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The Policy Responses and Implications of the Global Financial Crisis on Asia: A Case Study for Malaysia*

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Abstract:

This paper examines the impact of the 2008 Global Financial Crisis (GFC) on Malaysia's economy as well as challenges and responses of the government in countering this crisis. It argues that the impact of the GFC is different from the 1997 Asian Financial Crisis (AFC). The AFC impacted the financial industry with the resultant collapse of Malaysia's currency, while the GFC impacted the export sector with direct repercussions on Malaysia's real economy. This paper explores the structural weaknesses of Malaysia's economy exposed by the GFC. Given that Malaysia's economic growth had become more trade-dependent after the AFC, domestic investments, including foreign direct investments, could only grow anemically. This had jeopardized long-term economic growth and productivity, which were crucial in offsetting the impact of the GFC. This paper shows that the expansionary policies implemented by the government to counter the GFC were lacking in meaningful structural changes and could not yield the desirable results. Lastly, it assesses the extent to which the New Economic Model proposed by the present government could spur economic growth in dealing with the GFC.

Key Words: *Global Financial Crisis, Asian Financial Crisis, Malaysian Economy, Economic Countering Measures*

JEL Classification: *F40, F41*

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1. Introduction

Asia is hit by another major crisis barely ten years after the devastating Asian financial crisis (AFC). This time, the crisis emanates from the United States. While no two crises are identical, they share some basic common conditions, among which are a build up of excess liquidity, from either domestic sources such as loose monetary policy, or external sources such as rapid capital inflow, that invariably lead to poor credit discipline, misallocation of capital, and the consequent rise and collapse of asset bubbles (see Reinhart and Rogoff, 2008, Thalassinos et al., 2010, and 2006a, 2006b). They also exhibit quite similar financial practices, namely, excessive use of maturity mismatch (funding long-term assets with short-term funds) and unsustainable leverage, and the use of inappropriate and unregulated financial instruments. In the case of the AFC, the problem of maturity mismatch was aggravated by currency mismatch, i.e., borrowing in short-term foreign denominated loans to invest in long-term local currency assets. As a result the AFC was not only a banking crisis but also a currency crisis. As a consequence of this huge inflow of capital and double mismatch, many companies not only had high debt-to-equity ratios but also exposure to currency risks (Lau, 2005). A currency crisis was looming in Thailand when doubts were cast on the ability of borrowers to repay their loans. A massive outflow of portfolio capital coupled with speculative attacks on the Thai currency culminated in a currency crisis that led to a banking crisis. The Thai government, short of dollar reserves, allowed its currency, the baht, to depreciate in order to cut it loose from the dollar (Kamer, 2004). The currency crisis soon spread to other Asian countries, including Malaysia. The Malaysian ringgit had depreciated by 40 percent against the US dollar and the stock market lost 80 percent between February 1997 and September 1998 (Tan, 2005). However, the AFC did not bring about the collapse of the financial and banking sectors in Malaysia with the exception of the tumbling of the stock market due to large outflow of portfolio investments by foreigners.

In contrast to the 1997 AFC, the 2008 global financial crisis (GFC) stems from the weaknesses of the U.S. financial industry that escalated into a severe international financial crisis and caused global recession by late 2008. The crisis is triggered by the collapse of the U.S. housing asset bubble, in particular its subprime mortgages. The crisis that started in July 2007 was transmitted to the real economy as credit crunch and debt implosion led to job losses and a fall in consumer spending. The downturn effects of the US economy spread fast to other regions, especially export-driven countries like Malaysia, resulting in a crisis of exports with immediate impact on production and job losses.

Malaysia was lucky in the sense that the GFC did not metamorphose into a currency or banking crisis due to the stronger macroeconomic fundamentals and financial systems built up after the painful experience of the AFC. But there were still structural weaknesses that made it difficult for the government to address the GFC. In the aftermath of the AFC, Malaysia's economy had become more trade-

dependent where net export became a major driver of economic growth. However, in times of external recession, an export-oriented economy will become extremely vulnerable to the decline in the demand for exports. This is particularly evident in the GFC. Also, as a result of a slanted orientation towards export-led economic growth, private domestic investment had been neglected. All in all, these structural weaknesses had affected long-term economic growth and productivity and in turn, the ability of the government to offset the adverse impact of the GFC.

This paper examines the impact of the GFC on Malaysia's economy as well as the effectiveness of countering measures undertaken by the government. It begins with a discussion on Malaysia's economy in the aftermath of the AFC. It then looks at the subprime mortgage crisis which triggered the GFC. It goes on to identify the channels through which the GFC is transmitted to Malaysia's real economy, namely, the trade and finance channels. It finally examines the effectiveness of the government's expansionary policies and the New Economic Model in addressing the GFC.

