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REFORMI. .G FINANCIAL SECTOR AND PROMOTING CAPITAL MARKET DEVELOPMENT
-- With Special Reference to Malaysia

by

R Thillainathan

Malaysian Institute of Economic Research
Institut Penyelidikan Ekonomi Malaysia

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REFORMING FINANCIAL SECTOR & PROMOTING CAPITAL MARKET DEVELOPMENT – With Special Reference To Malaysia

by

R THILLAINATHAN

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1. The Rationale

A financial revolution has been sweeping the developed world from the seventies. The financial revolution we are referring to and which has taken place in the West has been characterised by the emergence of fund managers and non-bank financial institutions (FIs) which have quickly displaced the banking industry as the biggest mobiliser of savings on the one hand and as the biggest investor and lender on the other hand.

In the face of this onslaught, the banks have had no choice but to transform themselves from being intermediaries of credit to being intermediaries of risk. This transformation of the banking industry has been facilitated by the rapid development of capital markets, of new risk management products (many of which are in the nature of derivatives), and of securitisation. Thus the banks are now engaged more in the origination and servicing of loans and less in their financing as well as more in the arranging and underwriting of debt issues but less on straight lendings. To be in a better position to discharge their new role in pricing, warehousing and placement, the banks have had to develop expertise in trading and market making in such markets as the currency, money and bond markets.

The restriction on and the under-development of capital markets and non-bank FIs has meant that Asia unlike the West, is over-dependent on its banking industry. And Asian banking is more traditional and inward-looking. Given the influence of banks on money supply and the high risk nature of banking, this over-dependence has increased the macroeconomic vulnerabilities and hence the risk profile, of the Asian economies. And unlike fund manager and the non-bank FIs, as the banks are engaged in the payment functions, over-reliance on banks have also increased the exposure of the Asian economies to sysemic risk.

The reduced fear of disintermeditation has also not given the banking industry the right incentive to move with the times from being an intermediary of credit to being an intermediary of risk. This factor combined with inappropriate regulation has dampened the development of capital markets, risk management products and of risk intermediaries as well as of trading and market making. This deficiency can become catastrophic, as in many Asian economies, when the high-risk banking industry operates under a regime of pegged exchange rate and open capital flows or inconsistent macro-policies.

The high-risk nature of banking can arise from the high gearing and asset-liability mismatches that characterise this industry. Poor credit decisions can aggravate the problem. Regulators and even bankers often forget that to earn a ringgit from lending, a bank has to put at risk a 100 ringgit. The high gearing may in fact create the incentives for risky or imprudent lending. And the massive asset-liability mismatches can convert a liquidity crisis into a solvency crisis. A run on banks can cause a multiple contraction in credit and hence lead to macroeconomic instabilities.

This is unlike the situation in the fund management industry where the risks are borne by the investors and where any differences in the liquidity needs of individual investors and the maturity profile of the investment portfolio can be met by a liquidation of the underlying assets. Such liquidations will lead to price volatility, which risk has to be borne by the investor. But as any funds outflow has to be exactly matched by an inflow, liquidity and systemic risks are minimised.[1]

[1] If the maturity preferences of suppliers and end-users of funds are not fully matched, then the services of an FI will still be necessary to provide the required maturity transformation and to assume the resulting maturity mismatch risk. A well-developed financial sector is likely to minimise such mismatches between providers and end-users of funds and transfer the remaining risk to those who are willing or able to bear them (which may not necessarily be banks). The under-development of capital markets will cause an over-concentration of risks in banks and lack of risk management products will not enable the banks to transfer the risks to those who are best able to bear them.

To the extent that the regulatory environment in Asia including Malaysia had made us over-dependent on banking and under-reliant on the fund management industry, (and other specialised FIs) it has exposed the country to a high degree of liquidity and systemic risk, thus making its financial sector and economy that much more vulnerable to internal and external shocks.

Malaysia, for instance, boasts the largest private debt securities market in the ASEAN region (in terms of the size of the outstanding debt issues). Its origins can be traced back to the late 80s but it has grown rapidly since then. Malaysia also boasts the biggest stock market in the region (in terms of market capitalization). It secured this honours in the mid-90s when it over-took Singapore. In fact in early 1997 the Malaysian stock market ranked third in Asia after Japan and Hong Kong.

Inspite of this impressive rankings, Malaysia's banking system continues to be the dominant provider of funds in the country. In fact in relation to the total size of domestic debt, the banking system increased its share from 62% in 1986 to 75% in 1997 while that of the debt market declined from 38% to 25% over the period.

The only data we can use to compare the relative importance of the domestic bank market as a provider of funds vis-a-vis the domestic debt market, the equity market as well as the external debt market, are those on net funds raised. The data for the second half of 1997 has been distorted by the massive depreciation of the RM of around 50% over the period. Therefore, if we exclude this period from our data, it is clear that the share of funds sourced from the domestic debt market has decreased from 33% to 11% and that from the equity market has increased marginally from 1. to 14%. On the other hand, the share of bank debt increased from 50 to 58% and that of external debt jumped from 3 to 16%.

2. Reform for Averting a Future Banking Crisis

Malaysia experienced a major banking crisis in the mid 80s and is witnessing the unfolding of a second crisis currently. To avert a future banking crisis, the push for a prudential and disclosure-based regulatory regime is not adequate.[2] There is a need for strong management, (by hiring the best from around the world), enlightened supervision based on the adequacy of risk controls as well as for a realignment of the incentives of owners, managers and depositors with prudent banking. From the mid 80s, the Government has ensured, with very few exceptions, that there is no rescue of shareholders or managers of an insolvent bank. However, the depositors have always been rescued. This has meant that the Malaysian banking industry has been exposed to the problem of moral hazard, namely of bankers having an incentive to engage in more risky lending.

This incentive will be greater the lower the capitalisation of a bank. A bank's low capitalisation can be due to its under-capitalisation or because its capital has been impaired by actual or potential loan losses. The high gearing which characterises the banking industry may have been made possible only because of the implicit Government guarantee of deposits. In the absence of this implicit guarantee the market's tolerance level for gearing would have been lower. If this argument holds, then at current gearing level, there will be an incentive for owners to engage in risky lending.[3]

In this environment, even a private enterprise economy can be made very vulnerable to over-investment and to the boom-bust cycles of the property and share markets, unless this moral hazard problem is rooted out. However, if depositors are to be made fully accountable for their decisions,

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[2] The recent departure from international best practice with respect to interest suspension and specific provisions is nonetheless a setback. It goes against our mid-80s experience when such rules were introduced for the first time in the midst of a serious economic and banking crisis.

[3] The use of current norms for computing the risk weighted capital ratio (RWCR) with little or no distinction drawn between advanced and less developed countries (LDCs) may have also led to a lower RWCR for LDCs then warranted by the underlying risk considerations.

then unnecessary restrictions should not be imposed on their right to invest between industries and across countries. A prudential opening up of a country's capital account and maintaining a competitive environment towards investment will promote the optimal development of a country by ensuring specialisation in production within a country and diversification of investments across countries.

3. Reforms for Promoting Capital Market Development

a. Fund Management Industry

One key reason for the under-development of the fund management industry in Malaysia is due to the capture by the EPF (Employees Provident Fund) of a sizeable portion of national savings through its forced-savings scheme for employees and the centralised investment of these savings by the EPF.

The current contribution rate to the EPF is on the high side, especially if a tight labour market causes an increase in employee retirement age from 55 to 60. Given an individual's typical lifetime expenditure profile, a high contribution rate can lead to an under-investment in housing and education. Or it can breed inequities if the contributors are forced to borrow their own EPF savings which have been recycled to the banks, (as has been the case for many years now), at a disadvantageous rate.

The EPF is under-invested in domestic equities and is not invested in global equites or bonds. Given the benefits of diversification, the problem of persuading the Government and the contributors has to be addressed as a matter of priority.

The problem of over-centralisation of investment management can be addressed not by breaking up the EPF but by parcelling its funds for external management either for its own account or for the account of the individual contributor, as in Singapore. The role of EPF can then be two-fold: to manage funds which are earmarked for passive management and to ensure that adequate investment choices are offered to contributors on a competitive basis. The choices are between different asset classes (including domestic and international), as well as between different management styles (including passive and active management) so that each contributor can exercise his choice based on such considerations as expected return and risk, cost as well as his risk-bearing capacity (versus the current practice of a common investment plan irrespective of the age profile or risk-bearing capacity of the contributor). These reforms of the EPF can be reinforced by allowing the larger and more reputable employers to oversee the management of the retirement fund (arising from their contributions). These reforms should support the development of the private sector fund management industry as well as the pension industry, (one based on the defined benefit plan).[4]

A reform of the financial sector in general and of the EPF in particular is necessary to ensure the balanced development of the fund management industry vis-a-vis the banking industry. For a balanced development of the financial services industry, increasing reliance has to be placed on the financial and capital markets to price, mobilise and allocate savings between competing debt and equity market instruments as well as price and allocate risks (in the new environment of increased market volatility) between different market players based on their willingness and capacity to bear the risks. This will in turn require the liberalisation and deregulation of financial markets so that traders will be able to hedge, take position or make markets without unnecessary restrictions and without incurring high transaction cost.

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[4] See my paper on "The Fund Management Industry & The Employees Provident Fund", Bankers Journal, June 1998 for further details. There is a strong case for developing a defined benefit plan to minimise the volatility in after-retirement income of contributors to which they will be exposed if sole reliance is placed on a defined contribution (DC) plan. Unlike a typical DC plan, under EPF's DC plan, an average contributor has little choice on investment decisions. This makes it politically more explosive.

b) The Bond Market

The captive demand for and shortage of MGS (Malaysian Government Securities), an illiquid cash market and the lack of a futures market in Malaysia, as elsewhere in Asia, has made for an under-developed secondary market in MGS. Thus the problem of determining the risk-free interest rate cannot be separated from the problem of pricing credit risk which has in turn curbed the level of issuing and trading activity in PDS (Private Debt Securities).

If the Government does not have a need to borrow, it may still have to issue MGS papers periodically as a benchmark for the pricing of fixed rate papers. To serve this purpose better, there is also a need for consolidating existing MGS issues into fewer, larger issues. If Khazanah (the Government Investment Corporation) becomes a regular issuer and its issues set the benchmark yield curve, then the best way to utilise the issue proceeds is to build up a portfolio of foreign assets.[5] As Cagamas (National Mortgage Corporation) bonds are near riskless papers, freeing up the market for these papers offers the best solution for the generation of benchmark yields.

To develop an active secondary bond market, it is necessary to free yields, reduce or eliminate reserve and liquidity costs as well as to reduce interest rate risk premium. Liberalisation of the liquid asset requirements will have the effect of freeing yields and reducing liquidity costs. Reserve costs can be reduced by reducing reliance on statutory reserves as a tool of monetary policy or by exempting financial institutions from holding reserves against their inventories of fixed rate papers. The interest rate risk premium can be reduced by improving opportunities for hedging.

The development of an active and liquid bond market also requires the creation of an institutional framework for the borrowing and lending of securities as well as the removal of existing restrictions on repo and reverse repo transactions.

If the cash and futures markets are well developed, investors and speculators will be able to trade on their views on interest rates, on the shape of the yield curve, on the spread between MGS and PDS yields and on the spread in yields between the cash and futures markets thus boosting trading volume and market liquidity.

To accelerate the growth in the PDS market the restriction on the issue of speculative grade bonds should be removed, the shelf registration rule should be introduced to remove the interest rate risks associated with debt issues or otherwise the time required for the approval of such issues should be reduced well below three months and the interest income on debt issues should be exempted from withholding tax or cross-currency swaps should be permitted more freely to shift risk and thereby minimise the foreign currency exposures of Malaysian borrowers. The broadening of the investor base for private debt issues is most welcome but to ensure the necessary disclosure of information and due diligence, there should be a requirement for filing of the placement memorandum for such issues with the relevant authorities, as in the US, (but without it being subject to their approval). A neutral tax and regulatory regime is also necessary to ensure the balanced development of the debt and equity markets.

c) Securitisation

The securitisation of debt can reduce the asset-liability mismatches and capital requirements of a bank. To boost securitisation of mortgage loans, which is well-developed in Malaysia, the purchase of such loans should be done on a non-recourse basis to the banks and the restriction on securitisation of loans in respect of houses costing more than RM150,000 should be lifted. Approval should also be given for the securitisation of other kinds of debts, such as auto loans, credit card payments and lease

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[5] This is preferred to its current practice of using its funds as seed capital for picking potential winners.

receivables. The need for over-collaterilisation with respect to the securitisation of auto loans and credit card receivables can cause difficulties with the bankruptcy act as well as the tax status of a SPV and therefore requires remedial measures. The stamp duty exemption will also have to be extended to purchases of any kinds of assets which are amenable for asset-backed securitisation.

d) Equity Markets & Related Matters

The setting up of the Securities Commission in 1993 clarified the regulatory mandates in respect of the equity market. However, an overlap in mandates or other considerations are holding up the development of debt markets and risk management products. For the shift to a disclosure-based regulatory regime to be successful, good corporate governance and disclosure systems, well-functioning legal systems as well as well-developed self-regulatory organisations are required.

In spite of the major improvements in KLSE's market infrastructure, two key concerns remain: one is with respect to settlement risk and the other is with respect to the protection of investors assets from the insolvency of brokerage firms.

4. Role of Cross Currency Swap Market & Rating in Determining Benchmark Yields & Credit Risk in Malaysia[6]

In the absence of a well-developed and liquid domestic bond market, one which can also be accessed by non-residents, the yield curve generated by the cross-currency swap (CCS) market can be used as the benchmark yield curve. A more active and liquid CCS market will make for a narrower bid-ask spread and a higher transaction volume for each price quote. And the level of activity and liquidity will be higher, the lower the level of capital controls.

There was an active and liquid CCS market in RM from the last quarter of 1994 until mid 1997 as there were no restrictions on the offer or bid side of a swap or forward transaction. On the other hand, there were restrictions on the offer side (which is equivalent to an outflow control) from 1989 until August 1994 and on the bid side (which is equivalent to an inflow control) from June 1992 until August 1994. Accordingly, the bid-ask spread was around 150 bp in 1993 whereas on the other hand the spread was at or below 25 bp in 1996 and even during the first half of 1997. With the outbreak of the regional financial crisis in mid 1997 and the imposition of an outflow control on the offer side from August 1997, the spreads had once again opened up to over 100 bp but during the second quarter of 1998 the spread had ranged between 50 to 100 bp.

In spite of restrictions on the extent to which a resident can access the CCS market, the yields generated by the CCS market were in fact used as reference yields for issuing and trading activity in the onshore PDS market. This suggest that as non-residents could deal freely with the onshore banks during the 1994 to1997 period, arbitrage activities between the onshore PDS market and the offshore CCS market led to the narrowing of the onshore and offshore yields and thus for the use of the latter as indicative yields for activity in the onshore PDS market.

The international rating of certain Malaysian corporates and the active trading of their debt issues in the global bond market generated valuable information on their risk premiums or credit margins. The domestic rating of the same corporates and of many others, as well as the increasing acceptance of these domestic ratings by institutional investors, both local and foreign, made it easier for these investors to compare and price the debt issues of the various corporates.

[6] The analysis contained in this section is in respect of the situation prior to the imposition of more far-reaching capital controls from September 1, 1998. An analysis of the new capital controls and their implications is undertaken in the next section.

It should be apparent from the preceding discussion that the CCS market generated the indicative baseline interest rates and the increasing acceptance of rating by issuers and investors generated the risk premiums for the pricing of credit risk. With the two sets of data and available information on US Treasury yields and swap spreads from the global market place, the pricing of ringgit debt issues became less intractable in spite of the absence of a well-developed and liquid domestic bond market.

So long as the domestic bond market remains under-developed, as is the case in most Asian economies, reliance can be placed on the CCS market to generate the baseline data on interest rate for various tenors. This makes it essential for the Governments in the region to remove the outflow control that has been imposed on swap and forward transactions from August 1997[7]. Unless this capital control is removed, the level of trading activity in the CCS market will be lower and therefore the benchmark yields generated will not be the best indicators for the pricing of domestic debt issues. Without this proxy yield curve issuing and trading activity in the private debt securities market is likely to suffer a great deal.

The removal of this capital control is also necessary to enable investors and borrowers to hedge their interest and exchange rate risks more easily and at lower cost through the CCS market. This will increase overseas interest for investing in Asia and reduce the risk of Asians who have overseas exposures. This is more necessary where the value of a regional currency is market-determined.[8]

5. The September Capital Control Measures – An Analysis of their Implications

The exchange control measures introduced in Malaysia on September 1, 1998 imposed restrictions on the outflow of funds belonging to residents and on the inflow of portfolio funds. There are no restrictions on the flows of direct foreign investments (DFIs).[9] The measures also led to the shut down of the offshore ringgit market (based on deliverable contracts) and of offshore trading in Malaysian shares.

The exchange control in place prior to September prohibited borrowing and shorting and hence, speculation against the Ringgit in the onshore market. The swap market restrictions reintroduced in August 1997 eliminated substantially opportunities for speculation against the RM in the offshore market through borrowing of the Ringgit from the onshore market.

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[7] Reliance can be placed on swap restrictions on an exceptional basis to deal with a currency crisis. The substantial differential in the onshore and offshore ringgit rates during 1998 (until the closure of the offshore market on 1.9.98) were due partly to capital controls and partly to the relative supply and demand position for offshore ringgit. There was then continued uncertainty about the outlook for ringgit interest and exchange rates. The steep yield curve for offshore ringgit for funds of up to one year (and a gradually declining curve for maturities above one year) during the second quarter of 1998 suggested that the offshore market was expecting a sharp increase in interest rates rather than a sharp fall in the value of the ringgit. Given this shape of the yield curve, the huge differential between the onshore and offshore rates for term money was probably reflecting a demand for offshore ringgit more to fund an offshore ringgit loan book (whose size would have come down on account of the wide interest differential) and less to create a short position in the ringgit (irrespective of whether this short position was being put in by speculators or hedgers). My own hunch then was that, so long as capital controls continue, the interest differential between onshore and offshore rates would have continued but the actual size of this differential would have come down with the running down of the offshore ringgit loan book.

[8] The views expressed in this section may look obsolete with respect to Malaysia in the light of the capital controls imposed on 1.9.98. This section was written before far-reaching capital controls were imposed in Malaysia. It has not been rewritten as the capital controls imposed in the country are expected to be temporary.

[9] As initially conceived, there were no restrictions on foreign direct investments. But dividend payments have now been capped. For any given year, it cannot exceed profits in that year or the weighted average of the dividends paid during the preceding two years, which ever is the higher. This decision to cap is indeed surprising, when FDIs have served as Malaysia's life blood.

From August 1997, to speculate against the Ringgit in the offshore market, the Ringgit had to be borrowed from a party who was prepared to take the opposite position. As the offshore Ringgit interest rate was double the onshore rate, and as the Ringgit was grossly under-valued, speculating against the Ringgit was certainly a high-risk business.

With the new measures, it is not possible to borrow and speculate against the Ringgit in the offshore market (unless and until a non-deliverable forward market emerges, which is likely to take time). In the meanwhile, non-residents who are invested in Malaysia and who do not like the currency risk will not be able to lay off this risk through hedging. The offshore Ringgit loan market, which had emerged on account of regulatory, tax, credit or other considerations, will also be wound down.

The loss in hedging opportunities for investors from the shut down of the offshore cross-currency swap market is not deemed material as the value of the Ringgit is now fixed. This is true only to the extent that its value remains unchanged. The offshore Ringgit swap rates, under normal circumstances, and in the absence of a well-developed Government bond market, had served as a proxy yield curve for the issue and trading of private debt securities. The need now for a market-determined domestic yield curve is even more obvious. Given the current perception about financial markets in the country, it is unlikely that in the short or medium-term the regulatory environment will become more conducive for the emergence of an active and liquid cash and futures markets in bonds, which is the *sine qua non* for the emergence in turn of a market-determined yield curve.

The size of the offshore Ringgit market in Singapore was placed at RM30 billion. Shutting down this market may have been viewed as a way of bringing these funds onshore. The Ringgit funds would have come onshore when the additional offshore deposits were created and on-lent (as Ringgit is not accepted as a general means of payment abroad). On the shut down of the offshore market, there will be a net inflow of funds into Malaysia only if the offshore depositor wants to maintain its deposits in Ringgit. This will then require the offshore Ringgit deposit to be converted and remitted into the country in equivalent units of a foreign currency for reconversion into Ringgit. The new capital control regulations could have discouraged such remittance.

The rapid upgrading of KLSE's market infrastructure, the increased capitalisation of its member companies and reduction in commissions during the 90s had increased trading volumes in Malaysian shares and much of that through the KLSE. Continued improvements in credit and relaxation of forex regulations could have improved the situation further. The shut down of offshore trading in Malaysian equities, combined with the inflow controls on portfolio flows, will increase the cost of equity to Malaysian corporates, reduce liquidity and diminish the relative position of KLSE in the region but will make it difficult for shorting Malaysian equities (in line with the goal of public policy of protecting downside risk) and for Malaysians to take out money through the sale of their local shares abroad.

The new inflow control is such that inflow of short-term funds, including portfolio flows, have to remain in the country for at least one year. There is no requirement for the funds to be invested in the same instrument or share. KLSE is expected to be less volatile because of its reduced exposure to external exuberance or contagion. But the reduced activity by foreign portfolio investors and the resulting thin markets may make for more volatility in normal times. Under this inflow control, existing portfolio investors are also allowed to take out their funds only in a year's time irrespective of the time period they had been invested in the market. The retrospective implementation of this control was no doubt to stem selling activity and capital outflows on announcement of the new measures. But it had the unintended effect of rewarding the speculators but penalising the long-term investors and those who had the misfortune of not reading the signals correctly. Chile, which had served as a model for the control of portfolio flows from 1991, has relied on unremunerated reserve requirements to minimise the adverse impact of such flows.

Paul Krugman has made a strong case for the use of capital control and against the use of a high interest rate policy to deal with an acute currency crisis of the type Asia has been experiencing from

mid 1997, provided the control is used on a temporary basis and provided the required economic reforms are carried out. The problem will lie in identifying when a currency problem is likely to turn into a crisis, whether the expected use of capital controls will not trigger an outflow and a crisis whenever there is a problem in the currency market and whether on account of such behaviour and once recourse is made to it, capital control will not become a more permanent feature of an economy.

Given the prohibitive cost of a high interest rate policy in dealing with a currency crisis, a key goal of economic management is in preventing a crisis from developing. To minimise the probability of a crisis from developing, we must pursue sound macroeconomic and financial sector policies. A premature easing of or an open capital account can cause or aggravate a currency crisis if the financial sector is weak and if macro policies are unsound. Where a currency crisis is likely to be caused by the sheer size of offshore speculators and their speculative positions, this can almost always be dealt with through the imposition of restrictions on non-trade related transactions between residents and non-residents in the swap and forward markets.[10]

A case has been made in Malaysia for the more wide-ranging capital controls to reduce the additional damage that could have been inflicted on bank and corporate balance sheets from a further fall in asset prices. But much of the balance sheet damage and asset price falls had already taken place when the new measures were introduced. A recovery could have been expected from the continued pursuit of the right macro policies and from sending out the right signals. The case for more wide-ranging capital controls (related to asset price falls) may have also been based on political consideration and the fear of a global meltdown (but as performance is relative the latter factor should have been discounted but was not done).

In several of the crisis countries, interest rate had already peaked and were falling sharply. Even in Malaysia interbank rates were 20% below their peaks and were in single digits when the capital controls were imposed. The imposition of capital controls has enabled a further immediate easing of interest rates without a corresponding fall in the value of the Ringgit.[11]

There is scope only for a prudent easing of macro policies and only within limits dictated by economic fundamentals. A more aggressive easing of policies can provide relief only in the short-run. What we produce is largely exported and what we use is largely imported. The stimulation of domestic demand through an aggressive easing of policy to jump start the economy will lead to mounting external deficit, rising inflationary pressures or a falling ringgit or all of the above.[12]

If capital control becomes a permanent feature of the Malaysian economy but the stance of macro policies is prudent, then the long-term growth rate of the Malaysian economy will fall below what is attainable under a regime with less capital control. But the shortfall will depend on several factors. There are exchange control restrictions on foreign portfolio investments and on funds that Malaysians can take abroad. But there are no such restrictions on foreign direct investments. Exchange controls imply that the service sector will continue to be over-regulated, over-protected and will impose a burden on the goods sector. On the other hand, the goods sector viewed as the "more productive" sector, will enjoy the tax breaks or subsidies with attendant over-investments. These contradictory policies combined with the inefficiencies of capital control (See the paras below) mean that the long-term growth rate of the Malaysian economy may be anywhere between one-fourth to one-third below what is attainable if more optimal policies are pursued.

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[10] The fact that an offshore currency market does not exist cannot prevent the breakout of a currency crisis, as evidenced by the recent Korean experience, if macroeconomics is unsound or the financial sector is weak.

[11] Traditionally Malaysia has been a capital importer. Therefore, in the medium and long-run capital control will make for a higher and not a lower interest rate for any given level of the exchange rate.

[12] The 1999 Budget is comforting in that it is not based on an aggressive or irresponsible easing of macro policies. We hope that in the run up to the next elections, there is no change in the prudential stance of policies.

If capital control is combined with imprudent macro policies we run the risk of bankrupting the country but it is unlikely that the authorities will let this happen or pursue imprudent policies for any length of time. One obvious risk is from the fixing of the exchange rate. With exchange control there is a considerable reduction in exchange rate volatility. Therefore, I am a little bewildered why the Government has opted to fix the rate thereby sacrificing the useful role that the market can play in the exchange rate discovery process (even if it is within a controlled environment).[13]

The imposition of an outflow control on funds Malaysians can take abroad will lead to more paper work, an increase in the size of the bureaucracy and to the emergence of a black market and more so the tighter is the control. Given that international trade is almost twice the size of the country's GNP, opportunities for Malaysians to circumvent the control as well as engage in bribery and corruption will be more plentiful than in China or India whose economies are closed and whose dependence on international trade is significantly less. There will be an increased reliance on the bureaucracy than on the market for the allocation of foreign exchange and hence in the selection of investment (with a bias against the import-intensive non-traded goods sector). The incentive to engage in these activities will be greater if capital control is likely to be more permanent. Therefore, in order not to distort incentives it is best to look at the control as temporary from the outset and signal the market accordingly.

With increased reliance on capital control the extent to which the conduct of macro policies will be subject to the discipline of the market place will be reduced correspondingly. Even if the stance of macro policies is ..ry aggressive and lead to inflationary or external payment pressures or to a depreciation of the currency, Malaysians will not be able to switch their savings or investments into foreign currency denominated assets and to that extent they run the risk of a involuntary loss in their real wealth. The longer the controls are in place, Malaysians will face more restrictions or have less choice in their saving, investment and consumption decisions. This can discourage their incentive to work, save, invest or take risk and encourage them to migrate abroad. This is a powerful reason why exchange control should be viewed as a temporary and not as a permanent measure and why there is a need for markets as a check and balance on executive power.

6. The Way Ahead

The Financial Revolution : A financial revolution has been sweeping the developed world from the seventies. However, Malaysia and much of Asia has been cut-off from this revolution. The liberalisation and deregulation of fund managers and non-bank FIs is necessary if they are to grow and play their rightful role in Malaysia. The fund management industry, unlike the banking industry, for instance, specialises in financial intermediation service without a corresponding involvement in the creation of money or in the provision of payment services and with little or no asset-liability mismatches.[14] Therefore, the promotion of the fund management industry and non-bank FIs has the added advantage of reducing the exposure of the economy to macroeconomic and systemic risk.

Reducing Systemic Risk Fallouts of Banking Industry : How & Why ? : If reliance on banks can be reduced and that on fund managers and non-bank FIs increased, then the systemic risk banks pose from their involvement in the payment function can be controlled further by requiring them to engage

[13] So far the fixing of the rate has not caused any problem, thanks to the reversal in the fortunes of the USD in the currency markets. We cannot be lucky always, especially if we upvalue the currency in line with market trends. The risk may come from the USD5 to 10 billion of portfolio funds which are waiting to exit but which are presently locked up until September 1, 1999 or from the USD10 billion short-term loans that may have to be repaid over the next year or so. To avoid an unexpected calamity, it is preferable to let the value of the RM to be determined by the marketplace, one which has been made tame by capital controls.

[14] For a fund manager to run a position on interest or exchange rates, it has to have the prior approval of its clients. In this case, the risk is for the client's account.

in less risky lending and investment activities. For instance, by limiting their exposure to property and share financing (as well as to lending which are based mostly on collaterals and not on cashflows), the exposure of these banks to the boom-bust cycles of the property and share markets can be reduced.

It is also preferable for banks specialising in the provision of payment services not to engage in underwriting, trading and market making activities, as these institutions will then be exposed both to credit as well as market risk. In Malaysia, this means that the increasing role of banking groups in underwriting and brokerage business, (which is in any case a new phenomena), must be reversed or controlled by prescribing very safe limits on the risk capital required for carrying out such businesses.[15]

The case for certain banks such as commercial banks to provide the payment service on a specialised basis with a restriction on the type of activities these banks can engage in is also dictated by the constraints there are in Malaysia with respect to the supply of manpower and on hiring. Universal banking is more complex to manage and supervise. Given the manpower and hiring constraints faced by the regulated and the regulator, to minimise systemic risk and costly mistakes, a policy of requiring certain banks to specialise in the payment function may represent the least cost and low-risk approach.

Scenario Under Open Competition : If the banking sector can, however, be opened up to competition by the best players in the world, then a case can certainly be made for the continued promotion of the universal banking model, especially given the emerging body of literature which point to the dominance of economies of scale and economies of scope in the financial services industry. This approach is in fact the first-best solution. Reliance on the best and on markets to discipline the shareholders and depositors, as well as a firm commitment to transparency through the pursuit of international best practices in accounting, audit and financial reporting, will ensure efficiency as well as minimise the problem of systemic risk.

Costs & Benefits of Open & Restricted Competition : A policy of not favouring local banks vis-a-vis foreign banks will not affect the growth prospects and the wellbeing of Malaysians as amply demonstrated by the experience of Hong Kong whose banking industry is dominated by foreign players. And the opening up of the financial services industry to competition do not signal the demise of local banks as demonstrated by the Australian experience where the local banks are now more competitive, global and have continued to dominate the domestic banking industry in spite of the entry of the world's top banks into the Australian market after the liberalisation of the financial sector in the early 80s.

The current arrangement in many Asian countries represent the worst of all worlds as the over-protection and over-regulation of the banking industry imposes a higher cost on the more dynamic goods sector. The indiscriminate policy of rescuing all financial institutions in trouble to avoid systemic risk increases the burden on tax payers and the goods sector further.

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[15]In this connection, it is interesting to point out here the peculiar position of discount houses (DHs) in Malaysia currently. Traditionally, DHs act as providers of liquidity to the banking system by discounting riskless or near riskless papers (so long as the banks had such papers in their inventory). To support them in this role the DHs were allowed to take call money from banks which qualified as liquid assets and to ensure their undoubted credit standing they were in turn allowed only to invest in riskless or near riskless papers. However, in Malaysia for reasons too numerous to enumerate here, (including the blurring of distinction between primary and secondary liquid assets), the DHs have been allowed from the early 90s to underwrite, invest, trade and make a market in private debt securities. To facilitate this they are the only FIs which are exempted from holding statutory reserves with BNM at zero interest against their deposit liabilities. In spite of the dramatic increase in their risk profile, the capital adequacy requirement of DHs is geared only to deal with credit risk and not market risk. To complicate matters further, their financial reporting is lean on disclosures unlike the requirements for other licensed financial institutions in Malaysia.

Requirements for Balanced Development of Financial Sector & Markets : The balanced development of the financial services industry, including that of fund management, will require the liberalisation and deregulation of financial markets so that traders will be able to hedge, take position or make markets without restrictions (except for rules which are generally accepted) and without incurring high transaction cost.

Required Approach to Investment Management : The whole approach to investment management must also change, as in the West, from one based on the practice of holding-to-maturity one's investments to one based on marking-to-market (with the associated requirement for changes in accounting rules and financial reporting). This change in approach to investment management will require more liquid markets and more risk management products to minimise transaction costs and to hedge against contingencies. The decline in family ownership and control as well as the simultaneous increase in the spread of share ownership, combined with the rapid growth of the fund management industry, has dictated the need for transparency and the practice of marking-to-market.

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THE WORLD ECONOMIC OUTLOOK AND IMPLICATIONS FOR MALAYSIA

by

Kanitta M Meesook

Malaysian Institute of Economic Research

Institut Penyelidikan Ekonomi Malaysia

MALAYSIAN INSTITUTE OF ECONOMIC RESEARCH
NATIONAL ECONOMIC OUTLOOK CONFERENCE
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The World Economic Outlook and Implications for Malaysia
presented by
Kanitta M. Meesook[1]

The world economy is experiencing one of its most volatile and challenging periods in this century. Global financial markets have seen unprecedented turbulence, and investor confidence has been shaken not only in emerging markets, but also in advanced economies. Japan, the region's largest and the world's second largest economy, continues to be weighed down by overcapacity and a mountain of bad bank debt. As a small, open economy that has thrived on international trade and investment over the past decade, Malaysia inevitably has been impacted by the regional turmoil and worsening global outlook. Looking ahead, the world economy and global financial markets will continue to define some of the key policy challenges for Malaysia.

This paper has four objectives. First, it provides an overview of the IMF World Economic Outlook (WEO). Second, it identifies key risks to the baseline WEO scenario. Third, the potential impact of these risks on the Malaysian economy and their implications for macro-economic policy are discussed. Here, the objective is to evaluate the capacity of the current policy arrangements, and the exchange rate regime in particular, to absorb external financial and demand shocks. Specifically, does the peg to the dollar deliver the intended insulation from external shocks? Finally, the current macroeconomic policy mix and structural reform strategy in Malaysia are assessed.

The Asian financial crisis has raised profound questions on the efficiency of markets, the behavior of domestic and foreign investors, and the design of reform programs. A detailed treatment of these topics is beyond the scope of this paper, but some comments will be offered.

The principal conclusions of the paper include:

- At this stage, the risks to the baseline WEO projections appear to be predominantly on the downside.
- The principal risks to the world economy stem from Japan and the United States. The persistence of recessionary conditions in Japan or a greater-than-anticipated slowdown

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[1]Division Chief, Asia and Pacific Department, International Monetary Fund. This paper was prepared by Cem Karacadag and Scott Roger, with assistance from Kalpana Kochhar and Dimitri Tzanninis, all from the Asia and Pacific Department of the International Monetary Fund.

in the U S would reduce demand for Malaysian exports and exert downward pressure on world commodity and manufacturing prices. Apart from lower export demand, the principal risk to developing economies is that global capital markets may remain inaccessible through next year, removing a key source of financing for fiscal stimulus packages, bank recapitalization, and investment more generally.

- Malaysia's current monetary and exchange arrangements better insulate the economy from short-term financial market volatility, but could magnify the impact on the domestic economy of adverse developments in Malaysia's export markets.

- The sustainability of the fixed exchange rate regime could be threatened by either a strong rebound in domestic demand, a significant weakening of external demand, or both.

- Capital controls cannot support indefinitely a pegged exchange rate if there are fundamental inconsistencies in domestic policy objectives.

- The sustainability of the economic recovery through the medium term depends heavily on financial and corporate sector restructuring. Corporate debt restructuring is essential to lowering the high credit risk and improving the cost structure of existing businesses which, in turn, must underlie a sustainable recovery in investment.

- The mode of monetary easing pursued in Malaysia could hinder the process of financial and corporate sector reform.

I. OVERVIEW OF THE WORLD ECONOMIC OUTLOOK[2]

The world economy is projected to expand by 2 percent in 1998, only one-half the growth rate registered in 1996 and 1997, mainly on account of the downturn in Japan, and the rest of Asia. In 1999, world output is projected to grow by 2.5 percent, but the pick-up envisaged is predicated on several important assumptions (Table 1).

- Japanese output is expected to grow by 0.5 percent, following a 2.5 percent contraction in 1998. The projected recovery in 1999 assumes the effective restructuring of the troubled financial sector, a resumption of financial intermediation, and implementation of a fiscal stimulus.

- The U.S. economy is projected to achieve a "soft landing" without falling into recession, by expanding at a rate of 2 percent in 1999. Similarly, the European Union

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[2]The discussion below is based on the *World Economic Outlook*, October 1998, IMF. It is expected that a revised WEO will be discussed by the Executive Board of the IMF in December 1998 and published shortly thereafter.

economies will continue to grow, with output slated to rise 2.5 percent in 1999, down slightly from 1998. In the Asian crisis economies, output is expected to stabilize after large contractions in 1998.

- Oil prices are projected to rise by 9 percent in 1999, following a 31 percent fall in 1998, while other commodity and manufactured goods prices show little change from their levels in 1998.

- A key assumption with respect to developing countries is that interest spreads in international markets will gradually decline from their current prohibitively high levels, permitting access to external borrowing for the financing of fiscal stimulus packages and the recapitalization of banks.

Table 1. World Economic Outlook: Baseline Global Projections
(Percent change unless stated otherwise)

Parameter/Country	1998	1999	Assumptions
Output			**Japan**: fiscal stimulus implemented; bank restructuring undertaken.
World Output	2.0	2.5	US: "Soft-landing" without recession.
United States	3.5	2.0	**Europe**: Ongoing recovery to be sustained.
Japan	-2.5	0.5	**Asia**: Financial market confidence in Asia gradually returns.
European Union	2.9	2.5	
Asia NIEs*	-2.9	0.7	
ASEAN-4	-10.4	-0.1	
Trade Volume			
Advanced Economies			
Exports	4.5	4.7	
Imports	3.6	4.2	
Export Prices			Moderate recovery of oil prices and stabilization of non-fuel commodity prices.
Oil	-31.1	9.3	
Non-Fuel	-13.9	0.4	
Palm Oil			
EUV of Manufac.	-3.9	0.5	
Interest Rates			**Emerging markets**: Recovery of confidence and gradual decline in spreads.
Emerg Mar Spreads	>1000	<1000	
Libor on U.S.$	5.7	5.7	
Libor on Japanese ¥	0.7	0.6	
MYS Trading Partners			
Real GDP	0.8	2.2	
Real Imports (ex oil)	-1.6	4.8	

*Hong Kong, Korea, Singapore, and Taiwan Province of China

II. Risks to the Outlook

As with any set of projections, the baseline scenario in the WEO is surrounded by a variety of risks and uncertainties. At this stage, most of the risks appear to be on the downside.

External demand. In **Japan**, ongoing deflationary pressures, weak consumer, and investment demand persist, and the recent tankan business survey has confirmed an underlying weakness in business sentiment. Moreover, the yen's recent appreciation suggests the possibility that external demand may also erode. Thus, although the Fall WEO had projected a modest recovery of activity in 1999, the private sector consensus now assumes a further contraction of the Japanese economy in 1999 (Table 2), and the downside risks remain significant. These developments highlight the importance of ensuring a further significant fiscal stimulus in the coming year, in order to support domestic demand. On the structural front, there has been encouraging progress, with the recent passage of important bank reform legislation. Nonetheless, key details of how this framework will be implemented remain unclear, and it will be important to ensure that decisive action is taken to promote the recapitalization of the core banking system in a manner that promotes restructuring and strengthens confidence.

Table 2. World and Regional Growth Outlook: IMF and Consensus Compared

(Percent change)

Country/Region	WEO		CONSENSUS*	
	1998	1999	1998	1999
United States	3.5	2.0	3.4	2.0
Japan	-2.5	0.5	-2.5	-0.2
European Union	2.9	2.5	2.8	2.3
Asia NIEs*	-2.9	0.7	-2.4	0.9
ASEAN-4	-10.4	-0.1	-10.9	-1.9
Malaysia	-6.4	-1.5	-4.8	-0.3

*Consensus forecasts as of October 12, 1998.

**Hong Kong, Korea, Singapore, and Taiwan Province of China.

In the **United States**, expectations point to a "soft landing" in 1999, with the pace of economic growth moderating to 2 percent. However, there are several downside risks to consider. First, the stock market correction could slow the momentum behind consumer confidence and spending that have underpinned buoyant growth through the third quarter of 1998. Second, net exports could become a bigger drag on the economy as import demand in major emerging market economies fall. Third, uncertainties in the financial markets could create stress in certain segments of the corporate and financial sector. These risks combined could cause a greater-than-anticipated economic slowdown. However, a recession is unlikely, given rising real wages, historically low levels of inflation and interest rates, and the Federal Reserve's readiness to ease monetary policy further if global financial volatility resumes.

Export prices. Softer world demand and other supply side factors pose significant risks to commodity and export prices for developing countries. First, the projected stabilization of commodity prices predicated on relatively robust world demand may be overly optimistic. Oil prices may not rebound, especially if some fiscally strapped oil producers raise their oil production. Second, as many emerging market economies endeavor to export their way out of recession, prices of manufactured exports could decline further, rather than stabilize. Keen competition in the electronics and electrical equipment sectors throughout Asia could exert substantial downward pressure in prices in these sectors. The Malaysian economy is even more exposed to these risks than are other countries in the region.

Capital market access. Since mid-1998, spreads on emerging market debt have more than doubled, with spreads now over one thousand basis points. The envisaged decline in spreads in the WEO to levels prevailing in mid-1998, however, appears increasingly unlikely. Having suffered large losses in emerging markets over the past two years, foreign portfolio investors are reluctant to assume emerging market risk, despite the rich compensation offered by high yields. The depth of investor pessimism and conservatism is affecting not only emerging market borrowers, b· also br rowers in advanced economies, where a flight to quality has been evident. These trends, combined with tightening credit conditions in the U.S., prompted the Federal Reserve to cut interest rates twice, with further monetary easing still possible.

But lower interest rates in the U.S. and Europe will not necessarily translate into greater capital flows to emerging markets, at least not for all of them. Besides the current "bias" against emerging markets, fundamental risk factors are also deterring investors. The policy challenges for most developing economies, but particularly the crisis economies, are profound, and prospects for recovery still uncertain. With the economic recessions causing severe social dislocations, perceived political and financial risks will remain high until incipient economic recoveries become more evident and political pressures subside. As a result, access to international capital markets and the associated costs could remain prohibitive for some time.

Global currency instability. The relative calm achieved in the currency markets of late is far from secure and could be disturbed by a number of factors. Setbacks in Japan's reform efforts could trigger another round of downward pressure on the yen and, along with it, on the rest of Asia's floating currencies. In addition, unanticipated events in the crisis economies could reignite currency volatility. A devaluation of the Chinese yuan or abandonment of the Hong Kong dollar's peg to the U.S. dollar, in particular, would have immense negative impact on financial stability in the region. However, the recent appreciation of the yen has lowered the risk of potential downward pressure on the regional currencies for the time being and, if sustained, bodes well for currency stability in the region.

III. MALAYSIA'S EXPOSURE TO SHOCKS

The Malaysian economy is much more open to trade than most economies. Even by regional standards, Malaysia's trade orientation is exceptional. The export-to-GDP ratio is almost

100 percent, more than double the levels in Korea, the Philippines, and Thailand (Table 3). Such openness has provided the basis for much of Malaysia's prosperity, but it also makes the economy more vulnerable to world economic developments than most other economies.

Table 3. Selected Asian Economies: Economic Openness

Country	Export-to-GDP (percent), 1997
Malaysia	95
Indonesia	30
Korea	38
Philippines	40
Thailand	47

Moreover, Malaysia's exports are concentrated in electronics and electrical equipment, which account for 50 percent of merchandise exports (Table 4). How will various external developments be transmitted through the economy and how will their transmission differ from Malaysia's neighbors, which maintain floating exchange rates and open capital accounts?

Table 4. Malaysia: Direction and Composition of Exports
(Percent)

Direction of Exports	Share of Total Exports (1997)	Composition of Exports	Share of Total Exports (1997)
United States	18.6	Semiconductors	18.4
Japan	14.4	Electron Equip & Parts	18.1
EU	12.6	Consumer Electronics	8.0
		Industrial Elec. Prods.	5.4
Singapore	20.0	Textiles & Clothing	3.4
Hong Kong	5.5	Chemical Products	3.7
Taiwan	4.4	Palm Oil	4.9
Korea	3.2	Crude Oil	3.2

External demand. Consider the scenario where world economic activity is weaker than envisioned in our central scenario. Weaker world activity would dampen demand for Malaysian exports, and by potentially considerable amounts. Based on elasticities derived in Ito et al (1996), for every one percent less output in Malaysia's major trading partners, other things being equal, merchandise exports could decline by almost $1 billion.

An even greater source of external vulnerability is a potential drop in **export prices**, especially in the electronics and electrical goods sectors. For every 5 percent decline in the average price of electronics and electrical goods exports, the nominal value of Malaysia's exports could fall by almost $2 billion, nearly one-half the projected current account surplus in 1999. Admittedly,

if the fall in prices is driven by lower demand, rather than higher supplies, Malaysia then would face weaker import prices as well, partially offsetting the adverse effect on exports. Nevertheless, prices of tradables would fall relative to nontradables prices, causing consumers and businesses to switch spending toward imports, dampening GDP growth, and worsening the current account balance

Malaysia's currently strong current account surplus position and foreign exchange reserves provide a cushion, but a limited one. The combination of a weaker world economy and softer export prices could threaten balance of payments viability. Even if Malaysia's external liquidity remains sound, lower output growth would become inevitable in the absence of countervailing policies. Given the fixed exchange rate regime and controls on capital outflows, Malaysia's policy options, in principle, would include countercyclical monetary and fiscal policy.

Under present circumstances, however, Malaysia lacks leeway on monetary and fiscal policy. Fiscal policy is constrained by the absence of noninflationary sources of deficit financing, while monetary policy already is stretched to the limit with real interest rates barely positive and the need to improve loan quality. Malaysia thus has few policy options to offset a potential drop in foreign demand. Even if there was room for stimulating domestic demand, any added fiscal or monetary stimulus would be circumscribed by the external financing constraint. Demand management policies that are inconsistent with external balance would run the risk of precipitating a financial crisis and either a collapse of the exchange rate peg or a U-turn in monetary and fiscal policy, or both.

The scope for policy conflict would be mitigated if a more flexible exchange rate regime were in place as in other regional economies. Then, weaker export demand would put downward pressure on the ringgit which, in turn, would help sustain exports and redirect spending from imports to domestic goods. Both effects would cushion the impact of weaker world activity on Malaysia's economic performance. Therefore, Malaysia would need to consider how to modify its current exchange rate arrangements if external developments brought internal and external balance objectives into conflict, especially in the event of a weaker global economy that proves to be enduring.

Capital market access. Another challenge to Malaysia's external position stems from the capital account of the balance of payments. The persistence of cross-border lender and investor bearishness would challenge Malaysia, given that a considerable portion of the public sector borrowing requirement is slated to be financed from abroad, including market sources.

Moreover, even if investors regain their appetite for risk, they are sure to be selective in where they choose to invest, and on this score, Malaysia could be at a disadvantage. Successive policy reversals, incomplete policy statements, and above all, capital controls have shattered foreign investor confidence, and could deter foreign lending and portfolio investment in Malaysia for some time, regardless of external financial conditions. Sweeping changes at the highest level of political and technocratic leadership also have contributed to perceptions of policy

unpredictability and high country risk Therefore, the international capital markets may remain effectively closed to Malaysia through 1999 In the absence of external financing, the envisaged fiscal stimulus and bank recapitalization could be in jeopardy

Given the damage done to investor confidence, regaining access to global capital market requires rebuilding Malaysia's traditional reputation for policy continuity and predictability through the consistent and transparent implementation of structural reforms In the meantime, prospects for bilateral and multilateral official financing remain uncertain, given mixed signals on structural reforms and the possible indiscriminate use of public funds to support corporate and financial institutions alike.

Concerns over the fragility of the financial system could cause foreign credit lines to be withdrawn even further, especially if financial market volatility resumes. Furthermore, the traditionally high level of foreign direct investment in Malaysia is most likely to drop in the near term, and possibly to negligible levels. The combination of current and capital account shocks at once under the currently rigid exchange arrangements would risk a rapid depletion of Malaysia's reserves and, once again, force a reassessment of the exchange rate peg.

Global currency instability. Potentially sharp swings in the U.S. dollar-Japanese yen exchange rate would affect Malaysia's external competitive position in a way that would not occur under a more flexible exchange rate regime. The impact on the Malaysian economy from large movements in the dollar would depend not only on the direction and magnitude of the movement, but also on the cause of the movement. For example, if the dollar weakened in response to lower U.S. interest rates, then the fall in the ringgit effective exchange rate would offset potentially weak export demand for Malaysia's trading partners. By contrast, if the dollar strengthened in response to a deterioration in Japan's economic prospects, the real appreciation of the ringgit would exacerbate the impact of weaker regional demand on exports and growth.

Clearly, the discussion on negative external financial and economic shocks suggests that the fixed exchange rate regime should be modified in the event of an enduring shock. The authorities have indicated that the exchange rate peg would be reviewed in response to significant changes in the global economic and financial environment. But to avoid making such changes under crisis conditions will require close vigilance of balance of payments trends and anticipation of potential currency pressures before they actually occur. In practice, however, experience has shown that speculative attacks and currency rises are extremely difficult to predict, underscoring the importance of retaining policy flexibility.

IV. Macroeconomic Policy Mix and Structural Reform Strategy

Understandably, the economic policy agenda accords the highest priority to cushioning the effects of the ongoing economic recession and generating a swift recovery. Attaining these objectives, however, requires an examination of an alternative macroeconomic policy mix and structural reform strategy than currently in place. Even in the absence of external shocks, some

elements of the current policy framework could hamper, rather than expedite, the achievement of a sustained economic turnaround.

Macroeconomic policies. Macroeconomic policy has to ensure that the mix of fiscal and monetary policies is consistent with a fixed exchange rate and exchange controls. On **fiscal policy**, the expected widening of the federal government budget deficit to almost 6 percent of GDP in the 1999 budget appropriately allows the working of automatic stabilizers on the revenue side. Similarly, the envisaged fiscal stimulus through off-budget discretionary spending—if undertaken transparently—is also appropriate. Of concern, however, is the magnitude of the public sector borrowing needs, including bank recapitalization requirements, for which noninflationary financing sources have yet to be identified (Table 5). Moreover, details of the amount and types of off-budget spending remain unclear. Indeed, while providing government assistance to distressed companies and financial institutions may be called for, given the severity of the regional crisis, an indiscriminate use of public resources is not. Therefore, a clear reform strategy that prioritizes how public funds are deployed is essential. Otherwise, the government risks spending public monies where it is less needed, if not wasted, at the expense of where it is needed the most.

Table 5. Malaysia: Public Sector Financing Requirements, Sources, and Risks

Public Sector Financing Needs and Sources	1999 *Percent of GDP*	Risks
Total Financing Requirement	27.0	1. Possible revenue shortfalls.
Consolidated Public Sector Balance	15.0	
Of which: Federal Government Balance	16.1	
Infrastructure Fund 1/	5.0	2. Financial system recapitalization requirements may exceed expectations.
Danaharta 2/	5.0	
Of which: Budget Allocation	3.0	
Danamodal 3/	5.0	
		3. The expected surplus in public enterprise accounts may fail to materialize.
Potential Financing Sources		
Domestic		
Employees Provident Fund 3/	10.0	
Khazanah Bonds, MGS, etc. 3/	7.0	
External	?	
Non-Market	?	
Market	?	

Source: Economic Report 1998/99, Ministry of Finance.

1/ Assuming the government's infrastructure spending program in 1999 is broadly similar to the one announced for 1998.

2/ Danaharta's total funding need of RM 15 billion is assumed to be equally distributed over 1998–2000.

3/ By assumption.

