

Nambiar, Shankaran

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## Malaysia and the global crisis: Impact, response, rebalancing strategies

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**ADB Working Paper Series**

**Malaysia and the Global Crisis:  
Impact, Response, and Rebalancing Strategies**

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Shankaran Nambiar

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Shankaran Nambiar is a senior research fellow at the Malaysian Institute of Economic Research.

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Asian Development Bank Institute  
Kasumigaseki Building 8F  
3-2-5 Kasumigaseki, Chiyoda-ku  
Tokyo 100-6008, Japan

Tel: +81-3-3593-5500  
Fax: +81-3-3593-5571  
URL: [www.adbi.org](http://www.adbi.org)  
E-mail: [info@adbi.org](mailto:info@adbi.org)

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**Abstract**

The economic crisis that began in the United States had an effect on the developed world, including the European Union, Japan, and Singapore. The downturn of the economy in the United States, coupled with developments in the European Union, Japan, and Singapore, has affected the Malaysian economy. This paper argues that Malaysia, being a small open economy with a strong export-dependent manufacturing sector, was particularly vulnerable to the global crisis. The very countries that generate the demand for Malaysian exports have been struck by the crisis, leading to declines in output in Malaysia. These declines have resulted in labor market shocks which have led to retrenchments. The severity of the crisis and its prolonged duration requires an approach that is not unduly dependent on export-led growth. This paper will suggest that Malaysia adopt a rebalancing strategy in response to the current crisis.

**JEL Classification: F10, F40, E21, E60**

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## 1. INTRODUCTION

The Malaysian economy has been hit by crises in the past, but the current one is quite unlike those it has been affected by in the last 10 years. Because the present crisis was triggered by external sources, it demands a serious reconsideration of the country's growth strategy. The 1997 crisis, for example, required temporary measures (such as instituting capital controls) and some fundamental changes (such as the restructuring of the banking and financial system), but the present crisis will require new ways of thinking about how Malaysia should re-position itself, since the crisis undermines the assumptions on which the country's growth strategy is based.

If the present crisis leads to a continued decline in consumer demand from the United States (US), the European Union (EU), and Japan (as it seems likely), it would mean a softening of export-led growth in Malaysia. As Malaysia cannot rely entirely on domestic demand to drive economic growth, there is a need to revisit ignored aspects of the economy and rebalance growth in line with national strategies that emphasize domestic consumption and investment, without dismissing export and export-related activities. One of the crucial questions that demands attention is how domestic investment and consumption can be improved. Although it is necessary, increasing incomes, by itself, is not entirely sufficient to drive investment and consumption as increased incomes may only lead to increased savings if uncertainties persist.

This paper begins by reviewing the economic and financial crisis of 1997 to provide a background for understanding the present crisis. The 1997 crisis elicited policy responses that did not require structural changes to the economy or in industrial policy. The third section discusses the importance of trade to the economy and Malaysia's reliance on demand generated by developed economies. The fourth section analyzes the impact of the current crisis on the Malaysian economy. This is followed by an examination of the government's policy responses. The fifth section discusses the need for rebalancing and suggests possible strategies that could be adopted for economic recovery. Finally, some concluding remarks are made.

## 2. THE 1997–1998 CRISIS: A REVIEW

One of the immediate factors that triggered the 1997 crisis was negative perceptions of the Malaysian economy following the dramatic collapse of the Thai economy. Foreign investors and international rating agencies had failed to consider underlying risks in the Thai economy, and spurred by fear that the same currency devaluation would occur throughout the region, foreign portfolio investors withdrew from regional markets that were perceived to have underlying weakness (see Ariff et al. 1998). This perception influenced their assessment of Malaysia, leading to the fall of the ringgit exchange rate.

From March to July 1997, the ringgit-US dollar exchange rate fell from RM2.48 per US\$1 to RM2.57 per US\$1. By the end of 1997, the exchange rate had further fallen to RM3.77 per US\$1. Bank Negara Malaysia tried to shore up the value of the ringgit by raising short-term interest rates, but this did nothing to halt its slide, and the bank eventually gave up attempts to maintain the value of the ringgit (Ariff and Yap 2001). In early 1998, the ringgit had hit a low of RM4.88 per US\$1.

Along with the ringgit, the Kuala Lumpur Composite Index (KLCI) also fell sharply. The KLCI, which was at 1,216 points at the end of January 1997, dropped to 594 points by December of that year. Market capitalization contracted from RM200 billion in August 1998 from RM826 billion in January 1997. The slide in the exchange rate and the dive in the KLCI caused alarm in the markets. This led to a sell-down of stocks and there was a rush to sell the ringgit.

The policy responses to the crisis can be divided into two phases: the initial phase and the second phase. In the initial phase, the policy response was to raise interest rates. The three month interbank rate was raised to 8.7% by the end of 1997, up from 7.6% in September 1997. The three month interbank rate was further raised to 11% in February 1998. These efforts did little to control the value of the ringgit. Led by the depreciation of the Korean won and the Indonesian rupiah, the contagion effect began, leaving the ringgit volatile against major currencies. Some of the early monetary policy measures included limits on loans to the property sector and for the purchase of stock and shares by commercial banks and finance companies. There was also a reduction of financing on hire-purchase loans for non-commercial vehicles. Attempts were made to reduce the supply of offshore ringgit to stem the attacks that were made on the ringgit. Finally, there were changes made to disclosure requirements on non-performing loans (reduced from six month arrears to three month arrears) for the early detection of problem loans.

The 1998 budget that was proposed in October 1997 was based on a policy of pursuing fiscal restraint. In line with this approach, a fiscal surplus of 2% of the gross national product was proposed. Some of the principal measures of the 1998 budget were as follows:

1. Tax incentives were created based on the increase in the value of exports.
2. Import duties were levied to discourage the import of consumption goods and tax deductions were made on local advertising expenditure to encourage the production of local brand names.
3. Import duty on completely built-up and completely knocked down luxurious cars was increased sharply, so as to reduce consumption specifically on passenger cars.
4. To improve the services balance, measures were introduced to discourage international travel and education overseas.
5. Mega projects were deferred.
6. Quotas for foreign ownership of certain types of property were relaxed to reduce excess supply of high-end properties.

The measures introduced in immediate response to the crisis were not found to be effective. On the contrary, they led to disastrous consequences, some of which were:

- Borrowers were faced with high debt obligations.
- Construction projects with high import content had to be deferred.
- There was a rise in unemployment.
- Exports did not improve despite intended policy measures because of worsening external demand since the crisis was widespread in East Asia.
- Net non-performing loan ratio doubled from 4.1% in late 1997 to 9.0% by the end of 1998.
- Real gross domestic product (GDP) shrank by 7.5%.

The unfavorable outcomes that emerged in response to the first phase of policy measures called for a reversal in strategy. There was an urgent need to boost the economy and, at the same time, bring some stability to the ringgit which was still volatile. This was a difficult dilemma for policy makers. The solution that was ultimately taken was a complete reversal of the first phase measures. The second phase of policy measures was based on twin objectives of reducing interest rates to boost the economy and imposing selective capital controls to mitigate market forces that would contribute to the further fall of the ringgit (Athukorala 2008).

The second phase of economic measures to curb the impact of the crisis was punctuated by a set of selective capital controls that were implemented on 1 September 1998. The following day the ringgit exchange rate was fixed at RM3.80 to US\$1. The following are some of the main features of the capital control measures:

1. The ringgit was made non-legal tender outside Malaysia.
2. There were restrictions to Malaysian residents bringing capital out of the country, but there were no restrictions on the purchase of foreign currency for purposes of trade.
3. The current account was to remain fully convertible.
4. A moratorium of one year was placed on all foreign portfolio funds in the country, but foreign investors who had foreign direct investment (FDI) in Malaysia were free to repatriate profits, interest, and dividends.

The capital controls helped insulate the economy from the volatile external environment and the threat of further pressure on the ringgit (see Nambiar 2003 for a discussion). From these controls, there was also some room created for the use of monetary policy to respond to the declining GDP. With this margin at its disposal, Bank Negara Malaysia was able to enact on the following measures:

1. The benchmark three month interbank rate was reduced from about 11% in May–July 1998 to about 3% in mid-1999.
2. Base lending rates of commercial banks were reduced from 12.3% in June 1998 to 6.79% in August 1999.
3. Credit ceilings for commercial banks and finance companies to take loans to purchase stocks were raised.
4. Credit terms for purchasing property were relaxed.

Capital controls were also introduced with the second phase of measures, including an expansionary fiscal policy, with a fiscal deficit of 6% of the gross national product in October 1998. In the first half of 1998, government expenditure fell by 34.4%, but in the second half of the same year, government expenditure rose by 56.6%. The government undertook substantial institutional restructuring during the second phase of policy measures. A crucial part of this exercise consisted of establishing Danaharta, Danamodal, and the Corporate Debt Restructuring Committee (CDRC). Danaharta was set up with the aim of removing non-performing loans from the banking sector. Danamodal was formed to recapitalize sick banks. CDRC's objective was to enable borrowers and creditors to find amicable solutions to debt problems without resorting to legal disputes. CDRC was also meant to enable companies to obtain credit lines during the crisis. The process of institutional restructuring was extended to the merger program for banking institutions. It was thought that there were too many banks (21 domestic commercial banks, 25 finance companies, and 12 merchant banks) in existence at the time, and that they should be merged into six core banks.

