CHAPTER SIX

THE CRISIS

6.1 Introduction

In this chapter, a detail analysis of the recent economic crisis is described. This chapter would give a broad overview of the types of crisis but focus will remain on the currency crisis. It will also describe the IMF approach in tackling the crisis and the short comings of that approach while a alternative approach is analysed. This chapter also describes on causes of the crisis in Malaysia and policies implemented by the government to overcome the crisis.

6.1.1 Types of Crises

The financial crises that erupted in east Asia in the second half of 1997 are the latest in a series of such episodes that have been experienced by economies in various regions of the world in recent years. In the 1990s, currency crises have occurred in Europe (the 1992-93 crises in the European Monetary System's exchange rate mechanism. ERM), Latin America (the 1994-95 "tequila crisis"). As well as in east Asia (the 1997-98 crises in Indonesia, Korea, Malaysia, the Philippines, and Thailand). These crises have been costly in varying degrees, and particularly so where banking sector problems have been involved, both in lost output and in the fiscal and quasifiscal outlays to shore up fragile financial sectors. Also, they have involved significant international spillovers and in a number of cases have required international financial assistance to limit their severity, costs and to contain their contagious spread and spillovers to other countries.

A number of broad types of economic or financial crisis can be distinguished. A *currency crisis* may be said to occur when a speculative attack on the exchange value of a currency results in a devaluation (or sharp depreciation) of the currency, or forces the authorities to defend the currency by expending large volumes of international reserves or by sharply raising interest rates. A *banking crisis* refers to a situation in which actual or potential bank runs or failures induce banks to suspend the internal convertibility of their liabilities or which compels the government to intervene to prevent this by extending assistance on a large scale. A banking crisis may be so extensive as to assume systemic proportions. *Systemic financial crises* are potentially severe disruptions of financial markets that, by impairing markets' ability to function effectively, can have large adverse effects on the real economy. A systemic financial crisis may involve a currency crisis, but a currency crisis does not necessarily involve serious disruption of the domestic payments system and thus may not amount to a systemic financial crisis. Finally, a *foreign debt crisis* is a situation in which a country cannot service its foreign debt, whether sovereign or private.

6.1.3 Currency Crisis

A currency crisis could be identified simply as a substantial nominal currency devaluation. This criterion, however, would exclude instances where a currency came under severe pressure but the authorities successfully defended it by intervening heavily in the foreign exchange market, or by raising interest rates sharply, or by other means. An alternative approach is to construct an index of speculative pressure that takes into account not only exchange rate changes, but also movements in international reserves or interest rates that absorb pressure and thus moderate the exchange rate changes. Crises identified by using such an index would therefore include not only those occasions in which the currency depreciated significantly, but also occasions where actions by the authorities averted a large devaluation or the abandonment of an exchange rate peg.

Table 6.1

Cost of Crises in Lost Output Relative to Trend

	Number of Crisis	Average Recovery Time[1] (in years)	Cumulative Loss Of Output per Crisis[2] (in percentage points)	Crises with Output Losses[3] (in percent)	Cumulative Loss of Output per Crisis with Output Loss[4] (in percentage points)
Currency crisis	158	1.6	4.3	61	7.1
Industrial	42	1.9	3.1	55	5.6
Emerging market	116	1.5	4.8	64	7.6
Currency crashes[5]	55	2.0	7.1	71	10.1
Industrial	13	2.1	5.0	62	8.0
Emerging market	42	1.9	7.9	74	10.7

[1]Average amount of time until GDP growth returned to trend. Because GDP growth data are available for all countries only on an annual basis, by construction the minimum recovery time was one year.

[2]Calculated by summing the differences between trend growth and output growth after the crisis began until the time when annual output growth returned to its trend and by averaging over all crisis.

[3]Percent of crisis in which output was lower than trend after the crisis began.

[4]Calculated by summing the differences between trend growth and output growth after the crisis began until the time when annual output growth returned to its trend and by averaging over all crises that had output losses.

[5]Currency "crashes" are identified by crises where the currency component of the exchange market pressure index accounts for 75 percent or more of the index when the index signals a crisis.

Source: IMF World Economic Outlook May 1998. Pp. 79.

6.1.3 Currency Crises and Contagion

Macroeconomic imbalances have often been at the root of foreign exchange market crises. Most often, crises have arisen when large external imbalances have developed in inflexible exchange rate systems that have allowed the currency to become significantly overvalued. A remarkable feature of recent currency crises, however, has been the extent to which instability in foreign exchange markets has been transmitted across countries. An attack on one currency has spilled over or spread contagiously to the currencies of other countries with apparently sound fundamentals.

It is useful to distinguish three sets of reasons why currency crises tend to be clustered time. One is that crises may stem from a common cause – for instance, major economic shifts in industrial countries that trigger crises in emerging markets – in what has been referred to as "monsoonal effect." The sharp increase in U.S. interest rates in the early 1980s was an important factor in the Latin American debt crisis. Similarly, the large appreciation of the dollar, especially vis-à-vis the yen, between mid-1995 and 1997 contributed to the weakening of the external sector in several southeast Asian countries. But while external events may contribute to or precipitate a crisis, a country's vulnerability to a crisis depends on domestic economic conditions and policies, such as over-borrowing for unproductive uses, a fragile financial sector, or an inflexible exchange rate system.