2. Malaysia's Economic Position after the Asian Financial Crisis

Malaysia took proactive measures to address the AFC. As a response to the huge depreciation of the ringgit and the Malaysian stock market, the government implemented various financial and capital controls that included fixing the value of the ringgit at 3.8 to the US dollar, banning the circulation of the ringgit abroad, requiring official permission to remit more than 10,000 ringgit outside the country, and barring foreign investors from repatriating their investments in Malaysian stocks, bonds and properties for a year (Kamer, 2004). These measures were mainly aimed at containing the disruptive short-term speculative capital flows. They did not affect trade and foreign direct investment (FDI) flow and the current account remained fully convertible (Yap, 2001). Meanwhile, the imposition of capital controls gave the economy 'breathing space' and the government took advantage of this to lower domestic interest rates and to pursue expansionary macroeconomic policies to stimulate economic recovery. The banking system was also strengthened through mergers and consolidation to create a resilient, efficient and competitive banking sector (Lau, 2005).

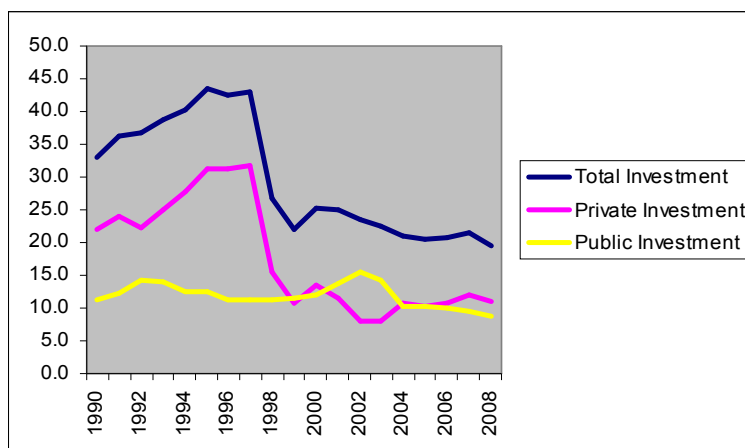
Malaysia's economic recovery from the AFC was dramatic. Gross Domestic Product (GDP) growth had turned around from a low of -7.4 percent in 1998 to 6.1 percent in 1999 and 8.9 percent in 2000. The speed of recovery was mainly driven by larger exports of electronics products, especially semiconductor products, which accounted for more than two-thirds of total manufacturing exports. In 1999, electronics exports amounted to almost 52 percent of Malaysia's total exports. But the economic contribution of the electronics sector, of which 91 percent is owned by foreign firms through FDI, is erratic and subject to global cyclical demand. For instance, during the upturn in the global electronics cycle from 1999 to 2000,

Malaysia's electronics exports rose to 52 percent of total exports. But during the downturn in 2001, adverse external circumstances affected Malaysia's electronic exports which shrank 13 percent from 2000 to 2001 while GDP growth contracted from 8.9 percent to 0.3 percent over the same period.

With strong performance of the electronics sector, inflow of FDI into Malaysia increased from RM10 billion in 1998 to RM14.8 billion in 1999. But FDI inflows declined to RM2 billion in 2001 due to the downturn in the global electronics cycle as well as increasing competition from China, India and Vietnam. Rising labor costs in Malaysia had resulted in the loss of competitive advantage for the production of lower value-added and labor-intensive products (Lee & Tham, 2007). Although FDI inflow recovered and increased to RM17.5 billion in 2004, it fell again to RM15 billion in 2005. Thus, Malaysia's economic growth from 2002 to 2004 could well be attributed to the undervalued ringgit rather than an increase in FDI as the peg was maintained right up to July 2005 before reverting to a managed float system based on a basket of currencies (Lee & Tham, 2007).

The main driver of growth in the demand components of Malaysia after the AFC was private consumption and net export in sharp contrast to private consumption and investments that featured prior to the AFC (Goh & Lim, 2009). Private investments were anemic after the AFC. Figure 1 shows that in the aftermath of the AFC, total investments declined from 40 percent to about 20 percent, led primarily by the fall in private investments which were halved while public investments stayed steady at around 11 percent.

