The Phenomenon of Economic Inertia

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Abstract

This paper explores the concept of economic inertia, and takes Malaysian economic performance as an example to support the phenomenon. An examination of available economic data by Bank Negara Malaysia and other independent economic monitoring agencies, in addition to data available to the World Bank and IMF, was utilized in the analyses. This research concludes that since nations strive to compete and grow economically, some countries find themselves by design in an uncompetitive position. Economic deficiencies in the form of lack of adequate actions when actions are needed, allow a monitory or fiscal policy to play out without early assessment of full impact on the economy. Ineffective social institutions, productivity, investments and policies, massive borrowing rates and high reliance on natural resources cause the phenomenon of economic inertia, whereby a country inflicts upon itself an uncompetitive economic position in comparison to other competitive nations.

Keywords: Malaysia, Economic Crisis; Economic Inertia, monetary, fiscal policy, Asia and Emerging Market Economies

1. Background and statement of the problem

The concept of inertia in social science was made famous by Karl Weick (1995). It assumes that organizations reach a point in which there is a gap between environmental change and organizational adaptation ability. This concept, we believe, extends to nations as well as organizations. The concept of economic inertia proposed here suggests that countries willingly put themselves in a position that lacks economic growth primarily because of inability to take corrective action mainly because of institutional and social factors. The social capacity of a population is comprised of psychological and cultural norms and mores that shape and dictate individual's capacity and collective capabilities. Richard Vietor of HBS (2012) argued that countries compete for growth and foreign direct investments to gain wider access to the global marketplace. Vietor (2012) also asserts that certain countries are economically stuck in the middle of competitive positions. Countries such as Malaysia, Mexico, Chile, Argentina, Turkey, Brazil, South Africa and Colombia are examples of this theory. They are caught between high-value added exporters such as Korea, Singapore and Taiwan, and low-cost exporters such as China and India (Vietor, 2012).

This research takes the Malaysian economic performance as an example of economic inertia and how lack of ability to move beyond current economic position, will create mid to long-term economic challenges. Although over the past 12 years, the economic performance of Malaysia showed an uninterrupted growth, yet the economic management of the country, accompanied by a monetary easing policy between 2008-2014, contributed to the grim, long-term economic outlook for Malaysia. To avoid being inflicted by the 2008-9 financial crisis, Malaysia, like many South-East Asian countries, Malaysia found itself in the midst of a global economic crisis and at a junction between slowing global demand, and economic growth in Asia, lead by China. Also bitter memories of the 1997 Asian financial crisis left Malaysia with better banking capitalization (Bank Negara, 2005; Rasiah and Shari, 2001), largely due to the sound monetary and fiscal policy implementation by Bank Negara. However, the implementation of accommodative monetary policy during and after the 2008 financial crisis in Malaysia has contributed, in part, to the alarming mid to long-term economic outlook.

Since 2009, the accommodative monetary policy in Malaysia, in the form of available credit, in addition to liquidity in the business sector, high government expenditure and FDI, helped sustain an average of above 5% economic growth. This, in turn, contributed to an asset bubble in the real estate market, a budget deficit, and a government borrowing and spending spree. Fitch was the leading rating agency to highlight Malaysia's financial standings, and to confirm that the long-term outlook for Malaysia would be turbulent. Finally, in late 2013, Bank Negara took measures to curb consumer lending by limiting the number of years on personal loans, and in 2014 Bank Negara imposed new rules on mortgage lending to a curb in the amount of borrowing. However, such measures came too late, as the bubble had already been created, the direct result of the negative effect of such accommodative monetary policies. In 2015, oil prices began to drop sharply, adding to the economic troubles of Malaysia, whose oil and gas income is estimated at 35% of GDP.

2. Research objectives

The objectives of this research is to examine policies pursued by Bank Negara Malaysia, and the impact such policies have had on the current Malaysian economic outlook. Another objective of this research is to determine whether the lack of action by the central bank and government policies can lead to a phenomenon of economic inertia.

3. Research questions

The research questions are;

1. Does Malaysia suffer from economic inertia?
2. Is the Malaysian economy able to sustain large public debt and withstand future global economic shocks?
3. Are current and long-term economic problems self-inflicted and can be described as economic inertia?

4. Theoretical Framework

Richard Vietor's (2012) argument that Malaysia, as a growing economy is stuck in the middle of a globally competitive market and unable to move beyond its current economic position provides the theoretical basis of this research. Malaysia is neither able nor willing to break out of its economic inertia in order to compete with rivals, on the basis of cheap labor, innovation and high-tech manufacturing bases. Reviews of public policy and private sector borrowing behavior, accompanied by productivity and social development, is the basis for the framework development of this research, since it is believed to be among the underlying bases in the creation of the economic inertia phenomenon. The mixed empirical analyses on the relationship between the central bank and government policies are examined in the frame of historical and most recent economic performance indicators.