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A second reason why crises may be clustered is that a crisis in one country may affect the macroeconomic fundamentals in another country, either because of trade and capital market linkages (for example, a devaluation in one country adversely affects the international competitiveness of other countries) or because of interdependences in creditors' portfolios (for example, liquidity in one market, forces financial intermediaries to liquidate assets in other markets). Such "spillovers" resulting from interdependences have been cited as contributing in important ways to the spread of the East Asian crisis.

A third reason for clustering is that a crisis in one country may lead creditors to reevaluate the fundamentals of other countries, even if these have not objectively changed, or may lead creditors to reduce the riskiness of their portfolios and "flee to quality." It is this effect, specifically, that is sometimes referred to as contagion (or "pure" contagion); it may be associated with "herding" by asymmetric information or from the incentives faced by fund managers.

6.2 Causes of the Crisis

The East Asian countries at the center of the recent crisis were for years admired as some of the most successful emerging market economies, owing to their rapid growth and the standards. With their generally prudent fiscal policies and high rates of private saving, they were widely seen as models for many other countries. However these economies suddenly become embroiled in one of the worst financial crises of the postwar period.

What went wrong? Were these countries the victims of their own success? This certainly seems to have been part of the answer. Their very success led foreign investors to underestimate their underlying economic weakness. Partly because of the large-scale financial inflows that their economic success encouraged, there were also increased demands on policies and institutions, especially those safeguarding the financial sector; and policies and institutions failed to keep pace with these demands. Only as the crisis deepened were the fundamental policy shortcomings and their ramifications fully revealed. Also, past successes may have led policymakers to deny the need for action when problems first appeared.

Several factors both domestic and external contributed to the dramatic deterioration in sentiment by foreign and domestic investors.

(A) Domestic factors include:

- A buildup of overheating pressures, evident in large external deficits and inflated property and stock market values;

- The prolonged maintenance of pegged exchange rates, in some cases at unsustainable levels, which complicated the response of monetary policies to overheating pressures and which came to be seen as implicit guarantees of exchange value, encouraging external borrowing and leading to excessive exposure to foreign exchange risk in both the financial and corporate sectors;

- A lack of enforcement of prudential rules and inadequate supervision of financial systems, coupled with government-directed lending practices that led to a sharp deterioration in the quality of banks loan portfolios;

- Problems resulting from the limited availability of data and a lack of transparency, both of which hindered market participants from taking a realistic view of economic fundamentals; and

- Problems of governance and political uncertainties, which worsened the crisis of confidence, fueled the reluctance of foreign creditors to roll over short-term loans, and led to downward pressures on currencies and stock markets.

(B) External factors include:

- International investors had underestimated the risks as they searched for higher yields at a time when investment opportunities appeared less profitable in Europe and Japan, owing to their sluggish economic growth and low interest rates;

- Since several exchange rates in East Asia were pegged to the U.S. dollar, wide swings in the dollar/yen exchange rate contributed to the buildup in the crisis through shifts in international competitiveness that proved to be unsustainable (in particular, the appreciation of the U.S. dollar from mid-1995, especially against the yen, and the associated losses of competitiveness in countries with dollar-pegged currencies, contributed to their export slowdowns in 1996-97 and wider external imbalances).

- International investors – mainly commercial and investment banks – may, in some cases, have contributed, along with domestic investors and residents seeking to hedge their foreign currency exposures, to the downward pressure on currencies.

To contain the economic damage caused by the crisis, the affected countries introduced corrective measures. In the latter part of 1997 and early 1998, the IMF provided $36 billion to support reform programs in the three worst-hit countries – Indonesia, Korea, and Thailand. The IMF gave this financial support as part of international support packages totaling almost $100 billion. In these three countries, unfortunately, the authorities' initial hesitation introducing reforms and in taking other measures to restore confidence led to a worsening of the crisis by causing declines in currency and stock markets that were greater than a reasonable assessment of economic fundamentals might have justified. This overshooting in financial markets worsened the panic and added to difficulties in both the corporate and financial sectors. In particular, the domestic currency value of foreign debt rose sharply. While uncertainties persisted longer in Indonesia, strengthened commitments were made elsewhere to carry out adjustment reforms.

6.2.1 The IMF approach.

Needed to restore confidence and support a resumption of growth include a range of measures, tailored to tackle the particular weaknesses of each country. These strategies are the basic ingredients of the IMF-supported programs in Indonesia, Korea, and Thailand.

- *Monetary policy* must be firm enough to resist excessive currency depreciation, with its damaging consequences not only for domestic inflation but also for the balance sheets of domestic financial institutions and non-financial enterprises with large foreign currency exposures. As fundamental policy weaknesses are addressed and confidence is restored, interest rates can be allowed to return to more normal levels.

- *Financial sector weaknesses* are at the root of the Asian crisis and require particularly urgent attention. In many cases, weak but viable financial institutions must be restructured and recapitalized. Those that are insolvent need to be closed or absorbed by stronger institutions.

