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**THE STOCK MARKET AND ECONOMIC  
DEVELOPMENT IN MALAYSIA**

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## THE STOCK MARKET AND ECONOMIC DEVELOPMENT IN MALAYSIA

### Introduction

The Kuala Lumpur Stock Exchange (KLSE) has experienced rapid growth and a series of reforms since 1990. New instruments, trading systems and regulatory frameworks have been put in place in order to widen and deepen the stock market. Within six years, the market capitalisation tripled, rising from 114.7 per cent of GDP in 1990 to 323.3 per cent in 1996, with 621 listed companies. Value traded in 1996 was at an all time high of RM463.3 billion, with 66.5 billion shares changing hands (Table 1). The daily turnover on the KLSE went up sharply to 268 million shares worth RM1.9 billion, in 1996.

Malaysia's stock market ranks high on the list of emerging stock markets. Some useful insights about its development, as compared to other emerging markets can be inferred from aggregate figures on listing, trading and new issue activity shown in Figures 2 to 5. Its share of total emerging market capitalisation doubled from 7 per cent in 1989 to 14 per cent in 1996 (Figure 1). In terms of market capitalisation, it was the largest market in ASEAN and the fourth largest in Asia, after Tokyo, Osaka and Hong Kong (Bank Negara Malaysia, 1997: 143). What explains such rapid stock market growth in Malaysia? Does the Malaysian stock market evolve and expand without government stimulus, as claimed by Drake (1986: 124). The next section of this paper attempts to address these issues.

Until recent years, the contribution of the stock market to economic development did not gain much attention for development economists.

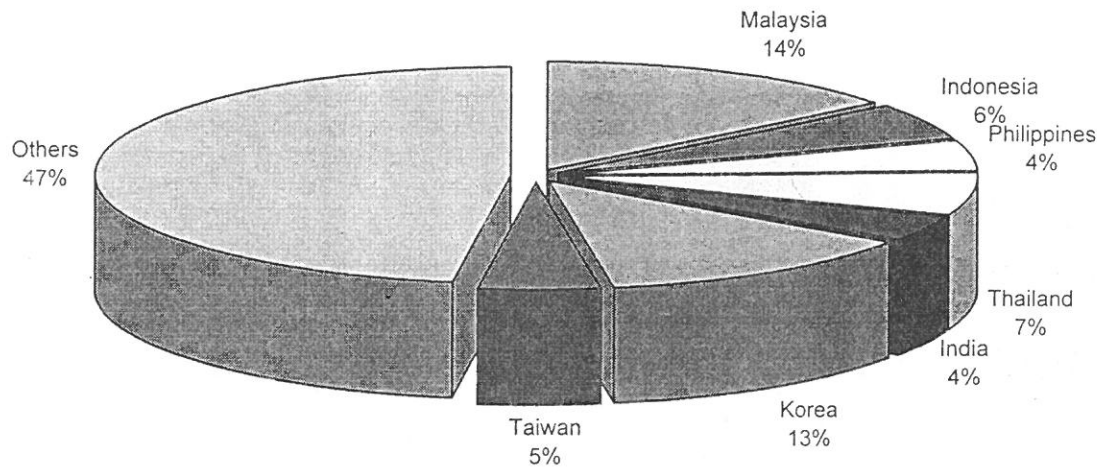
Recent academic research on the comparative failure of the stock market-based financial systems of the United States and the United Kingdom—relative to the bank-based financial systems of Germany and Japan—raises the question of the impact of stock market growth for financing economic development (Dertouzos, Lester and Solow, 1990; Mayer, 1988 and Vittas, 1986). While one strand in the literature argues that stock markets help economic growth by increasing the rate of investment and improving the productivity of investments (Levine and Zervos, 1995; Levine, 1996), another strand stresses the negative impact of stock market on the rate of investment, the time horizon of listed firms and economic development (Singh, 1992, 1995, 1997). In the light of these competing perspectives, the following section briefly reviews the recent literature on how stock market may hinder rather than promote economic growth. Given the swift expansion and modernisation of the local stock market especially during 1990-96, the final section examines the implications of Malaysian stock market growth during the period for the economy, particularly its contribution to aggregate savings, investments and output growth.

*Table 1* Kuala Lumpur Stock Exchange: Selected Indicators, 1990-96

	1990	1991	1992	1993	1994	1995	1996
Price indices							
Composite	506	556	644	1275	971	995	1,238
EMAS	131	141	162	384	284	279	348
Second Board	-	127	140	352	261	299	576
Total turnover							
Volume (billion units)	13.1	12.4	19.3	107.8	60.2	40.0	66.5
Value (RM billion)	29.5	30.1	51.5	387	328.1	178.9	463.3
Market capitalisation (RM billion)	132	161	246	620	504	566	807
Market liquidity:							
Turnover value/market capitalisation (%)	22.3	18.7	20.9	62.4	65.1	31.6	57.4
P/E ratio	25	24	23	48	28	24	28

Source: Bank Negara Malaysia Annual Report, 1991-1997 issues

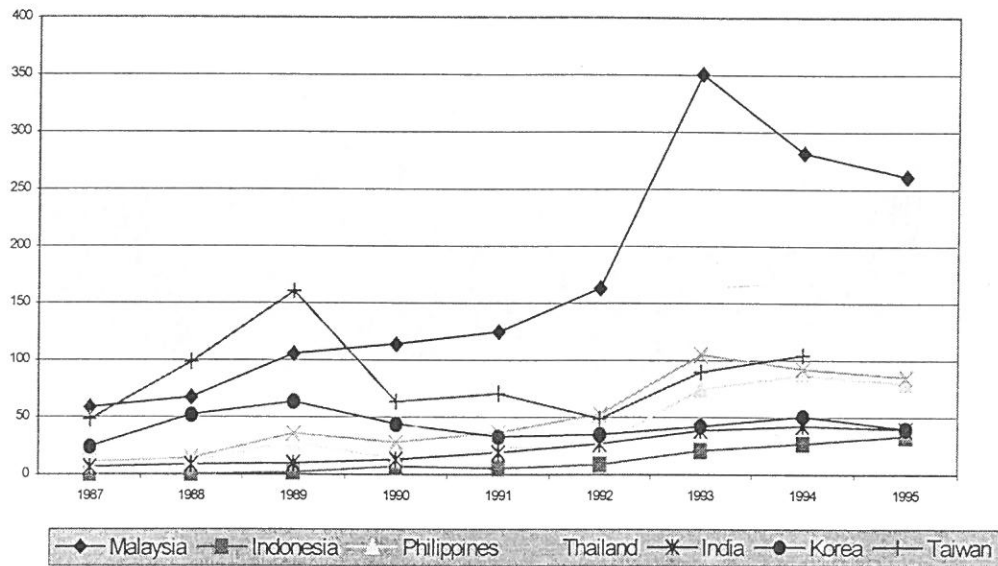
Figure 1 Share of Total Emerging Market Capitalisation, 1996 (%)



Notes: 1. 44 markets covered by Emerging Market Data Bank  
2. Total emerging market capitalisation at the end of 1996 was US\$2.162 billion.

