CHAPTER 3

CAUSES FOR CONCERN

3.1 Introduction

A thorough analysis on the Malaysian economy would give some indications and evidences that there were so many weaknesses and unhealthy trends that were going around and mounting prior to the crisis. It is essential for Malaysia to learn from the mistakes so that history will not be repeated. It will help Malaysia to be more careful and have stronger economic foundations and policies in future to ensure that similar crisis does not reoccur. Such economic crisis would ruin the chance of turning the dreams of Vision 2020 (see Appendix 6) into a reality.

3.2 Causes For Concern

The causes for concern are being listed and described in the following paragraphs. Some of the causes were so obvious and glaring. In most cases, the Malaysian government acknowledged the negative trends that were happening, unfortunately, due to uncertainties and perhaps slow reaction from government's side led to the occurrence of the crisis.

3.2.1 Slowdown In Foreign Direct Investment

Malaysia had benefited in the sense of making huge profits from the massive deployment of investment and production from Japan and other East Asian New Industries Economies (NIEs) to Malaysia during the boom years of late 1980a and early 1990s. Between the period 1980 -1990, the share of FDI in gross domestic capital formation rose to a level approximately 10.7 percent. For the period 1991 -1993, Malaysia saw the FDI in gross domestic capital rose to 24.6 percent (UNCTAD, 1996).

Early worries started when at the beginning of 1996, there had been a drastic decline in the amount of FDI inflow. The sudden drop in FDI inflow had impacted the Malaysian manufacturing growth and reduced the demand for services and construction. The reduction in the inflow of FDI was caused by several factors. One of the main factors was the diversion of investment to China. China was seen to be more attractive by the devaluation of renminbi. China, to an extent, was a big competitor to the Malaysian economy as both countries were 'lobbying' for foreign investors to invest in their countries.

The exhaustion of labour reserves in Malaysia had also influenced the amount of foreign investments. Malaysia was providing cheap labours and that attracted foreign investors for labour intensive industries. Although there were many Malaysians who worked in labour intensive industries, it was also a fact that many companies also engaged foreign labours to work in the factories and plantation fields as they were cheaper. Hiring of foreign labours was becoming more popular and there were many syndicates whereby those labours were brought into Malaysia illegally as to reduce costs. The government was very concerned of that development. There were also many cases reported by the police that many crimes that took place involving those foreign labours. That prompted the government to impose stricter supervision and monitoring of the incoming foreign labours. As a result, that reduced the inflow of the foreign labours, To certain extent, foreign investors had difficulties in getting cheap labours. With the development in China as mentioned in the previous paragraph and the massive number of cheap labours, China was then seen as a better place for investment.

The stagnation of the Japanese economy that resulted in the falling of the Japanese yen was also a big concern. The development resulted in many foreign investors from Japan took precaution and reduced their foreign investments. In Malaysia, the participation of foreign investment from Japan had been very encouraging ever since the Look East policy was introduced by Dato' Seri Dr. Mahathir in 1980s. Massive funds from Japan were injected through the establishments and business operations of multinational corporations such as Sony, Hitachi, Toshiba and etc. The cautions taken by the Japanese investors had a significant impact on the overall Malaysian FDI.

3.2.2 Dependence On Foreign Labour

Before the crisis, the success of the government development policy especially those in relation to creating job opportunities, had instead resulted in severe Malaysian labour shortfalls in certain areas such as construction, plantation and manufacturing sectors. Malaysian economy witnessed the change in the pattern of employment. Even though there were many job opportunities in the areas mentioned earlier, most Malaysian labour found that they would be better off getting jobs in other sectors which permitted them to work in the office or simply jobs that did not require them to spend too much time under the sun or having to shower themselves with their own sweat.