The recent **monetary policy** relaxation aims to stimulate credit growth and spending, but is likely to have only limited success in view of the collapse of investment spending and of demand for credit. Indeed, high interest rates were not the cause—and therefore low interest rates are not necessarily the solution—to the current economic conundrum. The principal source of financial stress in the private sector, in fact, stems from demand side factors, not supply side ones. The precipitous drop of sales and thus cash inflows for most corporates render any level of debt difficult to service regardless of interest cost.

In addition, the mode of monetary easing, including quantitative credit growth targets, runs the risk of throwing good money after bad and burdening the financial sector with additional loan losses. The cap on interest rate spreads, moreover, conflicts with the goal of stimulating credit growth. To the extent that banks cannot charge interest rates commensurate with the assumed credit risk, then the expected loss value of new loans would exceed their expected returns, creating a strong disincentive to lend. More fundamentally, like all prices of goods and services, the price of money must reflect its cost, including the risk of its potential loss. Like any supplier of a good or service in a market economy, if banks cannot charge the appropriate price for the good (i.e., money) they provide, they will be reluctant to lend. In the absence of real domestic or external demand, which are the sources of demand for credit in the first place, attempts to inject money to boost output will have limited success. In sum, aggressive monetary easing under the current circumstances amount to pushing on a string, and this may be reflected in recent data on credit trends that show the continued decline of the stock of outstanding loans.

Moreover, if the supply of money into the economy substantially exceeds demand, this would widen the wedge between foreign and domestic interest rates, and create incentives for domestic currency holders to convert their savings into other instrument and currencies.

In order for monetary policy to succeed in generating credit growth in support of an economic recovery, the embedded credit risk in the economy has to be reduced. This, in turn, requires both operational and debt restructuring within the corporate sector. Only after the business and financial profile of the corporate sector has improved and its credit risk lowered can the flow of credit resume. As such, highest priority must be accorded to financial sector and corporate sector restructuring.

Artificially low interest rates are also likely to impede the corporate restructuring effort, both operational and debt restructuring. Given the voluntary and informal nature of the London approach to debt restructuring adopted by the Corporate Debt Restructuring Committee, parties to this undertaking need sufficient incentive to negotiate and reach agreement. In this context, creditors must have the ability to price risk appropriately, especially as they agree to a more favorable maturity structure or partial write-off on a non-performing loan. Debtors, similarly, need to be given incentives to restructure obligations and improve cash flows by making the lack of action on either front prohibitively expensive.

On **capital controls**, measures taken have provided insulation from external financial market pressures. But such insulation comes at a price. First, although the capital controls are not aimed at preventing long-term foreign investment in Malaysia, the measures will deter overseas investment in Malaysia. In this context, introducing capital controls is quite different from maintaining existing controls, as the drastic change in regime catches investors off-guard, alters their operating assumptions, thereby magnifying the negative impact on their investment decisions.

Second, capital controls unavoidably give rise to distortions and inefficiencies that act as a drag on economic performance. When used to drive a wedge between yields on domestic and foreign assets, they distort the allocation of capital. The wedge between domestic and foreign currency yields, moreover, creates incentives for individuals to circumvent controls. Thus, controls are costly to administer and risk breeding corruption.

Indeed, while the motivation behind the exchange controls was to regain monetary policy independence, the experience of Korea and Thailand has shown that interest rates can be brought down over time amid an open capital account, so long as the unavoidable restructuring of the debt and operations progresses.

Structural reforms. Malaysia's initial strategy to preemptively address stress in the financial system and the swift establishment of a framework to restructure the sector have been impressive by any standard. However, the global financial turmoil, and unanticipated collapse in domestic demand and asset prices have overtaken the initial operating assumptions: the recession is much deeper; the stress in the financial sector much greater; and the task of striking a balance between macroeconomic and structural reform goals, and between social and economic objectives, is ever more daunting. Where does the reform effort stand now and how can it be improved?

- The three pillars of the restructuring framework, including Danaharta, Danamodal, and the CDRC, represent a solid foundation for undertaking reforms. The concerted manner in which the three institutions have begun to conduct their recapitalization, asset purchase, and debt restructuring operations is also critical and in conformity with best practices. Still missing, however, is an explicit enunciation of the end-goal envisaged once the reform effort is complete. Now that the finance companies have been consolidated, what is the vision for the commercial banking sector?

- Equally important, bank recapitalization with the use of public funds should be conditional on a commitment to a time bound operational restructuring program of beneficiary institutions. It is not clear that this cardinal principle has been applied in the recent recapitalization of some large financial institutions.

- Earlier in the year, the strong emphasis on stronger prudential guidelines, intensified supervision of financial institutions, and financial disclosure were laudable and had

favorably distinguished Malaysia from its regional neighbors. However, the recent reversal of important elements of these measures has been to the detriment of achieving a recovery. First, the loosening of prudential standards and disclosure requirements simply delays the recognition and revelation of existing losses in the financial system. In the absence of transparency and presence of uncertainty, domestic and foreign investors will assume the worst. Second, delaying the time frame for loss recognition lowers the incentives for financial institutions to maximize loan recoveries and minimize poor credit decisions in the future. With their creditors subject to regulatory forbearance, corporates have less incentive to remain current on their debt obligations and to improve their operations. Third, the policy reversals have sent the wrong signal to markets and fueled investors perceptions of policy unpredictability, a strong deterrent against foreign and domestic capital in all forms.

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In sum, the authorities' principal goals of averting further economic stress and achieving a rapid recovery are appropriate. In the pursuit of these objectives, however, it is critical that the macroeconomic policy stance remain flexible in order to cope with potential unanticipated external or internal developments. Finally, given that corporate and financial sector restructuring is a prerequisite for sustainable long-term growth, as well as securing a recovery in the near term, the highest priority must be accorded to structural reforms.

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ECONOMIC DEVELOPMENTS AND PROSPECTS FOR DEVELOPING COUNTRIES

by

Economic and Development Resource Centre (EDRC)
Asian Development Bank

Malaysian Institute of Economic Research
Institut Penyelidikan Ekonomi Malaysia

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ECONOMIC DEVELOPMENTS AND PROSPECTS FOR DEVELOPING ASIAN COUNTRIES[1]

The slowdown in Asian growth that began with the export deceleration of 1996 and worsened with the 1997 currency crisis turned into a widespread regional contraction in 1998. At –3.2 percent, growth in the developing economies of East and Southeast Asia (excluding China) was the lowest in the post-World War II period. Private capital flows to emerging Asia, which reached $110 billion in 1996, turned negative as foreign investors scrambled to move money out of supposedly risky markets. That forced central banks into monetary contractions, reducing domestic demand and exacerbating an already large bad debt problem. Although currencies stabilized near their depreciated end-1997 levels, export dollar receipts did not respond to the exchange rate stimulus as governments and investors had hoped.

In Asia, the richer and more open economies generally did worse during the year. Southeast Asia remained at the center of the crisis, with Indonesia suffering a huge contraction, and Thailand and Korea hit by substantial declines. Of the four newly industrialized economies, only Taipei, China weathered the storm with little damage, while Hong Kong, China and Singapore were unable to avoid the impact of the regional slowdown on their trade and financial services based economies. The

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[1] 1998: projection
1999: forecast

more protected economies of China and South Asia were less exposed to international capital flows and so did relatively better. Indeed, for the first time in the postwar period South Asia grew faster than any other subregion in Asia. Growth in the states of Central Asia slowed, while Pacific Island economies as a group grew faster than in the previous year.

Currency devaluations drove up inflation rates in several crisis-affected Asian countries. Across Asia, the average rate of consumer price inflation rose to 7.3 percent from 4.3 percent in 1997. The rupiah's sharp depreciation in late-1997 sparked high double digit inflation in Indonesia. More moderate depreciations in Korea, Singapore, Malaysia, the Philippines, and Thailand also prompted increases in inflation. Elsewhere – notably in Hong Kong, China – monetary contractions implemented to defend the currency exerted deflationary pressures. Average inflation should moderate to about 5 percent in 1999 as the shock of the late-1997 depreciations dies out.

Current accounts improved throughout the region as capital flowed out. From a regional deficit of 1 percent of GDP, Asia's aggregate current account moved to an almost 2.3 percent of GDP surplus. Most of that improvement came from import reductions – as indicated above, overall exports failed to increase as expected. In some cases, elimination of credit lines to Asian exporters was to blame. On the basis of a conservative forecast of capital flows to emerging Asia, together with continued restrained import demand, the region's aggregate current account should remain in the black in 1999.

Weak banking systems contributed heavily to Asia's initial vulnerability to capital flow reversals. Although many of the worst-hit countries – including Thailand, Korea, and (to some extent) Indonesia – have instituted significant financial sector reforms since the crisis began, the ratio of non-performing loans to total lending continued to rise in 1998. And the 20-30 percent regional non-performing loan ratio represented an equivalent share of output, as financial leverage in Asian economies remained at about 100 percent of GDP. Affected countries have been hard-pressed to clear the wave of defaults prompted by currency and maturity mismatches, policy and "crony" lending, and weak prudential standards and financial supervision.

In the first round of responses to the crisis many countries adopted conventional strategies to reverse capital outflows – tightening monetary and fiscal policies, implementing financial and other structural reforms, and floating exchange rates. But the cost of austerity has caused some to rethink those strategies. In September Malaysia imposed controls on the withdrawal of capital from the country, and fixed its exchange rate at 3.8 ringgit to the U.S. dollar. China and Vietnam also tightened existing exchange controls. Hong Kong, China's Monetary Authority departed from its longstanding policy of not interfering with capital flows (unsterilized intervention) by buying billions of dollars in Hong Kong, China equities to keep the Hang Seng Index from dropping. As the crisis has continued unabated, some observers have moved away from conventional IMF prescriptions to recommend less austere, more interventionist, economic policies.

As is usually the case in hard times, the poor have suffered disproportionately from the Asian crisis. During the two decades of rapid growth that preceded the crisis, the average poverty rate in East (including China) and Southeast Asia fell from 60 percent to 26 percent[2], representing a huge increase in average living standards for the more than 1.6 billion people now living in the region. But since the crisis struck in mid-1997, unemployment, inflation, and reductions in social services have combined to reduce effective income drastically for tens of millions. Indonesia's poor have fared the worst, but lower income groups in Thailand, the Philippines, and elsewhere have also suffered greatly.

The Newly Industrialized Economies. The crisis engulfed emerging Asia's richest economies in 1998, spilling over to the financial centers of Hong Kong, China and Singapore. Steep drops in regional trade, tourism, and financial activity slowed both economies, and prompted Hong Kong, China's generally conservative monetary authority to intervene in the equity market. Korea took firm steps to pull its way out of the late-1997 financial chaos, causing the won to stabilize and then strengthen. Taipei, China reaped the benefits of a strong financial system, large stock of foreign reserves, and a flexible manufacturing sector in resisting the regional contagion.

[2] Change in poverty rate from 1975 to 1995, based on ADB population and World Bank poverty statistics. The World Bank uses a poverty line of $1 a day (1985 prices) for developing countries.

Aggregate growth for the NIE's was negative, and two of the four economies suffered recessions in 1998. Only Taipei, China managed substantial growth. Korea's recession turned out to be much worse than anticipated at the end of 1997 – annual output fell by 6-7 percent. GDP growth in Hong Kong, China was unexpectedly negative, while Singapore managed to post a barely positive growth rate for the year.

Reductions in export demand helped explain the contractions in Hong Kong, China, Korea and Singapore in 1998. In Hong Kong, China, and Korea outflows of foreign capital forced up domestic interest rates, reducing domestic demand. But investment increased in Taipei, China, due in part to privatization of some public utilities and expansion in the airline industry. The private sector accounted for all of Taiwan's investment growth – about 20 percent over the previous year. A strong banking system made Taiwan more resistant than many of its neighbors to financial contagion.

Inflation in the NIE's rose in 1998, primarily because of price increases in Korea stemming from the won's steep depreciation. Hong Kong, China actually had lower inflation in 1998 than in the year before – largely due to the steep drop in asset prices. Although they continued to post the lowest price increases in the region, Singapore and Taipei, China experienced moderate upticks in inflation in 1998.

Export performance among the NIE's in 1998 was not encouraging. Weak demand from other crisis-affected Asian economies was largely to blame. Weak

global demand for electronic products also hurt exports from the NIE's. But currency depreciation and reduced domestic demand caused imports to fall even further, resulting in trade surpluses and pushing current accounts into the black.

Bad loans increased due to the impact of high interest rates on weak financial institutions, especially in Korea. The two regional financial centers saw massive stock market swings, with Hong Kong, China's Hang Seng Index and the Singapore Straits Times Index dropping by more than 30 percent and 40 percent, respectively, in 1998. Financial links to affected countries were key to those stock market drops. As an example, Singapore's four largest local banks had loan exposure as high as $35 billion to the ASEAN-4 (Malaysia, Indonesia, Thailand, and the Philippines) before the crisis.

Attempting to stimulate their economies, Taiwan, Singapore, Hong Kong, China, and Korea resorted to monetary and fiscal expansions. Korea reduced its key discount rate and accelerated disbursement of funds from its supplementary budget in late August 1998. Korea also announced a plan to provide as much as 15 percent of GDP for bank rehabilitation. Singapore unveiled an economic stimulus package that included a property tax rebate and the expansion of credit to smaller businesses. On top of conventional fiscal expansion achieved through increasing expenditures on infrastructure, Hong Kong, China's government took the more drastic step of purchasing about $15 billion in domestic equities in an attempt to bolster the Hang Seng Index. So far these actions have yielded limited results.

The outlook for the NIE's in 1999 will continue to be strongly affected by world capital flows. A recovery in the Japanese economy and a stronger yen would help stimulate recovery in this group of economies. The web of close trade and investment ties in the region also makes recovery in the newly industrialized countries partly dependent on Southeast Asia. For 1999, Korea and Hong Kong, China are projected to contract further at the rates of 1 percent and 2 percent, respectively. Singapore should recover some of its momentum and post 1 percent GDP growth, while growth in Taipei, China is projected to remain stable at a bit more than 5 percent in 1999.

If exchange rates stabilize as expected in 1999, inflation in the region should drop. Inflation in Hong Kong, China, Singapore and Taiwan is projected at less than 3 percent. Korean inflation will be about 5 percent. Current account balances should remain in the black in 1999 given continued expectations of low growth.

The PRC and Mongolia. China's growth slowed in 1998, largely due to a drop in foreign export demand. But China still did substantially better than most of its neighbors. Domestic investment demand remained strong, as China's exchange restrictions allowed the PRC to resist the high domestic interest rates forced on many other Asian countries by world capital flows. Domestic consumption grew more slowly than in previous years. Government spending stayed under control, with the consolidated budget deficit remaining close to balance.

Foreign investment fell but domestic savings remained near 40 percent of GDP, providing China with adequate investment capital to maintain positive growth. China made limited progress on its structural reform agenda in 1998, with few privatizations of state-owned enterprises or deregulation initiatives. There was some financial liberalization in 1998. The central bank also expanded its supervision role and encouraged state-owned banks to write off bad debts – which may amount to 20 percent of total domestic loans outstanding. The Asian crisis gave China little incentive to reduce trade barriers or eliminate its still-extensive exchange restrictions.

Export growth, which averaged 20 percent over the last five years, registered a mere 2 percent increase in 1998. The slowdown reflected sharply lower demand from Japan and the rest of Asia. Although the drop in export demand reduced its trade surplus from the previous year, China still managed a surplus on the current account for the fifth consecutive year. Foreign direct investment inflows fell slightly, but at $38 billion were still second largest in the world – after the United States. China's capital controls helped save it from the large capital outflows experienced throughout Asia. That contributed to an increase in the reserve stock to $140 billion, also second largest in the world – after Japan.

Protection from free capital movement and the surplus on the current account gave the central bank freedom to hold the exchange rate fixed while reducing interest rates twice during the year. That successful defense of the yuan in the midst of sharp regional depreciations earned praise from market participants and increased China's standing as an economic power. The central bank also slashed reserve

requirements from 13 to 8 percent of deposits. Despite the slightly expansionary monetary stance, inflation was dormant at zero percent as aggregate demand failed to keep pace with the growth of production capacity and the urban labor force. Government fiscal restraint partly explained the limited growth in domestic demand.

The outlook for China next year is positive with continued growth in the six percent range expected. Inflation will remain under control and the current account will strengthen. The combination of large reserves and still-stringent restrictions on foreign capital movements makes it unlikely that China will face a financial panic of the kind that struck many of its neighbors. Over the next few years, however, China will need to accelerate the pace of privatization and financial reform in order to maintain high growth rates.

Mongolia's GDP grew strongly in 1998, despite lower international prices for the country's two main exports – copper and cashmere. The lower export receipts affected government revenues, leading to a budget deficit exceeding 10 percent of GDP. An inflation rate of 15 percent would have been worse had it not been for the central bank's tight monetary stance. Economic reform has proceeded swiftly since 1991 as the government has slashed trade protection and strengthened macroeconomic management, but Mongolia still needs to privatize several state-owned enterprises and strengthen its financial sector. Growth in 1999 is expected to remain relatively strong.

The Central Asian Republics. Aggregate growth in the four Central Asian member countries of the ADB slowed in 1998. Progress on macroeconomic stabilization, structural reform, and better cotton and wheat harvests boosted Tajikistan's growth, despite the impact of a long-running civil war. Growth in Kazakstan dropped off from the previous year, hurt by the drop in Russian demand stemming from the financial crisis in that country. Growth also slowed in Uzbekistan as the depreciation of the Russian ruble lowered world prices of the main Uzbek exports – gold and other non-ferrous metals. A decline in export revenues also reduced growth in the Kyrgyz Republic. In 1998, Tajikistan and Turkmenistan became the newest Central Asian Republics to join the Asian Development Bank.

Tighter monetary policies in all four Central Asian Republics helped bring down inflation from high double digit levels to 10-20 percent (except for Tajikistan, where 1998 inflation was still above 50 percent). But all the Central Asian republics with the exception of Kyrgyz Republic suffered from rising budget deficits. The Kyrgyz Republic managed a fiscal contraction through vigorous implementation of tax and budget reforms.

In the difficult transition from centrally planned to market economies, Kazakstan and Kyrgyz Republic have made significant progress in privatization, agrarian reform, governance, and banking reform. Uzbekistan and Tajikistan still face difficulties in restructuring and privatizing enterprises and reforming financial institutions. But all of these nations will need further progress on structural reform and macroeconomic stabilization in order to sustain growth at 1998 levels. All will

need some relief from external shocks as well, as economic ties left over from the former Soviet Union make this group highly dependent on events in Russia.

The Southeast Asian Economies. Southeast Asia's economies remained at the vortex of the Asian financial crisis in 1998. Civil unrest and an unexpected change of government in Indonesia heightened the sense of instability as the subregion's largest country struggled to regain its economic footing. First to be struck by speculative attack in 1997, Thailand moved decisively to reverse capital outflows in 1998 through financial and other structural reforms. Malaysia chose a different path, shutting down capital flows and expanding the government's economic role in an attempt to shield the domestic economy from the volatility of international capital flows. Having participated less in the economic boom than its subregional neighbors, the Philippines got a proportionately lower dose of contagion, while the countries of Indochina were even less affected but did suffer export demand shocks.

After 4 percent growth in 1997, the region contracted by about 7 percent, underperforming even the most pessimistic expectations for the year. Over 30 billion dollars fled Indonesia, Malaysia, Thailand and the Philippines in 1997 and 1998. Indonesia continued to bear the brunt of the crisis as exports and investment collapsed, reducing output by more than 15 percent. Thailand implemented a series of financial reforms but still suffered a 7 percent contraction. Malaysia at first appeared to avoid the worst effects of the crisis, but capital outflows late in the year brought growth down to –6 percent. Arguing that it needed to be able to lower

interest rates without spurring another round of capital flight Malaysia's government imposed exchange controls in September that limited investors' rights to redeem domestic instruments for foreign currency.

In the Philippines tight monetary policy to defend the peso constrained investment demand, while poor agricultural performance limited supply growth. But the Philippines relatively low level of financial leverage (about 60 percent of GDP) and continued strong export demand helped save it from some of the worst effects of the crisis. Growth in Laos and Vietnam slowed slightly from the previous year, as Laos was hurt by the baht's depreciation and dropoff in Thai investment, and Vietnamese growth suffered from a dropoff in foreign direct investment from the NIE's. Cambodian growth picked up as fighting in the countryside diminished.

Inflation in 1998 increased fivefold from the previous year, driven by currency devaluations and, in some cases, food price increases arising from the impact of the El Nino drought. Indonesia -- stricken by shortages of basic products and import price increases – contributed most to the regional price index increase. Fiscal constraints limited the ability of governments to cushion the effects of depreciation, resulting in higher food, gas, and electricity prices.

Exchange rate stabilization remained a major economic objective for Southeast Asian countries in 1998. The Indonesian rupiah, Malaysian ringgit, Philippine peso and Thai baht all dropped to their lowest levels during the first half of 1998. Those currencies recovered much lost ground by the end of the year but

remained volatile. The crisis also prompted two moderate devaluations of the Vietnamese dong, and devaluations in Laos and Cambodia.

The situation of the corporate and banking sectors continued to deteriorate, particularly in Malaysia and Indonesia. Non-performing loans rose and more financial institutions found themselves insolvent. At the end of 1998 Indonesia had the highest level of nonperfoming loans in the ASEAN-4 at 35 percent of loans outstanding or more, followed by Thailand at upwards of 30 percent, Malaysia at 25 percent, and the Philippines at 10 percent or more[3].

In some cases, tight monetary policy exacerbated loan default problems. Short-term interest rates in Indonesia rose as high as 60 percent, forcing bank and corporate defaults. In Malaysia, the central bank's policy of limiting domestic credit expansion to 12-15 percent resulted in a complete lending freeze by several domestic banks. In the face of widespread defaults Thailand also tightened monetary policy.

The crisis created a dilemma for the monetary authorities in the region. Defending the currency required maintaining relatively high interest rates, but that worsened the financial condition of banks and firms. Through the end of the year Indonesia held to high interest rates, while Malaysia and Thailand gradually lowered their key rates, albeit for different reasons. Malaysia's currency controls allowed the central bank to lower rates without prompting further attacks on the currency.

[3] Source: IMF International Capital Markets, September 1998 (p. 37).

Thailand on the other hand gained some breathing space from investors through its vigorous application of financial and structural reforms. Vietnam also tightened its already stringent capital restrictions, requiring certain companies to convert 80 percent of their foreign exchange holdings into domestic currency.

The social cost of the crisis in Southeast Asia has been substantial. About 48 percent of Indonesia's population of over 200 million was estimated to be living in poverty in 1998, up from only 11 percent in 1996 (Indonesia's government determines the poverty line on the basis on minimum health and nutrition standards). Unemployment rates rose to 7 percent in Malaysia, 9 percent in Indonesia, 8 percent in Thailand, and 13 percent in the Philippines. Those figures represent an average increase of 4 percent from 1996[4]. Measures to mitigate the social impact of the crisis included creation of temporary jobs, provision of affordable education and training facilities, and free or subsidized distribution of basic goods. The large cost of these programs contributed to widening budget deficits in 1998.

The economic slowdown caused a significant import contraction, which bolstered current accounts throughout Southeast Asia. For the first time in a decade the aggregate current account for the region registered a surplus. While export revenues weakened as some creditors refused to roll over trade loans, export volumes started to pick up in the second quarter of 1998, possibly pointing the way to an export recovery.

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[4] Need to reconfirm this figure.

The outlook for 1999 depends on the fate of current reform initiatives and the mood of world capital markets. Restructuring and recapitalization of banks and firms will be high on the priority list. Even though fresh capital from several donor countries and multilateral institutions will be disbursed in 1999, the sharp reduction in the availability of private capital to the ASEAN-4 will keep the overall supply of foreign exchange to the region well below pre-crisis levels.

Among the ASEAN-4, countries that are likely to grow albeit at a modest rate in 1999 are the Philippines and Thailand. Indonesia will continue to perform the worst among the group. On the assumption that currencies will stabilize and aggregate demand will remain weak, inflation rates should drop. With the exception of Indonesia, Cambodia, and Laos, countries in the group will experience single-digit inflation. That lower domestic demand will bring continued improvement in the trade and current account balances in 1999.

South Asia. For the first time the fastest growing subregion in Asia, South Asia managed to evade the main impact of the Asian financial crisis. Indian growth was about the same as the previous year while Pakistan's economy grew by 5.4 percent in 1998. Damaged by the impact of massive flooding on agricultural and manufacturing output, Bangladesh's 5 percent growth was slightly lower than expected for the year. Sri Lanka managed a fairly robust 5.2 percent growth rate, down slightly from the previous year.

South Asian inflation was moderate in 1998. Inflation in India crept up slightly from 1997, driven by shortages of some agricultural goods. The decline in Pakistani reserves associated with test sanctions prompted a 20 percent depreciation of the Pakistani rupee. That drove prices up by more than 8 percent, despite the overall slowdown in economic activity. Aggravated by supply shocks, inflation in Bangladesh was about 5.5 percent – slightly above the levels of recent years. Reserve outflows associated with the test shock to South Asia prompted accelerated depreciation of the Sri Lanka rupee. That led to higher inflation.

Restrictions on trade finance lines imposed as part of the test sanctions reduced the amount of capital available to fund current account deficits in the region. Export growth slowed but imports grew very little as the fall in world oil prices reduced India's import bill for that commodity by 25 percent. India's current account deficit contracted to about 1 percent of GDP. With new reluctance from foreign lenders to provide financing, Pakistan had little choice but to reduce its current account deficit by half, to about 2 percent of GDP. Bangladesh – relatively unaffected by either nuclear test sanctions or the Asian crisis – continued to run a current account deficit of about 2 percent of GDP. Sri Lanka's current account deficit was 3.2 percent of GDP in 1998.

Pakistan's budget deficit expanded with the loss of aid flows that made up as much as 6 percent of government expenditures in previous years. That higher deficit

weakened market confidence in the country. Pakistan's high level of foreign debt ($33 billion dollars, or about 100 percent of GDP) and low foreign exchange reserves (about $1.3 billion) placed the country in continuous danger of default throughout 1998. The result was depreciation, stagflation, and the need to negotiate new loans from the IMF.

India also had a large budget deficit. Yet its more positive external position and conservative monetary policy have helped it increase reserves to the relatively comfortable level of $22 billion (about 15 percent of GDP). Despite a network of licensing rules and regulations that remains formidably comprehensive, India has made some progress in structural reform. That has given a supply-side boost to the economy.

Severe flooding struck most of Bangladesh in 1998, damaging rice production and reducing livestock herds. The flooding took out much of the country's infra-structure, destroying over 6,500 bridges and washing out 11,000 miles of roads. Food production in this largely agricultural country fell by about 10 percent as a result. Although the flooding had a strong adverse impact on the fiscal accounts, emergency loans from aid donors took up much of the slack.

Aggregate growth in South Asia next year is forecast at 5.1 percent, same as in 1998. In the short run, weather fluctuations, such as might be caused by the La Nina phenomenon, will have a large impact on actual growth results in South Asia. Over the longer run, growth in the subcontinent will depend on accelerated progress

in developing power and transportation infrastructure. Inflation will continue at the 1998 rate of 7.5 percent, assuming that governments do not resort to printing money to finance their large budget deficits. With continued slow growth and the reduction in world capital flows, current account deficits will remain low at 2.2 percent of GDP.

The Pacific Islands. Most Pacific Island countries were mired in slow growth even before the Asian financial crisis, and were not much affected by the crisis itself. But Papua New Guinea, the largest economy in the group, was an exception on both counts – it managed relatively strong growth despite falling commodity demand from Asia. Elsewhere in the Pacific, the Solomon Islands was hardest hit by the shock waves from Asia. Fiji, Nauru and Vanuatu felt moderate adverse effects. The remaining countries had limited direct exposure to Asia and so received little damage from the crisis.

Higher export revenues explained Papua New Guinea's strong growth following a recession the previous year. Those revenues reflected an increase in mineral output that more than compensated for falling commodity prices. Fiji maintained slightly positive growth in the face of increased competition from Asian exporters and a drop in world sugarcane demand. Vanuatu also managed slightly positive growth, despite civil unrest and a drop in foreign demand for beef and timber. Samoa, Tuvalu, and Kiribati all grew 2 to 3 percent. The Solomon Islands economy, which sends two-thirds of its exports to Asia, contracted by 10 percent. The economies of the Marshall Islands, Cook Islands, and Tonga also contracted.

In Papua New Guinea, a currency depreciation prompted by the Asian crisis and by the depreciation of the Australian dollar pushed inflation to 9 percent – a steep rise from the previous year. Currency depreciation also led to higher inflation in Fiji, while tight monetary policy kept Vanuatu inflation under control. Most Pacific Island nations continue to run large budget deficits. Accordingly, the outlook for the Pacific in 1999 depends heavily on progress in fiscal reform.

RISKS AND UNCERTAINTIES

The financial and exchange rate crisis remains the main source of uncertainty in Asia. While some currency and equity markets staged partial recoveries in 1998 and current accounts moved into the black, conditions continued to deteriorate in many areas of the real economy. For example, bad loan rates kept rising in 1998 as corporate failures exacerbated banking sector problems, even as many Asian countries initiated significant financial sector reforms. At the same time policymakers faced narrowed sets of alternatives. Many felt forced to choose between growth and stability.

The speed and unpredictability of the Asian crisis makes it difficult to forecast how long it will take for fresh portfolio capital and banking credit to begin flowing again to emerging markets. The danger of predicting a rapid recovery became clear in August, when Russia's devaluation and default prompted a new round of capital

flight and stock market drops around the world. International bond markets again demanded huge spreads for emerging market debt over "safe" issues, and bank credits contracted. As in 1997 shocks from the financial markets quickly spread to economies at large, as governments tightened their fiscal and monetary policies to constrict the capital outflows. As long as international capital markets remain shaky, developing countries in Asia and the world will appear vulnerable to investor panic, even when economic fundamentals are substantially sound.

That high level of uncertainty makes it difficult to forecast returns on investment, which means that Asian businesses will feel compelled to scale down investment plans for the foreseeable future. If firms now find themselves in a tight spot, Asian financial institutions are even worse off, with many carrying large and sometimes increasing bad debt loads on their books. Eager to avoid extending those bad debts, banks have tightened their lending standards. This newfound conservatism in the face of uncertainty, while arguably beneficial in the long run, is likely to restrain growth over the short and medium term, making it all the more difficult to predict just when overall Asian growth may turn the corner. And even when the recovery is established, it is not clear whether emerging Asia can ever return to the high single-digit average annual growth rates of the 1980's and early 1990's.

Financial markets in Asia itself are not the only source of uncertainty in the region. Integrated global capital markets transmit financial contagion almost instantaneously around the globe. Long distance trading relations make the impact

of a devaluation in one part of the developing world quickly felt elsewhere. Since the beginning of the crisis there have been times (such as the attack on the Hong Kong, China dollar in October 1997) when a selling round in Asia spread to other regions, and returned back to Asia in the form of new rounds of asset selling and capital withdrawal.

Brazil and Russia are two developing economies outside the Asian region with demonstrated potential to disrupt Asian markets. If, despite generous assistance from the International Monetary Fund, Brazil lost the battle to defend its currency, the impact on Asia would be considerable. Currency traders would take the shock to the world's ninth largest economy as an indication that virtually any fixed emerging market currency could be successfully attacked. Risk premia on emerging market debt would rise again and capital flows to developing countries would evaporate. On the other side of the world Russia's economic situation, exacerbated by banking sector insolvency, fiscal breakdown, and monetary irresponsibility, continues to deteriorate. Financial markets have already absorbed one round of bad news from Russia, but further economic shocks, or political unrest, would have a negative impact on Asian markets.

Developments in industrialized countries are also likely to affect prospects for Asia's recovery. As they appeared to do in the late summer of 1998, Asia's troubles could prompt a slide in U.S. stock prices. A large enough stock price drop would damage consumer confidence and reduce U.S. import demand. With the United States the first or second largest market for many export-dependent Asian countries,

a U.S. recession could spark another round of contagion in the region. A recession in Europe could have the same impact, though perhaps at a lower order of magnitude. Asia's crisis-driven trade surplus could also provoke a protectionist response in the United States or Europe, with potentially severe consequences for Asia exporters.

Arguably, there is more positive potential in Japan's trade and financial relationship with Asia. If Japan were able to pull itself out of its current recession, higher growth would raise import demand, which would provide a large trade boost to the region. Perhaps more importantly, given the large volume of Japanese lending to the region before the crisis, substantial progress in resolving Japan's banking difficulties under the current Japanese financial sector rescue package would increase the flow of private capital to Asian banks and firms. And the Miyazawa initiative to create a $30 billion Asian recovery fund may increase official capital flows to make up for lost private capital.

One source of uncertainty not apparently connected with the Asian crisis will be the introduction of a single European currency (euro) in 1999, at the beginning of the European Union's Stage III of integration. The currency shift matters because Asian economic ties to Europe are significant. Even though only about 12 percent of Asian countries' foreign exchange reserves are now denominated in European currencies, the Asian developing economies owe roughly half their external debt to the major European banks. Trade with Europe accounts for more than one-third of extraregional trade.

As the "Euroland" countries move towards making the euro their only legal tender between 1999 and 2002, Asian nations will settle trade transactions with those countries increasingly in the new currency. If they seek to stabilize trade-weighted real effective exchange rates, central banks will be impelled to move away from a dollar currency peg or a dollar-based float. Central banks will therefore hold a lower percentage of reserves in dollars and convert some of their existing dollar reserves into euros. It is not yet clear whether more or less stable exchange rate regimes in Asia will result from these changes in central banks' reserve portfolios. Nor is it easy to tell if the yen's relatively small role as a reserve currency in Asia will increase or decrease as a result of the euro's advent.

In the face of the worst economic crisis in their recent history, some Asian countries have attempted to neutralize the destabilizing effects of globalized financial markets by imposing economic regulations. Most have ruled out the type of comprehensive capital controls recently implemented in Malaysia. But growing impatience with what some see as the failure of conventional macroeconomic policy measures prescribed by the International Monetary Fund at the beginning of the crisis has made the idea of controls on the capital account much more attractive to policymakers in Asia. One danger is that slowing or reversal of capital account reforms will spill over to other economic regulations, posing a threat to the liberalization process in Asia. Governments distressed at the cutoff of private sector lending may even opt to revive old industrial policies – for example, directing credit to preferred export industries.

While financial markets will eventually recover and positive growth will return to Asia, there is a risk that some negative effects of the crisis will persist. In many affected countries families have pulled children out of school in order to work or because they could no longer afford school fees. Should the crisis last for two or three years, Asian developing countries will have fewer educated workers as a result. In countries such as Thailand the short supply of educated workers was viewed as a problem even before the crisis and would likely become even more of a production constraint if a generation missed school.

During economic contractions people may have no choice but to borrow in order to survive. Taking children out of school is one example of that principle – sacrificing tomorrow's consumption for today. Another is exploiting the natural environment for food or other saleable commodities, or neglecting basic environmental protections because they cost too much. The natural environments in many Asian countries were under severe stress before the crisis, with high levels of water and air pollution (Manila, Jakarta, and Bangkok, among others), extensive deforestation, and rapid rates of species extinction. While some short-term effects of the crisis – such as lower air pollution stemming from economic contractions – may be beneficial to the environment, there are also signs of faster deterioration. In Indonesia many rare species are being hunted for food. Illegal logging appears to be picking up[5]. Governments in some countries may cut back enforcement of environmental regulations because of reduced resources.

[5] Source: Wall Street Journal October 26, 1998

The economic crisis has had far-ranging political effects. Political uncertainties remain. Salient among these is the possibility of social unrest leading to a change in regime, as happened in Indonesia. But even when survival of a government is not at stake, political forces arising from the crisis may determine policy. For example, to cushion the social costs of recession, inflation, and unemployment, governments have been tempted to resort to higher subsidies, increased regulation, and other direct government interventions. To some extent, such responses are inevitable and even desirable. But those measures could also slow the adoption of needed structural reforms or, in an extreme case, lead to fiscal insolvency.

ADO Update: 24 Nov 98

Table 1
GDP Growth Rate (%)

	1997	1998*	1999*
Newly Industrialized Countries	6.0	-1.3	1.0
Hong Kong, China	5.2	-5.0	-2.0
Korea, Rep. of	5.5	-5.0	-1.0
Singapore	7.8	0.0	1.0
Taipei, China	6.8	5.0	5.2
People's Republic of China & Mongolia	8.8	6.5	6.0
China, PR	8.8	6.5	6.0
Mongolia	3.3	4.5	5.0
Central Asian Republics	7.8	0.9	1.2
Kazakstan	2.0	1.5	1.0
Kyrgyz Republic	10.4	4.5	4.0
Tajikistan		3.4	4.0
Uzbekistan	5.2	0.0	1.5
South East Asia	3.9	-6.9	-0.4
Cambodia	2.0	3.0	4.0
Indonesia	4.6	-16.0	-3.0
Lao, PDR	7.2	6.0	6.5
Malaysia	7.5	-6.0	-2.0
Philippines	5.1	0.2	1.0
Thailand	-0.4	-7.0	0.5
Vietnam	9.2	5.0	6.5
South Asia	4.8	5.1	5.1
Bangladesh	5.7	5.0	5.5
India	5.0	5.0	5.2
Pakistan	3.1	5.4	4.3
Sri Lanka	6.3	5.2	6.2
Pacific Islands	-4.1	2.1	2.2
Fiji	-1.0	1.0	0.5
Papua New Guinea	-6.5	2.5	2.9
Average	6.1	-1.9	3.4

*Projections

Note: 1997 figures are from 1998 ADO.
23-Nov-98

Table 2
Inflation Rate (%)

	1997	1998*	1999*
Newly Industrialized Economies	3.5	5.3	3.7
Hong Kong, China	5.7	5.0	2.9
Korea, Rep. of	4.5	8.0	5.0
Singapore	2.0	3.2	2.8
Taipei, China	0.9	3.2	3.0
People's Republic of China & Mongolia	2.8	0.0	3.0
China, PR	2.8	0.0	3.0
Mongolia	20.0	15.0	10.0
Central Asian Republics	24.8	15.3	19.0
Kazakstan	20.4	11.3	12.3
Kyrgyz Republic	25.5	15.0	9.5
Tajikistan		65.0	12.5
Uzbekistan	30.0	22.0	30.0
South East Asia	5.6	28.8	8.2
Cambodia	9.1	13.5	8.0
Indonesia	6.6	95.0	15.0
Lao, PDR	19.5	80.0	42.0
Malaysia	4.0	7.2	4.5
Philippines	5.1	9.0	5.0
Thailand	5.6	8.6	7.1
Vietnam	3.2	10.0	8.0
South Asia	7.1	7.6	7.5
Bangladesh	3.9	5.5	6.0
India	6.5	7.5	7.2
Pakistan	11.6	8.5	10.5
Sri Lanka	9.6	9.3	6.5
Pacific Islands	3.9	8.3	8.0
Fiji	2.9	6.5	8.0
Papua New Guinea	3.9	9.0	8.0
Average	4.3	7.3	5.0

*Projections

Note: 1997 figures are from 1998 ADO.
23-Nov-98

Table 3
Current Account Balance
(% of GDP)

	1997	1998*	1999*
Newly Industrialized Countries	1.4	3.6	3.0
Hong Kong, China	...	-2.7	-2.0
Korea, Rep. of	-2.0	7.0	5.0
Singapore	15.2	10.0	11.0
Taipei, China	2.7	1.7	1.0
People's Republic of China & Mongolia	2.2	2.0	1.5
China, PR	2.2	2.0	1.5
Mongolia	-5.6	-11.0	-6.0
Central Asian Republics	-3.5	-5.2	-5.7
Kazakstan	-4.6	-5.3	-5.9
Kyrgyz Republic	-10.5	-4.5	-4.1
Tajikistan		-7.5	-6.9
Uzbekistan	-6.0	-5.0	-5.5
South East Asia	-4.1	5.7	4.1
Cambodia	-13.2	-10.5	-10.7
Indonesia	-2.7	6.4	5.0
Lao, PDR	-11.8	-19.8	-17.8
Malaysia	-5.3	6.0	4.0
Philippines	-5.2	1.0	1.5
Thailand	-4.0	9.7	6.6
Vietnam	-7.7	-4.0	-3.0
South Asia	-2.0	-1.3	-2.2
Bangladesh	-2.6	-2.0	-2.2
India	-1.2	-1.0	-1.5
Pakistan	-6.5	-2.4	-5.7
Sri Lanka	-2.1	-3.2	-5.5
Pacific Islands	-3.9	-3.4	-2.8
Fiji	0.8	0.0	-1.0
Papua New Guinea	-6.2	-4.8	-3.5
Average	-0.0	2.3	1.6

*Projections

Note: 1997 figures are from 1998 ADO.
23-Nov-98

MIER
1998 NATIONAL OUTLOOK CONFERENCE

Shangri-La Hotel, Kuala Lumpur
1-2 December 1998

MALAYSIAN ECONOMIC OUTLOOK
1999-2000

by

MIER Forecasting Team

Mohamed Ariff
Michael Yap Meow Chung
Azidin Wan Abdul Kadir
Elaine Tan Lae-Imm
Ong Gaik Ean

Malaysian Institute of Economic Research
Institut Penyelidikan Ekonomi Malaysia

Malaysian Economic Outlook, 1999-2000

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MIER
Malaysian Economic Outlook, 1999-2000

Executive Summary

Economic growth in the Malaysian economy, having declined by 6.1 per cent in the first three quarters of 1998, is expected to remain anaemic in the final quarter of the year. Alarmed by the steep drop in the first half, policy-makers began to doubt the feasibility of the tight monetary policy and tight fiscal policy regime, and implemented capital controls in September. Following this, monetary policy was eased substantially to boost the economy. The fiscal policy announced in October was also an expansionary one. The capital control measures should not be regarded as a panacea for the problems that the economy faces. Programmes that were designed to alleviate problems pertaining to the banking sector, for example, should be carried out speedily and with the strongest intent and purpose.

A current account surplus is important in supporting the exchange rate peg and capital controls. Given the projected rate of growth in the economy and therefore the demand for imports, we still expect a current account surplus for 1999, albeit a smaller one. But this will be further reduced in the year 2000, when the economy is anticipated to start picking up, although at a moderate pace. In this respect, taking advantage of the capital control measures in providing the necessary conditions to lower interest rates without affecting the ringgit, the authorities will need to implement most of the programmes for stabilisation within 1999.

MIER's two surveys in the third quarter of 1998 on business and consumer sentiments show that there is little change from the previous quarter. Firms in the manufacturing sector are still cautious in their outlook and consumers are still not showing any rigorous signs of a rebound in sentiments. However, the results of the two surveys do indicate that sentiments may be stabilising. A turnaround may materialise in the first half of 1999.

Given the latest available indicators, the estimate for 1998 real GDP growth is at -6.2 per cent. All the domestic components of national income will see sharp declines. The sharper decline in imports relative to exports will see a better net trade position for 1998, with the merchandise trade surplus estimated at RM46.1 billion. The services deficit is projected at RM19.7 billion and the current account balance will see a surplus of RM23.0 billion for 1998. This amounts to 8.5 per cent of gross national product (GNP). Unemployment rate is estimated at 5.5 per cent of the labour force while inflation rate is anticipated at 5.2 per cent, largely due to the ringgit depreciation.

With the easing of monetary policy and a stimulating fiscal policy, aggregate demand will see a slight boost in 1999. Several factors will act as potential constraints to any huge gains in boosting growth. These include the high level of domestic debt that needs to be cleared up, the still tentative business and consumer sentiments affected by the still uncertain labour market outlook, sluggish stock market and property market, and weak external demand (though relatively better than in 1998). Private consumption is forecast to show some growth, at 0.8 per cent, following the easing of credit terms. The lower cost of financing and relative stability following the fixed exchange rate will also benefit the business community. Thus, private investment is projected to expand very marginally by 0.6 per cent in 1999. Public expenditure will be more expansionary in 1999, unlike the present year. However, it will be limited by a drop in revenue and the more difficult terms to borrow from abroad due to a declining sovereign rating. Public consumption is forecast to grow by just 0.3 per cent while public investment will expand by 2.2 per cent. In the external sector, following better growth prospects projected for the world economy and world trade, demand is expected to be relatively better. Nevertheless, exports are not anticipated to expand at a high rate, given that world economic growth prospects rest on somewhat fragile premises. Export of goods and non-factor services will grow by 1.0 per cent in 1999 while imports will rise by 1.7 per cent, in tandem with a slight growth overall in the economy. Real GDP is forecast to grow at 0.7 per cent for 1999, a slight turnaround after a steep decline this year.

The current account balance is still projected to register a surplus in 1999, at RM16.2 billion (or 5.9 per cent of nominal GNP). This will be chiefly through a merchandise balance surplus, projected at RM40.5 billion. The services deficit is projected at RM20.3 billion.

Demand for labour is expected to be still weak in 1999, as companies are likely to be cautious in expanding. The unemployment rate is forecast at 5.7 per cent. With the ringgit exchange rate stabilising and subdued domestic pressures on prices, inflation is forecast at 4.2 per cent next year.

Following a sharp decline in real GDP in 1998 and growth of a mere 0.7 per cent the following year, the economy is projected to see a better growth of 2.7 per cent in the year 2000. Private consumption will grow by a moderate 5.3 per cent following a contraction in 1998 and subdued growth in 1999. Private investment, after a colossal collapse in 1998 and meagre growth in 1999, should bounce back following the return of confidence and stability in the economy. It is forecast to grow by 4.8 per cent in 2000. Public consumption and investment are also projected to expand moderately by 1.2 per cent and 3.2 per cent respectively. Exports will rise by 1.9 per cent resulting from better external demand as the region regains its footing. Imports will pick up in tandem with the better overall growth, by a projected 3.2 per cent in the year 2000. In the balance of payments, the merchandise balance is anticipated to show a surplus of RM38.2 billion while the services deficit is estimated at RM21.2 billion. The current account balance is still expected to show a surplus of RM12.8 billion. This amounts to 4.4 per cent of nominal GNP.

Inflation will be moderate in the year 2000, projected at 3.8 per cent, while unemployment rate is forecast at 5.6 per cent with demand for labour expected to pick up slightly but will remain weak.

There are significant downside risks to the forecast. These include a weaker than expected external demand resulting in export growth being curbed, insufficient domestic funds for the purpose of helping ailing banks and financing the budget deficit, and a lack of confidence among consumers and the business community amidst uncertain economic conditions. There is also the risk of a large capital outflow come September 1999.

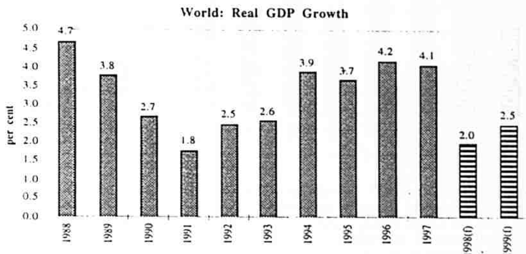
MIER
Malaysian Economic Outlook, 1999-2000

External Developments

World Economy

The world economy is expected to slow down substantially in 1998 as a result of the extensive impact of the Asian financial crisis which continues to be felt world-wide. The situation in Russia is still a great concern, while the Latin American countries are still struggling to stabilise their economies. The agreement of the IMF to extend financial assistance to Brazil recently would be a great help in containing the damage of the contagion. As for the crisis-affected Asian countries, their financial markets appear to have stabilised in recent months with some inflows of foreign capital. The currencies of Thailand, Indonesia and South Korea have strengthened, indicating some return of confidence in their economies. However, solid signs of sustained recovery are still unclear as the banking sector is troubled with bad loans while companies are in financial difficulties.

World: Real GDP Growth

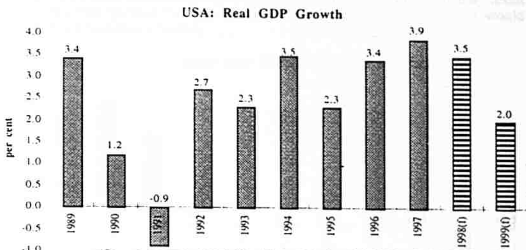


Affected by the crisis, the economies of industrial countries have slowed down. On a positive note, Japan is seen to be taking serious steps to reflate its economy by allocating more funds to resolve problems in the banking system as well as approving additional fiscal spending. The United States (US) economy is showing signs of slowing down and that is also the case in Europe as their exports to emerging markets declined markedly. However, the recent interest rate cut in the US would help cushion the impact of a lower economic growth, which would also indirectly benefit the rest of the world as others may follow suit in easing monetary policy. European countries have been able to lower their interest rates as a result of low inflation. However, the extensive relaxation in monetary policy in developed countries would take some time to have an impact on the global economy. Lower interest rates could help boost demand which is badly needed to counter deflationary pressures which are building up.

Global output is projected by the IMF to grow by 2.0 per cent in 1998, following a 4.1 per cent growth in 1997. During the period of 1994-1997 global economic growth had been robust, at an average of 4.0 per cent. In 1999, the world economy is forecast to accelerate slightly faster with a growth of 2.5 per cent. This is based on the expectations of some recovery in Asia and Japan although slower growth is projected for the US and the European Union.

United States of America

The US economy recorded a robust growth of 3.3 per cent (seasonally adjusted annual rates - SAAR) in the third quarter of 1998, following a 1.8 per cent growth in the second quarter and a robust 5.5 per cent in the first quarter. Consumer spending and the rise in inventory following the General Motors strike has contributed to the third quarter growth spurt. However, the US economy continued to feel the contagion effect from the Asian crisis as exports dropped by an annual rate of 2.9 per cent in the third quarter. Imports still grew by 3.4 per cent due to the strong domestic demand. Inflation rate remained subdued at 1.5 per cent (year-on-year) in September. The remarkably low inflation remains despite a low unemployment rate. This is attributed to lower global commodity prices, including oil prices.

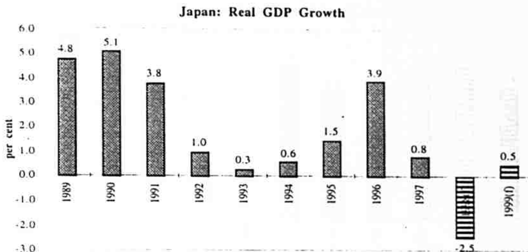


Some indicators, however, point to a slowing down. New orders for durable goods have flattened somewhat, which would mean reduction in company profits. Business investment slipped by 1.0 per cent in the third quarter after a fast 17.4 per cent growth in the first half. In addition, the Conference Board's Index of Consumer Confidence dipped further in October for the fourth consecutive month. Consumer sentiments are affected by the widespread economic and financial crisis occurring around the globe and the volatile stock market at home. Wages and salaries continued to be on the uptrend in the third quarter of 1998, most probably reflecting some tightening in the labour market. A persistent uptrend in wages may trigger an acceleration in inflation. The Composite Leading Index was on a downtrend, which suggests an upcoming slowdown of the economy.

As a pre-emptive move to simultaneously boost the domestic economy and assist the world economy, the Federal Reserve cut interest rates again in November. The federal funds rate was reduced by 25 basis points to 4.75 per cent on 17th November following two previous cuts in September and October by a similar margin. The reduction in US interest rates means that crisis-hit Asian countries would be able to cut their interest rates further to boost economic growth. The US stock market responded favourably to the recent interest rate cut by reaching record highs. However, the lowering of interest rates would weaken the dollar as some capital outflows occur. The US economy is projected to slow down to a growth of 2.0 per cent in 1999, expected to be due to lower domestic demand and the uncertain global economy. This follows an estimated strong real GDP growth of 3.5 per cent in 1998.

