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Internationalization of Finance and Changing Vulnerabilities in Emerging and Developing Economies: The Case of Malaysia

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In a recent South Centre Research Paper (Akyüz 2015) it is argued that after a series of crises with severe economic and social consequences in the 1990s and early 2000s, emerging and developing economies have become even more closely integrated into what is widely recognized as an inherently unstable international financial system. Not only have their traditional cross-border linkages been deepened and external balance sheets expanded rapidly, but also foreign presence in their domestic credit, bond, equity and property markets has reached unprecedented levels. New channels have thus emerged for the transmission of financial shocks from global boom-bust cycles. Almost all emerging and developing economies are now vulnerable irrespective of their balance-of-payments, external debt, net foreign assets and international reserve positions although these play an important role in the way such shocks could impinge on them. This brief uses the framework developed in that paper to take a closer look at Malaysia to assess its vulnerability to growing instability in international capital flows.

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Commodity dependence and vulnerability to trade shocks

Following the 1997 crisis Malaysia made a significant external adjustment. The current account deficit which averaged at over 6.5 per cent of GDP during 1994-97 turned into a large surplus in the new millennium, reaching 17 per cent of GDP on the eve of the global crisis. This has resulted in a substantial improvement in its net foreign asset position. At the beginning of the new millennium, Malaysia had a negative net foreign asset position reaching almost 30 per cent of GDP. By 2007 its gross external assets more or less matched its gross external liabilities (Akyüz 2015, Chart 6).

As a commodity exporter, Malaysia enjoyed a significant growth in its export earnings thanks to the price boom that started in the first half of the 2000s and continued until recently. Its commodity export earnings rose almost four-fold between 2003 and 2013. The increase in fuel exports was particularly strong, rising by about five-fold. By contrast, manufactured exports rose by only 73 per cent during the same period. As a result, the share of commodities in total export earnings doubled, to reach almost 40 per cent in 2013.

The share of primary commodities in total exports is higher if measured in value-added terms since commodities have much lower import (foreign value-added) content than manufactures. The import content of total Malaysian exports is estimated to be around 40 per cent while the import content of manufactures is at least twice as high as that of commodities. Consequently, value-added contents would be around 75 per cent for commodity exports and 50 per cent for manufactures exports. If this is taken into account, the share of manufactures in value-added exports would be about the same as, if not lower than, the share of primary commodities. In 2013, net manufactured exports stood at around 12 per cent of net commodity exports and 15 per cent of net fuel exports. Thus, although Malaysia is widely considered as one of the most successful second-tier Newly Industrializing Economies in East Asia, it is heavily dependent on commodities such as petroleum and natural gas, palm oil, timber and rubber. The dependence on commodities has increased with premature deindustrialization that began in the new millennium, coinciding with the rise of China as a major hub for the production and export of manufactures and aggravated by the commodity boom.

With the downturn in commodity prices, notably of oil, Malaysian commodity export earnings started to fall at the end of 2014 and throughout 2015. However, despite sharp drops from post-Lehman peaks, prices are still well above the levels recorded at the beginning of the boom in 2003-04. Given that growth remains sluggish in Advanced Economies (AEs) and has slowed down significantly in developing countries where commodity intensity of economic activity is much greater, further declines cannot be ruled out. Thus, demand is slowing at a time when the supply capacity is on the rise as a result of large investments made during the boom in energy and minerals. Furthermore, a financial turmoil in China resulting from excessive build-up of corporate debt could aggravate the glut in commodity markets. A renewed weakness in oil may well drive the Malaysian current account into a deficit.

Commodity dependence is a major reason why Malaysian exports declined by over 8 percent on a year-on-year basis between April 2014 and April 2015 (Department of Statistics of Malaysia, 2015) even though the Malaysian Ringgit (RM) depreciated by 10 per cent against the dollar during the same period. Since supply of commodities is inelastic in the short-run, currency declines cannot generate much expansion in export volumes. Another reason relates to the nature of Malaysia exports of manufactures. A large proportion of these exports consist of intermediate goods, mainly to China as part of the network trade. They are derived exports, driven mainly by Chinese exports of finished manufactured goods to other countries, notably the US and the EU.

Vanishing current account surplus

Despite the boom in commodity prices and export earnings, the Malaysian current account surplus declined sharply after 2008. Between 2008 and 2013 imports grew twice as fast as exports. This was associated with a rapid decline in national savings rather than a strong upturn in investment. In the run-up to the 1997 crisis, investment as a per cent of GDP was unusually high, exceeding 40 per cent. It dropped sharply after the 1997 crisis and never recovered to reach pre-crisis levels. It remained below 25 per cent in the new millennium, dropping even below 20 per cent during the global crisis. Although it recovered during 2012-14, the increase was moderate, hovering around 25 per cent of GDP, largely concentrated in construction.

