Collapse and recovery of the malaysian economy economics essay

ASSIGN BUSTER

Former U. S. Federal Reserve Chairman Alan Greenspan said “ It’s human nature: unless somebody can find a way to change human nature we will have another crisis.” Human nature always reverts to “ speculative excesses” during a period of sustained prosperity, hence crises are inevitable. They are often seen as an intrinsic feature of market-oriented credit and financial systems. Boom and bust cycles are omnipresent in the existence of financial markets. Since the beginning of the 18th and 19th century, the system has witnessed severe financial crises in different parts of the globe. Countries which had enjoyed strong economic performance in the past were not spared by unexpected collapses. In most cases the crises turned out to be virulent causing widespread disruption to emerging market economies.

Financial Crisis: South East Asia

The 21st century was said to belong to Asian countries namely Thailand, Korea, Malaysia, and Indonesia labelled the Asian tigers for their robust economies. These countries were growing at a rate that far exceeded growth rates in the United States and Europe. They even enjoyed trade surpluses with the United States, and did not suffer from the larger budget deficits that were too familiar to the U. S. Poverty was eradicated in a small lapse of time. Nevertheless, this phase did not last long. A financial crisis swept much of Asia in the late 1990s, leaving the region at economic, social, and political crossroads. The Asian “ miracle” had come to an abrupt halt and South East Asian economies went into severe contraction modes. This raised worries about the stability of the global financial system.

The crisis started in Thailand with the financial collapse of the Thai baht caused by the decision of the Thai government to float the baht, cutting its peg to the USD, after exhaustive efforts to support it in the face of a severe financial overextension that was in part real estate driven. At that time, Thailand had acquired a burden of foreign debt that made the country effectively bankrupt even before the collapse of its currency. As the crisis spread, most of South East Asia and Malaysia saw slumping currencies, devalued stock markets and other asset prices, and a precipitous rise in private debt.

Indonesia, South Korea and Thailand were the countries most affected by the crisis. Hong Kong, Malaysia, Laos and the Philippines were also hurt by the slump. The People's Republic of China, India, Taiwan, Singapore, Brunei and Vietnam were less affected, although all suffered from a loss of demand and confidence widespread in the region.

However, the Malaysian economy and population were relatively less affected compared to their counterparts in Thailand, South Korea, and Indonesia. While the pre-crisis level of indebtedness in Malaysia was very high, the level of foreign exposure was much lower- as a proportion of gross domestic product (GDP) and, especially, as a share of the open economy's extraordinarily high export earnings. Unlike other countries in the region, Malaysia's level of foreign liabilities did not exceed its foreign exchange reserves. So the country was not in need of emergency credit facilities from lenders at the instance of the International Monetary Fund (IMF).

Also, after the severe banking crisis of the late 1980s, Malaysian prudential regulation had been improved and had not been as badly undermined by liberalisation pressures as in the other three economies. A proof of the strong economy that Malaysia had is the fact that Malaysia was the one country involved in the East Asian crisis that did not seek help from the IMF. Undoubtedly adversely hit by the South East Asian Crisis in 1997, Malaysia has managed to recover swiftly on its own.

Objectives

Considering the devastating impact that the 1997 Asian crisis had on Malaysia's economy, it is important to analyse why the crisis occurred and how/if such an event can be avoided in the future. This report attempts to answer these questions. Firstly, the pre-crisis financial system of Malaysia is considered. Secondly, the various factors contributing to the collapse of the Malaysian economy is investigated. Some lessons to be learned are, then, derived and a conclusion about the Malaysian downfall is reached.

PRE – CRISIS MALAYSIA: STRONG FUNDAMENTALS

The currency crisis came as a real shock in Malaysia because the Malaysian economy was backed by a " rock steady economy, political stability and a business friendly environment" (Mahathir Mohamad, 2000, p. 11). Indeed the economic situation of the country was such that an immediate currency crisis was not anticipated in the least.

