ECONOMIC OUTLOOK AND FINANCIAL REFORMS IN THE ASEAN ECONOMIES: MAL AYSIA

Zainal Aznam Yusof

Introduction

The prospects of economic recovery for Malaysia appear to be brightening for 1999. The market and many analysts seem to be changing their perception of Malaysia. At the end of 1998 Malaysia was given no hope for an early economic recovery and it was seen as trailing Thailand, South Korea, and by some, even competing with Indonesia. The imposition of selective capital controls in September 1998 was received with derision, and coupled with political tension and uncertainties, damaged Malaysia's image and hopes for an early recovery. Now, real and financial indicators **(Tables 1 and 2)**, together with the relaxation of the capital controls and the introduction of a repatriation levy for short-term capital **(Table 3)**, show that the economy is lifting up and is on its way to economic recovery.

The publication of *Bank Negara's Annual Report, 1998* at end-March 1999 with its conservative estimate of one-percent growth in 1999 has been greeted favorably. Growth could even be stronger, nearing 2 percent, if external factors are favorable and the fiscal stimulus gets stronger. The Standard and Poor's rating agency recently improved its rating and the upgrading of Malaysia, although not spectacular, has boosted investor sentiment. Meanwhile, foreign direct investors have voiced their continuing optimism by going ahead with plans for growth and expansion. Very few could have anticipated this turnaround in sentiment.

The financial crisis appears to have exerted its full impact in 1998. Overall, according to Bank Negara Malaysia, the economy contracted by 6.7 percent in 1998; 2.8 percent in the first quarter, 6.8 percent in 2Q, and 9.1 percent in 3Q, and lower in 4Q. Manufacturing and construction were the two most badly hit sectors. In 1998, manufacturing output contracted by 10.2 percent and construction output fell by 24.5 percent. The decline was much smaller for agriculture (-4 percent) while small positive growth was recorded for mining and quarrying (0.8 percent) and services (1.5 percent).

1. Some Indicators of Economic Recovery in 1999 and 2000

With 1998 the trough of the recession, 1999 is expected to be a year of economic recovery. The easing of monetary policy, the fiscal stimulus package, and capital controls seem to indicate a return of some confidence and the beginning of a slow and moderate upturn. The second half of 1999 is expected to show stronger signs of economic recovery and the last quarter of the year should be even better. Public investment is expected to lead the recovery.

Officially the economy is anticipated to grow at 1 percent in 1999. However, if favorable factors prevail, especially timely implementation of public investment projects, growth of 2 percent would be within reach. Forecasts of growth for 2000 are subject to greater uncertainty. A better recovery in 1999 will provide a stronger base for 2000. As confidence and business sentiment are anticipated to be much stronger, growth in 2000 is expected to reach 4 percent. Some private analysts are even revising growth rates for 1999 and 2000 upward; growth forecasts of more than 2 percent for 1999 and more than 4 percent for 2000 are now being made.

