CHAPTER 3: THE ORIGINS OF THE CRISIS – THE MALAYSIAN PERSPECTIVE

3.1 Currency Speculation and Contagion Effects

The Asian financial crisis that began with the floating of the Thai baht on 2 July 1997, quickly spread to Malaysia and caused a massive devaluation of the ringgit. The ringgit lost more than 50% of its value against the US dollar, from RM2.4717 to RM3.8900. Since the crisis, many views have been put forward as to the causes of the crisis. Among the most vocal one was that it was the result of speculative attack by hedge fund managers in the financial markets. The speculative attacks of hedge fund managers created panic in East Asian markets that finally led to capital flight and the devaluation of the ringgit. Speculative attacks were based on the following beliefs:

i) Malaysia was perceived to have somewhat similar economic fundamentals as Thailand. Hence, there was concern about Malaysia's sustainable economic growth in the long run, particularly export and foreign exchange earnings. Export growth has slowed down in the country and the region as a whole. The devaluation of ringgit was foreseen as bound to happen (Camdessus, 1999; Corbett and Vines, 1998).

ii) The devaluation of Thai baht would make Thailand more competitive than Malaysia and this would erode Malaysia's foreign exchange earning from trade. Hence, the probability that Malaysia would devalue the ringgit that was high. The research by the World Bank (1997), found that if the East Asian countries compete in the same export markets, a devaluation of one currency places competitive pressures on other currencies,

which may then be forced to devalue to restore their competitiveness.

According to Sugisaki (1997), the causes of the regional economic crisis were not due only to speculation and contagion but also market expectations were affected by concern about the fundamental health of these economies. Generally, the market participants had paid close attention to the various policies, activities and general economic performance of these countries, that is, the overvalued property market and the weakening economic soundness of these countries, the tightening of the monetary policy and the willingness of the authorities in the concerned countries to raise interest rates. Market participants were also concerned that the governments interfered in the operations of the financial institutions and in the enterprise sector and the possibility that governments may re-impose controls on the capital market. In response, investors became more risk averse and withdrew from the market and created huge capital flights and the devaluation of major currencies in the region.

3.2 Macroeconomic Imbalances

3.2.1 Influx Of Capital And Current Account Deficit

The Malaysian currency crisis occurred following a decade of strong economic performance. This economic growth was led mainly by rapid export expansion and supported by substantial capital inflows (Tables 4). The build-up of foreign capital inflows and export growth were largely attributed to the sluggish growth in the advanced economies, in particular Europe and Japan, which had made investments in fast-growing Asian countries relatively attractive (NERP, 1998).

Worthy to note is that short-term inflows such as FPI had increased substantially for the country during this period. In 1993, FPI in the country was 14.5 % of GDP, while its FDI was about 7.8% of GDP only (Table 4). With the presence of substantial short-term FPI, the country would be subjected to higher risk and market volatility as suggested by the earlier literature review. According to Corsetti, Paolo and Roubini (1998), current account sustainability is enhanced when the deficit is largely financed by foreign direct investment (FDI), relative to a deficit mainly financed by short-term flows that may be reversed if market conditions and sentiments change. In addition, they also pointed out inflows from official creditors are more stable and less subject to sharp reversals in the short-run than those from private creditors.

Table 4: Annual Capital Inflows by Major Category, 1989-95 (in US$ billion)

	1989	1990	1991	1992	1993	1994	1995
	US$ billions						
GDP	37.9	42.8	47.7	57.6	61.0	68.9	87.2
Net Capital Inflow	1.3	1.8	5.6	8.7	10.8	1.3	7.4
	Percent of GDP						
Current Account Balance	0.7	-2.1	-9.0	-3.8	-4.8	-6.3	-8.5
Net Capital Inflow	3.5	4.2	11.9	15.2	16.8	1.6	8.5
Official Development Finance	-2.4	-2.4	-0.5	-1.4	0.6	0.3	2.7
Foreign Direct Investment	4.4	5.4	8.5	9.0	7.8	6.0	4.7
Commercial Bank Funds	1.1	2.0	2.8	6.3	6.6	-7.0	0.1
Portfolio Equity	-	-	-1.5	5.6	14.5	5.7	1.2

Source : *National Accounts Statistics and Balance of Payments Report, Department of Statistics, Malaysia; Cash BOP Reporting System, Bank Negara Malaysia.*

Alarming signs were noted by many despite the positive fiscal balances in the country since 1993 (Table 5). There were high skepticism on the overheating pressures in the country which was manifested by its persistent current account deficits since 1990 (Tables 6), the accompanying rapid credit growth (together with the rapid economic growth) in the private sector and the asset price inflation in the real estate and equity markets. From Table 6, it can be seen that the current account deficit started to decline from a negative RM2,483 million in 1990 to a negative RM12,252 million in 1996. The concern is, the persistent deficit in the current account would eventually dry up the country's reserves, which is of great importance for maintaining the country's foreign exchange rate and economy equilibrium.

