External Resilience: An International Balance Sheet Perspective

Introduction

One of the key strengths of Malaysia's economy lies in its strong external position. Despite the on-going global financial turmoil and the consequent deleveraging activities which had caused an outflow of capital from emerging economies, the external position of Malaysia remains resilient. This is reflected in a sustained sizeable current account surplus, a relatively low level of external debt and a high level of international reserves.

Assessment from the international balance sheet perspective

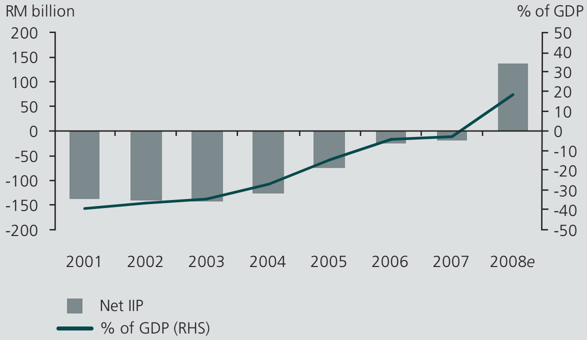
In addition to the traditional flow-based analysis of the balance of payments, the strength of the external sector could be analysed from the international balance sheet perspective. The international balance sheet is generally represented by the international investment position (IIP), which measures the stocks of the external financial assets and liabilities of a country. Analysis of the size and composition of the IIP facilitates identification of possible sources of vulnerability in the country's external financial position in the event of a shock.

During the period 2001-2008, Malaysia's external position has improved substantially (Chart 1). The net IIP of Malaysia strengthened from a large net liabilities position of RM137.6 billion as at end-2001 to a small net liabilities position of RM18.2 billion as at end-2007. This position improved further to a net assets position of RM138.3 billion as at end-2008. The improvement in the external position was due to faster accumulation of external financial assets relative to the build up in the external financial liabilities.

Since 2001, the **total external financial assets** of Malaysia more than tripled to RM778.4 billion as at end-2008 (Chart 2). The large increase was due mainly to:

i. the higher direct investment abroad by Malaysians, at RM240.3 billion (or 32.4% of GDP) and accounted for 30.9% of the total external financial assets as at end-2008, reflecting the diversification and expansion of Malaysian companies abroad. These investments have yielded positive results as shown by the rising profits and dividends accruing to the Malaysian companies from their operations abroad (2008: +RM14.4 billion; 2001: -RM0.2 billion); and

Chart 1
Net International Investment Position (IIP)



e Estimate
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

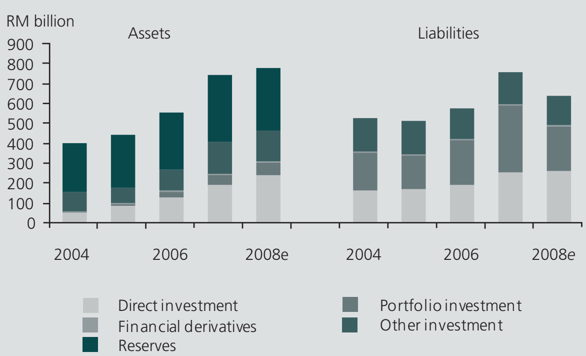
ii. the large build up in international reserves to RM317.4 billion as at end-2008, which accounted for 40.8% of the total external financial assets. The accumulation of reserves since 2001 was attributed largely to the favourable current account surplus and steady inflows of foreign direct investment (FDI). The increase in reserves was also contributed by large inflows of portfolio funds, particularly in 2007 and early part of 2008. Nevertheless, these inflows were subsequently reversed in the second half of 2008 due to the deleveraging activities following the intensification of the global financial turmoil.