The Malaysian economy was booming in the pre crisis period with growth averaging 8% per annum and the stable currency of the country was an added bonus. The Malaysian ringgit was trading at the rate of 2. 50 to the

dollar and fluctuations, which were very narrow, could be explained by the operation of market forces. The currency was usually maintained at this level by the timely intervention of the Central Bank of Malaysia (Bank Negara Malaysia). Currency stability was a major determinant of the economic performance of the country. Gross Domestic product was growing at an average rate of 8% per annum and it was expected that the country would be able to maintain this rate for the foreseeable future. The country was ranked as the world's 18th biggest importer and 17th biggest exporter with total external trade of nearly US$ 158 billion. The deficit of the balance of payments was reduced to 5% of the Gross National Product and inflation was low at 2. 1%. The total external liability of the country was estimated at 40% of GDP at the end of the year 1996.

The banking sector was heavily criticised during the crisis. However, prior to the crisis non-performing loans amounted to only 3. 6% of total outstanding loans, when estimated by the stringent three months classification; the asset quality was very high and the loan portfolio well diversified. The savings rate was 38%, one of the highest in the world and Malaysia had the potential to finance solely by its savings 95% of its total investment outlays.

Despite the fact that the Malaysian economy was backed by such strong economic fundamentals, it became a prey to the financial turmoil which severely affected the South East Asian region in 1997, the reasons of which are explained in the following section.

FACTORS CONTRIBUTING TO THE COLLAPSE OF MALAYSIA

Devaluation of the Thai Baht

The South East Asian countries were known as the Asian tigers in the 1990s. They registered 5 to 10 % annual growth over several years. Thailand did tremendously well as investment rates grew and Thai banks became the most profitable by charging 4 points higher rate of interest on loans than what they paid on deposits. The good days, however, did not last long.

The economy slowed down because much loans were non- performing and China emerged as a strong competitor with low interest rates and a devalued currency. Moody downgraded five Thai financial institutions. Also, the US $ was continuously appreciating which implied that the Thai Baht had to remain high. Most of the exchanges in those countries were linked to the US $. The Thai Baht was pegged at US $ 25 from 1985 to July 1997. Its value against devaluation pressures was defended by the Bank of Thailand. As the situation worsened, much capital started to flow out of the country as investors anticipated devaluation. Thailand's market was hit by a massive speculative attack. Most of the reserves were used up in maintaining equilibrium. However, in June 1997, going against expectations, the Thai Prime Minister announced that he would not devaluate the currency but rather shift to a flexible exchange rate regime. This was seen as a failure by the government to defend the currency against speculators. The Thai Baht collapsed and continued its downfall to reach the bottom of 48. 80 Baht per US $ in December 1997, a record low since 1969.

These events had immediate effects on the region. Investors became sceptic about the pegged currencies in Malaysia. The ringgit value was halved, falling from above 2. 50 to under 4. 10 per US $. The failure of the Thai Baht entailed the crumpling of the Malaysian currency which in turn led to more ripple effects.

Capital Account Liberalisation

Capital account liberalisation can be classified into two main categories, namely liberalization of capital inflows and liberalisation of capital outflows. The former covers four main areas: FDI in ‘ bricks and mortar’, foreign purchase of domestic assets such as real estates, foreign investment in domestic securities, and foreign lenders’ access to domestic borrowers, who has the possibility to borrow short term or long term. On the other hand, capital outflow liberalization involves either domestic investment abroad or foreign disinvestment.

In a study by Prasad et al. it has been noted that since FDI has a long term, and relatively fixed nature it constitutes the least volatile category of private capital flows to developing countries, whereas portfolio flows tend to be much more volatile and prone to sudden trend reversals.

Malaysia has been adopting a liberal capital count policy from 1972- with the government seeking to attract FDI by opening free trade zones- up until the early 1990s, when the government eliminated capital gains and dividend withholding taxes to promote foreign portfolio investment. FDI was highly attracted to Malaysia especially due to: heavy government restrictions on

labour unions, a policy obstructing wage increases and the preservation of Malaysia's labour-based comparative advantage to a certain extent.

From the late 1980s, individual and institutional investors were motivated to invest in the emerging economies of East Asia, where growth performances contrasted favourably with the prolonged slow growth of the developed economies in Europe and elsewhere. Malaysian policymakers found their decision leading to a rise in the Kuala Lumpur Stock Exchange index from 506 in 1990 to a peak of 1238 in 1997. This policy of capital account liberalization and exchange rate stability was considered to be exemplifying the perfect investment climate.