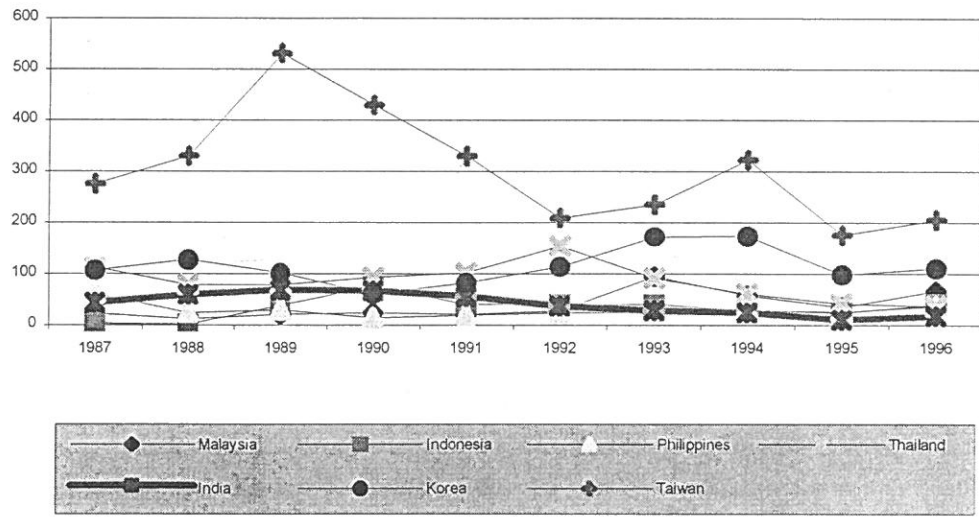
Source: IFC, *Emerging Stock Market Factbook*, 1997

Figure 2 Ratio of Market Capitalisation to GDP of Selected Emerging Stock Markets, 1987-95 (%)



Source: IFC, *Emerging Stock Market Factbook*, 1997

Figure 3 Turnover Ratio of Selected Emerging Stock Markets, 1987-96 (%)



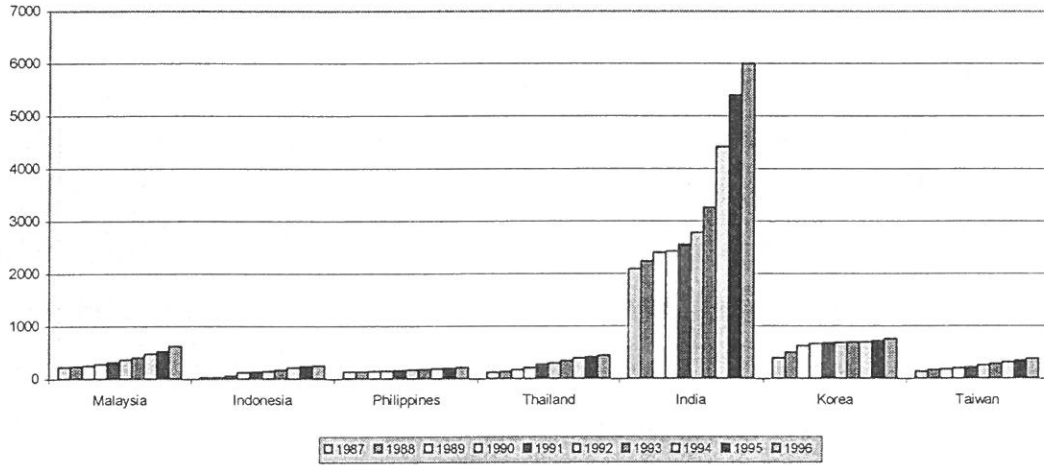
Source: IFC, *Emerging Stock Market Factbook*, 1997.

Figure 4 Price Indices of Selected Emerging Stock Markets, 1987-96



Source: IFC, *Emerging Stock Market Factbook*, 1997.

Figure 5 Number of Listed Companies in Selected Emerging Stock Markets, 1987-96



Source: IFC, *Emerging Stock Market Factbook*, 1997.

### What Explains Stock Market Growth in Malaysia?

The Malayan Industrial Development Finance<sup>1</sup> (MIDF)—proposed in the 1955 World Bank Report for post colonial Malaya to help foreign companies tap the country's capital market—ultimately led to the official establishment of a stock market in the country (Jomo, 1986). Although share trading had begun as early as the 1870s with the presence of British companies dealing primarily in rubber, tin and international trade, public trading of stocks and shares was not undertaken until May 1960 when the Malayan Stock Exchange was established (Drake, 1969: 210; Zeti, 1989: 90-1). It was renamed the Stock Exchange of Malaysia in 1964 after the formation of Malaysia on 14 September, 1963 and then the Stock Exchange of Malaysia and Singapore after the separation of Singapore from Malaysia in 1965, continuing to operate as a unified stock exchange with separate trading rooms in Kuala Lumpur and Singapore (Zeti, 1989: 92). To reduce the KLSE's vulnerability and subordination to the Stock Exchange of Singapore (SES), the government decided to totally separate the local stock exchange from the SES in 1990 by delisting all Malaysia-incorporated companies from the SES.