Several measures that were undertaken to overcome the 1997 crisis were of an institutional nature. Some of them were meant to serve immediate needs, examples of which are the establishment of Danaharta and Danamodal and the National Economic Action Council. Danaharta was an asset management company set up to acquire and manage nonperforming loans from banks. Danamodal, on the other hand, was a company that was meant to recapitalize financial institutions whose capital adequacy had fallen below 9%. Danaharta and Danamodal were dismantled once the economy recovered. The accumulation of foreign reserves is not an institutional issue. This crisis may have emphasized the importance of strong reserves to defend the ringgit. While the need for strong reserves may have been an appropriate response for the 1997 crisis it may have come to be held as a virtue to be espoused at all times. Strong reserves should not be held



in excess and they may have come to be seen as a source of strength subsequent to the 1997 crisis, even overlooking the costs connected with holding them. The increase in current account surpluses played a role in encouraging the accumulation of reserves. Other measures were much more long term in nature and included the merger program for the restructuring of the banking sector. While these long-term measures worked towards assuring that Malaysia could function in an increasingly liberal environment, many of the policies were geared to ensure that the country's export performance would not be jeopardized. The threat of a decreased demand for exports was not imminent at the time, and it may well have been helpful to attract FDI soon after the crisis, but the present crisis requires a completely different approach. In effect, the responses that were designed to mitigate the effects of the previous crisis do not have much relevance for the present crisis.

### **3. WHY THE CURRENT CRISIS WILL IMPACT MALAYSIA**

It has been observed that the current crisis has had an impact on developing Asia through the contraction of trade and FDI inflows (James et al. 2008). It is easy to see why the current global crisis will impact Malaysia via the trade channel. Malaysia is a very open economy, with exports and imports totaling RM1.11 trillion, two times the national GDP. For a country that is as dependent on trade as Malaysia is, it is obvious that if demand from the country's dominant trade partners were to decrease, its repercussions would be felt throughout the economy. The evidence for the extent of dependence on trade is striking when one notes the structure of Malaysian exports. This structure clearly indicates the dominance of manufactured goods which accounts for about 82% of total exports (Table 1). This is followed by minerals which contribute about 8% of exports. The share of agricultural commodities accounts for about 7% of total exports.

Within the category of manufactured goods, electronics, electrical machinery, and appliances are about 53% of the exports share. This category of commodities drives the manufacturing sector. Again, as a component of this broad category, electronics goods are the most dominant. Exports of electronics products can be sub-divided into semiconductors and electrical equipment and appliances, both of which have roughly equal importance.

There is no doubt that the export of manufactured goods is particularly vulnerable to drops in external demand. Since the demand for electronics goods largely comes from developed countries (particularly the US, EU, and Japan), a decline in consumption in these economies is bound to have a negative impact on the exports of Malaysian manufactured goods. It is important to note that percentage share in total exports has slipped the most from the previous year's percentage in 2008 in goods such as semiconductors (2.4%) and electronics equipment (3.3%). The export of electronics, electrical machinery, and appliances fell by 5.8% from 2007 to 2008. While manufactured goods accounted for 78.4% of total exports in 2007, it dropped to 74.1% in 2008.

**Table 1: Exports by Sector**

|   | 2000<br>% Share | 2001<br>% Share | 2002<br>% Share | 2003<br>% Share | 2004<br>% Share | 2005<br>% Share | 2006<br>% Share | 2007<br>% Share | 2008<br>% Share |
|---|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| <b>Manufactured goods</b>                         | 85.2            | 85.4            | 84.5            | 82.0            | 81.2            | 80.7            | 80.3            | 78.4            | 74.1            |
| Electronics, electrical machinery, and appliances | 61.7            | 59.9            | 59.4            | 56.0            | 53.4            | 52.7            | 51.1            | 47.6            | 41.8            |
| - Electronics                                     | 44.7            | 41.8            | 44.0            | 42.1            | 39.2            | 38.9            | 37.6            | 35.3            | 29.5            |
| - Semiconductor                                   | 19.1            | 18.1            | 20.4            | 21.4            | 18.5            | 16.8            | 15.9            | 15.9            | 13.5            |
| - Electronics equipment and parts                 | 25.6            | 23.7            | 23.6            | 20.7            | 20.6            | 22.0            | 21.7            | 19.3            | 16.0            |
| - Electrical machinery and appliances             | 17.0            | 18.2            | 15.4            | 13.9            | 14.3            | 13.8            | 13.5            | 12.4            | 12.3            |
| - Consumer electrical products                    | 7.1             | 7.1             | 5.9             | 5.0             | 4.6             | 4.2             | 3.2             | 2.7             | 3.2             |
| - Industrial and commercial electrical products   | 6.3             | 7.0             | 5.5             | 5.1             | 5.4             | 5.4             | 5.9             | 4.9             | 4.7             |
| - Electrical industrial machinery and equipment   | 3.4             | 3.7             | 3.5             | 3.4             | 3.7             | 3.7             | 3.9             | 4.2             | 3.8             |
| - Household electrical appliances                 | 0.2             | 0.3             | 0.4             | 0.5             | 0.6             | 0.5             | 0.5             | 0.6             | 0.5             |
| Chemicals and chemical products                   | 4.0             | 4.5             | 4.8             | 5.3             | 5.8             | 6.0             | 5.6             | 6.2             | 6.2             |
| Textiles, clothing, and footwear                  | 2.8             | 2.7             | 2.4             | 2.2             | 2.2             | 2.0             | 1.9             | 1.8             | 1.6             |
| Manufactures of metal                             | 2.3             | 2.6             | 2.5             | 2.8             | 3.3             | 3.2             | 3.9             | 4.4             | 4.4             |
| Optical and scientific equipment                  | 1.8             | 2.3             | 2.3             | 2.3             | 2.4             | 2.3             | 2.3             | 2.2             | 2.3             |
| Wood products                                     | 1.8             | 1.8             | 1.8             | 1.7             | 1.8             | 1.6             | 1.8             | 1.6             | 1.5             |
| Rubber products                                   | 1.3             | 1.3             | 1.3             | 1.3             | 1.3             | 1.3             | 1.5             | 1.7             | 1.9             |
| Transport equipment                               | 0.8             | 0.7             | 0.8             | 0.8             | 1.1             | 1.3             | 1.5             | 1.4             | 1.4             |
|   |                 |                 |                 |                 |                 |                 |                 |                 |                 |
| <b>Agricultural commodities</b>                   | 4.8             | 4.7             | 6.2             | 7.3             | 6.6             | 5.8             | 6.2             | 7.5             | 9.0             |
| Palm oil  | 2.7             | 3.0             | 4.2             | 5.1             | 4.3             | 3.6             | 3.7             | 5.3             | 6.9             |
| Rubber  | 0.7             | 0.6             | 0.7             | 0.9             | 1.1             | 1.1             | 1.4             | 1.2             | 1.2             |
|   |                 |                 |                 |                 |                 |                 |                 |                 |                 |
| <b>Minerals</b>                                   | 7.0             | 6.8             | 6.1             | 7.4             | 8.2             | 9.5             | 9.3             | 9.7             | 12.9            |
| Crude oil   | 3.8             | 3.3             | 3.2             | 3.9             | 4.5             | 5.3             | 5.2             | 5.3             | 6.5             |
| Liquefied natural gas                             | 3.1             | 3.3             | 2.8             | 3.4             | 3.6             | 4.0             | 4.0             | 4.3             | 6.1             |
|   |                 |                 |                 |                 |                 |                 |                 |                 |                 |
| Other exports                                     | 3.01            | 3.20            | 3.16            | 3.34            | 3.94            | 4.01            | 4.18            | 4.31            | 4.00            |
| Total Exports                                     |                 |                 |                 |                 |                 |                 |                 |                 |                 |

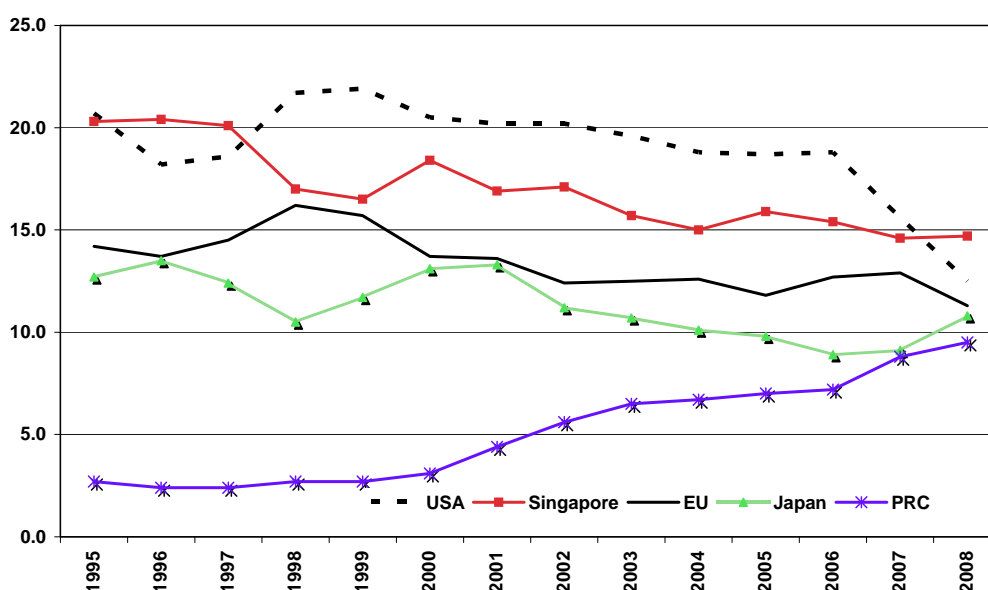
Source: Author's calculations compiled from Department of Statistics (2005–2008) and MIER computations.

