Finance and Economic Growth in Malaysia*

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Before the Asian crisis of 1997-98, Malaysia was widely seen (after South Korea) as the Asian economy "most likely to succeed". Indeed, among the major crisis-afflicted countries of the region at that time, the Malaysian economy was the first to recover and to suggest that it could come out of the crisis to resume its impressive growth trajectory. But that crisis did actually prove to be a watershed for the country, as its subsequent development trajectory has shown not only a much slower rate of output growth, but a significant change in its pattern.

Some has characterised this as yet another example of the "middle income trap" that has become the fashionable explanation for the deceleration of growth among a number of developing economies. But a closer look at the Malaysian case suggests that there could also be a more straightforward explanation linked to the financial deregulation that occurred in the wake of the Asian crisis. So this is a case not so much of a "middle income trap" as a "finance trap".

Consider the evidence on savings and investment rates that is presented in Chart 1. The remarkable feature that is evident is the dramatic divergence between savings and investment rates that occurred after 1998. This was not because savings rates increased (as would be implied by the "savings glut" argument of Ben Bernanke and others) but because of the collapse of investment rates. Before 1997, savings and investment rates in Malaysia moved broadly together, in the very high range of 39-43 per cent of GDP, with investment usually slightly greater than savings (and financed by foreign capital inflows). In the period after the crisis, however, savings rates have remained the same or fallen slightly. But investment rates have plummeted to almost half the previous shares of GDP, to an average of only around 22 per cent in the decade of the 2000s. The slight recovery in the most recent years still leaves a huge savings surplus.

But why should this be the case? After all, according to the mainstream formula, the emphasis on financial deregulation after the Asian crisis was supposedly to encourage "financial deepening" and thereby greater and more efficient intermediation between savings and investment. If this were indeed the case, then why should rates of investment decline so dramatically?

The related question to ask would be whether the financial liberalisation measures adopted in Malaysia (which involved a range of measures including freeing banks' activities and reducing firewalls between banking and non-bank activities, reducing directed credit, allowing the entry of foreign banks, etc.) changed the extent of financial penetration. Chart 2 suggests that this was not the case. The ratio of bank credit to GDP actually fell slightly over much of the 2000s but then remained stable or increased, but without any evident impact in terms of increasing investment rates. Stock market capitalisation to GDP fluctuated substantially, but once again with no apparent relation to investment.