As noted by Singh (1995: 27), contemporary stock market development in many developing countries has not been a spontaneous response to market forces; governments have played a major role in the expansion of these markets. This is particularly true of Malaysia. Between September 1961 and June 1964, the embryonic stock market enjoyed a short-lived major boom (Drake, 1975) before it turned bearish<sup>2</sup> and was plagued by the existence of counterfeit shares from 1965, though economic conditions during the year were relatively buoyant. Under the supervision of the Capital Issues Committee (CIC) and with the government requirement



that companies granted pioneer status tax relief go public, there was a marked recovery in new market issues from 1968 (Zeti, 1989: 97).

Since the promulgation of the New Economic Policy (NEP) in 1970, redistribution, especially along inter-ethnic lines, has been the most important government policy priority. Since 1976, firms issuing shares to the public have to offer 30 per cent of their equity to Bumiputeras<sup>3</sup>. The Foreign Investment Committee (FIC) has in practice become an important government body to monitor and influence non-Bumiputera and foreign owned corporations to restructure their equity to comply with the NEP's ownership regulations. Together with the FIC, the CIC set the price of shares issued by local Chinese and foreign firms to Malay interests, including special government by-financed investment funds for Bumiputeras. The prices were usually set below market prices<sup>4</sup> to ensure positive returns for these special investment funds as an incentive to speed up acquisition of corporate assets on behalf of Bumiputeras. Ariff *et al.* (1993) argue that the excessive underpricing of Malaysia's initial public offerings (IPOs) (Table 2) was mainly due to government intervention in the price setting mechanism, and not merely the consequence of asymmetric information, winner's curse or *ex ante* uncertainty or seasoning.<sup>5</sup> Excessive underpricing of new issues has meant good prospects for capital gains through immediate sale in the market after successful subscription allocation, resulting in the oversubscription of new issues, particularly in the case of Second Board new listings (Tables 3 and 4). The possibility of making a quick fortune, as well as capital gains tax exemption, have encouraged even more to subscribe to new shares (Ng, 1989: 44).

**Table 2 Summary of Research Findings on IPOs in Developed and Developing Markets**

	Year of Study	No. of Issues Studied	Percentage Underpricing
<u>U.S.</u>			
Newberger and Lachapelle (1983)	1975-80	118	27.3
Ritter (1984)	1960-87	1,028	26.5
Ibbotson, Sindeler and Ritter (1988)	1960-87	8,668	16.4
<u>U.K.</u>			
Buck, Herbert and Yeomens (1983)	1965-75	297	9.7
<u>Malaysia</u>			
Dawson (1985)	1978-83	21	166.0
Othman Yong (1991)	1983-88	33	154.0
Mohamed Ariff et al. (1993)	1975-89	65	135.0
<u>Singapore</u>			
Dawson (1984)	1979-83	29	39.5
Koh and Tee (1985)	1973-84	62	33.8
Wong and Cheng (1986)	1975-84	9	36.8

Source: Adapted from Mohamed Ariff et al. (1993)

**Table 3 Malaysia: Top Five IPO Performers of Listing Day, 1996**

	Date of Listing	Offer Price (RM)	Opening Price (RM)	Opening Premium (%)	Oversubscription	Closing Price on 31/12/96 (RM)
Taiping Super (SB)	23/12	2.50	12.00	380	142.40	11.20
Sunrise (MB)	06/12	2.65	12.00	353	47.91	6.65
Quality Concrete (SB)	14/11	2.00	8.70	335	N.A.	13.80
Espirit (SB)	03/05	2.00	8.50	325	109.07	11.50
Transocean (SB)	28/03	2.10	8.60	309	83.58	8.20
Ralco Corp (SB)	17/10	2.10	8.50	305	141.90	8.55
Isuta Holdings (SB)	01/08	1.80	7.20	300	N.A.	15.10
Ye Chiu Metal (SB)	12/09	4.00	15.80	295	56.39	10.10
DKLS Ind. (SB)	18/10	2.00	7.90	295	70.83	10.30
Eden (SB)	20/09	2.50	9.80	292	53.51	8.35

Note: MB = Main Board  
SB = Second Board

Source: Adapted from *Investors Digest*, February 1997: 11.

*Table 4* Malaysia: Oversubscription Rates of New Listings (number of times)

Year	Main Board	Second Board
1989	56.3	14.6
1990	52.5	20.1
1991	33.6	25.2
1992	15.9	13.7
1993	41.2	34.5
1994	46.7	32.5
1995	60.8	46.3
1996*	76.8	56.7

\* First quarter.

Source: Securities Commission (1996).

With the political influence of many key players, the stock market has grown with considerable support from the government, and those who stood or expected to be able to utilise the stock market and publicly-listed firms to capture various types of rents, as well as to secure better access to relatively cheap funds through the securities markets, or from financial institutions which increasingly used stock market listing and performance as loan market signals (Chin and Jomo, forthcoming). In August 1985, the former Finance Minister encouraged banks to give up to 100 per cent loan coverage for share purchases and directed government-related investment institutions, such as the Employees Provident Fund, to invest in share activities (Khor, 1987: 101). This was despite persistent warnings from Bank Negara Malaysia against giving out loans for share speculation. Thus, increased bank lending channelled to purchase shares increased share trading.

The privatisation of state-owned enterprises has further contributed to stock market growth in the country. The substantial net funds raised from the capital market since 1990 can be particularly attributed to the government's privatisation programme, which has undoubtedly deepened Malaysian's stock market considerably. In the equity market alone, privatised projects

accounted for more than 50 per cent of total funds raised through initial public offerings (IPOs) during 1990-96 (Bank Negara Malaysia, 1997: 149).

According to the World Bank, almost US\$177 billion of foreign capital has moved into emerging stock markets since 1990. Table 5 provides an approximate breakdown of long-term net flows to emerging markets over the last decade. During this period, equity flows have increased significantly from 1.1 per cent in 1987 of total net flows to over 14 per cent in 1996. The swelling equity flows into emerging markets are partly attributable to the gradual liberalisation of their financial markets. With greater access to emerging market stocks as well as reduction or removal of capital gains and dividend withholding taxes, the interest of international investors in emerging stock markets as a means of diversifying portfolios has grown. Table 6 reports the withholding tax rates for dividends and long-term capital gains that the sampled emerging markets offered to US-based institutional investors, as well as restrictions on foreign ownership of listed stocks in 1996. Malaysia is clearly the most liberalised market. The government announced an eighteen-point financial market liberalisation program to enhance Malaysia's position as a key financial centre in Southeast Asia. One strategy was to attract more foreign institutional investors by allowing fund managers to own more equity in local operations and imposing a low tax rate of 10 per cent on their profits. Such enormous foreign portfolio investment has acted as catalyst to accelerate the growth of emerging stock markets including Malaysia's.