Meanwhile, the **total external financial liabilities** almost doubled during the period 2001-2008, to RM640.1 billion as at end-2008. The increase reflected mainly inflow of long-term capital as well as foreign investment in the domestic capital market. During this period, Malaysia received a net inflow of FDI at an average of 3.1% of GDP, and the stock of FDI increased from RM129.1 billion to RM262 billion (or 35.4% of GDP) as at end-2008, reflecting Malaysia as an attractive destination for FDI. The external debt of the economy continues to be low, at 31.8% of GDP as at end-2008, with the debt profile remaining skewed towards a longer maturity structure. Following the recent large reversal of capital flows, a significant proportion of the remaining foreign investment in the domestic capital markets reflect the strategic long-term holdings by foreign investors.

The assessment of the external position indicates limited risks arising from maturity, currency and capital structure mismatches.

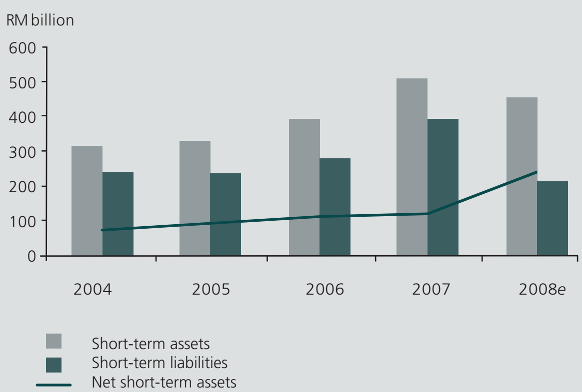
- The sustained net short-term assets position indicates minimum risks of maturity mismatch (Chart 3). The larger short-term assets relative to liabilities demonstrates the strong ability of the economy to service its maturing short-term external obligations, and thus, is unlikely to face liquidity constraints.
- The total foreign currency assets of the economy far outweigh the total foreign currency liabilities (Chart 4). This indicates a low risk of currency mismatch, and therefore, reduced vulnerability to exchange rate shocks.
- From the capital structure perspective, external financing in the form of debt is smaller than that of equity (Chart 5). The increase in the debt-to-equity ratio in 2008 was due mainly to large liquidation of non-strategic equity holdings by foreign investors following the global deleveraging activities in the second half of 2008. The relatively higher external financing through equity reduces solvency risk as equity obligations, in the form of profits and dividends, are not mandatory. In contrast, debt obligations, in terms of the debt servicing and repayment schedule, remain generally unchanged even under adverse economic conditions.

Chart 2
International Investment Position by Broad Components



e Estimate
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 3
Short-term Assets and Liabilities



e Estimate
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 4
Foreign-currency Assets and Liabilities

e Estimate

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 5
Capital Structure of External Liabilities

e Estimate

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Role of policy in strengthening the external position

The increasing resilience of Malaysia's external sector could be attributed to the policies and strategies adopted, in particular, the further liberalisation of the capital account. The liberalisation has been undertaken on a gradual and sequential basis, taking into consideration the state of the domestic economy, the level of development of the domestic financial system, the strength of the balance of payments position and global developments. Prudential rules are in place to ensure sound external debt management, particularly to reduce risks associated with large external obligations, servicing ability and uncovered positions. While the business and investment climate is continuously being improved to attract FDIs, local companies are also encouraged to invest abroad to expand business opportunities available in the regional and international markets, establish market presence globally and provide greater synergy to domestic businesses. With the increase in international reserves and complexity of asset classes and instruments amidst the challenging operating environment, the reserves management strategy and practices have progressively been enhanced to improve risk adjusted returns while maintaining the traditional objectives of capital and liquidity preservation.

Conclusion

The strong external position is one of the key strengths of Malaysia's economy, particularly during this period of heightened uncertainty in global financial and economic conditions. It is recognised that the openness of the Malaysian economy renders the country more susceptible to vulnerabilities arising from external developments. Thus, it is important to ensure that appropriate policy measures are taken continuously to further enhance the resilience of the external position. In addition, close surveillance and monitoring of global economic and financial conditions as well as strong co-operation and regular engagement with the regional economies are critical for early detection of risks and vulnerabilities in the external position.