ISIS FOCUS

• PP 5054/06/2011 (028668) • Issue No. 8 • August 2011

INSTITUTE OF STRATEGIC AND INTERNATIONAL STUDIES (ISIS) MALAYSIA
www.isis.org.my
Limited Circulation

ABOUT ISIS MALAYSIA

The Institute of Strategic and International Studies (ISIS) Malaysia was established on 8 April 1983, in realization of a decision made by the Malaysian Government to set up an autonomous, not-for-profit research organization, to act as the nation's think-tank. ISIS Malaysia was envisioned to contribute towards sound public policy formulation and discourse.

The research mandate of ISIS therefore spans a wide area. It includes economics, foreign policy, strategic studies, nation building, social policy, technology, innovation and the environment.

ISIS Malaysia today fosters dialogue and promotes the exchange of views and opinions at both national and international levels. It undertakes research in collaboration with national and international organizations, in important areas such as national development and international affairs.

ISIS Malaysia also engages actively in Track Two diplomacy, fostering high-level dialogues at national, bilateral and regional levels, through discussions with influential policymakers and thought leaders.

RESEARCH

Economics

Research in this area is generally aimed at promoting rapid and sustained economic growth and equitable development in the nation. We study specific (rather than generic) issues that concern the nation's competitiveness, productivity, growth and income. Areas of research include macroeconomic policy, trade and investment, banking and finance, industrial and infrastructure development and human capital and labour market development. The objective of all our research is to develop actionable policies and to spur institutional change.

Foreign Policy and Security Studies

The primary aim of this programme is to provide relevant policy analyses on matters pertaining to Malaysia's strategic interests as well as regional and international issues, with a focus on the Asia-Pacific Region. These include security studies, foreign policy, Southeast Asian politics and military affairs.

Social policy

Demographic and socio-cultural trends are changing Malaysian society and the social policy programme was established to respond to these developments. Research in this area is concerned with effective nation building, and fostering greater national unity. In particular, we look at issues involving the youth, women and underprivileged communities. In conducting its research, ISIS Malaysia networks with non-governmental organizations and civil society groups.

Technology, Innovation, Environment & Sustainability (TIES)

The TIES programme provides strategic foresight, collaborative research and policy advice to the public sector, businesses and policy audiences, on technology, innovation, environment and sustainable development. Its focus includes green growth as well as energy, water and food security. Towards this end, TIES has been active in organizing dialogues, forums, policy briefs and consultancies.

HIGHLIGHTS

ISIS Malaysia has, among others, researched and provided concrete policy recommendations for:

- Greater empowerment and revitalization of a national investment promotion agency;
- A strategic plan of action to capitalize on the rapid growth and development of a vibrant Southeast Asian emerging economy;
- A Master Plan to move the Malaysian economy towards knowledge-based sources of output growth;
- The conceptualization of a national vision statement;
- Effective management and right-sizing of the public sector; and
- Strengthening of ASEAN institutions and co-operation processes.

ISIS Malaysia has organized the highly regarded Asia-Pacific Roundtable, an annual conference of high-level security policymakers, implementers and thinkers, since 1986.

INTERNATIONAL NETWORKING

As a member of the Track Two community, ISIS Malaysia participates in the following networks:

- ASEAN-ISIS network of policy research institutes;
- Council for Security and Cooperation in Asia and the Pacific (CSCAP);
- Network of East Asian Think Tanks (NEAT); and
- Pacific Economic Cooperation Council (PECC).

It is also a partner institute of the World Economic Forum (WEF).

Editorial Team

Mahani Zainal Abidin
Steven Wong
Susan Teoh
Thangam K Ramnath

Design

Razak Ismail
Jefri Hambali

Photography

Jefri Hambali / Halil Musa

Published by
Institute of Strategic and International Studies (ISIS) Malaysia
No. 1, Persiaran Sultan Salahuddin
P.O. Box 12424, 50778 Kuala Lumpur, Malaysia
Tel: +603 2693 9366
Fax: +603 2691 5435
Email: info@isis.org.my
Website: www.isis.org.my

Is the World on the Brink of a Currency War, Inflation or Sovereign Debt Crisis? Understanding QE2, Capital Flows and the Real Economy in 2011

*Session One of the ISIS PRAXIS Seminar 2011 was held on 3 March 2011, at the Renaissance Hotel, Kuala Lumpur. The panelists were **Mr Manu Bhaskaran**, Partner and Member of the Board, Centenniel Group Inc., Singapore, **Ms Baljeet Kaur Grewal**, Managing Director and Vice Chairman, Kuwait Finance House Research Ltd, Malaysia, and **Mr Steven Wong**, Senior Director, ISIS Malaysia. The Session was chaired by **Dato' Dr Mahani Zainal Abidin**, Chief Executive, ISIS Malaysia. **Veena Loh** Senior Fellow, ISIS, reports.*

The first speaker, **Mr Manu Bhaskaran** took a look at the global environment and made an assessment of the situation, taking into consideration key risks in the following areas:-

- Geo-political risks to growth;
- Sustainability of economic recovery in G-3;
- Monetary overhang in China;
- Global inflation;
- Currency tensions/wars; and
- Capital flows and flights into/from EMs

Manu Bhaskaran

KEY GLOBAL THEMES

1. Geo-Political Risks Up

Risk appetites will be hurt by rising geo-political tensions in the Middle East, the Korean peninsula and Pakistan.

1.1 *Middle East tensions*

The Mid East tensions have a major global impact. Post-Egyptian and Tunisian changes in government, other countries in the Middle East are also facing simmering tensions. There is a new dynamic operating in the Arab world leading to an end to the fear of opposing long-entrenched regimes. The unrest is likely to continue for a long enough time to cause the risk premium on oil prices to rise significantly.

1.2 *Conflicts in North Korea and Pakistan*

There are high risks of escalating and calibrated provocations by North Korea to gain concessions in resources as well as legitimacy for their survival. The North has its fair share of domestic travails; twenty eight-year old Jong-Eun is not credible to the rest of the elite and has proven to be unconvincing as a successor to Kim Jong-il. Furthermore, the weak economy limits the regime from buying support.

A resolution is unlikely as the US and South Korea distrust any attempt by North Korea to offer to talk it over. Ties with China have become uneasy. North Korea distrusts China.

Pakistan is teetering on the brink of crisis and this could affect risk perceptions of India. Moreover, Pakistan has a big population and has nuclear weapons. The army had made progress in 2010 but violence remains high, although the incidences are decreasing. Extremists have been flushed out of key bases and victims of terrorism fell from around 9000 in 2009 to 5500 in 2010. There is likely to be renewed tension In 2011 with the killing of the Punjab Governor. The regime of the present President, Asif Zardari, may not last.

2. G-3 Prospects

Improving growth has been felt in the economy, seen in the near term as the impact of policies, but the process of healing is slow. Countries that have rebounded strongly have been dependent on anti-cyclical policy measures which are unsustainable.

2.1 *Downside Surprises in the US*

The stock markets are betting that recovery will solve underlying issues but strong headwinds are still at work as fiscal austerity and higher oil prices are likely to cramp growth. Economies continue to face adjustments in the housing and labour markets, and deleveraging continues.

The net effect is episodic but not sustainable recovery. Lead indicators by OECD show that G-3 economies and emerging countries are decelerating. The impact of a slowdown in Eurozone and Japan is hurting US exports while there is a political gridlock in the US between Republican leaders and President Obama.