However, this capital account liberalization was combined with an imprudent handling of massive short term capital inflows in the economy during the boom of the 1990s, on behalf of Malaysian bankers and investors. Instead of banking the massive influx of foreign capital that came into Malaysia, banks made carefree and excessive lending to finance investment in non-tradeables such as real estate and stock shares. With greater imports not matched by sufficient corresponding exports, Malaysian current account deficit aggravated and fuelled an asset price bubble.

Capital inflows generally make an economy vulnerable, especially when the currency is convertible and therefore subject to speculation. Indeed, in Malaysia's case, the massive capital inflows created the perception of an undervalued Malaysian ringgit. Such perceptions facilitated even greater influx of capital since investors speculated on the revaluation of the ringgit at a higher rate. Instead, the Malaysia central bank kept its commitment and

allowed the money supply to rise with increased inflows of capital, the consequence of which was an over-investment in real estate and stock market. An untenable exchange rate and asset market were sensed which entailed a massive capital disinvestment. Investors suspected an over-inflated economy and removed their investment from Malaysia in speculating on the devaluation of the ringgit. This had led to a forced devaluation of the Malaysian ringgit, resulting in a financial crisis, severe unemployment and a deep economic recession.

Domestic asset price bubbles and stock prices

The liberalisation of the capital account of Malaysia brought along with it massive inflows of investment in the country. Malaysia has always been an attractive destination for FDI, estimated at nearly 70% of total direct investments (World Bank, 1999).

In a study, Athukorala (1998) observed that while inflows in Malaysia were mainly in the form of foreign direct investment, outflows were in the form of the more reversible portfolio flows. Portfolio flows are a form of hot money. Hot money can be defined as a type of investment that is extremely volatile and prone to sudden reversals in its search of higher returns. The volatility associated with these types of capital outflows can severely handicap an economy if not managed properly. In Malaysia the portfolio flows increased to US$ 325 million in 1997, which exceeds even the cumulative portfolio inflows for the entire period between 1980 and 1996.

The massive influx of capital in Malaysia in the pre crisis period was channelled through the banking sector to the real estate sector. It was

advanced that the construction sector reduced to a great extent the lumpiness of investment. This is a concept that explains the time horizon associated with obtaining the return from an investment. The World Bank proposes that a large scale investment such as FDI takes at least a period of six years to yield returns and is higher still in countries like Malaysia where the rate of investment is already very high. The quicker means of earning a return is by channelling the massive influx in the real estate sector. Increased investments caused " inflation in asset prices" thereby leading to an asset price bubble. An asset price bubble is created when investors expect high yields on future investments despite flawed fundamentals.

This general increase in asset prices, above their fundamental value, did not last long. As the news of the devaluation of the Thai Baht reached foreign investors, they anticipated a fall in their investments in Malaysia and fearing a depreciation of the Malaysian Ringgit they started to massively withdraw their money from the Malaysian financial system. To recover their investments, investors started to sell their assets which led to an oversupply in the real estate sector. Coupled with a weak demand in the wake of an anticipated crisis, the asset price bubble finally burst in Malaysia. This led to a general fall in the price of assets.

As the asset price bubble burst investors knew that the Malaysian ringgit was overvalued and they anticipated devaluation, they started to sell their ringgits for US dollars. This increased the supply of ringgits which further depressed the exchange rate.

The devaluation of the Thai Baht also severely affected the stock exchange of Malaysia. The inflows of capital in the country were also channelled in listed companies as equity investments. As the ringgit depreciated due to the contagion effect from the Thai Baht, investors started to sell their stakes in the Malaysian companies and repatriate back their capital, resulting in massive panic selling of stocks which caused a general fall in the stock prices. The Kuala Lumpur Composite Index (KLCI) fell from 1271 points in February 1997 to 897. 25 points on August 1997. Thus, shares prices of highly geared companies plunged the most and they had to face unprecedented liquidity problems.

Financial Speculation

Speculation is another major reason for the currency crisis in Malaysia. Speculation arises whenever some market players anticipate either a rise or a fall in the value of certain assets. Speculation in assets prices has been rampant in South East Asia since the 1990s and this has led to an overvaluation of the collateral value of assets especially in the real estate sector. This type of market is easily affected by optimism as well as pessimism. This can easily result in herd behaviour where the selling off of assets can induce panic in the market and cause other investors as well to sell their assets.