- *Governance* must be improved in the public and corporate sectors, and transparency and accountability strengthened. Many recent difficulties spring from extensive government intervention in the economy, as well as widespread political patronage, nepotism, and lax accounting practices. In order for confidence to be restored, political leaders must send unambiguous signals that such abuses will no longer be tolerated.

- *Fiscal policies* will need to focus on reducing countries' reliance on external savings and take account of the costs of restructuring and recapitalizing banking systems. Resources will need to be reallocated from unproductive public expenditures to those needed to minimize the social costs of the crisis and strengthen social safety nets.

6.2.2 Criticism of the IMF approach

The Asian financial crisis is now moving into its second year, with no clear end to the turmoil in sight. The three hardest hit economies – Thailand, Indonesia and South Korea – have plunged into deep recessions, with widespread bankruptcies, massive lay-offs, and sharp rises in poverty. The Washington-based strategy to deal with the crisis, mainly through bail-out packages designed by the International Monetary Fund, has clearly failed. Every month or so, the IMF has been forced to downgrade its forecasts for the region. During the first few months of the crisis, it forecast 1998 growth rates of between 2.5 and 3.5 per cent in Thailand, Indonesia and South Korea. Now, after months of reform efforts, the latest market forecasts suggest that economic output this year will contract by around 5 to 8 per cent in South Korea and Thailand, and a whopping 12 to 25 per cent in Indonesia. The IMF's own forecast are almost as dire (refer to Table 6.2).

Their continued downward spiral cannot be attributed to implementation failures by their governments. Thailand and South Korea have done essentially everything the IMF has asked them to do. Even Indonesia, which clashed repeatedly with the Fund earlier in the year, and suffered in large part from poor IMF strategy rather than just non-compliance with the IMF's programmes, has toed the line carefully since signing its third agreement in early April. The IMF's approach, far from reviving confidence, has inadvertently made a bad situation worse. For the Asian crisis economies to begin to move forward, a different approach is needed, based on a new macro-economic strategy. Only such a change in direction will restore confidence and growth in the Asian economies.

TABLE 6.2: 1998 GDP GROWTH RATE FORECASTS

Country and forecat source		Date	Growth forecast (%)
INDONESIA			
IMF:	First programme	Oct 1997	3.0
	Second programme	Jan 1998	0.0
	Third programme	April 1998	-5.0
	Fourth programme	July 1998	-12.0 to 25.0
	Market forecast	July 1998	-12.0 to 25.0
SOUTH KOREA			
IMF:	First programme	Dec 1997	2.5
	Third programme	Feb 1998	1.0
	World economic outlook	April 1998	-0.8
	Article IV consultation	June 1998	1.0 to–2.0
	Market forecast	July 1998	-5.0 to–7.0
THAILAND			
IMF:	First programme	Aug 1997	3.5
	Second prgramme	Nov 1997	0.0 to 1.0
	Third programme	Feb 1998	-3.0 to –3.5
	World economic outlook	April 1998	-6.0
	Article IV consultation	June 1998	-4.0 to –5.5
	Market forecast	July 1998	-5.0 to –8.0

Source: Sunday Times, July 26, 1998.

6.3 Alternative approach in tackling the crisis.

The Fund's programmes have evolved significantly during the past year, and now include larger fiscal deficits, more realistic financial restructuring plans, and less emphasis on non-financial structural issues. Notably, foreign debts have been restructured or at least rolled over. These measures have finally led to currency stabilisation, but not to economic recovery. After one year, the combination of sustained high interest rates and illiquidity has, in fact, led to severe economic contraction and a vast overhang of bad debt throughout Asia. Corporations have seen their debt-equity ratios sky-rocket from initially high levels as currencies depreciated and interest rates soared. A large number of major firms in each of the economies are now unable to service their debts. Bank loans ae simply not being repaid. The mixture of high interest rates, rising non-performing loans, and IMF pressure for rapid banking re-capitalisation has left the entire banking sectors of South Korea, Thailand and Indonesia effectively moribund.

Only foreign banks and a small number of national ones continue to functions normally. Most are simply not lending fresh funds, even for normal trade credits and operating capital. Many firms including the majority that were well-managed and profitable under normal circumstances are closing down. The illiquidity crisis has thus evolved into a wide-spread insolvency crisis, as crushing debt burdens translate into negative net worth. Despite recent stability in currency markets, real economic recovery is still far off. Under these circumstances, continued high interest rates and the gradual workout of foreign and domestic debts will not solve the problem. As time goes on, more firms will become insolvent and shut their doors, leading to a deepening downward spiral. In order to overcome these shortcomings a different approach is needed. This approach includes expanding liquidity, restructuring debts and recapitalising banks.

6.3.1 Expand liquidity

The first step should be to ensure that there is sufficient liquidity in the banking system to enable firms to continue production even before these firms are able to restructure their debts. Exporting firms are the clearest case of the need for expanded provision of liquidity. One of the sad ironies of the current situation is that exporters, the very firms that should be able to profit most from the massive devaluations, have often been unable to get the credit they need to import raw materials and supplies. Exporters need special facilities to provide immediate lines of credit to enable them to meet their orders and even expand their operations. Weak and slow credit lines to exporters would worsen the crisis as exports performance remain weak and subject to erratic lending policies by banks.