Table 5: Government Fiscal Balance (as % of GDP)

	1990	1991	1992	1993	1994	1995	1996	1997
Korea	-0.68	-1.63	-0.50	0.64	0.32	0.30	0.46	0.25
Indonesia	0.43	0.45	-0.44	0.64	1.03	2.44	1.26	0.00
Malaysia	-3.10	-2.10	-0.89	0.23	2.44	0.89	0.76	2.52
Philippines	-3.47	-2.10	-1.16	-1.46	1.04	0.57	0.28	0.06
Singapore	10.53	8.58	12.35	15.67	11.93	13.07	14.10	9.52
Thailand	4.59	4.79	2.90	2.13	1.89	2.94	0.97	-0.32
China	-0.79	-1.09	-0.97	-0.85	-1.22	-1.00	-0.82	-0.75
Taiwan	1.85	-2.18	-5.34	-3.88	-1.73	-1.09	-1.34	-1.68

Source : International Financial Statistics, IMF, Economist Intelligence Unit Reports, Asian Development Bank.

Table 6: Malaysia's Balance of Payment, 1988-1997 (in RM Million)

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Merchandise balance (f.o.b)	14524	11871	7093	1449	8609	8231	4460	97	10154	11087
• Export (f.o.b)	54607	66727	77458	92220	100910	118383	148506	179491	193127	218734
• Import (f.o.b)	40083	54856	70365	90771	92301	110152	144046	179394	182973	207647
Balance on services	-10180	-11392	-9723	-13195	-14568	-16670	-17005	-19407	-19470	-20790
Balance on goods and services	4344	479	-2630	-11746	-5959	-8439	-12545	-19310	-9316	-9703
Transfers	395	219	147	102	337	513	-2225	-2515	-2936	-3697
Balance on current account	**4739**	**698**	**-2483**	**-11644**	**-5622**	**-7926**	**-14770**	**-21825**	**-12252**	**-13400**
Long-term capital	-3218	2060	3473	10331	10328	13864	11659	16610	13527	18705
• Official Long Term Capital	-5102	-2458	-2856	-665	-2876	979	861	6146	750	4805
• Private Long Term Capital	1884	4518	6309	10996	13204	12885	10798	10464	12777	13900
Basic balance	1521	2758	990	-1313	4706	5938	-3111	-5215	1275	5305
• Short Term Capital	-1962	1562	1356	5135	11957	13931	-8484	2529	10317	-14229
• Errors and omissions	-663	-988	3019	-395	81	9370	3333	-1717	-5347	-1968
Overall Balance	-1104	3332	5365	3427	16744	29329	-8262	-4403	6245	-10892
Net change Bank Negara M'sia Reserve	1104	-3332	-5365	-3427	-16744	-29239	8262	4403	-6245	10892
Net Bank Negara M'sia Reserve	18328	21660	27025	30452	47195	76435	68173	63770	70015	59123
% current account balance to GNP	5.5	0.7	-2.2	-9.3	-4.0	-5.1	-8.2	-10.5	-5.1	-5.1

Source : National Economic Action Council, August 1998

Lawrence Summers, the US deputy Treasury Secretary, indicated in *The Economist* that "close attention should be paid to any current account deficit in excess of 5% of GDP, particularly if it is financed in a way that could lead to rapid reversals" (IMF,1998). Table 7 shows that in 1991, 1994 and 1995, Malaysia had overshot this recommended rate. Although the current account deficit as a percentage of GDP had dropped in 1996 and 1997, it was still close to 5% of GDP.

Table 7: Current Account Deficit As A Percentage of GDP

Country	1990	1991	1992	1993	1994	1995	1996	1997
Korea	-0.69	-2.83	-1.28	0.30	-1.02	-1.86	-4.75	-1.85
Indonesia	-2.82	-3.65	-2.17	-1.33	-1.58	-3.18	-3.37	-2.24
Malaysia	-2.03	-8.69	-3.74	-4.66	-6.24	-8.43	-4.89	-4.85
Philippines	-6.08	-2.28	-1.89	-5.55	-4.60	-2.67	-4.77	-5.23
Singapore	8.33	11.29	11.38	7.57	16.12	16.81	15.65	15.37
Thailand	-8.50	-7.71	-5.66	-5.08	-5.60	-8.06	-8.10	-1.90
China	3.09	3.27	1.33	-1.94	1.26	0.23	0.87	3.24
Taiwan	6.82	6.94	4.03	3.16	2.70	2.10	4.05	2.72

Sources : International Financial Statistic, IMF, Economist intelligence Unit Reports, Asian Development Bank.