5. Significance of the study

This study is essential to the understanding of the degree of economic management success or failure. Also, Malaysia's ability to meet its future financial obligations in the event of future financial shocks to the global economy, and whether the Malaysian phenomenon is a pattern that extends to other developing and natural resources based economies. The theory of economic inertia can help in the prediction of the limitations of countries and the role they play within the global economy.

6. Methodology

This is an exploratory research that investigates the theoretical hypothesis of economic inertia. The researcher has observed a phenomenon of lack of willingness to take a corrective action amongst several central banks and attempts to investigate this phenomenon starting with Malaysia, and then expand the research to include other countries. of this research consisted of secondary data analyses obtained from the Malaysian Ministry of Finance, the Malaysian central bank (Bank Negara Malaysia) World Bank, IMF, and the Economic Planning Unit of the Prime Minister's department and other independent economic monitoring and reporting agencies such as Fitch Rating, Bloomberg, xe.com and Tradingeconomics.com. Historical data was compared and contrasted with socio-economic policies to determine causes of economic positioning.

7. Data Analysis/Results

To avoid the spillover effect of the 2008-2009 financial crises, the Malaysian Central Bank (Bank Negara) increased money supply in various forms. This policy facilitated an increase in household lending. The increase of money supply to both the business sector and individual consumers contributed to the inevitable increase in the inflation rate, which dramatically affected the real income of the majority of Malaysians, and corroded purchasing power in the long-run. The easing of lending by the banking system for individuals was based primarily on gross income. Bank Negara made adjustments to curb exposure risks stemming from rising household debt by introducing new regulations on individual loans, basing them on net income and with a 10 year limitation cap on all loans (Bank Negara Announcement, July 2013). The tightening of domestic credit measures was late in introduction, and thus, contributed to the inflation Malaysia is experiencing today.

Graph 1: The Malaysian Money Supply M3. Source: wwwtradings.com, Bank Negara Malaysia

This is coupled by excess in lending provided to the business sector in the form of bank loans and corporate bonds, which was mainly invested, not in research and development, or support and creation of new industries, but rather in the real estate market. The Malaysian corporate lending in 2013 reached 95.8% of GDP, in comparison to 79.9% in 2007 (Bank Negara Malaysia, 2014), which created a real estate overvaluation or otherwise known as a real estate bubble.

Since the majority of household debt is in the form of household loans, with high borrowing in the corporate sector, this puts extra strains on the economic performance of Malaysian banking sector, which could, as a result, fail to meet its obligations if a global economic crisis started somewhere and have a trickle down effect on Malaysia. Such a scenario is similar to the one in Dubai in the post 2008 financial crisis, when both the government of Dubai and the banking sectors were deeply in debt, and defaulted on their financial obligations. However, both the government of Dubai and the banking sector had the leverage of being bailed out by the central government of Abu Dhabi, since they are part of the Union of the Emirates. Such facilities will not be available to the Malaysian government in the event of an outburst of a global financial crisis, but will put Malaysia in dire straits and deeper in debt as part of a debt restructuring program.

Malaysia's public debt-to-GDP ratio is the second highest amongst emerging Asian countries (Appendix 6) at 53.3% of nominal GDP (Bank Negara, 2013) or about RM501.6 billion. This number excludes additional loans of about $51 billion USD guaranteed by the Malaysian government issued to non-financial enterprises to finance various projects (Bank Negara, 2013). All public data available indicates that the level of borrowing in the form of bonds and Islamic Sukuk is rising to finance public projects (Ministry of Finance, 2013). This puts additional constrains on the financial management of the Malaysian economy by creating heavier burdens on future Malaysian governments when balancing their budgets, which, in turn, will most likely lead to additional tax hikes.

The influx of capital inflows into Malaysia in the post 2008 financial crisis caused, in a short period of time, an overvaluation of the Malaysian Ringgit by about 25% against mainly the U.S. dollar (Appendix 5). Such an influx of capital inflow and massive increase in holdings of the Malaysian Ringgit denominated bonds by foreigners reached an all time high during the second quarter of 2013 (Bloomberg, 2013), causing the Kuala Lumpur Composite stock index to rise 120%, which badly affected Malaysian exports, specially when Malaysia is a commodities and natural resources export-based economy. This did not help Malaysia in an environment of softening commodity prices in 2014. The combination of policies pursued by the central bank of Malaysia, governmental economic planning with emphasis on the creation of growth, and accumulation of public debt by the government, household and business sector formed a phenomenon of economic inertia, i.e. the lack of ability to undertake corrective measures to this awry economic situation. The fall of the Malaysian Ringgit against the U.S. dollar and other major currencies in the first quarter of 2015 reflected the weakness of the economy, especially in light of the dropping oil prices (Appendix 5).