Other items such as chemicals and chemical products; textiles, clothing, and footwear; manufactures of metals; and optical and scientific equipment do not constitute a large share of Malaysian exports. In 2008, chemicals made up just 6.2% of exports and manufactures of metals contributed only 4.4%. Neither of them experienced any change from the previous year. The other items mentioned accounted for less than 2% in 2008, with the exception of optical and scientific equipment (2.3%), but they too were not affected by the global crisis.

The data strongly suggests that Malaysia’s export structure is such that those goods exported to developed countries are more important to the economy than other goods. Not only must we note that the country’s growth is largely dependent on trade, but also that the export structure is heavily weighted in favor of manufacturing goods. Further, Malaysia’s export-driven manufacturing sector depends on goods derived from the electronics and electrical sector.

The vulnerability of Malaysian exports is also confirmed from an examination of trends in exports by Malaysia to its major trading partners. The US was the largest single destination for exports in the mid-1990s (Figure 1). However, it seems to have lost its favored position, as other countries have come to take a place of roughly equal standing. In 1995, about 21% of exports were directed to the US, with a gentle decrease to about 18% in more recent years.

**Figure 1: Exports to Major Partners (% Share)**



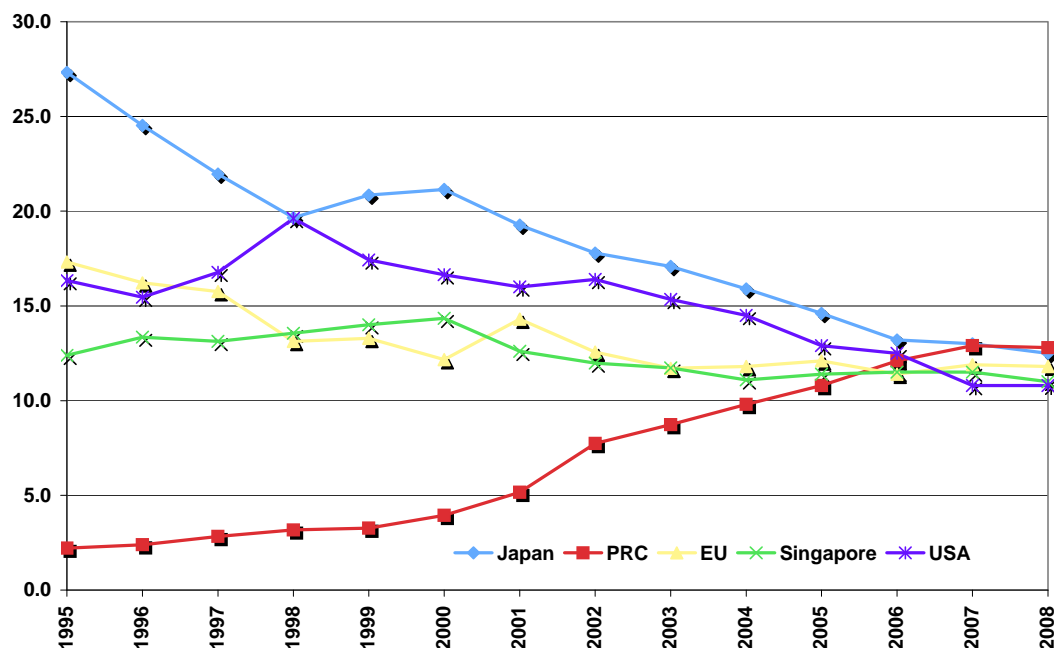
USA=United States of America, EU=European Union, PRC=the People’s Republic of China

Source: Author’s calculations compiled from Department of Statistics (2005–2008).

After the US, the EU was next in importance in 1995, claiming 14% of exports. The share of exports heading for the EU has hovered around 12.5% in recent years. Japan, to which about 13% of Malaysian exports went in 1995, now claims about 9%. The biggest decline has been in Singapore. In the late-1990s, about 20% of exports went to Singapore. Since 2006, the figure has dropped to about 15%. On the other hand, the People’s Republic of China (PRC) has been assuming a place of greater significance as a source for Malaysian exports. About 3% of exports went to the PRC in the late-1990s, but in the last two years, this figure has almost tripled. The five most important economies to which Malaysian exports go are the US, Singapore, the EU, Japan, and the PRC.

There is some convergence in terms of import sources. In the mid- and late-1990s, Japan was the largest import source, followed by the EU and Singapore (Figure 2). While 27% of exports were directed to Japan in 1995, this dropped to 13% in 2007 and further in 2008 (12.5%). The US accounted for about 16% of total imports between 1995 and 1997. In the years 2007 and 2008, only 10% of imports were from the US. About 11% of imports are currently from the EU. The PRC was the source of only 2.2% of imports in 1995, but shot up to 10% in 2005 and further to 12.9% in 2007.

**Figure 2: Import Sources (% Share)**



EU=European Union, PRC=the People's Republic of China, USA=United States of America

Source: Author's calculations compiled from Department of Statistics (2005–2008).

There is a strong relationship in Malaysia between exports and imports in that the goods produced for export have strong import content. Also, the same countries serve as destinations for export and sources of import. Again, these are the countries that have suffered severely from the impact of the current global economic crisis. Given the fact that Malaysia's growth relies heavily on export-oriented manufacturing, the crisis has had a strong impact on the Malaysian economy.

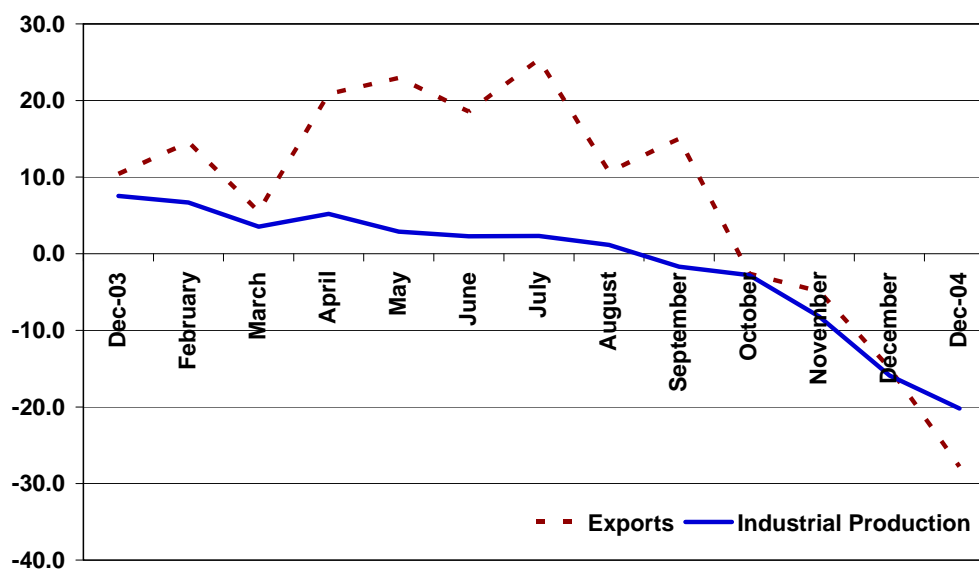
#### 4. IMPACT OF THE CRISIS ON THE MALAYSIAN ECONOMY

Two economic indicators that show the impact of the current crisis are exports and the industrial production index. Export figures, which were doing well in the first three quarters of 2008, took a downturn towards the end of that year (Figure 3). In January 2008, exports increased by 10.4% (year-on-year), and more-or-less doubled to 20.9% in April 2008. However, in October 2008, a negative figure was reported (-2.6%), only to decline more deeply as the months progressed. In December 2008 a decline was registered (-14.9%), which worsened in January 2009 (-27.8%).

Imports, which tend to follow export trends rather closely in Malaysia, reported a similar pattern. Imports increased by about 11% (year-on-year) in February 2008 and exceeded 10% in the months of June and July 2008 (12.5% and 15.0%, respectively). Again, the

change in imports fell into negative territory from October 2008, falling from -5.3% in that month to -23.1% in December 2008 and dropping to -32.0% in January 2009. It is understandable that imports should fall along with exports because imports of intermediate goods are required to meet the production of exports. The strong demand for exports that comes from Malaysia's major trading partners (US, Japan, and the EU) having fallen, it should be expected that exports from Malaysia would also fall.