Japan

Japan's real GDP contracted by 3.3 per cent in the second quarter of 1998, the third consecutive quarter of decline. This followed a steeper 5.3 per cent decline in the first quarter and a 1.5 per cent drop in the last quarter of 1997. Many economic indicators were still down sharply. Private consumption was still depressed as indicated by a 43.8 per cent decline (year-on-year) in retail sales in September while new passenger car registrations declined by 14 per cent in October. Industrial production was 7.7 per cent lower in September 1998 compared to the same month last year. However, industrial production has stabilised in the previous few months, and is seen to have reached the bottom. This is viewed as a one positive sign that recovery may be coming soon. On the contrary, the third quarter Bank of Japan Tankan survey indicated further gloomy conditions. Deflationary pressures have increased with inflation falling by 0.2 per cent in September. This may result in reduced profit margins for firms as price competition intensifies, which would restrain future business activities.



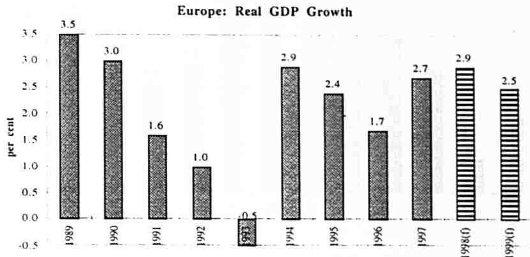
Not all indicators are unfavourable. The Diffusion Index of the Leading Indicator was stable at 50 points in August for the second consecutive month, rising from 27.3 points in June. This suggests that the economy may be bottoming out. Exports showed an encouraging uptrend but the recent strengthening of the yen may reduce export competitiveness. Imports too have been rising and is expected to increase further with the stronger yen. This would certainly be helpful to the Asian countries in turmoil.

Various measures have been implemented to help the economy recover. The most important is the measure to re-strengthen the banking sector which was burdened with bad loans said to be close to 100 trillion yen. A package of 60 trillion yen, or some 12 per cent of GDP, has been allocated to help revive the banking sector which faces tight liquidity due to the massive bad loans. The recapitalisation of banks is important to restore investors' confidence and to provide credit for investment. In order to ensure that borrowing takes place, business and consumer confidence would have to be revived. In addition to cleaning up the banking system, a fiscal stimulus package in the form of public works expenditures and tax cuts have been approved. In November, the government approved an additional 24 trillion yen worth of fiscal package to help the economy recover. This followed a 16.7 trillion yen package previously approved in June. The Japanese economy is projected by the IMF to contract by 2.5 per cent in 1998. In 1999, on the assumption that the measures undertaken proceeds effectively, economic growth is forecast at 0.5 per cent.

Europe

Economic growth in the European Union has generally moderated. Again, this was due partly to the slowdown in the global economy as a result of the Asian crisis. However, the strong domestic demand continues to cushion the deterioration in the external sector. The relatively easy monetary policy has also helped boost consumption and fixed investment. After growing by 2.7 per cent in 1997, the EU economy is expected to sustain growth at 2.9 per cent in 1998 before moderating to 2.5 per cent in 1999. Whether or not the "Euro" currency would have a positive impact on the Euro-area is being closely watched. Positive effects are likely to be felt only in the medium and longer term. In the near term, the Euro will impose new discipline and market restructuring which will have a sedating effect on the European economies. The low inflation level has allowed interest rates to be reduced. Unfortunately, unemployment remains stubbornly high despite the strong growth. The EU unemployment rate is predicted at 10.3 per cent in 1998, declining to 10.0 per cent in 1999. Unemployment rate in 1997 was 11.0 per cent.

Europe: Real GDP Growth

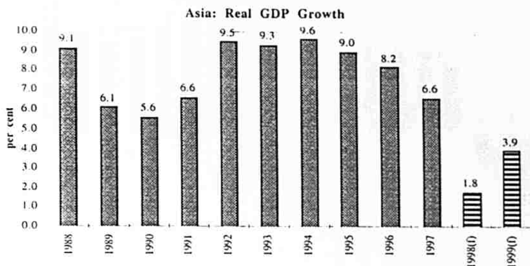


The German economy slowed down to a 1.7 per cent annualised growth in the second quarter in 1998, following a robust 4.3 per cent growth in the first quarter. Factors which contributed to the slower growth included the VAT tax hike in April and the mild weather in the first quarter making economic activity more vigorous during that period. Recent indicators pointed to slower economic activity. Foreign orders and exports have both weakened and the recent upsurge of the Deutschmark is expected to dampen exports further. The Business Climate Index fell sharply in September. Germany's real GDP is estimated to grow by 2.6 per cent in 1998, but to slow down to 1.9 per cent in 1999, mainly as a result of the global slowdown.

In the United Kingdom, real GDP growth moderated to 2.5 per cent in the third quarter of 1998, following two consecutive quarters of strong growth at above 3.0 per cent. The Business Confidence Index was on the downtrend and has reached worryingly low levels, indicating an unhealthy investment outlook. The export sector was hit hard with exports to Asia and Russia down by 30 per cent and 50 per cent respectively in September compared to the average in 1997. Interest rates have been cut to boost the economy and this was made possible with the underlying inflation meeting the 2.5 per cent target. The UK economy is forecast to slow down to 2.5 per cent in 1998, and to grow at a slower 1.8 per cent in 1999 in the face of a global economic slowdown.

Asia

The Asian economy continues to be affected by the financial crisis. However, positive developments took place in past few months in the crisis-affected countries. In Indonesia, Thailand and South Korea, currencies have stabilised while their stock markets showed some rebound. The recent strengthening of the yen against the US dollar has helped these currencies gain strength. During the period September to November 1998, the stock markets of Thailand and South Korea gained by 37.2 per cent and 24.1 per cent respectively. In China, the economy continues to be affected by Asian crisis and widespread flooding. The Chinese government has spent about US$13 billion so far in infrastructure projects and monetary policy has been eased to bolster growth. In the third quarter, China's GDP rose by 7.6 per cent, picking up pace from the 7.0 per cent growth in the first half.



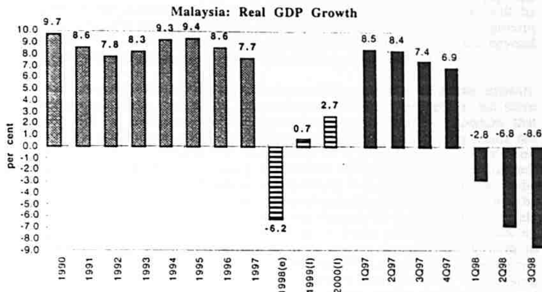
Asia's recovery would depend on exports, both manufactured and raw commodities. The depressing demand in the electronics sector has hindered a stronger export growth while the decline in commodity prices has not helped either. The IMF projects Asia's growth to slow down markedly to 1.8 per cent in 1998, but is projected to recover with a 3.9 per cent growth in 1999. In 1997, Asia grew at 6.6 per cent, and during the period 1990-1997, real GDP growth was recorded at an average of 8.1 per cent.

As for the crisis-hit countries, Indonesia is projected to show the largest decline. The Indonesian economy is predicted to contract by 15.0 per cent in 1998, but to stabilise in 1999 with no growth. However, the continued unstable political situation in Indonesia may pose a hindrance to a speedier economic recovery. Thailand's real GDP is forecast to decline by 8.0 per cent in 1998. In 1999, a small growth of 0.2 per cent is predicted for Thailand. Measures on banking reforms and the upgrading of bankruptcy laws would ensure a steadier recovery in Thailand. Problems in corporate and financial sectors would result in South Korea's growth sliding by 7.0 per cent in 1998. However, the easing in monetary policy and the restructuring exercise in the corporate and financial sectors would result in the contraction moderating to 1.0 per cent in 1999. All these countries have relaxed their monetary policy and have planned for larger budget deficits to boost economic growth.

MALAYSIAN ECONOMIC OUTLOOK, 1999-2000

Overview

Economic growth in the Malaysian economy, having declined by 6.1 per cent during the first three quarters of 1998, is expected to remain anaemic for the final quarter of the year. Real GDP contracted by a sharp 8.6 per cent in the third quarter of 1998. Only the mining and services sectors displayed growth in the third quarter. The construction sector was the hardest hit with a drop of 28.2 per cent (2Q:98: -22.0%). Manufacturing activities also slowed down markedly by 14.3 per cent in the third quarter of the year after dropping by 9.2 per cent the previous quarter. The agriculture sector contracted by 3.2 per cent, following a steep decline of 9.6 per cent in the second quarter.



Following the steep recession in the first half of 1998, policy-makers decided to stimulate the economy through monetary easing and an expansionary fiscal policy. The capital control measures should not be regarded as a panacea for the problems that the economy faces. Programmes that were designed to alleviate problems pertaining to the banking sector, for example, should be carried out speedily and with the strongest intent and purpose.

A current account surplus is important in supporting the exchange rate peg and capital controls. Given the projected rate of growth in the economy and therefore the demand for imports, we still expect a current account surplus for 1999, albeit a smaller one. But this will be further reduced in the year 2000, when the economy is anticipated to start picking up, although at a moderate pace. The sources of growth and efficiency gains in the economy will also be crucial. In this respect, taking advantage of the capital control measures in providing the necessary conditions to lower interest rates without affecting the ringgit, the authorities will need to implement most of the programmes for stabilisation within 1999.

In boosting demand in the Malaysian economy, it is preferable to stimulate the export sector, as higher exports will contribute to a better trade balance and generate foreign exchange earnings. This will contribute towards maintaining the peg of the ringgit against the US dollar and sustain the capital control measures by ensuring sufficient supply of foreign currency. However, it is observed that the manufacturing index for export-oriented industries is actually declining. This reflects declining export volume. There exists currently, and probably in the following year, a constraint to external stimulus of the Malaysian economy in the

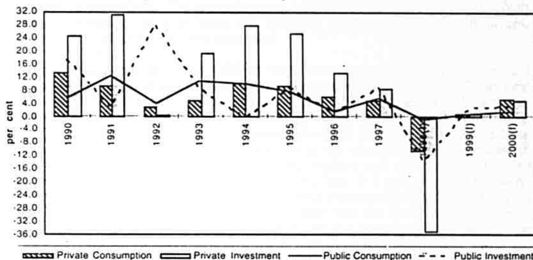
form of a still uncertain world economy. This is especially so in East Asia, inclusive of Japan. The export market is also more competitive now with the weaker currencies of several East Asian countries. Thus, there is limited scope to depend significantly on an export-push for economic recovery. It is also important to note that, given the high import-intensity of the Malaysian export sector, once exports pick up again it will stimulate import growth (especially import of capital and intermediate goods). The government will, therefore, likely stimulate domestic sources of growth to boost the economy in 1999. Monetary expansion and lower interest rates which result in private consumption being stimulated will also contribute to import of consumption goods. Private consumption picking up faster than income growth will mean that the saving rate will be relatively lower. On the other hand, rising investment expenditure responding to lower interest rates may see the investment-income ratio rising. This means that the saving-investment gap (the equivalent of the current account balance), which is currently positive, will be narrowed. This will be increasingly so when the economy picks up further growth momentum. This represents a potential constraint that is likely to surface beyond 1999. The present policy setting should take this into consideration.

Domestic savings, therefore, will act as the constraining factor to economic growth. Policies that encourage saving will mean relatively lower consumption, but more resources will be made available for investment purpose. It is important that investments are efficient, given the available resources. Productivity gains are essential to maximise the amount of value-added for a given ringgit of investment. In this regard, only the most promising and feasible investments should be funded. The banking sector, acting as financial intermediary, will play a crucial role in the recovery process. (The banks' role in this respect is made more important given the present unfavourable environment to raise capital through the stock market.) While it is important to ensure that sufficient credit is made available for financing economic activities, it is also important to allow market forces enough room to determine the most efficient allocation of resources. This can be best done by not attempting to influence *both* the price and quantum of loans given by the banking sector. The potential risk in setting *binding* loan growth targets in an environment of lowered interest rates (*and* expectations of further lowering of rates) is that banks constrained to meet such targets may inadvertently jeopardise their asset quality, resulting in even more bad loans in the future. If this happens, we will be confronting the same circumstances as before the onset of the currency crisis in July 1997, only this time from a position of weakness instead of a position of relative strength (as before July 1997). Policy-makers need to recognise that the high level of domestic debt (relative to national income) needs to be addressed. This cannot be reduced in a short time without damaging dislocation effects but needs to be pursued over a fairly longer period of a few years. This objective has to be maintained and achieved to ensure longer term sustainability of the banking system and the economy. The trade-off in the short-term is that of lower economic growth. The present reflationary objective of the government has to be seen in this context.

MIER's two surveys in the third quarter of 1998 on business and consumer sentiments show that there is little change from the previous quarter. Firms in the manufacturing sector are still cautious in their outlook. Especially worrying is that export sales and outlook remain rather limp. Consumers are still not showing any rigorous signs of a rebound in sentiments. However, the results of the two surveys do indicate that sentiments may be stabilising. With some stability introduced through the fixed exchange rate and easier credit terms following the drop in interest rates, a turnaround may materialise in the first half of 1999.

Given the latest available indicators, the estimate for 1998 real GDP growth is at -6.2 per cent. All the domestic components of national income will see sharp declines. Private consumption is estimated to drop by 10.4 per cent, following a growth of 4.7 per cent in 1997. The poor job market outlook following

retrenchment of workers, declining expectations of financial income and generally poor consumer sentiments, along with a depressed stock market are the causes of decline in private sector spending. Investment expenditure by the private sector is also expected to drop sharply in 1998, by 35.1 per cent. This results from a sharp reversal in the property sector and construction activities, sluggish manufacturing sector and decline in the agriculture sector. Certain services sub-sectors such as financial services are also consolidating in the wake of the currency crisis. The dampened outlook of the sectors is due to a combination of hitherto high interest rates, uncertain prospects and sluggish external demand for Malaysia's exports. As for public expenditures, the steep cutbacks following the austerity drive and also faced with the constraint of lower revenue (following the general decline in the economy), both public consumption and investment are expected to decline, by 1.0 per cent and 13.8 per cent respectively, in 1998. Due to weak external demand as the East Asia region goes through a difficult period resulting from the currency turmoil and Japan's economy continues to be in difficulty, exports of goods and non-factor services are estimated to decline by 0.8 per cent, while imports will drop sharply by 12.0 per cent.



The sharper decline in imports relative to exports will see a better net trade position for 1998. In nominal terms, this is reflected in a much higher merchandise trade surplus. Export of goods are estimated to grow by 23.6 per cent while imports will see lower growth at 8.1 per cent. This will result in a merchandise balance surplus of RM46.1 billion for 1998, sharply up from RM11.3 billion a year ago. The services deficit is projected at RM19.7 billion and the current account balance will see a surplus of RM23.0 billion for 1998. This amounts to 8.5 per cent of gross national product (GNP). Unemployment rate is estimated at 5.5 per cent of the labour force while inflation rate is anticipated at 5.2 per cent, largely due to the ringgit depreciation.

With the easing of monetary policy and a stimulating fiscal policy, aggregate demand will see a slight boost in 1999. Several factors will act as potential constraints to any huge gains in boosting growth. These include the high level of domestic debt that needs to be cleared up, the still tentative business and consumer sentiments affected by the still uncertain labour market outlook, sluggish stock market and property market, and weak external demand (though relatively better than in 1998). Private consumption is forecast to show some growth, at 0.8 per cent, following the easing of credit terms. The lower cost of financing and relative stability following the fixed exchange rate will also benefit the business community. Thus, private investment is projected to expand very marginally by 0.6 per cent in

1999. Public expenditure will be more expansionary in 1999, unlike the present year. However, it will be limited by a drop in revenue and the more difficult terms to borrow from abroad due to a declining sovereign rating. Public consumption is forecast to grow by just 0.3 per cent while public investment will expand by 2.2 per cent. In the external sector, following better growth prospects projected for the world economy and world trade, demand is expected to be relatively better. Nevertheless, exports are not anticipated to expand at a high rate, given that world economic growth prospects rest on somewhat fragile premises. Export of goods and non-factor services will grow by 1.0 per cent in 1999 while imports will rise by 1.7 per cent, in tandem with a slight growth overall in the economy. Real GDP is forecast to grow at 0.7 per cent for 1999, a slight turnaround after a steep decline this year.

The current account balance is still projected to register a surplus in 1999, at RM16.2 billion (or 5.9 per cent of nominal GNP). This will be chiefly through a merchandise balance surplus, projected at RM40.5 billion. The services deficit is projected at RM20.3 billion.

Demand for labour is expected to be still weak in 1999, as companies are likely to be cautious in expanding. The unemployment rate is forecast at 5.7 per cent. With the ringgit exchange rate stabilising and subdued domestic pressures on prices, inflation is forecast at 4.2 per cent next year.

Following a sharp decline in real GDP in 1998 and a mere growth of 0.7 per cent the following year, the economy is projected to see a better growth of 2.7 per cent in the year 2000. Private consumption will grow by a moderate 5.3 per cent following a contraction in 1998 and subdued growth in 1999. Private investment, after a colossal collapse in 1998 and meagre growth in 1999, should bounce back following the return of confidence and stability in the economy. It is forecast to grow by 4.8 per cent in 2000. Public consumption and investment are also projected to expand moderately by 1.2 per cent and 3.2 per cent respectively. Exports will rise by 1.9 per cent resulting from better external demand as the region regains its footing. Imports will pick up in tandem with the better overall growth, by a projected 3.2 per cent in the year 2000. In the balance of payments, the merchandise balance is anticipated to show a surplus of RM38.2 billion while the services deficit is estimated at RM21.2 billion. The current account balance is still expected to show a surplus of RM12.8 billion. This amounts to 4.4 per cent of nominal GNP.

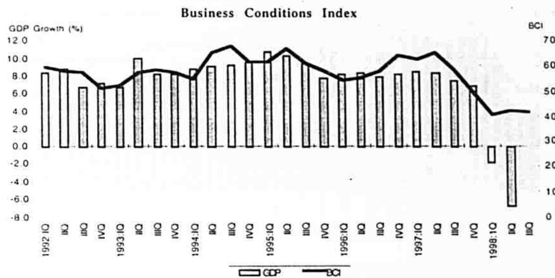
Inflation will be moderate in the year 2000, projected at 3.8 per cent, while unemployment rate is forecast at 5.6 per cent with demand for labour expected to pick up slightly but will remain weak.

Business Conditions Survey

Since the third quarter of 1997, the Business Conditions Index (BCI) has been trending downwards, with the exception of a blip in the second quarter of 1998 when the index nudged up slightly. This quarter's index is 41.8 points, down 0.5 percentage points from last quarter's 42.3 points. On a year-on-year basis, the present quarter's reading represents a slide of 15.7 points (3Q97: 57.5 points).

The sales performance of industries had stabilised for the quarter under review. Forty-six per cent of the companies surveyed revealed that their sales were unchanged compared to 40 per cent of the respondents who noted declining sales. The remaining 14 per cent reported that their sales had increased. In the last quarter, it was 42 per cent indicating unchanged sales, 42 per cent reported declining sales and 16 per cent registering higher sales.

For the third quarter, domestic orders continued to be sluggish with short-term domestic orders remaining unchanged. Export orders for the third quarter appear unchanged as 36 per cent of the respondents cited thus compared to the second quarter's 22 per cent. Twenty-eight per cent indicated that their export orders had gone up (2Q98: 27%) while 28 per cent mentioned that their orders had decreased (2Q98: 42%). Meanwhile export orders for the next three months are not too bright. Twenty-eight per cent of the companies surveyed are expecting higher sales, down noticeably from last quarter's 36 per cent. At the same time, more respondents are anticipating lower sales, up 5 percentage points from second quarter 1998 to 26 per cent. The remaining 39 per cent expect their export sales to remain unchanged, up from 35 per cent recorded last quarter.



Production in the current quarter appeared still sluggish, although a higher number of firms have produced more compared to last quarter. A similar number of respondents as in the previous quarter (38 per cent) reported that their production volume had remained unchanged. Twenty-one per cent of firms surveyed revealed that their production had increased compared to 16 per cent for last quarter. In terms of declining production, 41 per cent of companies disclosed such trend for this quarter, while it was 46 per cent. Production is expected to decline in the short term.

Since the rate of production and sales had stayed steady for this quarter, the overall stock level had been stagnant too. As a whole, less firms are making new investments, with 15 per cent of respondents indicating thus in the third quarter (2Q98: 23%). In line with steady production experienced in the third quarter, utilisation of manufacturing capacity was stable.

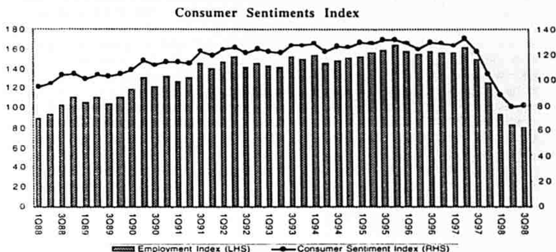
Domestic sales prices have stabilised with an overwhelming 60 per cent of manufacturers (2Q98: 46%) in all sectors reporting unchanged sales prices for the quarter under review. Only 10 per cent of firms (2Q98: 22%) cited increased prices while another 29 per cent (2Q98: 33%) disclosed lower sales prices. In the next three months, prices of locally sold manufactured products are anticipated to be steady.

Reflective of the unfavourable economic developments, manufacturers had cut back on their recruitment of workers in the quarter under review, and with the cool demand for workers, less firms are paying higher wages. It is anticipated that the recruitment pace will remain unchanged with stable wages in the next three months.

Consumer Sentiments Survey

MIER's survey of consumer sentiments for the third quarter of 1998 shows lingering concerns over the uncertain economic outlook. The Consumer Sentiments Index (CSI) inched upwards to 80 points, from an all-time low of 79.1 points in the previous quarter. The very marginal increase shows that consumers are still hesitant, although sentiments may be stabilising. The slight rise in the CSI reflects some gains in consumers' expectations with respect to both their current and expected financial income position. However, an astounding fall of 42.1 points from the third quarter of 1997, showed a stark turnaround in confidence compared to a year ago. Since then, sentiments had been going downhill.

Consumer Sentiments Index



Many consumers continue to expect scarce employment opportunities as revealed by the MIER Employment Index in the third quarter. As companies restructure due to increasing operating costs and weaker demand for products, recruitment plans seem to be temporarily shelved. The Employment Index stands at 80.5 points in the third quarter of 1998, the lowest ever since the inception of the survey. Nevertheless, the decline of 1.4 points from the last quarter suggests that the negative perceptions may be bottoming out. As with the CSI, the Employment Index has been on a downward slide since the third quarter of 1997, with the sharpest annual drop of 79 points in the second quarter of 1998. For the quarter under review, the index was 68.9 points lower compared to a year ago.

When asked about their current income position, slightly more respondents indicated a steady stream of income compared to the second quarter. Half of the respondents maintained that their income was stable as compared to 47 per cent in the preceding quarter. Nevertheless, many are uncertain regarding their future financial income position, given the prevailing difficult economic conditions. Twenty-five per cent of the respondents were unable to state their expected position compared to 22 per cent in the previous quarter.

Reflecting the present state of the labour market, more respondents thought there are fewer job opportunities in the past six months. Of the consumers surveyed in the third quarter, 53 per cent thought there were less employment opportunities, compared with 46 per cent in the second quarter. When asked about the prospects of job vacancies within the next six months, fewer consumers expressed optimism compared to the last quarter. Sixteen per cent thought that there would be better opportunities, down from 18 per cent who responded thus in the last quarter. More were uncertain about the future.

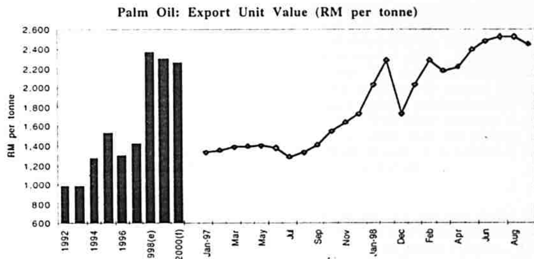
Consumers were also not enthusiastic in their spending plans. Only 11 per cent of those surveyed thought that it was a good time to buy, compared to 10 per cent in the previous quarter. For those with intentions to buy, slightly more respondents cited preferences for cars compared to the last quarter. Five per cent of those surveyed indicated as such, compared to four per cent in the second quarter of 1998.

Commodities Review

Palm Oil

Revenue from palm oil exports rose by a substantial 76.8 per cent during the period January-September 1998 compared to the same period last year. The strong gain in revenue was due to the surge in export unit value, which rose by 75.3 per cent to RM2,352 per tonne. Palm oil export volume fell by 3.7 per cent during the period. The large increase in revenue was due to the revaluation gain brought about by the ringgit depreciation. In US dollar terms, export unit price rose by 12.0 per cent during the period January-September 1998. Total domestic production in the first eight months of 1998 fell by 8.5 per cent, attributed to the previous drought caused by the El-Nino and the cyclical tree stress. The coming of La Nina, which brings heavy rain and flooding would result in lower production level. With the decline in production and the reduction in stock level, we are projecting a continued firm price of palm oil. The fixing of the ringgit exchange rate may also mean that prices would be less volatile. We expect price to be firm at RM2,370 per tonne in 1998, but moderating to a range of RM2,250-RM2,300 per tonne in 1999-2000 as production picks up again. Competition with soybean oil would also hinder prices from rising much higher.

Palm Oil: Export Unit Value (RM per tonne)



Rubber

Receipts from rubber exports rose by 1.9 per cent during the period January-September 1998 compared to the corresponding period last year. The gain in revenue was due to both higher export volume and the rise in export unit price. Export volume of rubber rose by 1.3 per cent while export unit price gained by a marginal 0.6 per cent. The weak rubber prices was attributed to lower demand amidst higher stock levels. It was also reported that Indonesia has been selling rubber at low prices due to difficulty in getting shipping lines for exports. Meanwhile, domestic rubber production fell by 14.2 per cent during the first seven months of this year. The steady decline in production over the years was attributed to the fall in rubber hectarage, low rubber prices and labour shortage. With the expected improvement in the world economy starting next year, the demand for rubber is forecast to pick up again, which may result in better prices. We are projecting export unit price for rubber to rise moderately to a level of 305-310 sen per kg in 1999-2000.

Saw Logs
Receipts from saw logs export fell by 20.8 per cent during the period January-September 1998 compared to the same period last year. The decline in revenue was due to a relatively substantial drop of 16.8 per cent in export volume coupled with a 4.8 per cent slide in the export unit price. The decline in revenue was attributed to the lower demand from traditional markets of Japan, Thailand and South Korea. The strong competition from other suppliers such as African tropical timber products also had some impact. The implementation of sustainable forest policy management have limited the availability of supply for exports. With depressed demand conditions, we estimate export unit price for saw logs to be at RM340 per cubic metre in 1998. Prices may improve to RM350 per cubic metre in 1999 with a pick up in demand.

Sawn Timber
Revenue from exports of sawn timber fell by a lesser extent than saw logs, with a loss of 8.9 per cent during the period January-September 1998 compared to the same period in 1997. The fall in revenue was due to a 15.8 per cent decline in export volume, more than enough to offset the 8.2 per cent increase in export unit price. Again, the major reason for the drop in earnings was lower demand from export markets such as Japan and Thailand which are going through economic downturns. We are projecting export unit price to be steady within the range of RM950-RM960 per cubic metre in 1999-2000.

Petroleum
Export value of crude petroleum rose by 19.1 per cent during the first seven months of 1998 compared to the same period in 1997. The increase in revenue was due to higher export volume combined with a smaller rise in export unit price (in RM). In US dollar terms, the export unit price for crude oil dropped from US$15.99 per barrel in January 1998 to US$13.94 per barrel in September 1998. In 1997, the price of crude petroleum averaged US$21.11 per barrel. The sharp fall in oil prices was in tandem with the decline in global oil prices, attributed to several factors which include the over-supply situation due to higher global production and the decline in demand from crisis-affected Asian countries. With some recovery in the global economy next year, the price of oil may rise again with the pick-up in demand. We project the export unit price for petroleum to firm up to US$15.3 per barrel in 1999, and to steadily rise to US$16.2 per barrel in 2000.

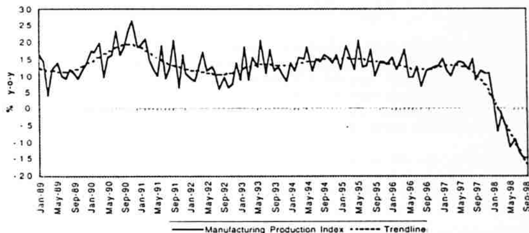
Liquefied Natural Gas (LNG)
Export earnings for liquefied natural gas (LNG) surged by 31.1 per cent during the first nine months of this year. The gain in revenue was due to a favourable 35.3 per cent rise in export unit price despite a 3.1 per cent drop in export volume. The decline in export volume was due to lower exports to South Korea which is going through a recession. We are expecting export unit price to soften to between RM480-490 per tonne in 1999-2000, from RM530 per tonne in 1998.

Tin
Earnings from tin exports rose by 8.5 per cent during the period January-September 1998, compared to the same period last year. The gain in revenue was due to a large 50.9 per cent increase in export unit price, which more than offset the 28.1 per cent decline in export volume. The strong rise in tin prices was attributed to the ringgit depreciation. To a lesser extent, tight supply conditions coupled with lower stock levels had also contributed favourably to the price hike. In US dollar terms, export unit price of tin actually fell by 2.5 per cent. We are projecting the export unit price of tin to moderate to a range between RM19,000-RM19,500 per tonne during 1999-2000 as supply conditions improve. This follows from a price level of RM21,500 per tonne in 1998.

Industrial Sector

Industrial Production

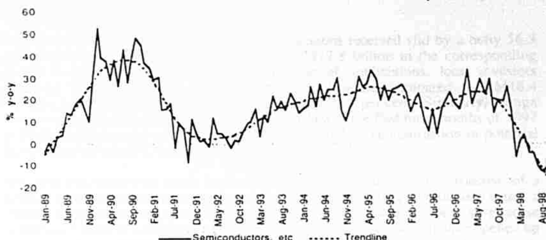
The Index of Industrial Production (IIP) registered a decline of 5.8 per cent for the first three quarters of 1998 compared to the corresponding period in 1997. On a monthly basis, the IIP contracted by 10.5 per cent (year-on-year) in September 1998, in contrast to a growth of 7.5 per cent in September 1997. Out of the three divisions within the index, only the manufacturing division registered a contraction in production for the period January-September 1998. When compared to the same period of reference in 1997, manufacturing output deteriorated by 8.6 per cent. Production was relatively more upbeat in the mining and electricity divisions with growth of 1.4 per cent and 4.4 per cent respectively during the first three quarters of the year.



The manufacturing division, which had been adversely affected by the downturn, showed signs of bottoming out lately. Despite cutbacks in production since the start of the year, the contractions were seen to be stabilising in recent months (see relevant graph). The decline in production has been hovering around 14 per cent (year-on-year) since July 1998. Contributing about 20 per cent to the overall manufacturing production, the *semiconductors and other electronic components* sub-sector contracted by 3.6 per cent for the period January-September 1998 compared to the corresponding period in 1997. Although double-digit contractions were seen on a monthly basis since July 1998, they seem to be stabilising thereafter. On the other hand, the production *of radio and television* sets were more impressive since the beginning of the year with a growth of 10.3 per cent for the period January-September 1998 compared to a year ago. Other sizeable contractions for the first three quarters of 1998 in the manufacturing division were in the *transport equipment* (-53%), the *footwear* (-39%) and, the *iron and steel basic* industries (-36%).

The export-oriented manufacturing industries basically displayed a downward production trend in 1998 although a slight pick-up was detected in September. Manufacturing production for exports contracted by 5.6 per cent for the first nine months of 1998 compared to the previous year's corresponding period. Reflecting poor domestic demand, manufacturing production for the domestic economy contracted by 11.6 per cent for the same period under review compared to a year ago.

Production of Semiconductors & Other Electronic Components



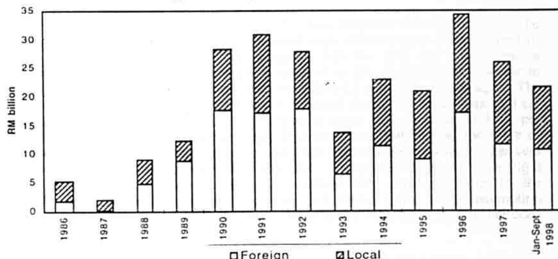
Approvals and Applications of Investment in the Manufacturing Sector

Approvals for the first nine months of 1998 were valued at RM21.4 billion, an 18.2 per cent increase from the corresponding period a year ago. This is equivalent to 83 per cent of the total amount approved for 1997. Foreign investment contributed 49.1 per cent of the approvals (RM10.5 billion in value terms) for the first nine months as opposed to 50.9 per cent proposed by local investors (RM10.9 billion).

The United States of America is maintaining its role as the top investor with approved capital of RM6.0 billion followed by Japan with RM1.4 billion, Taiwan with RM0.7 billion, the Netherlands with RM0.6 billion and Singapore with RM0.5 billion.

On an industry basis, the chemicals and chemical products sector attracted RM5.6 billion worth of investments while the petroleum products and petrochemical sector managed RM5.0 billion. The basic metal products industry pulled in investments amounting to RM2.2 billion while the electrical and electronics sector drew RM1.5 billion. Investment approvals in the transport equipment sector were also worth RM1.5 billion.

Total Approved Capital Investment (MIDA)



Furthermore, industries with the highest number of foreign participation were in the chemicals and chemical products sector (RM4.2 billion), petroleum products including petrochemicals (RM2 billion), basic metal products (RM753.6 million),

electrical and electronics sector (RM723.1 million), and textiles and textile products (RM602 million).

During the first nine months of the year, applications received slid by a hefty 56.8 per cent to RM12.0 billion as compared to RM27.8 billion in the corresponding period in 1997. In line with the slower rate of applications, local investors proposed RM5.2 billion in new investment applications compared to RM18.4 billion a year earlier. This marks a drastic drop by 71.7 per cent. Similarly, foreign investors' applications dropped from RM9.4 billion in the first nine months of 1997 to RM6.8 billion in the corresponding period in 1998. The contraction in potential foreign capital was 27.7 per cent.

We view this drop with much concern. Although it could just be reflective of a general drop in foreign direct investment in parts of the region, it could also signal a change in investors' perception and confidence. Of late there has been an increase in foreign capital to countries like Thailand and South Korea, which have opened up certain sectors to higher foreign participation. If Malaysia is slow in opening up its economy to higher foreign participation, there is a risk that the best foreign investors will instead be committed to other countries in the region. Foreign investments will bring together with it, not just much needed capital, but also expertise and know-how, as well as increased access to export markets. Their presence will help to speed up the economic recovery process when the region's outlook takes a turn for the better. A gradual increase in the percentage of foreign participation is in the medium to longer term interest of the nation from a competitive viewpoint, and in the short term, brings with it much needed capital.

Banking System

Loans extended by the banking system continued to be on a declining trend up till the month of September 1998. From a (year-on-year) growth of about 27 per cent since end of 1997, the growth rate of loans in September 1998 was only 4.5 per cent. The amount of loans extended by the banking system has declined from RM425.1 billion in January 1998 to RM418.8 billion in May, before picking up to RM422.0 billion in August. However, in the month of September, loans declined by RM2.4 billion. The sluggish growth rate of loans given out by the banking system reflects the sharp decline in economic activities this year. While banks are understandably cautious in approving loans, given the present economic scenario, the sluggish loans growth can also be attributed to tentative investor sentiments.

Analysing the composition of bank loans, the main recipient sector continues to be the broad property sector. This sector received loans amounting to 35.0 per cent of the total in September 1998. This is higher than the 32.0 per cent share in September 1997. The share of loans given out to the manufacturing sector in September 1998 was 15.5 per cent, compared to 14.7 per cent a year ago. The share of consumption credit to overall loans dropped slightly, with a share of 11.9 per cent in September 1998, which is marginally down from a share of 12.7 per cent last September. Reflecting the sluggish state of the local bourse, the share of loans for the purpose of purchasing securities and shares dropped from 9.8 per cent in September 1997 to 9.0 per cent this September. Overall there appears to be slight gains in the central bank's measures to increase the share of loans to the manufacturing sector and reduce the share of loans given for consumption purposes. But the share of loans to the broad property sector has in fact increased from a year ago.

Deposits placed with the banking system had dropped by RM12.6 billion during the period December 1997 to June 1998. However, deposits picked up to RM422.8 billion in August before declining to RM421.3 billion in September. On a year-on-year basis, deposits grew by 3.4 per cent in September 1998. Deposits by

individuals increased by RM1 billion during the month, while deposits by business enterprises increased by RM0.5 billion.

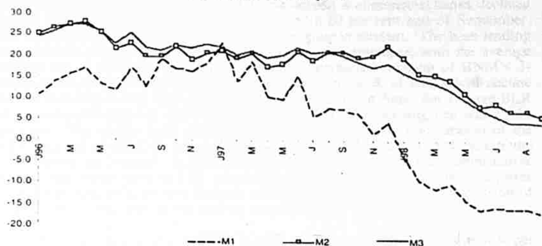
As loans declined in the month of September by more than the drop in deposits, the banking system recorded a resource surplus of RM582 million. As at end of September, the resource surplus rose to RM21 billion from RM20.4 billion a month ago. Thus, the loan-deposit ratio declined marginally from 95.2 per cent in August to 95.0 per cent in September.

Conduct of monetary policy
On 1st September, 1998, the government imposed capital control measures which were meant to close the capital account and prevent further outflow of ringgit. At the same time, the objective was to bring back ringgit deposits kept off-shore as the ringgit has ceased to be legal tender outside the country since 1st October, 1998. This enables the authorities to fix the exchange rate (against the USD at 3.80) and reduce interest rates to resuscitate the economy.

The central bank has targeted loans growth at 8.0 per cent by year-end. Understandably, it is concerned that banks are not extending sufficient credit to business enterprises. The target of 8 per cent loans growth by year-end 1998 is most likely to be unachievable. We reiterate that excessive compulsion on banks to achieve this target may result in loans being extended to companies of doubtful credit standing or for non-viable projects. This may have adverse implications for the asset quality of banks. It would be more attainable and feasible if the target is set for sometime in 1999.

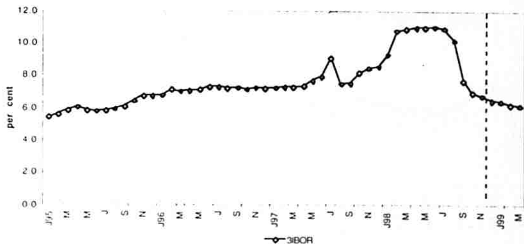
The redefinition of non-performing loans from three months arrears back to six months arrears (used in the pre-crisis period) is fine as long as it serves to enable banks to extend sufficient credit to the economy. But we stress here again that any extension beyond the current six-months definition should not be considered. This would mean relaxing prudential standards and will jeopardise the integrity of the banking system. It is important to be able to recognise early the possibility of loans turning bad, for both the regulatory body and the banks. This is especially so at a time when on the one hand, credit is needed by firms but, on the other, the ability of clients to service loans is of grave concern to bankers due to the prevailing difficult economic conditions. In this regard, we again suggest that the central bank, while using the 6-months arrears definition for non-performing loans,. continues to monitor and make public the ratio of loans that are "non-performing" based on the 3-months arrears definition. This will serve as an early warning system and enhance transparency, thus contributing to confidence-building.

Monetary Developments
The monetary aggregates continued to show a decline in its growth rates. In fact, narrow money or M1 contracted since January this year. Its decline (year-on-year) got steeper from –3.4 per cent in January to –17 per cent in September. This reflects the drop in demand for transaction balances in tandem with declining economic activities and also the shift towards interest bearing deposits such as time deposits. The broader monetary aggregates, M2 and M3, still showed positive growth (year-on-year) but on a declining trend. Money supply M2 grew by 5.9 per cent in September 1998 compared to 19.8 per cent in January. Money supply M3 expanded by just 4 per cent in July, significantly down from the 16.1 per cent growth in January.



Interest Rates

Interest rates peaked in the month of June 1998. The 3-month interbank rate, which went up to an average of 11.05 per cent in June (from just over 7 per cent in the beginning of 1997), declined to 10.22 per cent in August. An indication of the increased liquidity in the banking system is the drop in the loan-deposit ratio from 95.2 per cent in June to 94.7 per cent in July. In the month of August, there were three downward revisions in the 3-month intervention rate of the central bank. This had brought the rate down by 150 basis points, from 11 per cent to 9.5 per cent. Following the imposition of capital control measures effective September, the central bank's intervention rate for 3-month money dropped from 9.5 per cent to 8.0 per cent in early September. On 6th September, it was announced that the intervention rate will be further reduced by 50 basis points to 7.5 per cent. This was followed by another rate cut to 7.0 per cent with effect from 9th November. To ease liquidity further, the statutory reserve requirement (SRR) was lowered from a high of 13.5 per cent several times this year. The four cuts totalled a staggering 9.5 percentage points, resulting in the SRR standing at 4.0 per cent presently. With the massive injection of liquidity, the result was a significant drop in interest rates. The 3-month rate declined to an average of 7.75 per cent in September and further to an average of 6.80 per cent in November.

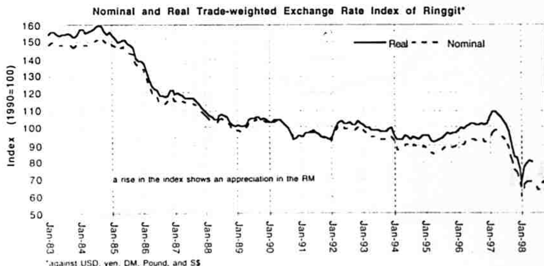


The drop in interbank rates was also reflected in the decline in deposit rates paid by banks. Interest rates offered for 3-month time deposit at commercial banks declined from a peak of 10.27 per cent in July to around 6.20 per cent end of September. The cheaper cost of funds saw lending rates dropping in tandem. The base lending rate of banks was at an average of 9.23 per cent in September, with the average lending rate at 11.09 per cent. With the latest downward revision of BNM's 3-month intervention rate to 7.0 per cent, the maximum BLR of banks will decline further to 8.08 per cent, from 8.50 per cent previosuly. In June, the average BLR of commercial banks was 12.27 per cent while the average lending rate was 13.51 per cent. The central bank also announced a revision in the computation of the BLR. Instead of using the average 3-month rate, the formula will now include the intervention rate instead. It also reduced by 25 basis points the administrative margin that banks have to 2.25 percentage points. Besides resulting in a lower BLR, *ceteris paribus*, the new formula will also result in a quicker transmission of changes in interest rates on the lending rates of banks.

The authorities may reduce the SRR further to 2 per cent from the current 4 per cent. Further reductions in the intervention rate of the central bank also cannot be ruled out. This is a crucial component of the determination of the BLR of banks. We anticipate that the authorities will further ease liquidity in the remaining part of this year and well into the first quarter of 1999. This will be done through a further reduction of the SRR and by lowering the intervention rate of the central bank. The 3-month interbank rate is forecast to drop to about 6.0-6.25 per cent in the first quarter of 1999. Assuming that the intervention rate drops further to 6.0 per cent and the SRR reduces to 2.0 per cent, the maximum BLR of banks will decline to 7.15 per cent. This scenario appears very likely. With the inflation rate hovering at about 5 plus per cent, deposit rates offered by banks is getting closer to zero in real terms. From the point of view of encouraging saving by ensuring a positive real interest rate, further reduction in rates need to be contemplated with caution.

Exchange Rate

At the end of November 1998, the ringgit's exchange rate against most of the major currencies strengthened following the decision in early September to fix the ringgit exchange rate with the US dollar at 3.80. From early September to end of November, the ringgit's value against the greenback appreciated by about 10.5 per cent. The local currency unit also gained strength against the pound (8.4 per cent), Deutschemark (3.5 per cent) and the Singapore dollar (3.2 per cent) in the said period. However, against the surging yen, it lost 8.5 per cent of its value.



Compared to the beginning of the year, when the ringgit appeared most vulnerable since the onset of the crisis in mid-1997, the ringgit appreciated by 15.8 per cent against the USD, 13.8 per cent against the pound and 8.0 per cent against the Singapore dollar. Against the Deutschemark and Singapore dollar, the ringgit lost ground by 6.7 per cent and 6.6 per cent respectively.

The ringgit had stabilised in recent months. Against a trade-weighted index of exchange rate of the country's top five trading partners, in November 1998, the ringgit had depreciated by 11.3 per cent compared to a year ago. At the height of the crisis in January 1998, the ringgit's value had dropped by 37.2 per cent compared to the corresponding month of 1997. Comparing the value of the index in November to that in January, the ringgit had gained 9.9 per cent.

The move to fix the exchange rate of the ringgit against the US dollar provides much needed stability to importers and exporters. Thus, it is favourable to the business community and will assist in putting back the economy on-track. We think that the rate fixed at 3.80 against the US dollar is still competitive for exporters in the current external environment. Flexible wages in the labour market, responding to weaker labour demand, will also avoid any unfavourable movement in the real exchange rate of the ringgit that may blunt the competitiveness of the country's exports. In the absence of the capital controls and fixed exchange rate against the USD, based on present market indicators involving other regional currencies, the local currency may be trading at about 3.50-3.60 to the greenback.

Price Developments

Consumer Prices

The inflation rate, as measured by the change in the Consumer Price Index (CPI), declined steadily since July 1998 after a peak of 6.2 per cent in June. Inflation for the month of September stood at 5.5 per cent, bringing the inflation figure for the first nine months of the year to 5.2 per cent (Jan-Sep 1997: 2.6%). The inflation rate is seen as stabilising for the three months up to September 1998, although it is still high compared to the previous years.

Inflation and Unemployment Rates (%)

The largest price increase came from the *food* group with an increase of 8.9 per cent for the period January-September 1998. Increase in food prices contributed 62.5 per cent to the overall inflation rate. The 8.9 per cent increase in the prices of food was due to the 9.2 per cent and 8.1 per cent increase in the prices of *food at home* and *food away from home* respectively. Among the items which comprises *food at home*, *sugar* (18.7%), *fruits and vegetables* (15.1%) and, *fish* (9.3%) registered the highest price increases.

Apart from the *food* group, another significant contributor to the increase in overall prices was the *gross rent, fuel and power* group. This group, which experienced a price increase of 4.5 per cent during the first nine months of the year, contributed 18.2 per cent to the overall rate of inflation. Other significant price increases came from the *furniture, furnishings and household equipment and operation* group and the *recreation, entertainment, education and cultural services* group. Prices for these two groups rose by 3.7 per cent and 2.9 per cent respectively during the said period. On the other hand, prices for *transport and communication* remained unchanged for the same period.

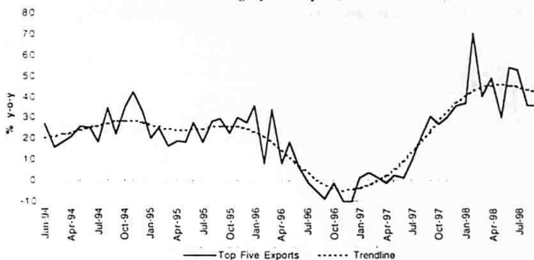
Producer prices

Producer prices have been on a downward growth trend after reaching a high of 17 per cent in the month of July 1998. Thereafter, the growth rate slipped to 14.5 per cent in August before settling at 10.4 per cent in September. Although the increase in producer prices had somewhat lost momentum, it remains high as compared to a growth of 2.1 per cent in September 1997. Double-digit growth rates were recorded since the start of 1998 thereby bringing the increase in prices for the period January-September 1998 to 13.2 per cent compared to a negligible increase of one per cent in the corresponding period of 1997. Out of the two components of the Producer Price Index (PPI), the domestic-PPI registered higher increase than the imported-PPI. Prices charged by the domestic producers were 13.8 per cent (Jan-Sep 1997: 0.9%) higher for the first nine months of the year compared to the same period in 1997. Importers, however, paid 10.8 per cent (Jan-Sep 1997: 1.7%) higher for commodities during the period of reference in 1998 compared to the year before.

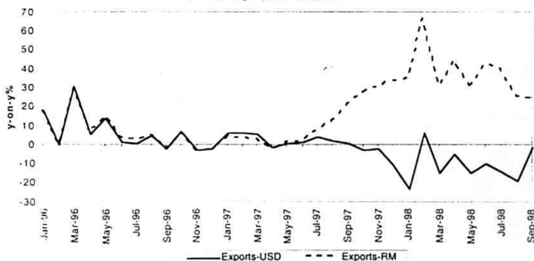
All items in the PPI basket of commodities registered increases during the first three quarters of the year. Carrying the largest weight, the *minerals, fuels, lubricants and related materials* sub-group recorded a 2.1 per cent (Jan-Sep 1997: 6.3%) increase in prices. Inflation was more apparent in *the machinery and transport equipment* sub-group where prices rose by 7.2 per cent during the period January-September 1998 (Jan-Sep 1997: 2.4%). Higher prices were largely due to the 15.7 per cent increase in prices paid by importers as compared to domestic producers charging 0.8 per cent higher. Significant price increases were found in the *animal and vegetable oils and fats* sub-group where the local-PPI and the imported-PPI were 77.3 per cent and 1.9 per cent higher, respectively, during the first three quarters of 1998 compared to the said period in 1997. Taken together, the overall increase in prices for that sub-group stood at 76.4 per cent.

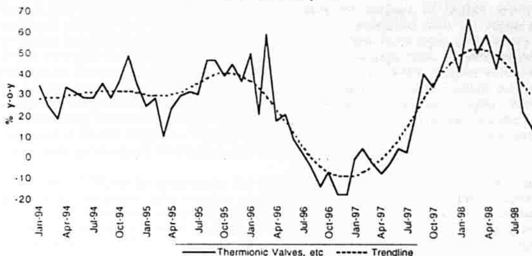
External Trade and Balance of Payments

The trade balance for the month of September 1998 registered an even bigger surplus of RM6.3 billion compared to a surplus of RM1.1 billion a year ago. This marks the eleventh consecutive month of surplus since November 1997. The continued rise in the trade surplus resulted in a huge cumulative surplus of RM38.7 billion for the first three quarters of 1998, in sharp contrast to the deficit of RM1.5 billion in the corresponding period of 1997.

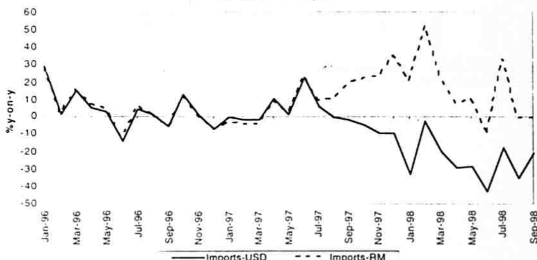


Higher trade surplus was made possible by the 37.1 per cent (Jan-Sep '97: 6.1%) growth in exports compared to the 11 per cent (Jan-Sep '97: 6.9%) increase in imports for the period January-September 1998. The robust growth in exports were largely due to the sharp acceleration in the *thermionic valves and tubes* component by 44.1 per cent (Jan-Sep '97: 5.5%) during the first nine months of 1998 as compared to the corresponding period in the year before. However, when measured in US dollar terms, exports have, in fact, contracted during the said period. Large exchange rate differentials and possibly lower export volume resulted in a decline in exports by 10.8 per cent (Jan-Sep '97: +6.8%) for the first nine months of the year. The sharp slowdown was, to a large extent, due to the contraction of 6.3 per cent (Jan-Sep '97: +2.4%) in the *thermionic valves and tubes* component during the period under review.





Imports of intermediate goods showed subdued growth in the second quarter of 1998 when compared with the first. The momentum slowed down to 15.9 per cent in the second quarter as compared with 31.8 per cent in the previous quarter. When measured in US dollars, a contraction of 24.1 per cent was recorded, significantly lower than the zero growth in the second quarter of 1997. Intermediate goods make up almost 70 per cent of total imports. On a similar note, imports of consumption and investment goods registered heavy decline in US dollar terms since the start of the crisis. The former contracted by 32.4 per cent in the second quarter of 1998 as compared with a growth of 11.1 per cent a year ago. Imports of investment goods, on the other hand, experienced a sharper contraction of 42 per cent in the quarter under review when compared with a more robust growth of 22.8 per cent in the second quarter of 1998.