**Table 5 Aggregate Net Long-term Resource Flows to Emerging Markets, 1987-96 (US\$ billion)**

Type of finance	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996 <sup>P</sup>
<b>Official Development Finance</b>	43.4	42.4	42.6	56.3	65.6	55.4	55.0	45.7	3.0	40.8
<b>Private Debt Flows</b>	9.8	12.7	12.8	16.6	6.2	35.9	44.9	44.9	56.7	88.6
Commercial banks	3.0	7.3	0.9	3.0	2.8	12.5	-0.3	11.0	26.5	34.2
Others	5.0	1.4	3.1	11.3	3.3	13.5	9.2	4.6	1.7	8.3
Portfolio, bonds & debt	1.0	2.9	5.3	2.3	10.1	9.9	35.9	29.3	8.5	46.1
<b>Portfolio, Equity</b>	0.8	1.1	3.5	3.2	7.2	11.0	45.0	32.7	32.1	45.7
<b>Foreign Direct Investment</b>	14.6	21.2	25.7	24.2	33.5	43.6	67.2	83.7	95.5	109.5
<b>Aggregate Net Resource Flows</b>	68.5	77.4	84.5	100.3	122.5	146.0	212.0	207.0	237.2	284.6
of which official (%)	63.3	54.8	50.4	56.1	3.5	37.9	25.9	22.1	22.3	14.3
of which portfolio, equity (%)	1.1	1.4	4.1	3.2	5.9	7.5	21.2	15.8	13.5	16.1

<sup>P</sup>: Preliminary

Source: World Bank, *Global Development Finance*, 1997 and *World Debt Tables*, cited by IFC (1997).

**Table 6 Barriers to Portfolio Investments in Selected Emerging Stock Markets, 1996**

Country	Withholding Taxes		Foreign Investment Ceiling for Listed Stocks
	Dividends (%)	Long-term Capital Gains (%)	
Malaysia	0.0	0.0	100% in general
Indonesia	20.0	0.1	49% in general; 85% for securities companies
Philippines*	15.0	0.5	40% in general; 30% for banks
Thailand	10.0	0.0	10%-49% depending on company by-laws
India	20.0	10.0	24% in general
Korea**	16.5	0.0	20% in general; 15% for KEPCO and POSCO
Taiwan	35.0	0.0	25% in general

\* Transactions tax in lieu of a capital gains tax

\*\* Rates are for funds in which US investments total more than 25%. Tax rates shown include 10% resident tax applied to base rates

Source: IFC, *Emerging Stock Market Factbook*, 1997.

In 1993, the Malaysian stock market gained a reputation as a kind of casino, with active trading fuelled by heady optimism, a sudden interest from foreign institutional investors and a frenzy of speculation about corporate takeovers (*Asian Wall Street Journal*, 26 March 1996). The KLSE witnessed the most remarkable performance in the year. The KLSE Composite Index almost doubled to 1275 points, before crashing to 971 points in the following year, while its market capitalisation as a proportion of GDP rose more than two-fold from previous year's figure. Volume of shares traded jumped by more than 450 per cent, and rose by more than 650 per cent in value terms to reach RM387 billion.

## The Stock Market and Economic Growth: Alternative Views<sup>6</sup>

Orthodox theory argues that the stock market has a number of distinct functions: it helps in mobilising society's savings dispersed among individual savers, allocating scarce capital among competing users and uses, and providing signals to firms making investment decisions (Baumol, 1965). How well are these supposed functions actually performed by actual stock markets? Most neo-classical economists have long assumed that stock markets fulfil these roles well through efficient pricing and takeover mechanisms.

Implicit in orthodox theory is the assumption that the stock market is informationally efficient in the sense that all publicly available information is fully reflected by and incorporated into share prices.<sup>7</sup> This is what Tobin (1984) calls 'information arbitrage' efficiency<sup>8</sup>, which is distinguishable from his related concepts of 'fundamental valuation' efficiency. The latter refers to how well relative share prices of firms reflect their expected profitability. An efficient pricing process will reward well-managed and profitable firms by valuing their shares more highly than those of unprofitable firms. Consequently, they can raise funds at lower cost and thus obtain greater allocation of new investment resources. Although there is a large body of evidence that share prices on advanced country stock markets are generally efficient in the 'information arbitrage' sense, not many studies suggest that share price movements are systematically related to current, past or future underlying performance variables of companies (Singh, 1990: 165). If stock prices do not reflect 'fundamental valuation' efficiency, then the stock market will not necessarily perform its allocative function well: an inefficient stock market does not direct investment funds to their best possible uses.

'Efficient' prices, in the sense suggested above, are not sufficient for the stock market to perform essential tasks. In addition, sufficiency requires that the 'takeover mechanism' be efficient so that all those companies whose profitability under their existing managements may be lower than it could be under some other management, can be acquired by the latter (Singh, 1992: 27). However, empirical studies of actual takeovers on stock markets do not show that only unprofitable companies are taken over, or conversely, that the greater the profitability or stock market valuation of a company, the lower its likelihood of being acquired. Evidence from a wide range of studies for the United Kingdom, the United States and other industrial countries indicates that takeover choice is based on profitability only to a very limited degree; much more relevant is the size of a company. A large, relatively unprofitable company has a much greater chance of being immune to takeover than a small, but much more profitable company. In fact, in actual stock markets, making an acquisition to increase size might be a tactic to avoid takeover (Singh, 1990: 164).