In the case of Malaysia the surges of foreign capital caused money to be available for speculative purposes which drove up the price of real estates. This caused these assets to be overvalued. However, the bad effects of speculation started to affect Malaysia only when Thailand was forced to devaluate its currency thereby leading to a contagion effect on other

economies. As the element of “ regional risk” identified by Summers (2000 cited Jordaan and Harmes (2001, p. 5) are becoming increasingly important, speculators thought it was only a matter of time , before Malaysia too affected by “ Financial Contagion” and proceeded to devalue its currency. By anticipating such an event, these speculators started to sell the Malaysian Ringgit and convert their capital into US dollars. By doing so, those who have borrowed in the domestic currency had to repay fewer dollars and thus could make huge profits.

These speculations were not only limited to individuals but also institutional players such as hedge funds. These entities had realised that the fundamentals of the Malaysian economy were flawed and anticipated a devaluation of the Malaysian Ringgit. By selling off the Malaysian Ringgits they owned in exchange for US dollars, they cause an oversupply of the currency, which due to higher risks depreciated even further. Thus, it can be concluded that speculative attacks were very harmful to the Malaysian currency as depreciation was anticipated and this resulted in a bandwagon effect that caused massive outflows of capital during this critical period.

Increase in the Overnight rate

The overnight interest rate is the cost of borrowing money from financial institutions over a short amount of time. They are the costs incurred to borrow money from other financial institutions whether those loans are acquired from banks or FOREX traders. In the case of lenders, the overnight interest rate specifies the amount those lenders are able to lend at overnight. Overnight loans are used for a number of purposes hence the need for interest rates on such loans. The interest rates for these loans tends

to be lower than longer term loans and is determined using particular economic, and financial goals such as economic growth, borrower risk and inflation.

Overnight interest rates are a key part of the domestic and international financial system and help provide liquidity and suitable cash availability for the financial and economic needs of that financial system and its various markets. Overnight rates are set by the Bank Negara Malaysia. Due to the fact that overnight interest rates can be quite low and money may be needed for a short period of time, overnight governmental or commercial loans can be an ideal source of financing. The reasons why financial institutions acquire these loans can depend on the financial circumstances the institutions find themselves in.

In July 1997, within days of the Thai baht devaluation, the Malaysian ringgit was " attacked" by speculators. Fear that the Thai Baht might devaluate further and apprehension of loan defaults made foreign short-term creditors withdraw funds from Malaysia's financial institutions. Consequently the overnight interest rate jumped from under 8% to over 40%. By end of 1997, ratings had fallen many notches from investment grade to junk, the KLSE had lost more than 50% from above 1, 200 to less than 600, and the ringgit had lost 50% of its value, falling from above 2. 50 to under 4. 10 to the dollar. Banks infected by the collapse of confidence within the financial system were wary of extending loans even to long-standing customers.

Deficient regulations and legal framework

While it can be said that the extreme volatility of capital flows is a major reason behind the currency crisis in Malaysia, the improper regulations and legal framework present in the country did also have an incidence on the occurrence of the crisis.

Malaysia has been implementing reforms in order to liberalise its economy with a view to attract more foreign direct investment. However, the " piecemeal approach" used by the Malaysian government in the implementation of the capitalist system based reforms caused a widening gap between the pace at which reforms were being implemented and the pace at which regulatory institutions were being empowered to keep a check on the financial institutions.

Partial financial liberalisation with no adequate supervision by regulatory authorities enabled loopholes to crop up and theses were immediately exploited by investors to their advantage. A lack of adequate means to supervise the agents in the economy led to abuses and in some cases the government was directly responsible for the waning of the force of law.

These abuses were observed mainly in the banking sector. The absence of sophisticated credit management systems, implicit support of financial institutions by the government as well as the lax regulations in the banking sector contributed to the currency crisis. The fact that banks were given high degrees of freedom; they lent on high loan to collateral value sometimes amounting to 90% of the collateral value, increased their exposure to credit risks. The massive inflow of liquidity was mostly channelled in the real estate

sector with banks providing very competitive terms for investors and being negligent of capital adequacy requirements. This also made the banks more vulnerable as their loan portfolio was made up of a consequential 40% loans advanced to the real estate sector.

