns remain. For starters, the Malaysian economy is still under-performing, with GDP growth falling short of the potential rate of 6.5 per cent. The huge current account surplus is indicative of a lackluster domestic sector, with savings exceeding investments. In fact, there has been a significant drop in investment, to a post-crisis low of 20 per cent of GDP from the pre-crisis rate of 43 per cent. GDP growth is not generating much employment. While the economy is creating fewer and fewer jobs than previously, a large portion of the new jobs are also increasingly going to foreign workers. Private consumption expenditure is losing steam, with growth decelerating from 10.5 per cent in 2004 to 9.2 per cent in 2005 to 7.0 per cent in 2006. Lastly, income disparity in the country is widening for all ethnic groups, especially the Bumiputra community.

While the Government has done a good job of getting the Malaysian economy back on an even footing in a macroeconomic sense, new and more nuanced policies are now required to address the more difficult structural problems in the economy.

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