Takeovers supposedly provide a mechanism by which capital markets ensure that non-owner managers perform their duties in the interest of shareholders and firms.<sup>9</sup> However, there are several reasons why this has not been and is not likely to be an effective control mechanism (Stiglitz, 1985: 137-9).<sup>24</sup> The argument is based on recent developments in the economics of information. For instance, outsiders face difficulty in determining whether a firm is or is not efficiently managed. Moreover, takeover mechanisms are ineffective since current managers are often in a position to take strategic actions to deter takeovers. Even in advanced capitalist economies with highly organised capital markets, the stock market is a poor disciplinarian of large management-controlled corporations (Singh, 1990: 173)



As far as the savings function is concerned, it turns out that the stock market makes a very limited contribution to social savings, at best. In fact, Mayer (1988) used flow-of-funds accounts to show that between 1970 and 1985, new issues in the United Kingdom and the United States made negative contributions to financing capital formation (Mayer, 1988: 1170-72). As he notes: 'The reason for this is cash expenditure on acquisitions. Repurchases of shares have not until recently been permitted, but the corporate sector as a whole has in effect been buying back shares in the process of making cash financed acquisitions' (Mayer, 1988: 1172). In other words, corporate new issues in both countries were more than matched by a net redemption of corporate shares, mainly because of takeovers. Furthermore, there are several factors which explain managements' reluctance to turn to securities markets to source investment funds (Baumol, 1965: 74-76). In such circumstances, the securities market does not actually allocate much capital in an economy. Very often, large corporations in capitalist countries finance their investments through retained profits or by borrowing from banks (Singh, 1990: 163).

Many empirical studies have shown the domination of stock market prices by short-term considerations.<sup>10</sup> The lack of long-term financial commitment can be attributed to the stock market liquidity, usually regarded as a virtue by orthodox economists (Singh, 1992: 32). Since the stock market provides investors with almost instant liquidity, they need have no commitment to the long-term prospects of a firm. Besides, equity financing may be damaging, especially since fund managers are primarily concerned with short-term financial gains, made possible by and contributing to the vicissitudes of the stock market. Although some fund managers invest for the longer term, most turn over their stock holdings to try to maximise the current value of their investment portfolios, since this is the main criterion against which their own performance is judged. Such short-termism<sup>11</sup> results

in a reluctance to lend except when returns are more or less assured (Barberis and May, 1993: 47).

Besides, the stock market can also affect the real economy, especially since these markets have emerged in recent years, as a major channel for foreign capital flows to developing countries, as shown by Table 4. It is argued that portfolio inflows are less vulnerable to external interest shocks than debt and have helped generate the stock market boom in developing countries, thus lowering the cost of capital to corporations there. However, Singh (1992: 41; 1997: 771-82) points out that in practice, such inflows have also proved to be destabilising. External liberalisation through opening the stock market to non-residents reduces the degree of policy autonomy, with adverse consequences for the economy. Inevitably, it will make the national economy much more vulnerable, to both international macroeconomic fluctuations as well as capital flight, and the tasks of exchange rate management and controlling inflation will be much more difficult. On average, foreign investors' net purchases of stocks, look like noise trading<sup>12</sup> and seem to create excessive volatility in the stock market in small open economies such as Sweden, as shown by Selin (1996). These uncontrolled capital flows will also lead to closer links between two inherently unstable markets—the stock and currency markets. In the wake of unfavourable economic shocks, the interactions of both markets may 'reduce aggregate investment through various channels, e.g. depressing business expectations because of greater uncertainty; greater instability in aggregate consumption because of wealth effects caused by large fluctuations in stock market prices' (Singh, 1997: 779).

*Table 7 Standard Deviations of Developing and Developed-Country Share Price Indices (five years ending December 1996)*

Market	Number of months	Standard Deviation	Annualised Standard Deviation
<u>Latin America</u>			
Argentina	60	9.96	34.50
Brazil	60	12.52	43.37
Chile	60	7.19	24.91
Colombia	60	8.46	29.31
Mexico	60	10.49	36.34
<u>East Asia</u>			
China*	48	10.72	37.14
Korea*	59	7.36	25.50
Philippines	60	9.28	32.15
Taiwan	60	10.90	37.76
<u>South Asia</u>			
India*	49	8.49	29.41
Indonesia	60	7.74	26.81
Malaysia	60	7.27	25.18
Thailand	60	9.53	33.01
<u>Europe/Mideast/Africa</u>			
Greece	60	6.63	22.97
Hungary*	48	14.52	50.30
Portugal	60	5.70	19.75
Turkey	60	16.86	58.40
Zimbabwe*	42	9.55	33.08
<u>IFC Regional Indices</u>			
Composite	60	5.38	18.64
Latin America	60	7.72	26.74
Asia	60	6.10	21.13
<u>Developed Markets</u>			
U.S.A. (S&P 500)	60	2.51	8.69
U.K. (FT-100)	60	4.00	13.86
Japan (Nikkei)	60	7.18	24.87
MSCI, EAFE	60	3.94	13.65

\* Statistical data based on less than 60 months of data.

Source: Adapted from IFC, *Emerging Stock Market Factbook*, 1997.

Apart from all the problems faced by well-organised stock markets in advanced countries, research suggests that most Third World stock markets have certain negative features. As has been widely known, stock markets in developing countries exhibit much greater volatility than those in advanced economies. Table 7 shows that during the period 1991-6, the standard deviation of monthly percentage changes in share prices in developing

country stock markets tended to be considerably higher than in developed markets.<sup>13</sup> For instance, the standard deviation of monthly price changes over the period was 7.27 in Malaysia, compared to 2.51 in the United States and 4 in the United Kingdom. A market characterised by a high degree of volatility is inherently more risky. The higher degree of volatility not only makes share prices much less useful as a guide to resources allocation, but also discourages risk-averse savers and investors. Risk-averse firms may also refrain from raising funds or even seeking listing on the stock market.

Kumar (1994: 341-43) has expressed his scepticism about the supposedly well-functioning equity markets claimed by Cho (1986). Kumar advances the following reasons for why equity markets are not free from allocative distortions. First, asymmetric information may give rise to principal-agent problems.<sup>14</sup> Because of asymmetric and incomplete information, each economic agent is tempted to use his informational advantage to pursue his own interest, which may differ from the objectives of those (principals) who are influenced by his action. Incentive problems may worsen when a firm is equity-financed as managers are less restricted in diverting profits for their private use. With debt financing, managers have less flexibility in diverting profits for their private use as lenders have the power to discipline managers by withdrawing their funds. This acts as a sanction that may be more effective than shareholder control via share voting in which the majority rule applies, or via takeovers, which are not likely to be an effective control mechanism.