Chart 1

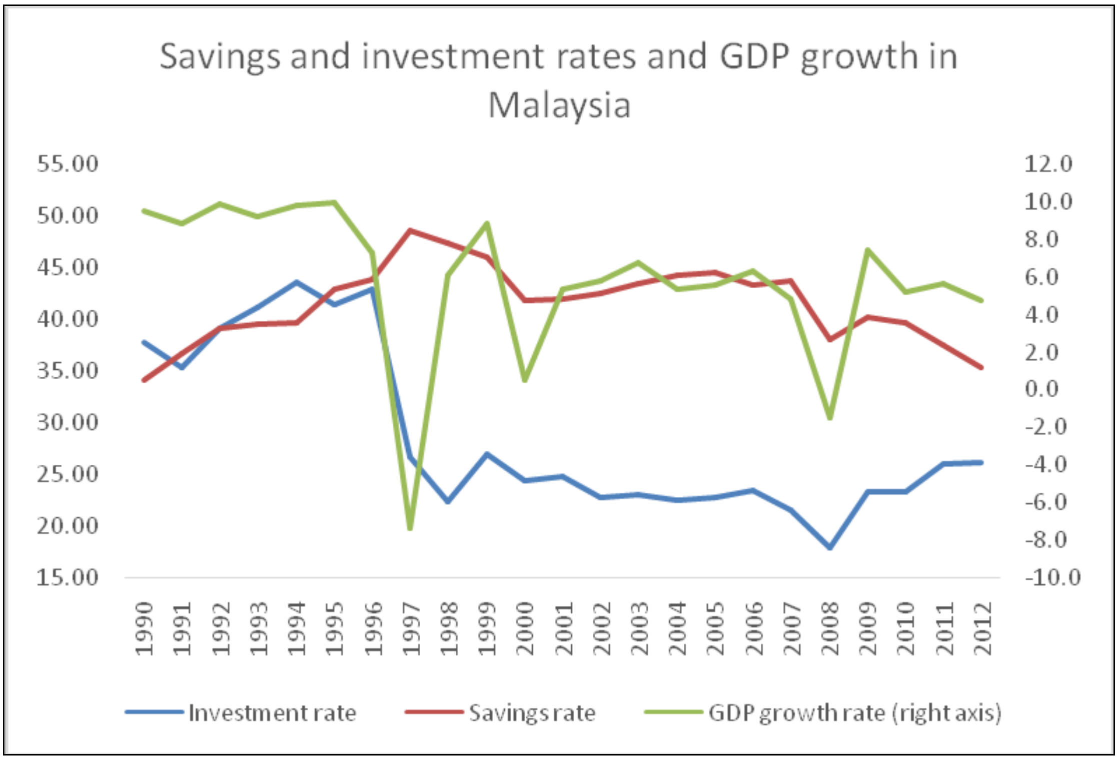
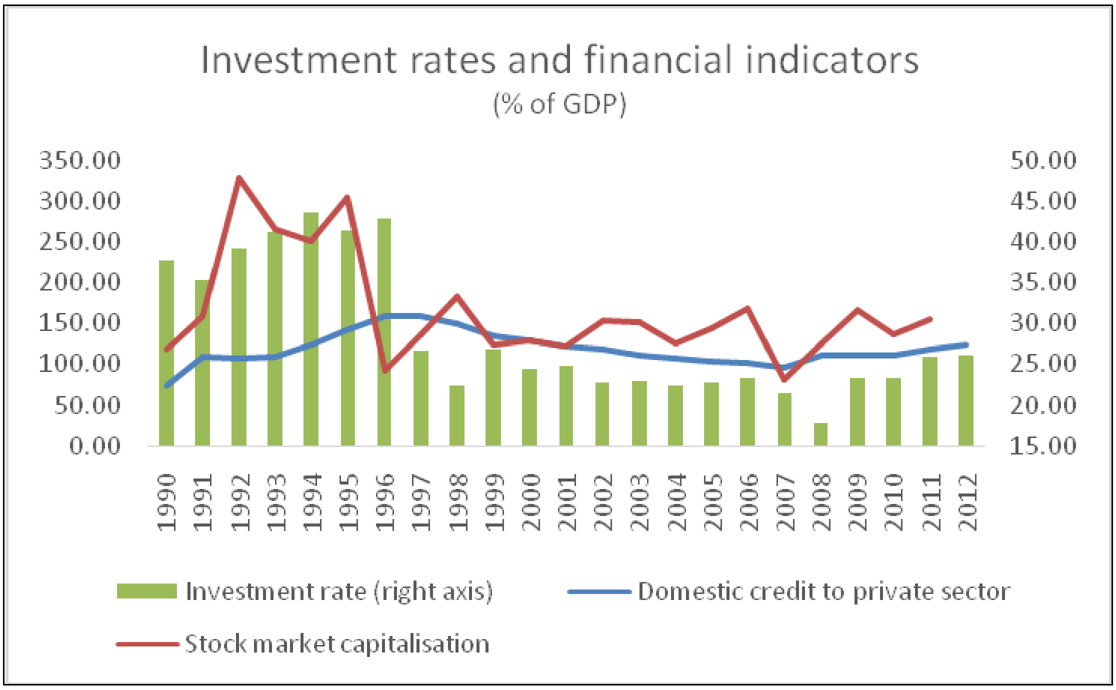


Chart 2



In the period since 2007, there has been an increase in bank credit, such that the ratio of domestic credit to GDP increased by around 25 percentage points (from 97 per cent in 2007 to 124 per cent in 2012). So where exactly has such bank credit been going? And why has it not had a more significant effect on investment?