On the other hand, the National Economic Action Council reported in the National Economic Recovery Plan that the persistent current account deficit was mainly the outcome of the shortfalls of private savings to match private investment, not public sector dissaving (Table 8)[NEAC,1998]. In other words, foreign capital inflows made up for the shortfall in national savings and were used to finance the very high national investment rather than consumption.

Table 8: Saving-Investment Gap (RM Million)

	1993	1994	1995	1996	1997p
Public gross domestic capital formation	23760	24833	27844	27970	32183
Public savings	27339	32733	32763	39729	47204
Deficit / Surplus	3579	7900	4919	11759	15021
Private gross domestic capital formation	38700	52070	67305	75799	86499
Private Savings	27195	29400	40561	51788	58078
Deficit / Surplus	**-11505**	**-22670**	**-26744**	**-24011**	**-28421**
Gross domestic capital formation	62460	76903	95149	103769	118682
(as % of GNP)	39.8	42.5	45.7	43.6	45.1
Gross national savings	54534	62133	73324	91517	105282
(as % of GNP)	34.7	34.4	35.2	38.5	40.0
Balance on current account	-7926	-14770	-21825	-12252	-13400
(as % of GNP)	-5.1	-8.2	-10.5	-5.1	-5.1

Source: National Economic Action Council, 1998.

3.2.2 Mis-management of money supply (in relation to capital inflows) and exchange rate system deficiency.

Corresponding with the surge of capital inflows of FDI, FPI and commercial bank loans into the country in the early 1990s and during the pre-crisis period, the amount of high-powered[5] money increased. When high powered money increased, it led to a vast expansion of money supply in the country (Sivalingam, 1999). From Table 11, the total money supply, that is, M2 and M3 increased at an annual average rate of more than 20 % between 1992 and 1997.

[5] High-powered money is basically made up of commercial bank reserves held in Bank Negara and currency in circulation. High powered money can also be increased by the inflow of foreign currency (Sivalingam, 1999)

Table 9: Growth Rates in Money Supply, 1992-1997

Year	Growth Rate of M3 [c] (%)	Growth Rate of M2 [b] (%)	Growth Rate of M1 [a] (%)
1992	19.6	19.1	13.0
1993	23.5	22.1	37.5
1994	23.5	14.7	11.2
1995	22.3	24.0	11.7
1996	21.2	19.8	16.7
1997	18.5	22.7	4.6
Average Annual Growth Rate for the period 1992-1997	21.43	20.40	15.78

a- Currency in circulation and demand deposits of the private sector

b- M1 plus narrow quasi money, which comprise of savings and fixed deposits of the private sector placed with Bank Negara and commercial banks, net Negotiable Instruments of Deposits (NIDs) and Repurchase Agreement (repos) by commercial banks.

c- M2 plus deposits (including NIDs and repos) with other banking institutions

Source: Bank Negara Malaysia, 1997

The concern is that, the vast expansion of money supply was generally greater than the money demanded by the market, which in turn generated price pressures and inflation, that eventually disturbed the country's exchange rate equilibrium (Sivalingam, 1998).

More worrisome, according to Bank Negara Malaysia (1997), the strong growth in money supply highly reflected the high credit growth in the country. When credit grew, it tended to drain the country's international reserves. This phenomenon is exactly explained by the Monetary Approach to Exchange Rate Determinations. Under this model, that is,

$$\hat{R} - \hat{E} = \hat{P}^* + \hat{Y} - \hat{D}$$

(NB: ^ = Percentage change, R =Reserves, E =Exchange Rate, P =Price of foreign goods, Y =Income, D= Domestic Credit)*

the adjustment mechanism for a country that adopted a fixed or managed floating exchange rate system would be a change in R, as very little or nothing can be done with E. The change in R occurs if D changes, while the foreign inflation rate or P* and Y remains constant. When D increases, R will fall. This shows that D and R have a negative relationship and it clearly indicated that in order for a managed floating or fixed exchange rate system to work, the nation must have sufficient reserves.

As Malaysia practiced a managed float exchange rate system prior to 1st September 1998, the mechanism for maintaining the exchange rate within a narrow band of RM2.50/US$ would therefore hinge highly on the use of foreign exchange reserves. On one hand, it is noted the country needed reserve to restore its exchange rate equilibrium, but on the other it was found that the reserves was depleted with the increase in the domestic credit.

In mid July 1997, after spending an estimated US$3.58 million in external reserves, Bank Negara Malaysia (BNM) ceased intervention. The ringgit was allowed to free-float clean for the first time since 1975 (Kwan,1998). BNM appeared to have insufficient reserves to support the ringgti and unwilling to commit the rest of its US$24.6 billion in external reserves in the face of a seemingly unlimited supply of offshore ringgit for sale (Kwan,1998). With the free float of the exchange rate, ringgit become even more vulnerable to the attack and depreciated even further. When the market lost its confidence, it eventually motivated the capital flight from Malaysia.

