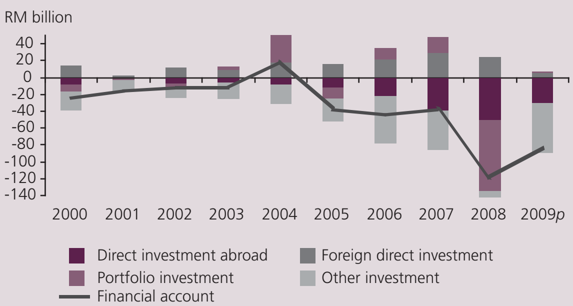
Nature and Trends of Capital Flows in Malaysia

Malaysia is one of the most open economies in the world. Throughout its development, Malaysia has been highly integrated with the global economy and international financial system, resulting in not only significant trade expansion, but also large investment flows. For more than a century, Malaysia has received foreign direct investment, which has been an important contributor to the country's economic development. As the Malaysian economy evolves to become more developed, the nature of the capital flows has changed responding to the changing conditions prevailing in the country. Two distinct developments have emerged in the recent years. First, short-term capital flows have become more prominent in the Malaysian financial system, in tandem with the global surge in this form of capital flows. Short-term flows, in particular, portfolio flows, have risen in volume and their volatility has been increasing, with potentially destabilising effects on exchange rates, the financial markets and the real economy. Second, a more recent development has been the large increase in investment abroad by Malaysian companies in search of new growth opportunities and markets.

Chart 1
Trends of Net Capital Flows in Malaysia



p Preliminary

Source: Department of Statistics, Malaysia

Chart 2
Net FDI Flows

p Preliminary

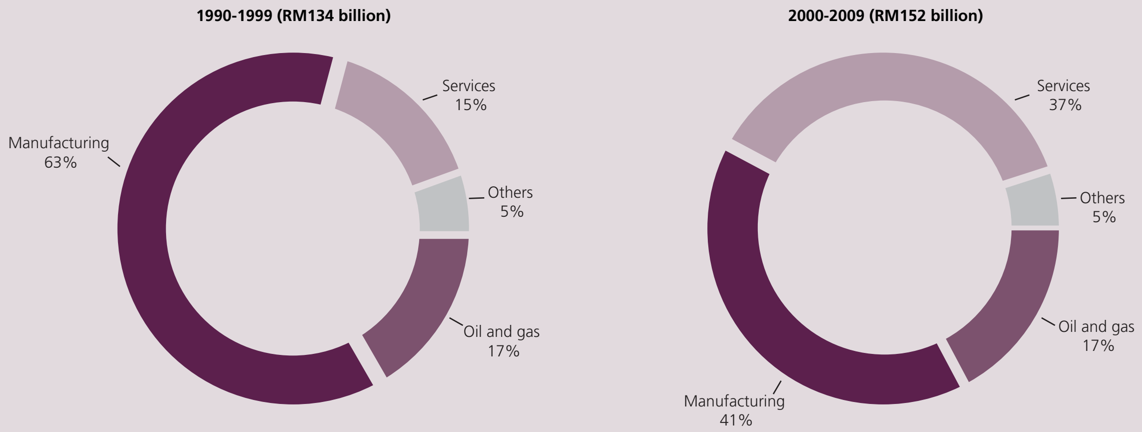
Source: Department of Statistics Malaysia

Foreign Direct Investment

Foreign direct investment (FDI) is an important contributor to the growth and the transformation of the Malaysian economy, particularly in establishing new industries, enhancing production capacity, employment, trade and technological capability. Malaysia has attracted a steady inflow of net FDI in the recent decade, averaging 3% of GDP per annum with a peak of 4.5% of GDP in 2007. However, relatively lower FDI inflows were recorded in 2001 and 2009, similar to the global trend, following the collapse of the technology bubble and the global financial crisis respectively.

In absolute volume, Malaysia recorded RM152 billion in net FDI inflows during the period of 2000-2009, higher than the RM134 billion received during the period of 1990-1999. However, as a share of GDP, the net inflows of FDI were lower during the period of 2000-2009 (3% of GDP) compared to the period of 1990-1999 (6.3% of GDP). This moderation was mainly attributed to two reasons. Firstly, the FDI inflows into Malaysia in this recent decade have increasingly been channelled into the higher value-added services sector, namely the financial services and shared services operations. The scale of the investments in these sub-sectors are less and are also less capital-intensive compared to the manufacturing sector, thus involving lower amounts. More importantly, however, is the value-add and contribution to growth of this lower amount of FDI is higher as these sub-sectors are more skill-intensive and have higher labour productivity. Secondly, the rising competition for FDI in the region from new emerging market economies such as PR China, India and Vietnam as well as established investment centres, namely Singapore and Hong Kong SAR. While global net FDI flows into the region have more than doubled during the period

