CHAPTER I

INTRODUCTION

1.1 The Malaysian Experience

Prior to 1980, Malaysia had not experienced prolonged periods of current account deficit. The current account balance is important since it essentially reflects sources and uses of national income. The first period of sustained current account deficit occurred in 1980 to 1986 when the deficit stated an average of 6.5% of GNP. However the deficit turned around to record surpluses in the period of 1987 until 1989 when Malaysia transformed itself to become an industrialized country.

During the period of 1990 to1997, the current account deficit re-emerged averaging 6.2% of GNP and the highest deficit stated was in 1995 reaching 10.5% of GNP. This scenario had raised considerable concern that the imbalances were attributable to excessive domestic demand in relation to the productive capacity of the economy and to distortions in the price levels resulting in the shift of resources away from the productive sectors to the less productive sectors.

The exchange rate of the ringgit vis-à-vis the United States dollar was very volatile following the floating of the ringgit in June 1973. Apart from the two oil price shocks, economic recession and currency speculation were the other main shocks influencing the volatility in the exchange rate of the ringgit against the US dollar in mid -1980s particularly. The increase volatility during the period was due to the sharp deterioration in the terms of trade that triggered the recession.

In 1990 the exchange rate volatility was the lowest and showed a declining trend. However another period of volatility had occurred during 1992-94 following substantial capital inflows into the country during the period. The sharp increase in volatility experienced by Malaysia was in 1997 where ringgit depreciated by 31.4% against the US dollar. When the crisis started in July 1997, the ringgit was RM2.52 against the US dollar and RM4.21 against the pound sterling. The depreciation of the domestic currency in such large magnitudes has serious implications on the economy.

In most discussions, real exchange rate misalignment and the associated balance of payments problems arise in developing countries were linked to domestic policy mistakes. Among the proponents of the view were the International Monetary Fund (IMF) and the World Bank. Among the academia, Professor Paul Krugman of the MIT attributed the crisis to macroeconomic policy slippages and weaknesses in the financial systems of the affected country.

Some of the "inappropriate" policies include unsustainable fiscal policies, inflexible exchange rates and excessive government control of economic incentives. Given the underdeveloped financial markets and limited domestic savings, central banks in the developing countries are left with the major responsibility to finance government budget deficit by printing more money that cause prices to rise.[1] With inflexible exchange rate, nominal exchange rates are not adjusted to account for the differences between domestic and foreign inflation results with real exchange rate to appreciate.

An alternative view pointed the blame on the weaknesses in the international financial system. The main proponent of this view has been Professor Jeffrey Sachs of Harvard University who noted that economic fundamentals in the crisis-affected countries were basically sound. He pointed out that the problem was compounded by weaknesses in the international financial system permitting massive and volatile cross-border capital flows which overwhelmed the relatively small size of emerging financial markets economies.

[1]See Ikoba J., Nyatepe-Coo, Akorlie A and Owoye O. in the article "The effects of domestic policies and external factors on the real exchange rate and economic performance in sub-Saharan Africa", American Economist, Spring 1996, pp. 93.

Professor Jagdish Bhagwati of Columbia University has written that the crisis was due partly to rapid financial liberalization in the crisis countries without the adequate policy and institutional framework. Malaysia has been among the first countries to voice the view that the crisis reflected the weaknesses in the management of the international financial system.

The Malaysian Prime Minister, Dato' Seri Dr. Mahathir Mohamad highlighted the dangers of volatile flows of speculative, short-term capital in disrupting trade and real economic activities in September 1997 during the Joint Annual Meetings of the IMF and World Bank. He had called for an international mechanism to regulate short-term capital flows as a way to control the large market players from being able to manipulate the financial markets.[2]

1.2 Statement of Problem

Basically there are various reasons and views given to explain the causes of both phenomena. From numerous research done, most of the causes centered on the monetary phenomenon to be the main reason for the crises. Various research had proven this to be true, however my main question is whether the same phenomenon also applies to the Malaysian 1997 crisis.