6.3.2 Restructure debts

Emergency credit lines, however, will not work by themselves. Even more importantly, new initiatives are also urgently needed for across-the board workouts of corporate debts. Bankrupt firms are simply closing their doors now, rather than winning the time to restructure their balance sheets, process that would give many, if not most, of these firms a new lease on life. After all, these firms are often highly competitive in international markets. Their problem is not a bad product line or an inefficient production process, but rather an overhang of bad debt which is strangling their operations. One solution to this problem would be to convert existing corporate debt into equity, so that the bank creditors would become owners of the firms rather than the creditors as now. The reduction of debt would ease the cash flow burdens of the debt, enabling the firms to re-enter the loan markets for working capital and long-term loans. This kind of debt-to-equity conversion is exactly what would occur in a well-designed bankruptcy system. The problem is that traditional bankruptcy-style procedures are much too slow in the current environment, especially since most financial market participants and court systems have had little previous experiences with bankruptcy-style procedures. The government should explore an across-the-board mandated conversion of debt (owned to banks) into equity which would make the banks the main owners of the corporations and companies. The current owners' shares will immediately be diluted substantially, though not completely. As part of the procedures, however, the existing owners could receive an option to repurchase the shares from the banks at some premium over current market prices, thereby maintaining incentives to improve the performance of their firms. The banks would be required to sell off these shares in a limited period of time, perhaps two years. It should be emphasised this strategy is not aimed at rescuing unviable firms. If, after the debt conversion, firms still cannot generate a positive cash flow then they should probably be liquidated. Firms should not be saved at any cost, but the better ones should be given the opportunity to re-establish their operations without the debt overhang.

6.3.3 Recapitalise banks

Some banks would go bankrupt (with or without the debt-equity conversions), some will have to be closed or merged, but for others, the government will have to inject new capital into the failed banks. Government intervention would presumably be in the form of new bank equity, which would give the regulatory agencies special control and supervision over the banks. Existing bank owners might retain a small portion of overall ownership, with the option to re-purchase equity shares issued to the government. During this period of balance-sheet restructuring, the government would protect depositors and maintain banking services. The injection of new capital would allow new lending to begin again. Over time, the government would sell off its shares in the banks to foreign and domestic investors, including the current owners. Corporate debt restructuring and bank recapitalisation should proceed in tandem. Neither step can await the completion of the other. For example, bank re-capitalisation needs to begin urgently so that lending can resume quickly for exporters and firms without a large debt burden. However, the process of bank recapitalisation cannot be completed until corporate debts are restructured, and the banks convert some corporate debt into equity. These highly unusual steps would carry real risks, not the least of which would be the possibility of stronger government influence over the economy and delays in the process of eventual privatisation. But they would also go a long way towards making both enterprises and financial institutions viable, and they would facilitate a much more rapid return to bank lending on a normal market basis. On balance, the risks seem worth taking in order to halt the precipitous slide in economic activity and social dislocation.

6.3.4 Re-adjust macro-economic policies

In the context of the adjustment, a shift in macro-economic policies would also be possible. The key is to reduce interest rates and expand domestic credit. This would probably entail some further depreciation in the region's currencies, at least in the short run. But that would be a relatively small price to pay for re-starting economic activity. In any event, the impact on exchange rates is likely to be fairly small. Over time, as economic activity picks up and foreign lenders re-enter the markets, exchange rates will again appreciate in real terms. Readjusting macro economic policies with policies that would enable the economy to take advantage of the crisis is key for recovery. This includes adjusting towards export promotion policy and import substitution policy.

6.4 Implications from the crisis

The crisis provided implications for exchange rate policy and austerity measures which are of importance for governments to adopt and induce the recovery programme.

6.4.1 Choice of Exchange Rate policy.

The crisis has provided some implication on the choice of exchange rate policy, fixed exchange rate and austerity measures. Fixed but adjustable exchange rates are a bad idea for almost all national currencies. The only viable regimes in our increasingly globalised financial world are either flexible exchange rates or irretrievaly fixed rates. The East Asian victims of currency crisis were, like most other nations, on fixed but adjustable pegs to the US dollar or to other major hard currencies or to a baskets of these. Often the pegs were ranges rather than precise values, and, in many cases, the midpoint of the bracket moved over time at a prescribed speed. The pegged rates were thus not immutable, and central banks could adjust or abandon them at any time, violating their own solemn promises. Naturally, market participants worldwide speculated on such possibilities. Worse yet, they speculated on what other currency holders thought about the risks of default. Such is the system's inherent source of instability.

In recent decades, such crises have hit European countries (Britain, Italy, Spain, Sweden, Finland), Latin America (notably, Mexico in 1994), Russia and other transition economies, and now the Asian tigers. The gold standard was a fixed-rate system. It suffered terminal collapse in the 1920's and 1930's. The Bretton Woods agreement of 1945 set up a new fixed-exchange-rate system, based on the dollar and gold. But this, too, ended in crises affecting in dollar, yen and Deutsche mark in 1971-73. Since then, the exchange rates among those three hard currencies have not been pegged, but have floated freely in currency markets. They have fluctuated but there have been no crises. A recent example is the gradual 50 per cent depreciation of the yen relative to the dollar. Japan's macroeconomic stagnation, of which the fall in the yen is but one symptom, could well be described as a disaster, but it is not a currency crisis like those of its East Asian neighbours. Floating rates have worked for the G3 curencies. They would forestall traumatic crises for other currencies too. Currency values would continue to go up and down, people would continue to speculate, and some of the fluctuations would be unpleasant for the economies affected.