An indicator of the adequacy of foreign exchange reserves is the ratio of money assets to foreign reserves (Corsetti, Paolo and Roubini (1998). Table 10 shows that in most Asian countries, the ratio between M2 and foreign reserves was dangerously high in 1996-1997. In Malaysia itself, the ratio has increased from 2.9 in 1990 to 3.7 at the end of 1996, which was far below the unity level. At the unity level, it is always assumed that any percentage increase in the money supply would be matched exactly by the same percentage increase in reserves. A ratio at 3.9, which was higher than the unity level, indicated that the money supply in the country was highly insufficient to meet the demand on reserves, hence it led the country to a disequilibrium stage.

Table 10: Ratio of M2 to Foreign Reserves

Country	1990	1991	1992	1993	1994	1995	1996	1997
Korea	6.48	8.33	7.20	6.91	6.45	6.11	6.51	10.50
Indonesia	6.16	5.51	5.61	6.09	6.55	7.09	6.50	7.37
Malaysia	2.91	2.99	2.64	2.09	2.47	3.33	3.66	4.99
Philippines	16.33	4.82	4.35	4.90	4.86	5.86	4.50	6.97
Singapore	1.23	1.18	1.17	1.05	1.06	1.05	1.03	1.17
Thailand	4.49	4.10	4.10	4.05	3.84	3.69	3.90	5.29
Hong Kong	-	5.43	4.84	4.54	4.43	4.35	4.25	3.18
China	10.37	8.00	21.39	26.93	10.29	9.65	8.55	7.76
Taiwan	3.20	3.36	4.28	4.61	4.78	5.35	5.78	6.30

Sources: International Financial Statistics, IMF, Economist Intelligence Unit Reports, Asian Development Bank.

3.2.3 Excessive Credit Expansion and Institutional Deficiencies in the Banking System

It is noted that the pre crisis years were a period of excessive credit growth in the banking system in the country. From Table 11, it can be

seen that the ratio of private sector lending to GDP shows an upward trend for Malaysia throughout the pre crisis period except for 1992-1993. This data suggests that, overall, there was a sustained lending boom in the country. A comparison with the neighbouring countries in the region showed that between 1990 and 1996, the magnitude of the lending boom was the largest in the Philippines (151%), Thailand (58%) and Malaysia (31%) (Table12). Interestingly, these countries were also the first countries to be hit by the currency speculation in 1997. This somewhat implied that there is a cause-and-effect relationship between the accumulation of loans and the currency crisis.

Table 11: Bank Lending to Private Sector (as a percentage of GDP)

Country	1990	1991	1992	1993	1994	1995	1996	1997
Korea	52.54	52.81	53.34	54.21	56.84	57.04	61.81	69.79
Indonesia	49.67	50.32	49.45	48.90	51.88	53.48	55.42	69.23
Malaysia	71.36	75.29	74.72	74.06	74.61	84.80	93.39	106.91
Philippines	19.17	17.76	20.44	26.37	29.06	37.52	48.98	56.53
Singapore	82.20	83.34	85.06	84.14	84.21	90.75	95.96	100.29
Thailand	64.30	67.70	72.24	80.01	91.00	97.62	101.94	116.33
Hong Kong	-	141.84	134.20	140.02	149.00	155.24	162.36	174.24
China	85.51	87.87	86.17	95.49	87.12	85.83	91.65	101.07
Taiwan	100.4	108.99	126.43	137.23	146.89	149.49	146.05	146.23

Sources : *International Financial Statistics, IMF, Economist Intelligence Unit Reports, Asian Development Bank.*

Table 12: Lending Boom* for the Period Between 1990 and 1996

Country	Average growth rate in lending (between 1990-1996)
Korea	11%
Indonesia	10%
Malaysia	31%
Philippines	151%

Singapore	17%
Thailand	58%
Hong Kong	26%
China	7%
* it measures the rate of growth between 1990-1996 for the ratio between the nominal GDP and the claims on private sector of the deposited banks.	

Sources : *International Financial Statistics, IMF, Economist Intelligence Unit Reports, Asian Development Bank.*

Based on the information obtained from the IMF(1998), in 1996, there was an overall increase in bank lending by 27.6% in Malaysia with a sharp switch from lending to the manufacturing sector to lending for equity purchases: growth in lending to the manufacturing sector fell to 14% in 1996 (from 30.7% in 1995), while growth in lending for share purchases accelerated to 20.1% (from 4% in 1995). It is reported that by end of 1996, the banking system's exposure to the property sector and equities stood at 42.6% of total credits, compared to 21% for manufacturing finance. Over the year 1996, the increased availability of loans drove up asset prices, with the price of up-market properties in major Malaysian cities growing by 25% in 1996 (IM,1998).