Given the fact that Malaysia was not blessed with big number of labour force, Malaysia had no other alternative but to import labour force from neighboring countries especially from Indonesia, Bangladesh and Philippines. There had also been concern relating to some of the professional posts whereby foreign experts were required to run some of the jobs that were unable to be performed by Malaysian professionals. It was estimated that there were around 2 million migrant workers in Malaysia filling up the gap in the labour supply. The number of foreign workers were equivalent to 20 percent of the workforce in Malaysia, thus creating disturbing and concerning phenomenon in the context of socio-economic.

To make thing worse, there had not been a comprehensive migrant policy. Policies pertaining to migration labour were done on ad-hoc basis. Whenever there was a call for labour to fill up gap in an industry, migrant labour was brought in a continous massive scale to a large extent that the heavy importation of those labour did not come to an end once the initial target was achieved. As a consequence to that, the easy supply of inexpensive labours brought in from neighbouring countries were seen a good excuse for reducing cost of productions for jobs initially can be done by Malaysian labour. Ariff and Syarisa (1998) suggested that the migration labour situation could be construed as one of supply creating its own demand.

The huge migration of foreign labour to Malaysia had brought to the fear of an imbalance in Malaysia's labour sector. As Malaysia is moving into high technology capital intensive industries, then there would be a need to have strict policies on the foreign workers. They need to transfer the skills that they had acquired through their trainings to Malaysian workers just to ensure that when the phasing out of foreign workers are done, at least there are going to be some people who would still have the knowledge to carry out the jobs previously done by those foreign workers. The policy for foreign workers must also cover their aspect of stay in Malaysia. What had happened in the past, especially those Indonesia workers who initially came to Malaysia to work eventually managed to bring their families to reside in Malaysia. In the long run, if this trend continues, it may create tension among the Malaysian and Indonesian workers having to fight for limited number of jobs.

3.2.3 Economic Growth Above Potential Output

Since 1991, the Malaysian economy has been consistently growing above what was identified to be its potential growth path. Zero output gap is achieved when the actual and potential GDP are equal in size. What happened was that the output gap increased during period 1994 to 1996. This scenario occurs when the actual GDP grew faster than potential GDP. The phenomenon generated price pressures, especially in the form of wage increasing above the productivity gains. As a result, instead of improvements to economic efficiency, the growth achieved during that period was primarily brought about through augmenting input. The above development created a situation that would clearly be unsustainable in the long-term period.

3.2.4 Loss Of Efficiency In The Economy

The efficiency in the utilization of resources in the economy is indicated by estimates of Total Factor Productivity (TFP) and the incremental capital-output ratio (ICOR). The computations of TFP growth indicated that it had been experiencing a down fall trend from 1994 to 1997. A thorough research indicated that the growth that was achieved had been driven primarily by a high rate of capital stock accumulation.

From 1995 to 1997, the Malaysian economy had witnessed an investment rate that has been approximately about 46 per cent of GDP. Meanwhile, the ICOR rose from 3.0 in 1988 to 6.5 in 1997. The sudden rise in ICOR, which took place for the above period indicated that the use of capital have been increasingly less efficient. Other reasons for the increased in the rate for ICOR in recent years may be attributed to the massive injections into capital-intensive projects with long gestation periods, leakages and initially underutilized capacity.

3.2.5 Build-up Private External Debt

The effort made by the Malaysian government to encourage the private sectors to take charge of the economic growth in the Malaysian economy was well received by the private sectors. Many private companies started to engage international consultants in their business activities. Some of these companies joint-ventured with international companies while in other cases, they bought materials or semi-finished goods from other countries and then processed those goods to finished goods.

Over a short period of time, over depending or reliance on foreign partnerships became a norm to many ambitious local companies. In some cases, those companies were heavily depended on capital injections or funds from cash rich foreign investors. As those investors were confident that the future of Malaysian economy was good based on the fact that government was stable and policies made by the government in the past had created win-win situations between them and local companies, they were quite happy to give massive loans to those companies. As a result of that the private debts were mounting.