**Figure 3: Exports/ Industrial Production (% y-o-y)**

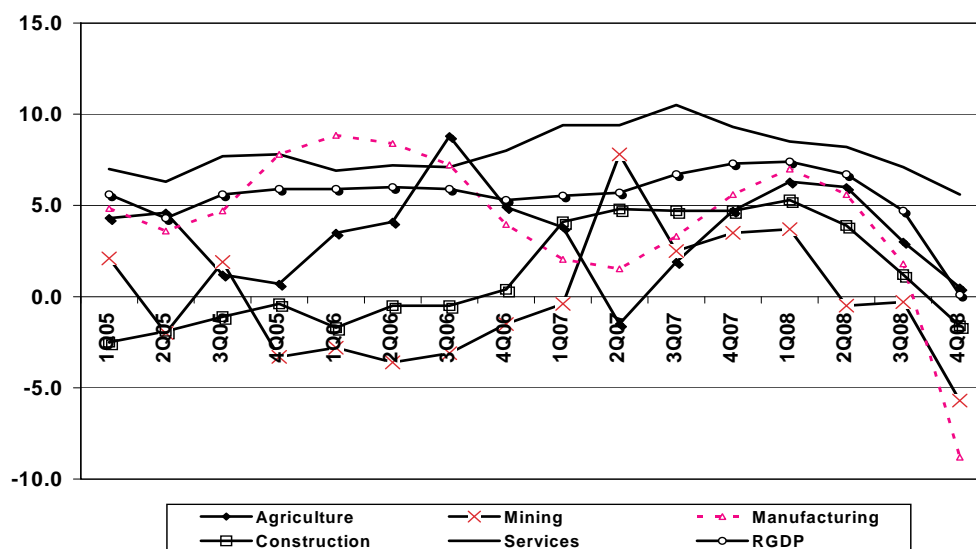


Source: Author's calculations compiled from Department of Statistics (2005–2008, 2008a).

Since most of the manufacturing sector is driven by the growth of exports, the industrial production index reflects the poor export conditions of the global environment and has been sinking since September 2008 (-1.7%, year-on-year), deepening towards the end of 2008, particularly in December, and into January 2009 (-15.9% and -20.2%, respectively) (Figure 3). These results are not surprising in view of Malaysia's heavy dependence on the environment and energy (E&E) sector and the fact that Malaysia's major trading partners were badly affected by the global crisis. Given these facts, claims that Malaysia has decoupled from the US do not seem valid. Others have claimed that Malaysia is shifting its trade towards the Association of Southeast Asian Nations (ASEAN). While there is evidence that trade with Singapore and Thailand has been increasing, this phenomenon must be contrasted with the nature of production networks. Units in other parts of ASEAN are a part of the production processes where the final products are ultimately exported to countries such as the EU and the US.

The effects of the crisis began to show in the GDP numbers by the third quarter of 2008. In no sector was this clearer than in manufacturing (Figure 4). The manufacturing sector had a 5.6% increase (year-on-year) in the second quarter of 2008. In the following quarter it was positive, but closer to 2% (1.8%), and it was negative (-8.8%) by the fourth quarter of 2008. The construction sector also showed negative growth in the fourth quarter of 2008. In fact, real GDP slid to a 0.1% growth rate in the last quarter of 2008.

**Figure 4: GDP by Sectors (% Change)**

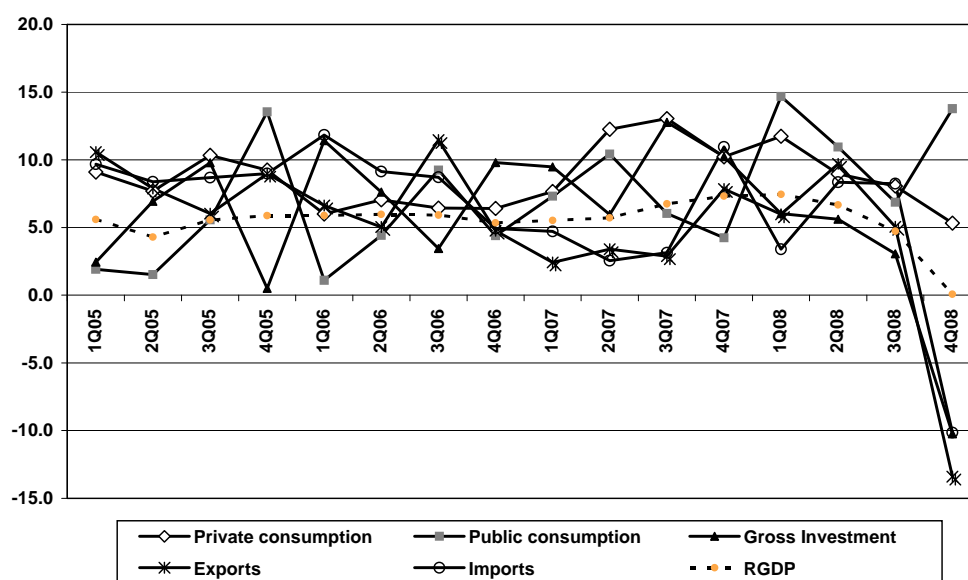


GDP=gross domestic product, RGDP=real gross domestic product

Source: Department of Statistics (2008b).

Viewed in terms of real GDP by demand expenditure, the most striking decreases in the fourth quarter of 2008 were observed in gross investment (-10.2%), exports (-13.4%), and imports (-10.1%) (Figure 5). Private consumption also fell, but remained at a respectable rate of 5.3%. Comparatively, in the first quarter of 2008, private consumption had increased by 11.7% and similarly, in the same quarter gross investment increased by 6%, with exports and imports showing increases as well (at 6% and 3.4%, respectively). The net effect of all the decreases in the various components was a decline in real GDP growth to 0.1% for the last quarter of 2008 compared to 7% in the first half of the same year.

**Figure 5: RGDP by Demand Expenditure (% Change)**



RGDP=real gross domestic product

Source: Department of Statistics (2008b).

The capital outflows from Malaysia increased with the onset of the crisis. First, reverse investments that were high in the second half of 2007 (about RM21.9 billion) slowed in the

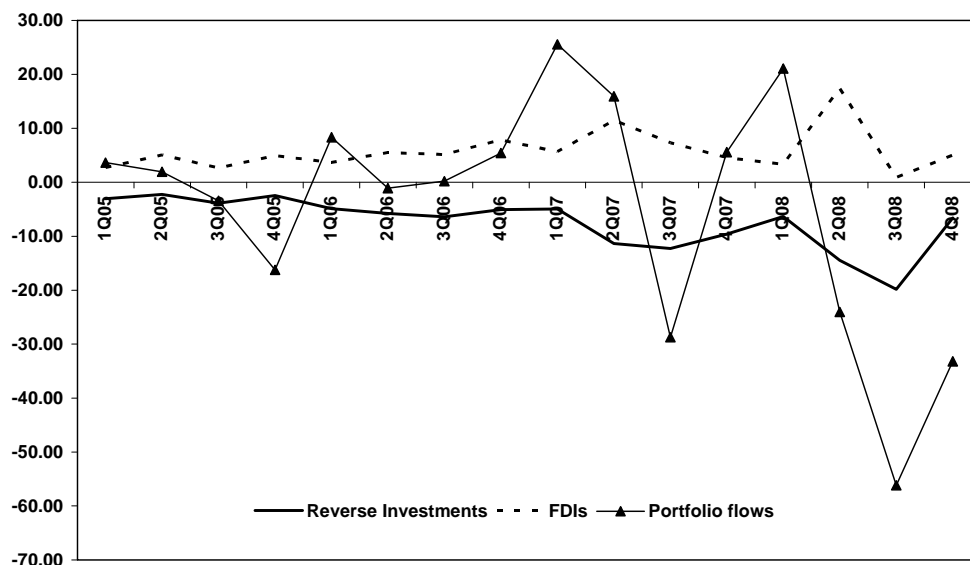
fourth quarter of 2008 to RM5.6 billion. The outflows of portfolio funds from Malaysian markets reflected the reality of the global crisis. There was a surge of portfolio flows into the country in the first quarter of 2008 (RM21.0 billion), and starting in the second quarter, the outflows continued to be extremely large. In the second quarter, portfolio outflows amounted to RM21.9 billion and in the third and fourth quarter, they were RM56.1 billion and RM33.2 billion, respectively.

FDI did not compensate for portfolio outflows during the same period. In fact, FDI has been hovering at around RM5.0 billion every quarter in recent years (2006–2008). There have been occasional spurts of FDI inflows into Malaysia, particularly in the second quarter of 2007 and the second quarter of 2008. The large increases in FDI that took place in the second quarter of 2007 amounted to RM11.5 billion, increasing to RM15.9 billion in the second quarter of 2008. The first was due to foreign investors (from Japan, the US, Germany, and Singapore) making investments in E&E activities. The second was due to a large joint venture enterprise initiated by an Australian company relating to aluminum processing. There is no doubt that with the crisis and with Malaysia's traditional FDI sources being adversely affected, FDI inflows have also decreased. This can be seen distinctly in the third quarter of 2008 when FDI worth RM900 million was all that flowed into the country, although it recovered to RM5.0 billion the following quarter (Figure 6). The full effects of the crisis on FDI are perhaps yet to be seen, since decisions by multinational corporations to invest in foreign countries will be made after the second half of 2008 and in the coming years.