Figure 1. Private and Public Investment as percentage of GDP, 1990-2008

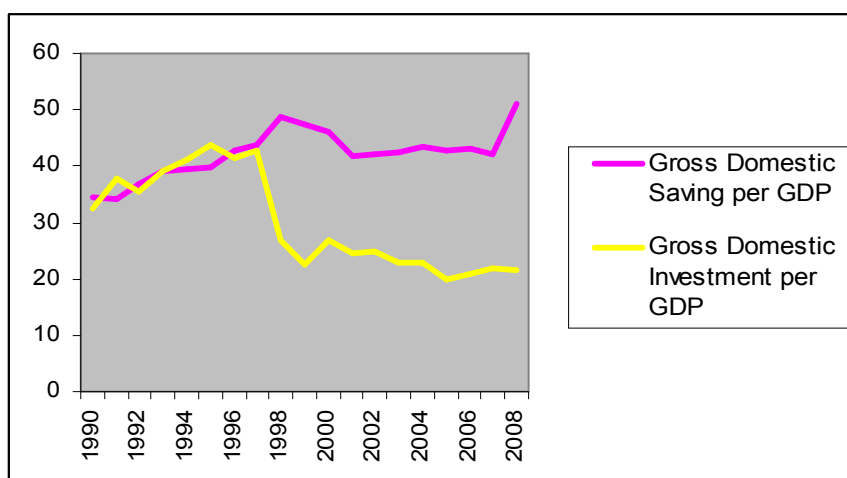


Source: Bank Negara Malaysia, Monthly Statistics Bulletin

Malaysia persistently records current account surplus during the post AFC period. In 2008, current account reached a surplus of 18 percent of GNP. However, Malaysia's current account surplus, i.e. the excess of savings over investments, is

due more to a drastic decline in investments than a rise in savings as shown in Figure 2. Gross national savings remained high during the post AFC period but were not used to finance domestic investments, a development that is not conducive to long-term growth in terms of productive capacity. From 2002 to 2007, Malaysia's GDP grew at an average of 5.3 percent annually, compared to an average rate of 8.1 percent from 1990 -1997.

Figure 2. The Saving-Investment Gap, 1990-2008



Source: Bank Negara Malaysia, Monthly Statistics Bulletin and authors own's calculation

There were two main reasons for the drastic drop in total investments: first, a decline in FDI inflows. While China and India experienced an unprecedented FDI boom after the AFC, inflow into Southeast Asia (including Malaysia) continued to shrink. The FDI inflows have moderated compared to pre-AFC periods. The average FDI inflows into Malaysia, which were US\$5.2 billion between 1990 and 1997, declined to US\$4.3 billion between 1998 and 2008. Second, a poor investment climate created by distortions and inefficiencies associated with the implementation of the New Economic Policy (NEP), bureaucratic red tape, shortage of skilled labor, and the brain drain problem contributed to low domestic investments (Goh & Lim, 2009). Malaysia has more than 700 thousand of its citizens working abroad, of which two thirds are professionals.

On the other hand, public investments funded through fiscal deficits have been a major source of investment in Malaysia after the AFC. Figure 1 shows that public investments had overtaken private investments from 2001 to 2004. However, it should be noted that sustainable growth will only come with prudence in fiscal policy. Alarmingly, oil and gas presently account for about forty percent of Malaysia's tax revenue. Given that reserve for oil and gas is depleting and could only last another ten years unless new fields are found (Narayan, 2008), the strong

reliance on these resources to fund public investments is certainly not a sustainable policy measures.

3. The Subprime Mortgage Crisis

The origins of the current GFC lie with the US real estate market supported by subprime-mortgage lending. The real estate market was fuelled by the lowering of interest rate by the US Federal Reserve which had led to speculative lending. The lowering of interest rate was one of the measures to overcome a recession deepened by a banking and real estate crisis that began in the 1990s as a consequence of a combination of financial deregulation and deposit insurance in the previous decade (Akyuz, 2008). Between 2001 and 2003, for instance, the Federal Reserve slashed interest rates and held them at 1 percent for a year and then raised them in slow, predictable quarter-point steps. With low interest rates, financial institutions took on more debts, making investments more profitable and riskier. They also designed a myriad of complex derivatives, among which were collateralized debt obligations (CDOs) and credit default swaps (CDSs). By combining debt and derivatives, financial institutions created a new machine that could originate and distribute prodigious quantities of risk to a baffling array of counterparts. Despite warnings, the Federal Reserve refrained from using monetary instruments and regulatory authority to slow down the credit and asset bubbles.

Many of these CDOs were held in off-balance-sheet vehicles that short funded themselves through the issuance of commercial papers. When investors suddenly stopped buying the commercial papers, the back-up credit lines provided by banks to these off balance vehicles abruptly came into force, causing a liquidity crisis to these banks. The subprime mortgage crisis finally led to a meltdown of the entire US financial market. Wall Street crumpled overnight. Sensing the danger of a collapse of the financial system, the US Congress and the Federal Reserve intervened to shore up the financial system by massive infusion of new equity into beleaguered banks. Other emergency measures were introduced: lending money directly to cash-strapped investment banks and brokers; accepting a broader array of collateral, including mortgage-backed and other investment-grade securities.