Table 1: Key Economic Indicators for Malaysia

	1996	1997	1998*p*	1999*f*
Population (millions)	21.2	21.7	22.2	22.7
Labour force (millions)	6.6	9.0	8.9	-
Employment (millions)	8.4	8.8	8.5	-
Unemployment (% of labour force)	2.6	2.6	3.9	4.5
Per Capita Income				
RM	11,228	12,051	11,835	11,831
US$	4,448	4,284	3,018	3,113
National Product		**% change**		
Real GDP	8.6	7.7	-6.7	1.0
RM billion	130.6	140.7	131.3	132.6
Agriculture, forestry and fishery	2.2	1.3	-4.0	5.0
Mining and quarrying	4.5	1.0	0.8	-0.4
Manufacturing	12.3	12.5	-10.2	0.8
Construction	14.2	9.5	-24.5	-8.0
Services	9.7	8.0	1.5	2.5
Nominal GNP	14.1	9.8	0.5	2.4
RM billion	237.7	261.1	262.5	268.7
Real GNP	8.3	7.8	-6.3	1.5
RM billion	123.2	132.8	124.5	126.3
Real aggregate domestic demand [1]	7.0	6.5	-25.9	4.3
Private expenditure [1]	9.0	6.3	-32.2	1.1
Consumption	6.0	4.7	-12.4	1.1
Investment	13.4	8.4	-57.8	0.9
Public expenditure [1]	1.3	6.9	-6.6	11.4
Consumption	1.4	5.3	-3.5	10.1
Investment	1.1	8.6	-10.0	12.8
Gross national savings (% of GNP)	38.5	39.4	41.2	40.2
Balance of Payments		**RM billion**		
Merchandise balance	10.2	11.3	69.3	57.1
Exports (f.o.b.)	193.1	218.7	282.0	277.6
Imports (f.o.b.)	183.0	207.4	212.7	220.5
Services balance	-19.5	-21.8	-23.4	-21.0
% of GNP	-8.2	-8.3	-8.9	-7.8
Transfers, net	-2.9	-3.7	-9.9	-6.6
Current account balance	-12.2	-14.2	36.1	29.5
% of GNP	-5.1	-5.4	13.7	11.0
Bank Negara Malaysia reserves, net	70.0	59.1 [2]	99.4 [3]	-
months of retained imports	4.4	3.4	5.7	-
Prices		**% change**		
CPI	3.5	2.7	5.3	< 4.0
PPI	2.3	2.7	10.7	1.5
Average wages in manufacturing	8.4	7.3	0.3	-

Notes: Figures may not add up due to rounding. *p* preliminary *f* forecast

[1] Excluding stocks.

[2] The foreign exchange gain on the balance sheet date was not recognised in the Bank's account in 1997, in view of the volatility of exchange rates during that year.

[3] Due to the fixing of the ringgit/US dollar exchange rate at RM3.80 in September 1996, all assets and liabilities in foreign currencies were re-valued into ringgit at the rates of exchange on the balance sheet date and the cumulative gain was reflected in the bank's current year account. On 31 December 1998 international reserves were equivalent to US$25.2 billion.

Table 2: Financial and Monetary Indicators for Malaysia

	1996		1997		1998*p*	
Federal government finance	**RM billion**					
Revenue	58.3		65.7		56.7	
Operating expenditure	43.9		44.7		44.6	
Development expenditure	12.6		14.4		17.1	
Overall balance	1.8		6.6		-5.0	
Overall balance (% GNP)	0.8		2.5		-1.9	
Public sector development expenditure	30.8		40.0		47.2	
Public sector overall balance (% GNP)	4.2		6.6		-1.8	
External debt						
Total debt (RM billion)	97.8		170.8		159.8	
Medium & long-term debt	72.7		127.5		131.3	
Short-term debt	25.1		43.3		28.5	
Debt service ratio	**% of goods & services exports**					
Total debt	6.9		5.5		6.7	
Medium & long-term debt	6.2		4.7		6.0	
	Change in 1996		**Change in 1997**		**Change in 1998**	
Money and banking	**RM billion**	**%**	**RM billion**	**%**	**RM billion**	**%**
Money supply						
M1	8.7	16.7	2.8	4.6	-9.2	-14.6
M2	39.3	19.8	54.0	22.7	4.3	1.5
M3	57.8	21.2	61.1	18.5	10.6	2.7
Banking system deposits	74.5	26.3	76.1	21.3	-2.1	-0.5
Banking system loans[1]	72.1	27.6	88.2	26.5	-7.6	-1.8
Manufacturing	4.6	9.5	9.9	18.5	-0.1	-0.2
Property sector	30.8	41.9	35.5	34.0	6.2	4.4
Finance, insurance, & business services	0.9	3.0	3.4	10.3	0.9	2.5
	%					
Loan-deposit ratio (end-of-year)	89.3		92.7		91.4	
Interest rates (end-of year average)						
3-month interbank rate	7.39		8.70		6.46	
Commercial banks						
3-month fixed deposits	7.21		9.06		5.83	
12-month fixed deposits	7.26		9.33		5.74	
Savings deposit	4.10		4.23		3.87	
Base lending rate (BLR)	9.18		10.33		8.04	
Finance companies						
3-month fixed deposits	7.32		10.32		6.43	
12-month fixed deposits	7.36		10.25		6.57	
Savings deposit	5.02		5.49		5.01	
Base lending rate (BLR)	10.65		12.22		9.50	
3-month Treasury bill	6.39		6.76		5.31	
1-year government securities	6.70		7.01		5.79	
5-year government securities	6.55		7.75		6.65	
Movement of ringgit (end-period)						
Change against composite	2.6		-31.4		-0.2	
Change against SDR	3.9		-30.8		-1.8	
Change against US$	0.5		-35.0		2.3	