Data from the 1998 National Economic Recovery Plan further reveals that, for most of 1997, loans to the property sector were growing above 30 percent and amounted to 26 percent of total loans. Loans for the purchase of stocks and share during 1993-1997 grew at an average rate of 35 percent per year (NEAC,1998).

Beside the indication on the "quantity" of loan (as shown in Tables 11 and 12), a more important issue is the "quality" of the loans, which is deemed would have even greater impact on the sustainability of the country's economy. Sources from IMF (1998) pointed out that many loans made by the bank and financial institutions in the East Asian countries were of low quality, that is, for financing investment of

dubious profitability or speculative purchases of existing financial assets. As reported in Table 13, the pre-crisis share of non-performing loans as a proportion of total lending was estimated at 10% for Malaysia in 1996.

Table 13 : Percentage of Non-Performing Loans as a proportion of total lending in 1996

Country	Percentage of Non-Performing loans as a proportion of total lending in 1996
Korea	8%
Indonesia	13%
Malaysia	10%
Philippines	14%
Singapore	4%
Thailand	13%
Hong Kong	3%
China	14%
Taiwan	4%

Source: IMF 1998

The problem was aggravated when the main source of funding for the domestic credit creation were mainly short term deposits, that is, fixed deposits that matured in one month, current and savings deposits and Negotiable instruments of Deposits. Following the rapid expansion of credit, private domestic debt escalated. Many of the private corporations have increased their borrowing from foreign commercial banks since capital was more costly in Malaysia because of interest rate differentials[6]. There was no worry on sourcing funds from foreign commercial banks because the managed floating exchange rate

[6] The Malaysian government efforts to sterilise the flows to curtail credit expansion has widened the interest rate differential. With higher interest rates, it induced more foreign investment and capital flows to the country, at the same time, it also motivated the private and public agents to increase borrowings from external market which offer at a lower interest rates (Sivalingam, 1999)

system in the country helped to minimise the foreign exchange risks of their investment. It was strongly believed that this resulted in a mismatch in the maturity of loans and deposits. The banks were borrowing short term in the external markets and lending long term or financing long-term investments with short term debt (Sivalingam, 1999).

According to Corsetti, Paolo and Roubini (1998), an otherwise solvent country may suffer a short-run liquidity problem when the availability of stock of the reserves is low relative to the overall burden of external debt service.

One of the ways to gauge the solvency of a country is by estimating its liabilities to assets ratios (Corsetti, Paolo and Roubini 1998). From Table 14, it is noted that this ratio is above unity for all crisis countries. In 1996, the ratio had reached 1.48 for Malaysia. This figure suggested there was a serious mismatch between foreign liabilities and foreign assets of the country. Based on their findings, Corsetti, Paolo and Roubini (1998) stated that in normal times a high ratio of foreign liabilities to foreign assets may not cause concern, as short-term foreign debts are easily rolled –over. Liquidity problems would emerge when panicking external creditors, perhaps in response to rapid devaluation, become unwilling to roll over existing short-term credits. So, if a large fraction of a country's external liabilities are short-term, a crisis may take the form of a pure liquidity shortfall and cause serious financial problems (especially when the domestic banks borrowed heavily from foreign banks but lent mostly to domestic investors and if the foreign borrowing is in foreign currency while the domestic lending is in domestic currency). Foreign lenders may suddenly refuse to roll over short-term lines of credit to domestic banks, hence precipitating a credit crisis (IMF,1998). To a large extent, this was what happened in Malaysia in 1997. In other words, if a liquidity crisis occurs, foreign

reserves must be large enough to cover a country's debt service obligations (including the roll-over of short-term debt)

Table 14: Ratio of Bank Liabilities to Assets

Country	1993	1994	1995	1996	1997
Korea	2.97	2.97	3.32	3.75	2.51
Indonesia	2.96	4.01	4.26	4.24	5.43
Malaysia	0.83	1.40	1.44	1.48	2.23
Philippines	1.14	0.97	1.10	1.72	1.71
Singapore	1.51	1.62	1.66	1.62	1.38
Thailand	6.93	7.73	7.81	11.03	8.12
Hong Kong	1.42	1.43	1.56	1.65	1.59
China	0.99	0.94	1.17	1.20	1.36
Taiwan	0.64	0.59	0.61	0.61	0.62

. *Sources :* *International Financial Statistics, IMF, Economist Intelligence Unit Reports, Asian Development Bank.*