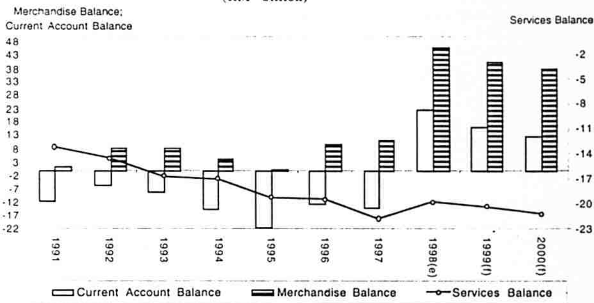
As for the forecast of the balance of payments, the merchandise surplus for 1998 is anticipated to be at RM46.1 billion. Exports will expand at 23.6 per cent while

import growth will lag significantly behind at 8.1 per cent. The services deficit will moderate to RM19.7 billion. Thus, the current account balance will turn around to register a surplus of RM23.0 billion in 1998.

Export growth for 1999 is forecast to be better on account of higher world economic growth and trade volume. However, this projection rests on Japan's economy faring better in 1999 and that Asia will also show some signs of recovery. These are rather fragile assumptions with substantial downside risks. Merchandise exports are forecast to grow by 0.7 per cent in nominal terms while imports will rise by 3.3 per cent. Nominal figures will need to be interpreted with caution as the ringgit exchange rate is now fixed against the US dollar at a rate that is higher than that prevailing before September 1998. The surplus in the merchandise balance is projected at RM40.5 billion. The services deficit is forecast at RM20.3 billion and the current account will continue to see a surplus, at RM16.2 billion.

In the year 2000, on the assumption that most affected East Asian economies will be on a steady recovery path, exports should pick up further. We project export growth of 2.6 per cent while imports will rise by 4.1 per cent. The merchandise balance is forecast to register a surplus of RM38.2 billion while the services balance will be in deficit by RM21.2 billion. The current account balance will see a surplus of RM12.8 billion, amounting to 4.4 per cent of nominal GNP.

Malaysia: Current Account Balance
(RM billion)



Downside Risks

The downside risks to the above forecast are as follows:

- The export sector is curtailed by a less than conducive external environment, with the Japanese economy and that of Asia not recovering as assumed. The economies of the US and Europe decline more than forecast. Export growth of Malaysian goods is curtailed and the trade balance surplus declines. The fixed exchange rate regime becomes difficult to sustain.
- There is insufficient domestic funds to recapitalise ailing banks and clean up bad loans. The downgraded sovereign rating of the country makes borrowing abroad costly. The budget deficit also becomes difficult to finance.
- The amount of bad loans in the banking system is larger than anticipated. Thus, the funding needed for vehicles like Danaharta and Danamodal exceeds the original estimation. This puts more pressure on raising the required capital.
- The lower interest rates do not stimulate demand as much as anticipated as confidence is still lacking.
- There is a severe outflow of capital come September 1999.
- The forecast above precludes political uncertainty.

Malaysian Institute of Economic Research
December 1998, Kuala Lumpur

Growth in Exports and Imports

Commodity Sections (SITC)	Imports (% change)				Exports (% change)			
	1996	1997	Jan-Sep 1997	Jan-Sep 1998	1996	1997	Jan-Sep 1997	Jan-Sep 1998
0 Food	15.3	10.5	3.2	10.8	4.6	12.3	3.2	27.1
1 Beverages and Tobacco	(10.7)	32.7	23.5	-0.3	45.1	29.5	17.7	40.1
2 Crude Materials, Inedible	6.7	10.7	4.5	11.4	(10.1)	(5.9)	-8.2	-4.0
3 Mineral Fuels, Lubricants, Etc	20.0	22.8	20.1	13.5	20.7	16.1	10.3	17.7
4 Animal and Vegetable Oils and Fats	(30.8)	87.6	27.4	215.7	(7.2)	10.8	7.3	77.9
5 Chemicals	(2.8)	15.3	8.9	14.9	11.6	25.7	19.2	39.4
6 Manufactured Goods	(1.8)	8.6	3.3	-4.1	12.0	8.8	3.2	27.8
7 Machinery & Transport Equipment	(1.5)	12.1	6.6	17.1	6.7	13.7	6.4	41.7
8 Miscellaneous Manufactured Articles	(0.0)	21.2	16.7	12.2	9.7	9.1	2.6	35.9
9 Miscellaneous Transactions and Commodities	(1.0)	(2.1)	4.9	-40.4	(10.9)	26.4	21.5	5.8
Total	**1.5**	**12.0**	**6.9**	**11.0**	**6.3**	**12.4**	**5.9**	**37.1**

Export and Import Value

Commodity Sections (SITC)	Exports, RM'000 Jan-Sep 1998	Imports, RM'000 Jan-Sep 1998	Trade Balance, RM'000 Jan-Sep 1998
0 Food	4,570,077	7,679,871	(3,109,794)
1 Beverages and Tobacco	712,925	454,280	258,645
2 Crude Materials, Inedible	7,005,644	4,377,821	2,627,823
3 Mineral Fuels, Lubricants, Etc.	14,704,040	5,264,358	9,439,682
4 Animal and Vegetable Oils and Fats	16,013,546	784,040	15,229,506
5 Chemicals	7,661,048	12,407,860	(4,746,812)
6 Manufactured Goods	17,950,134	19,269,198	(1,319,064)
7 Machinery & Transport Equipment	123,374,264	109,913,174	13,461,090
8 Miscellaneous Manufactured Articles	18,234,827	8,993,565	9,241,262
9 Miscellaneous Transactions and Commodities	2,034,111	4,409,140	(2,375,029)
Total	212,260,616	173,553,307	38,707,309

Top 5 Exports and Imports

Exports (SITC)	% share	% change Jan-Sep 1998
776 Thermionic valves and tubes; photocells; etc.	17.7	44.1
759 Parts and accessories for office machines and automatic data processing machines	6.1	42.0
764 Telecommunications equipment	5.1	33.7
422 Other vegetable oils, fluid or solid, crude, refined or purified	4.9	81.4
752 Automatic data processing machines and units thereof	4.7	37.5

Imports (SITC)	% share	% change Jan-Sep 1998
776 Thermionic valves and tubes, photocells, etc.	20.4	54.9
764 Telecommunications equipment	4.3	-2.7
772 Electrical apparatus, resistors	3.6	37.1
759 Parts and accessories for office machines and automatic data processing machines	3.4	11.5
728 Other machinery and equipment specialized for particular industries	3.2	-5.4

Table 1. GROSS DOMESTIC PRODUCT (1978 Prices), RM Million

								ECON. REPORT '98/99		BNM REPORT '97		MIER December '98	
	1992	1993	1994	1995	1996	1997	1998e	1998e	1999f	1997p	1998f	1999f	2000f
Private Consumption	44,804	46,866	51,516	56,288	59,668	62,490	55,991	56,266	56,355	62,504	63,154	56,439	59,408
(% change)	*3.0*	*4.6*	*9.9*	*9.3*	*6.0*	*4.7*	*-10.4*	*-10.0*	*0.2*	*4.8*	*1.0*	*0.8*	*5.3*
Public Consumption	13,464	14,903	16,372	17,568	17,818	18,763	18,578	18,825	19,009	18,677	16,540	18,631	18,855
(% change)	*4.0*	*10.7*	*9.9*	*7.3*	*1.4*	*5.3*	*-1.0*	*0.3*	*1.0*	*4.8*	*-11.4*	*0.3*	*1.2*
Private Investment	20,652	24,591	31,459	39,411	44,675	48,446	31,441	30,063	30,135	48,374	45,079	31,630	33,148
(% change)	*0.5*	*19.1*	*27.9*	*25.3*	*13.4*	*8.4*	*-35.1*	*-37.9*	*0.2*	*8.3*	*-6.8*	*0.6*	*4.8*
Public Investment	13,922	15,098	15,004	16,304	16,485	17,908	15,444	15,868	16,267	17,998	15,609	15,779	16,284
(% change)	*28.0*	*8.4*	*-0.6*	*8.7*	*1.1*	*8.6*	*-13.8*	*-11.4*	*2.5*	*9.2*	*-13.3*	*2.2*	*3.2*
Change in stocks	-1,117	-785	338	679	-1,485	-568	-896	-925	140	1,004	-355	-168	-126
Exports of Goods and Non-factor Services	76,303	89,455	109,566	128,829	138,043	152,942	151,642	156,019	159,723	151,507	157,697	153,158	156,038
(% change)	*6.2*	*17.2*	*22.5*	*17.6*	*7.2*	*10.8*	*-0.8*	*2.0*	*2.4*	*9.8*	*4.1*	*1.0*	*1.9*
Imports of Goods and Non-factor Services	75,162	89,511	114,279	138,770	144,583	159,297	140,181	142,177	146,292	159,200	153,326	142,557	147,119
(% change)	*1.2*	*19.1*	*27.7*	*21.4*	*4.2*	*10.2*	*-12.0*	*-10.7*	*2.9*	*10.1*	*-3.7*	*1.7*	*3.2*
Gross Domestic Product	92,866	100,617	109,976	120,309	130,621	140,684	132,019	133,939	135,338	140,864	144,398	132,912	136,487
(% change)	*7.8*	*8.3*	*9.3*	*9.4*	*8.6*	*7.7*	*-6.2*	*-4.8*	*1.0*	*7.8*	*2.5*	*0.7*	*2.7*
Net Factor Payments Abroad	-5,199	-5,326	-5,970	-6,568	-7,455	-7,873	-8,116	-8,014	-8,325	-8,516	-9,826	-8,466	-8,821
Gross National Product	87,667	95,291	104,006	113,741	123,166	132,811	123,903	125,925	127,013	132,348	134,572	124,446	127,666
(% change)	*7.6*	*8.7*	*9.1*	*9.4*	*8.3*	*7.8*	*-6.7*	*-5.2*	*0.9*	*7.5*	*1.7*	*0.4*	*2.6*

p-preliminary; e-estimate; f-forecast

Source: MIER Forecast; Ministry of Finance, Economic Report 1998/99 (Oct. 1998); Bank Negara Malaysia, Annual Report 1997 (Mar. 1998)

Table 2. CURRENT ACCOUNT BALANCE & MACRO ECONOMIC INDICATORS (RM Million)

								ECON. REPORT '98/99		BNM REPORT '97		MIER December '98	
	1992	1993	1994	1995	1996	1997	1998e	1998e	1999f	1997p	1998f	1999f	2000f
Merchandise Balance	8,609	8,231	4,460	97	10,154	11,337	46,066	42,724	33,358	11,088	27,614	40,480	38,168
Exports (f.o.b.)	100,910	118,383	148,506	179,491	193,127	218,701	270,227	280,248	281,258	218,734	298,838	272,037	279,219
(% change)	*9.4*	*17.3*	*25.4*	*20.9*	*7.6*	*13.2*	*23.6*	*28.1*	*0.4*	*13.3*	*36.6*	*0.7*	*2.6*
Imports (f.o.b.)	92,301	110,152	144,046	179,394	182,973	207,364	224,160	237,524	247,900	207,646	271,224	231,558	241,052
(% change)	*1.7*	*19.3*	*30.8*	*24.5*	*2.0*	*13.3*	*8.1*	*14.5*	*4.4*	*13.5*	*30.6*	*3.3*	*4.1*
Services Balance	-14,568	-16,670	-17,005	-19,229	-19,414	-21,792	-19,726	-19,486	-19,395	-20,790	-25,282	-20,337	-21,189
Current Account Balance	-5,622	-7,926	-14,770	-21,647	-12,196	-14,153	22,983	20,065	11,013	-13,400	-1,440	16,163	12,845
(% nominal GNP)	*-4.0*	*-5.1*	*-8.2*	*-10.4*	*-5.1*	*-5.4*	*8.5*	*7.7*	*4.2*	*-5.1*	*-0.5*	*5.9*	*4.4*
Inflation (% change in CPI)	4.7	3.6	3.7	3.4	3.5	2.7	5.2	5.0	3.5	2.7	7.0-8.0	4.2	3.8
Unemployment rate (%)	3.7	3.0	2.9	2.8	2.6	2.6	5.5	4.9	n.a	2.7	n.a.	5.7	5.6

p-preliminary; e-estimate; f-forecast

Source: MIER Forecast; Ministry of Finance, Economic Report 1998/99 (Oct. 1998); Bank Negara Malaysia, Annual Report 1997 (Mar. 1998)

Table 3 NOMINAL EXPORTS (RM million)

	1992	1993	1994	1995	1996	1997	1998e	ECON REPORT '98/99 1998e	ECON REPORT '98/99 1999f	BNM REPORT '97 1997	BNM REPORT '97 1998f	MIER December '98 1999f	MIER December '98 2000f
Rubber													
Export Volume ('000 tonnes)	1,035	937	1,017	1,013	980	1,018	1,030	1,012	1,000	1,018		1,009	1,021
Export Value (RM mil.)	2,357	2,132	2,927	4,038	3,509	2,971	3,027	3,115	3,100	2,971		3,128	3,114
Unit Value (sen/kg)	228	227	288	398	358	292	294	308	310	292		310	305
Tin													
Export Volume ('000 tonnes)	45	36	37	35	34	32	26	29	28	32		25	25
Export Value (RM mil.)	721	489	507	545	533	479	554	609	546	479		487	480
Unit Value (RM/tonne)	15,965	13,752	13,773	15,488	15,524	15,064	21,500	21,146	19,500	15,064		19,500	19,000
Palm Oil													
Export Volume ('000 tonnes)	5,536	5,838	6,863	6,656	7,324	7,609	7,381	7,250	7,850			7,971	8,314
Export Value (RM mil.)	5,412	5,772	8,479	10,395	9,436	10,810	17,492	16,458	17,663	10,810		18,334	18,706
Unit Value (RM/tonne)	978	989	1,235	1,562	1,288	1,421	2,370	2,270	2,250			2,300	2,250
Saw Logs													
Export Volume ('000 cub.mtr.)	17,888	9,288	8,417	7,746	6,985	6,396	5,309	5,040	5,000	6,396		5,282	5,208
Export Value (RM mil.)	3,843	2,914	2,543	2,264	2,282	2,346	1,805	1,721	1,775	2,346		1,849	1,849
Unit Value (RM/cub. mtr.)	215	314	302	292	327	367	340	341	355	367		350	355
Sawn Timber													
Export Volume ('000 cub.mtr.)	5,392	5,477	4,777	4,367	3,655	3,075	2,644	2,644	2,591	3,075		2,591	2,565
Export Value (RM mil.)	3,487	4,545	4,331	3,839	3,039	2,781	2,525	2,525	2,487	2,781		2,488	2,476
Unit Value (RM/cub. mtr.)	647	830	907	879	831	904	955	955	960	904		960	965
Petroleum													
Export Volume ('000 tonnes)	22,526	21,032	19,061	19,165	17,494	15,872	17,800	16,603	16,804			18,000	18,000
Export ('000 b.p.d.)	469	438	397	399	364	330	371	346	350			375	375
Export Value (RM mil.)	9,122	7,996	6,548	6,701	7,212	7,069	7,505	7,261	7,279	7,069		7,954	8,421
Average Price (US$)	20.9	18.9	17.1	18.3	22.0	21.1	14.6	14.7	15.0	21.1	16.0	15.3	16.2
Liquefied Natural Gas (LNG)													
Export Volume ('000 tonnes)	7,486	8,012	8,276	9,727	12,908	15,309	15,210	15,210	15,610	15,309		15,610	15,610
Export Value (RM mil.)	2,712	2,655	2,361	3,069	4,746	6,752	8,061	8,183	7,530	6,752		7,493	7,649
Unit Value (RM/tonne)	362	331	285	316	368	441	530	538	482	441		480	490
Total Major Commodity Exports	27,654	26,288	27,204	30,851	30,757	33,207	40,970	39,872	40,381	33,207		41,731	42,696
% change	*-4.6*	*-4.9*	*3.5*	*13.4*	*-0.3*	*8.0*	*23.4*	*20.1*	*1.3*	*8.0*		*1.9*	*2.3*
Manufactures	71,124	89,694	120,295	147,253	158,540	179,031	223,968	229,100	231,391	178,858	249,700	227,776	234,837
% change	*15.8*	*26.1*	*34.1*	*22.4*	*7.7*	*12.9*	*25.1*	*28.0*	*1.0*	*12.8*	*39.6*	*1.7*	*3.1*
Total Gross Exports	100,910	118,383	148,506	179,491	193,127	218,701	270,227	280,248	281,258	218,734	298,838	272,037	279,219
% change	*9.4*	*17.3*	*25.4*	*20.9*	*7.6*	*13.2*	*23.6*	*28.1*	*0.4*	*13.3*	*36.6*	*0.7*	*2.6*

Source: MIER Forecast; Ministry of Finance, Economic Report 1998/99 (Oct. 1998); Bank Negara Malaysia, Annual Report 1997 (Mar. 1998)

5

MIER
1998 NATIONAL OUTLOOK CONFERENCE

Shangri-La Hotel, Kuala Lumpur
1-2 December 1998

TOWARDS ECONOMIC RECOVERY:
The Fiscal Policy Side

by

Suresh Narayanan

Malaysian Institute of Economic Research
Institut Penyelidikan Ekonomi Malaysia

Towards Economic Recovery: The Fiscal Policy Side

Suresh Narayanan

School of Social Sciences
Universiti Sains Malaysia
11800 Penang, Malaysia

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Towards Economic Recovery: The Fiscal Policy Side

I. Introduction

Since the floating of the Thai *baht*, in July 1997, triggered a massive outflow of funds from the region, Malaysia, has been grappling with what was initially characterised as a monetary crisis. Attempts to address it through tight monetary and fiscal policies proved unsatisfactory. What began as a crisis in the monetary sector had, within thirteen months, engulfed the real sector as well.

In October, 1997, it was projected that the GDP would grow at 7 per cent in 1998. But by March 1998, this projection was revised downwards to between 2-3 per cent. With the first two quarters seeing negative rates of growth, this projection was downgraded further. The recent 1999 Budget proposals predicted a GDP contraction of 4.8 per cent in 1998 - the first contraction in 13 years (NST. October 24,1998).

The policy-mix designed to address the crisis has also undergone changes. When the initial tight fiscal-monetary policy-mix proved inadequate to turn the economy around, the government announced an easing of its fiscal stance through increased spending. However, the tight monetary policy was maintained. When even this failed to yield quick results, radical measures were imposed to facilitate a combination of expansionary fiscal and monetary policy.

The decision to adopt fiscal stimulation to revive the economy is the focus of this paper. However, monetary policy has eased so rapidly since the announcement of the

fixed exchange rate for the *ringgit* and forex controls in September 1998, it has once again taken centre-stage. Consequently, we will touch on these developments as well, although fiscal issues will remain the primary concern. Section II reviews critically the mixed record of using fiscal policy as a stabilisation tool. Section III outlines the developments that led to the shift from a tight monetary and fiscal policy approach to one that relies on expansionary fiscal and monetary policies. Additionally, it outlines the main fiscal initiatives to date. Section IV discusses some issues relating to the expansionary fiscal approach that has been put in place. The paper is concluded in Section V with the view that while the public sector is well-placed to *initiate* a fiscal stimulus through increased spending, the subsequent momentum should be sustained by the private sector aided by well designed tax-cuts. This will free the public sector to focus on the more critical task of restoring longer-term confidence in the viability of the economy.

II. Fiscal Policy in Malaysia: A Mixed Record[1]

Since independence in 1957, and well into the mid-sixties, there was no compelling evidence to suggest that fiscal policy went beyond the traditional role of generating revenues and providing expenditures to support basic infrastructure and maintaining law and order (MIER, 1987: 3).

However, fiscal policy became an important tool in the economic restructuring with the advent of the New Economic Policy (1970-1990). Increased public sector spending spearheaded these efforts. The public sector was enlarged, more universities

[1] This section is drawn largely from Narayanan (1996)

were established and well-endowed off-budget agencies (OBAs) were created to generate new opportunities. A system of quotas that favoured the *Bumiputera* ensured that they would gain the major share of these efforts.

Anticipating apathy from the existing indigenous Chinese business community to creating business opportunities for the *Bumiputera*, the government fostered an alliance with foreign capital. Liberal tax incentives were offered to them in return for reserved employment and equity shares. In fact, the generous tax holidays granted to "pioneer" firms under the Investment Incentive Act accrued largely to foreigners during the early NEP phase. Hence, the early efforts at economic restructuring proceeded through a combination of vigorous public expenditures aimed at enlarging public sector participation in economic activities and liberal tax breaks to foreign investors in return for increased *Bumiputera* stakes in industrial employment and equity.

A Successful Anti-Cyclical Effort: 1974-76

A growing economy was seen as being critical in the efforts to restructure society. It was therefore made clear that the government was ready to adopt anti-cyclical measures if external cyclical fluctuations threatened the growth process. This resolve was demonstrated during the brief economic downturn of 1974-75. The slackening real output growth in the industrial economies adversely affected the external demand for Malaysia's primary commodity exports. This impact was compounded by the lack of domestic investment activity induced by fears surrounding the newly introduced Industrial Co-ordination Act. The net impact was that real growth fell to 2.2 per cent in

19775, well below the 7.1 per cent average achieved between 1971-75 (Bank Negara Malaysia, 1976: 21).

A concerted effort was made to counter the recessionary impact. Although revenues were stagnating, federal capital expenditure was increased by 8.5 per cent in real terms in early 1975. Current expenditure too was upped by 11 per cent in real terms (Bank Negara Malaysia, 1974: 4). With the recovery of the export sector in 1976, GNP achieved a 11.3 per cent growth in real terms. Fiscal policy appeared to have been successfully used to ride an economic downturn. However, the key to successful effort lay in the fact that the downturn was relatively short and was primarily caused by weak external demand. Thus, the fiscal effort was needed only as an interim measure. When demand abroad picked up, it provided a natural antidote to the sluggish local economy.

Initial Success, Then Retreat: 1979-84

Buoyed by this success, the same approach was used in the face of another crisis that was looming in the horizon. And initially, at least, it appeared to work. By the 1980s, the OECD economies were displaying signs of weakening, but Malaysia was scarcely affected. An export boom and large public sector spending in support of an ambitious Third Malaysia Plan afforded some measure of protection. Between 1979-81, federal government spending had risen from RM14.2 billion to RM26.8 billion.

As the recession outside worsened, the strategy of counter-cyclical spending was adopted in earnest as the major policy initiative. The 1982 budget estimates saw a further increase in the allocation for government expenditure - it was raised by 38 per cent over the original allocation, to RM32 billion. The finance minister made it clear that public

spending was being increased to stave off the recession that was evident elsewhere. He declared (1982 Budget, 1981: 7):

"....regardless of international recession, we must strive to ensure that Malaysia's economy will continue to expand....in order to achieve the socio-economic objectives of the New Economic Policy and the long-term perspective Plan."

But this was not to be. Unlike the earlier attempt, the policy proved unsustainable and the fiscal initiative was soon in retreat. With the benefit of hind-sight, it is easy to see that the government had embarked on a task beyond its means. The length and severity of the world-wide recession remained unpredictable, forcing counter-cyclical spending to be sustained over a time horizon far beyond what policy-makers were prepared for. Furthermore, since the private sector was largely crippled, the public sector had to shoulder this burden alone. It turned out that the public sector could not marshal the resources for a task of this magnitude since it was already stretched with existing commitments.

The public sector involvement in economic activities had acquired immense proportions. Public enterprises that spearheaded these efforts had mushroomed rapidly during this period. Between 1970-80, their numbers had grown from 109 to 656. The financial allocation for them grew in tandem - from one third of the total development budget (RM1.4 billion) between 1966-70 to 48 per cent (RM12 billion) between 1976-80 (Rugayah, 1995: 66). In 1984, there were more public sector employees per thousand persons in Malaysia relative to the comparable figures for Africa, Latin America, Asia, the OECD and developing nations as a whole. The cost of maintaining the large number

of public sector employees was estimated at RM8.8 billion, or 46 per cent of the operating budget (cited in Yip, 1987: 137-38).

Public investment exceeded revenue and increasingly depended on foreign borrowing. Between 1979-81, foreign borrowing increased five-fold, from RM6.8 million to RM3.4 billion. In the two years of 1981-82, foreign borrowing amounted to RM8.3 billion and accounted for 45 per cent of total loans.

The enlarged public sector left two legacies in its wake. By the end of 1982, the federal budget deficit was equivalent to 18.7 per cent of the GNP, while the current account deficit amounted to 14 per cent of the GNP. These deficits were 8.3 per cent and 1.1 per cent of the GNP, respectively, in 1980. Consequently, about seven months after the earlier announcement of a resolute counter-cyclical policy - the policy was abandoned. In its place, expenditure cuts were announced. Subsequent budgets, until 1984, focused largely on restraining government spending, especially development spending, yielding what appeared to be a contradiction to conventional wisdom - cutting public expenditures during a recession.

The sudden expenditure cuts, coupled with the inability of the private sector to take up the slack, resulted in economic growth nose-diving. Real GDP growth fell from 7.8 per cent in 1984 to a negative one per cent in 1985. Malaysian fiscal policy was in disarray.

Fiscal Thrust Realigned: 1984-90

The fiscal thrust was overhauled under a new finance minister (July 1984-December 1990), who adopted a more appropriate fiscal strategy. While continuing the

efforts of withdrawing the public sector from economic activities, concerted efforts were made towards reviving the private sector to fill the gap. The strategy to pull back the public sector included reducing the number of off-budget agencies and placing the remaining ones under strict supervision. Privatisation was initiated to pass the burden of public economic entities into private hands. While questions have been raised about the manner in which the privatisation exercise has been carried out (see Adam and Cavendish, 1995), by 1990, about 24 major initiatives had been listed as government privatisations, although there were many more lesser efforts in this direction as well.

Improvements in the federal budget after 1987 and improved external conditions allowed the government to borrow cheaper domestic funds to refinance foreign loans. Between 1987-89, RM13.6 billion was pre-paid by both the public and private sectors. External debt as a proportion of the GNP fell from 75 per cent to 43 per cent between 1986-89.

Efforts to rehabilitate the private sector included rules that allowed 100 per cent foreign equity participation in certain export-oriented projects, liberalising some controversial provisions of the ICA on licensing requirements and income tax- based incentives under a newly announced Promotion of Investments Act of 1986 that replaced the Investment Incentive Act. Furthermore, a real attempt was made to boost local small-scale enterprises with the promise of automatic "pioneer" status for approved products, and other tax concessions.

To boost domestic demand and to keep the corporate tax attractive vis-à-vis Malaysia's neighbours, the income tax schedule was revamped in the budget proposals of

1985. In the case of personal income tax, the top marginal tax rate was cut, the number of taxable income brackets were reduced, and the lowest threshold income (when personal income tax becomes payable) was raised. Similarly, the corporate tax was reduced while the development tax was abolished in stages.

The fiscal initiatives were not only aided by a favourable turn of external events but allowed Malaysia to benefit substantially from them. Commodity prices strengthened with the recovery of the US economy, and rising labour costs and appreciating national currencies led to the relocation of investments from Japan, Taiwan and Singapore. The economy bounced back from the negative growth rate of 1985 to post a 5.2 per cent growth in GDP by 1987. Growth registered a 9.7 per cent rate by 1990. The twin deficits, too, had been brought to manageable proportions. The federal budget deficit and the current account deficits stood at 5 per cent and 4.1 per cent of the GDP, respectively.

However, one important area of fiscal reform failed to evoke the attention it deserved. The country's tax system remained fraught with weaknesses, distortions and an impaired capacity to maximise revenue. While there was a suggestion of a major tax reform - especially of indirect taxes - in the budget of 1989 (1989 Budget, 1988: 10), nothing came out of it.

The tax side of the fiscal strategy to revive the economy had focused on giving out liberal tax concessions to attract investment and stimulate the private sector. This was supplemented by reductions in the corporate and personal tax rates to keep Malaysia a competitive place to invest in. These moves eroded the revenue potential of direct taxes. In fact, neither the personal or corporate income tax is wide. The contribution of the

former is about 2 per cent of the GNP, while the latter amounts (excluding petroleum income tax) to less than 4 per cent of the GNP (Bank Negara Malaysia, 1991: 206) Consequently, more reliance has to be placed on indirect taxes to generate future revenues. Yet, the indirect taxes had major deficiencies that remain unaddressed.

The first point to note is that many of the indirect taxes (such as the sales tax, excise tax and import taxes) share a similar and very narrow base. An estimated 60 per cent of imported and locally manufactured goods are not within the ambit of the sales tax, more than 60 per cent of imports are spared the import tax (Bank Negara Malaysia, 1991: 206). In addition, the single-stage sales tax imposed on the manufacturer distorts behaviour[2], generates tax-pyramiding[3] and still has elements of tax-cascading[4]. These features cause the effective tax rates to diverge from the statutory rates (Narayanan, 1991). Second, revenues from export and import taxes are likely to be on a declining trend. The abolition of export taxes on most commodities and the commitment to reduce import taxes on most items by the year 2003, to conform to the ASEAN Free Trade Agreement, account for this. Third, the high dependence on petroleum-based taxes makes revenues both unstable and vulnerable to external conditions. It was estimated that a

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[2] For example, since the sales tax is levied in the early stage of production, it fails to tax value added in later stages. This results in the effective tax rate depending upon the number of subsequent stages the taxed commodity passes through.. Also, there is considerable incentive to push activities such as advertising and freight services beyond the point of impact of the tax (see Narayanan, 1991: 7-9).

[3] This occurs because the tax is applied at the first stage of the production-distribution chain. Ass the taxed good passes through subsequent stages, a mark-up is applied to the purchase price that includes the tax. Consequently, the tax "pyramids" as it reaches the consumer but the higher price paid by the consumer does not result in higher tax receipts to the government.

[4] This refers to the mutiple application of a tax to a given commodity as it goes through the production and distribution chain. Thus the total tax attracted by a good is not determined by any objective criteria. Instead, it will hinge on the number of stages it has to pass through. In Malaysia, a "ring system" and "refund system" attempts to minimise cascading but these are not entirely effective (see Narayanan, 1991: 8, for more details).

US$1 decrease in oil price would yield a revenue loss of about RM100 million from the petroleum income tax, export duty and royalties in the first year and an additional RM400 million in the following year (Bank Negara Malaysia, 1991: 206). Given these considerations, the revenue-raising function of the indirect system deserved high priority.

Between 1984-1991, the economy not only recovered from the negative growth of 1985 but returned a 9.7 per cent growth rate in 1990. Since then the economy has been averaging annual growth rates in excess of 8 per cent. The buoyant economy and good petroleum prices kept revenues high,[5] masking the underlying flaws in the tax system and pushing the need for tax reform further into the background.

The lessons from this experience are evident. Expansionary fiscal policies are burdensome and therefore essentially short-term measures that have to be well focused. They demand a huge amount of public resources that are often not available and frequently lead to borrowing. More importantly, fiscal stimulus must be a part of a larger and more comprehensive policy-mix that aims at reviving private sector initiatives - both domestic and foreign, particularly in a open economy like ours. Any attempt by the public sector to "go it alone" on a large scale will be counter-productive because it will "crowd out the private sector".

[5] More specifically, petroleum-based taxes played a major role in sustaining revenues in the 1981-85 period. Petroleum-based taxes aaccounted for 12 per cent of total tax revenues in 1981 and 34 per cent in 1991. Revenue short-falls arising from a drop in petroleum prices were offset by increasing production (see Bank Negara Malaysia, 1985: 102). This strategy did not work well in 1986 because of the magnitude of the fall in world petroleum prices and federal revenue fell for the first time in 30 years in 1986 and 1987. This also pushed up the federal budget deficit that had been decreasing in 1984 and 1985. Petroleum prices recovered by 1990.

Fiscal Stimulus in a Growing Economy: 1990-96

In a rapidly growing economy, further fiscal stimulus seemed hardly necessary. By 1991, the Governor Of Bank Negara cautioned that the economy might be overheating: inflation was on the rise, the current account deficit in the balance of payments was widening and infrastructural bottlenecks were surfacing in key sectors. The Bank, therefore, recommended prudence and policy measures to moderate growth and followed it up with tighter monetary policies (see Bank Negara Malaysia, 1993). However, the thrust of fiscal policy seemed to be in the opposite direction.[6]

The environment of growth presented an opportunity to address the much needed reform on the tax side. And these reforms had to focus on indirect taxes. This is because liberal personal and corporate income tax cuts and tax-based incentives had been used to stimulate recovery, thereby undermining the ability of the direct tax system to remain as an important source of revenue in the future. Furthermore, the scope for reversing these tax concessions was slim, given the need to remain competitive vis-à-vis our neighbours. The logical move would have been to strengthen the structure and scope of indirect taxes in order to restore its revenue-raising potential. The indirect system remains a product of piece-meal changes introduced to meet immediate concerns. This ad-hoc approach has resulted in an altogether complex system that does not yield revenues sufficient to justify its complexity.

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[6] Major fiscal incentives since 1992 included further cuts in personal and corporate income taxes, the lowering or abolition of import taxes on a large number of goods, primarily consumption goods. Alongside such moves, development spending of the federal government were increased and has recorded double-digit growth since 1988. The development allocation for the federal government was revised upwards from RM55 billion to RM58.5 billion in the Mid-Term Review of the Sixth Malaysia Plan. Current expenditures saw an increase in 1992 with the decision to raise the salaries of civil servants and to pay them salary arrears. A host of huge multi-billion ringgit projects that were public sector instigated but private sector executed also took centre stage.

As indicated earlier, although the need to rationalise the indirect system was mentioned as early as in 1988, with the possibility of introducing a broad-based tax on consumption such as the value-added tax (see 1989 Budget, 1988: 10), nothing came out of it. Then in 1993, when measures to extend the service tax slightly were announced, there was a promise of a broader sales and service tax (SST) to come. It was widely held that the SST would be a value-added tax in disguise. However, the continually buoyant economy yielded enough revenues to turn around the public sector budget from being in a deficit to a surplus since 1993. This may have reduced the urgency to act on the issue.

A period of rapid growth would have been the time to introduce the broad-based consumption tax that could "integrate the existing sales, service and excise taxes and derive economies in a single tax administration" (Bank Negara Malaysia, 1991: 207). Such a tax would have served several useful functions. First, a rationalised indirect tax structure would have removed the unintended distortions in the current system and simplified the tax machinery. Second, it could have helped moderate growth and curb inflationary pressures by reducing the resources in private hands. Third, a solid foundation would have been laid to generate significant fiscal surpluses all through the years of prosperity. More importantly, this could have been achieved without serious opposition to the new tax since general incomes were rising. Unfortunately, this opportunity was allowed to slip by.

III. The Current Crisis: A Changing Policy-Mix

The approach to handling the crisis appears to have gone through three phases. In the first phase, the problem was viewed as one caused by a weak financial sector, a

growing current account deficit, excessive and unbalanced lending to certain sectors (like property and the stock-market) and capital flight. Accordingly, a tight monetary and fiscal stance was adopted. Various measures were announced to reduce the excess liquidity in the system, raise interest rates, cap credit growth, and restrain further lending for real-estate and stock market purchases. Attempts to limit private consumption came via allowance- cuts in the public sector and wage restraints in the private sector. The underlying rationale was that financial prudence will stabilise the *ringgit*, restore market confidence, and attract *foreign* capital. These, in turn, will form the basis of an economic recovery. Although Malaysia had not accepted aid from the International Monetary Fund (IMF), it was following a strategy modelled on the IMF recipe for other troubled economies in the region.

In this connection, the high interest policy has been the centre of controversy. On the one hand, it had been defended on the grounds that it will help curb the outflow of funds, particularly by Malaysian citizens, by inducing saving. Furthermore, high interest rates, *ceteris paribus*, were likely to attract foreign funds. These developments will help stabilise the exchange rate. The downside of this policy was that the high cost of borrowing funds would choke new domestic private investment in an already lacklustre environment and burden existing firms in terms of higher debt repayment costs. Nevertheless, the general approach was to only consider easing interest rates after a period of high interest rates stabilised the exchange rate.

While high interest rates may have succeeded in reducing the taking-out of funds by Malaysian residents in the face of a rapid devaluation of the *ringgit*, it had virtually no

impact on attracting foreign funds. And it did have an adverse reaction on domestic entrepreneurial activity.

With more than a year of tight monetary policy and fiscal restraint, the results were less than satisfactory. The GDP contracted by 2.8 per cent over the first quarter of 1998 - that is, negative GDP growth for the first time in 13 years. Output of the manufacturing sector declined by five per cent for the first five months of 1998. Exports in US dollar terms declined by 10.3 per cent, primarily because of a 22.5 per cent fall in exports to Asean and Japan. This prompted the Finance Minister to declare a shift in strategy. This was to be the second phase of the policy-mix aimed at handling the crisis. He told Parliament on 13 July, 1998:

> "[T]he capacity of the private sector as the engine for economic growth is limited because of liquidity problems. The government has agreed to implement counter-cyclical measures including a fiscal stimulus to generate economic activities and contain the contractionary impact of the financial crisis" (NST, July 14, 1998: 12).

However, the measures announced came too late to avert the further contraction in growth. Bank Negara reported at the end of August 1998 that the GDP had declined by 6.8 per cent in the second quarter of the year, and announced measures to slightly ease its monetary stance (NST, August 28, 1998: 1). Manufacturing, a leading sector, had shrunk by 9.2 per cent while construction, another key sector, had declined by 22 per cent (cited in NST, 31 August, 1998: 23). It was widely expected that overall GDP growth for 1998 would be a negative figure. This was later confirmed. The 1999 Budget proposals has forecasted a GDP contraction of 4.8 per cent for 1998.

It should be noted that in the second phase of the policy, the primary focus was to inject some life into the domestic sector via increased government spending. However, high interest rates were still maintained (despite growing dissatisfaction from some quarters), presumably to address the problems of the external sector.

The high interest rate policy of the first 13 months will no doubt remain a point of debate. Opponents of the policy will attribute the GDP contraction to it.[7] Supporters, on the other hand, may well argue that it was precisely the tight monetary policy of the early phase that contributed to the stabilisation of the exchange rate and opened the way for a more expansionary stance.[8] While it was true that the exchange rate had depreciated by about 40 per cent, since the crisis began, it had shown signs of stabilising at RM4.20 to a US dollar, by the end of August 1998. Indeed, with inflation contained and the current account balance improving, Bank Negara announced (on August 3, 1998) that the "fundamental trends provide Malaysia with room for a cautious easing of monetary policy to minimise the severity of the downturn in [the] domestic economy" (cited in NST, August 11, 1998: 25).

September 1, 1998 marked the third phase in the policy mix. Despite signs of a lower but more stable exchange rate, the government opted for a fixed exchange rate. The *ringgit* was also no longer tradable in the foreign exchange market and capital account transactions were declared non-convertible. These measures effectively severed

[7] For example, the Minister for Special Functions declared on August 27, 1998 that "..the damage has been done to the economy" (cited in NSunT, August 30, 1998: 29).

[8] The tight interest rate policy of the IMF has received bad press. Yet, the President of the Daewoo Economic Research Institute of Korea was quoted as saying: "..the IMF did well in Korea. In about eight months, we have succeeded not only in raising our foreign-exchange reserves, but also stabilizing the won and lowering interest rates to pre-IMF levels." (Asiaweek, Sept. 18, 1998: 31)

the link between the exchange rate and domestic interest rates, allowing Bank Negara a virtually free hand to ease domestic credit.[9] Policy-makers had moved on to a strategy of fiscal and monetary expansion. It also signalled that the primary focus was to revive domestic economic activity since the forex controls afforded the economy some degree of insulation from external developments

IV. The Easy Fiscal-Monetary Stance

The package announced during the second phase of the policy consisted of two clear fiscal initiatives. First, an additional allocation of RM7.03 billion was made for development expenditure in 1998. This was reserved for projects that will not cause a decline in reserves or an outflow of funds; will facilitate import-substitution and increased exports; will generate demand for domestic goods and services; will increase efficiency and national competitiveness; will produce goods and services within a short gestation period and will afford a social safety net. The funds were primarily for social projects like health, education and poverty eradication. Second, RM5 billion was set aside for "critical" infrastructure projects such as highways, port and airports, water supply and waste disposal. These two initiatives will inject RM12.3 billion into the economy via increased public sector activity.

Two other initiatives were also announced. One was the setting up of a RM25 billion fund (or Danaharta)[10] to buy over non-performing loans (NPLs) from banks. Two, a special-purposes vehicle (SPV) called Danamodal, was established to recapitalise

[9] Controls are essentially distortions which bring with them a train of inefficiencies that are well documented. While they afford the much needed space to ignite the recovery of the real sector and strengthen and reshape the financial sector, they should not become a permanent feature of our economy.

[10] Later revised downwards to RM15 billion, following improvements in liquidity, lower interest rates and the reclassification on NPLs from 3 to 6 months.

domestic banking institutions to enable them to generate new lending. In a worst-case scenario, Bank Negara estimated that RM16 billion would be required to recapitalise banking institutions to "healthy" levels.[11] While these two measures may not fall within the traditional definition of a fiscal effort, they have implications for the federal budget.

Clearly, the expansionary fiscal policy was being initiated through increased government spending rather than tax-breaks.

However, the 1999 Budget proposals (announced in late October, 1998) moved towards utilising the tax side of the fiscal equation as well. A series of tax measures were proposed to rejuvenate activity in targeted areas such as export, import-substituting commodities and services and the services sector. These measures include the following: the tax exemption granted to international trading companies. Seen as a move to increase exports, such companies (meeting certain pre-conditions like local ownership and using local insurance, shipping and port facilities), are to enjoy a tax exemption on 70 per cent of their statutory income derived from the increased value of export sales. The exemption takes effect from the year of assessment 1999 and is effective for five years. Another measure, aimed at reducing the food import bill, allows "group relief" to companies that diversify their activities into the commercial cultivation of selected food and feed items like maize and cattle. They are allowed to deduct the losses incurred in the production of these two commodities from the profits of their other activities, for income tax purposes. Excise duties on refrigerators, TVs and air-conditioners were also abolished, with a view to making them cheaper relative to imported brands. These goods are expected to be

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[11] This figure too has been revised downwards to RM11 billion, given general improvements within the banking system.

cheaper by 6-10 per cent. To expand the domestic services sector and improve the services account of the balance of payments, rental income from time charter and voyage charter are to be exempted from income tax. Furthermore, to stimulate domestic tourism, companies involved in organising tour packages are to be exempted from income tax.[12]

In order to promote sports and cultural activities, partial (50 per cent) income tax relief was proposed on income derived by organisers of such activities, provided there is foreign participation in these events. Non-resident participants are completely exempt from tax on income derived from participation. All cultural performances, art exhibitions, sports activities etc. are also exempted from entertainment tax.

More general tax measures aimed at stimulating domestic businesses include tax exemption on instruments that attract stamp duty for refinancing of loans for business and trade.[13] In moving to change the income tax assessment method from that based on the income derived from the preceding year to the current year, beginning from the year 2000, income earned in 1999 is to be exempted from income tax. Furthermore, business losses in 1999 are allowed to be carried forward.

Revenue generating changes in tax were, understandably, few. Excise duties on alcoholic beverages and tobacco were raised, along with the tax on gambling. A new levy on crude palm oil and crude palm kernel was announced. It becomes payable when the price exceeds RM2,000 per tonne.

[12] Civil servants are to be given one Saturday per month as a holiday beginning from 1999. This gives them a long weekend to (hopefully) indulge in domestic tourism.
[13] Real property gains tax and stamp duty exemptions were also allowed in the case of mergers of financial institutions completed between October 24 1998 and June 30 1999.

Given the RM7 billion increase in the 1998 budget allocation and the reduction in revenue, the federal government is expected to register an overall budget deficit RM9.6 billion or 3.7 per cent of the GNP in 1998. The deficit is expected to increase in 1999 to RM16.6 billion or 6 per cent of the GNP. Malaysia has consciously embraced a deficit-budget strategy, after five consecutive years of surplus.

The easing of the tight monetary policy has come largely by way of reductions in the statutory reserve ratio (SRR) by the Bank Negara. The SRR has been lowered repeatedly from a high of 13.5 per cent in February 1998 to 6 per cent by September 1, 1998, when forex controls were announced. Subsequently, on September 16, 1998, it was further cut to 4 per cent, with the possibility of it being reduced to 2 per cent at some future date. Given that an estimated RM4 billion is released into the interbank market, for every percentage point reduction of the SRR, about RM38 billion has been freed into the system[14].

The base lending rate (BLR) framework was also changed to allow for a faster transmission of changes in monetary policy on interest rate levels . The calculation of the BLR is now based on Bank Negara's three-month intervention rate rather than KL Inter-Bank Offer Rate (Klibor). On August 3, 1998, the benchmark three-month intervention rate was cut from 11 per cent to 10.5 per cent, and a series of rapid cuts brought it down to 8 per cent by September 3, 1998. The BLR declined from 12.27 per cent from the end of June 1998 to 9.05 per cent, as at September, 1998. The administrative margins of

[14] RM8 billion of the funds released will be automatically invested by banking institutions into bonds issued by Danamodal, carrying a prevailing market coupon rate of 8 per cent a year.

financial institutions that are allowed in the BLR computation were reduced from 2.50 to 2.25 percentage points.

Other measures include a stipulation that banking institutions maintain a minimum annual loan growth of 8 per cent for 1998, relaxation of the tight restrictions on lending for transactions in the property sector and the stock market and the reclassification of non-performing loans as loans not serviced for six rather than three months.

How will the stimulus package work? The first two initiatives will directly pump in RM12.03 billion into the economy. If implemented faithfully and quickly, it can generate substantial direct effects in terms of increased jobs and output in critical sectors and also yield multiplier effects in sectors and subsectors that are closely linked to them. For instance, the construction sector alone has about 140 industries allied to it (cited in NST, July 25, 1998: 20). And many of these draw substantially on local inputs.

Additionally, if the injections are focused on civil engineering, critical infrastructure projects, highways ports and so forth, as originally envisaged, they will contribute to enlarging the productive capacity of the economy.

The funds set aside to create Danaharta and Danamodal are meant to strengthen the financial system and it ability to generate new, better supervised loans to critical sectors. Although they do not fall neatly within the traditional confines of a fiscal effort, the benefits are two-fold: a stronger financial sector, and a contribution to the economic recovery through the energetic efforts of this revitalised financial sector. This will hopefully be reinforced by the easing of restrictions on credit creation announced by

Bank Negara. These developments will go some distance to resuscitate domestic entrepreneurial activity that has been starved of credit on manageable terms. How quickly Danaharta and Danamodal can carry out their respective portfolios will of course determine the effectiveness of this policy prong.

IV. Some Issues

As indicated previously, a policy-mix that adopts an easy fiscal *and* monetary stance is clearly targeting the revival of domestic economic activity. The decision to run a budget deficit in the years 1998 and 1999 is clearly appropriate, given the need to provide a fiscal stimulus. A budget deficit strategy can be implemented in one of two ways: increasing government expenditure significantly, or through the sacrifice of substantial tax revenues via extensive tax cuts. The latter yields more resources for increased private spending and investment to revive the economy, while the former leaves the task to the public sector. Although the prevailing policy has elements of both, it appears that the budget deficit is being driven primarily by increased government spending.

A deficit budget strategy led by increased government spending is a proper prescription in circumstances where the private sector cannot or will not be able to move the economy out of the doldrums (such as in situations of imperfect information or poor level of business confidence). In the initial stages of the economic recovery programme, this may well be the case. However, it is essential to recognise that as the economy begins to gain momentum, the task of leading the recovery process is better left to the

private sector. And this is achieved, from the fiscal side, through appropriate and extensive tax cuts.

Leaving the bulk of the burden of a deficit budget strategy on public sector spending has several inherent problems. Once public sector spending begins to grow, it is often hard to check its momentum and focus. The over-involvement of the public sector in economic activities in Malaysia, and its negative consequences have already been discussed [15]. Large-scale public sector involvement will restrict its ability to act in future situations that can genuinely benefit from increased fiscal spending.

A further consideration with respect to a public expenditure-led budget deficit is its financing. In Malaysia, public sector surpluses, evident only from 1993, have remained small. A good run of 8 years of prosperity was not utilised to maximise fiscal surplus. The budget surplus in 1997 was an estimated RM7.4 billion - quite insufficient to sustain the RM60 billion needed for the national recovery plan until the year 2000 (Star, October 7, 1998), or the RM26.2 billion deficit implied in the 1998 and 1999 budgets taken together.

The various options being considered include the raising of funds through bond issues in the domestic and international markets. Unfortunately, major US-based rating agencies like Moody's Investor Services and Standard and Poor's Corp. downgraded Malaysia's credit ratings in late July, 1998. The former lowered its sovereign ratings for Malaysia, its deposit ratings of three Malaysian banks and the foreign currency ratings of Petronas and Tenaga Nasional. This was quickly followed by an announcement from

[15] See review in Section II

the latter that it too had downgraded the sovereign ratings of the country[16]. This news effectively aborted a high level international fund-raising mission. According to one commentator, these developments imply that attempts to raise capital in the international market in the current situation will attract interest rates as high as 11 per cent (Shaik Osman, 1998: 29). An additional problem with raising funds in international capital markets is the likely competition from other Asian countries. Both Thailand and Hong Kong, for example, were reported to have been preparing for such a venture, although they too have postponed their attempt due to adverse conditions for international credit.

Given the market sentiment about Malaysian bonds, it may make more sense to focus on the domestic market for a while. The *National Economic Recovery Plan* (see NEAC, 1998) has recommended that the government issue RM20 billion worth of long-term bonds to the Employees' Provident Fund (EPF), Petronas and local insurance companies. It was estimated that about RM 1.8 billion accrues to the EPF every month (See Prime Minister's comment in NST, July 15, 1996: 21). Petronas, on the other hand, has already expressed its willingness to absorb some portion of the bond issues. With reserves estimated at RM30 billion, it seems to be in a comfortable position to do so.[17] Needless to add, increased public sector borrowing comes with the obligation to service these debts at a later date. Debt-servicing can become a major burden later on.

Finally, the massive drawing of domestic funds by the public sector raises the sceptre of the "crowding out" of domestic private entrepreneurs who are seeking funds,

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[16] On September 28, Standard and Poor's Corp. lowered further the ratings of five Malaysian banks.

[17] It must be noted that in the financial year ending March 31, 1998, Petronas increased its production of crude oil to 196.2 barrels from the 179 million barrels it produced the previous year. Production was increased by an additional 50,000 barrels daily, from last October to "increase the nation's income" (NST, July 30, 1998: 1)

and have no other option except the domestic capital market. The greater the demand for funds by the public sector, the more difficult it would be to walk the delicate line between its needs and those of the private sector.

All told, a deficit budget implemented via substantial public sector spending is best adopted in the initial stages of the recovery effort. And even in this case, it is imperative that the impulse be aimed at sectors that have the greatest potential to not only be revived but also to capitalise on the momentum generated after the kick-start. Identifying such sectors will remain a major challenge. A macro approach that identifies broad sectors (like manufacturing, food-growing or education) is of less value than a more refined micro approach that identifies subsectors within each sector that are likely to benefit. To illustrate, within the broad manufacturing sector many subsectors are highly import-dependent in terms of inputs. Stimulating such activities will aggravate the import bill when the economy can least afford it. Resource-based activities with high net export values are more usefully encouraged at this juncture. Similarly, investments in basic training and skills that can be put to use immediately to increase productivity would have greater economic value in the current condition than investment in education projects with long gestation periods.

