CHAPTER 2

LITERATURE REVIEWS AND BACKGROUND TO THE STUDY

2.1 Review Of The Existing Literatures

In 1997 Malaysia was facing with one of its worst economic spells after gaining independence. This phenomenon started quite uniquely in the sense that it was the first time that the Malaysian currency was subjected to a lot of speculations. The fluctuation in the exchange rate at that time was classified as 'ridiculous' or 'unacceptable'. On the surface, the leaders in Malaysia widely pointed their fingers and solely blame the act of 'inhumanity' and 'rape' of our national economy prosperity by the so called the 'uninvited professional intruders' i.e. currency speculators.

The activities of hedge funds can be traced back when it first launched by Alfred Winslow Jones in the late 1930's. Hedge funds are unregulated investment entities and to date, there is not much about them being published. They are only bound by laws and regulations governing the market in which they operate and it is difficult to control their activities unless it is done through exchange and capital controls.

Jomo (2001a) discussed the impact of foreign capital inflow that had on the Malaysian economy. In the 1980s and early 1990s, FDI played an important
role in the Malaysian economy. Foreign funds were heavily pumped to finance various industries. However the scenario changed when the government decided to make the economy more liberalize. It was then seen that short-term investments were becoming more popular and started to replace the portions of FDI. Such development was significant as we will see later in the following chapter that it was one of the causes that contributed to the economic crisis in Malaysia.

Okposin (2000) and Cheng (2000) discussed and analyzed various economy crises that occurred in Malaysia since 1956. There had been four economic crises before 1997. Those crises did not start with the currency crisis as what happened to Malaysia in 1997.

Todaro (1989) warned the misconception in the relationship of a country's development as a result of economic development. According to the theory of development by Harrod-Domar, savings and investment are the two important components in maintaining the development of the third world countries.

There are some literatures and working papers discussing on the issue of the social impact of the economic crisis contributed by top scholars in economics. For instance, Jomo and Lee (2001) discussed on the effect of economic crisis towards the employment, wages, unemployment, retrenchment and economic welfare. Some statistic data were given to support evidences on the economic downturn that had affected the society in Malaysia.
In another article (Chosssudovsky 1997), suggested that the financial crisis and the role that IMF played in this region would contribute to the social impacts in the Asian region. With all those developments that were going on in the region would put a lot of pressure to the Malaysian economy. In relation to that, the Malaysian society would be facing with similar consequences that were happening to other societies in the region.

During the economic downturn, it is a common phenomenon that some of the projects that were scheduled to take place had to be postponed or in some cases had to be abandoned all together. Similarly, as Malaysia was experiencing downturn in the economy the writers were expecting that all mega projects would have to be put on hold. As a result, some of the existing workers would have to be made redundant. The inflow of labour from countries like Bangladesh and Indonesia to work at the construction sites would decrease significantly. Even though the demand for labour to work at the construction sites decrease tremendously, people still migrated from Indonesia to Malaysia illegally to seek for jobs. They were optimist about the job opportunities and they felt that it was better to migrate as the situation in Indonesia was becoming very critical.

Malaysian economy has been growing at a very high pace for a number of years just before the 1997. Generally, the phenomenon was a sign of a healthy and robust economy. Ariff (1998) argued that it was important to note that if high growth rates were achieved merely as the result of a deliberated attempt to target
high growth rates, then the economy would be in a precarious situation. The risks to the economy range from falling efficiency and productivity in the economy to 'overheating' which can severely affect the long-run sustainability of the economy. Analyses show that the growth path of the economy has been consistently above what was deemed to be its potential output since 1991, and was even as high as 10 per cent above potential output in 1996 (Ariff, 1998), a classic case of an overheating economy. Thus, the robust economic growth was unlikely to be sustained in the long-run period.