3.2.4 Actual Output vs. The Potential output

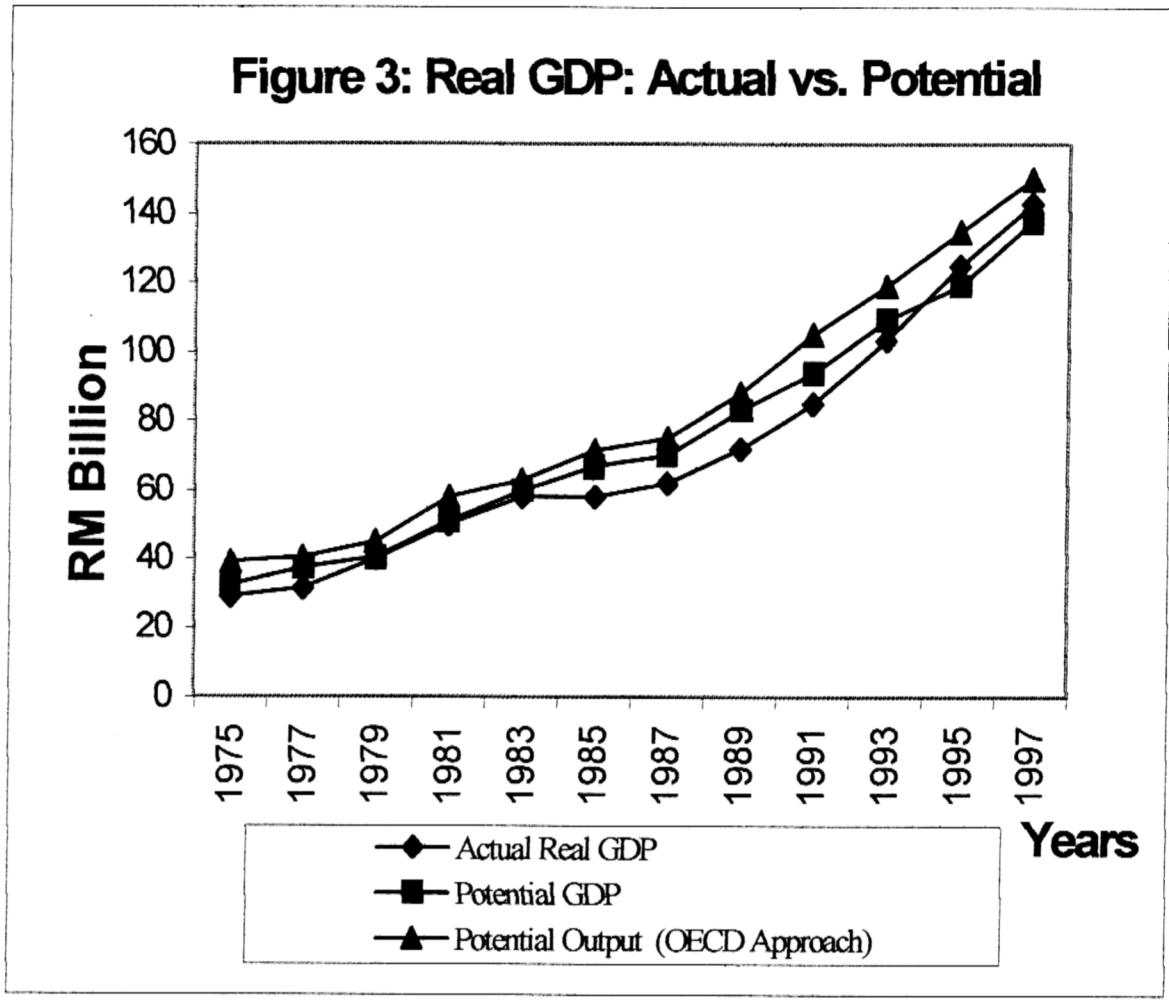
In macroeconomic theory, it is always claimed that a country is in equilibrium when potential output is equal to its actual output. According to Chrystal and Lipsey (1998), when the actual GDP exceeds the potential GDP, it will cause the output gap to become negative and the resulting upward pressures on prices, would eventually lead to an inflationary gap.

Since 1991, the economy has been consistently growing above what is deemed to be its potential growth path (NEAC, 1998). During 1994-1996, it was reported that the country's actual GDP has grown faster than its potential GDP and hence widened its output gap (Figure 3). Corresponding with the above theory, the increase in output gap has

generated price pressures, especially in the form of upward wage increases that have increased above productivity gains.