Lead indicators by OECD show that G-3 economies and emerging countries are decelerating

2.2 *Eurozone Sovereign Debt Crisis*

More shocks can be expected before resolution. The key issues are solvency, liquidity, and confidence. An orderly default process is needed if solvency becomes an issue. It is not clear if the political will exists yet to address this. Meanwhile, funds and processes are needed to provide liquidity in the interim. Structural changes/reforms specifying Euro-wide fiscal mechanisms and realistic budget targets are needed to restore confidence in financial and bond markets in the Eurozone.

The Eurozone crisis will force change within the region. Huge debt rising of close to US$1trillion is needed. Episodes of financial stress will continue to be seen. Unification of the Eurozone by the elite is holding the region together. The political will to push through reforms will, however, face protest risks from unhappy voters.

2.3 *Japan: When will the Drift End?*

Japan needs a broad consensus to move reforms in reining in national debt and in liberalizing trade and services. The country has been slow to form a consensus and faces many obstacles ahead. The economy is highly dependent on external demand for its manufactures but has to contend with a strong currency. As there are no credible plans to reduce its national debt, it runs the risk of having to pay for rising bond yields for its future borrowings.

3. Quantitative Easing (QE): Can It Work?

The credit mechanism is healing, but slowly, and the base money is expanding with the Fed's quantitative easing (QE). It is not convincing that QE will work. If banks do not lend out money, then the monetary effect of QE will be muted.

If households do not spend but instead increase their savings, or if money is used to buy assets, then asset prices will rise. In the short term, there will be a positive impact. However, any additional QE will impact the US dollar and in the long term, any positive impact is not sustainable.

Global economies are facing both rising excess liquidity since the collapse in 2008 and cost-push inflation from rising commodity prices. While current supply-demand appears finely balanced, any supply disruptions due to the La Nina effect will lead to exaggerated price rises due in turn to excessive liquidity.

3.1 More risks from China's slowdown

During the global crisis, the ratio of loans to GDP went up from under 100 per cent in 2008 to nearly 120 per cent in 2009. However, this has not been backed by a true demand for money. There is an overhang of money supply. Subsequently, non-tradable inflation has gone up, reflecting an increase in domestic prices.

Inflationary expectations of Chinese households over the next three months are rising based on a quarterly survey conducted in February 2011 by the People's Bank of China (PBOC). While household deposits are falling, annual loan targets remain high and continue to be exceeded.

Excess demand has been building up and China's inflation target has been raised from 3 per cent to 4 per cent

Generally, policy signals from authorities are weak. Previous policies have been slow to target inflation. Excess demand has been building up and China's inflation target has been raised from three per cent to four per cent. China's real estate is in a precarious situation. Asset markets in 11 out of 35 cities are 30-50 per cent overvalued. As a result, more tightening can be expected. Additional pressure will come from surging wages as the labour force declines due to over-done population policies.

Prices of food are rising as supply declines; the over-use of fertilisers in the past has led to the build up of acid in the soil. As China's financial market is not fully developed, the authorities use quantitative instructions on loans rather than interest rate controls. This is likely to lead to abrupt seizures in credit flows. A slowdown in China's growth will negatively impact China's trading partners.

3.2 *Currency wars*

How the RMB is being managed poses a risk to currency wars, but it is a diminishing one. Nominal appreciation is being stepped up and real appreciation is already happening. There is no appetite among countries to start wars; rational policy calculations are more likely. The risk, however, may come from domestic US politics.

4. Capital Flows to Emerging Markets (EM)

There is a risk of intensifying restrictions on capital inflows to EMs as seen recently. More harsh measures may be likely. Risk aversion may sometimes affect capital flows to EM negatively. As a result, spasmodic flows to EMs are likely to be the case.

5. Conclusion

In conclusion, the geo-politic situation in 2011 is likely to get worse; growth in G-3 will recover but weaken again thereafter. Any form of consensus views going forward remains questionable. QE 2 will be weakly effective but will distort exchange rates. Global inflation is higher than expected. Currency wars are not likely.

Mr Bhaskaran was followed by **Ms Baljeet Kaur Grewal**, who explained in detail QE and its consequences on the US and other countries, followed by the outlook on major developed and emerging economies.

1. Quantitative Easing (QE)

QE is an unconventional monetary policy where the central bank creates money which it uses to buy government bonds and other financial assets, in order to increase money supply and create excess reserves of the banking system. QE is used to invigorate borrowing, and the stock market, and to perpetuate spending. It can artificially lower the US dollar (USD) and encourage exports. It can effectively ease the process of deleveraging as it lowers yields.

However, QE can lead to risks of: (1) higher inflation than desired if it is improperly used, and too much money being created (asset bubbles and carry trade), (2) failure if banks opt simply to sit on the additional cash in order to increase their capital reserves in a climate of rising defaults in loan portfolios, and (3) in the context of a global economy, lower interest rates possibly contributing to asset bubbles in other economies.

2. US Quantitative Easing

2.1 QE1:

During the peak of the financial crisis in 2008, the Fed expanded its balance sheet dramatically by adding new assets and new liabilities without 'sterilizing' these with corresponding subtractions. The Fed held US$700-US$800bn of Treasury notes on its balance sheet even before the recession. In late November 2008, the Fed started buying US$600bn worth of mortgage-backed securities (MBS). By March 2009, it held US$1.75tr in bank debt, MBS and Treasury notes, and reached a peak of US$2.1tr in June 2010.

2.2 QE2:

Further purchases were halted since the economy had started to improve. Holdings started falling naturally as debt matured (projected at US$1.7tr by 2012). However in August 2010, the Fed decided to renew QE, i.e. QE2, because the economy was not growing as robustly as anticipated. Its goal was to keep holdings at the US$2.054tr level. To maintain that level, the Fed bought US$30bn in 2 to 10-year Treasury notes a month.

In Nov 2010, the Fed announced under QE2, it would be buying US$600bn of

QE is used to invigorate borrowing, and the stock market, and to perpetuate spending

Treasury securities (at a rate of US$75bn every month) by end-2011. The market currently expects QE2 to continue until end-2011 (US$1.2tr).

3. QE2 and its Consequences

3.1 Effect on the US

Monetary inflation is one result of QE2. When the Fed buys US Treasuries, it injects newly created money into the financial system, which in turn reduces the value of the US dollar.

A lower US dollar could stimulate US exports, but with unintended consequences, e.g. excess liquidity that could lead to asset price bubbles in the US.