But the trauma of a discrete regime change, a default of solemn official comitments, and the bandwagon momentum of these events, can be avoided. Foreign lenders who underestimated the risks of short-term loans to Indonesia, Thailand and Korea would have charged higher risk premiums in a floating rate world. Those sources of distrust in Asia's economic and financial prospects – some fundamental, some speculative – that triggered the crisis would have pushed down exchange rates in a floating world too, but not by nearly as much as they fell following the collapse of fixed rates. What explains the prevalence of fixed-rate regimes outside the hard currencies? For one thing, it is a residum of Bretton Woods. Through most of the period since 1945, Bretton-Woods- fixed rates were protected by capital controls and exchange restrictions. The International Monetary Fund sought to make currencies convertible in commercial transactions but tolerated regulations of capital account transactions. Lately, however, economies in all stages of development have been pressured by the world's financial establishments – national and international, official and private - to liberalise their financial markets, allow free foreign access to them, and make their currencies fully convertible. In many ways, these developments were advantageous to developing and emerging economies, and were welcomed by important local business and political interests. But currencies became more vulnerable as a result, and fixed exchange rates more problematic. Yet, the same authorities which pressed for global financial integration continued to favour fixed exchange rates. A fixed rate was seen as a "nominal anchor" against inflation, forcing disciplined monetary and fiscal policies, and touted as an attraction to foreign investors. Today, these arguments have a hollow ring. Recent short-term bank lending from major financial centres in the world Tokyo, New York, Frankfurt, and London to East Asian banks and businesses reveal how global financial integration and deregulation made fixed exchange rates more vulnerable. Short-term capital flows would also have been unacceptable in a floating-rate regime, because they would have threatened to move the exchange rate too far for the health of the economy. Even with floating rates, the central bank will need hard currency reserves, and will at times need to use them in currency markets. Such interventions are called "dirty floating", but they are an essential tool of monetary policy.

6.4.2 Fixed exchange Rate.

An alternative at the other extreme is to fix the national currency irretrievably to the dollar or some other hard-currency standard. The trouble with this course is that it surrenders national monetary sovereignty. Eleven countries of the European Union have merged their currencies forever into the euro. There are great advantages, political as well as economic, in a broad currency union, as demonstrated by two centuries of the US dollar. Whether these advantages can be artifically manufactured in a short time among diverse nationalities, governments and economies remains to be seen. European nations are surrendering their monetary sovereignty, voluntarily, to be sure.

They will no longer have individual monetary policies, or even discretionary fiscal policies, for that matter. Their economies can no longer adjust to payment imbalances and their macro consequences through exchange rate movements – as the UK, for example, did, very successfully in 1992. Economists who are optimistic advocates of the euro argue that anything that exchange rate adjustments can do can be done by movements of commodity prices and wages. This is an application of classical neutrality-of-money propositions, but the evidence is that they work very slowly and imperfectly. Hongkong and Argentina are not member of a currency union, but they have fixed their exchange rates permanently to the US dollar. Indonesia toyed with this idea, and Russia seems to be moving in that direction with IMF help. The idea is to sacrifice every other possible objective of monetary and fiscal policy to the defence of a permanent exchange rate. Indeed, dollars may partly or wholly replace local currency as the unit of account and means of payment. This is the essence of a "currency board", one well-endowed with reserves of its chosen standard currency to convince its citizens and the world of convertibility. For example, if it takes double-or triple-digit interest rates to attract and hold enough reserves, so be it, regardless of the macro-economic effects.

6.4.3 Austerity Policies.

Austerity is not invariably an essential ingredient is solutions of national and international economic crisis and difficulties. Nor is it always a constructive ingredient. Troubled countries need structural reforms, but macro-economic recovery programmes are the immediate priority. They failed to do so, and indeed the precipitous recessions that ensued had the opposite effects. These countries had not been guilty of irresponsible and inflationary fiscal and monetary policies, for which austerity is the natural punishment and cure. If their currencies were overvalued, it was more the fault of Japan's stagnation and the depreciation of the yen than of their own policies. Structural reforms to root out corruption and "crony capitalism" in these countries are doubtless overdue. But these conditions were not new. They had long coexisted with remarkable economic progress and with stable currencies. How could they suddenly be the cause of currency panics?

Macro-economic austerity is not a favourable climate in which to begin long-term structural reforms. In East Asia, the urgent priority is to arrest the plunge in economic activity and start vigorous recovery to restore rates of employment and GDP growth as happened in Mexico after one year of sharp decline in the wake of its 1994-95 currency crisis. The same cannot happen in the wounded Asian Tigers unless interest rates are reduced well below the high emergency rates designed to bribe residents and foreigners to hold their local currencies in the face of dismal economic outlooks. The IMF should support sensible recovery programmes by promising assistance to central banks in sustaining interest rate reductions to levels consistent with macro-economic recovery. Demand for Asian assets and currencies will be healthier if based on improved overall economic prospects. Also, long-run structural reforms can be undertaken more promisingly in such circumstances.