The crisis has also prompted a drop in the value of Malaysia's foreign reserves. The economy held foreign reserves valued at US\$82.4 billion in 2006. Reserves increased in 2007 (US\$101.3 billion) and a further increase was noted in 2008 (US\$91.5 billion). Although Malaysia's reserves have been high in the years following the 1997 crisis, the present crisis has taken its toll on reserves. Quarterly figures depict the reality of the crisis. In the second quarter of 2008, reserves were US\$125.8 billion and fell to a limited extent in the following quarter of the same year to US\$109.7 billion. However, in the last quarter of 2008, the fall was even sharper, reaching US\$91.5 billion, a loss of US\$18.2 billion.

The declines in FDI, foreign reserves, and portfolio funds had been cushioned by the relatively stable current account balance. In the fourth quarter of 2008, the current account balance dropped to RM29.8 billion from RM38.7 billion in the previous quarter. More striking, however, is the overall balance which has continued to drop drastically since the third quarter of 2008, falling from -RM31.5 billion to -RM61.9 million in the last quarter of 2008.

**Figure 6: Capital Flows (RM Billion)**



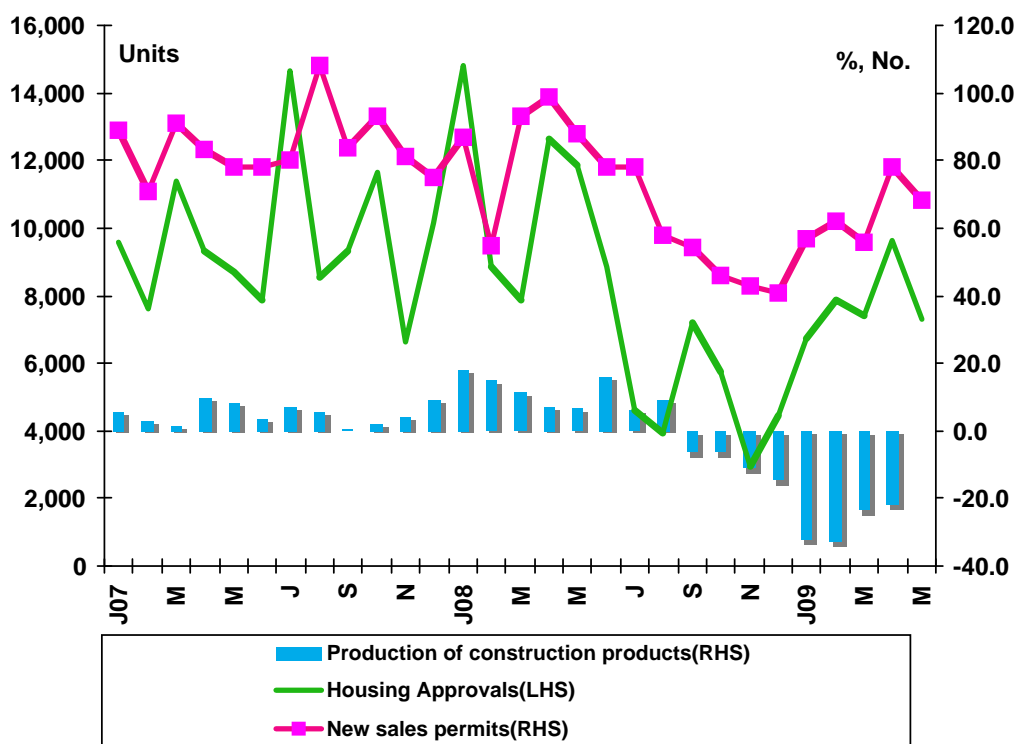
FDI=foreign direct investment

Source: Author's calculations compiled from Department of Statistics (2005–2008)..

The impact of the crises has been felt most strongly in two sectors of the Malaysian economy: the manufacturing sector (discussed above) and the construction sector. The impact on the construction sector can be seen in several of its key indicators. The number of new sales permits has been falling since July 2008, but the figures have reflected the pessimism of the industry most distinctly since August 2008. The number of new sales permits, which earlier in the year reached 87 per month, fell to 58 in August and 41 in December 2008. The number of housing approvals has also been on the downtrend. The change in the production of construction-related products shows the bleak outlook of the industry. In September 2008, there was a 6.8% increase (year-on-year) in this index. It fell by 1.9% in October 2008, but most alarmingly there was a contraction of 5.1% in November 2008.



**Figure 7: Property Sector Indicators**

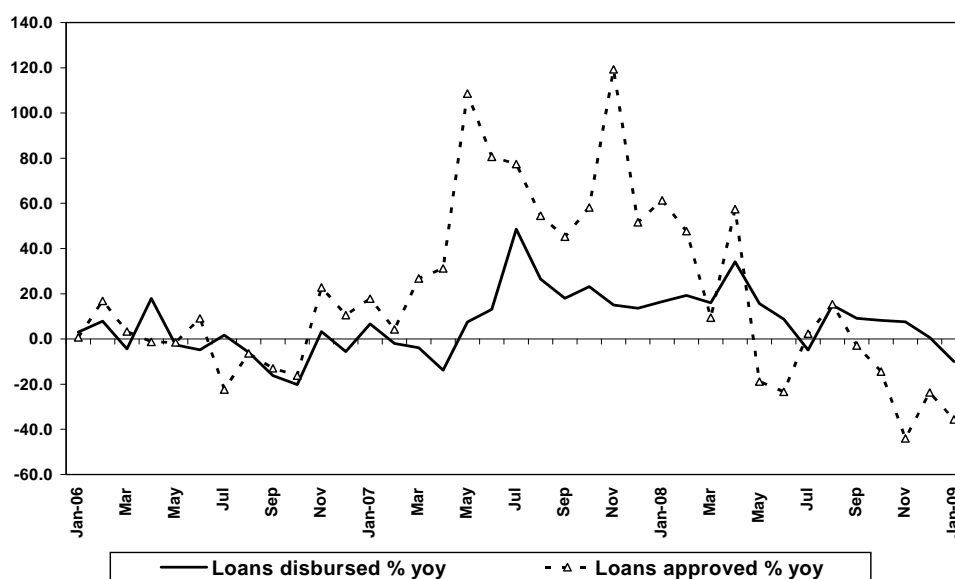


RHS= right hand side, LHS = left hand side

Source: Bank Negara Malaysia (2009).

The more prominent sectors in the economy are already beginning to suffer from the impact of the crisis. With the negative reactions that have been felt by the E&E sector, construction industry, and property development, the outlook for local markets is bleak. Not surprisingly, this bleak outlook has also had an impact on the financial sector. Given the uncertainty in the economy and declining consumer confidence, the credit market has been affected. As a consequence of this weak confidence, loan approval has fallen (see Figure 8). Particularly since September 2008, the growth in loan approval has been negative (-2.9%) and has continued to decline, especially in the months of October 2008 (-14.4%) and November 2008 (-44.0%) as well as January 2009 (-35.6%). The caution exercised in the banking sector is indicated by the growth in loans disbursed. This too declined in the months of October 2008 (8.2%), November (7.6%), and December 2008 (0.6%), finally becoming negative in January 2009 (-10.0%).

**Figure 8: Loans Approved and Disbursed**

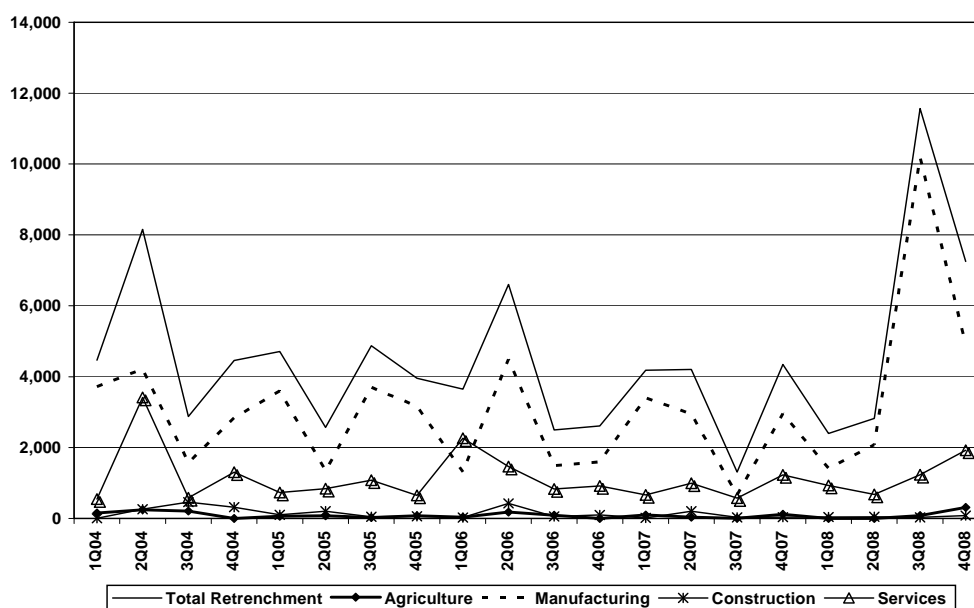


yoy= year-on-year

Source: Bank Negara Malaysia (2009).

The overall atmosphere of negativity has also led to unemployment. Not surprisingly, the manufacturing sector has suffered the most from the crisis in terms of retrenchments. This can be seen in the second half of 2008. In the third quarter of 2008 about 10,000 workers were retrenched and about 5,000 lost their jobs in the last quarter of that year (see Figure 9). Retrenchments were also high in the services sector in the third and fourth quarters of 2008. Except for the agriculture sector, retrenchments have been high, and about 20,000 workers were retrenched in the second half of 2008, according to published statistics (Bank Negara Malaysia 2009).