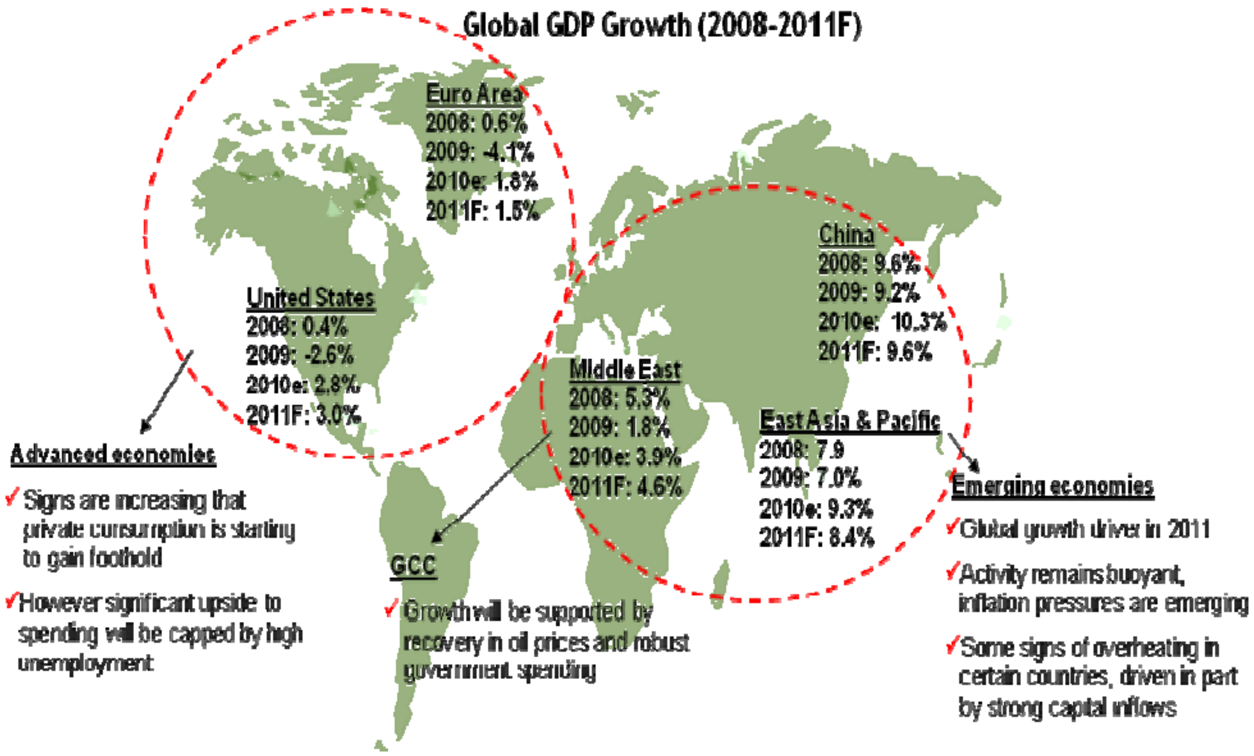
3.2 Effect on other Countries

Low interest rates are fuelling a US dollar carry trade that creates asset price bubbles beyond the US. Nations exporting to the US must control inflation through raising interest rates, but must also debase their currencies to maintain export competitiveness.

QE2 is a doubly destructive policy for exporting nations i.e. capital inflows are inflationary while exports are reduced due to currency appreciation.

Debasing the US dollar reduces the value of China's US Treasury holdings while China relies on exports to the US, totalling between US$200-US$300bn annually.

While it stimulates exports and helps create conditions for renewed economic growth in the US, QE2 represents a debasement of the US dollar and it suggests that demand for US debt may be weakening.



Source: IMF, KFHR

3.3 AAA Rating

Current facts regarding the US economy do not justify the AAA rating of US sovereign debt. In February 2010, Moody's warned that it might have to cut the rating on US government debt. The warning was reiterated in December 2010.

3.4 Deteriorating Confidence

Confidence in US sovereign debt and in the US dollar will continue to deteriorate unless the economy shows stronger growth, and the federal government gets deficit under control (expected at 8.3 per cent of GDP for 2011).

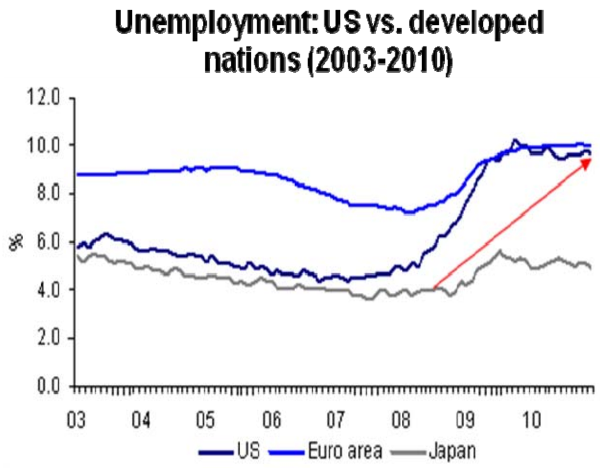
4. Global Economic Outlook 2011

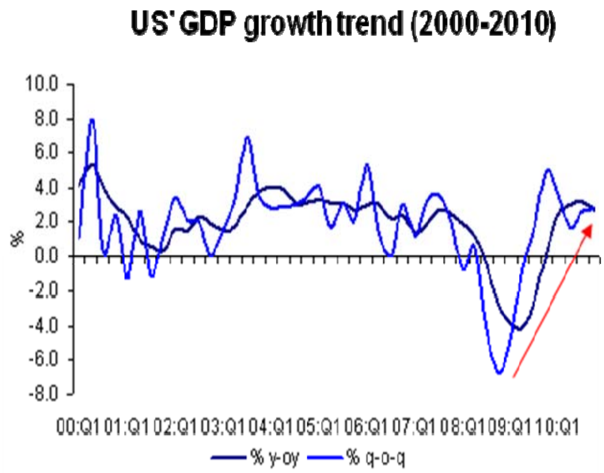
The IMF projects world GDP growth of 4.4 per cent in 2011, up from the earlier forecast of 4.2 per cent, mostly due to QE2 in the US that is expected to boost economic growth by 0.5 per cent to 3.0 per cent.

Emerging economies will drive global growth in 2011, underpinned by strong private consumption and infrastructure spending plans.

5. US Economic Outlook 2011

The US economy expanded by 2.8 per cent in 2010, the most in five years, after shrinking 2.6 per cent in 2009. Household purchases rose 4.1 per cent in 4Q2010 (3Q2010: 2.4 per cent), boosted by various tax cuts, and the renewal of emergency jobless benefits for the unemployed. Consumer confidence increased in February to the highest level in three years, supported by a drop in unemployment, but risks to growth may come from rising oil prices and more cutbacks by state and local governments, given the rising costs of food and fuel.





5.1 Inflation Manageable

US CPI rose slightly by 1.6 per cent in January 2011 (December: 1.5 per cent), as higher prices of food and fuel may have started to filter through to other goods and services. Core CPI stood at 1.0 per cent in January 2011 (December: 0.8 per cent), the most since February 2009. Even with soaring commodity prices, the Fed remains concerned that inflation is below its long-term target of 1.6-2.0 per cent. Spending is capped by high unemployment spending at or above 9.0 per cent since May 2009.

5.2 US Housing Market Struggling

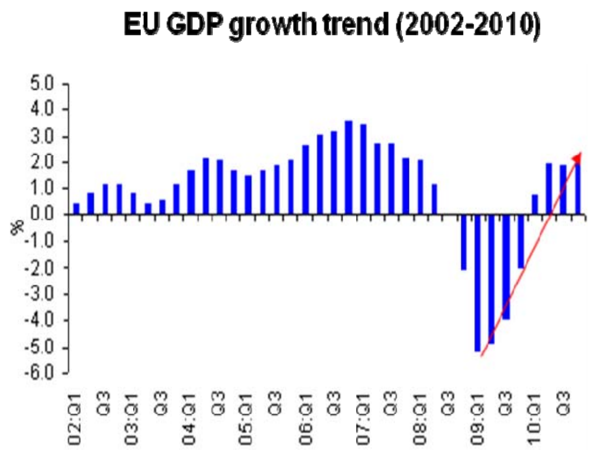
US home values fell 2.4 per cent in December 2010, the biggest decline since December 2009. Mortgage delinquency rate was the highest at 10.1 per cent in 2010, easing to 8.22 per cent by end-2010. Foreclosures are expected to increase as banks resume seizures. The number of homes receiving a foreclosure notice is expected to climb 20 per cent in 2011. This may depress home values further, prompting would-be buyers to hold off on purchases.