6.5 The Malaysian Economy-Causes for Concern.

The crisis that erupted in Thailand, implied some concerns on the Malaysian economy. These concerns were focused on economic growth above potential, rising current account deficit, excessive credit expansion to the non-tradable sectors and the real exchange rate.

6.5.1 Economic Growth Above Potential Output.

Since 1991, the economy has been consistently growing above what is deemed as its potential growth path. Zero output gap is when actual and potential GDP are equal in size. The output gap increased during 1994-96, as actual GDP grew faster than potential GDP. This has generated price pressures, especially in the form of wage increases above productivity gains. Instead of improvements to efficiency, growth during this period was primarily brought about through augmenting input, a situation that is clearly not sustainable in the longer term. It is greater cause of concern when a significant proportion of these inputs (both capital and labour) was imported.

6.5.2 Rising Current Account Deficit.

The deficit in the current account corresponds to the saving-investment gap. Despite having one of the highest savings rate in the world, Malaysia ran into current account deficit problems because of its high investment rate. The investment boom led to the current account deficit, and when coupled with the declining efficiency in capital utilisation, is a legitimate cause of concern. The current account deficit was only partially financed by net long-term capital inflows for some of the years. At the same time, reverse investments have steadily increased from RM4.0 billion in 1993 to RM114.4 billion in 1996, an increase of 2.8 times. Malaysian investment overseas in 1997 was estimated at RM9.9 billion.

6.5.3 Excessive Credit Expansion to the Non-Tradable Sectors.

Since 1995, total loans has been growing at a rapid pace. Loans for the purchase of stocks and shares during 1993-97 grew at an average rate of 35 per cent per year. Following the rapid expansion of credit, private domestic debt escalated in the past few years. Excessive credit expansion to the non-tradable sector induced price pressures and thus emanated into a bubble situation in the equity market and in the property sector.

Table 6.3: Total Outstanding Loans.

	Total Outstanding Loans	
	RM Millions	Growth (%)
		y-o-y
1990	107,781	23.9
1991	131,332.3	21.9
1992	143,959.6	9.6
1993	161,011.5	11.8
1994	184,237.7	14.4
1995	237,719.6	29.0
1996	300,316.7	26.3
1997	392,129.2	30.6

Source: Bank Negara Report, 1997.

6.5.4. The Real Exchange Rate.

The real exchange rate begun to appreciate in early 1994 and a sharp appreciation occurred in 1995. During this two years, inflation remained in the range of 3% to 4% while real interest rates edged up rapidly from 0.5% to 2.8%. At the sametime, the nominal exchange rate was relatively stable, thus the appreciation of the real exchange rate was mainly due to the decline in cost of tradables in the United States (producer prices). The decline in foreign prices, while stable nominal exchange rate and low inflation in Malaysia induced an appreciation of the real exchange rate. Implication of this appreciation was reflected by a widening of the trade deficit in 1994 and 1995. This scenario provided an opportunity to speculators to speculate on the ringgit by using the assumption that the ringgit was heavily pegged to the USD. The scenario however changed in early 1996, when the real exchange rate depreciated and gradually appreciated by end of that year. The nominal exchange rate and the inflation rate in Malaysia continued to remain stable, however, the cost of tradables in the United States (produce-prices) continued to decline sharply, thus keeping the trade balance of Malaysia in a deficit. On balance one can conclude that the lag effects of the appreciation of the real exchange rate in 1994, 1995 and 1996, weighed heavily on providing fundamental reasons to speculate on the ringgit eventhough the real appreciation of the currency was brought about by a decline in United States producer prices.

6.6 Trigger Effect.

Malaysia's impressive decade-long growth record came to an abrupt halt with the depreciation of the ringgit, which occurred within two weeks after the floatation of the baht on July 2 1997 which ultimately became the trigger effect that caused the beginning of collapse in all emerging markets in the world particularly in South East Asia. Buoyed by the success and profits associated with the floatation of the baht, currency speculators next focussed their attention to the other regional currencies and initially, Malaysia tried to defend the ringgit when it came under attack, but this strategy was not sustainable and proved costly. On July 14, the ringgit was allowed to depreciate from RM2.50 to US$1, the ringgit slipped to RM3.00 on September 2, 1997. The ringgit sank to an intraday low of RM4.88 on January 7, 1998. The turbulence at the Kuala Lumpur Stock Exchange (KLSE) was closely tied to the ringgit depreciation. Although the KLSE started declining in the early part of 1997, the fall grew in earnest after Thailand announced the floatation of the baht. In order to prevent currency speculation, in early August 1997 Bank Negara imposed a US$2 million limit on outstanding non-commercial-related ringgit offer-side swap transaction with any single foreign customer. This was later followed by KLSE declaring the 100 component stocks of the KLCI as designated securities. The short-selling in the stock market was suspended through the prohibition of securities borrowing and lending. Local funds were encouraged to start buying up shares at the time when foreign funds were retreating.