By contrast gross national savings as a per cent of GDP has seen a significant decline since the global crisis, from around 40 per cent to 30 per cent. The contribution of the public sector to the decline in national savings is relatively small. In the years before the 2008 crisis, general government deficits were higher by only one percentage point of GDP than the deficits registered during pre-crisis years. According to the figures given in the 2014 Annual Report of BNM (Bank Negara Malaysia) (2015a), public sector savings dropped by one percentage point of GDP between 2010 and 2013, and is expected to have declined by another two percentage points between 2013 and 2014. However, a more important reason for the sustained declines in national savings is private consumption boom. Since 2008, household consumption has grown by around 2 percentage points faster than GDP, rising from less than 45 per cent of GDP in 2008 to almost 52 per cent in 2014 while public sector consumption ratio rose by around 1.5 percentage points during the same period.

Debt driven growth

The consumption boom has been driven mainly by debt rather than a strong growth in wages and household income. Indeed, the share of wages in GDP has been on a downward trend (Lim 2014). Malaysia has the highest ratio of household debt to GDP in the developing world. According to a McKinsey Debt Report (McKinsey Global Institute 2015), in 2013/Q4 the ratio of household debt to GDP was 77 per cent, at the same level as in the US. Malaysian Rating Corporation Berhad (2015)estimates it at 88 per cent of GDP for 2014 while Merrill Lynch puts it at 86 per cent for 2015/Q1 (Chua 2015). In any case, household debt as a percent of disposable income is no less than 150 per cent, exceeding the leverage not only in other developing countries but also the US and many other AEs. At 44 per cent, its debt servicing ratio in 2014 was higher than all the countries for which data are reported by McKinsey which places it among seven countries where household debt may be unsustainable.

Not only household debt but also corporate and government debt has grown significantly in recent years. According to McKinsey between 2007 and 2014, the increase in total debt as a proportion of GDP was 50 percentage points. The ratio of total debt to GDP was estimated at 222 per cent for 2013/Q4, the highest among developing countries, including China and Thailand which also have high debt ratios.[i] Public debt as a proportion of GDP is close to 55 per cent, the limit self-imposed by the government. It is higher than the average of around 40 per cent for the developing countries reported by McKinsey. This does not include contingent liabilities, notably due to debt-ridden *1Malaysia Development Berhad*, a state-owned investment and development company which has experienced debt servicing difficulties in recent months and has had to reschedule debt at high costs, causing allegations of gross mismanagement.

There are widely divergent figures for corporate debt in Malaysia. McKinsey puts it at 91 per cent of GDP for 2013/Q4 while according to Standard Chartered it was no more than 45 per cent in 2012/Q3. The difference is too large to be explained by the increase between the two periods and is likely due to differences in the data and methodologies used. It appears that McKinsey figures are closer to reality. [ii] According to BNM figures, outstanding private debt securities alone were 41.5 per cent of GDP. If bank loans to non-household private sectors, given again by BNM, are added the total comes to 96 per cent of GDP.

Malaysian total external debt is reported to be over 70 per cent of GDP, far above the level of most developing countries. Much of this is in foreign currencies. According to the 2014 Annual Report of BNM (2015a), foreign-currency external debt is around 45 per cent of GDP, again among the highest in the developing world. The remainder is locally-issued local-currency debt held by non-residents.[iii]

Capital Flows: boon or bane?

Like most other developing countries Malaysia enjoyed a significant boom in capital inflows after the early 2000s. The boom accelerated after the global crisis as a result of rapid expansion of liquidity and sharp cuts in interest rates in the AEs hit by the crisis, notably the US and the Eurozone. Capital inflows averaged at over 10 per cent of GDP during 2010-13 before they weakened and became volatile on expectations of return of US monetary policy to normalcy.

During the previous boom in the 1990s capital inflows financed large current deficits resulting from an investment boom. By contrast during the recent boom, the surge came on top of a large current account surplus, resulting in a sizeable build-up of international reserves. Much of inflows went into property, stock and bond markets. They have also been a factor in the rapid expansion of domestic credit which went up from less than 100 per cent of GDP in 2009 to over 120 per cent in 2014, notably to the household sector.

Adequacy of international reserves

At first sight Malaysia does not appear to be particularly vulnerable to a reversal of capital flows due to a tightening of global financial conditions and/or a sharp swing in risk appetite of investors in Malaysian assets or to continued weakness of commodity prices because it still runs a current account surplus and its reserves are high. However, a closer examination reveals that Malaysia's vulnerability to external financial and commodity shocks is much greater than is suggested by conventional reserve adequacy indicators.

It is now increasingly agreed that reserve adequacy should be assessed on the basis of several actual and potential claims. These include not only current account deficits and short-term external debt, as has come to be emphasized after the Asian crisis, but also the drain that may be caused by the exit of non-residents from domestic deposit, bond and equity markets, capital flight by residents and the degree of vulnerability to terms-of-trade (commodity price) shocks. In Malaysia international reserves are more than enough to meet outstanding short-term external debt, but they may prove to be inadequate in the face of a continued decline in commodity prices and a rapid exit of non-residents from domestic deposit, bond and equity markets and capital flight by residents.

No doubt declines in stock prices and currency depreciations triggered by such an exit would alleviate the reserve drain by reducing the dollar value of such liabilities. However, these could have serious consequences for sectors indebted in dollars and the stability of domestic financial markets. Moreover, such episodes of foreign exit are often associated with capital flight by residents. This risk cannot be underestimated given that Malaysia has a highly liberal capital account regime. Furthermore, the kind of exchange controls used during the 1997 crisis appears to have been ruled out by present authorities.