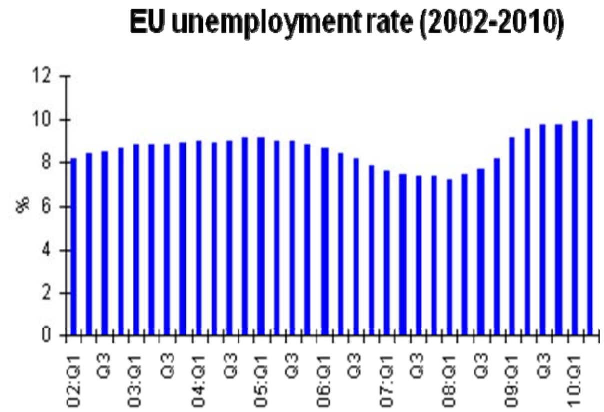
5.3 US Fiscal Deficit Topped 10.6 per cent of GDP in FY2010

US fiscal deficit official forecast was US$1.267tr or 8.3 per cent of GDP in FY2011 (FY2010: 10.6 per cent of GDP). The stimulus measures were: extended unemployment benefits and healthcare subsidies for the unemployed, tax and credit incentives for small businesses to invest and to hire workers, extended payroll tax cuts for the middle class, and increased funding for states, infrastructure and transportation. The US plans to reduce fiscal deficit in 2012 and bring it below 4 per cent of GDP by 2014.

6. EU Economic Outlook 2011

Official GDP in the Euro region is projected to increase by 1.6 per cent in 2011, up from an earlier forecast of 1.5 per cent. Services and manufacturing industries in February grew at the fastest pace in more than four years. The unemployment rate fell to 9.9 per cent in January 2011, down from 10 per cent in December 2010. Inflation gathered pace to 2.4 per cent in February 2011, and is expected to average at 2.2 per cent this year, above the European Central Bank's (ECB) ceiling of 2.0 per cent.





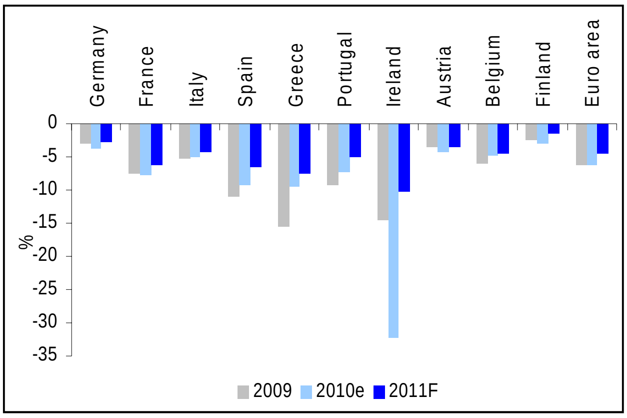
6.1 ECB is Expected to Raise Interest Rates to Counter Rising Inflation

Quickened inflation puts pressure on the ECB to raise rates later in 2011. The ECB has toughened its inflation-fighting rhetoric over the past two weeks, indicating it is moving closer to raising rates from a record low even as Europe grapples with a sovereign debt crisis. The market expects the ECB to make its move in September 2011.

6.2 Sovereign Debt Crisis

Ireland, Greece, Portugal and Spain had the highest fiscal deficits to GDP in 2010. They will see some success in bringing down their deficits in 2011 but the ratings of sovereign debt have been downgraded by as much as seven times for Ireland.

Euro area fiscal deficit per cent GDP (2009-2011F)



Country	Rating prior to 2009 (Moody's/ S&P/ Fitch)	Rating as at Mar 2011 (Moody's/ S&P/ Fitch)	Downgraded by (notches) (Moody's/ S&P/ Fitch)
Ireland	Aaa/AAA/AAA	Baa1/A-/BBB+	7/6/7
Greece	A1/A/A	Ba1/BB+/BB+	6/5/5
Portugal	Aa2/AA-/AA	A1/A-/A+	2/3/2
Spain	Aaa/AAA/AAA	Aa1/AA/AA+	1/2/4

7. Emerging Economies Registered Strong Growth Rates

Global economic growth will be driven by emerging economies this year, namely Asia Pacific (8.4 per cent) and Gulf Cooperation Council (GCC) countries (4.6 per cent). The growth drivers are high commodity prices, strong private consumption and huge infrastructure spending plans. The 2011 GDP growth projections are: China at 9.6 per cent in 2011 (2010: 10.3 per cent), India at 8.4 per cent (2010: 9.7 per cent), SEA at 5.5 per cent, Brazil at 4.5 per cent. However, the risks are political unrest in the Middle East and North Africa (MENA) region and rising inflationary pressures.

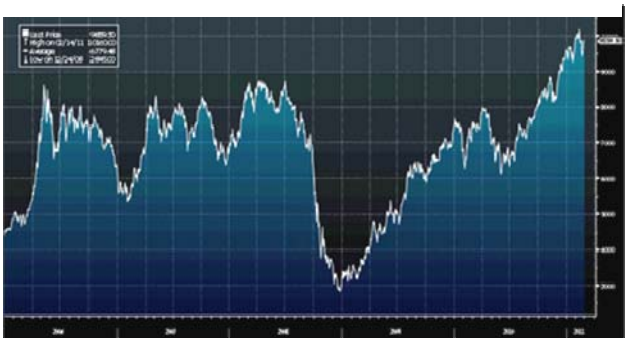
7.1. Recovery in Commodity Prices

Countries that are resource-rich will benefit from rising commodity prices. The price of crude oil surged to a 29-month high at US$99.63 per barrel amidst political unrest in the MENA region, gaining 10.9 per cent YTD (year to date). Commodity prices surged as investors turned to safe-haven investments. Gold prices gained 2.04 per cent YTD at US$1,433.28/ounce, aluminium rose 6.4 per cent YTD, platinum surged 76.7 per cent YTD.

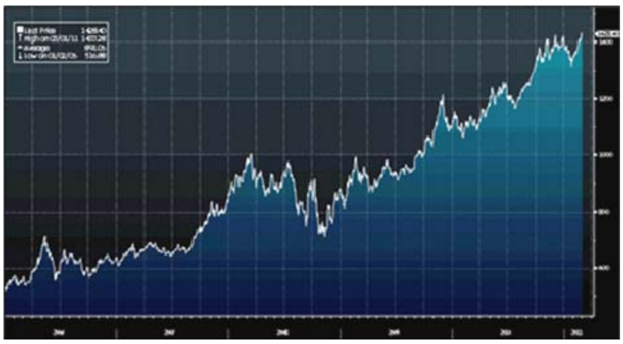
7.2. Divergent Inflationary Trends

Inflation is accelerating at a six per cent pace in emerging economies vs. two per cent in developed nations.

