Global Trends by Martin Khor
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The era of financial vulnerability

The crash in stock markets in China and around the world shows up how developing countries like Malaysia are increasingly vulnerable to financial events or shocks, including outflows of foreign funds.

The year 2016 started with a big bang, but the kind we would rather avoid. The Chinese stock market plunged for several days, causing panic around the world, with the markets also falling in many countries, East and West.

This is another wake-up call to alert us that the finance has become inter-connected, indeed much too inter-connected, globally.

In particular, many developing countries like Malaysia have been drawn into the web of the global financial system in manifold ways, and that has made them more vulnerable to adverse developments and shocks.

We are now in an era of financial vulnerability, which in turn easily turns into vulnerability in the real economy of GDP growth, trade and jobs.

An immediate issue is whether the rout in China's stock market will affect its real economy, in which case there will be serious effects.

One view is that it would contribute to a 'hard landing' as the Chinese economy already has many problems.

Another view, more realistic in my view, is that the spillover to the real economy will not be significant. A paper by Brookings-Tsinghua Centre shows that the inter-connection between the stock market and the economy is limited in China.

In the US, half the population own stocks and corporations rely heavily on funds raised in the stock market, but in China less than 7% of urban Chinese invest in the stock market and corporations rely much less than American companies on the stock market to raise funds.

Nevertheless, China's economy is expected to slow down this year. Besides this, other factors also add to a pessimistic outlook for developing countries.

These include the continuing weak conditions in Europe and Japan, that may offset the United States' more steady recovery; the expected interest rate rises in the US, which will draw portfolio funds out from developing countries; and the weakening of commodity prices.

Already many developing are suffering on the trade front. In Malaysia, exports in November 2015 grew only 6.3% from a year earlier. More worrisome, Malaysia's industrial production, also in November, grew by only 1.8% from a year earlier.

Other Asian countries fared worse. Korea's exports for the whole of 2015 fell 8%; Taiwan's exports are also expected to fall 10% last year and Singapore's manufacturing sector declined 6% in the most recent quarter.

China's exports in December fell 1.4% from a year earlier but imports fell more, by 7.6%, which is bad news for other countries as China has less demand for their exports.

But of equal if not more concern is how, in the financial area, emerging economies like Malaysia have in new ways become more dependent and vulnerable in recent years.

In particular, foreign presence in these countries' domestic credit, bond, equity and property markets has reached unprecedented high levels, and thus new channels have emerged for the transmission of financial shocks from global boom-bust cycles, according to a South Centre paper by its chief economist Yilmaz Akyuz. [http://www.southcentre.int/research-paper-60-january-2015/]

During a boom, there is a rush by yield-seeking investors to place their global funds in emerging economies. But when perceptions or conditions change, the same funds can exit quickly, often leaving acute problems or even crises in their wake.

Malaysia is among the vulnerable countries. Firstly, the fall in the prices of oil (on 12 January reaching a new low of below US$30 a barrel) and other commodities has affected export earnings.

The balance-of payments current account used to enjoy a huge surplus, but this has been shrinking.

In 2010-13 there were very high inflows of foreign funds into Malaysia, averaging over 10% of GDP. But by 2015 there was a sharp reversal, with foreign funds flowing out from the equity and bond markets.

Malaysia is vulnerable to large outflows as foreigners in recent years have built up a strong presence in the domestic bond and equity markets.

Foreign holdings of bonds (public and private) peaked at RM257 bil in July 2014. And the share of foreign holdings in the stock market was 23.5% at the end of 2014, indicating a foreign-holding value then of around RM400 bil.

Many billions of ringgit of foreign-owned bond and equity funds leaving the country in the past couple of years and especially in 2015.

Due partly to this, Malaysia's foreign reserves have fallen from US$130 bil in September 2014 to US$95.3 at end-December 2015.

Although the present reserves are adequate to cover imports and short-term external debt, they are also vulnerable to further outflows of foreign-owned funds in equity and bonds.

Debt held by locals is also high, compared to other countries, according to another paper by Akyuz. Debt by households was estimated at 86% of GDP in first quarter 2015 by Merril Lynch. Public debt is near to 55% of GDP (compared to an average 40% for developing countries covered in a McKinsey report). And corporate debt is estimated to be about 90-96 percent of GDP.

The overall local debt is thus very high, probably exceeding 200% of GDP, one of the highest ratios among developing countries. Thus, the country has financial vulnerabilities at both the external and domestic fronts.

What the country faces is a part of a trend among emerging economies that is likely to last for some time. Many other countries are in far worse shape than Malaysia.

In an article last week, Martin Wolf of the *Financial Times* highlighted the important shift in perception by investors of the prospects for emerging economies, that has resulted in capital flowing out.

Global investors withdrew US$52 billion from emerging market equity and bond funds in the third quarter of 2015, the largest quarterly outflow on record. The most important reason for this is the realisation of the deteriorating performance of the emerging economies, according to Wolf.

Thus, developing countries are in for a tough time this year. Of course the vulnerabilities may not translate into actual adverse effects, if global or local conditions improve. But it is better to prepare for the probable difficulties ahead.