In this crisis, it is important that a nation has a strategic plan and the people need to work in the same direction as to achieve the same goal. It was essential that the Malaysian government react effectively in order to contain the crisis in a manageable form. In conjunction to that it was necessary to come up with some action plans for economic recovery. The National Economic Action Council (NEAC) was established on the 7th. of January 1998 to act as a consultative body to the Malaysian government in dealing with the national's economic problems. Its main function was to recommend to government on how to restore the economy and prevent it from going into recession. Malaysia made things worse for itself by delaying policy action (Kaplan and Rodrik 2001). On 21st. July 1998, National Economic Recovery Plan: Agenda For Action was launched. Such action plans were vital to the Malaysian economy. The action plans were different from what IMF claimed that it would have done in order to achieve fast economic recovery.
The term "independent" has a wide meaning. When it is related to a country, it means that the government of that country has the authority to run its economy and political affairs in the way that it feels best for its nation. When some strong external forces or factors are influencing the direction of a nation in a way that the nation does not have a control in, the independent is said to have been violated. One of the remarks made by the Prime Minister of Malaysia, Dato’ Seri Dr. Mahathir Mohamad on the economic crisis was that “All Malaysians should work together to defend the sovereignty of the nation. What we are doing is actually defending our independence, no less than that. Do remember, those who created the economic turmoil that we are facing now are just like the colonists who once colonized us. Do you think their behaviour has changed? As the Malay adage goes,' Tiger will always have their strips'...”.

Malaysia also introduced the capital and exchanged controls as a measure to combat the economic crisis. As seen, until the late of 1970s, capital controls were widely and popularly used around the world as a tool to prevent the free flow of finance. However, by the early 1990s, capital controls were losing the popularity after IMF and World Bank managed to influence those countries to be more liberalized. Capital controls appeared to be finished as a serious policy tool for relatively open economies (Bhagwati, 1998).

If a country faces a severe external crisis, particularly one caused by a pure panic or speculative attack, and if standard measures have failed, Krugman
(1998) argued that imposing capital controls may be an effective way to stabilize the economy. Bhagwati (1998) and Rodrik (2000) opposed the conventional wisdom that free capital flows helped countries benefit from trade liberalization, and argued instead that capital market liberalization invited speculative attacks. Rajan and Zingales (1998) argued that capital controls were an essential part of the package of policies that allowed 'relationship-based' capitalism to function. Rajan and Zingales (1998) also mentioned that if capital controls were relaxed, as in some parts of Asia in the early 1990s, the result may be over borrowing and financial collapse.

The imposition of capital and exchange controls by the Malaysian government created some controversies. As highlighted by Jomo (2001b) “the window of opportunity offered by capital controls has been abused by certain powerfully-connected business interests, not only to secure publicly funded bailouts at public expense, but even to consolidate and extend their corporate domination, especially in the crucial financial sector. Capital controls have been part of a package focused on saving friends of the regime, usually at the public's expense”. “The introduction by Malaysia in early September (1998) of exchange and capital controls may also turn out to be an important setback not only to the country's recovery and potentially its future development, but also to other emerging market economies that have suffered from heightened investor fears of similar actions elsewhere” (WEO, October 1998).
Lim (1999) viewed that "following the imposition of capital controls, economic indicators in Malaysia did indeed start improving. But they also improved at the same time in the other crisis-hit countries which did not impose such controls but maintained open capital accounts. All the crisis hit countries' currencies stabilized and strengthened, their inflation and interest rates fell, their current accounts moved from deficit into substantial surplus and private capital inflows increased, contributing to the replenishment of previously depleted foreign exchange reserves. Their stock markets started climbing, and the decline in their GDP growth rates moderated sharply and have now reversed with positive growth predicted for 1999 as a whole everywhere except Indonesia. Until very recently, the recovery in Malaysia actually lagged behind that of its neighbors who were IMF patients, particularly in inflows of foreign direct investment which fell in 1998 whereas they increased in the other countries (except Indonesia). My own opinion is that capital controls in Malaysia were neither necessary nor sufficient for economic recovery, just as they have obviously not been necessary in the equally if not more impressive recovery of the other crisis-hit Asian countries which followed the more conventional IMF policy prescriptions. Indeed, given Malaysia's much stronger macroeconomic fundamentals and financial institutions before the crisis, one would have expected its recovery to be faster and stronger than that of the other countries. That this has not happened suggests that capital controls—or the heightened political risk which accompanied their imposition—may be exerting a drag on recovery through the discouragement of some foreign capital inflow."
Krugman (1999) and Jomo (2001b) suggested that even the sympathizers of capital controls have taken a cool attitude towards the success of Malaysian policies as there was a recovery even in countries that did not impose controls.