Information imperfections limit the ability of a firm to raise equity capital due to 'signalling effects' (Greenwald, Stiglitz and Weiss, 1984: 195). Signalling effects may arise because attempts to sell equity may convey a strong negative signal about a firm's quality. It is believed that 'good' firms tend to be more willing to rely on debt capital as both the absolute level of bankruptcy risk as well as any incremental increase in risk due to added debt

will be smaller for 'good' than for 'inferior' firms. That is to say, equity will be predominantly sold by 'inferior' firms rather than by 'good' firms. The effective marginal cost of capital comprises the monetary cost of interest plus the marginal increase in expected bankruptcy costs associated with additional debt. Thus, adverse signals associated with issuing equity may restrict a firm's access to equity markets as the cost of equity is prohibitive for many firms. It may reduce a firm's value, as indicated by some empirical studies (for example, Asquith and Mullins, 1983).

In addition, limited liability—a common legal organisation form of modern corporation—restricts the aggregate claims of various claimants on the corporation to the market value of the firm. In other words, owners of the corporation are not obliged to use their personal wealth to meet the claims of other stakeholders (suppliers, customers and workers)<sup>15</sup> which exceed the total value of the firm. This, in turn, results in a conflict of interest between equity stockholders and other stakeholders. Thus, a corporation's limited liability induces corporate insiders to make investment decisions that are sub-optimal from the perspective of the welfare of all stakeholders.

With asymmetric information, managers may prefer to rely on internal financing and may prefer debt to equity if new capital is needed. Managers may be reluctant to issue new shares, even at the cost of passing up good investment opportunities. Thus, real capital investment is misallocated. Distortions in investments in developing countries may be even worse since ownership and management of many small and medium-sized firms are usually in the hands of families.

Given the incomplete and imperfect nature of the real world stock markets, even advanced country stock markets, bank intermediation can reduce information and incentive problems by monitoring borrowers

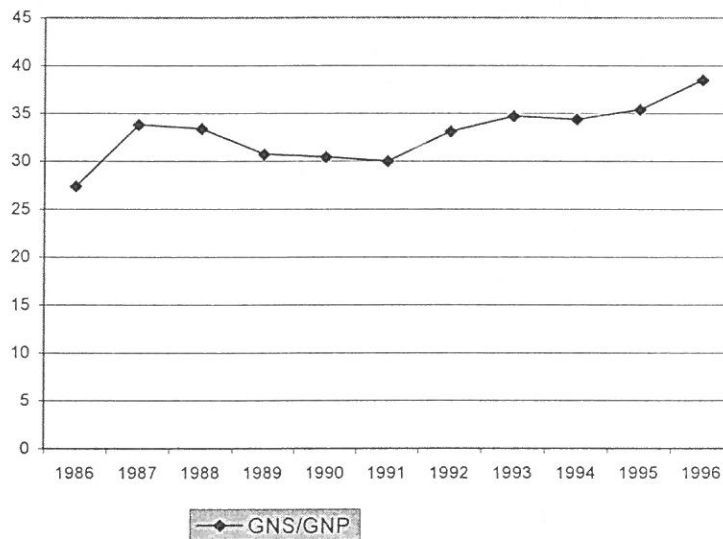
(Diamond 1984). Besides, banks are better equipped—than securities markets—to more effectively exercise control over managers (Stiglitz 1985) as well as develop long-term relations and commitments to firms (Mayer 1988, Sharpe 1990). This led Park to conclude that the role of banks is more important in developing countries, where information problems are severe because accounting and auditing systems are typically less reliable than in advanced countries (Park, 1994: 13). Historically, stock markets have played little role in the post-war economic growth of Germany and the East Asian newly industrialised economies (further Gerschenkron, 1962; World Bank, 1993).

### **The Implications of Malaysian Stock Market Growth**

**T**he preceding argument questions the desirability of promoting stock markets in developing countries for achieving long-term economic growth. Hence, Singh (1997: 778) raised several important issues regarding the benefits that developing countries can reap from their expanding stock markets: ‘has this (development of stock markets in developing countries) led to increased aggregate savings and investments, or raised the productivity of investments?’ Some evidence for India on these issues is provided by Nagaraj (1996). While a large number of empirical studies have been carried out on the price efficiency of the Malaysia’s stock exchange, no study has been attempted to examine these issues for Malaysia. Even though studies by Kok and Goh (1994) and Ismail, Ng and Attila (1993) indicate that Malaysia’s stock exchange has become more efficient due to the implementation of various measures taken to develop the KLSE in the 1990s, this does not imply ‘fundamental valuation’ efficiency, associated with the stock market ability to perform its allocative functions well, as

discussed above. Hence, an attempt is made in this section to examine these issues raised by Singh (1997) for Malaysia. It is, however, beyond the scope of this paper to examine the impact of foreign portfolio flows on the domestic real economy.

Figure 6 Malaysia: Gross National Savings, 1986-96 (% of GNP)



Source: Bank Negara Malaysia, *Quarterly Bulletin*, various issues

One of the arguments for developing stock market is it promotes higher aggregate savings by providing individual savers with an additional instrument which may better cater to their risk preferences and liquidity needs. However, this argument is not convincing for several reasons. With continuous rapid economic growth since the recovery from the recession in the mid-1980s, the national savings rate rose from 27.4 per cent in 1986 to 38.5 per cent in 1996 (Figure 6). Although Malaysia already has one of the highest savings rates in the world, more domestic savings are needed to fund

the growing investment needs of the country. To the extent that savings rate should increase still further, higher real deposit rates and improvement of deposit security and infrastructure (e.g. extension of modern banking to the rural areas) are likely to be better ways of achieving this objective than the attractions of stock market, characterised by volatility and speculation (Singh 1992: 39). Moreover, Gan (1997) notes that the fall in private savings since 1988 despite the robust growth in income can be attributed to the steady increase in net household wealth, precipitated by the appreciation of property prices and stock market boom since the late 1980s.