4. Impact of the Global Crisis on Malaysia's Economy

By late 2007, many financial institutions in the United States and other parts of the world suffered heavy losses from their CDOs, CDS and other financial assets. Fortunately, Malaysia's financial institutions had negligible exposure to these toxic products. Furthermore, Malaysia's financial institutions and banks were in stronger shape than they were during the AFC following better financial supervision and

regulation. The capital adequacy ratio has consistently been maintained at more than 13 percent after 2001, which is higher than the 8 percent requirement by the Basel international standard for minimum capital adequacy ratios of banks. More importantly, the nonperforming loan as a percentage of total loans declined from 11.5 percent to 2.6 percent in 2008, on the eve of GFC.

But when the financial crisis spread to the real economy in the United States and Europe, the drastic decline in consumption in these countries led to a collapse in Asia's export markets. Asian countries including Malaysia began to feel the adverse impact of the GFC towards the second half of 2008 and early 2009. Singapore was one of the first Asian countries hit by the GFC, followed by Taiwan, Hong Kong, South Korea and Thailand. Malaysia recorded a fall in real GDP by 6.2 percent yoy in the first quarter of 2009, the first time in negative territory since 2001. The contraction in growth has persisted into the second and third quarter of the year. IMF economists described this as an export-led recession (IMF Country Report, 2009).

The two major channels through which the GFC impacted Malaysia's economy were the finance channel and trade channel (Goh & Lim, 2009).⁴

After the economy began to recover in 1999, Malaysia's capital controls were gradually relaxed and removed. There was a liberalization of capital account with increasing freedom given to both inflow and outflow of funds. Foreign participation in the Malaysian stock market has been more than 30 percent since 2004 (Ooi, 2008). The economy on the eve of the GFC is more liberalized compared to 1997 (Khor, 2009).

Driven by global deleveraging and repatriation of capital by foreign investors, portfolio investment in Malaysia turned negative after the second quarter of 2008 following a huge net outflow of RM84.37 billion in 2008. This was in sharp contrast to 2007 when the country registered a positive net inflow of RM18.35 billion. This huge outflow in portfolio investment, mainly due to sale of shares in the stock market, was among the most severe in East Asia. Consequently, the Kuala Lumpur Composite index declined sharply by more than 30 percent between mid-2008 and March 2009.

Inflow of FDI into Malaysia declined 98 percent from RM15.89 billion in the second quarter to RM0.34 billion in the third quarter of 2008. On the other hand, outward direct investments by Malaysian corporations continued to grow—and FDI outflows have outstripped inflows since 2007.⁵ In 2008, outward direct investment rose to RM50.19 billion, and exceeded FDI inflow of RM24.13 billion which resulted in a net direct investment outflow of RM26.06 billion.

⁴ See also Khor, 2009

⁵ Liberalization on capital outflows since 2005 has led to this result. Since 2005, private capital outflow became a major method for reducing the exchange rate pressures arising from capital inflows. Besides, investments abroad allowed domestic firms to expand abroad and become important players in world markets.

The surge in bank outflow in the second half of 2008 had a negative impact on other investments. Other investments recorded a lower net outflow of RM8.06 billion in 2008 compared to a net outflow of RM46.9 billion a year earlier, due to lower net external debt repayment by both the official and private sectors (Bank Negara Malaysia, 2008).

Table 1. Financial Account in the Malaysia Balance of Payment, 2007 to 2nd quarter 2009 (RM Billion)

	2007	2008	2008Q1	2008Q2	2008Q3	2008Q4	2009Q1	2009Q2
Financial Account	-37.71	-	26.46	-11.09	-62.02	-71.83	-29.76	-24.19
		118.50						
Direct Investment	-9.14	-26.06	-5.15	0.17	-19.63	-1.45	3.19	-8.10
Abroad	-38.22	-50.19	-8.91	-15.72	-19.97	-5.58	0.43	-8.96
In Malaysia	29.08	24.13	3.76	15.89	0.34	4.13	2.76	0.86
Portfolio Investment (net)	18.35	-84.37	26.08	-21.95	-55.28	-33.21	-12.15	-9.93
Other Investment (net)*	-46.92	-8.06	5.53	10.69	12.89	-37.17	-20.80	-6.16
Official Sector	-5.79	0.85	-0.71	1.61	-2.74	2.70	-0.97	-0.65
Private Sector	-41.14	-8.92	6.24	9.08	15.62	-39.87	-19.83	-5.52

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

However, Malaysia is coping with the huge outflow of capital from a position of strength compared to the AFC. It has ample foreign exchange reserves and a more resilient financial and banking system (IMF Country Report, 2009). Figure 3 shows Malaysia's foreign exchange reserves stood at RM410 billion in June 2008 before it began to shrink beginning in the second half of 2008. As capital outflow intensified since September 2008, Malaysia's foreign exchange reserves continued to slip till March 2009. As of October 2009, Malaysia's foreign exchange reserves depreciated to RM334 billion, which constituted 9.9 months of its imports and 4.1 times of its short-term external debt. The ringgit has also depreciated against other major currencies from mid 2008 till early 2009. The real effective exchange rate (REER) has weakened by about 4.5 percent during this period, owing to nominal depreciation and a relatively higher domestic inflation.