The more viable, longer-term fiscal strategy is to provide incentives to the private sector to become active again. This is achieved, in part, by foregoing revenues by instituting substantial tax cuts. The advantages are clear-cut.

Private sector decision makers are more sensitive to market pressures and incentives. Their decisions are therefore apt to be more in line with consumer and market

sentiments. And the burden for wrong decisions will, in general, be borne by the shareholders themselves, not taxpayers. Furthermore, revenues foregone are not likely to be substantial in a recessionary environment[18]. Declining corporate and individual incomes and rising unemployment reduce income tax collections, while poorer output and sales lower indirect tax receipts. And once the economy recovers, tax receipts can be consolidated again through appropriate measures. In this sense, therefore, the policy supports itself. Finally, when the private sector shoulders the burden of economic recovery, the public sector is free to focus on other important longer-term issues.

Of course, foregoing revenues impinge on public sector activities. But this might not be an entirely negative development if it induces prudence and austerity in managing public sector resources.

What tax-cuts should be instituted to revive private enterprise? Since most domestic producers cater largely for the domestic market, tax measures should address their needs. Domestic producers will require easy credit availability, reductions in business costs and rising aggregate demand for their output. These, in turn, will restore confidence in the domestic business environment. The recent easing of credit due to rising liquidity and falling interest rates will hopefully meet the first requirement.

Although several of the tax incentives announced in the Budget of 1999 will go some way in lowering business costs, more can be done. An interesting proposal put forth by the Federation of Malaysian Manufacturers (FMM) Perak Branch (NST, August 2, 1998) failed to attract attention in the 1999 Budget proposals. Citing the present sales tax

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[18] Even if all direct and three-fourths of indirect tax revenues of 1999 are foregone, it will amount to RM32.3 billion, or less than half (49 per cent) of total revenue in the "normal" year of 1997.

regulation that requires all licensed manufacturers to pay 10 per cent sales tax within 58 days from the invoice date, the FMM has asked that this period be increased to six months. The request was based on the fact that domestic manufacturers have extended credit to suppliers from the usual 60 days to 150 days due to liquidity constraints faced by the latter. The FMM has also noted that the cost of utilities such as electricity, telecommunications, water, sewerage services and toxic waste disposal has increased since privatisation of these services. These have added to manufacturing costs by five to 20 per cent, depending on the nature of production. In the case of electricity, for example, the FMM points out that costs have increased between 22.9 per cent and 68.6 per cent since March 1996. In contrast, electricity costs in Singapore have been cut by an average of 14 per cent, with a three per cent decrease in July alone. This was made possible not only by lower oil prices but also due to increases in productivity arising from the corporatisation of electric supply in October, 1995 (cited in NSunT, August, 8, 1998). One of the key arguments for privatisation is efficiency and greater cost savings. If these do not materialise, the authorities should take another look at these privatised entities and how they manage their businesses.[19]

The third requirement - the stimulation of aggregate demand for domestic output has not been met adequately. The increased expenditure by the public sector will directly boost companies involved in infrastructure construction and related activities. But domestic activity outside this subsector, like manufacturing, received no direct stimulus.

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[19] Tenaga recently announced limited incentives to cut power costs to selected industries, on a temporary basis (see NST, Octobet 15, 1998). Such moves should not cloud the need to boost the long-term productivity and efficiency of privatised entities.

This is not to deny that the tax free income of 1999 may be expected to increase disposable incomes and increase the demand for domestically manufactured output[20].

In this connection, further tax measures should be considered. The corporate tax rate should be reduced further from 28 per cent. This will provide a strong incentive to attract new investment, both domestic and foreign. More importantly, it will help companies making profits to generate *internal resources* to reinvest or expand activities. And every tax *ringgit* saved helps maintain the competitiveness of companies.[21]

The reduction of corporate tax will also set the stage for the longer-run objective of revamping the tax system to make a streamlined indirect tax regime its linchpin (see Narayanan, 1991 and Bank Negara Malaysia, 1991)

At the consumer level, a *selective* lowering of the personal income and consumption taxes will encourage a higher consumption of *domestically-produced* goods. This, on the one hand, calls for the elimination of the disparity between the highest tax rate for resident individuals (30 per cent) and the corporate tax rate (28 per cent).[22] This will benefit the higher income groups, a bigger proportion of whom are savers and investors. Larger income tax breaks for those at the lower end of the income scale, and the restoration of allowances, previously cut, to lower-end public sector employees will increase consumption demand.

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[20] One source estimates that income earned in 1999 could be about RM20 billion (NST, October 28, 1998).
[21] This is the view emerging from the 156 responses to a survey of public companies, MNCs and SMIs in a wide range of industries conducted by Ernst and Young Tax Consultants. In fact, 84 per cent of the respondents favoured corporate tax cuts to stimulate businesses.(cited in NST, October 22, 1998).
[22] There is also a disparity between the maximum tax rate for non-residents (30 per cent) and non-resident corporations (28 per cent).

Recognising that income tax breaks only increase the disposable income of those paying taxes in the first place, an additional measure is required to encourage the domestic consumption of all, regardless of whether they pay income tax or not. This would call for a reduction of *both* sales and excise taxes on all domestically-produced output, *with high local content*. This will ensure that the bulk of the additional disposable income generated will be spent on locally produced goods that draw on local inputs. The 1999 Budget proposal of exempting only three categories of goods from the excise tax does not go far enough.

A further benefit of removing these taxes during the recessionary period is that while revenues foregone will be small, it will facilitate the streamlining and rationalisation of our indirect tax system at a later stage. As argued earlier, the distortions and complexities in the system needs to be addressed by a more straightforward value-added-type tax. There is a high level of dissatisfaction among businessmen with our current indirect tax regime (NST, October 22, 1998).

Apart from concessions on the tax, other measures to revive domestic private initiative needs to be explored. The NERP has moved some distance on this front by recommending that up to 51 per cent foreign ownership be allowed in the manufacturing sector for approvals made until the end of December 1999. It has been observed, correctly, by Navaratnam (1998) that the time period allowed for foreign participation may be too short to be effective. Seeing that the NERP was only released at the end of July, it effectively grants a mere 17 months for foreign investors to benefit from this relaxation. A more important omission is the fact that the RM2.5 million ceiling put in

place under the Industrial Co-ordination Act could have been raised. Navaratnam (1998) suggests that this be increased to RM5 million in order to enable non-*Bumiputera* family businesses to expand, without having to dilute ownership by offering the mandatory 30 per cent of share capital to the *Bumiputera*. Indeed, a similar move was made at the end of December 1985, as part of the successful strategy that combated the recession then (Narayanan, 1996: 876)

Finally, it is worth keeping in mind that any counter-cyclical effort in Malaysia is also conditioned by the external environment. Unfortunately, the external developments are not encouraging. Some of the largest economies are already in recession (Japan) or on the brink of it (Germany) and are threatening to drag the world economy down with them. Growth in the US economy has moderated and appears to be increasingly driven by the services sector and the inflow of funds. Thus, the crisis in Malaysia has every prospect of being a protracted one.

V. Conclusion

Expansionary fiscal policy has a definite, but limited, complementary role to play in the current crisis. And while a deficit-budget strategy is appropriate and can be initiated through increased public sector expenditure, it is better sustained via extensive but appropriate tax cuts. However, while well conceived fiscal interventions, alongside monetary and other measures, may provide an important stimulus, factors such as the restoration of market confidence and improved external conditions are necessary to return the economy to a stable and steady growth path.

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MERGERS AND ACQUISITIONS

by

Abdul Khalid Dato' Abdul Aziz

Malaysian Institute of Economic Research
Institut Penyelidikan Ekonomi Malaysia

MERGERS AND ACQUISITION

INTRODUCTION

The focus of this conference is Mergers and Acquisition under current uncertain economic conditions.

I am aware that the subject matter is both wide in scope and sensitive given the prevailing economic climate in Malaysia. Nevertheless, I've resolved a way out by structuring my paper within narrow limits.

After introducing the subject briefly, I bre k the subject into eight parts:

- Globalisation and transnational M&A activities
- Valuation methodologies
- Concept and theories behind DCF valuations methodology
- Some features of a typical DCF valuation
- M&A : Malaysian context
- Some searching questions
- The way forward

During good times, M&A activities are rampant and the transaction values astronomical (as in the recent spate of merger activities in the USA). During not so good times, such activities are, of course, not so rampant and the transaction values substantially lower.

Irrespective of the stage of the economic cycle, one of the most important factors, if not the most important one, in every merger, acquisition, MBO, divestiture is the establishment of the transaction PRICE.

To strike a deal, the transaction PRICE has to be the right price and deal DOABLE. This PRICE is somewhere between the maximum price the buyer is prepared to pay and the minimum price the seller is willing to accept.

Having said that, however, on a global basis, our 70% of merger and acquisition deals ***do not generate positive financial returns.***

There are several attributable causes of fixture, among others:

- Wrong strategy
- Weak due diligence exercise
- Paying too much
- Poor past merger integration
- Resistance and factionalism

To put M&A in perhaps a more better light, both sides strive through an exhaustive process of negotiating the magical right PRICE – a price that is WIN WIN to all parties involved.

GLOBALISATION & TRANSNATIONAL M&A ACTIVITIES

"Globalisation" is one of the new buzzwords and it is one of the reasons for the recent mega transnational M&A initiatives. However, some claim that globalisation promotes better allocation of the world's scarce economic resources, some talk about risk diversification while others grudgingly point to corporate epidemic of "big fish eating small fish".

The developed countries, notably USA, Japan and Europe, are perhaps the biggest global players. The M&A activities in the USA are particularly strong following years of strong economy growth, DJ hovering at all time high and a strong US dollar vis-à-vis most other world currencies.

How long the current good times in USA will last is anybody's guess. While they enjoy their run of good fortune, let us learn a lesson or two from them.

VALUATION METHOLOGIES

While there are many valuation methodologies, I will focus on two most widely used ones.

PRICE EARNINGS MULTIPLE : Traditionally, in the USA and elsewhere including Malaysia, the valuation or pricing of shares and companies in most M&A activities is based on some multiple of price earnings, commonly referred to as PE multiples. In fact, many are still engaged in playing the "enhancing the EPS" game.

DCF VALUATION : Since the early 90s, there has been a slow and discerning shift in the USA to place an equally strong emphasis on valuation based on Discounted Cash Flow (DCF) methodology IN ADDITION to the more traditional PE valuation. This follows the works of people like *Professor Alfred Rappaport* (Northwestern University), *Joel Stern* (Stern Stewart & Co) and lately *Professor Thomas Copeland* (previously with UCLA and now with McKinsey) to popularise the DCF valuation approach in real world applications.

CONCEPTS & THEORIES BEHIND DCF VALUATION

The financial concepts and theories behind the DCF valuation have been developed and refined over the last 38 odd years. I will not dwell into the details of the assumptions, mathematical derivations and statistical tests. Those who are more mathematically inclined may wish to refer to:

- The seminal works of Nobel price laurates, *Franco Modigliani & Merton Miller* on "Dividend policy, growth and the valuation of shares";
- Articles by *H. M. Markowitz and W.F. Sharpe and F. Black, M.C. Jensen and M. Scholes* on "Portfolio theory and CAPM" and
- Articles by *Rolf W. Banz and S.A. Ross* on Arbitrage Pricing Model (APM) as a better asset pricing alternative to CAPM

Suffice to mention that Rappaport, Joel Stern and Copeland have distilled these concepts and theories into a practical approaches which can quite easily be applied in most real-world situations. Most investment analysts can conduct a DCF valuation of company, group of companies or asset provided they have good appreciation of the concept of "time value of money", the basic assumptions and limitations of CAPM and APM and of course, the availability of market information.

SOME FEATURES OF A TYPICAL DCF VALUATION

Generally, a DCF valuation:

a. It takes into consideration time value of money;
b. It relies on cash flows (which is universal and not affected by accounting policies); and
c. It uses risk adjusted discount rate to discount the cash flow to establish "present value" of assets (and not capitalisation rate of earnings)

Perhaps, more importantly, from a practical application of value based management point of view, the DCF valuation:

a. Allows the application of different risk adjusted discount rate for different periods of time that is consistent with prevailing assumptions about future events; and
b. Facilitates the identification of key value drivers in acquisition targets which should be managed to improve the chances of post acquisition / merger success

M&A : MALAYSIAN CONTEXT

The current economic turmoil since August 1997 has ravaged the value of companies listed on the KLSE. Compounded by an equally severe depreciation of the Malaysian Ringgit, everything in Malaysia are extremely cheap and affordable from the eyes of the developed countries.

Without doubt, we have corporate predators and piranhas at our gate - all waiting to benefit from acquiring priceless Malaysian assets for a song. And it was indeed a timely decision to impose selective exchange control, which among other things, has limited the potential damage these predators and piranhas can do.

Some predators look for big companies in sectors which dovetail well in the global game plan, e.g. telecommunications and healthcare etc, while others look to purchase Small Medium size companies to gain market share quickly and cheaply. Incidentally, I have been retained by a wholly owned subsidiary of a chemical giant listed on the NYSE to identify and evaluate SMIs candidates for immediate takeover to gain immediate market share.

SOME SEARCHING QUESTIONS

Whether we like it or not, we are part of the global economy. We are facing a whole new ballgame. With a depressed KLSE and depreciated Ringgit, our companies and assets (and our country) are certainly under attack from various directions. We are too small to dictate the shapes and forms of global market forces. While it is suicidal if we submit ourselves totally to these free market forces in a global economy, we will be equally damned if we don't start preparing ourselves to face the challenges of a global economy.

Can we therefore allow our companies to be take over by foreigners who based their valuation on a grossly depressed market PE?

As the market PE has been artificially depressed, the answer is an emphatic NO

How can we justify to potential acquirors that our companies are worth much more? (much more than the NTA, of course !!)

Most of our companies have proven stream of strong cash flows. Using risk adjusted discount rate, the DCF valuation will show that the company is worth much more than a valuation that is based on PE multiple or NTA

Do we know how to apply the tools and techniques to conduct a DCF valuation?

Foreign consultants like McKinsey, A T Kearney and the Big 5 accounting firms can help but such help comes with a hefty bill. And yes, there are also locals who are equally adept at this

Are there sufficient market information to allow the application of DCF Valuation in the Malaysian context?

The amount of research being conducted on the Malaysian stock market and capital market is quite limited. Betas (for application of CAPM) cannot be easily obtained. Worst still, so far as I have been aware, even lesser work have been done on Arbitrage Pricing Model.

Due to the lack of information, the foreign consultants are likely to apply the Betas and risk premium of similar industry in their countries to derive at a risk adjusted discount rate to discount the cash flow streams of Malaysian companies. Because the Malaysia industry is more regulated (and therefore not as fiercely competitive as in the developed countries), the result of the DCF valuation is likely to work to our advantage

- CAPM – this model is commonly referred to as a single period / single index model. Briefly, it states that the return that can be expected on the shares of a particular company is equal to the return available for holding a risk free Government bond and a risk premium. The return is a function of a single risk premium (ie. One Beta value)
- APM – the most rigorously tested and best known of multi-factor asset pricing models. Briefly, it states that the return that can be expected on the shares of a particular company is not only a function of one risk premium (as in CAPM) but a function of various risk premiums associated with such changes in industrial production, default risks, unanticipated inflation etc.

THE WAY FORWARD : SOME RECOMMENDATIONS

The government has given assurances that our country's current regime of selective exchange control will be lifted when there is some new order in the international financial markets. Until such time when the floodgate is eventually open to foreign predators, our researchers should be encouraged to seize this window of opportunity to conduct more work on some of the following:

Recommendation 1

For the benefits of valuing publicly quoted companies:

a. Establish Betas for different industries and make such information publicly available; and
b. Identify significant macro-economic variables that contribute to the determining the expected return of a share in the KLSE, i.e. risk premiums for each of the statistically significant macro-economic factors for different industries

The recent effort by *Dr M Fazilah binti Abdul Samad* of University Malaya entitled "Fundamental Value & Stock Return in Malaysia and the Impact of Accounting Difference in P/E" is certainly a step in the right direction. More should be encouraged to undertake further research.

Recommendation 2

However, the researchers must also not forget the SMI and the closely held private companies. For the benefits of SMI and private companies, research can be conducted to:

a. Establish the acceptable range of "minority discount" when less than 50% stake changes hand; and
b. Establish the acceptable range of "marketing discount" when dealing in shares in companies which are not listed, ie. illiquid discount

Again in the USA, extensive researches have been done of M&A valuation of unlisted companies notably works by *James H Schilt* and *Shannon Pratt*. The issue of minority and marketability discount has been researched by firms such as Houlihan, Lokey, Howard & Zukin Inc, Willamette Management Associates, Inc and W T Grimm & Co. What we are currently doing in Malaysia is to (pardon my expression, blindly) treat and apply the findings of these US researchers to the local M&A scene.

Findings from some of the above research studies can contribute towards a better understanding of returns on Malaysian companies and assets. It can also contribute towards a fairer and perhaps more accurate DCF valuation of Malaysian companies.

* The Business Valuation Committee of the American Society of Appraisers defined "minority discount" as "the reduction from the pro-rata share of the value of the entire business to reflect the absence of the power of control and "marketability discount" as "an amount or percentage deducted from an equity interest to reflect the lack of marketability"

CONCLUDING REMARKS

I would like to conclude my presentation with an extract from an editorial which appeared in the Wall Street Journal about 24 years ago.

" ... A lot of executive apparently believe that if they can figure out a way to boost reported earnings, their stock prices will go up even if the higher earnings do not represent any underlying economic change. In other words, the executive think they are smart and the market is dumb ......

The market is smart. Apparently the dumb one is the corporate executive caught up in the earnings per share mystique .....

To us the lesson is clear : If the manager keeps his eye on the long-term health of the enterprise, the stock price will take care of itself"

The long term health of an enterprise is better assured when the decision makers of the enterprise strive for and achieve maximum long term wealth creation for its stakeholders through the use of DCF methodology which uses **risk adjusted** discount rates to discount **cash flows** to present value. Always remember, YOUR COMPANY'S WEALTH IS MEASURED BY THE AMOUNT OF CASH IT HAS, AND NOT BY THE AMOUNT OF EARNINGS IT GENERATES.

However, although the DCF valuation is theoretically superior as compared with the traditional PE valuation, each methodology has its own special

slant in any M&A transaction. It is a grave mistake to completely dismiss one methodology in favour of the other. Denying the existence of other methodologies (eg. Book Value, Merger Market Value, Break Up Value, Liquidation Value, Synergy Value etc) can lead to repudiating sources of potential values or ignoring areas of potential risk in an M&A target.

Most Malaysian merchant bankers and analysts are very familiar with PE valuation, and perhaps some are still engaged in playing the EPS game. With the increasing emphasis on managing VALUE (and relying on DCF methodology) since early 1990s, it is hoped that more work and research is done in the Malaysian context to improve our understanding of the returns of the Malaysian stock and capital markets. Armed with an improved understanding, we would be able to place a fairer valuation on our companies and assets. We would be in a better position to identify value drivers in the acquisition targets and better manage key post-acquisition business processes. Simply accepting every sophisticated DCF valuation (based on US business experience only) the foreigners throw at us is like giving our country away to hungry predators.

7

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THE ECONOMIC CRISIS:
Impacts on Islamic Banking Operations

by

Saiful Azhar Rosly

Malaysian Institute of Economic Research
Institut Penyelidikan Ekonomi Malaysia

The Economic Crisis: Impacts on Islamic banking operations

Saiful Azhar Rosly, Ph.D
Assoc. Professor, Department of Economics, Kulliyyah of Economics and Management, International Islamic University Malaysia, Km 16 Jalan Sungai Pusu 53100 Gombak, Selangor, Darul Ehsan, Malaysia. E-Mail: saiful@iiu.edu.my

1.0 Introduction

The banking crisis in Malaysia today saw the establishment of Danaharta and Danamodal to ease the problems of bad loans and depleting capital in the local banking firms. To what extent Islamic banks represent the beneficiaries of these rescue efforts can best described how the severity the crisis have impacted Islamic banking[1] performance. Other than that it is relatively difficult to gauge how the crisis have affected its performance or ability to provide continuous financing facilities to business and consumers. This is because, the market size of Islamic banking today is only marginal. It has yet to capture 5% target of the deposit market while market share of financing is less than 2% (See Table 1 and 2)

Table 1: Total Deposits – Interest-free and Conventional banking system (1996-1998)

Total Deposits (RM million)	Interest-free Banking system (IFBS)	Conventional Banking system (CBS)	(IFBS/CBS)
December 1996	3,932.5	284,353.5	1.38%
December 1997	6,525.2	328,261.0	1.98%
September 1998	8,147.7	335,362.3	2.42%

Source: Bank Negara Monthly Bulletin, September 1998

[1] In this paper, Islamic banking will refer to the banking system observed by Bank Islam Malaysia Berhad (BIMB) and the interest-free banking system (SPTF). Although both are not governed by similar banking laws, the underlying Shariah principles on which these banks operate remain the same.

Table 1: **Total Financing – Interest-free and Conventional banking system (1996-1998)**

Total Financing (RM million)	Interest-free Banking system (IFBS)	Conventional Banking system (CBS)	(IFBS/CBS)
December 1996	3,596.0	332,952.6	1.08%
December 1997	7,126.2	421,202.4	1.69%
September 1998	7,290.0	419,657.7	1.73%

Source: Bank Negara Monthly Bulletin, September 1998

However, to interested observers, Islamic banking last year received an official critique when Bank Negara revealed some of its structural weakness in the 1997 Annual Report. It says:

"The tight liquidity situation has put on pressure on the operations of Islamic banking. The current turmoil revealed a structural weakness in Islamic banking operations particularly under a volatile economic environment. In Malaysia, 90% of Islamic financing is negotiated on a fixed-rate terms such as *al-murabahah*, *al-bai-bithaman-ajil* and *al-ijarah thumma al-bai'*. Conventional banking has the flexibility to adjust upwards the interest rates on borrowing accordingly to reflect higher cost of funds. Comparatively, the return from financing under Islamic banking would decline under this environment and contribute to lower deposit rates to depositors. In essence, Islamic banking could not react swiftly under the current interest rates environment due to the absence of a floating-rate option. Thus the lagging factor resulted in a mismatch whereby the financing-deposit ratio registered an increase from 84.6% as at end-1966 to 108.6% as at end-1977. To accommodate the shortfall, Islamic banking institutions had to resort to Mudharabah placements which amounted to RM2.6 billion as at end-1997" [2]

Recently, it was reported in parliament that Islamic banking performance was also affected by the economic slowdown. In the first eight month this year, total deposit recorded a mere 6.2% growth against 36.2% last year. Financing fell by 1.7% this year compared with a 75% growth recorded last year. As of August 31st 1998, total deposits mobilized by banks listed under Interest-free banking and Bank Islam Malaysia Berhad came to RM10.51 billion while financing was RM10.57 billion.[3]

The above statements to some extent gave some indication of harder times to come for Islamic banking. At the micro-level, this paper will try to explain why

[2] Bank Negara Report 1977, pp.

[3] See Business Times, 26/10/98. However published data given in Bank Negara Monthly Bullettin, September 1998 gave a different figure.

performance have been badly affected by the crisis, most of which is due to the nature of interest-free products utilized by the system. High-intensity application *of al-bai-bithman ajil* (BBA) financing has been identified as the main factor leading to the declining performance. This over-dependence on BBA financing has somewhat made Islamic banking fall into employing a Negative-Fund Gap (NFG) strategy during both periods of economic booms and slowdown.

At the macro-level, Islamic banks with high-dependence on BBA financing tend to behave in a procyclical manner. That is during times of inflation, they are expected to exert more inflationary pressure on the economy. Similarly, during an economic slowdown, they become contractionary instead. The author will argue that in terms of cyclical behaviour, over-dependence on BBA financing has made Islamic banking of no less different from conventional banks.

This paper however does not intend to provide any empiral evidence how the crisis have impacted Islamic banking performance. It is mainly theoritcal and argumentative in nature based on real situations, namely the structure and nature of assets and liabilities of Islamic banks in Malaysia.

2.0 Islamic banking in Malaysia

The prohibition of interest as riba in the Quran by essence is meant to protect both private wealth and property (*al-Mal*) from depletion. The Quran sees riba as an unfair business practice since contractual profit from loans and other debts were created in the absence of risk-taking and valued added elements. Unsytematic risks are relatively absent since borrowers are required to pledge collaterals and guarantees on the loans received. Volatility in price movements, namely interest rates is unlikely to reduce earnings when banks are actively involve in managing risks such as buying or selling interest rate futures. So, if a banking crisis ever come, it is only because bankers have been inefficient. Or they have simply failed to honour the trust that depositors have given to them.

Islamic banking activities in Malaysia began in the early 1980s with the enactment of the Islamic Banking Act 1983 which defines the nature and function of an Islamic bank. In the Quran, the explicit prohibition of riba has put *al-bay'*, namely trade and commerce as the alternative to debt contracts in the banking business. The term trade and commerce, in Fiqh normally include the contract of spot sale (*bay' musawamah, bay'al-nuqud*) and deferred *sale (al-bay' bithaman ajil, murabahah, salam, istisna'),* leasing (*ijarah*), agency (*wakalah*), guarantee (*kafalah*), trustee partnership (*al-qirad/mudarabah*), general partnershsisp (*shirkatul amwal*) and many more. In modern banking law, these contracts of trade and commerce are in general, explicitly prohibited. For example, the Malaysian Banking and Financial institution Act 1992 (BAFIA) stipulates that commercial banks can only perform lending and borrowing activities[4]. By virtue of

[4] According to BAFIA 1989. "...no licenced institution shall engage, whether on its own account or on a commission basis, and whether alone or with others, in wholesale or retail trade, including import and

the nature of *al-bay'*, the Islamic Banking Act 1983 therefore gave an Islamic bank the opportunity to provide non-traditional banking facilities such as venture capital, stockbrokerage, fund management, insurance etc to be offered under one roof[5].

To further widen Islamic banking activities, the interest-free banking system (STPF) was set up in 1993. Under the instruction of the Bank Negara Malaysia, conventional banks have begun to provide various interest-free facilities through their respective interest-free counters. SPTF is however still governed by BAFIA 1992 but allowed to offer interest-free products designed along the guidelines of the Islamic Banking Act 1983. In this paper, the term Islamic banking is used to denote Islamic banking operations undertaken by Bank Islam Malaysia Berhad (BIMB) and the commercial banks, finance companies and merchant banks that participated in the interest-free banking scheme, often called the Islamic windows.

Interest-free banking in Malaysia has one unique feature that sets it apart from the model applied in Iran and Pakistan[6]. That is, the Malaysian model is based on a parallel or dual banking system, which allows interest-based and interest-free banking to coexist and compete for deposits and financing. As the Malaysian are multi-religious and multi-cultural, Islamic banking is therefore expected to deal with situations in which the demand for and supply of excess funds are no longer made on the basis of faith alone but also on pecuniary factors such as return on deposits, cost of financing and customer service. These religious and non-religious elements in the market segment of the Malaysian Islamic banking industry is likely to affect performance as changes in market interest rates will likely to affect Islamic bankers' asset-liability management strategy.

2.1 *Al-Bai-Bithaman Ajil* Financing

One of the most popular financial instruments in Malaysian Islamic banking system is known as *Al-Bai-Bithaman Ajil* (BBA) financing[7]. It is a contract of financing involving a deferred payment sale. BBA financing is currently applied in almost all financial instruments in which consumer and trade financing are involved. It is also applied in corporate finance where it became an crucial component in the issuance of Islamic debt securities[8]. Unlike conventional financing where contracts of debt are evidenced between bankers and

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export trade...". For more detail provisions, see, *Banking and Financial Institution Act 1989 (Act 372), Regulations and Orders*. International Law Book Services, 1993, pp.40-42.

[5] The Islamic Banking Act in fact paves the way for an Islamic bank to become a universal bank such as found in Germany and Switzerland.

[6] See, Muhammad Anwar, Islamic Banking in Iran and Pakistan: A Comparative Study, *ThePakistan Development Review*, 31:4 Part II (Winter 1992).pp.1089-1097.

[7] Also known as *murabahah* in the Middle-Eastern countries.

[8] The issuance of an Islamic debt security requires a creation of an underlying asset which comes in to existence by virtue of the al-bay'bithaman ajil sale between the issuer and the bank or financier.

customers, BBA financing allows Islamic banks to undertake buying and selling activities in which payments are made by installments.

Al-bay' bithaman ajil in essence is a contract of sale, only to differ from cash *sale (bay' al-nuqud)* by virtue of the payment system. In the former, payments are deferred to some future date while in the the latter, the contract requires payments to be made immediately. BBA must still fulfill the principles and conditions of a sale contract, which consists of four namely the agents of contract (*tharafayil 'aqdi*), the objective of contract (*maudu'ul 'aqdi*), the object of contract (*mahallul 'aqdi*) and the offer and acceptance (*ijab qabul*) . The price element in the BBA and spot sale are spelt out in the third principle (*mahallul 'aqdi*).. In spot sale, the offer price must reflect current market determined price while in BBA, the offer price will include some time element since payment will be made in some future time. In other words, it was argued that Islamic jurists have no objection to set credit price higher than cash or spot price. This also means that the profit generated from a BBA sale is legitimate in Shariah Law since it was derived from trade rather than debt. Profit fixation in trading is allowed because profit generated from trade and commerce are not free from risks, losses and uncertainties. Even if profits are prefixed in trade, expected profits remain random and uncertain. For example, a trader may lose his inventories due to market risks He may not be able to sell his goods due to factors beyond his control, such as earthquakes, floods or political instability. To sell his goods, some added value is also required to make it more attractive or bearing utility to buyers. These risk-taking as well as value-addition elements in trading, therefore deserve some rewards, namely profit. On the contrary, risks and value-added are relatively absent in loans. For instance, in eliminating default and market risks, bank loans are collateralized and further supported by credit checks and guarantees. In some cases restrictive covenants are imposed on the loan agreement so that it can be restructure to speed up repayments. The remaining risks such as interest-rate and foreign exchange risks can be avoided by hedging in the financial futures market. Profits from loans are therefore certain with relatively zero variance, which is unfair and thus contradict the essence of justice that the Quran desires to examplify in trade in commerce.

2.2 *Al-Bai bithaman Ajil* as a mode of financing

When BBA is used as a mode of financing, the Islamic bank now must assume two roles, namely that of a financier and a trader. As a banking firm, an Islamic bank it may find it too difficult to involve directly in trading or real production such as the wholesale and manufacturing business. But to apply the *al-bai-bithaman ajil* contract in the banking business, Islamic banks must fulfill the first principle of *al-bay'*, that is being a seller or buyer which is significantly different from the role played by a lender or financier. As stated earlier, a *al-bay'-bithaman ajil* transaction takes place in a purchase of a property and its resale involving the repayment of the resale price upon deferred payment terms. In such a purchase and resale exchange process the Islamic bank then becomes a trader, which is

evident in the property-sale agreement between the bank and the customer. In this agreement, the property is sold to the customer at a price that is higher than cash sale. Prior to the property-sale agreement, a novation agreement between the bank, vendor and customer is undertaken to secure the purchase of the property by the customer[9].

In other words, in the BBA sale , no loan is made to the customer.Instead, the Islamic bank will purchase the property direct from the developer or vendor at market price and sells it back to the customer at a mark-up price. In the BBA sale, the determination of the mark-up or selling price will depend on the stipulated annual rate of profit the bank desires from the transaction. Once the rate of profit is determined and financing period specified, the selling price can be computed using the annuity factor table[10]. The difference between the market price (cost price) and the mark-up price (selling price) is the profit created over the installment periods, which is permissible or *halal* since the transaction is based of a deferred sale contract rather loan a loan..

4.0 Bank Islam Malaysia Berhad : Truncated structure of financing

Table 1 shows the dominating size of BBA financing in Malaysia's only full-fledge Islamic bank, namely Bank Islam Malaysia Berhad (BIMB). In 1985 , it accounted for more than 40% of assets which is relatively lower since the economy then was in a recession. As the economy recovered as early as 1987, the increasingly greater demand for landed property in Malaysia have expanded the application of BBA and *murabahah* into new heights peaking at 94.1% in 1989. In 1997, the size of BBA and *murabahah* amounted to RM2.5 billion or 90.6% of total assets. Profit-loss sharing (PLS) financing is relatively absent. Trade-financing facilities should have utilised the PLS system as it involves business and entreprenuership, but due risk aversion the *murabahah* principle has become a better alternative.

[9] The role of the bank as a trader, namely buyer of property from the vendor and seller of the same property to the customer is somewhat clouded and misconstrued. This is because, a sale and purchase agreement between the bank and the vendor or developer is relatively absent. Instead, the same agreement is evident between the customer and developer, as commonly practiced in conventional sale documentation. Under this state of affair, the role of the Islamic bank as a financier is most revealing. If the bank desires to embrace the spirit of *al-bay'* as the Quran has rightfully intended, it must hold risks of possession of the property before resale. Doing so, will make the profit generated from the BBA sale legitimate as it involves the element of risk-taking, namely risks of holding possession of property.

[10] If the cost of financing is $100,000 with desired annual profit rate of 10% and 60 months period of financing, an annuity factor of 0.0098345 is used to obtain the monthly installment payments which equals to $875 per month. Multiplying $875 by 60 will give the selling price, which equals to $210,000.

Table 3: Bank Islam Malaysia Berhad: Structure of Financing 1985-1997

Year	Deferred Sale (RM'000) (BBA & Murabahah)	Total (RM'000)	BBA & Murabahah / Total Financing (%)
1985	142,351	340,512	41.8
1986	310,353	422,963	73.4
1987	391,691	474,064	82.6
1988	588,674	620,518	94.86
1989	655,407	695,912	94.17
1990	729,832	843,247	86.5
1991	701,688	828,313	84.7
1992	912,116	1,048,442	86.9
1993	889,326	1,037,634	85.7
1994	885,407	1,023,539	86.5
1995	1,355,897	1,520,686	89.2
1996	1,859,098	2,080,767	89.3
1997	2,324,718	2,566,072	90.6

Source: Bank Islam Malaysia Berhad Annual Reports 1985-1997.

4.2 Structure of financing in the Interest-free banking system

The experience of the interest-free banking system (SPTF) in BBA financing is relatively less significant in the early years compared with BIMB as these banks have yet to show their full-commitment to the system. Leading SPTFs such as MayBank and Arab-Malaysian Bank have shown credible support as both were able to offer a number of Islamic deposits and financing products, while many others have yet to offer financing facilities. As shown in Table 2, in 1993, that is a year after its official launch, no finance companies were able to offer any form financing products. But beginning 1996, finance companies have overtaken the commercial banks in BBA financing. In 1997, the deferred sale financing in the finance companies reached RM978 million while commercial banks relatively lower at RM248.5 million[11]. However, the size of BBA and murabahah financing in the SPTF was relatively lower than BIMB. In 1997, it only amounted to 22.6% of total financing compared with 90.7% in BIMB. This is partly due to investment strategy of most SPTF banks, who prefers to buy government Islamic certificates

[11] The bulk of financing in finance companies took the form of hire-purchase and property financing, while commercial banks specialized in trade financing and property. However, Islamic trade financing have less appeal to businesses as it is new and bears no significant advantage over conventional facilities. This could explain why BBA and murabahah financing is lower in the commercial STPF banks.

(GIC) and green bankers acceptances to generate income as they have yet to introduce Islamic facilities for home and auto financing.

Table 4 : Interest-free Banking System: Deferred Sale Financing (RM millions)

Year	Commercial Banks	Finance Companies	Merchant Banks	Total BBAs and Murabahah	Total Financing[12]
1993	3.5	0	0	3.5	6.2
1994	18.3	9.9	0.4	28.6	463.1
1995	108.9	79.2	0.1	188.22	1525.5
1996	314.5	364	0.4	678.5	3742.1
1997	248.3	978	0.4	1226.7	5407.4

Source: Bank Negara Malaysia, Quarterly Bulletin, July 1997.

3.0 Impact on banking performance

3.1 Determination of selling price: BBA as a fixed rate asset

The impact of BBA financing on bank's performance will be analysed on the basis of some restricted assumptions. First, there exists a parallel or dual banking system each governed by different banking laws. These laws will put restrictions on the respective banks in product development and marketing. For example, conventional banks are allowed to make loans and attract deposits on the basis of interest receipts and payments while Islamic banks can do the same but only through the application of trade and commercial contracts. Secondly, customers irrespective of faith are free to pursue financing or deposit in banks of their choice as banking law only apply to the banking business alone. For example, Muslims seeking interest-based financing or deposits in conventional banks will not be penalized by either the Shariah or civil law. On the other hand, non-Muslims customers are free to use both banking system as no discriminatory policies are applied to favor Muslim customers.

3.2 Al-Bai' bithaman ajil as a fixed rate asset (FRA)

Based on the contract of sale, the BBA facility requires the selling price to remain fixed since only one set of selling price is allowed. This would imply that rate of profit in each contract must remain unchanged. It cannot not be adjusted to a

[12] In practice, each SPTF banks were initially given a fund of RM10 million by the respective parent bank to begin their operations. Most of these funds were used to buy the government Islamic bonds (GIC) for revenue purposes as well as to conform with the statutory liquidity requirement under the name "other financing" in the Bank Negara's monthly bulletin. Since product development and the subsequent lauching of completed products will usually take time,most of the excess funds are used to buy the green or *halal* bankers acceptances, also known as bill financing. Green banker acceptances are fixed rate assets.

new level as doing so will lead to the creation of many selling prices in a single contract, thus making it null and void[13]. To avoid potential contract violation, the selling price cannot undergo any changes even if Islamic banks are widely exposed to economic volatility. For example, bank's earning in the conventional system will vary in accordance to movement in market interest-rates. Because BBA is a fixed rate asset, there is relatively none the Islamic bankers can do to react swiftly to such macreconomic shocks. In a case of rising interest rates, conventional bankers normally revise interest-rates on loans upwards, so that earnings can be maintained since they too have to raise interest-rates on deposits. Section 3 will further elaborate on this matter.

3.3 Al-Bai' bithaman ajil financing and interest-rates volatility .

As any contract of sale requires the agents (*tharafayil 'aqdi*) to sell or buy goods and services on the basis of a single price, price fixation has made BBA facility a better alternative to loans among non-Muslim customers (NMC), especially when interest-rates are rising[14]. With rising interest rates, the non-Muslim customers are expected to use more BBA financing instead of loans which is now more costly. Thus, the Shariah constraint imposed on the BBA pricing made it a popular alternative to loans in an event of rising interest rates. As a fixed rate asset, *al-bai-bithaman ajil* contractual prices cannot change to reflect a tight credit market, thus making it relatively cheaper than loans[15].

The above argument therefore rests on some assumptions about Islamic banking customers. In economics, an individual is said to be rational when he can fulfil his objective with the least possible effort. For example, as a producer, he will try to obtain the highest level of profit by using inputs at the lowest cost. In other words, a rational producer is an efficient producer. He will make decisions only the basis of costs and benefits. When this notion of rationality is applied to depositors and fund-users or borrowers in the banking system, one can expect to see various forms of rational decision making process that often reflects one's upon value orientation.

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[13] For example, 10% profit rate per annum on a BBA facility is partly influenced by market interest rates as Islamic banks would use the interbank rates as a benchmark in their respective pricing policy. If the cost of financing is $50,000 with a 5 year installment period, the profit generated is equal to $25,000, thus setting the selling price at $75,000. The contract of sale is therefore concluded based on a selling price of $75,000. Now if market rates go up, to say 13%, it would now be a disadvantage to Islamic banks as they now cannot adjust the 10% profit rate upwards to remain competitive since they too have to pay higher on deposits. Doing so would cause profit to increase to a new level at $32,500, thus making the selling price to change from $75,000 to $82,500.

[14] The benchmark market interest rates is the KLIBOR (Kuala Lumpur Interbank Offer Rate). It is the price of funds in the interbank money market usually used as the basis of the base lending rate (BLR) for the banking system.

[15] In Gap Analysis, overdependence on deferred sale financing would mean that most assets will not be sensitive to changes in market interest-rates. Since all Islamic liabilities are interest sensitive (i.e. hibah and dividend rates can be altered according to prevailing competitive market deposit rates) , funds gap will always be negative. For more discussion on Gap analysis, see Sinkey Jr., Joseph F. *Commercial Bank Financial Management*, pp.372-881 and Williams, Bill. *Asset-Liability Management Techniques*, pp.7-25.

For Muslims customers, behaviour is influenced by values, which is divine in nature. Even when interest-free products do look expensive, the choice using them will remain strong among Muslims as decisions among the believers are made on the basis of faith if not financial matters alone. This is because, in Islam values tied to material or money is not the only basis of rational action as the Quran remains to be the paramount source values in life.

But the same cannot be applied to non-Muslim customers. They are expected to gain most from the dual-banking system since they can choose products that benefit them most. This opportunity however is not open to Muslims customers. Using the concept of *ikhtiar*, there is only one choice the Muslim can make, namely employing the Islamic products while doing otherwise is a not choice but an act of defiance[16]. But, decision among the non-Muslim customers are purely made on the basis of reasons and sense experiance where rationality means subjecting oneself to scientific values. As they posses adequate information about the dual-banking system, the choice of banking facilities is now a matter of costs anu benefits.

3.4 Rising interest rates

Contractionary measures taken by Bank Negara last year to stabilise the ringgit saw an upward movement of interest rates.. To what extent this credit crunch has affected Islamic banking performance is best explained by observing the types of assets it holds. Table 1 shows that *al-bai-bithaman ajil* and *murabahah* products commands more than 80% of BIMB's assets. BIMB can be used a model for other Islamic windows to emulate as the former has more experience in the Islamic banking business. Since BIMB is a commercial bank, most operations centered on financing real estate and construction, housing, trade financing and consumption credit, which amounted to 44 % of total financing in 1997 (see Table 2). In the same year, agriculture, mining,quarrrying and manufacturing accounted for RM692.3 million or 26.9% of total financing. Since the size of *mudarabah* and *musyarakah* financing has been on the lower side in BIMB accounting for only 1.5% of total financing, it can be concluded that a huge bulk of financing has taken the form of fixed rate BBA and *murabahah* assets.

As mentioned earlier, BBA is a deferred sale contract in which payments are made on fixed instalments. *Murabahah*, however is also a short-term deferred sale contract with payments normally paid lump-sum. Both BBA and *murabahah* are fixed rate assets in which, the selling price and hence the annual profit rate remains constant irrespective of variation in market interest rates. Now a rational non-Muslim customer will always use products that will give him the most monetary benefit. If he can derive more benefits from Islamic product such as higher rates of return on Islamic deposits or lower charges on BBA, he is expected to use the Islamic facilities. Likewise if returns on fixed deposits are

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[16] See, Syed Naquib Al-Attas, Islam and Secularism.

higher than *mudarabah* deposits or interest rates on loans are lower than BBA profit rate, a rational non-Muslim customer will naturally use the conventional facilities. He is able to substitute products that gave him the most pecuniary benefits. The question now is how would such rational behaviour affect Islamic banking performance?

Table 5: Direction of Financing 1995 –1997 (RM'000)

Economic Purpose	1995	%	1996	%	1997	%
Agriculture, mining and quarrying	40,769	2.6	48,640	2.3	156,697	6.1
Manufacturing	484,023	31.8	600,685	28.8	535,648	20.8
Real Estate and construction	208,756	13.6	510,449	24.5	473,630	18.45
Housing	248,141	16.3	297,506	14.2	537,519	20.9
General commerce	148,206	9.74	123,300	5.92	146,925	5.72
Finance, insurance and business services	40,849	2.6	62,039	2.98	41,662	1.62
Consumption credit	43,241	2.8	99,290	4.77	118,339	4.61
Others	306,808	20.1	340,808	16.3	555,652	21.6
Total	1,520,686	100	2,080,767	100	2,566,072	100

Source: Bank Islam Malaysia Berhad Annual Reports 1996- 1997

The answer to the above question is a simple one, which can help explain why the *bai-bithaman ajil* facility is popular among non-Muslim customers in Malaysia. Due to the expectations that future rate will rise, home or auto loans will be more expensive now. This is because borrowers will have to pay higher monthly instalment as the base lending rate increases. This is absent in BBA financing as the contract prohibits Islamic banks to adjust their profit rates since doing so will dramatically change the contractual selling price.[17].

3.5 Declining earnings on existing *Al-bai' bithaman ajil* sale

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[17] To arrive at a BBA selling price, the cost of financing (COF) namely the market price of asset is multiplied by the annuity factor. The annuity factor is obtained from the annuity factor table based on the term to maturity and annual profit the bank wants from the BBA contract. For example, if COF is $50,000 and payment period is 25 years or 300 months, an annual profit rate of 10.5% will give an annuity factor equal to 0.0087369546. Monthly payments of $436.8 is obtained when the annuity factor is multiplied to the COF. To find the selling price, the monthly payment is multiplied by 240 which gives the selling price equal to $131,053.5. The profit from the sale is the difference between the selling price $131,053.5 and the COF of $50,000 = $81,053.5. Now if the bank decides to increase the annual profit rates due to rising market interest rates, to say 10.5%, this may change the annuity factor to 0.0094498257. With the new annuity factor, the monthly payment will increase to causing the selling to change from $131,053.5 to $141,747. This certainly have altered the selling price, thus violating the BBA contract.

As interest rate rises, the demand for BBA is expected to increase since existing BBA profit rate will not change. As the volume of BBA financing increases, Islamic banks are expected to make more profits as now higher profit rates can be imposed on the new BBAs. However, the margin on existing BBAs will be severly affected if the bank decided to increase the *hibah* and dividend on *Al-Wadiah* and *Al-Mudarabah* Investment deposits in order to attract more deposits. This is highlighted in the illustration below.

Bank's profit = Total revenue – Total costs

Conventional bank

Bank's profit= (contractual interest rate on loans x size of loans) x (interest rates on deposits x size of deposits)

Given:

Contractual loan rate	=10%
Interest rate on deposits	=6%
Size of loan and deposits	=RM100 million each

RM4 million = (0.1 x 100) – (0.06 x 100)

Islamic bank

Bank's profit = (contractual BBA profit rate x size of BBA) – (costs of deposits x size of deposits)

Given:

BBA profit rate =	10% per annum
Cost of deposits (hibah and dividens)=	6% per annum
Size of BBA and deposits=	RM100 million each

Bank's profit= (0.1 x 100) – (0.06 x100) = RM4 million

In the dual-banking system where size of assets and deposits of conventional banks are relatively larger than Islamic banks, changes in market interest-rates are expected to shift the supply of deposits towards alternative facilities that awards higher returns. For example, when interest-rate is rising, more customers will demand more BBA financing since it is not a floating rate asset. However in the existing BBA sale, the profit rates cannot be adjusted upwards if Islamic banks desire to compete with conventional banks whose interest-rates on loans is flexible. To maintain profit margin, conventional banks will increase interest-rates on deposits and to regain competitiveness, Islamic banks may also choose to increase the *hibah* and dividends but this strategy will only to see their profit margin falling . See example below:

Conventional bank

New interest rates = 12%
New deposit rates = 8%
Profits on existing loans = (0.12 x 100) – (0.08 x 100) = RM4 million

Islamic bank

Contractual profit rate = 10% (unchanged)
Islamic deposit rates = 8%
Profit on existing BBAs = (0.10 x 100) – (0.08 x 100) = RM2 million.

Profit on existing loans > Profit on existing BBA

Since every dollar of BBA financing must be supported by deposits, deposit mobilization is therefore crucial to sustain financing activities. When market interest rate rises, so would interest rates on deposits. However, Islamic banks are not able to offer higher returns on their deposit products because the return on existing BBA assets is always fixed as required by the Shariah. Doing otherwise would mean declining bank's earnings as illustrated in the above example.

Firstly, if Islamic banks failed to increase the deposit rates, non-Muslim customers will shift their savings to interest-based deposits because they can gain more from the rising deposit rates offered there. This may cause the supply of deposits in conventional banks to increase relative to the supply of deposits in Islamic banking. In the event of greater demand for BBA financing, Islamic banks have two options, either to increase deposit rates or to acquire funds from the Islamic inter-bank money market.

If the bank choses to increase returns on deposits so that the supply of Islamic deposit increases, banks earning may fall. Similarly, if they prefer to seek new funds in the interbank money market, earnings may also fall since cost of funds in the money market is higher than deposits. What is seen here is a mismatch between deposits and financing. It will bound to happen when Islamic banking activities are pursued along a dual system.

With regards to product choice, the Muslim customers however may have less options than the non-Muslim customers. Irrespective of changes in interest-rates, they have to be contend with the existing or the new BBA financing. In the event of rising interest rates, there is no tendency to shift deposits from Islamic to conventional facilities in view of the Islamic prohibition of riba. Non-Muslim customers who are exposed to greater options in banking tend to benefit most

from the dual-banking system. When interest-rates are rising, they are expected to use BBA financing as this option will protect them from interest-rate risk. If Islamic banks choose not to increase rates on deposits for fear of falling earnings, non-Muslim customers may place their savings the in conventional banks where interest rates on deposit are always adjusted to account for rising market interest rates.

3.6 Falling interest rates

The same argument holds during an economic slowdown. The currency crisis saw many companies failing to pay up loans. The drop in share prices further deplete the value of collateral pledge as security to the banks causing banks to stop credit lines. Without credit, investment will fall and further cause a decline in spending in output. Due to fear of default risk, many banks have refused to make loans. Declining business activities saw a fall in market interest-rates.

Although banks may refuse to make loans, successıul applicants will be able to obtain a relatively cheaper loan. To compete with the much cheaper loans, Islamic banks are again trapped into holding assets that fail to react swiftly to market volatility. The BBA facility simply cannot adjust the contractual selling price downwards as this will violate the sale agreement, in which the bank is required quote only one selling price. As such, customers, especially the non-Muslim will find BBA as inferior option to loans as the former is now relatively more expensive. As a result, the demand for BBA by the non-Muslim customers is expected to fall while the demand for loans will increase.

The impact of declining interest rates will not alter the demand for BBA by the Muslim customers, if there is any. However, on average BBA financing is expected to fall but this event may not jeopardise bank earnings in the short-run as existing BBAs can still generate higher margins for the bank. As mentioned earlier, this is due to the fact that selling price of existing BBA cannot be reduced to account for falling interest rates, which Islamic banks may want to undertake to remain competitive. What is observed here is a case that disfavour Muslim customers who cannot enjoy lower premium on their exisiting BBAs [18]. In the final analysis, the Islamic bank will stand to gain more during falling interest rates since they are able to increase profit margin. The higher margin is evident because Islamic deposits are in essence variable rate liabilities (VRL)i.e the *hibah* on Wadiah deposits and dividends from AMIA are allowed to fall to remain competitive following a declining trend in deposits rates of conventional deposits[19].

[18] For example, when BBA price is set at a 10% profit rate per annum with a contractual price of say, $100,000, interest-free banks cannot reduce this rate comparable to the new but lower interest rates on loans. If a new and lower profit rate of 7% is quoted, the selling price of exisiting BBAs will fall to say, $80,000 and therefore making the contract void.