3.2.6 Rising Current Account Deficit

Rising in the current account deficit can be very alarming. In this case, Malaysia was experiencing the deficit in the current account that was corresponding to the saving-investment gap. As recorded by the World Bank (1996), Malaysia happened to be one of the highest savings rate nations in the world. Despite that record, Malaysia ran into current account deficit problems because of its over-investment activities.

The over-investment activities led to the current account deficit as the import figures were greater when compared to exports. To make things worse that above fact was being accompanied by the declining efficiency in capital utilization. The current account deficit was only partially financed by net long-term capital inflows for some of the years. Meanwhile, the reverse investments were registered to be drastically increased from RM4.0 billion in 1993 to RM11.4 billion in 1996. On the other hand, Malaysian investment overseas in 1997 was estimated only to be around RM9.9 billion.

3.2.7 Exchange Rate Appreciation And Growing Imports

Malaysia was enjoying export competitiveness between 1986 and early 1990s as a result of falling exchange rates. The Malaysian goods were cheaper and attracted many buyers in the international market. The Malaysian ringgit strengthened especially since mid-1995. Meanwhile the Japanese yen was declining from mid-1995 and China's renminbi was devaluated in 1990 and 1994. Those developments had negative impacts to Malaysia 's current account and FDI inflows. The fact that ringgit was rising coupled with the government policies to lift some of the tariffs and other trade control resulted in many of the Malaysian companies imported goods from overseas. Such wealth was not properly monitored. No effort was taken to adjust the exchange rates in order to neutralize the impact of import liberalization.

3.2.8 High Loan Exposure Fuelled Asset Price Inflation

Before the crisis in 1997, BNM was rather ineffective in its duty to supervise the growing fragility in the financial sector, especially when concerning the trends and growths of bank lending. BNM with all its expertise in financial and banking matters failed to take certain things seriously especially when it was crystal clear that there had been tremendous growth in the NPLs reported after the property market collapsed in 1986. In 1986, such loans accounted for 55 per cent of all new loans, compared to 32 per cent in 1980 (Zainal 1994).

In 1989, Malaysia adopted the Banking and Financial Institution Act (BAFIA). To a certain extent, despite adopting the BAFIA and understood what the contents were, the Malaysian policymakers acted rather carelessly or perhaps due to ignorance by not taking prudent steps and measures when it came to lending matters. Another reason for not being prudent in lending practices was simply due to the fact that the banks were facing greater competition to lend money in the more liberalized and competitive market. They also preferred to lend money for financing real estates and share purchases as long as the loans were collateralized.

From the record provided by BNM, the monthly total loan growth (year-on-year) was around 28 to 30 per cent in 1997 except for November and December. It was also discovered that the loans given to the property sector were reaching above 30 per cent (year-on-year). That figure resulted to 26 per cent of total loans given out in 1997.

The percentage of loans given out for the purpose of purchasing of stocks and shares during 1993 to 1997 grew at an average rate of 35 per cent per year. That development led to property and stock prices rising rapidly. Thus the easiness in getting loans did encourage over-investment in non-tradable resulting in current account deficits (corresponded with other factors that the import materials where much greater than the recorded exports) and fuelling asset price bubbles.

3.2.9 Cronyism

Cronyism was a common scenario and much talked about especially when the economy crisis was taking place. There had been many evidences that business people that were closely connected to the Malaysian government owned big businesses in Malaysia. It was also a common practice that some of the companies that were granted the contracts from the governments were making huge profits by sub-contracting several potions of the jobs to other vendors and contractors. In some cases, due to lack of supervision and proper management from the main contractors, co-ordinations were very poor resulting in late deliveries. Mismanagement of projects affected the strategic development of the country and the same time portrayed poor corporate governance among Malaysian businessmen from the eyes of long-term foreign investors.