Therefore, the main research question would be specifically:

1. Are the Malaysian Balance of Payments and Exchange Rate crises essentially a monetary phenomenon?

1.3 Objective of the Study

Through assessing the balance of payments and exchange rate position in Malaysia before the crisis, the objective is to determine whether monetary phenomenon is the main reason for the July 1997 financial crisis that resulted its government to opt for a fixed exchange rate and capital controls policies in September 1997.

[2] See the interview with Dr Mahathir by Serge Berthier at www.asian affairs.com/crisis/mahathircrisis.html

1.4 Significance of the Study

The significance of this paper is to provide an insight into this 1997 crisis as it hit only a few countries in Asia, which are Thailand, Indonesia, Korea and of course Malaysia particularly. These countries are closely involved with the Japanese and American markets and hence are affected by the volatility of the dollar-yen rate. This volatility played a big role in the so-called Asian crisis. On the other hand, Singapore, Hong Kong, China, Taiwan and Japan were able to avoid it.

The explanations for this were that each of these countries had a very explicit target for their monetary policy in a manner that they were transparent and automatic. Besides these, Singapore, Taiwan and Japan had commodity basket targets (inflation targeting) whereas China had a fixed exchange rate with the dollar with capital controls, and Hong Kong had a currency board fix against the dollar. Moreover these countries also had huge amounts of international reserves.[3]

Another vital significance of this study is to provide a conceptual framework that helps to understand these traumatic events and possibly to improve policy design so as to minimize the likelihood of their occurrence. In searching for the determination of the country's BOP position and the exchange rate, two broad aggregate approaches are used namely the monetary approach and the portfolio balance approach. In this study, the monetary approach shall be focused on the ground of analyzing whether the country's BOP deficit was essentially a monetary phenomenon.

1.5 Scope of the Study

The analysis in this paper chooses only Malaysia as the target study to allow gathering information and the relevant data across time. In this case the years of

[3] This was mentioned and discussed by Robert Mundell in his paper titled Currency Areas, Exchange Rate Systems and International Monetary Reform. This paper was delivered at Universidad del CEMA, Buenos Aires, Argentina on April 17, 2000.

the study will be a period of about twelve years starting from 1986 until 1997. Malaysia had experienced recession in 1985 before facing the same problem in 1998.

The reason for limiting the scope of the study to Malaysia is to have a specific idea regarding the reasons for the crisis since Malaysia was having such a high economic growth could face such sudden or rather unexpected problem. As mentioned by Tun Daim Zainuddin, the Malaysian Finance Minister, the crisis was regarded as an unavoidable and painful lesson in economic development for the East Asian governments including Malaysia but he is confident that the Asian 'miracle' will be reborn because the foundations of growth are still sound - diligence, an educated workforce, governments that are pro-market, and the effective deployment of investment.[4]

1.6 Limitations of the Study

Most of the studies in this area are specifically in the context either the country is under the fixed or the flexible exchange rates. In the Malaysian environment before the crises, the country was having a managed floating exchange rate system. Hence to get the accurate formulae for the purpose of assessing the situation will be difficult without assumptions. A few assumptions would be made to get accurate results. However the nearest similar case was conducted by Mickey Wu (1979) for Singapore that also uses a managed floating exchange rate system.

1.7 Organization of the Study

Completing the objectives and purpose of the study, the second chapter will present and discuss the previous research and paperwork done on this topic by various other scholars. Most of them are western scholars and some are well-

[4] See special issue of the Malaysian Journal of Economic Studies (1998) on the Financial Markets, Corporate Governance and the Future of the Asian Miracle.

known economists that have contributed a lot of studies in this field. Unfortunately, it is difficult to get the local studies in this field.

The third chapter will discuss thoroughly the research methodology to give a clear description on the research technique and the methods including the procedures for collecting and analyzing the relevant data and information.

The fourth chapter presents the empirical tests of the predictions of both the monetary approach to the BOP and the monetary approach to the exchange rates for the period of 1986 to 1997.

The final chapter, chapter five will summarize this study and end up with a conclusion that includes a discussion on the policy implications that is currently being pursued in Malaysia.