**Figure 9: Retrenchments**



Source: Ministry of Human Resources (2009).

## 5. POLICY RESPONSES TO THE CRISIS

The immediate response to the global crisis was one of denial, expressed through arguments that included the following: the Malaysian economy was decoupled from the US economy, the subprime crisis would not affect Malaysia because Malaysian banks had no exposure to such financial instruments, and Malaysia could tap into the growth generated by the PRC. As if to produce evidence that the Malaysian economy would continue to grow despite the global slowdown, the Ministry of International Trade and Industry highlighted the fact that the Malaysian Industrial Development Authority was receiving an increasing number of applications for investment in Malaysia.

However, with the continued global slowdown, it became clear that Malaysia would be adversely affected. In response to the threat posed to the economy, the government reacted with the following measures:

1. A RM7 billion stimulus package, announced on 4 November 2008;
2. A second stimulus package of RM60 billion, announced on 10 March 2009; and
3. Interest rate cuts by Bank Negara Malaysia, the central bank of Malaysia.

The introduction of these measures demonstrates that the government realized the seriousness of the problem and decided to use the full array of fiscal and monetary measures to mitigate the effects of the crisis. It was necessary to protect the economy against declining aggregate demand and to ensure that domestic spending did not recede. Further, there was an urgent need to protect the economy against any erosion of confidence. No less crucial was the recognition that social well being could not be sacrificed should the effect of the crisis be severe.

The two principle objectives of the first stimulus package (SP1) as declared by the finance minister were to reinforce and stimulate the economy, and to bring relief to the public.

The principle allocations under SP1 are as follows:

- RM1.2 billion to build 25,000 units of low- and medium-cost houses.
- RM500 million to upgrade, repair, and maintain police stations and quarters, and army camps and quarters.
- RM500 million to construct roads, schools, and hospitals.
- RM500 million to construct roads in rural areas and villages.
- RM500 million to improve public transport systems in urban centers.
- RM200 million to revive abandoned housing projects.
- RM200 million to fund micro-enterprises.

The incentives extended under SP1 included:

- Extension of all housing loans for government servants to 30 years (from 25 years) and an increase in loan amounts for certain categories of government servants to buy cars.
- Employment Provident Fund members can reduce contributions by 3% for two years.
- Foreigners and foreign companies can buy commercial real estate valued at RM500,000 or more without seeking the approval of the Foreign Investment Committee.

- Hypermarkets can extend business operations until 11pm on weekdays and until 1am on weekends. Hypermarkets in shopping complexes can apply to operate on a 24-hour basis.
- Import duty on cement, long iron, and steel products will be abolished.
- Permits for foreign knowledge workers will be issued directly to workers rather than to employers.
- Government-linked companies will launch the Graduate Employability Management Scheme to help train 12,000 graduates in two years.
- Recruitment into the public sector to be expedited so as to fill vacancies in critical areas. (This is expected to include about 18,000 vacancies.)

The Second Stimulus Package (SP2), besides involving a far larger amount of funds than SP1, is more comprehensive. SP2 is more ambitious in terms of reach as it is directed at a wider range of target groups and covers a broader range of economic activities. SP2 promises to address four strategic issues: reducing unemployment and increasing job opportunities; easing the economic burden of the people, particularly those in vulnerable sections of society; supporting the private sector; and undertaking capacity building for the future.

Given the concerns the fund allocation addresses, the robustness of the private sector seems to be of top priority. The task of promoting private sector confidence and ensuring that this sector does not collapse due to the deepening of the crisis has attracted an allocation of RM29 billion, almost half the amount of the total budget. Next in importance is RM19 billion to build capacity for the future. This is followed by the concern for compensating individuals whose welfare has been adversely affected due to a recession, for which RM10 billion has been set aside. Reducing unemployment and creating job opportunities seems to attract the least funding (RM2 billion), but is understandable as the other strategic thrusts will directly and indirectly result in the creation (or retention) of jobs.

SP2 works towards bolstering the private sector in a variety of ways, including direct financial assistance, incentive packages, and mega-projects that require private sector participation. The focus of this thrust is on small and medium enterprises (SMEs) since SMEs comprise 99% of total registered businesses in Malaysia. SMEs are an important link as they account for 56% of total employment and contribute almost 32% of GDP. The government is committed to extending several guarantee schemes that are specifically directed at SMEs. Through these schemes the government intends to provide guarantees to assist SMEs in raising funds for working capital, industry restructuring, and raising loans in the bond market. Most of these guarantee schemes are meant for companies with shareholder equity below RM20 million. The Industry Restructuring Guarantee Fund Scheme (which encourages the taking out of loans for productivity-increasing activities, value-added activities, and the application of green technology) will serve companies with equity below RM20 million as well as those with shareholder equity of RM20 million or more. Companies that fall into the latter category will enjoy a 50% guarantee from the government and an equal guarantee from financial institutions, whereas those with shareholder equity of RM20 million or less will receive a larger guarantee from the government (80:20).

In order to facilitate the proper financial functioning of the private sector during times of crisis, SP2 includes measures to enable companies to raise funds in the capital market with greater ease. To ensure that this is possible, the following is permitted: rights issued by listed companies now do not require application and approval of the Securities Commission (SC), the Code on Take-overs and Mergers 1998 no longer applies to private limited companies, bond and sukuk holders need only inform the SC of any amendments to the terms and conditions of their issuances without having to apply and await approval, unlisted public companies can proceed with issuance and offerings of equity securities without seeking the SC's approval, the SC need not be informed of revisions relating to terms and

conditions of bonds and sukuk to be listed on Bursa Malaysia, and convertible and exchangeable bonds will be exempted from mandatory rating requirements.

SP2 also attempts to reduce the cost of doing business by exempting and reducing levy payments that companies must pay to the government. Companies in the E&E sector will not have to make levy payments to the Human Resource Development Fund for a period of six months. Further, levy payments will be reduced by 1 to 5% for a period of two years for all employers.

The transportation sector (particularly, the automotive and aviation industries) receives special attention under SP2. The aviation industry will benefit from a new low cost carrier terminal that will be built at the existing Kuala Lumpur International Airport for an estimated RM2 billion. A rebate of 50% on landing charges will be given for a period of two years to all airlines that operate from Malaysia. The government is also committing itself prominently to the sustenance of the domestic automotive sector. It is doing this by providing RM200 million to the Automotive Development Fund and has committed itself to establishing the Automotive Institute of Malaysia. A discount of RM5,000 will be given to car owners who trade in cars which are at least 10 years old for the purchase of new Proton or Perodua cars. The tourism industry is also targeted by SP2, and the building of an extension to the existing airport and a decrease in landing charges will incentivize tourists. In addition, the government will allocate RM200 million to upgrade and develop the tourism industry. Areas such as eco, health, and education tourism are areas that the government would like to develop. Some of the allocation will be spent on promoting tourism through international conferences and exhibitions, and promoting second home ownership by foreigners in the country.

There are ample fiscal measures that have been created in this stimulus package for the resuscitation of the private sector. An accelerated capital allowance has been proposed. This deduction is applicable to investments in plant and machinery as well as expenses incurred from renovation and refurbishment of business premises. Another tax instrument that is being made available to alleviate the effects of the crisis is allowing companies to set losses made in the current year against any profits that were made in the preceding year (2008). This arrangement will allow companies to pay a lower tax on the profits made in 2008, or enjoy a tax refund should they incur losses this year. Yet another fiscal instrument is a revision in the windfall profit levy on oil palm. At present, a profit levy is imposed on crude palm oil when the price exceeds RM2,000 per ton, but this will be raised to RM2,500 for peninsular Malaysia and RM3,000 for Sabah and Sarawak.

The intention to build capacity for the future is second in importance. The measures that come under this thrust include investments to be undertaken by Khazanah Nasional Berhad in sectors such as telecommunications, technology, tourism, agriculture, and life sciences. The Iskandar Development Project is scheduled to be a key beneficiary of funds under SP2, with the development of infrastructure, hotels, theme parks, and universities being specific areas of interest. RM3 billion has been earmarked for the development of the telecommunications sector, particularly for the improvement of the country's broadband infrastructure. Several off-budget projects have been listed under SP2 and these include: the building and expansion of airports (RM2.3 billion), projects to improve the telecommunications infrastructure (RM2.4 billion), and the construction of sky bridges and covered walkways (RM100 million).

Funds totaling RM2 billion have been set aside to boost private investment activities through private finance initiatives and public-private partnerships. These projects will be in areas such as education, health, and tourism. Other projects are expected to improve infrastructure (relating to traffic and building of offices, hotels, and shopping complexes), develop new technologies (particularly biotechnology), and upgrade human resource development (with an emphasis on private tertiary education). The movement of skilled foreign labor will be eased to complement the investments in the aforementioned areas.