Table 8 reveals that the promotion of Malaysia's stock market by the government in recent years has been accompanied by significant portfolio substitution of bank deposits by tradable securities. When the stock market was booming, Malaysia's banks lost much of their deposit base to the stock exchange, particularly during the bull period in 1993 and 1996. Higher returns on equities, with opportunities for making quick capital gains, which are tax-free, accounted for the shift in portfolio substitution. The Malaysian stock exchange's share of the total deposit base increased significantly from 48.8 per cent in 1991 to 53.3 per cent in 1992, before reaching almost 70 per cent in 1993, while the commercial banks' share has dropped from 23.1 per cent in 1991 to 13.4 per cent in 1993. On the other hand, the disintermediation trend of bank deposits was reversed when the stock market began to turn bearish in 1994.



Table 8 Malaysia: Classification of Deposits by Financial Institutions, 1990-96 (% Share)<sup>1</sup>

	1990	1991	1992	1993	1994	1995	1996
Commercial Banks <sup>2</sup>	22.8	23.1	20.1	13.4	16.1	17.3	16.1
Finance Companies <sup>2</sup>	10.4	10.6	8.5	5.3	6.2	6.3	5.7
National Savings Bank <sup>3</sup>	1.0	0.9	0.8	0.5	0.6	0.5	0.5
Employees Provident Fund	16.9	16.0	13.4	8.1	10.3	10.5	9.2
Life Insurance Companies	0.6	0.6	0.5	0.3	0.4	0.5	0.4
Unit Trust Funds	n.a.	n.a.	3.4	3.1	4.4	4.7	4.7
K.L. Stock Exchange	48.2	48.8	53.3	69.4	62.1	60.2	63.4

<sup>1</sup> Allow for +/- 3% variation;

<sup>2</sup> Figures do not include Negotiable Certificates of Deposits (NCDs) issued and Repurchase Agreements (Repos)

<sup>3</sup> Figures consist of 'amount standing to credit of depositors' plus 'Premium Savings Certificates depositors'

n.a. - Not available

Source: *Asian Banker*, cited by *Banker's Journal Malaysia* (1995: 33), Bank Negara Malaysia, Ministry of Finance and Kuala Lumpur Stock Exchange.

The proponents of equity financing argue that stock markets contribute to output growth by improving the allocation of capital and facilitating longer-term investments. Despite the stock market boom, however, Malaysian Department of Statistics surveys of manufacturing industries indicate that growth rates of listed manufacturing firms' investments in fixed assets for the period 1985-94 were lower, on average, than those of the non-listed manufacturing firms except for 1986 and 1992 (Table 9). The hypothesis that the stock market boom contributed to output growth does not seem valid either. The average annual growth rate of value-added in listed manufacturing firms for the period 1985-94 was lower than that for non-listed manufacturing firms except in 1990. Thus, non-listed manufacturing firms have contributed more to investment and output growth than listed manufacturing firms.

Table 9 Malaysia: Annual Growth Rates of Fixed Asset Investment and Value Added in Corporate and Non-Corporate Manufacturing Firms, 1986-94 (per cent)

	Fixed Asset Investment		Value Added	
	Non-listed <sup>1</sup>	Listed <sup>2</sup>	Non-listed <sup>1</sup>	Listed <sup>2</sup>
1985-86	-2.6	9.4	0.1	-0.2
1986-87	10.7	-2.6	12.1	-0.4
1987-88	9.8	-0.4	27.9	5.9
1988-89	13.8	7.8	27.0	22.0
1989-90	30.1	15.9	18.2	24.8
1990-91	31.8	19.3	31.3	5.8
1991-92	22.2	24.1	13.8	6.2
1992-93	20.0	19.9	21.1	14.7
1993-94	21.9	7.5	21.2	-2.8

<sup>1</sup> Individual proprietorship, partnership and private limited companies.

<sup>2</sup> Public limited companies

Source: Computed from Department of Statistics, *Industrial Surveys 1985-1991*, *Annual Manufacturing Survey 1992*, *Annual Statistics of Manufacturing Industries 1993* and *Annual Survey of Manufacturing Industries 1994*

Table 10 seems to suggest that the Malaysian stock market has emerged as a more important source of funds since 1990. The share of equity market financing of total net funds raised by the private sector rose significantly from 9 per cent during 1980-85 to 19 per cent during 1990-96. However, it should be noted that the substantial net funds raised from the capital market since 1990 can be particularly attributed to the government's privatisation programme, which has undoubtedly deepened Malaysian stock market considerably. In the equity market alone, privatised projects accounted for more than 50 per cent of total funds raised through initial public offerings (IPOs) during 1990-96 (BNM, 1997: 149). Adam and Cavendish (1995: 37-39) show that these privatisation issues may well crowd out other private investment issues, unless foreign capital and portfolio inflows are high. This may be true considering the recent increase of funds raised through rights issues—i.e. reflected in the expansion of existing stocks or capitalisation. Table 11 shows that the bulk of funds raised from the equity market in 1996 was mainly through rights issues,

which mobilised RM5.3 billion, or 33.2 per cent of the total funds raised. Significantly important were funds raised from private placements totalling RM4.5 billion, or 28.4 per cent of total funds raised. As pointed out by Jomo (1995: 51), “with privatisation, capital resources—which might otherwise have been invested into expanding productive capacity—have instead been diverted into acquiring or transferring existing public sector assets”.

*Table 10 Malaysia: Net Funds Raised by the Private Sector, 1980-85 and 1990-96 (% share)<sup>1</sup>*

	1980-85	1990-96
Bank Loans	67	51
Private Debt Securities	1	13
Equity	9	19
EPF <sup>2</sup>	-	3
Foreign Borrowing	23	14

<sup>1</sup> Excluding loans to individuals and CAGAMAS (National Mortgage Corporation) papers.

<sup>2</sup> Direct equity financing.