Estimates shows that the increase in real labour productivity of 5.3% in 1996 continued to lag behind the growth of real average wages in the manufacturing sector of 9.6% (Table 15). In fact, in its 1995 Annual Report, Bank Negara Malaysia had raised concerns over the sustainability of the strong economic growth over a long period as strains began to emerge in the form of supply bottlenecks that were manifested through labour shortages as well as infrastructure constraints. What is more worrisome, according to the National Economic Action Council (NEAC) is, the economic growth during this period was primarily brought about through augmenting inputs rather than the improvements of efficiency. This phenomenon is deemed highly unsustainable in the longer term, particularly when a significant proportion of the inputs (both capital and labour[7]) was imported. The economic growth would be affected due to the short supply of skilled labour as industries continued to shift into higher value added products and more knowledge-based and technology intensive processes.

[7] Based on BNM 1997 Annual Report, there were 1.14 million registered foreign workers in 1997



Source: Bank Negara Malaysia, Annual Report, 1997

Table 15: Labour and Employment, 1993-1997

	1993	1994	1995	1996	1997
Labour force ('000)	7,627	7,834	8,140	8,372	8,607
(annual change in %)	3.5	2.7	3.9	2.9	2.8
Employment (annual change in %)	4.2	3.0	3.9	3.1	2.6
Unemployment rate (%of labour force)	3.0	2.9	2.8	2.5	2.7
Labour productivity growth (GDP/Employment)	4.0	6.1	5.3	5.3	5.1
Average wages in manufacturing sector (annual change in %)	2.4	4.2	6.1	9.6	7.0

Employment by sector ('000)					
Agriculture, forestry and fishing	1,680	1,585	1,413	1,339	1,274
Mining	36	36	41	43	43
Manufacturing	1,742	1,892	2,052	2,178	2,316
Construction	544	598	667	726	765
Electricity, gas and water	48	61	71	74	76
Wholesale and retail trade, hotels And Restaurants	1,292	1,318	1,337	1,375	1,383
Finance, insurance, real estate and Business services	332	352	379	403	422
Transport, storage and communication	344	366	395	414	433
Government services	864	868	872	877	880
Other services	514	542	688	732	783
Total	**7,396**	**7,618**	**7,915**	**8,161**	**8,375**
Services	3,393	3,507	3,742	3,875	3,977

Source: Economic Planning Unit, Department of Statistics, BNM Annual Report 1997

3.2.5 Investment and Loss of efficiency

Table 16 shows that the East Asian countries had very high rates of investment as a percentage of GDP throughout the 1990s, that is, the investment rates were above 30% of GDP except for Philippines and Taiwan. In Malaysia, the investment rate had increased above 40% of GDP since 1994. This high investment rate became a concern, particularly when the funds raised to finance this investment growth did not seemed to be efficiently used to generate the expected profit and increase the output growth of the country (IMF,1998).

Table 16: Investment Rates as a percentage of GDP

Country	1990	1991	1992	1993	1994	1995	1996	1997
Korea	36.93	38.90	36.58	35.08	36.05	37.05	38.42	34.97
Indonesia	36.15	35.50	35.87	29.48	31.06	31.93	30.80	31.60
Malaysia	31.34	37.25	33.45	37.81	40.42	43.50	41.54	42.84
Philippines	24.16	20.22	21.34	23.98	24.06	22.22	24.02	24.84
Singapore	35.87	34.21	35.97	37.69	32.69	33.12	35.07	37.40
Thailand	41.08	42.84	39.97	39.94	40.27	41.61	41.73	34.99
Hong Kong	27.44	27.20	28.50	27.54	31.85	34.91	32.38	35.08
China	34.74	34.77	36.17	43.47	40.88	40.20	38.73	37.55
Taiwan	23.08	23.29	24.90	25.16	23.87	23.65	21.24	22.20

Sources: *International Financial Statistics, IMF, Economist Intelligence Unit Reports, Asian Development Bank.*

The evidence on the profitability of investments or the efficiency in the utilization of resources in an economy is provided by estimates of TFP (Total Factor Productivity) and the ICOR[8] (Incremental capital-output ratio). From Figure 4 and Table 17, it can be seen that Malaysia has lost its productivity and investment efficiency with a declining TFP growth rate (Figure 4) and an increase in its ICOR over the years (Table 17). It is noted that the ICOR had risen from 3.7 between 1987-1992 to 4.8 between 1993-1996.