Notes: [1] Beginning December 1996, loans by sector are classified using a new statistical reporting format.
P Preliminary

Table 3: Repatriation Levy on Short-term Capital

Principal held for:	Funds brought into Malaysia: before 15 February 1999 — Levy on principal	Levy on profits	Funds brought into Malaysia: on or after 15 February 1999 — Levy on principal	Levy on profits
Up to 7 mos.	• 30% of principal on 1 Sept 1998 and repatriated on 31 March 1999	• 0% if repatriated during 12-month holding period	• No levy	• 30% if repatriated up to 12 months after profits are made
Exceeding 7 but not more than 9 mos.	• 20% of principal on 1 Sept 1998 and repatriated on 30 May 1999	• 10% if repatriated thereafter		• 10% if repatriated thereafter
Exceeding 9 but not more than 12 mos.	• 10% of principal on 1 Sept 1998 and repatriated on 31 August 1999			
Exceeding 12 mos.	• 0% of principal on 1 Sept 1998 and repatriated on 1 Sept. 1999			

Indicators of economic recovery include:

- **Merchandise Balance and Current Surpluses Up**

  The balance of payments has strengthened. The merchandise balance recorded a net surplus of RM69.3 billion in 1998 and is anticipated to reach RM57.1 billion in 1999. In 1998 the current account recorded the first surplus since 1989. The surplus of RM86.1 billion (13.7 percent of GNP), exceeded the Budget 1998 forecast of RM20.1 billion and was enough to finance 5.7 months of retained imports. With growth picking up, imports will rise and the current account surplus is anticipated to fall to RM29.5 billion in 1999 (11 percent of GNP).

  A trade surplus of RM4.9 billion was recorded in February 1999 following RM4.3 billion for January 1999, bringing the trade surplus to a total of RM9.2 billion for the first two months, compared to RM 5.1 billion a year ago, largely due to faster decline in imports.

  Exports of electrical and electronic products, netted RM25.4 billion (58.1 percent of total exports) for the two months of 1999, an 8.4 percent increase over the corresponding period in 1998.

- **External Reserves Rising**

  The net international reserves of the Central Bank have increased to RM 99.4 billion at end 1998 after falling in 1997. The reserves have increased further to about RM 105 billion by end-March 1999. Following capital controls the reserves increased by US$6 billion between end-August and end December 1998.

- **Bond Spreads Tightening**

  The fixed income market, i.e., the international market for bonds, is an indicator of favorable sentiment. Surprisingly emerging markets are now attracting closer attention and with the better economic and financial news things are looking up. With increasing Korean exports and imports, the fiscal stimulus plan for Thailand, and possibly earlier prospects for China's entry into WTO, emerging markets look better. Markets for new issues including sovereign and corporate issues are picking up. In the early part of the year the Republic of the Philippines issued a jumbo US dollar bond and the People's Republic of China did the same. All these issues capitalised on the tightening of Asian secondary spreads.