Source: Compiled from BNM (1997: Chart IX.2)

*Table 11 Kuala Lumpur Stock Exchange: New Issues of Shares, 1992-96 (RM million)*

	1992	1993	1994	1995	1996 <sub>p</sub>
Initial Public Offers	5,415.8	912.7	2,972.9	4,175.0	4,099.2
Rights Issues	3,437.8	1,176.9	3,436.7	5,240.2	5,268.5
Special Issues <sup>1</sup>	300.4	684.2	1,249.4	875.5	2,000.7
Private Placements <sup>2</sup>	27.5	658.8	798.9	1,146.9	4,510.5
Preference Shares	-	-	-	-	-
Call Warrants	-	-	-	178.8	-
Total	9,181.5	3,432.6	8,457.9	11,616.4	15,878.9

<sub>p</sub> Preliminary

<sup>1</sup> Issues to Bumiputera investors and selected investors

<sup>2</sup> Include Restricted-Offer-For-Sale

Source: Adapted from Bank Negara Malaysia (1997: 249)

As noted earlier, Malaysia's stock exchange saw bigger listing premiums compared with some international markets such as Singapore, the

United Kingdom and United States. In 1996, the top ten IPO gainers—dominated by second board counters—recorded an average premium of 319 per cent (Tables 3 and 4). As a result of such excessive underpricing, most players in Malaysia's stock exchange are speculators mainly concerned with short-term profit margins from trading shares rather than with the long-term performance of companies. About 70 per cent of investors in Malaysia's stock market are retail, while institutional investors only occupy 30 per cent. The former is easily influenced by rumours due to lack of education and imperfect information. Thus, it is not surprising to note that speculative stocks dominated the top volume list on the KLSE for the first six months in 1997.<sup>16</sup> The heavy trading on these stocks were spurred by rumours of companies winning a major project or takeovers and acquisitions. To the extent that such high turnover of shares was generated by a public taste for speculation and gambling, the job is likely to be ill-done as pointed out by Keynes (1936: 159).

In Malaysia, the takeover mechanism is far from being efficient. There have been numerous cases of some 'paper entrepreneurs' pursuing stock market opportunities for acquisitions, mergers, restructurings and leveraged buy-outs, taking over productive manufacturing, plantation or mining companies to use them as corporate vehicles for raising funds to venture into real estate and other activities which yield quicker profits.<sup>17</sup> As noted by Gomez and Jomo (1997: 180):

... the contemporary conglomerate style of growth, especially pronounced in the last decade, involves mergers, acquisitions and asset-stripping, with scant regard for relevant experience and expertise. This change reflects the greater attention to financial accumulation rather than the difficult but ultimately necessary development of internationally competitive productive capacities.

Such phenomenon is likely to hamper rather than promote long-term economic growth as it 'undermines the capitalistic ethic by destroying the link between effort and reward' (Singh 1997: 776), hinders the growth of small productive firms, reduce product market competition and lead to dynamic inefficiencies (Singh, 1995).

### **Conclusion**

**T**he rapid growth of the KLSE in the 1990s has partly been the result of government efforts to develop the stock market through its affirmative action, privatisation and liberalisation programmes, as well as various other measures to widen and deepen the stock market. Despite its rapid expansion and growing importance as a source of funds since 1990, the foregoing analysis suggests that the development of stock market does not necessary contribute to long-term economic development in Malaysia. It is not clear at all in what ways the institution of stock market will encourage higher national savings. Recent data seems to suggest that development of Malaysia's stock market has mainly diverted funds from one instrument of savings, namely bank deposits to equity purchases. To the extent that the Malaysia's stock market development was spurred by a public taste for speculation and gambling and characterised by greater attention of large conglomerates to financial accumulation rather than the necessary development of internationally competitive productive capacities, it is unlikely to help in contributing much to long-term productive investments and output growth. A broad conclusion from this study is that the stock market should not be promoted aggressively without development of adequate and effective institutional capacities and instruments to check corporate abuses, short-termism and misallocation of funds to unproductive sectors.

## NOTES

<sup>1</sup> Renamed Malaysian Industrial Development Finance after the formation of Malaysia in August 31, 1963.

<sup>2</sup> There was only one public issue in 1965 (Drake, 1975).

<sup>3</sup> Bumiputera refers to the 'indigenous' population of Malaysia, mainly comprising the Malays of Peninsular Malaysia.

<sup>4</sup> Some examples are provided by Jesudason (1989, endnote 31: 126).

<sup>5</sup> One may disagree by arguing that shares which are issued at their intrinsic values, can be bid up by an overly optimistic market, leading us to wrongly interpret demand pressures as underpricing. However, demand pressure at or after listing may push up prices above their intrinsic values in the short-run, as prices of new issues decline in the longer run after demand pressure subsides.

<sup>6</sup> The analysis in this section draws heavily from Singh (1992; 1996; 1997).

<sup>7</sup> Since there is a voluminous literature on this subject, a comprehensive review will not be conducted here. For details, see Fama (1970).

<sup>8</sup> In Fama's terms, the market is said to be 'semi-strong' efficient.

<sup>9</sup> If the managers were not maximising the market value of the firms, this would render the firms attractive to takeover raiders.

<sup>10</sup> See, for example, Shiller (1981) and Poterba and Summers (1988). Poterba and Summers (1988) examined monthly data on New York Stock Exchange returns from 1926 to 1985 and annual returns from 1871 to 1985. They also analysed monthly data for 17 other equity markets over various periods. In each case, the results suggest that the presence of important transitory components in stock prices resulted in deviation 'from the stocks' fundamental values. For a non-technical analysis, see Dertouzos, Lester and Solow (1990: ch. 4)

<sup>11</sup> Refers to investors' pre-occupation with the short-term performance of a company as measured by financial criteria such as current dividends, price-earnings ratios, earnings per share and shareholder values

<sup>12</sup> Trading that is not based on information about fundamentals.

<sup>13</sup> The distributional form of stock price changes reflects the riskiness of an investor's investment, with standard deviation used as a measurement of this risk.

<sup>14</sup> The information problems are sometimes referred to as 'principal-agent' problems as each agent's action affects the welfare of the principal and the principal tries to ensure that each agent will behave according to the principal's interest.

<sup>15</sup> Since suppliers, customers and workers are influenced by the corporation's decision and performance, they are also stakeholders of the corporation.

<sup>16</sup> For details, see *Malaysian Industry* (August, 1997: 40-2).

<sup>17</sup> Many of the Malaysian-based companies listed in the Kuala Lumpur Stock Exchange's property section—which had been increasing since 1979—were formerly manufacturing or mining companies (see Yoshihara 1988: 81-2). See also Gomez (1991) and Gomez and Jomo (1997) which provide some interesting case studies of conglomerates created through changes in ownership, rather than accumulation and expansion of a productive investment activities.

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