The impact of the GFC on Malaysia's trade sector is more serious. Statistics shows that the most important factor contributing to its sluggish GDP growth in the last quarter of 2008 and the first quarter of 2009 was the big slump in the export market, though low private investment was also another reason. Malaysia's exports, highly dependent on electronics and semiconductors (contributing 40 percent of total export), started falling since October 2008. In January and May 2009, total exports fell by 27.9 percent and 29.7 percent y-o-y terms respectively – the biggest drop since 1981 as shown in Table 2.

Apart from the fall in manufactured exports, there was also a sudden drop in the demand and prices of Malaysia's export commodities such as petroleum, palm oil, rubber and timber. These commodities account for one-third of Malaysia's exports. Palm oil and palm oil-based products are the second largest export earners for Malaysia, contributing 9.6 percent of total exports in 2008. In May 2009, export of palm oil contracted 32 percent on yoy basis. Over the same period, the export of crude petroleum, which was the fourth largest export commodity, declined by 53 percent yoy.

The impact of the GFC on Malaysia's exports was further aggravated by the fact that more than 40 percent of Malaysia's exports were destined for the G3 countries of the United States, Japan and Europe which were heavily affected by the GFC. Hence, this time around, unlike the AFC, Malaysia could not export its way out of the recession since the demand from these countries for Malaysian exports fell.

The crisis also affected the import of intermediate goods that are used in exports. Malaysia's imports contracted 32 percent to RM29.5 billion in January 2009. Since 70 percent of the country's imports are in the form of intermediate goods, imports fell faster than exports so that Malaysia still maintained a small trade surplus as shown in Table 2.

Table 2. The Performance of the External Sector

	Export		Import		Trade Balance	
	Y/Y	M/M	Y/Y	M/M	Y/Y	M/M
Sept,2008	15.0	4.5	11.4	1.2	28.48	16.9
Oct, 2008	-2.6	-14.2	-5.3	-7.9	11.82	-34.8
Nov,2008	-4.9	-3.1	-8.6	-8.1	10.71	19.8
Dec,2008	-14.9	-11.0	-22.8	-14.3	22.59	0.3
Jan,2009	-27.9	-16.9	-30.4	-12.7	-16.59	-29.7
Feb,2009	-15.9	3.4	-27.3	-8.8	31.46	48.7
Mac,2009	-15.6	10.1	-28.8	12.8	56.26	4.0
April,2009	-26.3	-5.6	-22.4	8.7	-24.6	-41.1
May,2009	-29.7	4.5	-27.8	-2.3	-35.3	35.6
June,2009	-22.6	5.0	-20.8	9.3	-29.1	-9.0

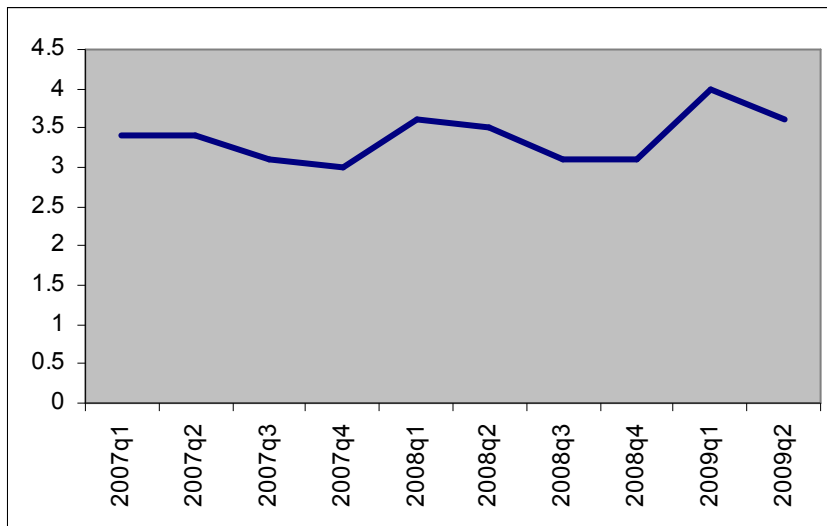
Source: Department of Statistics, Malaysia, author own calculation

The impact of the crisis on unemployment in Malaysia is not as alarming as compared to other countries or during the AFC. Malaysia had a tight labor market prior to the crisis. With an unemployment rate of about 3.5 percent, and the presence of almost 2 million of foreign workers,⁶ the impact of the crisis on employment opportunities for Malaysians was relatively moderate. The brunt of unemployment was mostly borne by the foreign workers. Figure 4 shows that during the depth of

⁶ According to the news released by the Ministry of Human Resource, there is another 1 million of illegal foreign workers in Malaysia

the crisis in quarter one of 2009, the unemployment rate increased only to 4.0 percent compared to 3.1 percent in the fourth quarter of 2008. According to a World Bank report, “Some 8 percent of the manufacturing workforce, more than 120,000 workers, was shed with foreign workers taking a disproportionate hit. Job losses, shorter working hours and lower wages are likely to have raised absolute and relative poverty in urban areas” (World Bank, 2009).