Copper price (2006-2 Mar 2011)



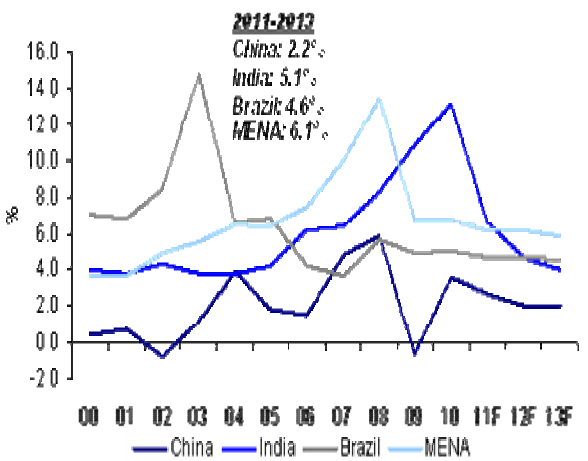
Gold price (2006-2 Mar 2011)



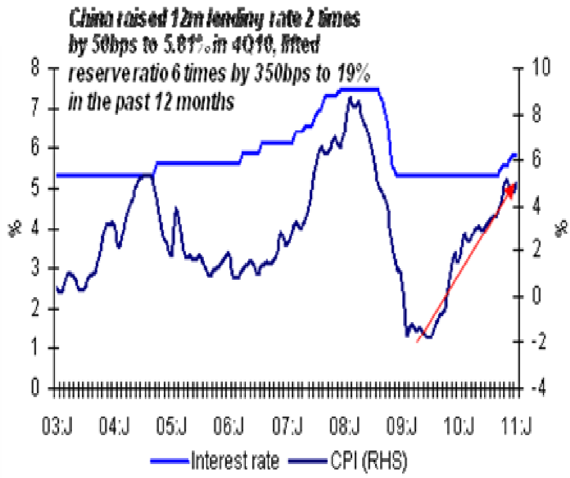
Crude oil price (2006-2 Mar 2011)

7.3 Central Banks Raise Rates to Fight Inflation

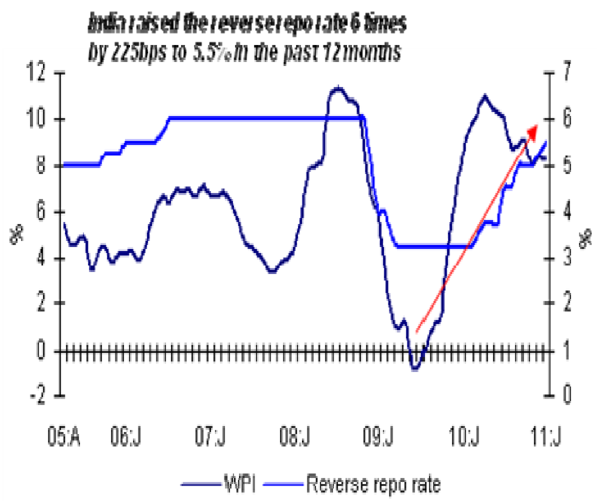
Australia was the first country in Asia Pacific to raise its interest rates four times since December 2009, going from 3.0 per cent to 4.75 per cent. China raised the 12 month lending rate two times by 50bps to 5.81 per cent in 4Q2010, and lifted reserve ratios six times by 350bps to 19 per cent in the past 12 months. India raised the reverse repo rate six times, by 225bps, to 5.5 per cent in the past 12 months. These countries have seen strong capital inflows into their stock markets. Malaysia raised the overnight policy rate (OPR) three times since February 2010, by 75bps, to 2.75 per cent.



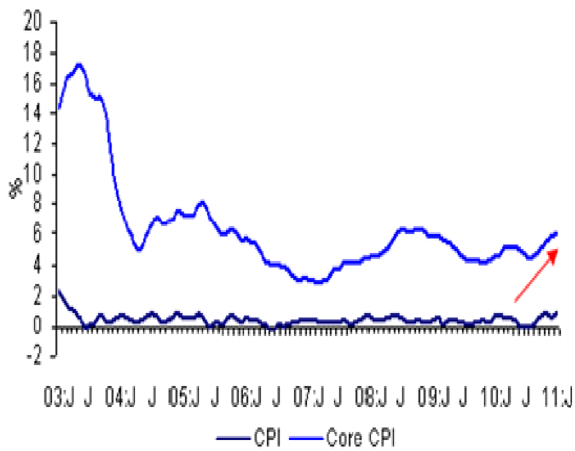
Emerging economies inflation (2000-2013F)



China CPI vs. interest rates (2003-2011)



India WPI vs. interest rates (2005-2011)



Brazil inflation trends (2003-2010)

7.4 *Currency Appreciation for Asia Pacific and Emerging and Economies*

China's yuan has strengthened 4.23 per cent, since mid-2008, to 6.5750/US$. The Australian dollar has reached parity vs. the US dollar. South Africa's rand appreciated by 44 per cent vs. the US dollar in the past two years. The ringgit appreciated by 10.4 per cent to 3.0350/ US$ in the past 12 months. South Africa and Indonesia have shown that stronger currencies can quell rising prices. Russia favours a 'very flexible' exchange rate.

8. Conclusion

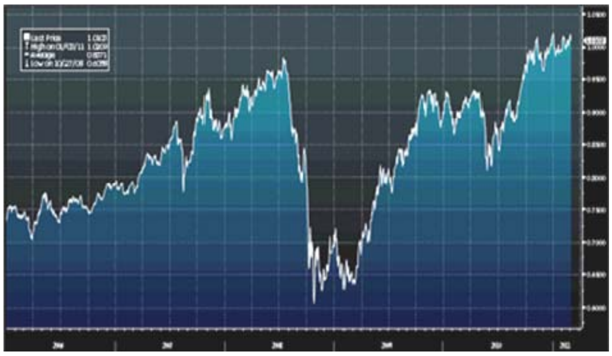
Despite the aggressive fiscal stimuli provided by central banks around the world since the beginning of 2009, private expenditure has not picked up, and economic recovery remains fragile and uneven. While bond yields and mortgage rates are at record lows, credit growth in the US remains very subdued.

We think the further lowering of interest rates (via QE2) would do little to stimulate demand due to the still high unemployment rate and the weak housing market in the US. Consumers continue to deleverage by paying down debt. While QE2 improved sentiments temporarily, it is unlikely to pull the US economy out of its current lacklustre economic cycle.