Chart 3
Cumulative Net FDI Flows by Sector



Note: Others mainly consist of the agriculture and construction sectors

Source: Department of Statistics, Malaysia

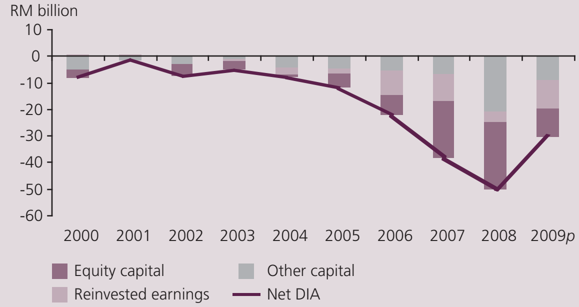
of 2000-2009 (USD1.4 trillion; 1990-1999: USD0.6 trillion), Malaysia's share of the regional FDI flows has declined as a major part of these flows went to PR China.

In terms of the sectoral distribution, inflows of FDI into Malaysia are relatively broad-based. While FDI inflows continue to be underpinned by the large and long-standing presence of MNCs in the manufacturing sector and investments in the oil and gas sector, the period 2000-2009 saw the rising importance of FDI into the services sector, with the share of FDI in this sector more than doubling to 37% of the total FDI flows (1990-1999: 15%). FDI in the services sector is well diversified, with investment being channelled to the financial services, shared services and outsourcing, communications, transportation, hotels and wholesale and retail trade sub-sectors. A significant development is the sizable increase in FDI in the financial sector, including Islamic finance. It is estimated that net FDI inflows into this sector amounted to RM41.6 billion over the recent 10-year period following the liberalisation that has been undertaken in this sector. In the oil and gas sector, investment in upstream activity continued to be significant as PETRONAS and its foreign partners continued to be actively engaged in exploration, production and the development of oil and natural gas resources in the country. Additionally, the manufacturing sector in Malaysia continues to be successful in attracting FDI in new growth areas such as renewable energy and medical equipment.

Direct Investment Abroad

An important development in recent years has been the sharp increase in direct investment abroad (DIA) by Malaysian companies, averaging 3.5% of GDP per annum between 2000 and 2009, and peaking at 6.8% of GDP in 2008. Cumulatively, net DIA amounted to RM182 billion over this period, with 78% occurring between 2006 and 2009. The increasing trend of DIA reflects the growing presence of Malaysian companies abroad, especially in the Asian region. Similar to other global companies, the factors driving Malaysian companies to invest abroad include expanding markets for their products, gaining access to more competitive supply of land and labour, expanding into rapidly growing industries, acquiring brands and technology, and taking advantage of the comparative advantage of host countries. In particular, given the relatively small domestic market, regional and global expansions allow Malaysian companies to achieve greater economies of scale by tapping into new and larger markets. Generally, Malaysian companies which invested abroad have also enhanced their domestic operations by expanding capacity and moving up

Chart 4
Net DIA Flows



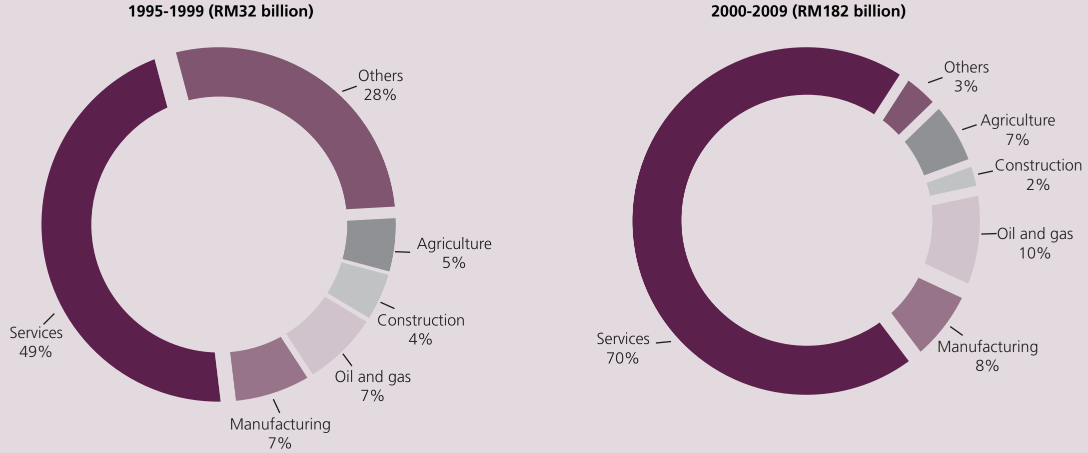
p Preliminary

Source: Department of Statistics, Malaysia

the production value chain in order to establish an integrated supply chain management with their overseas subsidiaries. This has increased their overall efficiency and enabled them to better compete in the global market. Therefore, the rising investment abroad by Malaysian companies, over a medium term, will benefit the country through having more competitive and globalised Malaysian companies, through greater job opportunities for Malaysians, higher dividends for shareholders, and higher inflows from profit repatriation.