Figure 4. The Unemployment Rate, 2007q1-2009q2



Source: The Department of Statistics, Malaysia

5. Policy Responses to the Economic Slowdown

To counter the impact of the GFC on Malaysia’s economy, the government introduced economic stimulus packages to revive spending and stimulate domestic demand; at the same time, Bank Negara Malaysia (BNM) introduced an expansionary monetary policy by reducing interest rates.

5.1. Expansionary Fiscal Policy

On 4 November 2008, the Government announced the first economic stimulus package amounting to RM7 billion. The funds provided by the stimulus package would be allocated to projects that have high and immediate multiplier impacts on the economy. The government also set up an Investment Fund to attract more private sector investments. Several measures to directly boost domestic consumption were also introduced, such as a reduction of Employment Provident

Fund (EPF) contributions and a higher vehicle loan eligibility for government servants.

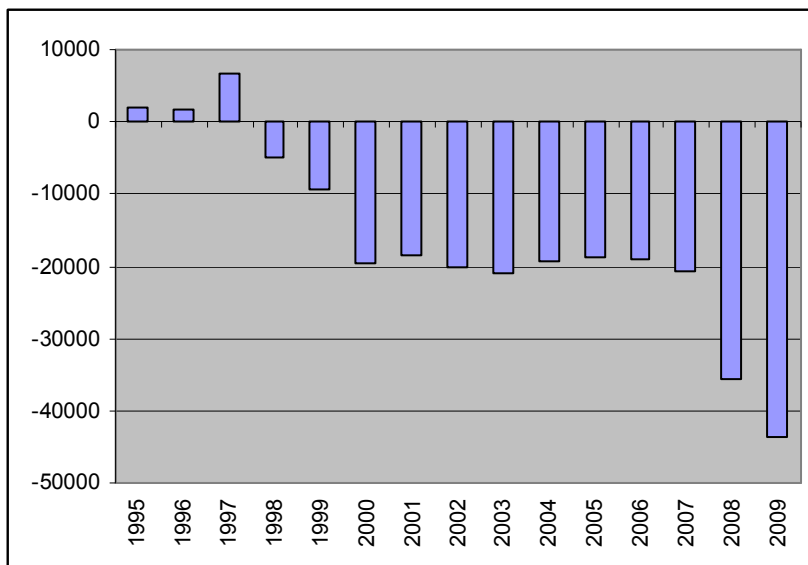
In early 2009, with the global economic conditions putting economies all over the world in disarray, Malaysia's economy faced the prospect of a deep recession. The RM7 billion stimulus package which accounted for approximately 1 percent of Malaysia's GDP was clearly too small to prevent Malaysia from slipping into a deep recession. The government on 10 March 2009 announced a bigger and more comprehensive second economic stimulus package of RM60 billion. The stimulus package was allocated for various purposes: fiscal injection (RM15 billion),⁷ Guarantee Funds (RM25), equity investments (RM10 billion),⁸ RM7 billion private finance initiative (PFI) and off-budget projects (RM7 billion) and tax incentives (RM3 billion). The RM60 billion stimulus package amounts to almost 9 percent of the GDP. The introduction of such a large stimulus package is unprecedented. The package will be implemented over 2009 and 2010, and will involve spending on training, job creation, improving public infrastructure, school facilities and basic amenities as well as establishing guarantee facilities. Two loan guarantee facilities, namely, the Working Capital Guarantee Scheme and Industry Restructuring Loan Guarantee Scheme were established to provide working capital and to encourage investments by businesses. In addition, the Financial Guarantee Institution will also be established to provide credit enhancement to companies that raise funds from the bond market.

The total allocation of the first and second economic stimulus packages (RM67 billion) amounted to 10 percent of the GDP of the economy. This is the 5th largest economic stimulus package in East Asia, after China, Japan, South Korea and Singapore.