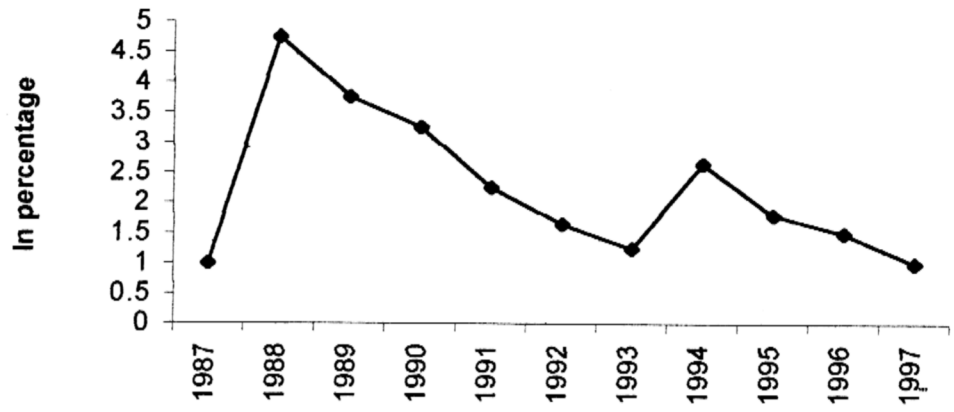
Table 17: Incremental Capital Output Ratio (ICOR)

Country	1987 - 92	1993 – 96	Country	1987 – 92	1993 – 96
Korea	3.8	4.9	**Thailand**	3.4	5.1
Indonesia	4.0	3.8	**Hong Kong**	3.7	6.1
Malaysia	3.7	4.8	**China**	3.1	2.9
Philippines	6.0	5.5	**Taiwan**	2.4	3.9
Singapore	3.6	4.0			

Source: JP Morgan

[8] ICOR measures the overall investment efficiency. It is the ratio between the investment rate and the rate of output growth.

Figure 4: Total Factor Productivity Growth (%), 1987-1997



Source: NEAC, 1998

3.2.6 Balance of Trade Imbalance – Deteriorating Export Growth

Trade has been the engine of growth for East Asia's 30-year rapid expansion (Word Bank, 1998). Data obtained from the World Bank showed that trade as a share of GDP increased considerably, from 15% in 1970 to over 50% in 1995 in the five East Asian countries, that is, Thailand, Korea, Indonesia, Malaysia and Philippines. However, by the first quarter of 1996, the export growth began to taper off and the export growth fell to zero in these East Asia 5 countries. In Malaysia, the export growth rate dropped from a high of 21% of its GDP in 1995 to 6% in 1996 (Table 18).

Table 18: Export Growth rate in East Asia (as a percentage of GDP)

Country	1994	1995	1996	1997
Thailand	19	20	-1	3
Korea	14	23	4	5
Indonesia	8	12	9	7
Malaysia	20	21	6	I
Philippines	17	24	14	21
China	25	19	2	21
Hong Kong	11	13	4	4
Singapore	24	18	5	-1
Taiwan	9	17	4	4
Japan	9	10	-8	2
United States	9	12	7	10
World	14	20	4	4

Sources: *International Financial Statistics, IMF, Economist Intelligence Unit Reports, Asian Development Bank.*

The slowdown in export growth, according to World Bank (1998), actually reflected forces that were largely cyclical in the world and within the regional economy. These forces included:

i) the long period of stagnation within the Japanese economy and the depreciation of the Japanese yen. The sharp depreciation of the yen in 1995 is deemed to have compounded the negative impact of the slowdown in the world exports of many East Asian countries. This is due to the fact that Japan is both a major market for other East Asian producers and a competitor in export markets.

ii) The increasing weight of China in total exports from the region have enhanced competitive pressures in many Asian countries,

and coupled with the devaluation of the yuan in 1994, it was almost equivalent to a negative productivity shock to the other Asian tigers.

iii) sector-specific shocks such as the fall in the demand for semi-conductors in 1996 and the significant price declines from major export products in some countries in the region. The largest price decline occurred in the electronics industry, especially for computers, semiconductors, and telecommunications, in which East Asia specializes. Price wars and intense competition were two features of the global electronics industry that arise from (a) standardization and mass production, leaving less room for product diversification; and (b) a persistent trend toward over-capacity problems. East Asian countries have been aggressive in expanding capacity and capturing significant market shares, but in the process, they have also became more vulnerable to terms of trade declines and over-capacity problems. Conversely, prices of labour-intensive manufactured goods, such as textiles and apparel, have been more stable. This relative price stability partly explains China's export growth, which is heavily based on labour-intensive manufacturing.

When the news of declining export growth in all East Asian countries spread, coupled with the appreciating ringgit against the US dollar and the Japanese Yen between 1993 and 1996 (Table 19), skepticism on the earning stream and competitiveness of Malaysia became more significant (as trade was an important engine of growth for the country for the past decade). As a consequence, it induced speculative attack on ringgit and caused capital to flows out from the country.

Table 19: Exchange Rates of the Ringgit against the US dollar and the Japanese Yen

Year	Yen	US Dollar
1991	2.17	2.72
1992	2.09	2.61
1993	2.41	2.70
1994	2.56	2.56
1995	2.47	2.54
1996	2.18	2.53
1997	2.99	3.88

Source: Ministry of Finance, Economic Report 1998/99