Hence, the Malaysian monetary policy needed adjustment and restructuring early in 2010 rather than the post-election of 2013. The above 5% economic growth during the past five years was largely accomplished through debt creation and a budget deficit that will lead inevitably to a future recession. The Fitch downgrading of the Malaysian economic outlook in the third and fourth quarters of 2013 to "A-", which is the fourth lowest investment grade, is justly founded and confirms the findings of this research. From 2010 to 2013, public finances, budget deficit and debt-to-GDP hindered Malaysia's financial standing and ability to manage future obligations, and caused the government to increase taxes and lift subsidies on essential commodities such as flour, sugar, oil, gas, fuel and tobacco from. The post-2008 financial crisis accommodative monetary policy pursued by Bank Negara should have been revered in mid 2010 to avoid massive accumulation of debt in the form of personal and business sector loans, in order to halt the creation of the economic bubble. The Malaysian monetary policy pursued in the post-2008-09 financial crisis allowed for massive accumulation of public debt and alarming debt-to-GDP ratio.

The failure to avoid future economic crisis is a shared responsibility of both the leading government and the central bank of Malaysia. A revamping in the economic fundamentals and political reforms is urgently needed to avoid a dangerous exposure of the economy to any changes in the global economic environment.

Economic deficiencies in the form of lack of adequate action when needed, which allows monitory or fiscal policies to play out without early assessment of full impact on the economy, together with ineffective social institutions and productivity rate, ineffective investments and policies, massive borrowing rates and high reliance on natural resources, cause the phenomenon of economic inertia. Economic inertia also suggests that a country inflicts upon itself an uncompetitive economic position in comparison to other global competitors. These findings are supported by the recent 1MDB fiasco and the large depreciation of the Malaysian ringgit. Although Malaysian is experiencing a current account surplus, yet the depreciation in commodity prices and political fiasco caused investors unrest and willingness to take money out of the country.

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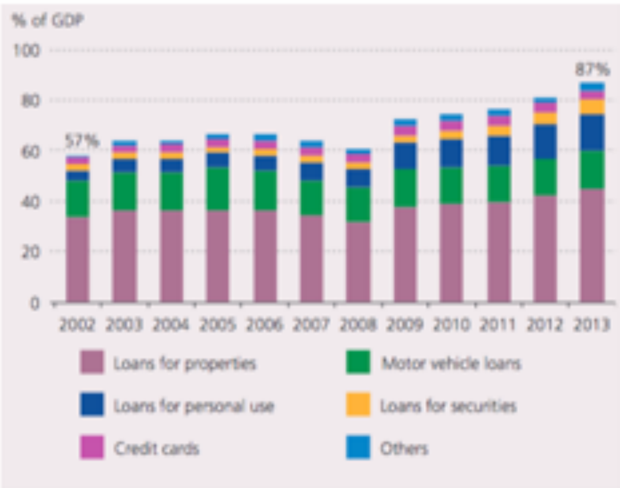
Appendix 1

Consumption of Household Debt.



Source: Bank Negara Malaysia

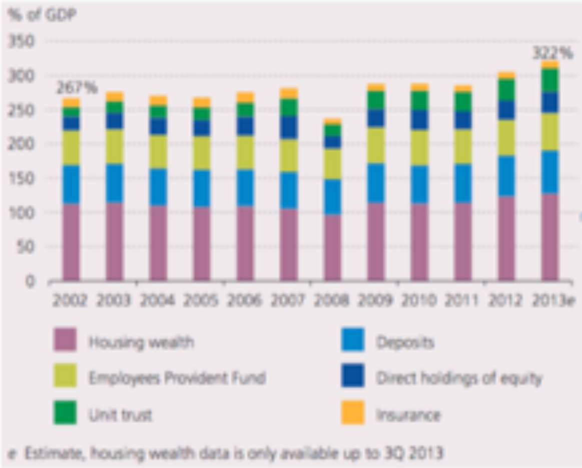
Appendixes 2

Malaysia bank lending rate

Source: www.tradingeconomics.com, Bank Negara Malaysia.

Appendix 3

Comparison of household assets



Source: Bank Negara Malaysia estimates

Appendix 4

House Price Index (2000=100)

Source: Globalpropertyguide.com

Appendix 5

Malaysian Ringgit exchange rate to the U.S. Dollar

Source: www.xe.com January 16, 2015

Appendix 6

Malaysian Government debt-to-GDP

Source: www.tradingeconomics.com, Bank Negara Malaysia.