This will increase the Federal Government's budget deficit from 4.8 percent in 2008 to 7.6 percent in 2009 (BNM, 2008). Figure 5 shows Malaysia has never gotten out of its fiscal deficit since the AFC. The economy has experienced 11 years of fiscal deficit. Although fiscal deficit eased in the mid 2000s, it widened again in the late 2000s. As the saying goes, the government has to spend when times are good and has to spend even more when times are bad. Malaysia has a very narrow tax base, 40 percent of the government tax revenue is derived from the oil and gas sector (Ariff, 2009). A large amount of the fiscal deficit was financed from domestic sources, given the ample liquidity in the domestic financial system arising from forced private savings, and are directed at the purchase of government securities through institutions such as public pension funds, banks or public enterprise.

⁷ This amount is drawn from the government's coffers where RM10 billion is allocated for development and RM5 billion is allocated for operating costs

⁸ This amount of money is given to Khazanah Nasional to acquire equity stakes in local projects with high multiplier effects.

Figure 5: Malaysia's fiscal position, 1995-2008

Source: Bank Negara Malaysia, Monthly Statistics Bulletin

5.2. Expansionary Monetary Policy

With the slowing down of inflation,⁹ Malaysia has more room to pursue expansionary monetary policy to support domestic economy. BNM 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 maintained at 2 percent. Meanwhile, the Statutory Reserve Requirement (SRR) has been reduced by 200 basis points to 1.0 percent.¹⁰

The key to economic recovery now lies with the government's economic intervention. Although it may not be the best economic policy, it is the only way to get out of the crisis. There are concerns as to whether expansionary policies will yield the right economic push and multiplier effects needed to cope with the recession. One criticism is that both economic stimulus packages have been disbursed mostly to infrastructure or construction projects which employ a substantial number of foreign workers and remittance made by them creates leakages in the domestic economy. Data showed that the total recorded remittance outflows from Malaysia in 2006 amounted to 3.7 percent of the GDP (Quah, 2009a). Furthermore, like Japan, Malaysia has a huge number of contractors, numbering 67,000. These contractors, mostly Bumiputeras, form a formidable support base for

⁹ Inflation has been decelerated from 8.5 percent in August 2008 to 3.5 percent in March 2009

¹⁰ Bank Negara Malaysia Annual Report, 2008, p.99 and Monetary Policy Statement, announced by Bank Negara on 24 February, 2009

UMNO.¹¹ The awarding of contracts is made more for political rather than economic reasons.

6. Policy Implications and Conclusions

The GFC has affected Malaysia in ways that are slightly different from the AFC. The AFC was truly a currency and financial crisis. The rapid and huge inflow of foreign capital into Southeast Asia led to current account deficits, massive misallocation and wastage of capital, risky financial practices like excessive leverage compounded by currency and maturity mismatches of assets and liabilities. Additionally, the pegged currency regimes allowed investors and speculators to exploit arbitrage opportunities. All these eventually led to the collapse of the currencies, and the financial industry and the economies. In contrast, the GFC, as it affected Asia, was neither a currency crisis nor a financial crisis. It is essentially an export crisis, mainly of manufactured products directed at G3 countries, with direct impacts on the real economy.

The shocks of this crisis are transmitted through the financial and trade sectors. In the financial sector, Malaysia became even more integrated into the global financial system and the big impact was felt primarily in the stock markets with rapid outflow of portfolio investments sending the stock market down by over 50 percent. Fortunately, the fall-out to other parts of the financial sector was limited as the banking sector was better supervised, sound and healthy and there was no huge build up of a property asset bubble. Also Malaysian banks had limited exposure to toxic financial assets having learned their lessons in the AFC.

However, the GFC has a huge impact on Malaysia's trade. Malaysia has always relied on exports to stimulate its economic growth, more so after the AFC. Declining external demand in the aftermath of the GFC has adversely affected Malaysia's foreign trade. Malaysia registered a drop of 27 percent in exports in January 2009, the biggest drop in exports since 1982. This brings to fore the question on whether without external trade from the G3 countries, the economy of Malaysia in particular, and East Asian countries in general, can sustain their growth through domestic and intra-regional consumption and investments.

The GFC has exposed critical structural flaws in Malaysia's economy. Alarming, the current account surplus in Malaysia after the AFC, is not due to a significant increase in total savings but rather a drastic drop in total private investments. Many factors have contributed to the drastic drop in total private investments, among which are poor and biased implementation of the NEP, bureaucratic red tape, declining standards of education, severe shortage of skilled labor and serious brain drains. All these have reduced Malaysia's competitive edge

¹¹ UMNO is Malaysia's largest political party and a founding member of the Barisan National coalition. It has played a dominant role in Malaysian politics since independence

in the global economy and hence its failure to make a quick recovery from the GFC. Malaysia is now stuck in the middle-income trap. On the one hand, it does not have the cost advantage as a low-cost producer to challenge countries like Vietnam, Indonesia and Thailand. On the other hand, it is struggling to become a high-end producer but lacks the required technological advancement (World Bank, 2009).