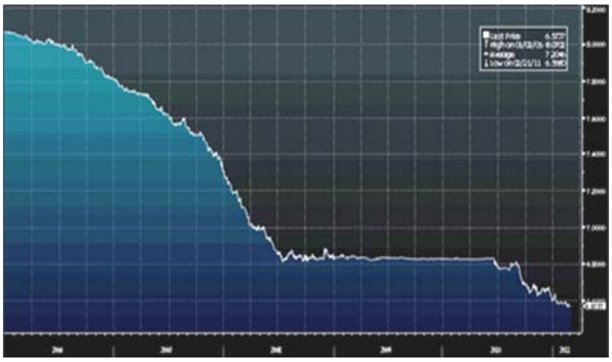
On the contrary, QE has caused its own share of side effects which include:

- Further establishing the US dollar as a funding currency for carry trades;
- The rallying of global markets, as lower bond yields make equities and other risky assets relatively attractive; and
- A decline in US dollar, forcing emerging economies' policymakers to intervene in the forex markets

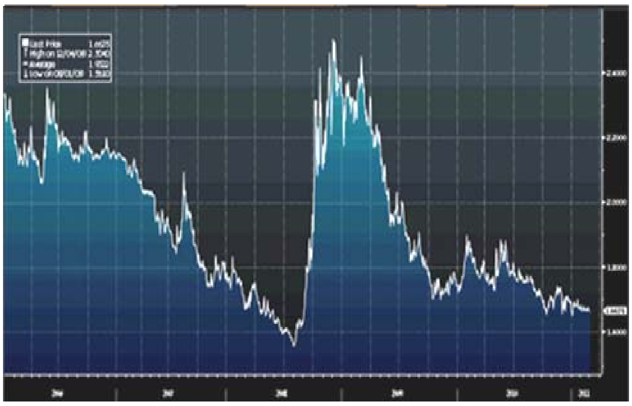
Australia's AUD/USD (2006-2 Mar 2011)



China's yuan/USD (2006-2 Mar 2011)



Brazil's real/USD (2006-2 Mar 2011)



Emerging economies are forced to trace the Fed's decision of monetary easing to prevent unwanted currency appreciation i.e. an 'international currency war' with emerging economies trying to avoid the appreciation of their currencies in order to support the growth of exports in a challenging global economic environment. The search for yield, growth and inflation protection is likely to continue.

Mr Steven Wong, Senior Director of ISIS Malaysia, gave his views on five areas of macro-policy concerns – output, inflation, unemployment, fiscal balance and public debt in G-20 countries as well as in Malaysia.

- Output growth is trending in a tight band, and one that appears to be a little too low for comfort. At these levels, the buffer is not very thick and there are risks that even moderately strong political and financial shocks can send economies spiralling into recession.

  Inflation forecasts are more dispersed and generally of a higher order of magnitude. This would seem to suggest an upward bias i.e. the risk of prices taking flight, especially if driven by even more cheap US money and substantial food and energy increases.

- Unemployment is also of concern. Of the three macro indicators, this seems to be the most stubborn and the hardest to dislodge, indicating that countries will have to contend with the politics of high potential unemployment into the medium-term (i.e. cheap money, labour protection, etc.).

- On fiscal policy, however, there seems to be greater scope. Not all countries have been reckless in the past three years and most can accommodate some increase should the need arise. The pervasive mindsets about financial markets over fiscal spending, however, will need to be broken.

- On gross public sector debt, the wiggle room is less, given that notional safe debt ceilings are lower (40-60 per cent). Major Western economies have already racked up very significant debts and may be close to 'maxing out' their credit. East Asian economies (except Japan), however, still have some room for manoeuvre.

Broad Macroeconomic Indicators for Twenty Three Countries in 2012

OUTPUT (% change)				
< 2%	2%~<4.0%	4.0%~<6.0%	6.0% ~+<7.0%	7.0%>
FR, IT	AR, AU, CA, DE, GB, JP, TR, US, ZA	BR, KR, MX, **MY**, SA, SG, TH, PH, RU	ID, IN	CN
INFLATION (% change)				
< 0%	0%~-<2.0%	2%~+<4.0%	4.0%~<6.0%	6.0%>
JP	DE, FR, GB, IT, US	AU, CA, CN, KR, MX, **MY**, SG, TH	BR, ID, IN, PH, ZA	AR, RU, SA,TR
UNEMPLOYMENT (% labour force)				
10.0%>	7.5%~<10%	5.0%~<7.5%	2.5%~<5.0%	<2.5%
SA, ZA, TR	AR, BR, FR, ID, IT, US	AU, CA, DE, GB, IN, PH, RU	CN, JP, KR, MX, **MY**	SG, TH
FISCAL BALANCE (% GDP)				
-10%>	-10.0%~<-5.0%	5.0%~<2.5%	-2.5%~+<0%	+0%>
	FR, GB, IN, JP, **MY**, US	AR, AU, BR, CA ID, KR, PH, RU, SG, TH, TR, ZA	CN, DE, IT, MX	SA
PUBLIC DEBT (% GDP)*				
0%~25%	25%~50%	50%~75%	75%~100%	100%>
AU, CN, RU, SA	AR, KR, ID, MX, PH TH, TR, ZA	BR, DE, IN, **MY**	CA, FR, GB, SG	US, IT, JP

Expanding Amidst Contraction? Malaysian Economic Policies and Performance in 2011-2012

*The third session of the Inaugural ISIS Praxis Seminar 2011 discussed Malaysia's economic performance and its policies in 2011-2012. The panelists were **Dr Albert Zeufack** of Khazanah Nasional, **Mr. Nor Zahidi Alias** of Malaysian Rating Corporation Berhad (MARC) and **Dato' Dr Mahani Zainal Abidin** of the Institute of Strategic and International Studies (ISIS) Malaysia. **Dr Rozali Mohamed Ali** was the moderator of the session. ISIS Researcher **Nor Izzatina** reports.*

From left: Mahani Zainal Abidin, Albert Zeufack, Rozali Mohamed Ali and Nor Zahidi Alias

The Malaysian economy recovered from the recent global financial and economic crisis and in 2010 generated positive economic growth of 7.2 per cent, from 2009. This put Malaysia back into the growth trajectory of Vision 2020. However the three panelists warned about factors that might derail the attainment of Vision 2020; several policies are expected to be implemented by the government to ensure growth is robust in 2011-2012 and beyond.

The downside to Malaysia's economic prospects can be traced to external economic conditions after the 2008-2009 crisis. As of the beginning of 2011, countries around the world can be divided into two categories; a) countries that are still dealing with the repercussions through ongoing de-leveraging and debt consolidation processes and b) countries that experienced record growth in 2010 due to the low growth base of 2009, but are still having difficulties in sustaining high growth momentum.

The prospect for the Malaysian economy falls into the second category. **Dr Albert Zeufack** made this argument stronger by using indicators such as; i) real growth fixed investment ii) employment growth in advanced economies iii) real private consumption for both emerging and advanced countries and iv) ISM index for manufacturing sectors in the United States, China and other main Asian countries. All this points to the probability that the recovery recorded in 2010 may falter within the next two years.

Mr Nor Zahidi Alias provided an explanation for the future projection of the Malaysian economy when he pointed out that the expected slower growth in 2011 will be due to weaker external trade (smaller net exports) due in turn to waning global demand for electrical and electronic (E&E) products. This trend was illustrated by the projection of global chip sales in 2011 and 2012. The economy is expected to grow moderately by 6.0 per cent and 3.4 per cent respectively in the two years.

Current geo-political events in the Middle East added a further dent to fragile global economic growth. Since the people's uprising spread across the Middle East, commodity prices, especially that of crude oil, have been on the rise. The three panelists agreed that shocks in commodity prices will influence the global recovery process.

Given the gloomy global economic outlook, what can Malaysia do?

Countries can still push towards high economic growth despite discouraging external conditions but not without economic costs. One option is through borrowing from the future. Given this option, there is the possibility that 2008-2017 will be known as the 'decade of debt' said Dr Zeufack. He also added that this will prolong the process of private leveraging, open new ways for future banking methods, and provide solutions to the sovereign debt crisis. Malaysia like other nations also has the option of increasing its future commitments to fund its immediate aspirations.