The series of measures adopted in August failed to stop market panic. From the high of 1271 level in 25 February 1997, the KLSE composite index plunged to 477 points on 12 January 1998, with a loss of about 800 points or 63%. At the high in 1997, the market capitalisation (comprising the main board and the second board) was RM917 billion but sank to RM308.69 billion by 12 January 1998. The KLSE composite index recovered briefly with the Chinese New Year/Hari Raya rally and rose to 745.12 on 2 March 1998. Since 2 April 1998, the KLSE CI started falling again with reports of poor corporate performance as well as the depreciation of the yen in mid-May. The KLSE composite index was 467.55 on 7 July 1998.

6.7 Policy Response

Economic recovery measures are being implemented under the National Economic Recovery Plan as formulated by the NEAC (National Economic Action Council). This plan aims at freeing the nation from the grip of the regional financial crisis and subsequently, to place the nation's economy on a stronger footing. Measures being focused by the NEAC include restructuring the banking sector, easing of monetary policy, credit growth, expansionary fiscal policy and strengthening the balance of payments.

6.7.1 Recovery Of The Banking Sector

The depreciation of the ringgit and the decline in share prices has had an adverse effect on the banking sector. Many companies, including large corporations that have borrowed from the banks were unable to repay loans from their cash flows. The situation worsened when interest rates were increased and the period for NPLs shortened. As the value of the banks shares had also deteriorated, bank customers became concerned that Malaysian banks were facing problems. They then transferred their deposits to foreign banks in Malaysia or deposited their ringgit in banks overseas. All these meant that Malaysian banks were unable to provide sufficient funds to finance business. NPLs (non-performing loans) rose in the meantime while the banks' capital contracted substantially. To address this problem, the Government set up Danaharta which will purchase the NPLs of the banks and manage the recovery of these debts, as well as manage the recovery of affected companies. This will free the banks from the burden of debts that had prevented them from providing loans to their customers. The total funding required by Danaharta to remove NPLs from the banking system has been revised from RM25 billion billion to RM15 billion following the improved liquidity and lower interest rates. The reclassification of NPLs from, 3 months to 6 months would also result in a moderation in the growth of NPLs. Danaharta will acquire up to RM8 billion of NPLs from 21 financial institutions by the end of 1998. Danaharta is expected to take over NPLs at a much faster rate than anticipated when it was first set up. To promote transparency, starting from December 31, 1998, Danaharta will publish details of NPL acquisitions and disposals. Further, international best practices are applied in all areas of its activities including valuation of NPLs.

As the capital base of banks has been affected by the decline in share prices and NPLs, the government noticed that there is a need to recapitalise these banks. For this purpose Danamodal was established to inject capital into banks facing difficulties. From the RM16 billion required by Danamodal, Bank Negara must provide RM3 billion as a seed capital. An international investment banker, Salomon Smith Barney has been appointed to advise the management of Danamodal and determine the viability of any one particular recovery effort based on due diligence.

On Oct 20, 1998 Danamodal signed agreements with eight banking institutions for recapitalisation through the Exchangeable Subordinated Capital Loans (ESCL) involving a sum of RM4.5 billion. This injection of capital was meant to enhance the resilience of these institutions, increase their capacity to grant new loans and consequently speed up economic recovery process. The Corporate Debt Restructuring Committee (CDRC) was set up to assist viable Malaysian corporations from being forced into liquidation as a result of the financial crisis. The committee is expected to provide a conducive environment for both debtors and creditors to be more transparent in implementing the process of debt restructuring. A total of 23 companies with accumulated debts of RM5.5 billion have applied for CDR's assistance. The establishment of Danaharta, Danamodal and CDRC will assist in strengthening the banking system. However, it must be stressed that what is more important is that management of banking institutions should be more efficient, transparent and characterised by integrity. In this regard, Bank Negara must closely monitor the banking system and should not hesitate to take action against management that is negligent. In the meantime, to facilitate the process of intermediation of the banking system, IMF-style prescriptions were removed. The maximum BLR (base lending rate) that was 12.3 per cent in June 1998 declined to 8.5 per cent currently (as of 24 October, 1998). Lending rates were consequently reduced from a high of 24 per cent in February 1998, to between 8% - 11% to which was the level prevailing before the crisis. The repayment of debts are to be made from resulting income or cash flows that will also assist in reducing bad debts. The government also eased the loan restrictions placed on a number of sectors and these sectors which were previously not considered as priority sectors and could not borrow, are once again active. This is expected to increase business and economic activities, enabling companies to make profits and the Government to increase its tax revenues.

6.7.2 Monetary Policy

Malaysia has always practised liberal policies in relation to capital inflow. However, the regional financial crisis has demonstrated the high risks of such policy. When capital reversals suddenly take place, the economy comes under severe pressure. The IMF prescription of raising interest rates and restricting credit growth, which was adopted at the beginning of the crisis, only served to worsen the economy. At the same time, it failed to convince foreign investors to bring back their capital. Given the severity of the situation, the Government implemented radical measures to overcome the crisis, such as capital controls. The control imposed by Malaysia are limited to only preventing currency traders from using their leverage to determine the value of the ringgit to make large profits or intimidate the government into not taking any action to revive the economy. Without such controls, currency speculators have the ability to bring down the value of our currency and shares if interest rates were lowered. On the other hand, if the government does not lower interest rates, not only will companies, but also banks and the Government will encounter financial difficulties. Although the Government has regained control to determine the value of the currency, its value must contribute to improving the competitiveness of locally manufactured products in overseas markets, as such the government implemented a fixed exchange rate at RM3.80 to the US dollar or RM1.00 equivalent to US 26 cents.

