Zeti Akhtar Aziz: The outlook for the Malaysian economy: issues and strategies

Address by Dr Zeti Akhtar Aziz, Governor of the Bank Negara Malaysia, at the Malaysian Unit Trust Week Second Annual International Seminar 2001, Kuala Lumpur, 23 April 2001.

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Bismillah hirahman nirahim

Yang Berbahagia Tan Sri Dato' Seri Ahmad Sarji bin Abdul Hamid

Ladies and Gentlemen

Introduction

It is my honour and pleasure to speak to you this morning on the current economic situation and the outlook for the Malaysian economy at this seminar organised by Permodalan Nasional Berhad (PNB) in conjunction with the Malaysian Unit Trust Week. In the recent months, there has been a number of global economic and financial developments that impinge significantly on the prospects for our region. The slower than expected growth in the industrial economies, the increase in the volatility in the major currencies and the sharp movements in the global stock markets have generated further weakness in external demand and unstable financial market conditions. As we enter into this more uncertain and challenging period, it is important to assess these developments in their appropriate context and perspectives. Should market sentiment dominate, its impact on the business cycle could increase the amplitude of the cycle. In such an environment, it is therefore important to look beyond the immediate term and take a longer-term perspective of these developments so as to avoid such over adjustments.

The issue before us is, to what extent will these developments affect Malaysia's overall economic performance. How well can Malaysia withstand this current phase of slowdown without undermining our long-term growth prospects. What are the important elements that will determine a country's resilience and performance in this environment. What are the strategies that need to be adopted by the authorities and by the private sector to deal with the emerging issues. Specific to Malaysia, these recent developments have raised questions on the viability of the exchange rate regime and the associated level of reserves. Let me begin with the current economic situation and then proceed to discuss these issues that have emerged before proceeding to discuss the strategies that have been implemented and the important role that has to be played by the private sector in addressing these issues.

Current economic situation

The United States economy has entered a period of cyclical slowdown after a decade of rapid expansion. Given that the United States accounts for slightly above one-fifth of world output and absorbs about 19% of world exports, its slowdown is expected to result in a more moderate world growth. While there has been aggressive monetary easing by the United States, it is likely that the full impact of the easing will only be felt with a six to nine month lag. Thus, while the severity of the slowdown may be contained, the assessment is that a recovery will only emerge towards the end of the year or early next year. Against this background, we have already experienced some moderation in the expansion of Malaysia's exports and in output in the first two months of 2001. In this environment, the strategy is to promote further the domestic sources of growth. While growth will moderate, the momentum of growth built up over the last two years, the pre-emptive measures introduced in the 2001 Budget in October 2000 and the more recent package announced on 27 March 2001 are expected to mitigate the extent of the slowdown. In the context of these developments, real GDP is forecast to experience a slowdown in growth in the first two quarters of 2001 before recovering in the second half of the year.

In the next few months, before clear signs of a recovery in the United States emerge, the external environment can be expected to be vulnerable to volatility as markets react to specific developments. This uncertain environment has raised the potential risks of over reaction by the market and of further instability. In an environment where the focus is on the immediate term, the outcome risks being driven by market sentiment. Over adjustment not only occurs due to misjudgements of the economy, but market sentiment can collectively reinforce the business cycle to amplify the magnitude of the business cycle. Amidst such an outlook, it is important to stay focused and to have an ability to see beyond the immediate term. More specifically, to have an ability to assess and distinguish between short-term trends and longer-term fundamentals and structural developments. In this regard, it is important to recognise the context of this current external environment and the domestic resilience that Malaysia has to ride out this more challenging external environment.

The underlying economic conditions in the country are sound. Growth has slowed but will remain firmly in positive territory with the medium-term outlook remaining favourable. The strong fundamentals allow macroeconomic policies to promote domestic sources of growth. These same fundamentals allowed Malaysia to recover within a short period of time from the major economic contraction in 1998. While the current environment is triggered by external developments, the momentum of growth experienced over the last two years and the strong foundations built-up have enhanced Malaysia's ability to absorb and adjust to this more challenging environment. Let me highlight these factors:

- Malaysia has ***diversified its economic structure*** over several decades to become less vulnerable to external shocks. The recent recovery which has been broad based across all sectors has further reinforced this trend. The diversification has taken place not only in terms of expansion in new growth areas but also within the traditional sub-sectors. Even in terms of electronics exports, an area which is perceived to be vulnerable to the global downturn in the electronics sector, Malaysia has a relatively well diversified mix of products and range of markets.
- ***The current account surplus*** remains robust, lending strength to the balance of payments. While the services deficit will continue to be large, the forecast shows that the current account surplus is likely to remain significant through this year and the next. For the year 2001, the current account surplus is estimated to be in the region of 6-7% of GNP.
- ***Inflationary pressure is contained in the region of 2%,*** thus allowing monetary policy to remain accommodative to reinforce the fiscal measures. The low inflation has kept the cost of doing business in Malaysia low.
- ***Low levels of external debt has further*** reduced vulnerabilities to external developments. Debt levels declined further in 2000. A total of US$4.2 billion was repaid in the year 2000 by both the private and public sectors. External debt declined to 50.5% of GNP as at end-2000, from 57.8% the year before.
- ***The high savings rate,*** not only provides a large pool of domestic liquidity for capital formation, but also allows for pro-growth measures to raise consumption spending. The rate of savings in 2000 was 39.5% of GNP. There is therefore, adequate domestic sources of financing. There is also efficient financial intermediation and systems for payments.
- ***The fiscal position is strong,*** with outstanding debt of the Federal Government contained at 37% of GDP in 2000. The fiscal deficit continues to be financed largely from non-inflationary domestic sources. As part of the fiscal stimulus, expenditure allocations have been targeted to projects with strong linkages to the economy to ensure maximum impact on growth, minimal leakage in terms of imports while meeting socio-economic targets.
- ***The Malaysian banking sector has strengthened and become more resilient*** with enhanced asset quality, higher capitalisation and improved profitability. This has been reinforced by the consolidation of the banking institutions with the focus being on enhancing efficiency. With the further development of the private debt securities market, financing of the domestic economy is now more diversified.
- Overall, Malaysia has a ***high degree of policy flexibility*** for effectively managing the impact of the external slowdown on the domestic economy. Policy options are available to absorb potential shocks to the economy given the low level of indebtedness and the low rate of inflation.
- ***Malaysia has high grade infrastructure*** that has been put in place during the high growth years without resulting in high external indebtedness. There is therefore an adequate physical infrastructure in place to support growth.

- ***There is full employment,*** with the unemployment rate at 3.1% in 2000, and high level of labour mobility. While some dislocation may occur with rationalisation, unemployment levels will be contained in a growing economy where employment opportunities will emerge in new growth sectors.

Given these strong initial conditions, Malaysia is well positioned to absorb this current phase of slowdown in economic activity and maintaining our long-term growth prospects.

Ladies and Gentlemen,

Policy strategies adopted during the past decade have enhanced Malaysia's prospects for productivity-driven growth. Malaysia is already on track towards achieving this goal. In 2000, Malaysia achieved a strong growth of 8.5%, with labour productivity rising strongly by 3.8%. The higher growth was also supported by a lower investment to GDP ratio of 31% compared with 49% in 1995-96 when a significant part of the capacity expansion programmes undertaken during the 1990s were projects with long gestation period.

The capacity of the domestic labour force to achieve productivity gains should not therefore be underestimated. Malaysian workers have demonstrated ability to adjust to the changing environment. Policy strategies have also focused on providing an enabling environment for training and retraining of workers displaced by structural adjustments in the economy. Emphasis also continues to be placed by the Government on the education system and industrial training to increase the pool of high-end skilled labour. While there are shortages in high-end, rules on the import of high skilled labour have been liberalised. Overall, Malaysia is committed to enhancing productivity to achieve sustainable growth. Long-term strategies under the Third Outline Perspective Plan are geared towards achieving this objective.

The recent policy package to promote domestic economic activity contains the measures to bolster consumption spending. Malaysia has essentially been an investment driven economy where investment was the main driver of high growth in the 1990s. As Malaysia transitions into the next stage of development, where growth is derived from efficiency and productivity gains, the rate of investment required to produce higher growth can be expected to moderate. In 2000, the rate of investment to GDP declined to 31% to achieve an overall growth of the economy of 8.5%. Malaysia therefore has room to manoeuvre to increase consumption spending while maintaining an adequate rate of savings. Going forward, consumption spending will need to become relatively more important to boost further domestic economic activity. Consumers therefore need to spend productively albeit within their means.

