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Malaysia's Economic Challenges: Implications of Ringgit's Fall

By Saleena Saleem

Synopsis

The political crisis in Malaysia risks exacerbating the country's economic challenges at a time when strong and credible leadership is needed to boost investor and consumer confidence.

Commentary

WHILE MALAYSIA'S economic fundamentals are assessed to be sound enough to withstand the external factors hampering growth, the protracted political crisis over the 1MDB fund's troubles makes it more vulnerable to their effects relative to Malaysia's neighbours.

That is evidenced by the Malaysian ringgit's dismal performance, falling to over RM4 to the US dollar for the first time since the 1997 Asian financial crisis. The currency has been on a downward slide the past year despite the government's efforts to prop it up by spending its foreign reserves. Heightened economic woes can aggravate popular discontent over domestic economic policies that impact the cost of living.

Three external factors

Malaysia has been hit by three external factors: the oil price plunge, China's economic slowdown and foreign capital outflow.

Since June 2014, global crude oil prices plunged by more than 50% due to oversupply and weak demand. Even though, Malaysia is a net oil importer, oil-related industries account for a third of its revenue. Palm oil prices are likewise on the decline; and Malaysia is the world's number two producer of palm oil. Both oil-gas related products and palm oil constitute at least 28% of Malaysia's total exports, significant enough to narrow the trade surplus as has been the case over the last few months. This leads net commodities-exporting countries like Malaysia to contend with currency weakening issues.

The second external factor is China's economic slowdown. The rationale for China's currency devaluation is to boost exports by making them price-competitive and thus stimulate growth. China has been trying to shift its export-driven growth to consumer spending, but evidently this has not been smooth sailing. Just two months prior to China's currency devaluation, its stock market plummeted 30% and it took government intervention to halt the sell-off.

Individuals constitute a large majority (80%) of investors on China's stock market; the sell-off taken together with an overall decline in domestic consumption is indicative of waning Chinese consumer confidence. China is Malaysia's top trading partner; Malaysia exports primarily electronics followed by oil to China. Notably, Malaysia's continuous decline in trade surplus was reversed in June 2015 with an expansion of oil-gas exports to China. Given the low oil prices, this may be in China's interest, but contraction in Chinese demand will lead to a decline in Malaysia's primary exports to China. Malaysia will not be able to ride on Chinese demand as it has been doing for the past decade.

The third external factor is foreign capital outflows sparked by an impending interest rate hike in the US; investors appear to be moving away from investing in risky economies to what is perceived as stable economies like the United States. Malaysia has seen outflows in equities and bonds, totaling nearly US \$7.6 billion.

Malaysia is not the only country that has to contend with these global economic challenges, but it has been hit particularly hard. The ringgit is the worst performing currency in Asia, having lost more than 20% of its value against the US dollar over the past year. The speed of the ringgit's decline, falling past the psychological RM 3.8 peg, is reminiscent to risk-averse investors of the Asian Financial Crisis. It has been suggested that the lack of transparency over 1MDB has lowered investor confidence contributing to the foreign capital outflows, which in turn has impacted the ringgit.

Domestic economic challenges

At the height of the 1MDB allegations against PM Najib Razak in July 2015, Malaysia's foreign reserves dived by almost 5% in two weeks as the central bank unsuccessfully attempted to maintain the ringgit at RM 3.8 per US dollar. And the sharp decline in foreign reserves coincided with the onset of publicity over 1MDB's troubles. Malaysia's foreign reserves now stand below US\$100 billion, raising concerns over its ability to defend against further currency shocks. Financial analysts also suggest that capital outflows will continue leading to further ringgit weakening.

The ringgit's diminished value has an impact on Malaysians' purchasing power. If the prices of Malaysian exports decline more than its import prices, people will end up paying more for goods. Inflation is already a concern - during January to July 2015, consumer prices rose 1.7%, and inflation is forecasted to reach 3.5% by year's end.

To compound inflationary pressures, Malaysians have to deal with two other domestic policies that further impact cost of living: removal of fuel subsidies in December 2014 and the implementation of a Goods and Services (GST) 6% tax in April 2015. From a long-term perspective, these policies are advantageous because it reduces government expenditure and raises revenue. However, wages have simply not grown enough to compensate for increases in cost of living, and people are starting to feel the pinch.

Then there is the added pressure of private household debt. Malaysia has the highest ratio of household debt to GDP in the developing world; it was debt, not wage growth that drove domestic consumption's 52% contribution to the GDP in 2014. Therefore, increases in cost of living and the economic slowdown will inevitably limit domestic spending as Malaysian households are already significantly over-leveraged in debt. This would only further hamper economic growth.

Shift from political to economic focus

When 1MDB's debt troubles first emerged, it was largely framed as a political issue; after all, it was mostly highlighted by Najib's fervent opponents. But 1MDB was quickly re-framed as an economic issue as more serious allegations emerged amid the ringgit's rapid decline and the worsening global economy; the fall-outs of which would directly impact both investor and consumer alike.

Central in their concerns is the possibility that 1MDB's debt troubles are only the tip of the iceberg, that more is yet to come. The lack of transparency over 1MDB, coupled with recent governmental actions that suggest interference, does not help assuage such fears. If a sceptical (and nervous) populace is to be reassured, Najib and the government will have to offer credible and transparent solutions to steer the country through its looming economic challenges.

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