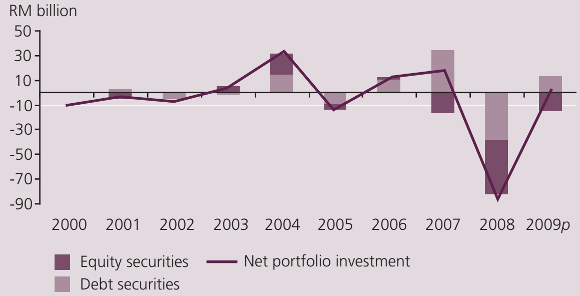
The scope of DIA by Malaysian companies has also broadened over the years. In the earlier years, investments were undertaken mainly by PETRONAS and Government-linked plantation companies, to explore the potential for further natural resources such as oil and gas as well as to increase the available land for plantation activity. This has, however, changed in recent years, with investments, mainly in the services sector, being undertaken by both the Government-linked companies and private companies, particularly in the financial services, telecommunication, utilities and business services sub-sectors. Most of the investments were undertaken in the region, particularly in ASEAN, the Asian Newly Industrialised Economies (NIEs), PR China and West Asian economies.

Chart 5
Cumulative Net DIA Flows by Sector



Source: Department of Statistics, Malaysia

Chart 6
Net Portfolio Flows



p preliminary

Source: Department of Statistics Malaysia

Portfolio Investment Flows

A key development since the early nineties has been the surge in portfolio flows to Malaysia. At its peak in 2008, total gross portfolio inflows and outflows in absolute terms were 23 times higher than in 2000. In addition, a distinct characteristic of the portfolio flows in recent years has been the increased volatility of the flows. Since 2004, there have been several episodes of large inflows and outflows of portfolio funds in response to the developments in global financial markets as well as changes in domestic economic conditions. Of significance, between 2004 and the first half of 2008, Malaysia experienced net portfolio inflows of RM54 billion. These inflows were mainly driven by Malaysia's strong economic fundamentals as well as the prospects of better corporate outlook as the economy recovered strongly following the aftermath of the Asian financial crisis. In addition, the rapid development of the domestic bond market has also attracted sizeable inflows of foreign portfolio investment into the debt securities market. The emergence of debt securities as an asset class for foreign investors alongside the equities has resulted in an increasingly diversified composition of portfolio investment flows in Malaysia.

The build-up of inflows of speculative funds in 2005 was due to the expectations for the appreciation of the ringgit which was floated on 21 July 2005. The surge of portfolio inflows since 2005 was interrupted by several external market developments which led to episodes of reversals in flows by foreign investors. Among others, the deteriorating global inflation outlook in 2006, the Shanghai stock market correction in February 2007 and the heightened global market uncertainty following the US sub-prime mortgage problem in July-August 2007 had subsequently led to outflows of foreign funds. Of significance was the massive deleveraging activities by foreign financial institutions following the global financial crisis in the second half of 2008 that triggered large-scale liquidation of portfolio funds by international investors, which affected emerging markets across the board including Malaysia. These reversals culminated in a net portfolio outflow of RM111 billion between the second half of 2008 and the first half of 2009. Nevertheless, inflows of foreign portfolio funds resumed in the second half of 2009 amid stronger growth prospects in the region as well as further normalisation of conditions in the international financial markets. This subsequently led to an improvement in investors' risk appetite for financial assets in the emerging markets, including Malaysia.

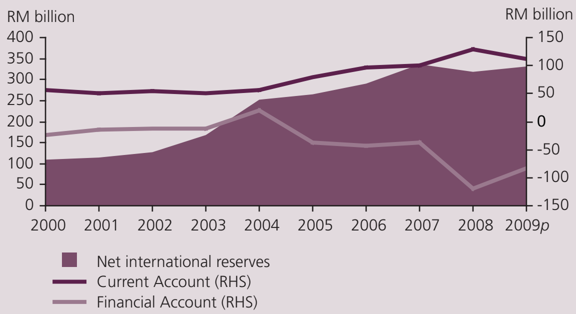
While the magnitude of the recent reversals were larger than the net outflows recorded during the height of the Asian financial crisis, the impact on the domestic economy was limited given Malaysia's well-developed financial system. In particular, the development of the debt market allowed for the diversification of the composition of portfolio flows into Malaysia. As such, the reversals of the flows did not cause a significant disruption in any particular asset market. In addition, the depth of the domestic financial market also provided greater liquidity and price sensitivity to changes in financial conditions, facilitating more effective monetary operations to sterilise the impact of large capital flows. The strong international reserves position has been able to accommodate these outflows of funds without affecting overall domestic liquidity or interrupting the normal functioning of the foreign exchange and domestic money markets. Given these conditions, Malaysia has not only been able to withstand large shifts in funds but has also managed to ride out the recent period of turbulence in international financial markets without serious disruptions to the domestic economy.