Ladies and Gentlemen,

In the recent period, there has been significant discussions and debate on the exchange rate regimes and policies. Recent events in the global economy indeed warrant a greater understanding of the complexities and efficiencies of exchange rate policies in the management of our economies. The exchange rate is a means to an end. It is a mechanism that facilitates international trade and investment. The search is therefore for an efficient functioning exchange rate regime that will facilitate international trade and investment. Over the decades, we have seen a shift by countries towards more flexible regimes. It has been argued that greater exchange rate flexibility would insulate a country from external shocks and that it has a built-in mechanism for automatic adjustment to deal with external imbalances. However, experience has shown that the change in the exchange rate system, from a fixed to a more flexible system of floating rate regime, however, has not contributed towards reducing the economic problems. In theory, there should not be any balance of payments disequilibrium under the floating exchange rate system. Market forces should correct any imbalances arising from an overvaluation or an under- valuation of the exchange rate. Under such an arrangement, there will be a reduced need for Central Banks to hold external reserves since it would not be necessary for Central Bank intervention to support the exchange rate at predetermined levels. Consequently, the floating system should enable governments to use monetary and fiscal policies to achieve the domestic macroeconomic stabilisation objectives of sustained economic growth and price stability.

In reality, however, it is not so straight forward. The international economic and financial turmoil experienced since the abandonment of the Bretton Woods System indicates that we are a long way from the Utopia that we seek. Indeed, during this period, exchange rates have experienced significant and violent movements. Volatility of the exchange rates over a prolonged period, particularly of the currencies of the major industrial countries is a matter of concern for emerging and developing nations. Volatile fluctuations in the exchange rate have destabilising consequences on our economies, affecting trade, capital flows and external debt servicing. Significant currency movements also result in increased risk for investment. Exchange rate management is further complicated by capital flows that have during unstable market conditions resulted in an over shooting of the exchange rate. When the market perceives that this has taken place, there will be expectation for a retracement. Such reversal in market sentiment generally produces a severe correction. As experience has shown, flexible exchange rates can be equally demanding on policy when extreme volatility and misalignment is experienced. Depending on the openness of a country, such movement in the exchange rates arising from short-term capital movements have resulted in severe adverse effects on the real economy. It is therefore important for the market to have the ability to assess the viability of alternative exchange rate regimes and the conditions under which such regimes are viable and sustainable.

In the recent weeks, there has been heightened concern over the movements of the major currencies, in particular, the Japanese yen, which triggered expectations that other currencies in the region would depreciate to preserve competitiveness. Seen in a historical context, the experience has been that excessive yen movements in the last decade were not sustained for long periods. Over reaction to adjusting the exchange rate in response to these short-term movements would result in misalignments of exchange rates. The exchange rate should adjust to structural changes that result in shifts in the underlying fundamentals. For Malaysia, domestic macroeconomic fundamentals continue to remain consistent with the pegged exchange rate system. The exchange rate continues to be supported by a strong current account surplus, projected at 6-7% of GNP in 2001. Inflation is expected to remain low at about 2%. External debt remains low with reserves exceeding short-term external debt by 5.7 times.

Historically, it has never been Malaysia's policy to rely on the exchange rate to strengthen international competitiveness. Currently, the exchange rate is assessed to be at fair value. It would not bring any advantage to Malaysia to depreciate the currency to reap temporary pricing advantages. If we look in the context of the current environment, an adjustment in our prices through the exchange rate by 5 to 10 percent is unlikely to increase exports at a time where external demand is slowing down. Competitive depreciation would also wipe out the gains for an individual country. Under these circumstances, depreciation would only contribute to rising inflation and higher cost of doing business which would wipe out any gains derived from depreciating the currency. On balance, it is assessed that there would be no advantage and it therefore would not be in our interest to precipitate greater uncertainty by an adjustment in the current peg. We need to recognise the importance of the exchange rate in our economy and our financial system. An economy which is open, with the volume of trade that is two times the size of our economy requires an efficient functioning mechanism to facilitate international trade and investment.

