Chapter 1

Introduction

1.1 Overview

On July 2,1997, the Thai government introduced a managed float of the Thai baht. The baht depreciated by 14 per cent within a month and depreciated further by 33 per cent by November. The devaluation of Thai baht has sent panic waves across the Southeast Asia. As a results, Indonesian rupiah, Philippine peso, Malaysian ringgit and Singapore dollar depreciated by 27 per cent, 24 per cent, 26 per cent and 10 per cent respectively by November 1997. The Taiwan dollar and Korean won were also affected. In December and January 1998 another round of speculations attacked currency of the East and Southeast Asia economies and caused the rupiah to depreciate by 68 per cent, baht by 56 per cent, won by 42 per cent, ringgit by 43 per cent and peso by 36 per cent.

Prior to the mid-1997, the East Asian region had enjoyed strong economic performance with high economic growth, relatively low inflation, rising per capita income and low rates of poverty. This impressive performance was due to good fundamentals such as high saving ratios, keen interest in education, diligent work habits and active entrepreneurship (World Bank 1993). Also the favorable macroeconomic development has attracted large capital inflows, which enable the East Asian countries to maintain a sustainable growth with low inflation and viable current account position. This development in the East and Southeast Asia countries has made it a role model for economic development to the less developing countries (LDCs).

However, in the recent years, imbalances and weaknesses in the East and Southeast Asia countries began to emerge making the region vulnerable to sudden reversals of capital flows, with consequent destabilizing effects on the exchange rates and the domestic economy. It is observed that the currency crisis had transformed once successful economies into deep recession. Studies that have conducted to examine the impact of currency depreciation on the domestic economy have found that the consequence of depreciation is contraction in the economic growth of the affected nations. Most of the countries are expected to experience a negative growth rate, which is expected to contract by as much as 5 per cent or more (Table 1.1). The currency crisis also disrupted trade and investment, which led to deterioration in the economic growth. It is well known that, the growth of East and Southeast Asia economies was made through steady expansion of trade and investment. The trade of East and Southeast Asia economies expanded at 15 to 20 per cent annually.

Table 1.1: East and Southeast Asia 1998 Economic Growth Forecasts

	1997	1998
Malaysia	2.0% to 3.0%	-1.0% to –2.0%
Hong Kong SAR	5.3%	3.0%
China	8.8%	8.0%
Japan	1.1%	-1.5%
Taiwan	6.9%	5.5% to 6.0%
Korea	5.5%	-4.0%
Singapore	4.8%	0.5% to 1.5%
Philippines	3.8%	2.5%
Thailand	0.4%	-4.0% to –5.5 %
Indonesia	2.0%	-13%

Source: Ministerial Statement, Dewan Rakyat, July 13,1998
New Strait Times.

However, since the outbreak of East Asian financial turmoil, the trade and investment has changed accordingly to the fluctuation in the exchange rates. As a result of currency depreciation, export prices decreased abruptly and boosted the export of manufactured goods in Thailand and Korea (Yamazawa,1998). On the other hand, exports of primary products were boosted in Malaysia and Indonesia. Exchange rate devaluation also increases the import prices of industrial materials and this tended to raise the domestic prices and discourage imports. However, the currency depreciation has changed a deficit in trade balance to a surplus in many economies because of reduced imports and increase in exports. In another spectrum, exchange rates devaluation tended to decrease the acquisition prices of assets and encourages foreign investment. However, in East and Southeast Asia, most investors especially from Japan and Europe have become more cautious and many of them are taking out their funds from this region

At the initial stage of crisis, various policy measures were implemented by those affected countries to stimulate recovery. However the measures were seemed ineffective in handling the situation. Thailand, Indonesia and South Korea, who sought help from the International Monetary Fund (IMF), had to comply with severe contractionary policies. Other affected economies also have responded to constraining their budgets, suspending development plans and reducing their growth rate considerably. Anyhow, the situation seemed to get worse, especially in Indonesia.

