

## **Global Trends by Martin Khor**

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### **Economy under stress as we hail Merdeka**

**This Merdeka Day, we should celebrate how the country has developed relatively well, but also reflect deeply on how to get out of the economic stresses which have reached a crisis point.**

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Today marks the completion of 58 years of Merdeka. On the economy, there is much to be proud of, with nearly six decades of generally good growth.

One key reason is that the national economy has become well diversified. At Independence, Malaya was dependent on exporting just rubber and tin.

Through the years, more commodities including palm oil and petroleum were introduced and the raw materials were processed and manufactured for example into rubber gloves and furniture.

The manufacturing sector also diversified, to include electronics. Construction has boomed and has high potential.

There have been mistakes too along the way. Policies could have been better designed and implemented. And growth, though quite well distributed, could have been more inclusive.

There are many regions and communities still left out of development. This Merdeka, we should resolve that those living at the bottom of the pyramid should receive the most attention and resources.

There is no reason why, 58 years after Merdeka, Malaysia cannot cater to the needs and interests of the poor and vulnerable.

Despite the achievements, the economy now is facing what could be its greatest test. We are already inside the start of an economic crisis, and it will get worse before it gets better.

The fall in prices of petroleum and palm oil has rightly been blamed. Our economy is still reliant on commodity and thus affected by the booms and busts of the global commodity cycle, which turned downwards in the past couple of years.

Even more important, Malaysia has also become dependent on another boom-bust cycle – that of global finance, the rapid inflows and outflows of funds.

This cycle is even more volatile and dangerous than the commodity cycle. Volatile because the flows can be huge and can change suddenly, and dangerous because the change can damage many parts of the system.

There is a large literature on the dangers of global financial flows, when trillions of dollars of short-term funds go hunting for investment venues and modes in search of higher yield.

These funds choose Malaysia and other emerging economies to place many billions of dollars.

When fundamentals or perceptions change, the funds move out.

Allowing the free flow of speculative funds is not a good idea. When too much comes in, effects include stock market and property price bubbles and currency appreciation.

And when the investors exit, there are other bad effects, as is now becoming evident.

Foreign funds in the stock and bond markets are leaving the country. The ringgit has fallen more than 20 percent since a year ago, with expectations of further falls prompting further outflows.

Local capital flight is also taking place.

Since the trade surplus has declined, it cannot fully offset the outflow of funds. Thus the overall balance of payments is now negative and this is reflected in the falls in the foreign reserves from US\$132 bil (or RM424 bil at the exchange rate then) on 29 Aug 2014 to US\$94.5 bil (or RM356 bil) on 14 August 2015.

Unless the investor mood reverses, there is potential ground for higher foreign outflows.

The relevant foreign funds are in four categories: equities, bonds and deposits (denominated in ringgit) and loans to Malaysia denominated in foreign currency.

Foreign investors have around RM300-400 billion in the stock market. This year up to 31 July, they pulled out MR11.7 bil from the stock market, according to MIDF Research.

Foreign funds invested in bonds denominated in ringgit are high and falling fast. Foreigners own RM206.8 bil of government and corporate bonds at end-July, having declined from RM226 bil at end-2014 and RM257 bil in July 2014, according to government data.

They also own deposits in Malaysian institutions of RM91 bil as at end-March.

Thus, there are RM600-700 bil of foreign funds in the country as equities, bonds and deposits. If a sizable amount moves out, this would further drain the foreign reserves which stand at RM356 bil on 14 August.

On top of this, the public and private sectors also had RM399 bil of external debt (of which RM157 bil is short-term) denominated in foreign currencies as at end-March 2015, according to Bank Negara.

The country has thus become dependent on foreign funds and lenders to maintain their assets in and loans to Malaysia.

The foreign reserves are still quite high, but has been declining and subject to future stress if outflows continue.

It is timely that an economic task force has been set up by the Prime Minister and it should one examine all facets of the emerging crisis.

Should the country re-establish a currency peg? If this is done, there should also be controls on capital outflows, otherwise the fixing of the currency may not prevent and may instead cause further large capital outflows.

The 1998-2000 policy measures that overcame the crisis were successful because they were done in combination: a fixed exchange system; control over certain types of capital outflows; and reflationary monetary and fiscal policies. One without the others would not have worked.

The committee should also consider whether it was wise to have recently liberalized the financial system so much, as to now have such free inflows and outflows of funds.

Excessive fund inflows and debts could have been limited in the first place, as done in some other countries. Local institutions should also not have been encouraged or allowed to invest so much abroad; now it is not easy to get them to reverse the flow.

The policies have resulted in high dependence on foreign funds, and the economy being susceptible to the stress of capital outflows.

We shouldn't welcome or attract all the funds that want to enter to do so, and then later bewail the fact that these same funds now want to exit when the economy cannot afford them to do so.

In any case, it is important to give priority to reviving the economy, which is now clearly under stress and already inside a crisis.