There has also been recent concern about the sustainability of the peg given the declining level of international reserves. While outflows have occurred, there is a need to recognise the nature of these flows. Flows need to be distinguished from those that reflect trade transactions and those that reflect capital account transactions. With the latter, we need to distinguish the short-term flows from those that are long term, that is, foreign direct investment and official flows. During the period 1993 and early 1994, Malaysia received substantial inflows of short-term capital. Reserves that were built-up from these short-term flows are vulnerable to the reversal of flows. During the course of 1994, there was indeed such a reversal of these flows. During that period, it was also widely discussed as to whether the currency should be allowed to adjust in response to these short-term flows. Allowing the currency to adjust in response to short-term flows would have resulted in an overshooting of the exchange rate and increased volatility. It was assessed that given the significance of trade in the Malaysian economy, the stability and a degree of predictability of the exchange rate was vital for the conduct of business decisions and that it should not be determined by developments that for the most part were driven by sentiment.

The role of short-term flows came to the forefront again in 1997-1998, when such flows was one of the trigger factors for the depreciation of the East Asian currencies. Countries in this region experienced a 30-70% depreciation of their currencies. In the current environment, countries continue to be vulnerable to inflows of short-term funds and their reversal. In early 2000, Malaysia received significant short-term flows amounting to US$2 billion. While this raised the reserves level to US$34.5 billion in April 2000, an outflow of US$3.1 billion occurred during the remaining part of the year. For the year as a whole, net portfolio outflows amounted to US$1.1 billion. The increase in reserves during this period were from the trade surplus, foreign direct investment and official inflows. These inflows have to some extent cushioned the outflows. A significant part of the outflows in 2000 and early 2001 were also for repayments of external debt and direct investment abroad by Malaysians. In addition, after adjusting for a revaluation adjustment by US$900 million, the reserve level as at end-March was US27.2 billion.

In contrast, in the first half of April, the heightened uncertainty and unstable market conditions that prevailed, both at home and abroad resulted in an overreaction by the market. The period saw marked movements in Japanese yen which depreciated to touch a low of Y126 against the US dollar towards the end-March, its lowest level in two and a half years. Following the rapid movement of the yen, the market expectation was for a further weakness in the yen which would result in competitive depreciation in the regional currencies. Developments in the global equity markets were also not encouraging due to continued concerns over the slowdown in the US economy. Profit warnings by corporations and the release of disappointing quarterly corporate results by a number of US technology companies led to a 6.5% decline in the Nasdaq and a 0.9% decline in the Dow Jones in the first week of April. In this environment, the announcement by Standard and Poor's on 4 April that the outlook for Malaysia was revised from positive to stable contributed to further volatility in the domestic financial markets. These specific events had an adverse impact on the local market sentiments. The negative expectations culminated in a 6% decline in KLSE composite index on 4 April and another 4.2% fall on 9 April. Over reaction by the market to these developments resulted in an increase in the gross outflow compared with trend levels previously seen. While this trend has now subsided and net inflows have occurred, the events in the first half of April resulted in an outflow of US$0.9 billion.

Positive developments in the third week however, have led to an improvement in the flow of international reserves. The volatility in the financial markets has subsided during the third week. The yen and most regional currencies have stabilised. The US interest rate cut by the Federal Revenue Board of the United States on 18 April also improved market conditions. Global stock markets also recovered. This situation has also been reinforced by the narrowing of the interest rate differentials. Going forward, the regional currencies would continue to be influenced by movements in the major currencies, in particular the yen, the developments in US financial markets and the growth prospects in the United States.

Conclusion

Ladies and Gentlemen,

We live in an increasingly complex world where there are no straight forward answers to the issues that have emerged. In addition, the environment is characterised by incomplete information, contradictory knowledge and understanding, conflicts of interest, divergent views and preferences conditioned by experience and ideology.

What is important is to ensure sustainability. While daily assessments of opportunities, risks and trends are important, those who over react to change and perceived risks will only contribute towards destabilising conditions. To secure the future, focus has to be on building on those elements that provide the foundations for sustainable performance. The focus has to be beyond being concerned with issues of immediate term and immediate relevance. A longer-term perspective is required, looking beyond the immediate term and immediate interests.

In managing the environment, sustainability requires that we pay attention to the entire cycle and that takes into account context and perspective. While managing the environment has been seen to be the realm of the governments, the response by businesses, consumers and the market will determine the overall resilience and performance of a nation. While Malaysia will not be immune to external developments, it is our combined actions that will secure sustainability of economic prosperity for Malaysia.