[19] In the *Al-Wadiah* contract, depositors have no contractual claim on any returns but they do have legal claim on the principle deposits. Return on deposits is given out at the bank's discretion which among others

However, Islamic banks can choose to increase the deposit rates when existing BBAs profit rates stayed at the old level, as doing so will not reduce their margins. Raising the rate deposits will therefore attract new deposits. But problem of increasing excess reserves may occur since the demand for new BBAs is now weaker given the non-Muslims's preference for conventional loans available now at lower rates. As the SPTF banks are also BBA-intensive, less demand for BBAs is expected to increase excess reserves and therefore lowering earnings. Inability to offer new variable rate products will further aggravate the problem. That is, the non-Muslim customers may choose to make early settlements to avoid using BBAs at higher rates or even defaulting on payments[20]. Some important points raised are summarized below:

1) Fall in interest rates→profit of existing BBA unchanged→demand for loans increases while demand for BBA falls.
2) Fall in interest rates→interest rate on deposits declines as well as hibah and dividends on Islamic deposits. Islamic banking earnings will increase since total revenue on exisiting BBA remains unchanged while cost of funds is lower.
3) If Islamic banks opt to keep hibah and dividends unchanged, earnings will still be higher but now size of deposits will increase since returns on Islamic deposits are relatively higher.
4) With more deposits but less new BBA financing, the bank may face a problem of excess liquidity, thus lowering earnings which will affect returns on deposits as well. The BBA trap is indeed harmful. Using BBA in this way has in fact contradicted the 2 principles of the Shariah, namely:

    a) the removal of hardship *(raf' al-haraj)*
    b) the prevention of harm *(daf' al-darar)*

A look at Table 6 below shows that Islamic banking have relatively no option but to adopt the negative fund gap strategy (NFGS) during both periods of rising and falling interest rates. This is because they have fallen into the BBA trap. The NFGS is only suitable when interest rates are expected to fall. Somehow, the BBA trap leaves no other choice but to adopt the NFGS. Conventional banks however are free to adopt any three of the given portfolio strategies as they are able to negotiate the type of loans and deposits to be given out to customers.

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depends on its performance. However in the *al-Mudarabah* deposits, contractual claim is non-existent on both principle deposits and returns as these deposits are equity in nature. By virtue of the variability of returns on the *Wadiah* and *Mudarabah* deposits, they are in essence variable rate liabilities (VRL). For example, when profit rate of BBA assets remain at 10% while the rates of Islamic deposits are allowed to fall to say, 4%, the profit margin will increase.

[20] SPTF banks may be able to obtain higher margins on the existing BBAs but once these assets reached their respective maturities, bank's earning may fall since the demand for new BBA financing has also fallen down due to declining interest rates.

Table 6: Asset-Liability Management in Islamic and Conventional Banking System.

BBA intensive Islamic banks: No option but Negative Fund Gap	**Conventional banks: Open to three options**
i) VRA/FRA < VRL/FRL (Negative Fund Gap) FRA (Fixed rate assets) a) Al-bai bithaman ajil (BBA) b) Al-Murabahah c) Al-Ijarah Thumma Al-Bai; VRA (Variable rate assets) a) Al-Mudarabah b) Al-Musyarakah c) Al-Ijarah VRL (variable rate liabilities) a) Al-wadiah deposits b) Al-Mudarabah deposits FRL (fixed rate liabiities) a) Negotiable Islamic certificates of deposits (NICD)	i) Inflation: VRA/FRA > VRL/FRL (Positive Fund Gap) Applied when interest rates are expected to rise) ii) Recession VRA/FRA < VRL/FRL (Negative Fund Gap) (Applied when interest rates are expected to fall) VRA/FRA = VRL/FRL (Zero-Fund Gap) Aplied when interest rates are stable.

Based on the above arguments, the future of Islamic banking in Malaysia will depend much on the structure of financing of BIMB and the SPTF's banks. Even when they are able to attract more deposits by virtue of the greater margins generated from the existing BBAs financing, the ability to expand financing activities will be frustrated by the absence of new variable rate instruments such as *al-Mudarabah* and *Musyarakah*[21].

4.0 Islamic banking and economic stability

[21] For further discussions on the problems of applying *Mudarabah* and *Musyarakah* financing in the banking firm, see Saiful Azhar Rosly , "Problems on *Mudarabah* financing in Malaysian Islamic banks", IKIM Journal, Vol. 2 No.5. 1996.

In traditional banking, excess reserves are used to make loans, which include overdrafts, personal loans, housing loans, hire-purchase loans, corporate loans as well as debt based off balance sheet instruments. The bank also buys private debt securities and government bonds, both of which are debt instruments.

In Islamic banking, the excess reserves are used to make mark-up sales (*murabahah and bai bithaman ajil*), which often made up more than70% of banks' assets. In this respect mark-up sales have replaced loans. Mark-up sales or non-PLS instruments are in essence debt instruments, which have strictly, observe traditional conditions in making loans such as security or collateral requirement and payment scheme via installments.

To understand how Islamic banking responds to monetary policy instruments, some basic understanding about banking objectives and operations are required. In short, banks whether Islamic or traditional must observe three basic principles of banking, namely, profitability, safety and liquidity.

Table 7 : Three Principles of Banking

1. **Profitability- to make more loans**
2. **Safety – make quality loans**
3. **Liquidity – make more short-term loans**

PROFIT = TOTAL REVENUE – TOTAL COSTS

Traditional Banks

Profit = (interest rate on loans x size of loans) - (interest rate on deposits x size of deposits)

Islamic banks

Profits = (profit rate on sales x size of sales) – (rate of return on deposits x size of deposits)

So, despite the fact that Islamic banking operations are interest-free; it does not mean they have revolutionized the principles under which the banking business operates. This is because, traditional and interest-free banking alike operate using the same principles above. In traditional banks and asset portfolio management, profits are maximized when the banks grant more loans and investments. How banks obtain funds may depend on its liability management and the monetary policy pursued by Bank Negara. For example, the central bank may increase banks' ability to make loans by lowering statutory reserves. In liability management, bankers can attract new depositors through new high yield products such as certificate of deposits.

However, the ability of banks to attract depositors does not mean that they can make easy money from loans. This is because profit-making strategies must be consistent with banking safety. Loans with high interest-rates are normally more risky. The safety principle, therefore, must be strictly observed to avoid credit risks which eventually end up in loan defaults.

At the same time, the liquidity principle requires banks to keep ample cash to honour withdrawals by depositors. Withdrawal risk can be minimized when bank holds large amount of idle balances. But to hold huge idle cash is not profitable, as fewer funds will be used to make loans. So there is trade-off between holding cash balances and loans. How an optimal mix is determined depends on economic conditions. Normally banks will approve fewer loans during a recession, as the default risk is higher. The reverse is true during economic boom, as high demand for loans by firms with strong cash flows would mean higher banks earning.

In the final analysis, loans rank highest in terms of risk but also highest in profit. This is followed by government securities. Idle balances have zero risks but also bear zero profits. So how banks maximize profits during different phases of the business cycles will depend on how assets are mobilized according to the principle of profit, safety and liquidity.

Table 8: Profitability, Safety and Liquidity: Ranking of Assets

Profitability	Safety	Liquidity
Loans	Cash	Cash
Securities	Securities	Securities
Cash	Loans	Loans

Profitability	Safety	Liquidity
BBA	Cash	Cah
Islamic Securities	Islamic securities	Islamic securities
Cash	BBA	BBA

The same applies to the Islamic banking products available in the market today. In terms of profitability, *al-bai-bithman ajil* (BBA) products are seen as the best since it mimic traditional loans. Unsurprisingly, BBA got lowest rating in terms of safety and liquidity.

Table 9: Islamic Banking Asset-Liability

Profits = revenues from financing – cost of deposits

Assets	Liabilities
Statutory reserves	Demand deposit (*Al-Wadiah Amanah*)
Deferred financing (*al-bai-bithaman ajil*)	Saving deposit (*Al-Wadiah Dhamanah*)
Leasing(*al-ijarah)*	Fixed deposit (*Al-Mudarabah*)
Equity investments (*mudarabah-musyarakah*)	Certificate of deposits (*Bay' al-Innah*)
Cash (excess reserves)	

Monetary policy instruments →***affect excess reserves***→affect financing→affect household and business spending or aggregate spending→affect level of output and employment.

5.1 *Musyarakah-Mudarabah* products: Cautious approach to investment

During a boom period the economy observes a relative high level of trading and production activities. With higher expected returns from potential investment projects, high levels of investment spending eventually follows. Money supply increases as loans expand to meet business demands. But strain of resources will soon take place which may push the price level. This explains why inflation normally accompany boom periods.

We all know well that inflation is basically a phenomenon in which society experiences a fall in purchasing power. On the demand side, it is partly due to high level of deposit creation in the banking system due to excessive lending, which is a rational thing to do in the profit-maximizing banking business. As a result, we see more money chasing fewer goods.

When the industry competes for existing resources to satisfy demand, cost of production will go up. Unless something dramatic is pursued to stimulate the supply side, inflation will continue to eat into our hard-earned cash. This has something to do with the nature of loans given by traditional banks.

In general, two types of loans make up the bulk of funds supplied by the interest banking industry, namely production and consumption loans. Production loans are normally injected into industry while lending to consumers help stimulate the demand for houses, automobiles, home appliances etc.

But too much money creation due to more lending during an economic boom can produce more inflation.In fighting inflation, the role of *mudarabah musyarakah* banking venture can best be observed if one appreciates the cautious approach to investment. *Mudarabah* or equity-based interest-free banks will make sure that the appróved projects are able to garner inputs effectively without hurting cost efficiency. For example, projects that require cheap labor and imported machinery would face potential rejection, as Malaysia has no comparative advantage on these factor endowments. Hence intelligent selection of equity projects will help ease pressure on the resource market.

This *cautious approach to investment* will help reduce the rate of increase in the money supply during inflation. This is highly unlikely in traditional lending, as bankers will not put these factors high in their agenda.

5.2 Genuine *al-bai-bithaman ajil* finance: Expected to reduce speculative investments

Existing financing of industry via the *murabahah/bai-bithaman-ajil* instruments too is expected to exert inflationary pressure on resources. This is because; deferred sale activities are less sensitive to the general from the deal.

Hence the purchase of special capital equipment via *murabahah/bai-bithaman-ajil* will take place even if the price is exceedingly high. As more deferred sale contracts are concluded, money supply will increase to meet new sales and purchases.

Here, an Islamic bank is not so concerned how much the fund user will profit from the deferred sale transaction or how the sale affects macroeconomic variables. Despite its *halal* attributes, the impact of deferred sales transactions on the economy has shown no significant difference from loans. But there is an advantage *murabahah/bai-bithaman-ajil* instrument. That is, it can reduce speculative activities. A control on speculative investment activities is needed to help reduce inflation caused by excessive money creation. The deferred sale scheme is a potential remedy when applied to real property, such as land and residential assets.

Once purchase of assets are tied to the *murabahah* scheme, speculative buying can be reduced since the rice of assets bought under the *murabahah* contracts does not reflect present market price or cash price but the expected future market price of the asset, namely the credit price. Hence, a person ho bought at RM200,000 double story house at Bandar Sir Damansara at RM400,000

deferred price payable in 15 years will not sell the house a month later on a speculative deal unless someone wants to buy it at more than RM400,000 which is highly unlikely. Once such a framework is set up, demand for money tends to be smaller due to a slowdown in speculative purchases.

However, the system of rebates can neutralize the BBA effect on sales. But the impact of Islamic banking system in reducing money supply expansion rate during an economic boom can still be achieved if banks adhered truthfully to the BBA contract which requires banks to hold full possession of assets[22]. This practice will force banks to be very careful in approving BBA sales as failure to purchase by the customer will lead to problem of asset disposal and subsequently allowing margin of losses.

6.0 How changes in statutory reserve requirement in Islamic banks can affect economic stability

But some may ask how the change in SSR would affect reserves of interest-free banks (IFBS). If a higher SSR would reduce loans and deposit creation, how could the same happen to Islamic banks. Let's not forget most financial instruments in Islamic banks are based on trade contracts. So, how would products based on debt contracts differ from those based on trade and equity contract when changes in SSR are made? Actually the difference is only minimal when a large portion of banks' asset are invested in trading product based as the *murabahah* and *bai-bithaman ajil* contracts. That is, the impact of changes in SSR on money supply may be similar under both debt and trading contracts. For example, an increase in SSR may reduce the ability of banks to make new loans. Similarly, an increase in SSR may not allow interest-free banks to sell new goods and services based on the *murabahah* and *bai-bithaman ajil* contracts. Either way no new cheques will be written on the borrower and buyer. There is now no new deposit created in the banking system. Money creation will be reduced no matter what banking system is used. See Figure 4 below

Table 10: Credit Creation in BBA transaction with SRR = 10%

Bank A

Asset	Liability
SRR1,000	**10,000**
BBA 9,000	

Bank B

Asset	Liability
SRR 900	**9,000**
BBA 8100	

Bank C

Asset	Liability
SRR 810	**8100**
BBA 7190	

[22] Existing *Al-bai-bithaman ajil* legal documentation however does not show any indication about bank's legal ownership of assets prior to the property sale agreement, which somewhat imply that the bank has been selling goods it does not own. The novation agreement does not provide any legitimacy that the bank is the genuine owner of the asset.

Total deposit creation = $10,000 + $9,000 + $8,100 +... = $100,000

Money Multiplier = 1/rr = 1/0.10 = 10
Total deposit created = initial deposit x money multiplier = $10,000 x 10 = $100,000

Things may be a little different if a large portion of investments is made in equity intensive products using the *mudarabah* and *musyarakah* contracts. This is because equity investment is not a trading activity. The latter is about buying goods at a lower price and selling them at a higher mark-up price. It is relatively easier to do so once buyers are readily available. The amount of profit to be made is a known fact. Likewise, contractual interest-earning from loans are prefixed in the lending agreement. Hence, both returns show similar character eventhough the contracts on which they are based are not similar.

With regards to equity instruments, the decision to reduce equity transaction due to higher SSR is not easily made as evident in trading contracts. This is because successful equity projects often produce higher profit margins than trading or debt instruments. Hence the bank may try to mobilize new sources of funds to ensure sufficient amount of equity projects are undertaken. It is expected to stimulate the supply-side, which can gradually cause the price level to fall.

This is a possibility because unlike the demand-driven *murabahah* and *bai-bithaman ajil* instruments, equity investments can directly stimulate production and the provision of value-added goods. Higher SSR may be relevant to trade products but it may do harm to equity investments, if any. It may be able to reduce demand-pull inflation but may also retarded productive investments when fewer funds are available but only at higher costs.

7.0 Cyclical behaviour of Islamic banks

Islamic banks will remain procyclical if most assets are held in trading products such as BBA and al-murabahah. This is because any changes in SRR to either reduce or increase money supply will only frustrate regulators. For example, in a recession, it is important to see that business have ample capital to increase aggregate demand. By reducing SRR, more cash will be released to the banking system. But due to fear of default, traditional and Islamic banks may not want to make loans and BBAs respectively. Instead, they prefer to hold the excess reserves as idle balances as safety is more preferable to profitability. When this happens, the recession will get no better. Both banking systems have now made the recession even worse. This procyclical behaviour is one phenomenon that Islamic banks could have aborted but due to the overdependence on BBA which mimics traditional loans, trading-based Islamic banks have less to show the world what Islam can contributed to combat the recession.

Similarly during inflation, procyclical behaviour of trading-based Islamic banks is evident. When the central bank increases the SRR to reduce bank ability to make loans, the latter instead will sell securities in order to obtain cash so that they can increase lending and financing. Trading-based Islamic banks too will do the same since during an economic boom, less consideration is taken about safety of credit financing. Over-optimism about the future make bankers pay more attention to collateral requirement and the ability to give out more financing and less on risk. More financing mean more spending and as more money chasing too few goods, inflationary pressure becomes worse[23].

However, if large amount of assets is equity related, the response to changes in the SRR will be more constructive. Since *mudarabah* and *musyarakah* investments requires serious observance to risks and losses, an increase in excess reserves does not mean a simultaneously increament in financing. Equity driven Islamic banks will pursue due dilligence process in making investment appraisal, which allows greater room for caution and careful deliberation. This cautious approach to financing can play a role to reduce the increase in the money supply.

In a recession, a reduction in the SRR will make it more possible for equity-based Islamic banks to extend capital to entreprenuers. Due-diligence process will make them relatively less obsessed with default-risk as partnership relation will ensure minimal moral hazards. Thus, when traditional banks can resist making loans during a recession, which is procyclical in nature, equity intensive Islamic banks will make relatively more financing. Such anticyclical behaviour will make Islamic banks more constructive during an economic slowdown. See diagram below.

[23] See Saiful Azhar Rosly, "Welfare Implication of interest-free bank asset-liability management, *Journal of Islamic Economics*, Vol. 2. No.3, 1989, pp. 15-25.

Table 11: Islamic banking and economic cycles;

Trading-Intensive Islamic Banks (*al-bai-bithaman ajil* and *Murabahah*)	Traditional banks
Reduce SRR → increase excess reserves → increase idle balances→no change in money supply → no change in output and employment **Pro-cyclical**	Reduce SRR → increase excess reserves →increase idle balances →no change in money supply→no change in output and employment **Pro-cyclical**
Equity-Intensive Islamic Banks (*Mudarabah* and *Musyarakah*) Reduce SRR → increase excess reserves → increase partnership ventures – **cautious investment – due diligence** → increase in money supply → higher investment→higher level of GDP and employment **Anti-cyclical agent**	

8.0 Credit view of transmission mechanism in Islam:

In view of the relatively dominant role of loan finance in Malaysia, the credit view of transmission mechanism does hold for the Malaysian case. The credit view simply looks at the asset side of the bank, namely the supply of credit, which is unlike the Keynesian explanation of interest-rate effect on investment where focus is given to the liability side, namely bank deposits. According to the credit view, an increase in excess reserves due to say, a cut in the SRR will make more loans or credit available to those business, who do not have access to the more sophisticated credit market like the bond market. With more loans, investment and aggregate spending will increase. Expansion of loans or credit will thushave a potent effect on the economy. Similarly, raising the SRR will reduce excess reserves and limit credit expansion. This will cause investment, aggregate demand and output to decline.

The above process shows the importance of credit to an economy where the role of banks as a financial intermediary or supplier of capital is still strong. When BBA financing is seen as one that mimic conventional loans, the credit view will certainly hold for Islamic banking as well. This will further support the author's argument that Islamic banks are procyclical by nature.

To make Islamic banks a counter measure against economic instability, it is therefore urgent for Islamic banking practitioners to use equity-based financing. Failure to do so will make Islamic banking as a new deterrent to economic stability and growth as conflict between private profit seeking motives and public interest cannot be avoided . Trading intensive products should nor be allowed to dominate Islamic banking business as implication detrimental to the banks and society will only demoralize effort to create a just and moral order in the financial market.

4.0 Conclusion and recommendations

This paper looks at some possible outcomes of dual-banking system on Islamic banking performance and its benefits to customers. The economic crisis in this country has introduced some volatility in interest rate movement. Under some restricted assumptions, it is argued that non-Muslim customers will gain most from the dual-banking system while Islamic banks are expected to perform better only when the economic is slowing down. During an economic boom, the demand for financing by non-Muslims will shift from one system to the other depending which one provides the greatest benefit. For example, when interest-rate is rising, BBA financing will be relatively less expensive than loans since BBAs are fixed rate assets. Islamic banks are not able to increase the profits rates as this will alter the contractual selling price and therefore making the BBA contract void.

But the subsequent higher demand for BBA financing requires more deposits, which can only be mobilized at higher deposit rates. But doing so will reduce bank's margin since existing BBA margin will remain the same. If Islamic deposit rates are not increased, banks may have to look for new funds in the money market, which will cost more than deposits. Either way, Islamic banks will see lower earnings relative to conventional banks during economic booms. However, during an economic slowdown, conventional banks are expected to revise the loan rates downwards as market rates decline across the board. This makes loans cheaper than BBAs causing the demand for the latter to fall. However, existing BBAs reveal higher cost of financing relative to loans as conventional banks were able to cut interest rates on their existing lending. Since Islamic banks are highly dependent on BBAs, the lower demand for BBAs is expected to increase excess reserves and therefore lowering profit. Such structural weakness was noted in Bank Negara's latest report, which call on Islamic banks to come up

with a floating rate product that can swiftly react to volatile economic environment[24].

To avoid further decline in income, Islamic banks have less options but to begin diversifying into equity financing such as *Mudarabah* and *Musyarakah* ventures both of which are variable rate assets (VRA). In housing and real estate financing, Islamic banks should venture into the construction business itself rather than to assume a role of a trader. Profit margin on trading is relatively small compared with manufacturing and other direct production activities. If Islamic banks insisted to pursue the trading approach where relatively no value-added is created, depositors can only receive a marginal return. This may put pressure on Islamic banks to alter rates of Islamic deposits given a marginal change in market interest-rates. However, when Islamic banks ventures into direct production, although risky, the margins can be higher. Higher profits are eventually passed on to depositors in the form of higher *hibah* and dividends. The supply of deposits is expected to rise as the incentive to place deposits in Islamic banks will be stronger. Although ventures in real production are risky, with adequate monitoring and supervisory role, Islamic banks should be able to generate higher profits to emerge as a superior alternative to conventional banks. But, failure to do so will show an unfortunate case in which both banks and Muslims customers are not able to reap the fruits of Islamic banking in Malaysia.

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[24] See, Bank Negara Annual Report 1997, pp. 141-142.

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THE THAI CORPORATE GOVERNANCE:
From Crisis to Recovery

by

Deunden Nikomborirak

Malaysian Institute of Economic Research
Institut Penyelidikan Ekonomi Malaysia

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Thailand Development Research Institute

1. Introduction

Besides cronyism, corruption, and nepotism, "bad corporate governance" has been ascribed as one of the factors responsible for the fall of the East Asian economies. It is interesting to note that, when the good times rolled, such serious defects were never brought to light. But when money dries up, the search for answers exposes many serious underlying defects of our economy. As the Thai proverb goes: *When the tide recedes, the stumps appear.*

Until the crisis, the issue of corporate governance is rather unfamiliar with most of us in Thailand. Even now, we cannot find a Thai word that can convey the idea of "governance" properly. There are at least three versions in use at the moment. So, to be able to deal with the issue of corporate governance, we feel that it is necessary to first define it.

In a nutshell, corporate governance concerns the responsibility that directors and managers hold to other stakeholders of a company which include shareholders, creditors, the government, employee, the society, the environment and consumers. Managers are responsible for managing the business in such a way that maximizes value to owners or shareholders; directors are responsible for monitoring that managers do so. Both are jointly responsible for servicing debt, ensuring the well-being of employees, providing reliable services to customers, taking responsibility in environmental concerns, etc. Indeed, balancing the responsibilities to diverse groups can be complicated. For the purpose of this paper, we shall focus only on the board's and management's respobsibility to financial stakeholders: shareholders and creditors.

2. Corporate Governance and the Crisis

Part of the crisis has been attributed to bad corporate governance which includes reckless lending by commercial banks, risky investment by managers, expropriation of company's funds by large shareholders, shady business deals and poor audits. While it

would be somewhat far-fetched to attribute this crisis to bad corporate governance, but weaknesses in the governance certainly expedited and exacerbated the fall. What is more interesting is that we are now realizing the cost of such weaknesses.

Fire sale of leasing businesses taken over from the 56 closed finance are fetching only 25-30% of the face value due to unreliable accounting[1]. Poor accounting also pose a major obstacle to the on-going debt restructuring process. Unreliable financial data has caused distrust among creditors and debtors. Intransparent management and lack of effective monitoring also made foreign investors hesitant about buying up a minority share in Thai businesses. Hence, recapitalization has been slow-coming. As a result, the imposed cap on foreign shareholding is current being reconsidered in the parliament.

3. Corporate Ownership and Control

The pillar of corporate governance is corporate ownership. Ownership implies control; and control -- to a great extent -- determines the structure and the behaviour of board and management. Ownership of a company may be concentrated or dispersed (see Figure 1). Ownership may be concentrated in the hands of institutional investors such as banks, mutual funds, pension funds or insurance companies, or a large shareholder (companies or individuals and families). Creditors do not necessarily own the company, but in some case as in Germany, they do insert more-than-proportionate corporate control through custodian ship of shares deposited therewith.[2]

Table 1 shows the degree of concentration of corporate ownership in East Asian Corporation measured by the fraction of ownership made up of blockholders -- i.e., individual holding shares that are greater than 5%. Thailand, Indonesia and Singapore exhibit the highest level of concentration. In Singapore and Thailand, corporations and

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[1] The true value is estimated to be approximately 50% of face value, which is the bid submitted by the (well-informed) foreign consulting company who assists the government in the sale (this is an issue which has become very controversial). The discrepancy reflect the cost of unreliable fiancial data.

[2] Nearly one-half of listed corporate shares are under control of German banks, while they own only less than 10% of the shares.

financial institutions hold relatively comparable shares, while in Indonesia, the bulk of the blockholding is held by holding companies of private companies. The insignificant Indonesian banks' shareholding may be due to sheer size of Indonesian banks that are much smaller than those in Thailand and Singpore. The Thai equity holding by the financial sector is a result of direct shareholding by commercial banks.

Among the major industrialised countries, pension funds play the role of the large investor in the UK, private companies in Germany and households in the United States (see table 3). The unique large household holding in the United States can be attributed to the US policy to limit the size of equity share and corporate control of US institutional holders. For example, commercial banks' holding of non-commercial businesses is limited to 5% and banks' claim over assets in case of bankruptcies may be given a very low priority. Also, to limit banks' corporate control, the *Har-Scott Rodino Act 1976* stipulates that the following activities may require a notification to the Federal Trade Commission 1) nomination of a candidate for the board of director 2) soliciting proxies 3) having a controlling shareholder, director, officer, or employee of the investor as a director of the company in which they have invested.

While firms with concentrated ownership offers a relatively stable ownership, effective monitoring and continuous relations with suppliers, creditors and customers, small shareholders are at risk of being marginalised. Thus, concentrated ownership must go hand-in-hand with a strong small shareholder's protection through various provisions such as the ability to nominate, appoint and dismiss directors and managers through cumulative voting, the ability to call emergency shareholders' meeting, to make proposals at meetings, and to have access to relevant information (mandatory reporting by large shareholders, mandatory disclosure of non-financial information[3]) and reliable financial statement. (See table 2).

Firms with disperse shareholding encounter a different problem. While inequitable treatment of large and small shareholders may not be an issue, lax

[3] Non-financial information may include governance arrangements, management structures and compensation and pay procedures.

monitoring can be a serious problem. Without a major stakeholder, much of corporate control falls in the hands of management. Shareholders must then rely heavily on the elected board of directors to represent their interest by monitoring the potentially unruly management.

The disperse shareholding structure among US corporations lends an exceptionally managerial control. Thus, the issue of self-dealing such as excessive compensation and "golden-parachutes" provision in the case of merger and acquisition are high on the list of corporate governance code of conduct. But exactly how much can shareholders rely on the board of directors to represent their interests?

4. The Board of Directors

At the second hierarchical level of corporate governance is the board of directors. The board is elected by the owners to monitor management. Key tasks of a board includes 1) nominating directors and officers 2) overseeing accounting procedures and the account audit and 3) deciding the pay for corporate executives. It is thus recommended in the 1992 Cadbury Committee report that board should name advising committees to address each of these specific tasks om order to alleviate its workload and to increase the quality of monitoring.

The key corporate governance issues with regard to the board of directors are *independence* of the board from management and its *accountability* to shareholders. Effective monitoring require an arm's length relationship from management. How do we make a board independent when excessive managers are also represented on the board? One way would be to increase representation of non-executives on the board of directors[4] and to staff key committees such as the audit, compensation and nomination committees exclusively with independent directors. A more radical approach would be to split the board into two: the supervisory board and the executive board. The supervisory consist of outside directors who are not involved in the management of the company[5], while the executive board consists of managing directors. The supervisory board appoints the executive board members. At present their are only two countries with two-tier board system which are Germany and France.

Another governance issue is how to make the board *accountable* to the shareholders. Without proper check-and-balance mechanism, the power of an independent board can easily spawn unaccountability. Thus, provisions should be made to enhace

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[4] The Cadbury Code recommends that a board should have al least three non-executives, of whom two should be fully independent (do not hold any stake in the concerned company)

[5] In the case of Germany, the law requires that for companies with more than 2000 employees, shareholders elect half of the supervisory board and employees elect the other half.

1) *shareholders' ability to nominate, appoint and dismiss the directors and to determine the compensation of board members*[5]. The extent to which a small shareholder is empowered to hold directors accountable include the size of the minimum shareholding required to nominate[6] or dismiss directors[4];

2) *shareholders' voice in important corporate decisions* such as the change in corporate mandate and governance, merger and acquisition, approve auditors and their fees, ratify board actions, approve intra-company contracts, etc. Indeed, a balance is required such that shareholders' direct involvement does not render their representation through the board of directors meaningless.

3) *prohibition of cross-directorship.* A director often sits on more than one corporate boards. While cross-directorship between competing businesses is prohibited (unless shareholders are notified prior to the resolution for his appointment), any cross directorship would lessen director's ability to perform his du'. effectively. For example, in large public companies in the US, the compensation of the board is determined by the compensation committee, which consists entirely of outside directors. But since two-thirds of the outside directors themselves, are chief executives of other companies, they have little incentive to control the compensation of the top executives of the board.

4) *disclosure of information* with regard to interested transactions between the company and directors of the board.

5. Audit Committee

Institutional investors and shareholders rely on financial statement to evaluate a company's condition. Yet poor audits in many countries has rendered accounting an art more than mathematics. As mentioned earlier, unreliable financial reporting can work to

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[5] Shareholders must approve the level of compensation of the board of directors in France, Japan and Germany, but not so in the United States.

[6] Nominating candidates for the board in Germany and Japan is relatively easy than in the UK where a minimum shareholding of 5% is required or in the US where shareholders have to finance their own proxy campaign.

[4] In France shareholders are free to dismiss any director of the board by a resolution with a simple majority whereas in most other country, a three-quarter of the votes.

the advantage of management and large shareholder who monopolizes corporate control, but it can be very costly for other stakeholders including investors, regulators, small shareholders and creditors. Investors will not be able to make investment decisions accurately (thus, inefficient firms will not be penalized, while efficient ones will not be rewarded). Regulators will fail to detect weaknesses and take timely corrective action. Small equity holders cannot detect managers' misappropriation of company' funds by managers. And finally, creditors will not be able to assess the company's ability to repay loans.

Efforts to promote better accounting and audit standards come from both the government and the private sector. The government should ensure that the local accounting standard is consistent with international standards (such as the US General Accepted Accounting Standard (GAAP) and the International Accounting Standards (IAS)). It should also make auditors subject to professional liability or government sanctions.

The responsibility of monitoring audits falls on the board of directors. As this is an enormous task, an audit committee can reduce the workload borne by director in dealing with statement analysis, operational performance, and both internal and external auditor. Making audit committees mandatory can also enhance the board's ability to monitor management and to assess the performance of the company.

An audit committee is expected to play an increasingly important role in corporate governance. The committee shall consist of knowledgeable professions who would examine corporate management on a neutral basis. Key function of the committee includes giving advice to the board of directors, inspect and look after legal and financial issues, analysing findings submitted by internal and external auditors, analyse accounting and internal control systems by giving early warning should certain sign emerge and examining financial statements and annual reports before submitting them to the board for approval.

Self-regulation can provide solutions to the problem of audits. Many businesses adopt voluntary external auditing by reputable institutes to enhance the transparency of their corporate governance. In some country, the Association of Accountant or Auditors play an important role in establishing an industry-wide accounting standard to which members must comply. Although this may come at a greater cost, but tranparency and credibility in management can add value to the company.

The private sector's strive for higher standards can be realized only when there is competitive pressure. Competition in the auditing prefession and businesses will thus be a key factor in improving the standard of accounting practices. In many country, the profession is still closed to foreigners and the business closed to foreign companies. Opening up these markets can certainly enhance the quality of audit services and the accounting standard of the corporate sector.

6. Managers

The key problem concerning management is the agency problem due to the separation of ownership and control. As it is impossible to draw up a complete contract which covers all possible future contingencies, managers inevitably retain residual control. The agency problem can be manifested in several forms such as expropriation of company's funds (purchasing objects for private use, transfer pricing, pet project), self-dealing (executive compensation, golden parachutes or share ownership in the case of mergers and acquisitions), empire building (excessive expansion and diversification of business) and resistance to value-increasing takeovers (by taking costly measures such as poison-pill). All these comes at a great cost to shareholders.

Evidence of agency cost is ample. For example, Jensen (1986) argued that managers are inclined to reinvest the free cash rather than return to investors. Roll (1986) and Lewellen at al (1985) find that in the case of acquisition announcement, negative returns are most common for bidders in which managers hold equity suggesting that agency problem can be alleviated with incentives. Walkling and Long (1984) find that

managerial resistance to value-increasing takeovers is less likely when top management can secure their private benefits (through golden parachutes provision or share ownership). More indirectly but interestingly Johnson et al (1985) found that sudden executive deaths are often accompanied by increases in share prices of the companies to which they belong. A plausible explanation is that the flow of benefits from control is expected to cease after the death of powerful managers.

Making managers more accountable to owners requires both a carrot and a stick. Incentive contracts that is contingent on corporate performance may help align managers' interests with those of the owners. Such contracts may include share ownership or stock options. At the same time, legal restrictions and prevention of potential managerial self-dealing such as excessive compensation, outright theft, insider trading, interested business deal will also have to be in place.

To conclude, the government and the private sector hold key solutions to good corporate governance. The government must provide the legal and regulatory framework that is conducive and consistent with an accountable, transparent and equitable corporate governance. These include 1) disclosure requirements (financial statement: mandatory reports of financial engagement of large shareholders and of interested transactions) 2) prevention of abusive behaviour by insiders (insider trading laws and enforcement, prohibition of loans to directors, promotion of effective audits 3) facilitation of shareholder control and monitoring (permitting proxy voting, cumulative voting, voting by mail) 4) implementation of proper punititve measures in case of misconduct or violations.

But law and regulations have a major weakness, enforcement, which is both time and money-consuming. A market-based solution do not run into such problems. Lack of competition in the goods market can contribute greatly to bad corporate governance as firms with bad corporate governance can continue to survive simply from monopolistic rents. Competition in the investment market will also force local companies to elevate their governance structure in order to tap the vast pool of capital in the global market.

Competition will instigate private sector's desire to self-regulate. Voluntary adoption of a well-accepted corporate governance standard is now widely practiced in most developed economies. These governance standards or so called "codes" are sometimes established by a government body, large international investors and trade associations. Known codes include the Cadbury and the Greebury Codes of the U.K. the Vienot Report of France, the CalPERS (California Public Employee Retirement System) Governance Principles and the Hampel Committee on Corporate Governance. Self-regulation is the long-term solution to corporate governance.

7. The Thai Corporate Governance

The Thai corporate governance has been dominated by family-run style of business management. Several families such as the Sophonpanich (Chareon Pokaphand (CP) Conglomerate), the Lam Sam Family (Thai Farmers Bank), the Sophonpanich Family (Bangkok Bank), and the Chirativat family (Central department store and hotel chains) -- to name a few --dominate the landscape. Although some of these businesses have become publicly listed companies, founders often keep the majority within their family. As can be seen in table 5, individual blockholders represent 21.38% of the size of ownership share of top five largest shareholders of 150 largest companies listed on the stock exchange. Indeed, with relatively weak judicial process, fictional accounting and poor audits, there is much to be gained from corporate control.

The owners' corporate control is relatively unchallenged by other stakeholders such as smaller shareholders or creditors. Through majority shareholding, the owners have the power to appoint directors and managers. They are often friends or families. Thus, elected directers are often neither competent nor independent from management; rather, they represent the interest of the large shareholder.

Prior to this crisis, shareholders themselves are very little informed about their rights and duty as a corporate owner. The boom years offered all investors a positive

return regardless of the governance of the corporation. Most investors are driven by speculative motive rather than by the company's business fundamentals. It is only recently when the money stopped flowing do news reporting small shareholders protest at a shareholder meeting begin to appear.

The concept of shareholder protection is relatively new. It is only six years ago (1992) that the Public Company Act was introduced. The law is comprehensive and offers all the basic shareholders' right (see table 2). Unfortunately, it has been rarely exercised: partly because shareholder's are not aware of their rights and partly because of the domination of control be a single large shareholder.

Improving the Thai corporate governance will require institutions that may play the advocacy role for small shareholders. However, it must be reminded that institutions that perform such a role in other countries such as commercial banks in Germany, mutual funds in the US, pension funds in the UK all have direct and indirect stake in the real sector. This is because the Thai commercial banks have a relatively large shareholding in the real sector as well as in major insurance industries. Mutual funds in Thailand are also run by Thai banks. Therefore, these institutes may not be able to perform the proper advocacy role for small shareholders.

Putting their shareholding in financial and non-financial companies aside, Thai banks have not been performing their role in monitoring the management of their large debtors despite the fact that the Thai corporations have been increasingly reliant on debt as can be seen in table 4. This may be due to two reasons. First, a large part of the loan is extended through personal connections. Thai banks rarely scrutinize the feasibility of the projects; rather they assess the personal reputation and credibility of the borrower. That is why most banks' loans are secured only by personal guarantees of the owner. Second, the bubble economy which spread from the real estate sector to the manufacturing sector, has led to competitive credit extension -- i.e., if a bank makes too much fuzz about lending, a potential debtor can easily secure the loan somewhere else during the period of euphoria. Thus, reckless lending was contagious.

To promote a more effective monitoring, long-term equity holding will have to be promoted. This includes the introduction of corporate debentures. Because the Thailand had been experiencing continual fiscal surplus for almost a decade, the bond market is very much underdeveloped in Thailand

Better protection of small shareholders' rights will also be required. These Stock Exchange Commission in Thailand is studying ways to improve proxy solicitation and considering making cumulative voting mandatory.

Shareholders are not the only one that need protection, creditors also do. The speed on bankruptcy court procedure and foreclosing on collateral is appalling. It may take up to 10 years, during which the loans remain non-performing. A revised bankruptcy and foreclosure laws will be scrutinized by the parliament during the current session. Amendments are made to limit debtors attempt to drag on the case through no-shows for hearing and appeals. Unfortunately, few of the MPs and Senators are personally mired in bankruptcy cases. These people have all the incentives to undermine the passing of the revised laws.

Better monitoring can also be promoted by making boards' supervision more effective. To this end, the Stock Exchange Commission is considering making a two-tier board mandatory and recommends the establishment of subcommittees such as the remuneration committee and nomination committee. Audit committees will be mandatory for all listed companies by 1999.

Also, to promote better accounting standard, the SEC is considering requiring listed companies to establish an auditing department. But changing institutional structure can help better governance only to a limited extent as the quantity of qualified accountants and auditors in Thailand are very limited. What is urgently required is opening of the profession and business to foreign competitors.

This crisis will have a great impact on the ownership landscape, in particular in the financial sector. Many families in the banking business have lost their empires

through massive writedowns of their shares and nationalization of 56 closed finance companies most of which are affiliated with a commercial bank. With a large quity holding in public hands, it is difficult to predict the future corporate ownership structure of the banking and finance industries. But greater foreign presence is certainly in the picture.

In the non-financial business, many large shareholders have to render control in the hands of new foreign owners through recapitalization. Those that have spread themselves too thin by having diversifed into non-core businesses are selling off their stakes, especially those overseas. The days of family-run businesses and conglomerates are numbered.

With rapidly changing corporate ownership and management, it is prime time to ov -haul the Thai corporate governance. All we need is the will to do so.

Table 1: Ownership concentration in East Asian Corporation (average 1991-97)

Country	Concen-tration	Management	Individuals	Corporations	Financial Institutions	Others
Hong Kong	53.2	10.03	3.61	30.78	8.29	0.49
Indonesia	67.19	1.84	6.21	52.51	2.68	3.94
Japan	26.08	1.78	1.59	18.00	4.43	0.28
South Korea	26.35	6.12	5.69	10.33	3.22	0.99
Malaysia	53.82	2.32	2.45	27.57	17.91	3.68
Philippines	56.54	1.79	3.73	40.26	10.77	0
Singapore	61.47	4.72	2.50	28.17	[illegible]	0.16
Taiwan	14.89	2.55	3.69	7.19	1.25	0
Thailand	72.90	4.46	6.20	28.13	32.93	0.6
All countries	31.90	2.59	2.10	20.06	6.55	0.58

Source: Claessens, Stijn et al (1998)

Note: Concentration refers to the cumulative shareholding greater than 5%.
Management ownership includes ownership be officers and directors.
Individual ownership includes ownership by persons who are not employees, officers, directors.
Financial institutions include banks, insurance companies, mutual funds and pension fund.
Others include government, employees and unclassified

Table 3: The Structure and Shareholding in Major Countries

	Germany	United Kingdom	United States	France
	1990	1993	1992	1992
Institutional Investor	22	59.3	31.2	23
Banks	10	0.6	0.3	
Pension fund/insurer	12	51.5	23.9	
Others (unit trusts)		7.2	7.0	
Households	17	19.3	48.1	34
Private Companies	42	4	14.1	21
Government	5	1.3		2
Foreign Investors	14	16.3	6.6	20

Source: Lannoo, Karel (1996)

Table 4 Debt-equity ratio of listed Thai companies

Period	profits / interest expense	leverage
1994: Q4	5.78	1.50
1995: Q4	4.01	1.67
1996: Q4	3.11	1.90
1997: Q1	3.66	2.01
1997: Q2	3.18	2.12
1997: Q3	2.59	2.95
1997: Q4	1.49	2.95

Source: Alba, Pedro et al. (1998)

Table 5 Type of ownership share of top 5 largest shareholders among 150 largest listed Thai companies in 1997

Type of Investor	Share
Private Companies and Holding Companies	38.38
Individuals	21.38
Foreign banks (including securities and nominees)	15.41
Domestic banks	5.18
Finance and securities Company	5.84
Insurance	2.00
Others	11.81

Source: TDRI calculations from Stock Exchange Commission's data

FIGURE 1 Corporate Governance Hierarchy

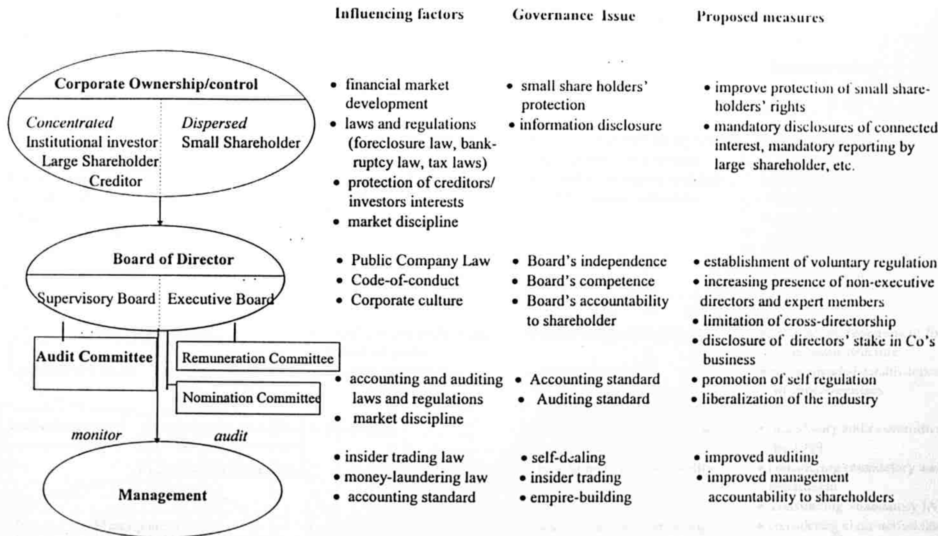

FIGURE 2 Thai Coprporate Governance

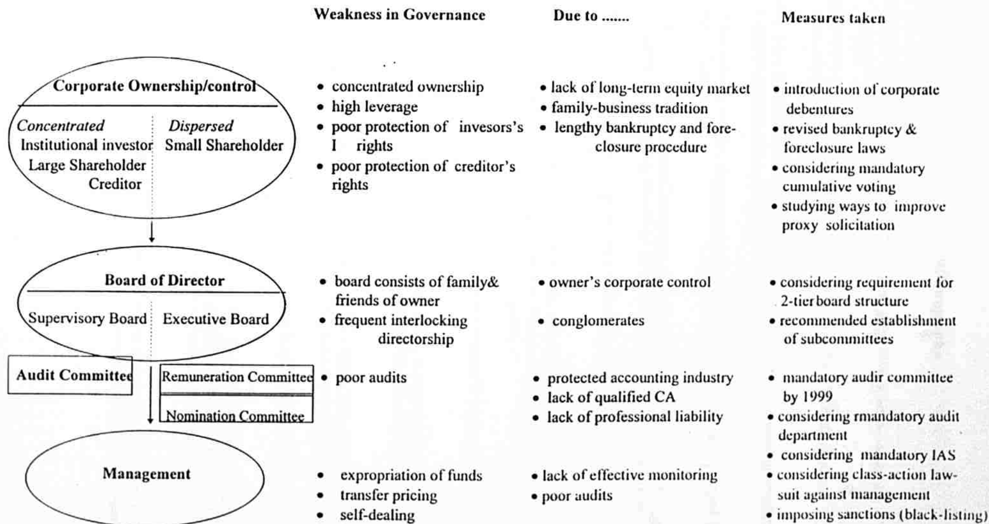

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Table 2.

BOX 4.2

Corporate governance in East Asia and other emerging economies (prior to July 1997).

Variables	Description/Effect	Indonesia	Malaysia	Philippines	Thailand	Mexico	India	Pakistan
Right to Call Emergency Shareholder Meeting (percent share capital to call meeting)	Facilitates shareholder control.	YES 10	YES 10	YES 10	YES 20	YES 33	YES 10	YES 10
Right to Make Proposals at Shareholder Meetings.	Facilitates shareholders control; increased opportunity to prevent biased decisions by insiders.	YES	YES		YES	NA	NA	
Mandatory Shareholder Approval of Interested Transactions.	Protects against abuse and squandering of company assets by insiders.	YES	YES	YES	YES	NA	NA	
Preemptive Rights on New Stock Issues	Protects against dilution of minority shareholders; prevents insiders altering ownership structure.	YES		YES	YES	NA	NA	
Proxy Voting	Facilitates shareholders control.	NO	YES	YES	YES	NO	YES	YES
Alternative Dispute Resolution mechanism	Facilitates shareholder control.	YES						
Mandatory Reporting by Large Shareholders	Disclosure of transactions by large shareholders protects against abuse by insiders.	YES	YES	YES	YES			YES
Ownership concentration in the 10 largest private firms (percentage owned by the 3 largest shareholders)		62	NA			64	43	49
Penalties for Insider Trading	Protects against use of undisclosed information at the expense of current and potential shareholders.	YES	YES	YES	YES			
Provisions on Takeovers Legislation	Protects against violation of minority shareholders' rights.		YES	YES	YES			
Mandatory Disclosure of Non-Financial Information	Both financial and non-financial information data are important to assess a company's prospects.	YES	YES		YES			
Mandatory Disclosure of Connected Interests	To protect against abuse by insiders.			YES	YES			
Mandatory Independent Board Committees	If composed of independent directors, audit and remuneration committees protect against insider abuse.		YES		YES			
Mandatory Shareholder Approval of Major Transactions	Protects against abuse by insiders. Protection can be enhanced through supra-majority voting.	YES	YES	YES	YES	YES		YES
One Share-One Vote	Basic right; some shareholders may waive their voting rights for other benefits such as higher dividends.	NO	YES	NO	NO	YES	NO	NO
Allow Proxy by Mail	Facilitates shareholder control.	NO	NO	NO	NO	NO	NO	NO
Shares Not Blocked Before Shareholder Meeting	Mandatory depositing of shares prior to shareholder meeting makes shareholder control more difficult.	YES	YES	YES	YES	YES	YES	YES
Cumulative Voting for Directors Allowed	If shareholders can cast all of their votes for one candidate, it increases probability of outside directors.	NO	NO	YES	YES	YES	NO	NO
Automatic Stay on Assets if filed for bankruptcy	Shields shareholders from creditors	NO	NO	YES	NO	NO	YES	NO
Oppressed Minorities Mechanisms	Shareholders' right to a judicial venue to challenge insider decisions or to request company purchase their shares if they object to fundamental changes.	NO	YES	YES	YES	YES	NO	NO

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INDUSTRIAL RELATIONS

by

A Navamukundan

Malaysian Institute of Economic Research
Institut Penyelidikan Ekonomi Malaysia

INDUSTRIAL RELATIONS

A. NAVAMUKUNDAN
National Union of Plantation Workers

INTRODUCTION

1. Industrial Relations is an important aspect of economic and social development in society. A stable and effective industrial relations situation is important for facilitating economic growth and equitable distribution of incomes to labour. Industrial relations focuses on employer, employee relations with regard to terms and conditions of employment and grievance redressal procedures within the framework of existing legislation. The government plays an important role in ensuring the framework necessary for stable and effective industrial relations. Industrial relations is therefore a shared tripartite responsibility between the three equal social partners in society namely the government, the employers and the trade unions.

2. Malaysia's current industrial relations policies are based partly on the inherited "control culture" of the colonial era, the Emergency between 1946 and 1960, the Emergency during Confrontation (1963 – 1966) and NOC Rule after May, 1969. The National Five Year Economic Development Plans have also influenced the evolution of the industrial relations system. Currently the 7th National Five Year Economic Development Plan (1996 – 2000) is in progress. During the First and Second Plan period the strategy adopted was the diversification of the economy especially in the agricultural sector and the building of the infrastructure requirements for the creation and expansion of the manufacturing sector especially value added industries based on local raw materials. The Third Malaysia Plan set the strategies firmly in the context of the New Economic Policy. Industrialization was emphasized together with the expansion of the Petroleum and petro-chemical industries. The courting for foreign investments to accelerate the process began aggressively with the offer of special incentive packages to foreign investors. Public investments were directed for the creation of free trade zones and industrial areas in strategic locations to attract foreign investments and encourage local investors. The subsequent plans proceeded with the same thrust but resorted to greater 'market friendly' policies. The gradual shift from the public sector to the private sector as the engine of economic growth is apparent subsequent to the Third Malaysia Plan period (1976 – 1980).

3. These development strategies demand a high level of discipline in industrial relations especially with regard to establishment of trade unions, procedures for Collective Bargaining and settlement of industrial disputes so as to ensure that turbulence in production as a result of labour unrest in minimized. The emphasis on discipline as a part of development strategies adopted is clearly reflected in the rural development programmes during the First and Second Malaysia Plans when the Red Book system for the planning, implementation and evaluation of rural development projects and programmes were implemented. The Red Book system was based on the model of the British Military operations against communist insurrection where the emphasis on

'control' and discipline was important. Malaysians are therefore well oriented into a culture of discipline in society which assists in maintaining industrial peace and stability.

4. The current legislation governing industrial relations has its origins in the colonial period and is sensitive to potential threats to internal security, social and economic instability. The "control culture" of the colonial period continued in current legislation to suit the needs of the economic and social development policies of the nation. Malaysia's industrial relations legislation is considered positive in the context of formal discipline requirements for industrial relations. The two important legislation governing industrial relations and administration are the Trade Union Act and the Industrial Relations Act.

TRADE UNION ACT 1959

5. The Trade Union Act ensures that workers and employers are free to form trade unions subject to compliance with the provisions and regulations of the Act. No organization other than a trade union of workers or employers registered under this Act can represent workers and employers in industrial disputes. The Act provides for trade unions to be formed on the basis of one particular establishment, trade, occupation, industry or in similar trades occupations or industries or establishments.