Malaysia's credit spreads also have narrowed in recent months, with more realistic perceptions and appreciation of the prospects for economic recovery. The upgrading of Malaysia's rating by Standard and Poor's from BBB-minus to stable has also contributed to tightening spreads. By mid-April, for example, the spread had narrowed to 280-310 basis points on Petronas bonds and 350 - 400 basis points for Tenaga Nasional bonds, compared to the more than 1,200-point spreads in the latter part of 1998.

- **Industrial Production Slowly Moving Up**
  The Index of Industrial Production for February 1999 increased by 4.8 percent to 141.6 compared to 135.1 in January 1999.
- **Demand for Housing Increasing**

  During the Home Ownership Campaign from December 12 to January 1999 as much as RM3.5 billion worth of property sales were transacted.
- **Consumer Durables—Passenger Car Sales—Rising**

  Passenger car sales increased three-fold from their lowest level in February 1998 to 20,248 units by December 1998. In January 1999 sales remained relatively strong at 16,106 units.
- **Consumer and Business Confidence Rising**
  The Malaysian Institute of Economic Research (MIER) Business Conditions Survey indicates that manufacturers are sanguine about the future and will be increasing production in 4Q 1998 and anticipate an increase in activities in 1Q 1999. The business confidence index for 4Q 1998 increased by 2.9 percentage points from 41.8 to 44.7 points. MIER's Consumer Sentiments Index also showed a slight increase in consumer confidence on the basis of a stable position and employment prospects.

3. Financial Reforms

The pace of financial reform is picking up. Mergers of banks and finance companies are being pushed. Banking reforms are also picking up pace and are anticipated to raise the level of confidence. Malaysian banks are in a stronger position than in some other Asian economies—the level of the non-performing loans (NPLs), the risk-weighted capital adequacy ratio (RWCR), and the quality of bank regulation and supervision are better. Danaharta, the asset management company responsible for taking over the NPLs, and Danamodal, responsible for re-capitalizing banks, are making good progress and they are expected to complete their tasks by mid-1999.

There is an emerging consensus that the progress that has been achieved by Danaharta in taking away the non-performing loans from the banks and by Danamodal in re-capitalizing banks is much better than in neighboring countries. Danaharta's removal of NPLs will occur in three stages: secured NPLs; unsecured NPLs; and foreign currency loans. Compared to Thailand's estimated 40-50 percent non-performing loans Malaysia's NPL rate is much smaller and more manageable. Excessive gloom and lack of confidence have been replaced by a better appreciation that the agencies mean business and the end-objective is to get business going.

All the NPLs were acquired at fair market value and pain has been inflicted on those banks that had to transact loan prices at steep discounts. Overall, the weighted-average discount on the acquisitions was 61 percent. In payment for the NPLs it purchased Danaharta issued RM3.84 billion of government-guaranteed bonds with maturity dates ranging from end-December 2003 to end-March 2004. It also paid out RM416 million in cash to the financial institutions. Acquisition of the remaining NPLs is expected to be completed by end-June 1999, six months ahead of the scheduled date of end-December 1999.

Danamodal's role in banking reform is equally important and its activities are closely coordinated with Danaharta. Financial institutions that have sold off their NPLs will need to be re-capitalised, to raise their capital base above a certain level, i.e., the risk weighted capital adequacy rating (RWCR). Under Phase I, Danamodal has re-capitalised 14 banking institutions. By September 1998 eleven banking institutions had signed Conditional Agreements with Danamodal. By the first quarter 1999, 6 banking institutions had signed Definitive / Subscription Agreements. It is likely that the re-capitalization of the banks will be less than the RM16 billion that had been estimated earlier. Re-capitalization is expected to stabilize and bring down the growth of NPLs.

One important indicator that the banking system's NPL re-capitalization problems have been arrested and overcome is the resumption of bank lending. This is another pivotal indicator that the pace of economic recovery is picking up. Searching for viable economic projects will then become an important task for banks. The recent easing of interest rates and the likely further easing are expected to increase bank lending for consumption and investment. Bank Negara has eased its intervention rate from 7 to 6.5 percent. And banks have reduced their base lending rates below 8 percent.