6.7.3 Ensuring Healthy Credit Growth

The annual credit growth of the banking sector contracted from 25.9 per cent at the end of December 1997 to 4.5 per cent at the end of September 1998. However, new loans approved by the banking system have been maintained at an average of RM4.5 billion per month since June 1998. The drastic reduction in credit growth was due to a number of factors including tight liquidity for a large number of banks, high interest rates and the reluctance as well as extremely cautious attitude of several banks in approving new loans. As such to ensure economic activities have access to sufficient financing, the Government took several steps to promote lending. These included among others, reducing interest rates and the SRR (statutory reserve requirement) to increase liquidity in the banking system, removing restrictions on lending and stipulating a minimum requirement for credit growth. These measure also accorded priority to lending for construction and purchase of medium and low-cost residential houses.

In the equity market, the shares of Malaysian companies became the targets of foreign investors. Foreign investors pushed down the value of these shares to extremely low levels where the Kuala Lumpur Composite index (KLCI) which was at 1,271.45 points on Feb 25 1997, declined to 262.70 points on 1st September, 1998. More than RM600 billion was wiped out with the decline of the index, as a result banks have had to call in addition margins from borrowers who have used shares as collateral. When this margin was not provided, the banks sold the pledged shares thereby further depressing the value of shares. The companies were then unable to service their loans. In order to arrest this problem, the government did not recognise the trading of shares outside the KLSE especially Malaysian stocks that were traded in the Singapore stock market. The government also imposed a one year ban on repatriation of the principal amount invested in stocks by foreign investors in the KLSE. This measure was done in order to minimise speculation activity in the KLSE and at the same time to attract only long-term investors.

6.7.4 Fiscal Policy

Given that the contraction in private sector activities severely affected the performance of the nation's economy, the Government undertook steps to boost growth through fiscal stimulus. As such, the Government changed its fiscal stance from a surplus to a deficit budget. The Government increased the 1998 budget allocation by RM7 billion, in particular, to finance development projects. As a result, the Federal Government is expected to register an overall deficit of RM9.6 billion or 3.7 per cent of Gross National Product in 1998 compared with the surpluses registered for the past five consecutive years since 1993. The Government also established a fund to finance infrastructure projects that cannot be implemented because of difficulties in obtaining loans from banking institutions. This was aimed at reviving the construction and manufacturing sectors producing for the domestic market, in particular construction-related industries. For this purpose, the Government changed Bank Pembangunan into Bank Pembangunan dan Infrastruktur Malaysia (BPIM) with a paid-up capital of RM1 billion.

6.7.5 Strengthening The Balance Of Payments

Although in 1998, the current account of the balance of payments registered a surplus, it was due to the depreciation of the ringgit that led to higher export prices in ringgit terms. It was also due to a significant decline in imports following slower economic activities in the country. Recently export performance also declined in US$ terms, while the deficit in the services account of the balance of payment continued to increase. As such, attention has to be given to efforts at strengthening the position of the current account of the balance of payments. In line with this, the following efforts was undertaken by government. Firstly encouraging increased exports especially of manufactures and reducing imports; and secondly enhancing the capacity of the domestic services sector to export and substitute for imported services.

Manufactured exports contribute 80 per cent of the nation's overall export earnings. Efforts to encourage exports continued to be intensified by reducing the business costs. This is to ensure that Malaysian manufactured exports will be able to compete in international markets. At time same time the government took urgent steps to improve the quality of services and basic infrastructure. In addition, the Government has intensified agriculture sector activities to reduce imports. The active involvement of the corporate sector to undertake agriculture on a commercial basis is necessary. The Government realised that the effort to undertake large-scale food production involves high risk, thus investors are more inclined to invest in commercial crops such as rubber, oil palm and cocoa. In this regard, the Government encouraged large enterprises to invest in food production by reducing income taxes on companies that incurred losses in the production of approved food items.

In the services sector the development of the shipping and insurance industries has not been satisfactory although it has begun to show progress. This situation resulted in large deficits in the services account of the balance of payments, which amounted to RM19.4 billion in 1998. To improve the situation, the Government implemented various measures including to further developing the nation's services sector by encouring the utilisation of domestic port facilities, and reducing the cost of container transportation between ports. The overall strategy of the government was focused on strengthening the balance of payments in the services sector and the tradables sector. The elimination of currency risk (due to a fixed exchange rate system) is seen as a main factor in strengthening the external sector of the economy.

6.8 Conclusion

The crisis has provided insights for policy makers in Malaysia to increase the competitiveness of manufactured products and services and at the same time strengthening the financial sector. The government has sheltered the domestic economy from volatile external factors by imposing capital controls, however it is important that these measures are implemented thoroughly and growth should be the ultimate aim.