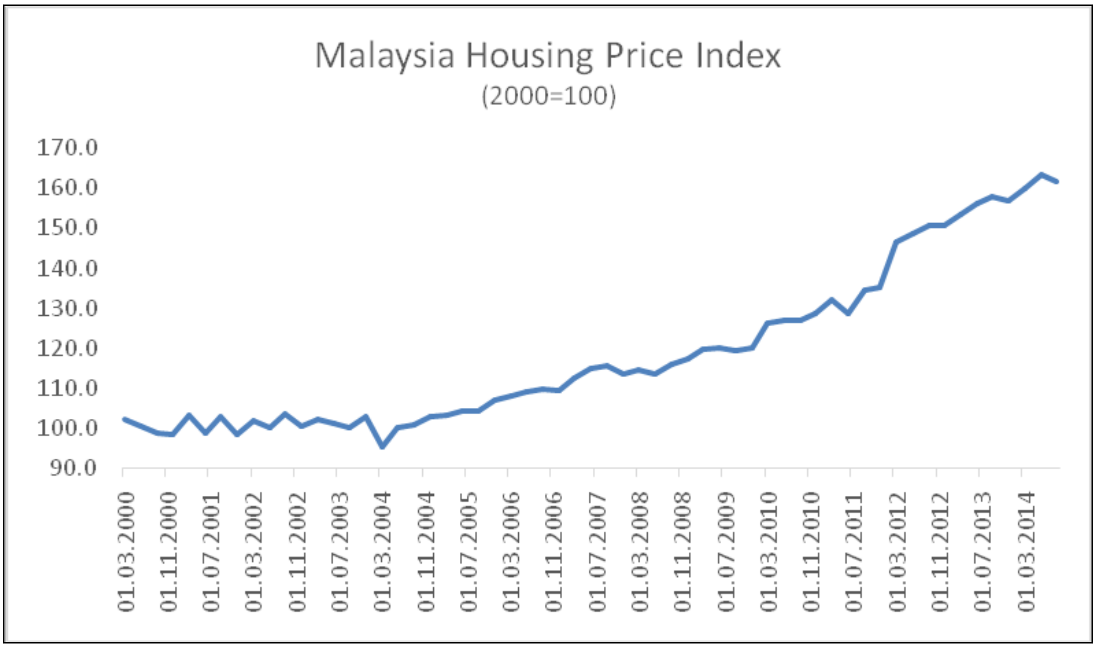
It turns out that the big increase in bank credit has not been to business (and therefore not to productive investment) but to households. The share of bank credit going to business has fallen from 65 per cent in 2000 to just under 50 per cent in 2012 – so that households account for more than half of commercial bank credit. Since this essentially means the rise of consumption loans, this is clearly not a desirable development from the point of view of growth.

A more detailed disaggregation of bank credit in 2011 found that 27 per cent of the volume of loans was for purchase of residential property, 14.4 per cent for vehicles, 3.3 per cent for credit cards and 5.1 per cent for "personal use". Working captial accounted for only 25.3 per cent, and non-residential properties for 11 per cent.

The story of credit-fuelled consumption booms is by now a stale one, and no one needs to be reminded that these usually end in tears. What is of even greater concern is that even all this unsustainable debt-driven consumption of households has not been associated with any significant increase in growth rates. So this pattern of growth is clearly problematic.

The case of housing loans is particularly important here, because unlike other household borrowing that is affected by the income stream of households and thus by GDP growth, the viability of housing loans depends critically on the value of the underlying asset. It is not surprising that house prices rose sharply suring the period when banks increased their lending for such household asset purchase. But as Chart 3 shows, they have already started coming down – and that throws the game wide open in terms of the implications for both households and banks.

Chart 3



This brief consideration of recent Malaysian experience points to some lessons that have wider relevance for many developing countries. Financial deepening does not have a positive effect on investment and real economic growth, but can generate savings "surpluses" that are then exported. In such conditions, domestic growth relies on the expansion of consumer credit that fuels housing and real estate booms. But this is obviously unsustainable and indeed the downturn has already begun in several countries. The unravelling of household debt has knock-on effect on bank viability and on investment.

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