An external liquidity problem could well result in severe instability in the domestic credit market given the relatively large volumes of debt carried by households and corporate and public sectors. As the currency falls, bond yields rise and capital inflows dry up, banks could be inclined to cut domestic lending and may also be tempted to reduce their bond holdings. The public sector could be hit not only because of rising cost of new borrowing to refinance maturing debt and meet budget deficits, but also by falling government revenues from exports. Rising borrowing costs and falling revenues could push the public debt well beyond the limit set at 55 per cent of GDP. This could narrow the room for countercyclical fiscal policy to offset contractionary impulses that may be generated by financial instability.

In April 2015 Malaysian reserves stood at RM390 billion exceeding by only 10 per cent the level of short-term external debt (some RM360 billion) defined by BNM (2015b) as short-term offshore borrowing plus non-resident holdings of short-term ringgit debt securities plus non-resident deposits with the banking system and other short-term debt. Given that there is a strong presence of non-residents in Malaysian domestic bond and equity markets, the margin of reserves over short-term debt is too small to accommodate a sizeable exit of foreigners from these markets.

Strong foreign presence in bond and stock markets

According to the figures published by ADB, at the end of 2014 non-resident holdings of locally-issued Malaysian government bonds were around RM150 billion while according to the Malaysian Securities Commission, non-resident holdings of total (private and public) debt was RM226 billion, down from a peak of RM257 billion in July 2014 as a result of exit of foreign investors.

According to the IMF's *Coordinated Portfolio Investment Survey,* at the end of 2014 non-resident equity holdings were around $86 billion. At the prevailing exchange rate this comes to some RM300 billion. However, national data indicate higher figures. According to Bursa Malaysia (2015), at the end of 2014 the share of foreign holdings in the stock market was 23.5 per cent while market capitalization was around RM1.65 trillion. According to these figures, foreign holdings should be close to RM400 billion.

Even if one were to take the lower estimates for foreign bond and equity holdings, even a moderate exit of foreign investors from these markets would exert a significant pressure on reserves and the currency. Such an exit can be triggered not only by a tightening of global financial conditions but also a sudden turnaround in risk appetite of investors and lenders in Malaysia as a result of a deterioration of its current account and reassessment of Malaysian debt sustainability.

Conclusion

Declines in commodity prices and export earnings, and shrinking current account surplus, together with the concern with high leverage have started to dent investor sentiments in Malaysia. Many foreign holders started to unload RM dominated assets from mid-2014 and the equity market fell by some 10 per cent by June 2015. Foreign reserves have declined from over $130 billion to $108 billion and the currency fell by 13 per cent against the dollar between September 2014 and June 2015. By 31 July 2015, the foreign reserves had dropped further to $96.7 billion, according to Bank Negara Malaysia data.

The bounce-back in oil prices in the first months of 2015 provided some temporary relief, but given the high leverage in the economy and the poor outlook for commodity prices, Malaysia remains vulnerable to financial instability. Indeed, in the early days of August 2015, the ringgit came under strong pressure, hitting the lowest level since September 1998 when it was pegged to the dollar at 3.80.

Is Malaysia now more vulnerable than it was on the eve of the 1997 crisis? The current account balance is significantly better now than in 1997 while fiscal position is much less favourable. However, with continued weakness of commodity prices, Malaysia can start running twin deficits even before the end of the current year, particularly as the impact of the decline in energy prices is fully transmitted to the current account. On external debt, the economy is now more fragile than in the 1990s; on the eve of the 1997 crisis, Malaysian external debt was 42 per cent of GDP compared to 70 per cent at present. Its international reserves look better now than in 1997 in relation to its short-term external debt, but not when account is taken of foreign presence in domestic bond and equity markets. Furthermore, the leverage within the economy, notably in the household sector, is significantly greater than in the 1990s. Finally, the Malaysian capital account is considerably more open now than in the 1990s, posing the risk of resident capital flight.

Endnotes:

[i] According to Standard Chartered (2015) the debt ratio was 181 per cent of GDP in 2012/Q3.

[ii] According to the figures given by the BIS, about 81 per cent of Malaysian external commercial debt in 2013 was private (Akyüz 2015, Table 7). Since external debt is around 70 per cent of GDP, then private (corporate) external debt would be around 56 per cent of GDP, greater than the figure given by Standard Chartered for total (external plus domestic) private debt.

[iii] BNM has started using a new definition of external debt which includes all debt owed to non-residents irrespective of currency of issue (BNM 2014). This includes non-resident holdings of domestic bonds (that is, locally-issued bonds in

local currency) as well as bonds issued abroad in foreign currencies. This definition does not appear to include bonds issues abroad in Malaysian ringgit. According to BIS figures such issues accounted for more than 9 per cent of total international issues by Malaysia in 2013 (Akyüz 2015, Table 8). On this count, therefore, Malaysian external debt, defined as debt held by non-residents irrespective of currency and place of issue, may be higher than that reported by BNM by some 5 percentage points of GDP.

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