The institutional element has not been ignored in the thrust to build future capacity. First, the framework for government procurement will be improved with the promise that all government procurements will be made on the basis of open tenders or restricted tenders. Transparency has also been mentioned as an issue that will be addressed. Second, it is stated that the Standards and Costs Committee must approve any changes to project costs, scope, and plans. This committee will report to the cabinet on standards compliance and related issues. Third, the Foreign Investment Committee will restructure its outlook and adopt a more liberal stance. The Foreign Investment Committee will monitor investments and engage in micro-management only in projects that affect the national interest, such as ports, airports, defense, public transportation, and telecommunication.

The second thrust of easing the burden on the populace includes measures for the following: poverty eradication; a social safety net scheme to protect oil, palm, and rubber smallholders who may be affected in the event of a fall in the prices of these commodities; subsidies and assistance for fuel consumption, food security, and educational assistance; the provision of microcredit programs for small businesses; and the Fisherman's Welfare Fund. The third point will be directed at ensuring that basic necessities and transport costs do not erode the purchasing capacity of the population. An allocation of RM830 million is provided to implement social safety net programs for the elderly, disabled, and single mothers.

While an attempt is made to address the concerns of vulnerable groups, a range of issues that affect a broader portion of the population is also targeted. These include issues such as: repairing and maintaining drains and roads; improving the living conditions of those in public apartments; maintaining and repairing welfare homes, and fire stations and their quarters, and public toilets; improving school facilities, by building and repairing schools; and improving basic amenities in rural areas (especially public utilities and roads). The needs of retrenched workers is emphasized, with the government giving a tax exemption of RM10,000 (up from RM6,000) on retrenchment benefits for each year of service completed. Retrenched workers will also be able to defer the repayment of their housing loans for one year.

Although the budget allocation for reducing unemployment and increasing employment opportunities is not the largest, this thrust receives some attention in terms of the strategies that have been designed to tackle the economic problem. The strategies that have been created cover training and re-training, job placement, and job creation. Some of the prominent measures that have been proposed include the following:

1. Providing training in skill-specific areas (e.g., robotics, welding, construction, and jobs in technology),
2. Creating jobs in government-linked companies and employing graduates on a contract basis within the government service,
3. Ensuring that private companies employing retrenched workers receive double tax deduction,
4. Establishing a sufficient number of job placement centers,
5. Providing incentives for postgraduate education,
6. Providing training for graduates to become entrepreneurs, and
7. Restricting the employment of foreign workers in all areas except construction and plantation.

In the months leading up to the global crisis, the government insisted on increasing expenditure. The 2009 budget was expansionary and had increasing the welfare of the lower- and middle-income groups among other objectives. To achieve these aims, the government offered a one-month bonus for civil servants and reduced import duties for several consumer products. The personal income tax rate was reduced by 1% for those in the top income bracket as well as for those in the RM35,000–50,000 bracket.

The policy measures that have been announced by the government do not seem to recognize that the problem is structural and needs a deeper readjustment. First, the federal government has been running a deficit in its fiscal balance since the last crisis. As has been discussed, with the financial crisis deepening the government has adopted a fiscal policy that is counter-cyclical in nature, both with the RM7 billion Economic Stabilization Plan on 4 November 2008 and with the additional stimulus package announced on 10 March 2009. The large stimulus packages have resulted in widening fiscal deficits. The fiscal deficit now amounts to 7.6% of GDP, but it will only add a 1% increase in growth.

Of the RM60 billion that has been allocated, only RM15 billion is direct expenditure, with RM10 billion being allocated for the first year (2009) and the remaining RM5 billion for the following year (2010). Much of the second stimulus package consists of government guarantees. This raises the question of whether or not the guarantees will work. It should be noted that the guarantees are meant to take away the burden of failed loans from banks, but under the difficult and pessimistic circumstances that presently prevail, the more pressing question is whether or not there will be demand for loans at all. The second question is whether or not banks will be encouraged to be less risk averse with the guarantees being put in place by the government. With questionable effectiveness, this measure again avoids addressing the underlying problems of the crisis.

Many of the measures included in both stimulus packages treat the economic problem as one that will be short lived. Under this assumption, it is not useful to offer scholarships to students for post-graduate courses, nor give tax exemptions to companies that offer retrenchment benefits, as this does little beyond providing immediate relief. Similarly, granting contract employment in government-linked companies (GLCs) to the unemployed is, again, only a temporary benefit.

Some of the measures that have been designed are ill-conceived and will work against economic recovery. The heavy emphasis on providing huge funds via the GLCs will do little to bolster the private sector's participation in the economy through the crisis and after. Even more unhelpful is the intention to assist the GLCs in stimulating investments that depend on foreign investment. A stark example of this is the idea of directing funds towards the Iskandar Development Project which depends very much on investment from foreign countries, such as Singapore, or from the Middle East.

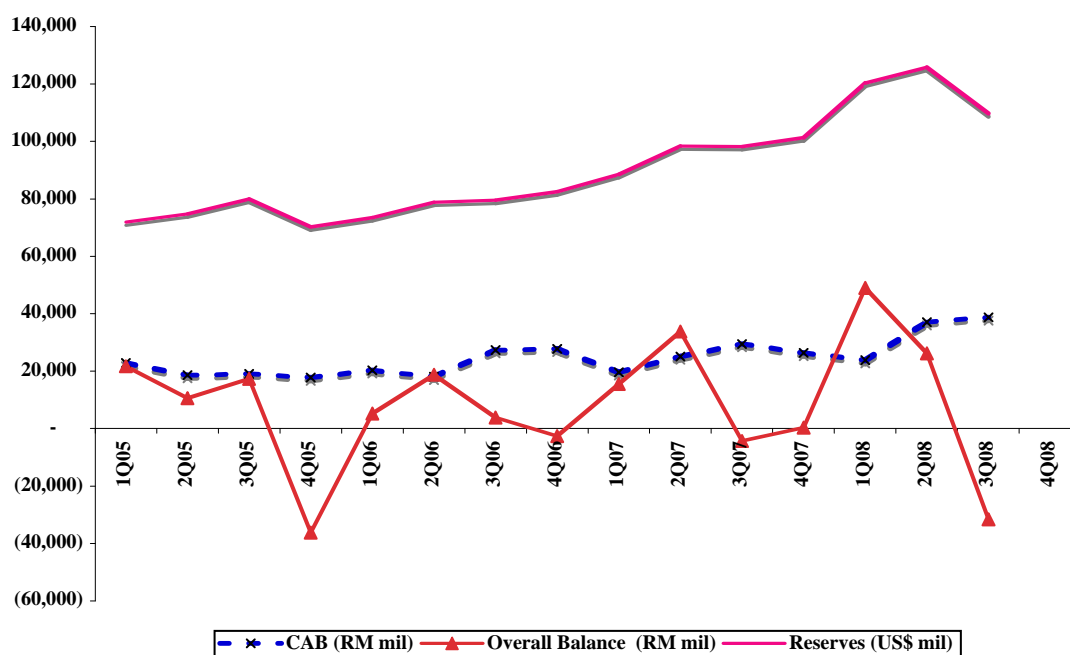
Nevertheless, the government is correct to target SMEs and the development of infrastructure projects to stimulate the economy. This is a concern that needs a better planned approach for the long term. However, the manner in which the government has set out to accomplish the task of developing SMEs is inadequate since it relies on providing guarantees to raise loans. Clearly, this does not address the issue of building a robust SME sector. Indeed, a more comprehensive plan is needed to re-shift the focus to domestic investors and rebuild the robustness of domestic consumption. The concern for social protection, an issue which has long evaded the attention of policy makers, must be seriously revisited as part of a long-term plan to recover from the crisis.

## **6. REBALANCING FOR GROWTH**

The industrial policy in at least the last 20 years has been centered on increasing export growth. The government has tackled employment generation and poverty eradication through export-led economic growth, creating five-year plans and industrial policy largely premised on this assumption. The approach, however, must be re-evaluated and alternative scenarios must be devised to prepare for what could be a prolonged period of soft demand for Malaysian exports. Accomplishing this will be very difficult because some of the assumptions that have traditionally driven policy-making must be reexamined and replaced. Accordingly, new strategies to drive economic growth must be designed and implemented.

After the 1997 crisis, given the robust export trends that worked to Malaysia's advantage, the current account posted encouraging gains. In the years directly preceding the current economic crisis, the current account balance has enjoyed an upward trend (Figure 10). With favorable export figures, Malaysia has had a large current account surplus, and consequently, reserves have also been growing rapidly. There were decreases in reserves in the fourth quarter of 2005 and in the third quarter of 2008 due to capital withdrawals, but the reserves continued to be strong. These events attest to the importance of exports in the economy. Much has been done to assist growth in exports, through institutional support, fiscal incentives, and the undervaluation of the ringgit. As these strategies have been employed for more than 20 years, there will likely be some resistance to changing them.

**Figure 10: Current Account, Overall Balance, and Reserves**



CAB=current account balance

Source: Author's calculations compiled from Department of Statistics (2005–2008).

The economic crisis challenges two assumptions that policy makers do not seem to have questioned so far: Malaysia's comparative advantage in E&E exports, and the prevailing predominance of the US, the EU and Japan as sustained destinations for Malaysian exports. It is not clear when the US will recover from the present crisis, how prolonged it will be, and whether the pattern of recovery will be "V-," "U-," or "L-shaped." Under these circumstances, Malaysia cannot expect to continue to depend on US-generated consumer demand.