Meanwhile, portfolio outflows due to residents investing abroad have been steadily growing over the years, averaging about 3.9% of GDP during the period of 2000-2009 and were mainly in the form of equity securities. The liberalisation of the foreign exchange administration rules since 2005 has also allowed for greater flexibility for residents to invest abroad. The increase in external portfolio assets resemblance similar trends in other parts of the region, especially among the Asian NIEs in which the build-up in external portfolio assets at the international level has become increasingly significant.

Other Investment

In addition to portfolio investment, other investment comprising mainly net external loans undertaken by the official and private sectors, net placements of deposits by the banking institutions as well as trade credit extension, have consistently recorded net outflows, averaging 5.6% of GDP over the recent ten years. The net external loan repayments by both the official and private sectors have contributed to these outflows. Another component of other investment includes activities by the banking institutions in managing their liquidity. This reflected mainly placement of deposits abroad and inter-bank borrowings. These flows in the banking sector have in part been responsive to interest rate and liquidity movements. The non-bank private sector experienced an outflow during this period, due mainly to extension of trade credits by Malaysian exporters and repayments of trade credits by Malaysian importers. These flows have been fairly volatile and large, and they were mainly driven by financing requirements and business decisions of the non-bank private sector.

Chart 7
Movement of International Reserves



p Preliminary

Source: Department of Statistics Malaysia

International Reserves

The changes in net international reserves over this recent decade have been shaped by developments in both the current and financial accounts of the balance of payments, particularly movements in portfolio investments. With current account surplus exceeding financial account deficits, there was a build-up of external reserves from 2001-2003. The large inflows of portfolio funds from 2004 up to the first half of 2005 coupled with the continued surplus in the current account resulted in a significant increase of international reserves from RM168 billion (USD44.2 billion) as at end-2003 to RM297.1 billion (USD78.2 billion) as at end-July 2005. While a significant amount of these inflows were attracted to the investment opportunities provided by the deepening Malaysian capital market, there were also significant speculative portfolio inflows over this period in anticipation of the ringgit exchange rate realignment. These speculative inflows reversed in the second half of 2005 after the ringgit was floated in July 2005 and reserves stabilised at RM265.2 billion (USD70.2 billion) as at end-2005.

In 2007 and the first half of 2008, Malaysia again received substantial capital inflows, particularly portfolio funds. These large capital inflows coupled with the current account surplus, resulted in a significant appreciation of the exchange rate and an increase in the international reserves which peaked in June 2008 at RM410.9 billion (USD125.8 billion). The significant deleveraging activities following the intensification of the global financial crisis led to a large reversal of portfolio flows of RM111 billion between the second half of 2008 to the first half of 2009, resulting in a substantial decline in the international reserves to RM322.9 billion (USD91.5 billion) as at end-June 2009. The decline in reserves during this period is less than the net portfolio outflow as Malaysia continued to record a current account surplus during this period. The portfolio inflows resumed since the second half of 2009. The external reserves as at end-2009 amounted to RM331.3 billion (USD96.7 billion). This reserves position was sufficient to finance 9.7 months of retained imports and is 4.3 times of the short-term external debt. As at 25 February 2010, the net international reserves was amounted at RM331.8 billion (USD96.8 billion).

Conclusion

This review of developments in capital flows in Malaysia over the recent ten years has brought to the forefront several important policy considerations for Malaysia moving forward. First, investments abroad by Malaysian companies can be expected to continue to remain sizeable in the future and this development is in response to the changing structure and competition in the region and in the global economy. The changing composition of capital flows would contribute to Malaysia's long-term competitiveness, economic transformation and growth. Second, competition for FDI will continue to intensify, going forward. Malaysia has shifted gear to attract FDIs in the high value-added activities and those that will bring in new technology, required to support Malaysia's transition into a high income economy.

The third, is the challenge with respect to managing the increasingly volatile nature of short-term capital flows. The strategy adopted is to further deepen and broaden the domestic financial system to cope with and manage the volatile capital flows without resulting in disruptions and instability in the domestic financial markets. Malaysia has also consistently maintained vigilance over developments in capital flows through close surveillance and assessments of the risks associated with these flows. Maintaining Malaysia's strong macroeconomic fundamentals and a sound and strong banking system will provide the flexibility for the country to intermediate volatile capital flows while maintaining financial stability and promoting growth in the domestic economy.