With an uncertain global outlook, Malaysian policymakers are more than ever forced to be introspective. In order to maintain growth trajectory of six per cent (GDP growth) for the next nine years, policymakers must be able to stimulate domestic growth through investment and consumption. Supportive monetary and fiscal policies are needed if such a direction is to be pursued.

Accommodating interest rates will set the tone for private investment in Malaysia and its ability to grow. However, according to Nor Zahidi, interest rates in Malaysia are low enough for capacity buildup, exhibited in rising Malaysian consumers and producers price indices (CPI and PPI), and the increase in payroll and employment in the manufacturing sectors. Normally the overnight policy rate (OPR) reacts to rising capacity utilization to prevent the second-round effect or a higher increase price level from occurring. This signifies that the OPR cannot be kept at its current level, and readjustment is needed.

The intention to adjust the OPR to reflect the current economic situation is an invitation for a further influx of capital from around the world, added Nor Zahidi. Massive capital inflows are evidenced by the surge in the local stock and bond markets and are in the form of portfolio investments. However entry of hot money from abroad is highly related to swings, and any drastic outflow can affect both the financial market and the real economy.

To show how open the Malaysian economy is to the world, **Dr Mahani Zainal Abidin** pointed out that capital inflows into Malaysia's domestic capital market is an outcome of the Quantitative Easing 2 (QE2) undertaken by the Federal Reserve. The increasing capital inflows also exert upward pressure on the ringgit which will in turn impact Malaysia's trade performance. With Malaysia's real effective exchange rate currently hovering above its mean, any sudden reversal in flows will affect the ringgit's performance, which will hurt Malaysia's balance of payments.

Another reliable instrument used to prop up economic growth is fiscal policy. Malaysia has been using fiscal policy to expand public investment. One such policy is the subsidy of retail fuel prices. However given the short period between the global financial crisis and the current slow growth outlook, the Malaysian government

Participants at the conference

cannot be expected to take another expansionary role. Expanding on Dr Zeufack's points, Dr Mahani agreed that government action to finance the growth initiative through debt financing can cause a huge stress on the future of economic performance.

However, the use of fiscal expansion as a policy option is still on the table, although its form might be different. Dr Mahani added that it is expected that the next General Elections will be announced well before the end of 2013 and that this will act as a stimulus for the economy. It is certain that elections in the state of Sarawak this year will require fiscal spending.

While revenues collected by the government are steady and growing, considering the relatively high tax-to-GDP ratio and the recent commodities rally, the burden on the government subsidy programme is expected to grow. Nor Zahidi pointed that the crux of Malaysian government finance lies in its operating expenditures, where the subsidies are, and not in development expenditures. The exuberance of the first half of 2010 made the government, with PEMANDU's assistance, embark on a subsidy rationalization exercise that will see subsidies being reduced and eventually removed.

However the current rally of oil and food prices have added pressure to maintaining domestic retail prices for some goods, despite efforts to phase them out. If the government decides to refrain from taking future debt and rapidly eliminates subsidies, there will be a negative impact on household consumption.

In relation to fuel subsidies, Nor Zahidi established a positive correlation between high petrol retail prices, the retail trade index and the consumer sentiment index. With the additional volatility in international food prices and huge food deficits in Malaysia's trade, household incomes will be pressured to undergo changes, and ultimately, consumption will be scaled back, shaving Malaysia's growth prospects even further.

Dr Mahani added that sustaining household confidence is crucial, given the uncertain world economy. While it might be possible to create higher consumption growth through higher consumption requirements and easy credit, a weak domestic outlook with rising fuel retail prices, the commodities and food prices rally, the property market asset bubble and existing high household debt have all proven that the household sector is not the best sector for growth.

Malaysia's private investments suffered after the 1998 Asian Financial crisis. To counter this, strategies like the Economic Transformation Programme (ETP) and Government Transformation Plan (GTP) were introduced in 2010, to improve Malaysia's appeal as a business and investment destination. Since the introduction of the ETP in October 2010, the private sector has pledged RM67 billion. On the other hand, reforms under the GTP, such as improving government effectiveness in managing issues like street crime, and public transportation, are qualitative in nature.

Despite these efforts, a stronger momentum on ETP implementation is required as RM65 billion worth of investments are needed every six months until 2020 in order to reach Malaysia's private investment target of RM 1,311 billion, which is a prerequisite to reach the high-income threshold bracket under the Vision 2020.

With excess capacity reported under the manufacturing sector, private investments in the service sectors are imperative to make Malaysia's economic growth sustainable.

While domestic-driven economic growth will be pursued, Dr Mahani re-affirmed the role of external factors in Malaysia's economic growth. She pointed out that trade policy through bilateral and regional arrangements will continue to be pursued as an avenue for Malaysia's goods and services. Productive capital outflows, in the form of M&A and FDI, to high impact sectors, must be encouraged for the purpose of technology transfers and strategic industries. Trade in finance can be intensified in niche services like Islamic banking and finance.

The 2011-2012 economic outlook may on the surface look grey. However, with effective policy designs, Malaysia's economy can avoid the malaise that dents economic growth. The government must not rely completely on normal economic tools such as fiscal expansion and interest rate reduction to propel growth. Measures such as increasing reserve requirement ratios and private-public partnerships (PPPs), as exhibited in the Iskandar Johor project, are among policy options that can be used.

Strategic Reform Initiatives for the New Malaysian Economy

The final session of the Inaugural ISIS Praxis Seminar was a tête-à-tête session on the Strategic Reform Initiatives for the New Malaysian Economy. Senator ***Tan Sri Amirsham A. Aziz,*** *the Chairman of the National Economic Advisory Council (NEAC), spoke in this special session which was moderated by* ***Tan Sri Dr. Sulaiman Mahbob****, Chairman of the Malaysia Investment Development Authority (MIDA).* ***Mazlena Mazlan****, Researcher at ISIS reports.*

From left: Amirsham A. Aziz and Sulaiman Mahbob

Tan Sri Amirsham A. Aziz said the New Economic Model (NEM) is a two-part recommendation by the NEAC to the government on the critical transformation needed for Malaysia to become an advanced nation, based on the principles of high income, inclusiveness and sustainability. While the first part of the report analysed Malaysia's position and the fundamental weaknesses that have caused the country to be stuck in a middle income trap, the second part delved deeper into the government's eight strategic reform initiatives (SRI) and recommended essential policy measures to overcome these weaknesses. The baton has since been passed on to The Performance Management & Delivery Unit (PEMANDU), which at the time of the conference was close to completing the detailed implementation plans before submission for cabinet approval. PEMANDU will also coordinate the execution of these plans.

The four main thrusts of the strategic reform initiatives are:

Farish Noor (third from left) discussing a point with Amirsham A. Aziz

(i) The creation of a competitive investment environment;

(ii) Development of a quality workforce;

(iii) Transformation of the government so as to improve its service delivery to support the private sector and become fiscally sustainable; and

(iv) The narrowing between disparities

These thrusts reflect the challenges of the nation in placing the private sector back in the driver's seat to steer the economy, while the government plays the role of facilitator, rather than active player in economic activities. One of the challenges is to strike a balance between allowing the bigger players to drive the economy forward and continuing to support the small and medium enterprises (SMEs), who should not be left to lag behind.