These uncertainties also place additional pressure on the manufacturing sector. The initial challenge that the sector is facing—and has not yet come to terms with—is increasing competition from the PRC and Viet Nam. The comparative advantage of Malaysia's cheap, compliant, and well-educated labor force has disappeared and has led to concerns about the inflow of FDI. Malaysia cannot compete for FDI as it could ten years ago, since it neither has the unskilled labor advantage, nor an abundant supply of skilled, knowledge-intensive labor. The present crisis will continue to intensify the problem, particularly if the demand from developed economies that Malaysia has traditionally depended upon does not return to pre-crisis levels. If demand does not completely recover, Malaysia's growth rate will continue to fall with other macroeconomic variables including employment and well being in the economy.

In view of the current global crisis, Malaysia will have to readjust its growth strategies and shift away from its dominant emphasis on export-oriented growth, especially if the crisis is



prolonged. Currently, support for the export-oriented policy comes from other elements in the policy landscape and involves a suitable industrial policy, export promotion institutions and strategies, and fiscal incentives.

A reorientation can only be successfully accomplished if the new goals are articulated and defended, and suitable alternative policies and strategies are selected and implemented. A reorienting strategy would function along three lines. First, resources would be shifted from manufacturing industries that are concentrated on exports to developed countries to industries and services that serve the domestic market. Second, strategies would have to be designed to improve the disposable income of individuals. Third, the government would strengthen the provision of public goods, particularly those affecting the well being of individuals. These policies, if successful, would affect a rebalancing of economic growth. Growth rebalancing would also have an impact on the economy's macroeconomic variables. As a consequence of growth rebalancing, it is possible to expect that Malaysia will achieve a reduction in the savings rate as well as increases in domestic consumption and investment.

In Malaysia, there are a variety of public goods, the provision of which deserves more attention in Malaysia. The provision of health care, education, and social safety nets, are among public goods whose provision leaves much to be desired. With the privatization wave of the 1980s, there has been a feeling that the government cannot bear the burden of making these services available to individuals. In the case of health care, it was argued that with escalating costs the government could not afford to fund health care in the way it previously had. This was also related to the rising cost of pharmaceutical products, medical equipment, and investigative procedures. Higher standards of living and education also led to a higher demand for specialized treatment. Further, the cost of retaining medical personnel within government employment was rising. The government reasoned that with greater demands on health care expenditure, the private sector needed to play a more active role in the health care market.

With the growing population, there was also more demand for education. The government assumed a bigger role in the provision of education for the Bumiputera (as the ethnic Malays and indigenous people are referred to) in keeping with the spirit of the New Economic Policy. The New Economic Policy was dedicated to improving the economic participation of the Bumiputera and necessarily required more investment in education, especially at the tertiary level. This obligation meant leaving larger numbers of non-Bumiputera without avenues to pursue post-secondary education. There was a political issue associated with this trend since the non-Bumiputera were excluded from the public universities. In order not to aggravate non-Bumiputera discontent in being excluded from public institutions of higher learning, the government permitted the establishment of private colleges in the mid-80s. This has led to large numbers of colleges, branch campuses of foreign universities, and private universities opening up in Malaysia.

The government has also been reluctant to create social safety nets and to ensure adequate social protection for the disadvantaged. There have been complaints from non-governmental organizations, activists, and citizen's groups that social safety nets are not being given enough consideration or being implemented, but the government has not been receptive. Although the trade unions have been arguing that there is an urgent need for a minimum wage, this has been ignored because of the belief that Malaysia's competitiveness is based on cheap labor costs. Similarly, the government has shown no interest in introducing unemployment benefits, nor has it introduced any scheme that supports workers who lose their jobs in times of economic downturns. The poor state of public transport has also been criticized, but has not been the focus of any action. Indeed, there is worry about the state of urban poverty and concern that the welfare reduction caused by the current crisis has been understated. There is concern that official definitions of poverty do not do justice to current living standards and living costs.

Unfortunately, the prevailing government sentiment goes against the provision of social safety nets and social protection because of the following: it is felt that the burden on government expenditure will be increased, provision of social protection for the disadvantaged will draw resources away from more profitable allocations, and growth rates will be compromised if unproductive investments are made in improving social welfare. However, policy makers fail to see that there are valid reasons why the provision of public goods and social protection programs should not be viewed as a drain on government resources and a misallocation of funds. As the capability approach as shown, state provision of education and health care on a wider basis has yielded better economic outcomes (Sen 1999). In fact, expenditure on such programs can better help combat poverty, reduce inequalities, and induce pro-poor growth. The question of growth is particularly important in the Malaysian context.

Although retrenchments occur regularly in Malaysia and often worsen with crises, no programs have been instituted to protect workers despite the economic downturns that have occurred in the past (most notably the crisis of 1997). There are three reasons why health, education, and unemployment benefits must be given more attention. First, the costs of private health care and education are rising and are a heavy burden on the middle class. Second, in times of economic crisis, the costs of these items, which cannot be avoided, weighs heavily on consumers. Third, after retirement and diminished earnings, these costs can lead to debt. A survey conducted by the Employers' Provident Fund (EPF) indicates that individuals tend to spend all the funds that they are entitled to from their EPF contributions within three years of retirement. This means that those over 55 have diminished consumption patterns after retirement, but also are unable to finance any unexpected expenses after using all of their funds. It is important to note the rising life expectancy rates. It follows that individuals are likely to have higher savings rates, in addition to their contributions to their EPF. Thus, they would have lower disposable incomes during their years of active employment. Malaysia does not yet have a problem due to its aging population. With a more significant aging population there would be a larger decrease in household consumption and savings rates would be higher, reducing aggregate demand. A large aging population would increase household savings, reduce consumption, and so dampen the prospects for growth.

The argument that public spending on education, health care, pensions, and social safety nets does not foster growth and encourages a welfare state is not without flaws. Well-designed social safety nets can minimize the disincentive effects that have been wrongly attributed to social safety nets. There is also evidence that the disincentive effect is not as severe as it is often portrayed in public debates (see Grosh et al. 2008; Coady, Grosh, and Hoddinott 2004). More importantly, socially oriented programs have the capacity to generate multiplier effects due to the investments they require (as in the construction of schools, better public transport, and health centers) and this may generate growth. With doubt being cast on the US as a continued source of vigorous demand for Malaysian exports, attention must be directed at generating domestic consumption. This can only take place if individuals have higher disposable incomes. The measures that have been taken by the government (as exemplified by SP2) do not have the capacity to act as solutions to increasing disposable income in the face of what may be an extended decline in export growth rates.

Malaysia should revise the focus of its development policies. The Ninth Malaysia Plan (2006–2010) and the Third Industrial Master Plan (2006–2020) were conceived at a time when the global economic scenario was buoyant, and Malaysia's only challenge was to be more competitive in the international trade environment. The issues that are at stake now are different and more complex. Among the problems that Malaysia would have to solve are: the higher risk that individuals and households have to manage in the face of global uncertainties, the higher demand for precautionary savings due to the receding role of the government in the provision of public goods, creating opportunities for domestic investors, generating employment through industries and services that are directed at domestic or

regional markets, and finding more profitable uses for foreign reserves or reducing the tendency to induce export competitiveness by undervaluing the ringgit.

Finding solutions to the issues that have been suggested first requires a shift in developmental emphasis to small and medium enterprises that produce for the domestic and ASEAN markets. This in no way implies that the markets of developed economies would be excluded from consideration. Second, the government should favor the building of infrastructure. Many aspects of transportation that have been ignored in the last decade should be revisited. This includes improving urban transportation and rapid travel between cities. Third, the government should re-involve itself in education and training, as well as the provision of health care and low-cost housing. There are three aspects to government expenditure in these areas: improving human capabilities over the long term; enabling the economy to benefit from ensuing multiplier effects through the construction industry, by the building of clinics, schools, and community colleges; and releasing savings for consumption purposes.

The claim is often made that government support for health, education, and social protection is not the best allocation of resources because it is a straightforward drain of funds, since these are subsidies that the government cannot afford. However, this is not the case. In fact, export promotion and FDI attraction demand government investment. The government must allocate funds for the maintenance of free trade zones and fiscal incentives, not to mention the subsidies that are extended to multinational corporations. The changed export patterns and the lower inflow of FDI will free some of the resources that could then be directed to improving capabilities and the social welfare function.

## **7. CONCLUSION**

Malaysia's response to the economic and financial crisis of 1997 was a set of unorthodox policy measures, highlighted by the use of capital controls. This was complemented by institutional measures, some of which were temporary, such as the establishment of organizations to restructure debt, while others were of a more long-term nature. Among those in the latter category were actions taken to strengthen the banking sector through bank mergers and initiatives for the phased liberalization of the financial sector.

At the center of Malaysia's development plans is an export-oriented growth strategy. This has implied encouraging and providing incentives for export-oriented manufacturing and the promotion of exports. Closely related are efforts to attract FDI and support the location of multi-national corporations in Malaysia. In view of the nature of the current crisis and the economies involved, there is an urgent need to reconsider the basis for these policies. The crisis requires a rebalancing of strategies and consideration of policies that could change the structure of the economy. The present crisis will require deeper changes that can be viewed not simply as an adjustment due to a possible decreased demand for exports, but as an attempt to enhance human security, and upgrade human capital for Malaysia's passage into a more knowledge-intensive era of economic development.

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