6. The policy of the government especially during the pre independence and New Economic Policy era, was to encourage national unions or industry based unions. The formation of General Labour Unions which caters for workers of all categories and industries was however prohibited since colonial times as part of a strategy to prevent the infiltration of the Malayan Communist Party into the trade union movement. A further characteristic of trade unions is the restriction in the registration of trade unions specific to Peninsular Malaysia, Sabah and Sarawak. There is therefore, no opportunity for workers in similar trade, occupation, industry or establishments to register unions with membership in Peninsular Malaysia, Sabah and Sarawak. Through amendments in 1989 the policy of promoting national industry-based unions was relaxed to provide for the easy registration of company or in-house unions. National unions were desired during the pre New Economic Policy period as they were useful mechanisms to control the activities of the trade unions and monitor for any subversive activities of the Malayan Communist Party through the trade union movement. However, when the government strategy to promote foreign investments to achieve economic growth became important the earlier policies changed to provide for freedom of association on a reduced scale i.e. on a geographical or on an in-house union basis. The change was inevitable especially when foreign investors were looking for not only political stability but also flexibilities with regard to wage rates which can be determined on a in-house or geographical basis. This situation saw the birth of in-house unions and unions limited to specific geographical areas. For example, trade unions in the textile industry were registered on a regional basis and electronic industry workers were given registration for in-house unions. Provisions in law, however provide for the formation of federation of unions in similar industries and the state based regional textile unions have formed a national federation of textile unions. Workers in specific industries in the private sector will be able to organize themselves in unions subject to being in similar trade or occupation. For

example, the plantation industry has two unions viz. All Malayan Estates Staff Union (AMESU) which caters for white collar workers and the National Union of Plantation Workers (NUPW) which caters for skilled, semi-skilled and manual workers. Thus national, regional, in-house and occupational categories of unions co-exist in the Malaysian trades union movement.

7. Public sector workers cannot be represented through private sector unions. Workers in the public sector viz. government, statutory corporations and local government and class of workers. This is illustrated in the example of the national electricity corporation when it was a statutory corporation where four unions existed for four levels of workers viz. the senior officers, the junior officers, technical services personnel and other employees.

8. The most potent weapon of the trade union is the freedom to strike. The Trade Union Act has extensive regulations to comply with before a strike can be called by workers. An illegal strike is fatal for trade union membership as workers automatically loose their membership rights. This provision reduces the risk of frequent 'wild-cat' strikes in the industries. The Trade Union Act also prevents the trade unions from direct political party affiliation and activities. Officers of political parties are prohibited from becoming officers of trade unions. The formal isolation of trade union organizations from political parties is an important feature in Malaysian labour movement which has contributed to relative stability in industrial relations.

9. Trade unions are however allowed affiliate with the national centre. The Malaysian Trade Union Congress is a society of trade unions registered under the Societies Act. The Malaysian Trades Union Congress is therefore without collective bargaining and industrial action rights. However, it is the national centre for both private and public sector unions. The public sector unions have opportunities to affiliate with the Congress of Unions of Employees in the Public and Civil Services (CUEPACS) which is a federation of trade unions registered under the Trade Union Act. Trade unions are also permitted to affiliate with international trade union organizations such as the International Trade Secretariats and the International Confederation of Free Trade Unions, subject to the approval of the Director General of Trade Unions.

10. The important feature of the Trade Union Act in the development process in its role in ensuring total transparency and accountability in the trade union movement which can be monitored by the Director General of Trade Unions in the Ministry of Human Resources. There are extensive provisions in the Trade Union Act with regard to financial management and accountability in trade unions through mandatory obligations to submit financial records on income and expenditure to the Director General of Trade Unions annually. The powers of the Director General of Trade Unions are extensive and any breach of the law can be dealt with through formal charges in court with penalties of fines and imprisonment for officers who are found guilty. The policies with regard to trade unions in Malaysia as reflected in the Act reveal that trade unions are permitted to function in society but within the confines of a defined role. The freedom to act is not

absolute as some trade unionists want it to be. The overriding objective of the Act is to maintain industrial peace and stability in the national interest.

11. Although there are checks and balances in the system for monitoring trade unions, these organizations nevertheless are free to express their views concerning labour and represent them at appropriate national and international forums. Concerted trade union actions through industrial action on a national and international basis was visible in the 1978/1979 Malaysian Air-Lines System's disputes with the MAS Employees Union which led to a strike and international threat of boycott by the International Transport Federation. Further, international pressure has been exerted on the Malaysian Government by the trade unions through the Malaysian Trades Union Congress. For example, the Malaysian Trades Union Congress had called for the withdrawal of the G.S.P. privileges by the U.S. to exert pressure improvements in trade union rights and liberties. The Malaysian Trade Union Congress is also actively involved in the support of the Social Clause which links trade union rights to trade in trade agreements although the government is opposed to it. The role of trade unions can therefore be summed up as a 'watch-dog' role within specific confines. The international links of trade unions is illustrated in Figure 1.

Industrial Relations Act 1967

12. This legislation provides for the regulation of relations between employers and workmen and their trade unions, and the prevention and settlement of any differences or disputes arising from their relationship and generally to deal with trade disputes and matters arising from them. The term 'industrial relations' is referred to as the relationship amongst and between workers and employers (and their organizations) and between these organizations and public authorities. The three parties in industrial relations are the three social partners viz. the workers, employers and the government. The principles governing industrial relations are derived from common law, legislation and awards of the Industrial Court and decisions of the High Court, Court of Appeal and the Federal Court.

13. Prior to the introduction of compulsory arbitration in the industrial relations system in 1965, the voluntary system of industrial relations based on the British model was in practice which encouraged the concept of self regulation and autonomy within the industries as the key to industrial harmony. Both employers and workers were encouraged to regulate their collective relationship and to settle any disputes arising through their own efforts and through mutually agreed procedures. Government intervention was kept to a minimum and was confined mainly to providing a legal framework to which the parties could turn to if they so wished in accordance with the Industrial Courts Ordinance 1948 and the Trade Disputes Ordinance 1949. The Industrial Courts Ordinance provided for the promotion of peaceful and voluntary settlement of trade disputes through conciliation by a third party or through the voluntary reference of a dispute to the Industrial Court for arbitration. The Trade Disputes Ordinance provided the Government with supervisory powers to maintain vigilance over trade disputes and

certain matters arising from such disputes so as to ensure and safeguard the interest of the public in general.

14. In 1965, the Essential (Trade Disputes in Essential Services) Regulations, 1965 was promulgated. It was designed to ensure that disputes in certain scheduled services would not lead to disruption of such services. These Regulations vested in the Minister of Human Resources certain powers to intervene on his own volition in such disputes and if necessary, to refer them to the Industrial Arbitration Tribunal for settlement. No strike or lock–out could be declared or where already declared could continue once the Minister had intervened. The award of the Tribunal was final and legally binding on the parties to the dispute. The promulgation of the Essential Regulations in 1965 was indeed a turning point in the pattern of industrial relations system in the country. For the first time, an element of compulsory concept was introduced into the system regulating the relationship between management and labour.

15. Subsequent to the promulgation of the Essential Regulations, the Government conducted a review of the then existing law and practice in the field of industrial relations which resulted in the substitution of the previous laws by the Industrial Relations Act, 1967. This Act came into force on 7th August, 1967 and is applicable throughout Malaysia.

16. The Act retains most of the principles and practices as set out in the repealed legislations and continues to promote the voluntary system up to the point where Government intervention is necessary so that the ever present public and national interests are not prejudiced while the parties promote their own respective interests.

17. One specific aspect of the Act which is important is the definition of "strike" which includes "any act or omission by a body of workmen acting in combination or under a common undertaking, which is intended to or does result in any limitation, restriction, reduction or cessation of or dilatoriness in the performance or execution of the whole or any part of the duties connected with their employment". It is obvious that this definition extends to all aspects of retaliation by trade unions.

18. This Act however provides for the rights of workmen and employers and their trade unions and prohibits workmen, employers and their trade unions from resorting to certain acts of anti union activity, victimization and other unfair labour practices. The Act makes it obligatory on the part of employers to grant workers leave of absence of a reasonable period for the performance of their duties as trade union officers, and the employer is further obliged to grant such leave with pay if the workman's absence is to represent the members of his trade union on matters concerning the employer.

19. Trade unions require recognition by their employers before they can represent their members. Recognition is granted by the employers voluntarily failing which a claim for recognition based on the membership of workers in the union can be made based on a majority of membership of workers through the Director General. It is important to note that workers employed in managerial, executive, confidential or

security capacities cannot be members of a union. Workers are prohibited from going on strike or picket for whatever reason during the period proceedings relating to a claim for recognition is pending. Employers are also prohibited from declaring a 'lock-out' or dismissing a workman (except on disciplinary grounds) during this period. Once recognition is accorded the process of collective bargaining can begin and proceed as provided for in Figure II. Common law rights of an employer such as promotion, transfer, employment, termination of service on grounds of redundancy or reorganization, dismissal and reinstatement of a workman on disciplinary grounds, assignment or allocation of duties, cannot be included in the proposals of a trade union of workmen for a collective agreement.

20. The Act also protects pioneer industries for a period of at least five years from the date of commencement of operation in Malaysia in that the approval of the Minister of Human Resources is required for any collective agreement which is to contain terms and conditions of service more favourable to workers than contained in the Employment Act, 1955.

21. The Act also provides for the reference of trade disputes for conciliation. The procedure for resolving disputes in shown in Figure III. Either party to a dispute may report to the Director General of Industrial Relations any trade disputes which has not been resolved by the parties themselves for conciliation and settlement. The Minister may at any time intervene in a trade dispute on his own motion if he deems it necessary. It also empowers the Director General of Industrial Relations to direct any person engaged in or connected directly or indirectly with the dispute to attend conciliation meetings and to furnish all necessary information relating to the matters in dispute. It further stipulates who could represent the parties during conciliation proceedings. There is prohibition of representation by an Advocate, adviser and consultant in particular.

22. The Act provides that if a workman regardless as to whether he is a member of a trade union of workmen or not, if he is dismissed by his employer without just cause or excuse, he may within sixty days of such dismissal, make his representation in writing to the Director General to be reinstated in his former employment. If the representation remains unsettled after the Director General has taken such steps as he considers it necessary or expedient to bring about a settlement, the Minister is notified accordingly, who may, if he thinks fit, refer it to the Industrial Court for an award.

23. The parties to a trade dispute may jointly request the Minister to refer a trade dispute to the Industrial Court and the Minister may on his own motion refer any trade dispute to the Industrial Court if he is satisfied that it is expedient to do so. In the case of a trade dispute in any Government service or in the service of any statutory authority, such reference shall not be made except with the consent of the Yang di Pertuan Agong (King) or State Authority as the case may require.

24. The Act also provides for the establishment and functioning of a Committee of investigation or a Board of inquiry. This is meant to cater for issues or disputes which may not be amenable to be dealt with under the normal forms or methods of settlement.

This Minister is given the power to appoint a Committee consisting of one or more persons or a Board consisting of a Chairman and such other persons as the Minister thinks fit to inquire into the facts; causes and circumstances of a dispute referred to it and to submit its report. Any report of a Board of Inquiry is required to be tabled in Parliament.

25. In relation to the trade disputes, strikes and 'lock-outs' and matters arising therefrom, pupils are not permitted to take part in trade disputes and any pupil convicted or found guilty of an offence under this is liable to expulsion from his school. It also provides that intimidation, willful and malicious breach of contract liable to injure person or property is illegal and the offenders are liable for punishment.

26. Peaceful and ordinary picketing in furtherance of a trade dispute is permitted provided that such picketing is carried out at or near the place where a workman works and where a trade dispute exists. It will be illegal however, for one or more persons to attend at or near a place of employment, where a workman works, if such attendance is, by nature of its manner or number, calculated to intimidate any person in that place or to obstruct the approach thereto or exit therefrom or to lead to a breach of the peace.

27. This Act imposes certain restriction on strikes and 'lock-outs' in essential services. No workman shall go on strike and no employer in essential service shall 'lock-out' his workmen without giving the other party notice within 42 days before resorting to such action and within 21 days of giving such notice or before the expiry of the date specified in such notice. It is compulsory for the employer who serves or receives such notice to report to the Director General particulars of the notice. The essential services identified are as follows :-

1. Banking services
2. Electricity services
3. Fire services
4. Port, dock, harbour and airport services and undertakings, including stevedoring, lighterage, cargo handling, piloting and storing and bulking of commodities.
5. Postal services
6. Prison services
7. Production refining, storage supply and distribution of fuel and lubricants.
8. Public health services
9. Radio communication services, including broadcasting and television services.
10. Telegraph, telephone and telecommunication services.
11. Transport services by land, water or air.
12. Water services
13. Any service provided by any of the following Departments of Government:-
    i. Chemistry
    ii. Civil Aviation
    iii. Customs and Excise
    iv. Immigration

v. Marine
vi. Meteorology
vii. Printing

14. Services which are connected with, or related to, or which assist towards, the maintenance and functioning of the armed forces and the Royal Malaysian Police Force.
15. Business and industries which are connected with the defence and security of Malaysia.
16. Any action of any service, on the working of which the safety of the employees therein or of the establishment relating thereto depends.
17. Industries declared by the Ministry by notification in the Gazette as industries essential to the economy of Malaysia.

28. The Act also prohibits a strike or lock-out under any of the following circumstances :-

(a) during the pendency of the proceedings of a Board of Inquiry appointed by the Minister and seven days after the conclusion of such proceedings;
(b) after a trade dispute or matter has been referred to the Industrial Court and the parties concerned have been notified of such reference.
(c) after the Yang di Pertuan Agong or State Authority, in the case of a trade dispute relating to any Government service or the service of any statutory authority, has withheld consent to the reference of the dispute to the Industrial Court and the parties concerned have been notified thereof;
(d) in respect of any of the matters covered by a collective agreement taken cognizance of by the Industrial Court or by an award; and
(e) in respect of any of the matters covered and listed as management prerogatives.

29. Any strike or 'lock-out' declared in contravention of this Act or any other written law, or if it has objectives other than the furtherance of a trade dispute between the workmen and the employer concerned is illegal. It is also an offence for any person to give financial aid in direct furtherance or support of any illegal strike or 'lock-out'. Offences are seizable in nature and no bail shall be granted.

30. This Act also contains provisions relating to procedures to be followed in cases of non-compliance of awards or collective agreements which have been taken cognizance of by the Industrial Court, the enforcement of subsequent orders and general penalties for contravention of certain provisions of the Act. It is an offence to dismiss a workman or injure or threaten to injure him in his employment or later or threaten to alter his position to his disadvantage under certain circumstances. Any employer contravening this section is liable on conviction to imprisonment for a term not exceeding one year or a fine not exceeding two thousands ringgit or to both.

INDUSTRIAL COURT

31. The most significant development in the field of industrial relations in Malaysia was the introduction of Compulsory Arbitration in 1965. The first Industrial Court was set up under the Industrial Court Enactment promulgated on 21-9-1940. Following this the Industrial Court and Courts of Inquiry Rules 1941 was passed but its proper functioning was prematurely terminated with the outbreak of the Second World War and the Japanese invasion at the end of 1941. With the increased growth in trade unions during the post was years, the Industrial Court Ordinance, 1948 was introduced and this paved the way for the establishment of an arbitration machinery. The Ordinance was in line with the United Kingdom system based on the concept of voluntary arbitration. Its essential features were that the Court derived its jurisdiction to arbitrate a trade dispute with the consent of the parties concerned and any award made was only morally binding. During the period of confrontation with the Republic of Indonesia in 1964, it was felt that control of trade disputes, especially in the "essential services", was necessary for the smooth operation of certain industries and service both in the public and private sectors. The Essential (Prohibition of Strike and Prescribed Industrial Actions) Regulations 1965 were promulgated, but were later repealed and replaced in September, 1965 by the Essential (Trade Disputes in Essential Services) Regulations, 1965. The Industrial Arbitration Tribunal was then established to deal with matters under the said Regulations, thereby introducing compulsory arbitration (in limited sphere) for the first time in the country. By August, 1967, the above regulations, the Industrial Court Ordinance, 1948 and the Trade Disputes Ordinance 1949 were repealed and replaced by the Industrial Relations Act, 1967 presently in force. Thus the change from a system of voluntary arbitration to that of a combined nature where compulsory and voluntary arbitration run parallel was introduced.

32. The Industrial Court established under the provisions of the Industrial Relations Act 1967 hears and adjudicates trade disputes and dismissal matters referred to it by the Minister of Human Resources. It is provided that the Industrial Court acts according to equity and good conscience and substantial merits of the cases without regard to technicalities and legal form, in making its awards in respect of trade disputes. The Court shall also have regard to the public interest, the financial implications and the effect of the award on the economy of the country, on the industry concerned, and also to the probable effect in related or similar industries.

ORGANISATION OF INDUSTRIAL COURT

33. The Industrial Court is headed by the President who is appointed by the Yang Di Pertuan Agong from among the serving judges of the High Court. Chairmen are also appointed by the Yang di Pertuan Agong on the recommendation of the Minister of Human Resources to preside over cases referred to the Court. All of them have equal powers under the law. Both the President and the Chairman must have at least 7years standing in the legal profession. Panels of worker and employer members are appointed by the Minister of Human Resources to assist the Court. However, in dismissal cases the President or the Chairman can sit alone to hear such cases. In a case where Panel Members are required, one member representing workers and one representing employers are appointed to sit with the Presiding Officer. The Registrar of the Industrial Court, is

responsible to the Secretary General of the Ministry and to the President for the smooth and efficient running of the Court.

The Industrial Court besides sitting at its premises in Kuala Lumpur, Pulau Pinang and Kuching, also holds hearings at other state capitals. In this matter, social justice is not only done but also seen to be done at local levels.

Functions :-

The functions of the Industrial Court are as follows :-

1. To arbitrate and adjudicate in the trade disputes and dismissal matters referred to it by the Minister of Human Resources.
2. To take cognizance of Collective Agreements jointly deposited by employers and workers union.
3. To decide on matters concerning interpretations and non-compliance of Collective Agreements or Awards.
4. To draw up principles and guidelines in regard to social justice in employment and industrial relations matters through Awards that are handed down.

34. The public sector employees and trade unions do not follow the same procedures as the private sector employees and trade unions to conclude Collective Agreement and resolve grievances. Wages and terms and conditions of employment are determined by special salaries Commissions. However, CUEPACS and the public services department discuss issues concerning revision of salaries and conditions of service of public sector and civil service employees. National Joint Councils provide forums for trade unions and staff associations to discuss conditions of employment, enabling the Government to consider the views on the staff side when decisions are made affecting public sector employees. There are three National Joint Councils viz. Joint Council for Employees in the Superscale Management Group and Joint Council for Employees in the support group.

35. Anomalies in terms of conditions of employment in the public sector are negotiated and resolve at the Public Services Department. If the anomalies are not resolved, the matter could be referred to the Public Service Tribunal for arbitration which is established pursuant to the Public Service Tribunal Act 1987. Decisions of the Tribunal are final conclusive and binding on all parties. Decisions of the Tribunal cannot be challenged, appealed against, rebuke, quashed, or called into question in any court. In making a decision the Tribunal will take into account national interests, financial implications, and effect of the decision on the economy.

OTHER LABOUR LAWS

36. Apart from these two Act which constitute the foundation of the industrial relations system, there are several other legislations which can be classified as follows :-

LEGISLATION ON LABOUR STANDARDS

Employment Act, 1955

37. This legislation provides for the minimum benefits in employment for workers with regard to contract of service, payment of wages, deductions from wages, maternity protection, rest days, hours of work, overtime rates, holidays, sick leave, termination, lay-off and retirement benefits and prohibition of employment of women in specific work.

Occupational Safety and Health Act, 1993

38. This legislation provides for the Occupational Safety and Health Standards for workers in the various sectors of the economy.

Factories and Machinery Act, 1967

39. This legislation provides for the Standards to be complied with in the establishment of work places especially factories and lay-out of machineries in such work places.

Wages Councils Act 1947

40. This legislation provides for the establishment of wages councils for the regulation of wages and conditions of employment of workers in specific categories of employment e.g. catering and hotel workers, cinema workers, shop assistance and stevedores and cargo handlers.

Workers Minimum Standards of Housing and Amenities Act, 1990

41. This legislation is specific for plantation workers and sets Standards for employers to comply with regard to quarters and all amenities viz. health, child-care, potable water supply, electricity and community facilities, provided for a healthy living environment.

Children and Young Persons (Employment) Act, 1966

42. This legislation is to regulate the employment of children and young persons. Children are defined as persons who have not completed their 14th year of age and yound persons are defined as those who are above the age of 14 and below the age of 16. Employment in which children and young persons may be engaged is specified in this legislation as follows :-

a. employment involving light work suitable to his capacity in any undertaking carried on by his family.
b. employment in any public entertainment, in accordance with the terms and conditions of a license granted in that behalf under this Act;
c. employment requiring him to perform work approved or sponsored by the Federal Government or the Government of any State and carried on in any school, training institution or training vessel; and
d. employment as an apprentice under a written apprenticeship contract approved by the Director General with whom a copy of such contract has been filed.

A young person may be engaged in any of the following employment :-

a. any employment mentioned above suitable to his capacity.
b. employment as a domestic servant;
c. employment in any offic., shop (including hotels, bars, restaurants and stalls), godown, factory, workshop, store, boarding house, theatre, cinema, club or association;
d. employment in an industrial undertaking suitable to his capacity; and
e. employment in any vessel under the personal charge of his parent and guardian;

Provided that no female young person may be engaged in any employment in hotels, bars, restaurants, boarding houses or clubs unless such establishments are under the management or control of her parent or guardian.

Provided further that a female young person may be engaged in any employment in a club not managed by her parent or guardian with the approval of the Director General.

Weekly Holidays Act, 1950

43. This legislation is to provide for a weekly holiday for persons employed in shops, restaurants and theatres.

Employment Information Act, 1953

44. This legislation facilitates the collection of information regarding the terms and conditions of employment of workers. It empowers the Ministry of Human Resources to require employers to submit written statements on the terms and conditions of employment of workers by them especially with regard to the following :-

a. the number of persons currently employed by him and the age and sex of each persons;
b. the terms of the contract between him and each such person;
c. the hours required to be worked and actually worked by, and the leave holidays and rest periods allowed to, each such person;
d. the nature of the work performed for him by each such person;
e. wage structure, by occupation;

f. the qualification and experience required for each occupation;
g. the prospects of promotion to a higher grade;

h. the job description of each occupation;
i. the normal hours of work and actual hours worked, by occupation;
j. paid and unpaid leave, holidays and rest periods;
k. total earnings including wages, allowances, overtime, bonuses and other monetary benefits, payment in kind for each person employed; and
l. any other information as may be required by the Secretary General of the Ministry of Human Resources.

Employment (Restriction) Act, 1968

45. This legislation provides for the restriction of employment in certain business activities in Malaysia of persons who are not citizens and the registration of such persons, issuance of employment permit and for related matters.

Private Employment Agencies Act 1991

46. This legislation, regulates the conduct of the business of private profit and non-profit making employment agencies, which acts as an intermediary for the purpose of securing employment for a worker or supplying a worker for an employer with a view to deriving either direct or indirect benefits from either employer or worker.

SOCIAL SECURITY LEGISLATION

Employees Provident Fund Act 1991

47. This legislation provides for the establishment of a Provident Fund for workers for post retirement benefits. Employees contribute 11% of their wages and employers contribute 12% of the workers wages towards the individual workers savings in this fund. This is accumulated together with annual dividends for withdrawals on retirement. This fund also assists contributors with withdrawals for purchase of houses and critical medical treatment.

Employees' Social Security Act, 1969

48. The Social Security Organization (SOCSO) was set up as government department on 1st January, 1971 to enforce the Employee's Social Security Act 1969. It later became a Statutory Authority from 1st July, 1985. SOCSO administers the social security schemes which give protection to employees for several contingencies, namely, employment injury, invalidity and death. The objective of the social security schemes is to guarantee payment of benefits to employees and their dependents in the event of a contingency occurring. Among the services provided are medical care and vocational rehabilitation. Other measures are also taken to prevent accidents and promote work

safety. The rehabilitation services are to enable the injured workers to return to their jobs as soon as possible.

All employers employing one or more workers specified by the Act must register and contribute to SOCSO. An employee earning two thousand ringgit and contribute to SOCSO. An employee earning two thousand ringgit (RM. 2,000) or less monthly is required to contribute to SOCSO. An employee who has never been registered with or contributed to SOCSO and is earning more than two thousand ringgit monthly is given an option to be covered and to contribute, subject to both the employer and the employee agreeing. However, once such an employee is covered under this Act, he will continue to enjoy SOCSO coverage irrespective of monthly salary.

SOCSO offers two types of protection namely:-

A Employment Injury Scheme

This scheme provides an employee with protection for industrial accidents that occur at work while travelling on a route between his residence and his work place where he takes his meals during an authorized break or during a journey which is directly connected to his job. The scheme also provides coverage for occup ional diseases. The benefits provided are :-

i. Medical benefit
ii. Temporary Disablement benefit
iii. Permanent Disablement benefit
iv. Constant Attendance Allowance
v. Dependant's benefit
vi. Funeral benefit
vii. Rehabilitation benefits
viii. Education loans

B. Invalidity Pension Scheme

This scheme provides the employee with a twenty-four hour coverage in event of invalidity or death resulting from whatever course. The benefits provided are:-

i. Invalidity Pension
ii. Invalidity Grant
iii. Constant Attendance Allowance
iv. Survivors Pension
v. Funeral Benefit
vi. Rehabilitation Benefit

Workmen's Compensation Act 1952

49. This legislation provides for the payment of compensation to workmen for injuries suffered in the course of their employment. This legislation does not cover workers who are covered by the Social Security Act. Legal immigrant workers are covered by this Act.

South Indian Labour Fund Ordinance, 1958

50. This legislation is for the administration of the South Indian Labour Fund which was created during the colonial period for the repatriation of South Indian plantation workers by the plantation owners. Since independence this fund provides financial assistance to destitute south Indian plantation workers and runs an old folks home for such people. This fund also provides study loans to enable plantation workers children of South Indian origin to pursue tertiary education. This fund amounts to approximately 2.3 million Malaysian Ringgit in 1997.

HUMAN RESOURCE DEVELOPMENT

Human Resources Development Act, 1992

51. This legislation provides for the imposition and collection of human resources development levy for the purpose of promoting the training of employees, the establishment of a Human Resources Development Council and Fund and for related matters. Every employer is required to pay a levy for human resources development for each of his employees at the rate of 1% of the wages per month. This levy is pooled into the Human Resources Development Fund which provides financial assistance to employers for the purpose of promoting the training of workers.

Malaysian Migration Fund, 1966

52. This legislation provides for the administration of the fund designated to assist Malaysians from Peninsular Malaysia to migrate to Sabah.

TRIPARTITE CONSULTATIONS

53. The government provides for tripartite consultations on a regular basis through a formal forum in the Ministry of Human Resources called the National Labour Advisory Council. This a consultative forum where representatives from trade unions, employers' organizations and representatives of government discuss all issues concerning labour so that a fair opportunity is given to both trade unions and employers' organizations to present their views and offer suggestions on labour policies. The Minister of Human Resources is the chairman of the National Labour Advisory Council which meets at least twice a year. Although this Council does not have any executive powers in government, it is nevertheless an extremely useful forum in easing unwarranted misunderstandings between the three social partners in the society. The tripartite consultative process in reflected in Fig. IV.

54. There are three important policy guidelines which were adopted by the National Labour Advisory Council which have significant influence on labour relations in the country. These are the Code of Conduct for Industrial Harmony 1975, the National Labour Policy 1992 and Guidelines on Wage Reform System 1996. All three policies were adopted through tripartite consultations and agreements.

55. The aim of the Code of Conduct for industrial harmony is to lay down principles and guidelines to employers and workers on the practice of industrial relations for achieving greater industrial harmony in the country. All three social partners recognized that industrial peace is essential for a sound and stable economy which is of paramount importance for achieving the objectives of the national development plans which are committed to the task of creating a united, socially just, economically equitable and progressive Malaysian nation. Both employers and workers committed through this formal agreement between The Malayan Council Employers' Organization, Malaysian Trades Union Congress and the Ministry of Human Resources to comply with the following :-

i. to refrain from taking unilateral action with regard to any industrial dispute;
ii. to resolve all differences, grievances and disputes strictly in accordance with the grievance procedures of collective agreements, or, where there are no agreements, by negotiation, conciliation and arbitration;
iii. to ensure that at all times all matters in dispute are dealt with by the proper machinery establishment for that purpose;
iv. to promote constructive and positive cooperation at all levels in industry and to abide faithfully by the spirit of agreements mutually entered into;
v. to establish where none exists, a procedure which will ensure a complete and speedy investigation of grievances leading to a joint settlement;
vi. to comply with the various steps in the procedure for disposal of grievances and to avoid any arbitrary action which ignores these procedures;
vii. to refrain from resorting to coercion, intimidation, victimization and to avoid go-slow, sit-down and stay-in-strike;
viii. to educate management and workers of their obligations to each other.

Employers further agreed not to support or to encourage unfair labour practices such as :-

(a) interference with the affairs of a trade union and the rights of workers to organize;
(b) discrimination, restrain or coercion against any worker because of legitimate trade union activities; and
(c) abuse of authority in any form.

Trade unions on their part further agreed not to encourage the following :-

(a) negligence of duty;
(b) damage to property;
(c) insubordination; and

(d) interference with or disturbance to normal work.

56. This agreement forged the necessary tripartite cooperation essential in industrial relations during the 1970s to encourage foreign investments and to implement the New Economic Policy effectively. Narrow and parochial interests of individual social partners gave way to the larger goals of national economic and social development.

57. The National Labour Policy adopted by the National Labour Advisory Council and the Cabinet in 1992 paved the way for updating the Code of Conduct for Industrial Harmony 1975 in the context of current challenges in industrialization and globlisation of the economy. The objective of the National Labour Policy is 'to mobilize a national effort through tripartism in order to maintain industrial peace, improve the quality of life of the workers and increase Malaysia's technological capability and competitiveness. ' The specific objectives are as follows :-

(a) Employment policy objectives must stress on the needs to formulate a full employment strategy. In this strategy, the jobs created must be of some quality and explicitly aim to upgrade workers to meet their basic needs. Employment policy objectives will continue to stress the need for increasing the participation in the workforce or women, the disabled and disadvantaged as well as give preference to citizens over non-citizens in so far as employment opportunities are concerned.

(b) To need to create a highly skilled and trained workforce capable of adapting to an evolving work environment brought about by technological changes. In this regard, policy objectives will stress the need for continuous training and retraining, encourage the development of more creative and flexible skills and ensure that the skills and ensure that the skills of the workforce are relevant to meet the demand for specific skills in new or emerging areas.

(c) There is a need to improve labour productivity and promote good work ethics. This is to ensure that the national economy will be sustained by an exemplary work ethics, quality consciousness and the quest for excellence. The goal should be also to ensure that the wages take cognizance of company-industry performance and worker productivity.

(d) The need to create a harmonious industrial relations climate so that the energies of both management and labour will be channeled constructively into production and growth

(e) Labour standards and social security measurers should be responsive to meet the requirements for improving the quality of life of the workforce.

58. In order to achieve the above objectives the National Labour Policy emphasise tripartite consultations to formulate policies pertaining to labour relations and human resource development. Special focus is given to the open nature of the economy and the need for dynamism to cope with unanticipated circumstances. Globalisation and the new challenges it poses is also addressed with emphasis on competitiveness. The right to a living wage is recognised in this policy but emphasis is given to productivity and its importance in wages and global competitiveness. The policy also speaks of strategy for

full employment, skills development, harmonious labour relations, progressive management philosophies, workers rights and responsibilities, improvement in quality of working life, social security, retrenchment, women workers, children and young persons, labour education and review of labour laws and practices to better cope with the changing social and economic conditions and national development needs and goals within the frame work of the international economic and social order.

59. The National Labour Policy 1992, strengthens the commitments by the three social partners in the economic development of the nation. Although specific measurers are further discussed during implementation, the tripartite consultation process ensures the discipline of proceeding in directions as agreed upon in the National Labour Policy.

60. A sensitive policy measure is with regard to wage reform to suit changing circumstances. The concern of the government is that recent trends in wages and productivity show that wages rise faster than productivity increases. There is therefore, a need for wage reform to check this negative trend. The tripartite agreement on Guidelines on Wage Reform System 1996 is adopted with a view to facilitate Wage Reform which will be biased towards productivity linked wage systems. The objective of these guidelines are as follows :-

a. to establish a closer link between wages and productivity so as to enhance competitiveness and promote employment stability.
b. to enable employers to develop a wider and systematic approach towards improving productivity and wages through the active involvement and cooperation of their employees; and
c. to enable employee to obtain a fair share of the gains that arise from productivity growth and performance improvements thereby promoting equity, social cohesion and enhancing the quality of life as well as developing improved skill-related career paths and increasing job satisfaction.

The key elements of the system are :-

(a) Wages would cover a combination of monthly or other frequent payments, annual increments, an annual or other infrequent bonus;
(b) Wages shall comprise of a fixed component which includes basic and an additional component in the form of a variable payment.
(c) With regard to the fixed and the variable components, an illustration of the key elements of these two difference components are as follows :-

Fixed Component	Variable Component
i. Basic Wage	i. Wage increase for the year based on productivity improvement/profit sharing formula.
ii. Annual increment	
iii. Contractual bonus	

(where applicable)

(d) Changes in the basic wage shall take into account factors including changes in the cost of living.

(e) Fixed wage component should reflect the value of job and annual increment paid is in recognition of the employees length of service and experience; and

(f) The variable component of wages could be determined in relation to productivity and performance of the individual, workgroup or organization. The indicators used must be transparent and measurable and consideration must also be given by parties to the timing of payment of the variable wage component.

61. The above guidelines is intended to assist trade unions and employers to reform payment systems in the industries. Several teething problems are anticipated in the adoption of these guidelines as trade unions will be reluctant to give up current comforts in Collective Agreements while employers will shy from total transparency of their business accounts. An approach based on mutual trust will have to be in place. Employers must recognize that co-determination of the future of industries with trade unions is the key to wage reform.

62. One other concept which has been introduced by the government for effective modernizing of the Malaysian economy is the "Malaysia Incorporated". This concept forges close cooperation between the private and public sectors to ensure that optimum results are obtained in all aspects of the management of the economy. Values such as mutual trust, understanding, cooperation and confidence between the private and public sector is promoted as a philosophy for management. Although this concept focuses on being a catalyst to accelerate the economic development of the nation, the promotion of positive values of trust and confidence has been strengthened with the support of trade unions.

Current Economic Crisis

63. The current economic crisis which began in 1997 has posed several challenges in our society. The drastic reduction in economic growth compared to previous years clearly indicates the deteriorating quality of life of workers in several sectors. Since the currency crisis began several sectors have been affected. The construction sector has been severely affected by deferment of projects. The manufacturing sector has also experienced similar effects especially in industries linked to the construction sector. Industries with a high import content in their products have also faced problems with regard to their competitiveness. The services sector especially in the hospitality industries have also faced problems arising from the slow economic growth. The plantation sector, however, did not experience such negative effects but continued to face labour shortage.

64. The labour market is not homogeneous. It is divided into the "formal" and "informal" sectors. Both these sectors have legal and illegal immigrant workers. Estimates of the number of both illegal and legal workers in the country vary from time

to time and according to source. However, it is estimated that approximately two million legal and illegal foreign workers and their dependents are in the country today. Their presence has contributed to the supply of low wage labour in the "formal" and "informal" labour markets. Employment is casual through "contractors for labour services", who are able to evade the payment of statutory benefits and wages in accordance with terms and conditions of employment governed by collective agreements. Unfair labour practices are therefore common and in the current crisis on the increase.

65. The government has acted to repatriate foreign workers to ease the pressure of rising unemployment amongst Malaysians. The steps taken by the government is welcome. This is based on the assumption that Malaysians will respond to jobs previously held by immigrant workers. However, in reality there is a time lag involved for adjustments to materialize in the labour market. The jobs vacated by foreign workers especially in the construction, plantations, manufacturing and services sectors are mainly in the manual and semi-skilled categories. Malaysians may therefore not respond to the vacant jobs arising out of the repatriation exercise. It is yet to be seen how much of the vacancies are taken by the locals. The Ministry of Human Resources plays an active role to assist retrenched workers to obtain their termination benefits and find new jobs. The estimated number of approximately seventy thousand workers retrenched who have sought the assistance of the Ministry does not indicate the real situation in the labour market. The workers in the formal sector with trade union representation are those who resort to the formal channels to redress their grievances with regard to termination benefits and new employment opportunities. The informal sector comprises of self-employed, daily rated and piece-rated workers, rarely appear in the statistics. The economic slowdown has affected the informal sector substantially. Self-employed workers especially home-based workers have reduced employment opportunities and as a consequence earn lower income. The economic pressures on these precarious groups of people is severe.

66. The termination and lay-off benefits paid to retrenched workers is usually governed by the provisions of the Employment (Termination & Lay-Off Benefits) Regulations 1980 under the Employment Act, 1955. The minimum benefits subject to regulations are as follows :-

(a) ten days' wages for every year of employment under a continuous contract of service with the employer if he has been employed by that employer for a period of less than two years; or

(b) fifteen days' wages for every year of employment under a continuous contract of service with the employer if he has been employed by that employer for two years or more but less than five years; or

(c) twenty days' wages for every year of employment under a continuous contract of service with the employer if he has been employed by that employer for five years or more.

In industries with trade unions representing the workers, there are occasions when ex-gratia payments are obtained in addition to the above benefits to assist the workers to

cope with the adjustment during unemployment. However, the above benefits do not provide adequate resources to adjust to the challenges facing retrenched workers. According to the Ministry of Human Resources 85% of the retrenched workers have obtained their retrenchment benefits and have found alternative employment. However, it must be noted that several firms retrenching workers face insolvency and are therefore unable to pay the benefits to the workers.

67. Trade Unions have acted to sustain employment through accepting pay cuts, deferment of conclusion of collective agreements, reduced working hours and temporary lay-off. Trade Unions have also encouraged employers to organize training and retraining programmes for workers during this period so that workers can become multi-skilled and better cope with the changing demand for labour in the industries especially with the introduction of advanced technologies. The Human Resource Development Fund provides assistance for such programmes. However, it must be noted that trade unions are active in representing about 10% of the labour force. This does not reflect the voluntary adjustments by the workers in the informal sector. Since the economic crisis began the demand for casual employment has increased as a result of increasing unemployed workers joining the informal sector. However, the immigrant workers have catered for this demand with the result that employers prefer to continue with immigrants who are prepared to accept low wages and terms and conditions of employment. The estimates of potential unemployment rising to approximately 500,000 workers in the current crisis will include workers in the "formal" and "informal" sectors. The lack of focus on the informal sector is a matter of grave concern to trade unions. The absence of a comprehensive, social security "safety net" for workers in our society is the cause for unchecked deterioration of quality of life of workers especially in the lower income groups.

CONCLUSION

68. The experiences in industrial relations thus far indicate that there is a high degree of regulation in industrial relations in Malaysia. The historical 'control culture' in the nation has made it possible for the total regulation of industrial relations in the country. It is impossible to envisage any break from this tradition especially when workers participation in trade unions is limited. Approximately 10% of the labour force account for the total trade union membership. However, it is interesting to note that there is gradual increase in trade union membership over the years but one must reconcile with the fact that Malaysian workers do not place total emphasis on trade unions to pursue with their welfare objectives. The highly regulated process of collective bargaining and compulsory arbitration system poses limitations for unions to bargain effectively. Further, the provisions of the Trade Union Act has brought about a proliferation of unions with small membership as reflected in Tables 2 and 3.

69. The Industrial Relations Act sets out the compulsory conciliation and arbitration process through the Industrial Court. Experiences have shown that this process is time consuming, costly and frustrating for workers who are looking forward to quick

settlement of their grievances. Revisions to this Act must be considered to remove the powers of the Minister of Human Resources to refer cases to the Industrial Court after conciliation and provide for voluntary arbitration through the Arbitration Act . This opportunity exist but is rarely practiced as trade unions and employers resort to the Industrial Relations Act. The grievance procedures in collective agreements will have to be extended to provide avenues for resorting to the arbitration of disputes through the Arbitration Act. Appeals from the Industrial Court to the High Court is expensive for ordinary workers and their unions. Justice therefore is denied when the aggrieved party is unable to meet the costs. This is a major cause for frustration amongst workers in the current system.

70. The traditional trade union weapon of 'strike' has very little effect in the industrial relations process. In theory strikes can be called with due compliance with all the provisions in the Trade Union Act and the Industrial Relations Act. However, provisions in these Acts can also diffuse any strike action by invoking the compulsory arbitration provision. For example, in 1990 the National Union of Plantation Workers called for a nation-wide strike in their claim for a basic monthly wage for plantation workers. However, the strike had to be called off once the Minister of Human Resources referred the dispute to the Industrial Court. The number of strikes, workers involved and working days lost and the handling of industrial disputes is shown in Tables 4 and 5.

71. Trade Unions have always found the vigilance of the government in trade union activities uncomfortable. All the legal formalities which needs compliance make it possible for trade unions only to play a passive watch-dog role in society with regard to the welfare of workers rather than a aggressive pro-active role. This relative stable industrial relations climate has been a catalyst in encouraging foreign investment, which is crucial for economic development in the country.

72. Labour policies pursued by the government have succeeded in helping to reduce unemployment. Table 1 shows the gradual reduction of unemployment in the country over the years. The unemployment rate of 2.8 % was a remarkable achievement. However, in the recent decade a tight labour market has opened the doors for both legal and illegal immigrant workers into the country. It is estimated that foreign workers amounted to 290,000 in 1990, 650,000 in 1995 and will reach 781,000 in the year 2000. These foreign workers estimates do not take into account the population of illegal immigrant workers. The tight labour market helped trade unions to negotiate for higher wage rates but the ever increasing incidence of immigrant workers seem to relax the pressure for wage increases through Collective Bargaining as immigrant workers are usually employed through Third Party Contract Systems for supply of labour. Inspite of this situation average nominal manufacturing wages increased but productivity growth however, lagged behind wage growth in this sector. The current concern of unit labour cost increase and competitiveness is expected to be resolved through the implementation of the Guidelines for Productivity Linked Wage Reform. The industrial relations system as a whole has ensured the necessary restrain on wage increases.

73. The current challenges, with regard to competitiveness in a global enconomy is an important factor in the formulation of policies on industrial relations. All three social partners are conscious of the need to shift from labour intensive and low technology based industries to high-tech industries with higher levels of productivity. Labour cannot carry the costs of out-dated technology with low productivity. It is therefore, apparent that workers views on the impact of the transformation of the economy on labour, must be heeded by the government and employers.

74. Tripartism through the National Labour Advisory Council has played an important role for on-going dialogue between government, employers and trade unions. All three partners understand the current responsibilities in promoting economic growth with equitable distribution of income. There is therefore a consensus in approach to resolving disputes. This culture helps in easing tensions in industrial relations.

75. The government has been sensitive to expectations of workers with regard to basic needs. Compared to many of Malaysia's neighbours wages and quality of life of Malaysian workers are better. This is one of the causes for rapid migration of workers into Malaysia from neighbour countries in the recent decade. This in migration of workers has also caused several problems in the labour market especially with regard to wages and terms and conditions of employment to local workers through unfair labour practices.

76. The legislation governing industrial relations, labour standards, human resource development and social security need to be reviewed to meet the challenges of a turbulence in the economy. The absence of a comprehensive social security "safety net" is a major concern as it will provide basic protection for an acceptable quality of life for workers. The provisions in the various legislation must be culled and brought into a comprehensive social security legislation so that the basic needs of workers with regard to health, sick leave, maternity benefits, contingent payments, relief, retrenchment and retirement benefits can be built through both workers and employers contributions to ensure that workers are adequately protected.

77. The government's role in economic planning especially with regard to human resource development planning has been sensitive to the overall objective of achieving industrial nation status by the year 2020. Policies on education and manpower training have changed in favour of creating a highly skilled and versatile labour force to cope with the dynamic changes in technology in the industrialization process.

78. Trade Unions are aware that their social relevance lies in their effective participation in the development process. Traditional 'stunts' of strikes and acrimonious relationships with employers and government are no longer popular with the workers. Workers expect trade unions to deliver better opportunities in employment, terms and conditions of employment and social welfare. Trade Unions rely more on persuasion today to achieve their objectives. This system provides for this and hence there is the relative calm in the industrial relations.

79 The future for calm industrial relations lies in the team work spirit of the three social partners. However, government must realize that workers demands especially with regard to a comprehensive social security system must be heeded to. Out dated control legislation must give way to positive social security legislation, which will ease tension at the bargaining table between employers and employees while trade unions must recognize that workers must cooperate and adapt to changes so that economic development can be accelerated to the benefit of every one in the nation.

FIGURE I

INTERNATIONAL LINKAGES OF TRADE UNIONS

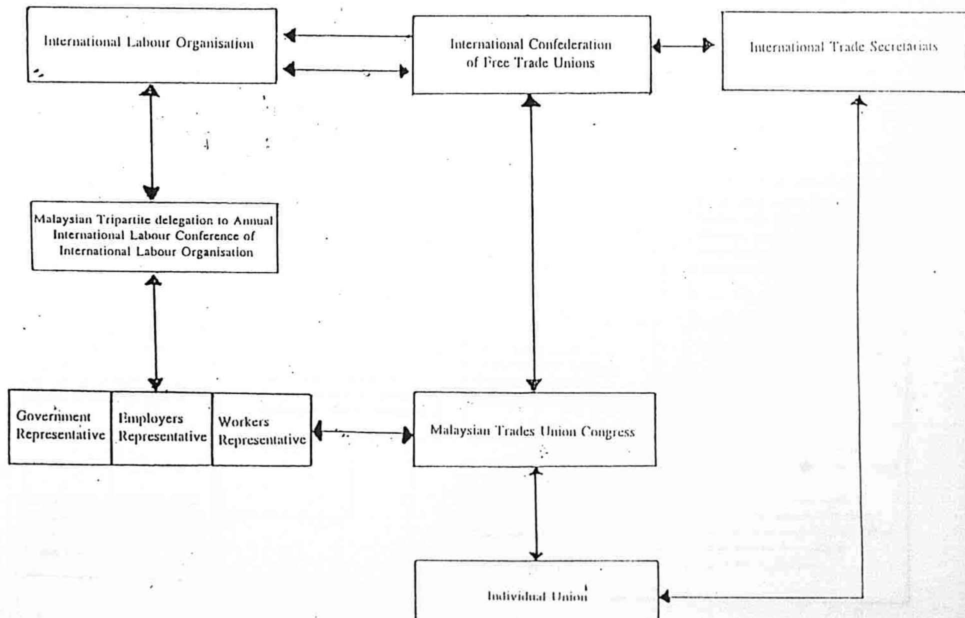


FIGURE II

COLLECTIVE BARGAINING PROCESS

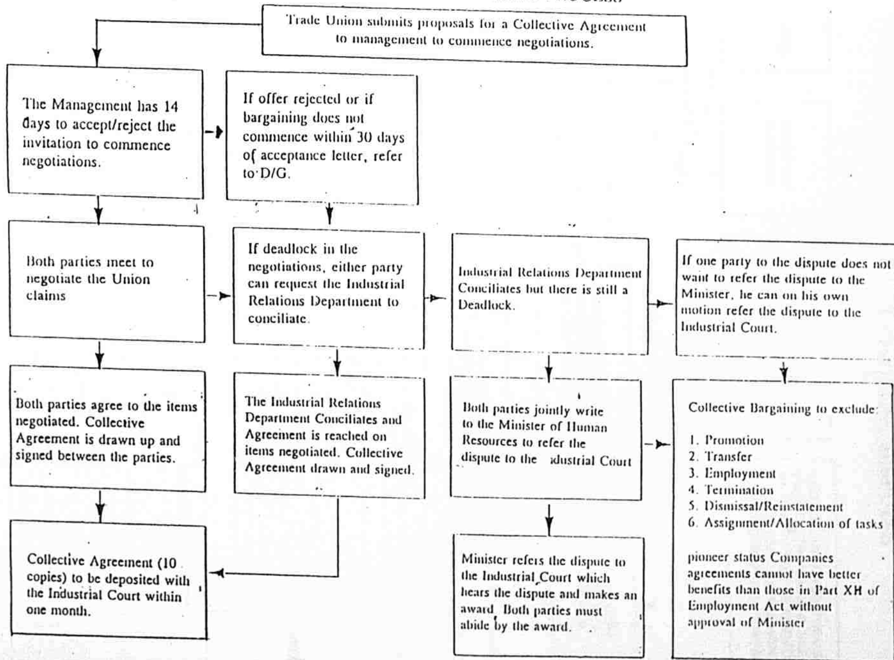


FIGURE III

PROCEDURE FOR RESOLVING DISPUTES

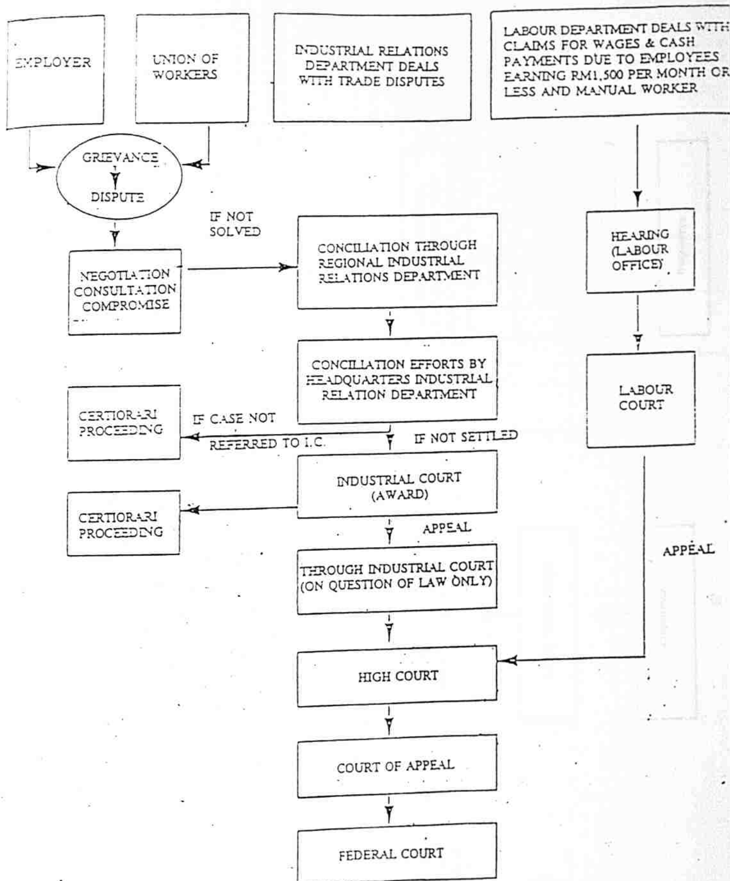


FIGURE IV

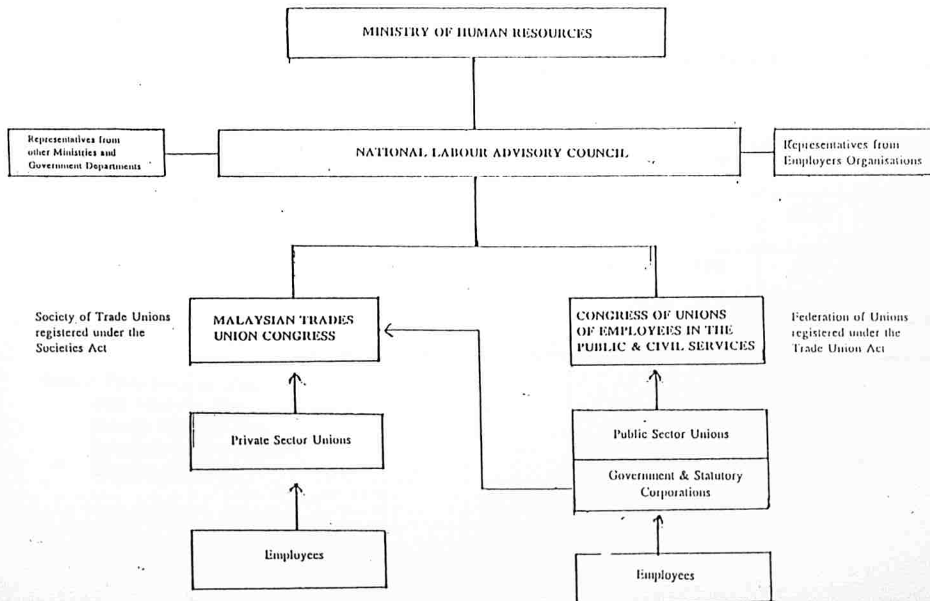


TABLE 1

POPULATION, LABOUR FORCE & EMPLOYMENT ESTIMATES 1970 - 1995

YEAR	1970	1975	1980	1985	1990	1995	1998
Population (in million)	10.77	12.24	14.26	15.86	18.01	20.26	22.18
Labour Force (in million)	3.60	4.22	5.38	6.03	7.04	8.14	9.00
Unemployment Rate (%)	7.4%	7.0%	5.3%	6.9%	5.1%	2.8%	4.9%

Source: Third Malaysia Plan
Sixth Malaysia Plan
Seventh Malaysia Plan
Economic Report 1998/99
Ministry of Finance

TABLE 2

TRADE UNIONS AND MEMBERSHIP ACCORDING TO SIZE IN MALAYSIA

Number of Members	Number of Unions				Total Membership			
	1982	1986	1990	1997	1982	1986	1990	1997
Under 100	46	69	99	127	2,660	3,153	4,601	11,355
100 - 200	39	54	72	76	5,988	7,727	10,237	17,489
201 - 500	50	82	85	113	16,150	27,748	27,715	38,957
501 - 1000	42	65	76	82	28,856	46,509	52,325	65,132
1001 - 2000	39	47	50	67	53,917	65,131	72,622	95,727
2001 - 5000	30	37	35	36	92,260	117,149	109,045	125,180
5001 - 10,000	20	16	19	11	136,693	112,889	130,437	82,472
Above 10,000	6	9	10	14	191,891	225,518	251,517	298,373
Employer's Union	13	19	17	-	631	670	621	-
Federation of Trade Unions	2	3	4	-	-	-	-	-
Total	287	401	446	526	529,046	606,494	659,120	734,685

Source : Ministry of Human Resources

TABLE 3

TRADE UNIONS AND MEMBERSHIP
ACCORDING TO SECTORS IN MALAYSIA

Sector	1995		1996		1997	
	No. of Unions	Membership	No. of Unions	Membership	No. of Unions	Membership
Private Sector	281	396,663	292	407,303	303	405,674
Government	135	226,823	136	241,411	132	252,854
Statutory Corporations & Local Government	88	82,767	88	79,532	91	76,157
Employers	13	572	13	528	11	475
TOTAL	**517**	**706,825**	**529**	**728,774**	**537**	**735,160**

Source: Ministry of Human Resources

TABLE 4

NUMBER OF STRIKES, WORKERS INVOLVED & WORKING DAYS LOST
1974 - 1997

Year	Number of Strikes	Number of Workers Involved	Number of Man Days Lost
1974	85	21,830	103,884
1975	64	12,124	45,749
1976	70	20,040	108,562
1977	40	7,783	73,729
1978	36	6,792	35,032
1979	28	5,629	24,868
1980	28	3,402	19,554
1981	24	4,382	11,850
1982	26	3,330	9,621
1983	24	2,458	7,880
1984	17	2,437	9,267
1985	22	8,710	34,773
1986	23	3,957	14,333
1987	13	3,178	11,035
1988	9	2,192	5,784
1989	17	4,761	22,877
1990	17	98,510	301,978
1991	18	1,920	6,610
1992	11	2,401	5,388
1993	13	2,399	7,162
1994	7	2,289	5,675
1995	2	1,748	4,884
1996	9	995	2,553
1997	5	812	2,396

Source : Ministry of Human Resources

TABLE 5

HANDLING OF INDUSTRIAL DISPUTES
FOR THE PERIOD 1993 - 1997

Subject/Year	1993	1994	1995	1996	1997
Number brought from previous year	169	170	128	171	250
Number reported	534	503	511	476	463
Total	703	673	639	647	713
Number of cases handled	703	673	639	647	713
Number of settlement through peaceful negotiations	440	478	404	361	355
Number of cases referred to Industrial Court	67	43	47	31	76
Number of cases not referred to Industrial Court by the Minister	26	24	17	5	9

Source: Ministry of Human Resources

MIER
1998 NATIONAL OUTLOOK CONFERENCE
Shangri-La Hotel, Kuala Lumpur
1-2 December 1998

SMART PARTNERSHIP

by

Ahmad Tasir Lope Pihie

Malaysian Institute of Economic Research
Institut Penyelidikan Ekonomi Malaysia

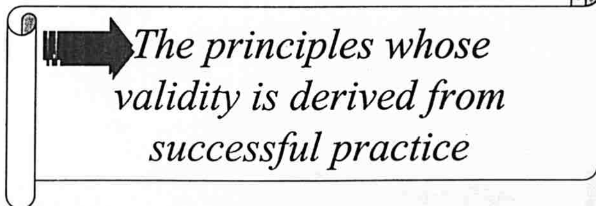
WHAT IS SMART PARTNERSHIP ABOUT ?