Numerous authors noted that the worsening of the currency crisis in Malaysia was mainly due to a lack of prudential regulations that controlled domestic banks on the extent to which they could intermediate foreign funds and the violation of capital adequacy requirements that could have restricted the amount of loans that banks could extend (Edwards, 1999. P. 22).

China as a competitor

Pegged exchange rate regime

Generally an internationally oriented developing economy would prefer to adopt a fixed exchange rate for one main reason: it leads to an exchange rate stability promoting confidence amongst foreign investors and in the minds of import and export business. With a stable exchange rate, investors bother less about abrupt currency fluctuations that may adversely affect their investments. Thus, they are less likely to suddenly pull their money out of the country because of speculations of the future value of the currency. Consequently, in many Asian countries it was believed that, in order to maintain a fixed exchange rate, the currency must be pegged to a currency widely used throughout the world, such as the U. S. dollar. Central bank regulators in Malaysia maintained the Malaysian Ringgit (MR) as a virtual peg to the U. S. dollar from 1947 until 1997. The challenge was to ensure that economic growth continued at a manageable pace. Exchange rate stability

was a great concern for the government because of the relatively small size of its economy which was growing so rapidly. Therefore, if investors lost confidence in its exchange rate, the flow of foreign investment might become highly unstable, hence, the peg to ‘ hard’ currencies, like the U. S. dollar, which tended to remain stable.

Malaysian policymakers had little control over the price of their currency, a sacrifice deemed necessary in order to participate in the increasingly global economy. Indeed, this pegged exchange rate regime of Malaysia was a big advantage for short-term capital inflows. It provides short-term lenders and borrowers with a guarantee against negative exchange rate movements. In contrast, a flexible exchange rate regime would mean high fluctuations. As a consequence, short-term investors and borrowers would need to cater for exchange rate risk in their calculations before investing and borrowing, thus making investments increasingly erratic. This highly pegged nominal interest rate in emerging economies, including Malaysia, led to large short-term capital inflows.

Malaysian emerged with an increase in its terms of trade following a control depreciation of the U. S dollar relative to the yen through the 1985 Plaza Agreement between the United States and Japan. The latter decision made Malaysian production and exports cheaper compared to Japan. FDI also started to rise from 325m MR in 1986 to 6. 2 b MR in 1990, proving foreign currency reserves to Malaysia’s central bank. However, the compromise was reversed when, in April 1995, central bank regulators in the United States and Japan agreed to initiate a controlled appreciation of the dollar with respect to yen. Malaysian Ringgit simultaneously appreciated, rendering FDI

less attractive. This deepened the current account deficit, which was of great concern to foreign investors who had put their money in Malaysia's stock market and banking sector, and pushing FDI towards China and India. This led to a crisis of confidence on behalf of international investors.

With the devaluation of the Thai baht, currency speculators were very much attracted to Malaysia, where commercial banks' over exposure in real estate, weak export growth and a widening current account deficit stoked fears, among foreign investors, of currency devaluation that could endanger their investments. This led to high capital exit from Malaysia, tumbling the Malaysian ringgit. This summarized the inherent risk of a policy upholding exchange rate stability in a developing country.

Cronyism and Controversial Government intervention

It has often been said that in Malaysia, cronyism is indeed widespread, if not unusually high. Cronyism awards government contracts to or bails out politically connected friends without regard to their qualifications. These do little to contribute to the country's productive capacity or economic development. Crony rent seeking concerns mainly government-supported, large-scale infrastructure projects and other ventures that are " sometimes unnecessary and often unviable," fuelling rampant real estate speculation. In South Korea and Taiwan, in return of government support, corporate investors are tied to performance standards and the potential international competitiveness of their investments which is, unfortunately, not the case in Malaysia. In explaining how cronyism brought Malaysia down, the Malaysian government's response to the crisis should be analysed. Three key decisions were taken.