Malaysia's fiscal deficit since the AFC is yet another problem that reflects its structural flaws and its inability to counter the GFC. As previously mentioned, public investments funded through fiscal deficits have been a major source of investments in Malaysia, even overtaking private investments in 2002. Forty percent of tax revenue is derived from oil and gas. The over-dependence on non-renewable natural resources to spur public investments should be a short-term and not a long-term fiscal policy, as Malaysia's oil and gas reserves are estimated to be depleted in another decade or so. Thus the government should adopt long-term fiscal measures to strengthen its vulnerable fiscal system.

Meanwhile, the effectiveness of the massive fiscal stimulus packages (amounting to 10 percent of Malaysia's GDP) introduced by the government to counter the impact of the GFC remains in doubt. This is primarily because the stimulus packages failed to address the critical structural flaws mentioned earlier. Instead of stimulating private spending, the stimulus packages substituted private spending with public spending. In Malaysia, public spending is fraught with leakages in the implementation process leading to higher fiscal deficits. However, there are new measures undertaken by the government under the new Prime Minister, Najib, to spur economic growth and to reach a high-income country by 2020, a target set in 1991 under the premiership of Dr Mahathir. The new government has lifted some restrictions imposed by the NEP. In particular, it revoked the thirty percent bumiputra equity requirement¹² for firms seeking to list on the stock market. This has freed investors from the compulsion to seek bumiputra partners who, more often than not, are sleeping or rent-seeking partners. The Foreign Investment Committee's guidelines on acquisition of equity stakes, mergers and acquisitions have also been repealed.

The government has recently come out with the New Economic Model that aims to transform Malaysia from middle income to a high income country. One of its focuses is to build up the service sector as the main engine of growth and to bring its contribution to more than 60 percent of GDP by 2020 from the current 55 percent (MITI, 2009). To meet this goal, it has further liberalized 27 sub sectors in the service industry to promote competitiveness, upgrading of technology and skills, and export of services. Some of these 27 sub sectors are tourism, health, education, computer and IT services, transport, finance and insurance, construction, business and professional services etc. While there is a need to diversify the sources of

¹² The NEP, formulated in 1971, targeted a thirty percent share of the economy for the Bumiputra, as part of the socio-economic restructuring affirmative action launched by the then Prime Minister Tun Abdul Razak.

growth, it is necessary to focus on areas where one has competitive advantage, and also to be selective in the adoption of policies and practices. For example, an uncritical liberalization of the financial sector can cause more harm than good as is evident in this financial crisis.

A third pillar of the government's liberalization effort is the privatization of its government-linked corporations (GLCs) that are associated with the bumiputra equity policies. The government through its investment arm, Khazanah Nasional Bhd, owns substantial equity holdings in many publicly listed companies. The government attempts to divest part of its holdings to diversify and attract more public ownership. But many people are concerned that this attempt may repeat similar malpractices of the government when it privatized its public enterprises beginning in the 1990s. This privatizing exercise not only led to cronyism but also huge financial losses involving the sale and later repurchase of shares in debt-ridden privatized companies, such as the Malaysian Airline System, the national airlines (Tan, 2008).

Finally, the government is aiming to increase domestic consumption as an engine of growth. Mohamad Nor Yakcop, the Second Minister of Finance of Malaysia, in a recent interview with CNBC said he would like to see consumption in Malaysia increase from 51 percent of GDP to 70 percent. This ratio will put it on par with the U.S. consumption level as a proportion of its GDP. One of the structural causes of the financial crisis is the increasing imbalance in wealth and income distribution contributing to increase in household debt as a way to sustain a high level of consumption (Tan, 2008). Malaysia's Gini coefficient is 49, slightly higher than that of the United States and the second worst in Asia (Lim, 2005). The country's total bank loans are skewed to private consumption with 55 percent directed to households in the form of residential and non-residential property loans (36 percent), passenger car loans (10 percent), credit cards and personal loans (7 percent). Without increasing household income or improving its income and wealth distribution profile, pumping up consumption through debt creation could take it down the same path as the United States. In fact, this is a policy challenge for most Asian countries, particularly China, that are attempting to turn to domestic consumption as an engine of growth.

Most of the components of the new economic model of the government, such as focusing on innovation and a knowledge-based economy, consumption growth, increasing productivity etc. are, in fact, not new (Quah, 2009b). They have been suggested in one form or another under the Eighth Malaysia Plan (2001-2005) and the earlier Master Industrial Plans. The big challenge is whether the present government, burdened with a political base that has benefited so much from rent-seeking activities for decades, has enough political will to carry through any meaningful structural changes and removal of the barriers identified earlier. This remains the most crucial issue facing Malaysia as it tries to escape from its middle-income status trap to move up to the next level in the income ladder.

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