As the country is highly geared to achieve rapid development and conduct business activities with the assistance of sophisticated new technology machines invented by developed countries, it was evidently clear that in most critical parts of delivering the user requirements in those projects, local companies had to rely on foreign technical experts. Those local companies had to pay the services given in either in US dollar or other strong currencies such as Japanese yen or UK sterling. That resulted in huge exchange of Malaysian ringgit in the currency market. The point of concern was more and more of the Malaysian ringgits were held outside of Malaysia.

3.2.10 Surge Of Portfolio Investment Inflows

In the early and mid-1990, Malaysia experienced an unprecedented surge in portfolio investment inflows. This scenario can be attributed to various push and pull factors. The Malaysian government was actively encouraging foreign investors to invest in the Malaysian booming market. From the period 1991 to 1995,it was recorded that the net foreign portfolio investment achieved an average figure of 5.1 per cent of the GDP, portfolio investments accounted for 88 per cent of identified gross capital inflows (Ong 1998). Amazingly in 1993 and 1994, the portfolio investment inflows recorded a remarkable figure as it surpassed GDP in current market prices, reaching USD 67 billion and USD 87 billion respectively.

The Malaysian effort to encourage massive inflow of foreign investors' participation in the Malaysian market eventually exposed the vulnerability of the national economy to any international macroeconomic fluctuations as well as capital flight. That effort also led Malaysia into the state of difficulty when trying to manage the exchange rate and control the inflation.

The huge inflow of short-term capitals somehow proved to be a destabilizing factor. Their involvements were concentrated in two unstable markets that were the stock and currency markets. In 1998, BNM reported to have been losing a lot of money in its effort to maintain tight monetary policy by neutralizing the potentially inflows of foreign speculative funds.

3.2.11 Slow Technological Progress

In Malaysia, the slow technological deepening in the real sector slowed the country's growth potential. In various industries, Malaysia had yet to go beyond original equipment manufacturing (OEM) capabilities. To add to the matter, Malaysia does not have the institution to generate the required human expertise and technological capability to cope up with rapid technical change.

High technology activities were promoted strongly in from 1988. In 1990, with the launched of Action Plan for Industrial Technology Development (APITD), tax deduction incentives were given to allow for high technology companies, double deduction benefits for any approved research and development carried out, aggressive promotional efforts, technology prospecting and specially developed and subsidized and infrastructure for high tech companies to encourage more high technology activities to carry out in Malaysia.

3.2.12 Less Priority And Investment On Research And Development

In all developed countries, research and development are an important aspect to enable them to come up with new ideas and new technologies to improve the things that are currently available in the market. The private companies and government of these countries allocate huge amount of and spend so much time for research and development simply to gain competitive edge. In Malaysia, the scenario is so how different. In order to catch up with these developed countries, Malaysia preferred to take a shorter route by buying more of these new things from developed countries. After all, the argument was that we could not afford to wait so long to be a developed country.

An example to address this issue would be the case of Malaysian involvement into the car industry. Malaysia ventured into the car industry with the assistance of Mitsubishi. Until today, after more than 15 years involvement, Malaysia has not been able to produce a single engine that can be classified as competitive, reliable, fit for the purpose and marketable to be used by the national car. All the while, Malaysia had been busy importing the Mithubishi, Daihatsu and Citreon engines to run the national cars. The policy practiced by the Malaysian government indicated that it was more interested in selling and making profits from the sales of the national cars rather than coming up with a proper planning for fast transfer of technologies from the Japanese and French companies to enable Malaysia to built a 100 per cent car made in Malaysia. As a result of this ignorance, Malaysia will always face with problems when the Japanese and French currencies appreciates.

3.2.13 Speculation And Contagion

It had been anticipated that a glut in the property market was expected. As a matter of a fact, some of the key figures from the Ministry of Finance had voiced out the possibility of downturn in the economy due to rapid over expansion in recent years. It was believed that there was over supply of properties either for sales or rentals.