Malaysia is losing its attractiveness as a business destination, due to archaic regulations

Secondly, in the efforts to attract and retain local and foreign talents in the country, job security for the employees must be balanced with the employers' demand for increasing flexibility in the management of their workforce. In this respect, retraining and re-skilling opportunities, as well as unemployment insurance should be introduced as offset mechanisms, along with the more flexible work permit regulations which are longer term in nature.

These offset mechanisms will act as a buffer and reduce uncertainty. They will complement a policy that increases flexibility in hiring and firing to weed out the non-performers.

A participant expressed concern over the quality of Malaysia's education system, especially in public schools, which he said needed to be improved, as many young couples are migrating due to concerns over their children's future prospects.

...the minimum wage policy will be indiscriminate between local and foreign workers

Thirdly, Malaysia is losing its attractiveness as a business destination, due to archaic regulations. Amirsham expressed his delight that the SRI laboratories have identified key issues that have to be addressed to transform the government. Among others, measures to bring new talents into the civil service, such as through tapping talents from government-linked companies and the private sector, and positioning them in the government sector, were suggested. Finally, the bottom 40 per cent of the population should not be overlooked as their potential would be underutilized in generating economic growth.

Nevertheless, such transformation requires private sector participation. Industries need to shed their low cost mentality and accept the increased wage costs resulting from competition for talents. The continuing reliance on low cost resources, namely semi-skilled workers and underpriced energy must change. Unfortunately, the government is also seen as giving employers too much access to cheap foreign labour.

Energy subsidies will be gradually withdrawn. Likewise, the implementation of a minimum wage policy is highly likely. Certainly, the minimum wage policy will be indiscriminate between local and foreign workers. The challenge is that it will result in a steep rise in production costs, given that a large proportion of the labour force currently earns below the potential minimum wage. There is concern that Malaysia is losing out to China, which is also trying to shed its low cost image, but has the advantage of cheap and reliable energy.

However, it has been historically proven that subsidised energy in Malaysia has not led to increased investment, whereas countries such as Japan and Korea who pay market price for energy have been incentivized to strive for high technology, productivity and value-added products to offset the higher energy cost.

A participant suggested that rising wages have not been matched by increases in productivity. However, Amirsham said that the last 10 years have shown that productivity has risen ahead of wages. It is therefore a situation of catching up. But more importantly, this also signifies that the economy has been riding on low cost labour in a way that has led to underinvestment. The speaker therefore urged industry players to adapt to these challenges, improve productivity, improve research and development (R&D) and use technology to transform their companies to make them more competitive.

Local players are also urged to rise to and adopt international standards in quality, health, safety and security. The domestic market can be a starting point as Malaysian consumers increasingly demand higher quality products and services, but upgrading beyond this is a necessity in order to break into the international market. Industry players must also scale up their operations, adopt new technologies and skills and collaborate with other players. Depending on the 27 million people that make up the local market is no longer sufficient to move forward.

Certainly, undertaking transformation is not without its challenges. Various conflicting stakeholders need to collaborate and compromise to a certain extent. The government needs to make some difficult decisions, especially since

...liberalization encourages intellectual property standards to be raised

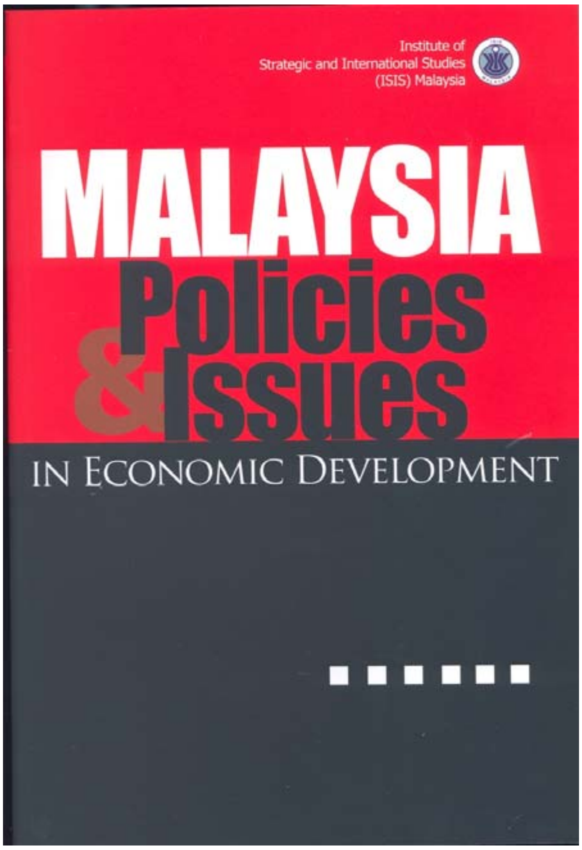
other countries are also undertaking reforms, and moving as fast, if not faster than Malaysia. Malaysia is lagging behind other countries post the Asian financial crisis because the nation underwent neither major fundamental transformation nor investment policy reform while the other badly hit countries evolved. Nevertheless, Malaysia has an advantage in that it began its liberalization much earlier. The good infrastructure and healthy banking system will also complement our willingness to support the transformation in order for the country to move successfully forward.

The session concluded with the moderator, **Tan Sri Dr Sulaiman Mahbob** suggesting that professional services be liberalised. The law has been very protective although our professionals are on par with world standards and are global players. Such liberalization encourages intellectual property standards to be raised. Countries such as Britain and Singapore have taken steps in this direction and it was suggested that Malaysia should do so too.

We have time constraints, as we have nine years to achieve this before 2020. The key is therefore to be able to drive the National Key Economic Areas (NKEA) and at the same time address the foundational impediments as recognized in the first part of the NEM. Without the foundational improvements, the NKEA will not be able to operate at its fullest potential. Transformation will be both time-consuming and painful, but standing still is certainly not an option.

Resistance to change is ongoing, therefore the NKEA must be made to work. The public will be convinced if they observe that well-rewarded jobs are being created and real income is moving upward. Effective communication, with the cooperation of the mass media, is therefore crucial to ensure that the public buys into this initiative and therefore supports the transformation efforts.

LATEST ISIS PUBLICATION



Malaysia: Policies & Issues in Economic Development
693 pp. 2011 RM80.00
ISBN 978-967-947-308-7

The book, consisting of more than 20 chapters, covers four main themes: Macroeconomic Management, Economic Growth and Transformation, Management of Growth and Equity, and Enabling Environment and Institutions for Development. The authors are drawn from various sectors, with wide-ranging and rich experience in academia, the public sector and the private sector.

Compared to previous studies which focused mainly on the development process, this book takes a different approach to Malaysian economic development. It traces landmark achievements, and present challenges and pitfalls faced by the nation over the last five decades after Independence. More importantly, it pays tribute to the role and contributions of various players and protagonists in this development process.

Available at all local book shops or please e-mail: publications@isis.org.my

NOTES

INSTITUTE OF STRATEGIC AND INTERNATIONAL STUDIES (ISIS) MALAYSIA
No. 1, Persiaran Sultan Salahuddin
PO Box 12424, 50778 Kuala Lumpur
Malaysia
Tel : +603 2693 9366
Fax : +603 2691 5435
Email : info@isis.org.my
Website : www.isis.org.my