"It is about creating limitless opportunities and wealth that is shared that is sustainable and that allows the participants to function in the global economy"

WHAT WERE THE OBJECTIVES OF SMART PARTNERSHIP?

"...to match people, companies and industry in order to increase investment and trade and practical research......"

PHILOSOPHY OF SMART PARTNERSHIP



SMART PARTNERSHIP FEATURES

- Shared Vision
- Cultural Diversity
- Code of Ethics
- Trust
- Longevity
- Value
- Transparency
- Equity
- Networks
- Fair Play

WHAT RELATIONSHIPS AMONG SMART PARTNERS ?

- ☛ No formal contractual relationship
- ☛ hierarchy is irrelevant
- ☛ flexible to seize opportunities and avert threats
- ☛ crafted and managed intelligently
- ☛ recognises competition/cooperation and rejects competition/conflict

SMART PARTNERSHIP : CONCEPTUALLY

"An effective concept that underpins the cultural thrust of enterpreneurship, doing business and governance across the globe and into the next millenium"

SMART PARTNERSHIP : AN ELEMENT FOR SUCCESS

" It is one of the elements for success, which depends on many other factors : political and economic environment, culture and value systems, etc.."

MiGHT

No: 320059-P

AVENUES TO FOSTER SMART PARTNERSHIP : DIALOGUES / PEOPLE NETWORKING

- **Assess the needs and aspirations of partners**
- **Reveals new means of achieving aspirations**
- **When face-to-face, person-to-person, estabilishes and sustain trust, respect and credibility**

LANGKAWI INTERNATIONAL DIALOGUE (LID)

LID 1995

- Was launched in 1995 by the Rt. Hon. Prime Minister
- Jointly organised with CPTM
- Promotes Smart Partnership and win-win outcomes

LID 1996

- Shared vision
- Provide International stage for Malaysian wisdom/ values/ philosophy

LID 1997

- Project Malaysia as a good business partner

MIGHT.... your gateway to global competitiveness through 'SMART PARTNERSHIP'

FIRST NATIONAL SMART PARTNERSHIP DIALOGUE
(2 & 3 MARCH 1998)

Some Key Summary Points :

- Image Building
- Differentiate Malaysia
- Information Management
- Workers Deployment
- Regional food security
- "Transparency"
- Mobilising HRDF
- Bill of guarantee
- Consultation in pricing
- Policy and implementations gaps
- Productive sectors
- Tourism
- Office and commercial space

- Smart Parnership is useful
- Admit we have problems BUT can be resolved

MiGHT
No: 320059-P

SECOND

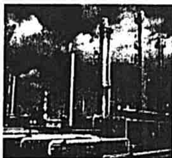
NATIONAL SMART PARTNERSHIP DIALOGUE
(24 & 25 OCTOBER 1998)

- **Land as National Resource : Understanding Social, Economic and Policy Issues**
- **Federal and State Partnership on Land Matters**
- **Technology in Land Management**

WHO ARE THE PRIME MOVERS OF SMART PARTNERSHIP ?

- Prime Minister, Malaysia (joined by Heads of Governments/States of SADEC/Commonwealth)
- MIGHT
- CPTM

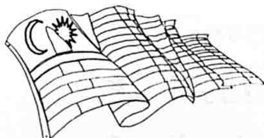
MIGHT is a SMART PARTNERSHIP between



INDUSTRY

GOVERNMENT

To prospect and harness technology for



Domestic Market

Business Opportunities

Global Market

MIGHT

No: 320059-P

MIGHT, RIGHT ?

- Partnership Company
- Limited by guarantee
- Not-for profit
- Business friendly
- Government - supported
- Neutral
- Technology savy
- Consensus building

MIGHT's ROLE MiGHT

- ***Business and investment opportunities.***
- ***Policy formulation.***
- ***Research priorities***
- ***Development of human resources***

MiGHT

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FOSTERING SMART PARTNERSHIP

MiGHT

MIGHT's INITIATIVES

- Business Forums
- Smart Partnership
- MIG's
- MIGHT Consultation
- Strategic Advisory
- PrimeNet
- Mission Visits

MiGHT

No: 320059-P

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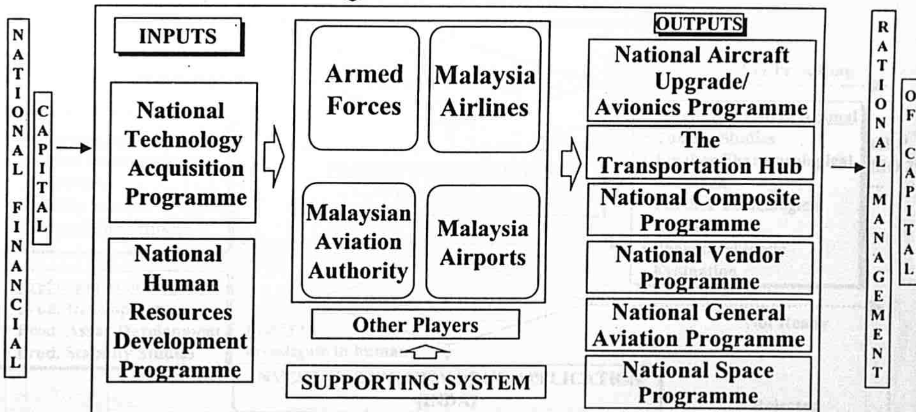
PROPRIETARY

MIG'S : STRATEGIC AND TACTICAL

- ★ Telecommunication
- ★ Aerospace
- ★ Housing
- ★ Pharmaceutical
- ★ Environment
- ★ Electric Vehicle
- ★ Advance Material

Key Recommendation : 1

To establish a framework for strategic aerospace planning in Malaysia.

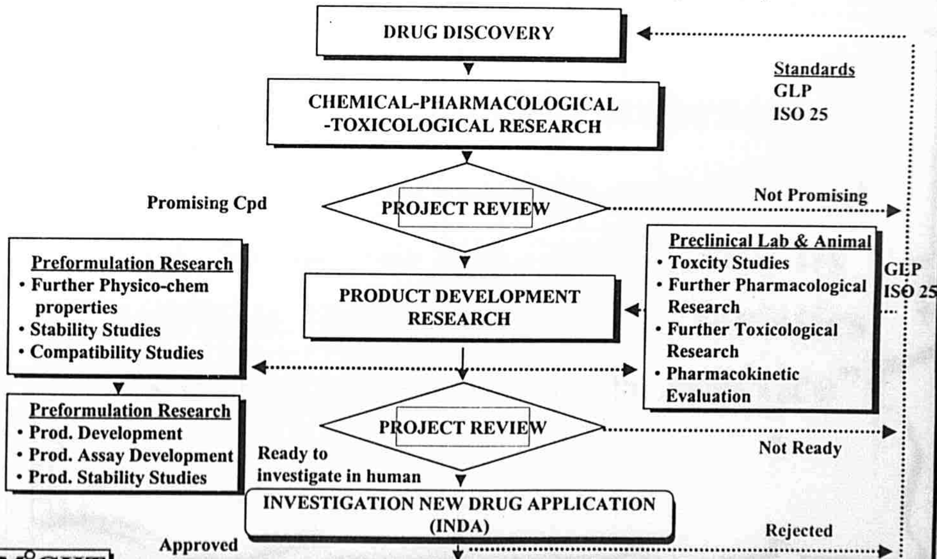


MiGHT

No: 320059-P

PROPRIETARY

R&D CHAIN FOR PHARMACEUTICAL PRODUCTS NEW CHEMICAL ENTITIES (NCE)



"Smart Partnership embraces the complex relationship engendered by Malaysia Inc., articulates its various facets and characteristics and add value to its practice"

Malaysia Inc involves smart partnership: DG

MALAYSIA Incorporated is about Smart Partnership at the national level, involving all the relevant sectors of government and the private sector, to mobilise them towards the same goals.

"It is about three things — getting everyone into the same boat, getting them to row together, in the same direction," Institute of Strategic International Studies (Isis) Malaysia director-general Datuk Dr Noordin Sopiee said in Langkawi yesterday.

Without this communion of thought and action, it will not be possible to create the correct atmosphere for smart partnerships.

Noordin added that Malaysia's privatization policy would not have been so phenomenally successful without the Malaysia Incorporated policy. "Government efficiency leads to government effectiveness," he said.

Noordin was speaking on

SECOND LANGKAWI INTERNATIONAL DIALOGUE

SMART PARTNERSHIP FOR GLOBAL CO-OPERATIVE PROSPERITY

"Malaysia Inc" on the second day of the Langkawi International Dialogue.

He stressed the role of Government in achieving successful smart partnerships, especially with regard to improving national efficiency. Malaysia has many accomplishments under its belt in this area and it is the Government that can take credit for it, he added.

REPORTS BY: HARDEV KAUR, KAMARUL YUNUS, PARAMJIT SINGH, LEELA BARROCK

Proper machinery for consultation will also have to be established so that constant discussion can be carried out, and there can be consultation on issues and problems as they arise, by-passing normal bureaucratic channels.

This machinery has to be established at all levels, Noordin explained. It is important that the whole government machinery, from the village, district to the federal levels, should work together with the private sector.

At another level, he pointed out it is important that people are trained in the right disciplines, and this is where the role of schools and universities lie.

In addition, he said there is a need to change the attitudes of both the civil service and the business sector so that they develop a sense of responsibility and mutual trust. Thus, they need to be empowered and trusted with the tasks they are assigned.

Noordin pointed out that there still exist age-old obstacles to implementing such changes. He noted that old suspicions and habits die hard, leading to a lack of trust all round.

He stressed the importance of developing mutual trust and confidence between the public and the private sectors.

Noordin warned, however, that there are dangers in the concept of country incorporated and smart partnerships between government and private sector. If the vision or the goals are wrong there could be trouble for the country and its people, he said.

MIGHT operationalises and practices Smart Partnership

THANK YOU

11

MIER
1998 NATIONAL OUTLOOK CONFERENCE
Shangri-La Hotel, Kuala Lumpur
1-2 December 1998

COMPETITION POLICY FOR THE YEAR 2000

by

Christopher Maule

Malaysian Institute of Economic Research
Institut Penyelidikan Ekonomi Malaysia

Paper prepared for MIER's National Outlook Conference, Kuala Lumpur, December 1st & 2nd 1998. (Nov. 25, 1998).

Competition Policy for the Year 2000

by
Christopher Maule
Research Professor, Department of Economics, Carleton University, Ottawa, Canada.

Contact e-mail: cmaule@ccs.carleton.ca; Tel: 613-744-2050; Fax: 613-744-0397.

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    - Price controls
  - Group 3 policies
  - Summary
- Influence of international factors
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Introduction

For over two centuries a central tenet of modern economics has been that the pursuit of self interest by individuals will result in the maximum public benefit, providing it takes place within an appropriate institutional structure. No one knew better than the proponent of this view, Adam Smith, that there was also a dark side to the market. Left unsupervised, competitors will conspire to fix prices and engage in restrictive business practices. Smith would not have been surprised at the actions taken by Microsoft to hobble its competitor Netscape, especially if the two could not reach agreement to restrict competition in their common interest. He would also have noted that in a relatively short period of time Microsoft had arisen from infant status to challenge IBM, at one time itself considered to exercise undue market power and the object of antitrust attention. The challenge for the policymaker is to get the right balance in the market, enough freedom that entrepreneurs flourish, not enough that they engage in unfair trade practices. Rule-making for markets is similar to rules for football. Spectators are rewarded with entertaining play if the rivals are well matched and play according to the rules. Absent a referee and the game may turn into a brawl of benefit to neither players nor spectators.

In recent years, economists supportive of the use of markets to allocate resources have gone out of their way to understand circumstances of market failure and to propose a range of remedies. At times they have been blind to the fact that their cures may be worse than the disease and too little attention has been given to the circumstances of government failure due to the ineffectiveness of policies. Often there has been disagreement over the proposed remedies. This has given economists a bad name. As the *Economist* (October 3, 1998, Survey of World Trade, 4) recently wrote, three sins of economists are "an inability to agree among themselves; stating the obvious; and giving bad advice." However, on the question of the appropriate institutional structure for competition policy there has been remarkable agreement that if unconstrained by some form of government legislation, markets may perform in ways leading to undesirable economic consequences. This conclusion is obvious to economists but not always to others and, in general, the advice on this subject has been good, although not all countries have chosen to follow it.[1]

[1] The Canadians who have preceded me in talking on this subject in Malaysia or in connection with other industrializing countries, have all sung from the same song sheet. This may be because they were not randomly selected but my impression is

Some glaring examples of unconstrained markets are found in those economies making the transition from the use of planning to the use of markets to allocate scarce resources. In the absence of a transparent legal framework establishing property rights and preventing people from exploiting these rights unfairly, not only will monopolies flourish, criminal elements will hold sway. Extortion by gunpoint or by monopoly supplier is a matter of degree. Both represent taxation by private interests.

Other examples of the undesirable consequences of unconstrained market forces are revealed in the early history of major developments such as the gold rushes in Australia, Canada, South Africa and the United States. While competition was necessary to encourage entrepreneurial activity, the absence of any rules lead to technical and economic inefficiency which eventually civil society corrected with legislation. Consumers and workers united to complain about the injustices being perpetrated in terms of excess profits and prices. The waste of resources became obvious to all.

What has all this got to do with competition policy and Malaysia on the eve of the twenty-first century? The successful functioning of a market economy requires a framework of laws related not only to property rights and taxation but also to competition. Those countries, like Malaysia, which have undertaken remarkable economic growth in recent years have used a combination of policies promoting market forces through privatization, deregulation and liberalized trade regimes. Governments undertaking these reforms have had to consider what other policy changes are necessary as the market plays a more important role in allocating resources. Some have introduced competition legislation while others have held back, but as will be argued below all have some kind of competition policy. Even no policy is a policy. The question is whether it is appropriate for the conditions faced by the country and if not what approach might be considered in the light of experience gained elsewhere.

UNCTAD reports that an increasing number of developing countries and countries in transition have introduced competition policies in the past few years. In 1990, about 40 countries had competition laws and over half of these were developed countries. In 1997, of the almost 80 countries with competition laws, nearly half are developing countries, one-fifth countries of central and eastern Europe and the remainder developed countries.[2] The content of each of these new laws varies considerably, as do the laws of the developed countries, because policies have been shaped to particular circumstances. Some of the differences are also due to the laws being poorly drafted, sometimes as a result of mistakes and sometimes because the wording is a

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that support for an active competition policy would be widespread among those economists studying industrial organization - see F.Flatters (1997). S.Khemani (1994). D.Ireland (1992) and T.Hazeldine (1992).

[2] See Economist, October 3, 1998, Survey of World Trade, 4

compromise reached among the groups affected by the legislation. Developments relating to competition laws in selected Asian economies are shown in Table 1.

Two contentions are made in this paper. First, all market economies have a competition policy (CP) even if they do not have competition legislation because of the influence that other policies have on the competitive process. Second, increasing trade and foreign investment means that countries cannot insulate themselves from outside competitive forces and from importing the effects of other countries' competition policies. This requires them to have some institutional arrangement that focuses on competition. Both sets of factors suggest that such countries should consider introducing competition legislation, if they have not already done so, to coordinate their domestic policies and to be prepared to deal with foreign pressures. The two are interrelated.

The devil is in the details

A broad view of CP is that it is the sum of all government policies that affect competition. A narrow view includes only policies directly affecting restrictive business practices. Some policies are more important than others from the viewpoint of competition and it is useful to make some distinctions. For convenience we separate the policies into three groups. In Group 1 are those policies considered by most observers as part of traditional CP - they address conspiracies, mergers and monopolies or abuse of dominant position. Policies in Group 2 typically have a different focus but impinge indirectly on competition - consumer policies, intellectual property, public ownership, regulation, international trade and investment, and price controls. In Group 3 are framework policies addressing matters such as property rights, taxation and subsidies, incorporation, bankruptcy, banking and financial markets. Clearly, the allocation of policies is somewhat arbitrary. For example, subsidies and taxation could be considered in Group 2.

Group 1 policies

There is widespread agreement that certain structural and behavioral conditions can have adverse effects on competition in terms of efficient resource allocation. In Group 1 are conspiracies or horizontal agreements between competitors on prices, profits and market shares, mergers, and monopolies or abuse of dominant position. Common to these three sets of activities is the view that acquiring or exercising market power, meaning the ability to raise prices without losing significant market share to competitors as measured by the price elasticity of demand, is not in the interest of efficient resource allocation. Prices in excess of costs represent a tax on consumers which is paid to the seller not the state, and diverts resources away from activities where market power is exercised.

Each of these elements needs to be qualified according to the prevailing circumstances. An agreement between two small grocery stores to fix the price of milk, where there are a number

TABLE 1

COMPETITION LAW-POLICY IN SELECTED ASIAN ECONOMIES	
BANGLADESH	• There is no Competition Law in Bangladesh. • Most monopolies are government-owned, as in the markets for electricity, gas, railways, telecommunications, sugar, paper, fertilizers, glass and steel.
INDIA	• The Monopolies and Restrictive Trade Practices Act (MRTP Act) was enacted in 1969. Protection of "public interest" is its principal objective. • Following the New Industrial Policy (1991), regulatory controls directed at dominant enterprises were deleted from the MRTP Act. • The MRTP Act does not fully extend to public sector enterprises and regulated industries. • Mergers, acquisitions, divestitures and joint-ventures fall outside the purview of the MRTP Act.
INDONESIA	• Indonesia does not have a competition law but is considering adopting one. • Several existing licensing arrangements and local content programs have been reported as acting as barriers to entry to certain markets. • The State Logistical Agency has a monopoly over imports of rice, sugar, wheat, flour and soybeans. • Domestic fees on the movement of goods, such as retribution taxes, have been reported as facilitating market segmentation.
JAPAN	• The Antimonopoly Act (AMA) was enacted in July 1947 • The Fair Trade Commission of Japan (JFTC) was established as an independent regulatory commission.
MALAYSIA	• Malaysia does not currently have a competition law but is considering adopting one. • The Foreign Investment Committee (1974) was set up to regulate mergers and acquisitions.
NEPAL	• Nepal does not currently have a competition law but is considering adopting one. • State-owned monopolies dominate the markets for electricity, telecommunications and drinking water. There have been allegations that there exist various cartels, including the market for construction materials. There have been reports that an agreement among private sector airlines has prevented reductions in air fares.
PAKISTAN	• The Monopolies and Restrictive Trade Practices (Control and Prevention) Ordinance V of 1970, prohibits undue concentration of economic power, unreasonable monopoly power and unreasonably restrictive trade practices. • No conduct is deemed "unreasonable" when it enhances economic efficiency, and if benefits are greater than the adverse effects of lessening competition.
PHILIPPINES	• Section 19 of Article XII of the 1987 Constitution prohibits monopolies and combinations in restraint of trade. • Monopolies and Combinations, under Act No. 3247 as amended, read along with the Revised Penal Code, as amended by Republic Act No. 1956, prohibit unfair trade practices, monopolies and combinations in restraint of trade. • There is no central competition agency in the Philippines.
SRI LANKA	• Sri Lanka enacted the Fair Trading Commission Act No.1 in 1987. Amendments were made in 1993. • The Act provides for the establishment of a Fair Trading Commission.
REPUBLIC OF KOREA	• The *Monopoly Regulation and Fair Trade Act (MRFTA)* was revised in 1996 to increase its effectiveness • The Korean Fair Trade Commission (KFTC) is determined to make market structures more competitive.
VIETNAM	• Vietnam does not currently have a competition law but is considering adopting one.

Source: World Bank (1997, 19)

of alternative suppliers in the neighborhood not party to the agreement and ease of entry by new suppliers, will raise little concern because the ability to maintain the higher price will be limited. Should all the suppliers in the neighborhood become party to the agreement and there are barriers to new entry, as a result of say government licensing requirements, another set of circumstances prevails and action may need to be taken. The policy addressing conspiracies has to be worded so that the facts are filtered and only the potentially harmful circumstances prohibited. The remedy may require removal of some government restriction.

The second set of issues, mergers, come in different varieties, horizontal, vertical and conglomerate. Each has the potential for different consequences, some benign and some harmful to competition. The CP concern is that the merger may enhance market power more than it results in productive efficiency. Most clearly this is seen in the case of horizontal mergers where the effect is to consolidate in an organizational arrangement, the merged firm, those circumstances that might otherwise be achieved through a horizontal conspiracy by two or more competing firms, or by a firm operating as a monopoly. Countries such as the U.K. which have introduced policies to control restrictive business practices such as agreements and have had no parallel merger policy have found the anticompetitive effects of the agreements could be achieved through merging and have subsequently had to introduce a merger policy. The lesson from these experiences is that a merger policy is a necessary complement to a policy on conspiracies.

With vertical mergers, for example between a bottling plant and a supplier of soft drink, the CP concern is that the merged firms may be able to enhance their market power by foreclosing the plant to other suppliers of soft drink or by preventing other bottling plants from being able to get supplies of soft drinks. Facts concerning the ease of entry for bottling plants and the number of other existing plants will condition whether there is a serious competitive problem and the policy has to allow for the details of the particular circumstances to be evaluated. With conglomerate mergers, an issue is often whether profits made in one line of business can be used to cross-subsidize other lines, or whether the firm has sufficiently deep pockets to be able to squeeze other firms out of the market. Again the actual conditions, such as ease of entry, have to be evaluated to determine whether this is likely to be a CP problem.

If horizontal agreements and mergers are ways of becoming a monopoly in a given market, then being a monopoly in the first place is equally undesirable if it permits the exercise of market power. That power may be the ability to raise price but this may be done in conjunction with a number of other business practices. Another possible consequence of monopoly is that the firm lives a quiet life wasting resources because there is no pressure to operate in an efficient manner or undertake R and D. The issue of monopoly is addressed either through assessing actual size relative to the market or through examining the way in which undesirable acts are able to be performed because of the firm's dominant position. Some countries legislate this in terms of a firm being a monopoly, others in terms of the abuse of dominant position or behaving like a

monopolist. Practices examined often include predatory pricing, price discrimination, basing point pricing, exclusive dealing, tie-in arrangements, requirements contracts, refusal to supply, restrictive franchising arrangements, restrictive patent licensing, and resale price maintenance. A number of these can occur without the firm being a monopolist but usually involves a highly concentrated market structure and the group of firms having a dominant position in the marketplace. Some of the practices observed may belong with other aspects of CP. Resale price maintenance and basing point pricing, for instance, can be viewed as a type of price fixing agreement.

The elements found in Group 1 refer to economic conditions that can under certain circumstances have adverse economic effects. The details of the cases will determine how serious these are likely to be and what remedies are required. Most argue that there are no redeeming features to horizontal agreements and that they should not only be banned but be considered criminal offenses if they occur leading to fines and/or imprisonment of individuals and fines for corporations.[3] For the other restrictive business practices, the actual circumstances now and in the future will determine their likely harmful effects and so a process of and criteria for evaluation need to be developed. Entry conditions play a key role in determining potentially adverse economic effects. The idea of contestability refers to the potential for entry. A market may be highly concentrated or supplied by a monopolist but if the threat of entry exists, the suppliers may be disciplined to behave in a competitive manner. What needs to be known is whether the threat is real and leads to competitive prices. This may create employment for economists and accountants as they line up to argue pro and con what the costs of production are and how these relate to the prices charged. Their answers are often based on speculation but as shown below, evidence can be collected which makes the speculation more reliable.

This core set of competition policies should have as their principal if not sole objective the promotion of economic efficiency and consumer welfare in order to improve overall standards of living. In the remaining policies discussed there will normally be multiple objectives, such as sustaining a particular region or industry, for example agriculture or clothing, as well as promoting competition. Multiple objectives tend to give rise to lobbying by vested interests and a suppression of the efficiency objective (Khemani, 1994).

Considerable variation is found in the administrative and legal approach taken by countries to implement these core policies, depending on the level of development, political institutions and the number of years a country has had such a policy. Canada introduced its core CP in 1889 when the country was at a much earlier stage of development than Malaysia is today. Since that time it has amended the policy on a number of occasions suggesting that changes are needed as conditions evolve. Changes have addressed both the wording of offenses included under the act and procedures for administration. The laws of different countries at the same level of

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[3] Tom Ross argues for the law to permit firms to undertake strategic alliances (Ross, 1997).

development vary considerably so that one size does not fit all.[4] Care has to be taken in maintaining the core ideas but shaping the policy to local circumstances. Those who come later have the advantage of learning from the mistakes of others and shaping their policies to deal with current circumstances such as the increasing use of electronic commerce for trade in goods and services.[5]

Underlying rationales for Group 1 policies

Theories of industrial organization have evolved over time from a structural view that if the structure is right all will be well, collusion and other restrictive business practices will not be a problem and static and dynamic efficiency outcomes will emerge. A variant of this view is that structure alone, e.g. firm size and industry concentration, is only indicative of the likelihood of problems and that focus should be on conduct, e.g. collusive behavior and abuse of dominant position, since this is what matters in terms of economic performance. The idea of contestability challenged these views by arguing that concentrated structures and collusive behavior would not survive as long as there was the threat of real entry. In the face of profitable opportunities, new firms would enter and compete away excess profits. The threat would be enough to discipline the behavior of monopolists or actual entry would take place providing there were no sunk costs. This varies between industries, for example, aircraft manufacturing versus retail distribution.

In turn this view has given way to another, that entry is not always easy to achieve quickly and effectively enough to restore competitive conditions. Rather than argue about market definitions, firm size, industry concentration, sunk costs and the meaning of certain types of behavior - do identical prices represent competitive or collusive conditions - it is more fruitful to focus on the real prices paid by consumers and to see how these compare, whether differences occur and if so why. A case involving the merger of two competing office supply companies was evaluated on the basis of collecting actual prices paid by consumers in those markets where the two firms competed and where only one of them supplied the market. Competition was shown to result in lower prices and the merger was prohibited. The approach has the benefit of working with hard data providing transaction prices can be obtained from retail sales information. This is not a problem for everyday consumer items like food, clothing and public transportation but becomes more difficult to collect for prices of intermediate goods where the information has to be extracted from business invoices. An added advantage of using retail

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[4] See D.P.Wood, "International Competition Policy in a Diversified World," reprinted in J.Jackson et.al., Legal Problems of International Economic Relations, 3rd edition, West Publishing, Minnesota, 1995, 1100-1107.

[5] A conference on Competition Policy and Cyber-Law is being held at the Columbia Business School, Columbia University, New York, Dec. 3 and 4, 1998

price data is that it involves those affected by pricing decisions and encourages them to become part of the process of implementing a CP.

Group 2 policies

The second Group contains policies that have a focus not directly related to competition but which nevertheless affect the core issues of concern to CP in terms of efficiency. These policies are often administered by a different set of officials so that there can be interagency rivalry especially where there are conflicting objectives. The policies may have a principal rationale other than efficiency. They may address other types of market failure due to public goods, externalities and informational deficiencies or they may address objectives such as supporting a region, industry or firm through some subsidy or bailout, or responding to pressure to alleviate unemployment, inflation or balance of payments difficulties. More than one country has used price controls in an attempt to prevent inflation despite the fact that controls distort the signals that prices give to allocate resources. In the following we examine consumer policies, intellectual property, public ownership, regulation, trade and investment policy, and price controls.

Consumer policy

One way of disciplining market power on the supply side of the market is to strengthen the buyer side through improved information about the available sources of supply, prices, and quality of products. Buyers armed with information to evaluate the quality and attributes of goods and services, not mislead by deceptive advertising and with access to accurate price and quality information will serve to discipline those who try to engage in unfair marketing practices. In contrast to promoting competition between sellers on the same side of the market, consumer policies promote the countervailing power of buyers against sellers. In labor markets this happens when unions negotiate with firms. In the same way that governments provide framework laws for collective bargaining, so they may have policies that assist consumers in their purchasing decisions.

While a cost efficient way of disciplining market power on the supply side of the market may be to have informed buyers, this varies between intermediate and final markets and according to the type of goods and services purchased. Some buyers are much better informed than others due to the frequency with which purchases are made, the type of product and its cost. Each final consumer is reasonably well equipped to evaluate purchases of items such as foodstuffs bought on a daily basis, especially when competing sellers are located next to each other in an outdoor market, but less well equipped in the case of occasional purchases such as consumer durables - a television set, furniture, car or house. On the other hand, a construction firm operating a fleet of trucks will acquire more experience in purchasing vehicles than a person buying one car every five years.

Services present a particular problem to consumers. It is difficult to assess *ex ante* the services that will be supplied by a doctor, lawyer, accountant or teacher. Reputation, word of mouth reports and certification and licensing procedures play a role in assuring that an acceptable level of quality is supplied. Licensing is a way of establishing standards and codifying information but the process can be used in an anticompetitive manner to restrict entry into a profession providing services. Accountants, doctors, lawyers and teachers have been known to elevate entry barriers so as to restrict supply to the benefit of those already qualified and practicing. For example, foreign entry of professionals tends to be restricted if special barriers are erected to those who qualify abroad, creating a trade in services barrier to limit supply. Increasing use of the electronic transmission of services is one way in which technology undermines barriers to intangible services.

In sum, improving consumer information is a procompetitive policy but the techniques used to achieve it may be anticompetitive. The overall policy requires a balancing act that may be difficult to achieve when conducted by different departments of government and with different interest groups involved. The more tightly organized groups such as associations of professionals are always better organized than the mass of consumers where the free rider problem prevails unless consumers can be coerced into supporting their interests. At times, consumer and competition polices are administered by the same department or agency of government, and at times separately. The "Wise Spending" column in the *New Straits Times* is a low cost way of keeping consumers informed.

Intellectual property

As more and more knowledge is embodied in products traded domestically and internationally, increasing focus is placed on policies affecting the production and distribution of intellectual property. The trade-off between monopoly and competition is no more apparent than in government measures to promote new knowledge where the property right is protected by a patent or copyright. State granted property rights giving temporary monopoly power conflict with the consumer interest in having the knowledge distributed as widely and cheaply as possible to a large number of firms that compete with each other in its application or production and sale. Once the investment has been made in the good or service, the marginal cost of producing the idea is zero although there may be costs of embodying the idea in a good or service. An unlimited number of people can make use of the knowledge or ideas contained in a pharmaceutical drug, a software program or the script of a play. Only delivery requires additional costs.

The existence of intellectual property laws means that consumers will have to pay a positive price to the holder of the patent or copyright and will use less than would be the case if the price reflected the marginal cost of the knowledge embedded in the product. Of course, if the price was equal to marginal cost, there would be no incentive for producers to create or invent in the

first place. The tradeoff has to be between the increased incentive to create and the desire to spread the benefits as widely as possible. Group 1 CP grapples with this problem in part by recognizing the legitimacy of intellectual property laws but assuring that the market power created is not abused by the rights holders. For example, holders of patents may try to tie the sale of some non-patented product to the right to act as a patentee. Those administering intellectual property polices have to decide terms of patents and copyrights. How long should they be for? Should a new drug be protected for five, fifteen of fifty years? Should the copyright in a book be given for the life of the author or for life plus a number of years for the benefit of the author's estate? Should the copyright in a book be exhausted after first sale? Should parallel imports be allowed? Authorities also have to decide how piracy or illegal use should be treated. For some of these issues, countries are members of international agreements which will discipline their actions. In general however, competition conflicts with monopoly in intellectual property policies with opposing interests and criteria at stake.

Public ownership

The assumption underlying many cases of public ownership of certain sectors in the economy is that increasing returns to scale prevail and that reserving the market for one producer is the most efficient way to structure the industry. Where a competitive market outcome may not be achievable in structural terms, the resulting monopoly is often disciplined either by government ownership or by private ownership accompanied by government regulation. Alternatively it is argued that the activity is so important to the state that private ownership, domestic or foreign, is unacceptable. Thus most countries own and run their own educational, judicial and defense systems, and some their broadcasting and telephone systems. A mixture of national security and socio-cultural concerns underlie many of these cases of public ownership regardless of whether a single supplier is the most efficient way of delivering the product.

Monopoly public ownership is supposed to provide the good or service in an efficient manner as far as scale economies are concerned with the consumer protected by the fact of government ownership and government appointed directors who will act in the public interest. It is assumed that governments will act not only to operate the firm efficiently in terms of cost minimization but will ensure that consumers do not pay excessive prices. Unfortunately this benign outcome is not always achieved and public monopolies become fat and bloated with the higher costs passed on to the consumers, or they become poorly managed and require cash injections by the state. This is not only the experience of public ownership in previously planned economies but in market economies at all stages of development. Converting a state monopoly to a private monopoly in the absence of a competition policy can lead to a worse outcome.

An alternative is to permit privately owned monopolies and to regulate their behavior. This requires the establishment of government appointed regulators leading to regulatory oversight

and a process of collecting information, holding hearings and setting prices and conditions of operations. In order to operate effectively, the regulators have to become quasi-managers so as to assess the decisions of the operating managers. There is also the possibility of regulatory capture by the interested parties.

While rate regulation has been widely used in the case of privately owned monopolies sanctioned by the state in an attempt to achieve a competitive outcome, it is increasingly being challenged and more competition allowed. In Canada, there has been a marked drop in long distance telephone rates as a result of the regulator permitting increased competition. My long distance supplier now offers a rate of C89 cents per minute from Canada to Malaysia at any time of the day, any day of the week, C$1.06 to Thailand, C35 cents to France, C20 to the UK and C19 cents to the United States. Another supplier recently offered me still lower rates for each of these countries. Two years ago, the rates would have been at least twice as high for most of the countries. Deregulation and the entry of new players have been the most important reasons for lower prices. Pressure for change often came from CP authorities and the firms are now subject to competition legislation.

Regulation

Regulation has become pervasive in market economies for a variety of reasons : the environment, health and safety in the workplace, nutritional and drug safety, standards for products, rates and return on investment for public energy utilities, transportation services, cable television services and the regulation of broadcasting content. Underlying the myriad forms and purposes of regulation is the belief that without intervention market forces will lead to undesired outcomes. Rate regulation has been noted above in terms of natural monopolies where Group 1 policies are considered inadequate.

In areas other than rates, the regulatory process can impact on competition domestically and internationally. Health standards for food, for example, can be administered in a way that favors some products and producers over others. A chapter of the WTO deals with phytosanitary standards because they may be used to restrict trade and competition. There are numerous cases, some justified, where one country uses health concerns to prevent the sale of products, often those of foreigners, from entering the market. Or there may be objections to the way in which a product is harvested and this becomes a barrier to trade and competition.

So prolific are the types of regulation affecting markets, it is difficult to generalize about their effects. These few examples show how regulation can be administered in a manner that restricts competition more than necessary given the objectives aimed at. In order to address this problem, some CP authorities are given the power to intervene in regulatory procedures in order to ensure that the consequences for competition are understood and in the hope that the procedures will be handled in a manner least harmful to competition.

Trade policy

It is sometimes argued that trade policy is a substitute for CP. By opening national borders to foreign competition through trade liberalization with reduced tariff and non-tariff barriers, the definition of the market for competitive purposes is enlarged as more firms become effective suppliers in the marketplace and the disciplining effects on domestic suppliers increased. In effect the market becomes less concentrated due to an expansion of the boundaries of the market.

While trade liberalization is a strong procompetitive force, its effect varies with particular circumstances. Again the devil is in the details of the actual situation. The procompetitive effects will be diluted by: an inelastic supply of imports; currency depreciation; existence of nontariff barriers to trade; nontradable goods and services such as high weight-to-value goods; perishable goods; legal, financial and other services that are difficult to trade; interfirm restrictive arrangements that limit market access; and the existence of international cartels (World Bank, Global, 1998, 6).

Powerful producer interest groups influence trade policy usually to the detriment of domestic competition. They often ally themselves with labour groups which feel threatened by free trade. The consumer interest in trade liberalization is seldom well represented as fragmented consumer interest groups are poorly organized and the free rider problem prevails. In some countries, governments support the operation of consumer associations in order that their voices are heard. Opposition by producer interests often insures that consumer interests are poorly funded.

Investment controls

Measures that control new entry by firms into a market whether by way of new investment or takeovers of existing firms have the potential to restrict competition. A number of countries screen foreign investment and either exclude or limit the level of foreign ownership thereby reserving the sector in whole or in part for domestic investors. Broadcasting and banking have been typical of these policies with the effect being to reduce the level of competition in these industries. If there are a large number of domestic competitors, then limiting foreign entry may not be harmful although it tends to shield the domestic economy from exposure to new ideas. Industrial policy that aims to promote certain sectors and is accompanied by policies to attract foreign investors may be procompetitive and offset screening mechanisms but it relies on governments knowing which industries are the best to promote. At times investment incentives take the form of tax measures tied to performance requirements that force the investor either to source certain inputs domestically or to tie imports to exports. The anticompetitive nature of

these requirements is one reason for the TRIMs agreement in the WTO. While investment controls are undertaken for reasons other than competition, they do affect the level of competition and thus are part of Group 2 policies.

Price controls

A direct form of market intervention is to regulate prices, either by setting price ceilings or price floors. Inevitably such actions distort the signals that the market sends to allocate resources. Price floors are set above and price ceilings below equilibrium prices leading to excess supply and demand respectively. The former requires storage of the excess or incentives to prevent oversupply; the latter typically leads to pressures for a black market situation in which those possessing the price controlled items will try and sell them at a higher price. This type of intervention is usually associated with costs spent on an administrative structure (Thillainathan, 1996).

Group 3 policies

The third group contains policies that have a still less direct impact on competition but remain important. They include measures such as framework policies for incorporation and bankruptcy, contracts, taxation and subsidies. The last in particular are often structured to benefit some firms in an industry more than others - small versus large, domestic versus foreign, firms in a given region - and thus may affect establishment and growth by firms in an industry. For example, tax incentives and subsidies available only to domestic firms will skew the nationality of competing firms and may lead to a large number of small inefficient firms supplying the market. Under the common agricultural policy of the European Union, a large number of small inefficient farms have been able to survive in the member countries while at the same time larger farms that do not need the support have benefited from the assistance. Consumers and taxpayers are the losers. The terms and conditions of incorporation and the provisions of bankruptcy laws affect the ease of entry and exit from markets. More attention has been given to incorporation, with jurisdictions competing against each by lowering standards for incorporation.

Even where open markets are essential for the development of an industry, market forces are often shaped by government intervention to secure certain objectives. In the emerging case of electronic commerce where open competitive markets are desirable,[6] government intervention is argued by some to be necessary to achieve an appropriate institutional setting containing the following (WTO 1998, 35):

1. Standards for the emerging global telecommunications infrastructure
2. Adequate investment in the infrastructure

[6] With new technology, unrestricted experimentation will lead to maximizing social benefits.

3. User-friendly and broad-based access
4. A predictable legal and regulatory environment which enforces contracts and property rights
5. Security and privacy of data
6. Rules for dealing with unacceptable content
7. A predictable framework of taxation and financial regulation
8. Equal opportunity for users in industrialized and developing countries

While each of these measures may have a competitive dimension, they are undertaken with a view to achieving some other objective and are thus placed in Group 3. Malaysia's initiatives regarding its Multimedia Super Corridor can be considered in this regard by examining the roles of MIMOS and the MDC.

Summary

All market economies including Malaysia have policies in some or all of Groups 1,2 and 3. By classifying the various policies a country can make an inventory of those policies having some impact on competition. Group 1 contains the policies with the most direct impact. They work best when they have a narrow set of objectives in terms of efficiency and are not influenced by other objectives. Establishing a CP authority with a focused mandate allows for learning and experience to be gained in pursuing cases selectively and increases the likelihood of getting consistent decisions from the courts or some administrative tribunal. At the same time CP authorities should be in a position to intervene so as to point out the competitive dimensions of other policies such as regulation, public ownership and the screening of foreign investment. The process is one of education and learning.

Introducing competition legislation is not a requirement for a developed market economy. It is a requirement for the effective functioning of any market economy. The precise policy approach requires careful consideration. A country that has never had such legislation might well start by addressing those aspects of competitive process that are clearly harmful and getting the support of business and consumer groups. CP is not anti-business. In fact, it is often business that initiates actions against other business as a result of alleged anti-competitive behavior, for example Netscape versus Microsoft. Experience has shown that CP works best where it is administered by a cadre of officials who are viewed to be independent of government, business and other interest groups so that they can act impartially within narrowly defined objectives.

The influence of international factors

Because business transactions do not conform to territorial boundaries, anticompetitive practices undertaken in one country have impacts elsewhere. Trade in goods and services may transmit these effects as may foreign investment. The interwar period was marked by the existence of a number of international cartels whose behavior affected economic relations in different countries (Edwards, 1945). In the absence of an international competition authority, there was no way to attack these practices other than through domestic legislation and ad hoc cooperation. In the event that countries have different standards regarding cartel behavior, it is quite likely that anticompetitive practices will be transmitted internationally. Examples include the extraterritorial application of domestic competition policies and the operation of export cartels, where countries permit firms to collude for sales in export markets providing there are no harmful effects in the domestic market.

The postwar negotiations that led to the GATT included at the outset provisions to address investment and restrictive business practices (RBPs) and the formation of the International Trade Organization (ITO). In the interwar years, a number of domestic industries had operated as part of international cartels. Some were described as defensive cartels aimed at achieving stability in highly competitive markets like those for agricultural products, while others were offensive as in the case of the highly concentrated aluminum industry where the aim was to act like a monopolist and raise prices.

If the cartels worked, they did so in the interest of producers rather than consumers. The intention of the framers of the postwar international economic agreements was to create a framework of rules for trade and investment that would prevent the outbreak of another depression. To do so required addressing both trade and investment issues among the major trading countries of the day as well as RBPs. While the ITO was stillborn,[7] discussion of RBPs took place in other international fora such as UNCTAD and the OECD, in regional arrangements such as the European Union and NAFTA, and more recently in the WTO. The negotiations surrounding the stillborn Multilateral Agreement on Investment did not address CP issues, although they have been flagged as an item for the next round of WTO negotiations along with investment.[8]

The traditional focus of trade policy has been on government measures which restrict market access or distort trade patterns through the use of measures such as subsidies. A recent OECD study suggests that restrictive business practices by firms may now be a more important

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[7] See William Diebold, "The End of the ITO," Essays in International Finance No.16, Princeton University, 1952.

[8] See International Chamber of Commerce, "Competition and trade in the global arena: an international business perspective," Draft Report, Feb. 12, 1998, Doc #:353722.4; and "Trade and Competition Policy," Chapter 4 in WTO 1997 Annual Report, 31-91.

barrier to trade than border controls imposed by governments.[9] As trade agreements have reduced government sanctioned trade barriers, those undertaken by business have become more visible. The different scope and enforcement procedures of each country's competition legislation mean that private barriers are unevenly applied across countries in the same way that intellectual property laws vary in their effects.

Countries that are parties to the WTO have already made commitments regarding CP. Article VIII of the GATS concerns "Monopolies and Exclusive Service Suppliers," and Article IX addresses "Business Practices." Commitments made by countries with respect to individual service sectors are covered by these two articles. Article 9 of the TRIMs contemplates adding investment and CP policy provisions to the TRIMs. In the NAFTA, the three countries signed an agreement in which Chapter 11 deals with investment and Chapter 15 is devoted to CP, monopolies and state enterprises. NAFTA contains a basic framework and provisions for expansion of these provisions.[10]

Areas in which business practices impinge on trade are export cartels, patent licensing, private measures to restrict market access, international mergers and price discrimination/dumping. Each country is concerned not only about barriers to trade for their exports but also about the price of imported products. Export cartels affect imports elsewhere by establishing higher prices than would otherwise be paid. Thus Malaysia, like Canada and other countries, has an interest in blunting the extraterritorial effects of foreign export cartels.[11] This requires agreement between members of the trading community for a common set of rules. In their absence the benefits of trade liberalization will reduced, although domestic competitors may welcome the relief provided by higher import prices.

Market access may be restricted by private actions in the case of: boycotts or refusal to supply; a range of contractual relationships that place conditions on the ability of a supplier to distribute products in a market such as exclusive dealing, requirements contracts, full-line forcing and franchising; and licensing arrangements that give incumbent firms the right to determine whether there should be a new entrant into a particular market. In these cases exporters suffer from private restrictions placed on imports.

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[9] See OECD, "Antitrust and Market Access. The Scope and Coverage of Competition Laws and Implications for Trade," Paris. 1996. At the Singapore Ministerial in December 1996, the WTO established a working group to study issues concerning the interaction between trade and competition policy. A 1945 study of cartels made a similar point, that in order to facilitate world trade it was necessary to destroy governmental barriers "...and then to seek by every means at our disposal, short of military, to destroy all *private* barriers to trade (Lewis, 1945, 46, italics in original)."

[10] UNCTAD has a "Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices," which is a voluntary code on RBPs, allowing for preferential treatment for developing countries; and the OECD in 1967 and 1986 set forth the "Recommendations to Member Governments Concerning Anti-Competitive Practices Affecting Trade in Goods and Services." These were revised in 1995.

[11] A number of countries including Canada and the United States have exemptions in their CP for export cartels.

Mergers are a third area where actions taking place abroad may affect competitive conditions in domestic markets. The spillover effects of mergers occur when there is a change of ownership of assets in one country which results in there being fewer foreign suppliers for domestic markets, or when a foreign merger leads to the common ownership of two subsidiary companies in the domestic market thereby reducing the number of competitors. In the absence of a domestic CP, it is unlikely that there will be procedures to monitor and respond to these situations. For example, the merger of two aircraft manufacturers in North America may affect the price and supply of aircraft available for purchase by Malaysian Airlines. If the two manufacturers have subsidiaries in Malaya, they would become jointly owned leading to higher concentration in the Malaysian market.[12] Alternatively a foreign court could order the break up of a foreign company. If it owned assets in Malaysia, there could be an ownership restructuring in Malaysia as well.[13]

Dumping and anti dumping policy in the international arena has its counterpart in price discrimination and predatory pricing provisions of domestic competition legislation. Because allegations of price discrimination and dumping are often indicative of competitive market situations, proposals have been made to address dumping issues in domestic competition legislation. At present dumping procedures are often used to restrict competition.

Conclusion

The growing international economic interdependence of nations, known loosely as globalization, has meant that there are fewer national products, firms and industries. As deeper integration occurs, each country becomes sensitive to the domestic policies of other countries. These include competition policies. Even if a country does not have its own domestic competition legislation, it is affected by that of other countries. In order to be able to monitor and respond to the foreign intrusions, it is advisable to have an agency that specializes in these issues.

A second reason for establishing an authority is to recognize the investment and competition commitments that have already been made by a country as a signatory to the WTO. Added to this is the fact that in a broad sense the country already has elements of a CP taking into account the competitive consequences of policies in the different groups outlined above.

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[12] An actual case is the European Union complaint concerning the merger of the Boeing Co. and McDonnell Douglas Corp. because of its effect on European owned Airbus and the sale of planes internationally. It was a combined trade and competition case and resolved when Boeing made concessions on long term exclusive dealing contracts it had previously negotiated with major customers.

[13] Divestiture of Alcan from Alcoa and Bell Canada from ATT resulted from antitrust decisions in the United States.

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