There were signs that the economy looked very vulnerable and the currency speculators believed that the Malaysian ringgit would suffer the same fate as the Thai baht. The only question was how bad would the Malaysian ringgit be when compared to the baht. The decline in the points registered by KLCI from February 1997, the reversal of portfolio investment funds and the economy's recent enhanced exposure to short term foreign borrowing not only led the foreign investors to withdraw their investments in Malaysia but also encouraged the currency speculators that had already made huge amount of profits from the speculating the Thai baht to start speculating the ringgit.

3.2.14 Confidence Undermining

The news of bank closures requested by the IMF as part of the bailout exercises that it was carrying out in Thailand, Indonesia and South Korea send panic signals about the strength of Malaysian banking sector as compared to its counterparts in the region. The development caused massive savings been withdrawn from the local banks. Malaysians were seen to deposit their money in the foreign banks operating locally as well as those in overseas. In other instances, Malaysians converted their money into foreign currencies. The scenarios affected the market capitalization of firms in Malaysia.

3.2.15 Diversion Of Resources From Real To Speculative Sectors

The fall in the FDI was replaced by the increasing portfolio or short-term investment. Since 1993 following the government measures to liberalize the capital account, short-term investment began to play an important role in the Malaysian economy. Investments must be channeled into productive sectors (Agosin, 1997). In the case of Malaysia, it was seen that those investments were primarily been channeled to non-tradable and speculative sectors. It was a big concern that the increasing trend in short-term investment would create instability because any slightest hint of political, economic and social instability within Malaysia or in the region could lead to massive pull out of investments.

3.2.16 Capital And Industrial Inefficiency

The inefficiencies that existed in the way that resources were being allocated and industries being structured, contributed towards both capital and industrial inefficiencies. There was also evidence of a declining trend in the Total Factor Productivity indicating that the overall economy was experiencing a down turn (Okposin and Chen 2000).

Despite the efforts to deepen the Malaysia's economic structure through the implementation of the two Industrial Master Plans (IMP) the outcomes were very discouraging. The idea of the IMP was to create backward and forward linkages for key sectors such as export oriented manufacturing. Unfortunately, the reality was that the import contents were still very high. While transnationals had been reluctant to source more inputs locally, local firms had also not developed adequate productive capabilities to increase their participation in foreign-firms' value added chains (Rasiah 1998).

The Malaysian heavy industry policy also led to the industrial inefficiency. Even though the idea was good, the same cannot be said about the implementations and supervisions. The reality was that some industries were really depending on special treatments and to make things worst, they rarely reached to their expectations. In some cases, they could hardly survived without the assistants and protections given by the government.

3.2.17Lack Of Transparency

One of the bad things about the way administrations were done in the government sector and organizations that were closely linked to the government before the crisis was lack of transparency. As been claimed by the government, some matters were best kept secret and they were done to ensure smoothness in the overall impacts. These bad practices of restricting vital information to be shared after years and years of administration had made the government become ignorance.

3.2.18 Wrong Business Decision Makings

There were cases whereby strong companies with the business traditions of a specific industry were seen to be venturing into different industries where they do not have the expertise or real interest in. These companies had to rely on the experts from the companies that they had acquired. The companies that were acquired generally had the following characteristics ailing, less competitive, burden by huge debt and in some situation did not have good management teams. The fact that companies from other industry acquired their businesses did not improve things. Technically as the acquirers did not have any experts to take over the management team of the acquired companies, some of the key people in the acquired companies were given mandate to run the 'new' companies. One of the best well-known and most disputable cases would be the acquisition of UMBC Bank by Sime Darby. The bank was later known as Sime Bank. The controversy was ended up when the bank collapsed and Sime Darby's management team confessed that they were not keen to take over the UMBC bank in the first place, as they had no expert to run the bank. Initially, they had no alternative but to ensure that they complete the purchase of UMBC Bank as demanded by the government.

3.3 Conclusion

There were so many causes of concerns before the start of the crisis. Some of them were quite obvious while others were suggesting that they could get even worse as the time went by. It is important that in future, the Malaysian government should be more cautious about similar signs so that precautions can be taken.