Initially, there were ill-advised attempts to assert Malaysia's sovereignty over market forces and economic policy. This was led by Prime Minister Mahathir, who portrayed the collapse of the ringgit as being due exclusively to speculative attacks on South East Asian currencies. In September 1997, Mahathir declared that " currency trading is unnecessary, unproductive and immoral," and argued that it should be " stopped" and " made illegal." More damagingly, he threatened a unilateral ban on foreign exchange purchases unrelated to imports (which never happened). All this upset " market sentiment" and seemed to exacerbate the situation. Mahathir's early policy responses to the crisis made things worse. In late August 1997, the authorities controlled short selling. Liquidity was adversely affected, by this ill-conceived measure, causing the stock market to fall further. The government's threat to use repressive measures against commentators making unfavourable reports about the Malaysian economy strengthened the impression that the government had a lot to hide from public scrutiny. The Malaysian Finance Minister Anwar Ibrahim mid-October 1997 announcement of the 1998 Malaysian budget was perceived by " the market" as reflecting " denial" of the gravity of the crisis and its causes, ostensibly including " populist" fiscal deficits (which were not the case).

On 3 September 1997, a post-cabinet meeting announced the creation of a special RM60 billion fund for " selected Malaysians". It was understandably seen as a bailout facility designed to save " cronies." Although the fund was never institutionalized, government-controlled public funds-including the Employees Provident Fund and Petronas-were later deployed to bail out some of the most politically well-connected and influential individuals and

organizations, including Mahathir's eldest son; the publicly listed corporation set up by Mahathir's party cooperative; and the country's largest conglomerate (Renong), previously controlled by the prime minister's party and believed to be ultimately controlled by his confidant Daim Zainuddin.

The nature of these bailouts gravely undermined public confidence in the Malaysian investment environment as stock market rules were suspended, at the expense of minority shareholders, causing the stock market to collapse by a fifth in the next three days.

Subsequently, Malaysia swung to orthodox macroeconomic policies. As the economic situation deteriorated in November 1997, Finance Minister became more receptive to IMF policy advice. Securing full cabinet support, Anwar implemented a series of orthodox policies. The central bank, Bank Negara, raised its three-month intervention rate from 8. 7 percent at the end of 1997 to 11. 0 percent in early February 1998. Drastic 18 percent reductions were made in budgeted government expenditure. Loans in arrears were redefined as nonperforming loans after three months, instead of the previous six months. Bank statutory reserve requirements were also raised and tighter definitions of nonperforming loans were enforced. Malaysia's orthodox measures deepened the impact of the crisis. The massive ringgit devaluation imported inflation into Malaysia's very open economy. Overzealous efforts to check inflation exacerbated deflationary tendencies.

Confidence in official policy declined with cronyism while the orthodox policies from late 1997 accentuated declining domestic and regional

demand. Thus, what began as a currency crisis soon generated a financial crisis, which in turn led to a recession.

In the second quarter of 1998, Finance Minister dramatically changed course, turning away from contractionary measures and instead reflating the economy through spending policies designed to stem the downturn. By this stage, however, a political drama had begun to unfold as Prime Minister Mahathir, shocked by the resignation of Indonesian president Suharto in May 1998, began to worry about the foreign media's calls for Anwar to replace him. Mahathir began to portray Anwar as a stooge of the West, especially of the IMF.

Finally, Malaysia decided to apply capital controls to support reflationary monetary policies. On 1 September 1998, the Malaysian authorities introduced capital and other currency controls. The ringgit exchange rate was fixed at RM3. 8 to the US dollar, compared to the pre-crisis rate of around RM2. 5. The Prime Minister then dismissed the deputy Prime Minister and Finance Minister, Anwar Ibrahim.

Cronyism and controversial interventions has, thus, provided a ready-made explanation of how politically connected investment and bailouts of the politically powerful eroded the sustainability of Malaysian economic growth and made its economic crisis worse.

Decline in output of real economy

Absence of a lender of last resort in the region

Countries routinely have crashes in real estate and other asset markets without jeopardising the whole economy. The head of the International Monetary Fund (IMF) said in mid-1997 that the government of Thailand was taking courageous steps to address the problems of the financial sector and that he ‘ did not see any particular reason for this crisis to develop further.’ The Asian financial crisis should have stopped at the correction in Thailand. However, in November, the Managing Director of the IMF said in Singapore that while the origins of the crisis in Thailand was clear, ‘ what is less evident and therefore more unsettling’ to all is how the crisis spread to Indonesia, Malaysia and the Philippines.

Countries whose currencies and well-being were under attack needed large amounts of liquidity.