The weakening of Japanese Yen against the US dollar and the possibility of China devaluing its renminbi also contributed to the worsening situation in affected countries. Many observers felt that unless Japan takes a drastic action to revive its economy, there will be another round of currency crush in Asia (Asiaweek,1,May 1998). For years Japan helped fuel growth in the rest of Asia. Its investments in factories and real estate created jobs and wealth. Japans import of Asian goods provided many countries with a lucrative market. Moreover, Japans loans to Asian companies enabled them to expand and diversify (Asiaweek,1,May,1998).

Being the world biggest creditor nation with 100 trillion yen, and equipped with its exchange reserves of US$218 billion, Japan has provided US$37 billion in rescue funds to Thailand, Korea and Indonesia (Yamazawa,1998). However, Japan has been unable to play a major role in contributing to regional recovery. This is because its own economy is in deep recession. The East and Southeast Asia countries can recover from the current crisis through regional cooperation. The Japan economy has to recovers first to help the Asian economy out from current crisis.

The debate about causes and the remedies of the East and Southeast Asia economic crisis continues to rage. The international establishment has put the blame on the affected countries for wrong policies and weak economic structures. One the other hand, a large section of academics and even the established financial media have put the focus on the way global financial markets operate. The problem of East and Southeast Asian economy has became global problem since the impact of the East Asian economic turmoil have been felt in Latin America and Russia. With this respects, global economists and policymakers have arranged numerous seminar, forum as well as dialogue to discuss the appropriate policies that should be undertaken by the ailing economies in the Asia region to enable a fast recovery from current crisis.

Malaysia, being an open economy was adversely affected by the contagion impact of the East and Southeast Asia financial crisis. The domestic demand declined as a result of the pursuance of a tight monetary policy as well as decrease in export performance. The real GDP contracted sharply by 6.7 in 1998. Due to contraction in the real economy, has led to massive layoffs and unemployment. However, there has been a positive turnaround in the current account position of the balance of payments to record a large surplus of RM36.8 billion in 1998. Various policy measures were adopted by Malaysian government to help the economy recover fast. The initial focus of policies was one of restoring investor confidence to stabilise the financial markets as well as strengthening the resilience of the economy.

1.2 Objective of Study

The purpose of this study is to:

I. Briefly discuss the causes of financial crises in the East and Southeast Asia, whether it is because of weak fundamentals of affected countries or caused by contagion effect or the way global financial market operates.

II. To evaluate the overall impact of currency crises on the Malaysian economy. And secondly to analyze the impact of currency crises on the Malaysian exports of agriculture and manufactured products based on co-integration and error-correction models.

III. To discuss effectiveness of the measures that are adopted by Malaysian Government in handling the economic crisis.

1.3 Data and Methodology

The source of information and data were from Government agencies namely Bank Negara Malaysia and Ministry of Finance. Also information and data from International Financial Statistics (IMF), Asiaweek, Business Week, Investors Digest, Far Eastern Economic Review, The Economist and Internet is utilized.

To investigate the impact of currency crisis on Malaysian exports, the co-integration and error-correction model introduced by Engle and Granger (1981) will be utilized. The analysis will be conducted for two time period that is from 1975-1997 and July 1997 to November 1998. Also the Augmented Dickey-Fuller unit root tests will be used to test for stationarity of the data.

1.4 Organization of the Study

This study is divided into six chapters. The first chapter is an overview on the East and Southeast Asian currency turmoil, in which, the causes and the consequences will be discussed in briefly. Chapter two examines in depth the causes of the economic crisis in East Asian countries. The following chapter discusses the impact of ringgit depreciation on Malaysian economy. In Chapter four, the impact of currency crises on Malaysian exports are analyzed based on co-integration and error-correction models. The fifth chapter discusses in depth the possible remedies that can be adopted by Malaysian Government to overcome current economic obstacles. The final chapters conclude the findings of the past chapters.