Yang (1998) who was the U.S. Executive Director of the Asian Development Bank said that “You look at country after country, from Thailand to South Korea, and you find governments that are more accountable to people, with more rule of law, with less rule by man or connections... If the region can survive the major changes and have a peaceful transition period, then the Asia that emerges will be stronger for the exercise”.

2.2 How The Currency Crisis Started

In this South East Asia region, the first attack to the currency occurred to the Thailand’s Baht. It was so bad that at times local banks were not in a position to sell baht simply because the exchange rate was moving too fast. There were rumours that the attack would not stop at Thailand. After massive gains were made in Thailand, speculators then decided ‘to travel’ to other nearby countries to demonstrate their supreme financial dominance. Countries such as Philippine, Indonesia and Malaysia became their obvious targets.

The Indonesian rupiah and Malaysian ringgit felt at a very unbelievable rate against the greenback along side the crash in respective stock market.
Situation in Indonesia was even worse. IMF was brought in to 'remedy' the Indonesian rupiah. Even strong manufacturing and technology country, South Korea had to bow down to those speculators and IMF.

2.3 Comparison With The Previous Malaysian Economic Crises

Generally there had been four periods of economic crisis before 1997. The first crisis took place between 1956 to 1972. Malaysia at that time was an agricultural country. It was still young, gaining the independence in 1957. Economists argued that there were two possible causes to the crisis. The first view was that it was normal to experience such crisis as upswing in the economy was normally followed by periods of slow down. The second argument was based on the fact that Malaysia was depending too much on the agriculture outputs. When the demands for such outputs fell or in some cases, the outputs were over supplied, prices of agriculture outputs fell and that affected the Malaysian economy.

The second economic crisis was the oil crisis in 1973 - 1974. The wars and other conflicts that took place in the Middle East disrupted the supply of the world oil, thus triggering drastic escalation of oil prices. As a result, prices of goods increased. The impact of inflation led to rising in unemployment rate. The Malaysian economy was once again affected.
The third economic crisis occurred from 1980 to 1981. Major agricultural commodities were seriously affected due to international recession. The earnings from agricultural commodities dropped from RM 11.1 billion in 1980 to RM 9.9 billion in 1982. The fluctuation in commodity prices led to economic instability.

The fourth economic crisis took place from 1985 to 1986. In 1985, the economic growth was negative 1.1 per cent. It was the first recession that Malaysia had experienced. Malaysia was at the early stage of migrating from an agricultural depended country to an industrialized based economy. The world in general at that time was experiencing a slowdown in the economy. That led to poor demand for electronic and commodity products on overall. The impacts to the Malaysian economy were inevitable. Low growth, weak domestic demand and high unemployment were scenarios at that time. It was also the first time that the Malaysian government were facing 'twin deficits' i.e. current - account and budgetary - account deficits. The comparison between the 1985 / 1986 and 1997 / 1998 recessions can be seen in the Appendix 2.
2.4 Differences With The Latin American Economic Crisis

Looking from the economic history, the currency attack is not new. Similar incident had taken place in countries such as Argentina, Brazil, Chile and Uruguay in the early 1980's, some Scandinavian countries suffered the same fate in late 1980's and the latest was Mexico when it was declared technically bankrupt in 1984.

Though there are similarities to the causes of the currency crises, it is essential to point out that there are some differences between the currency attack in Malaysia and those happening in the Latin American countries namely, Argentina, Brazil, Chile, Uruguay and Mexico:

1. It had been identified that there had been huge amount of short-term external borrowing to finance for investments in the private sectors, therefore it allowed foreign investors to pull back their investments in short time period. When this happened, the private sectors had massive difficulties in financing the ongoing projects. As a result, some of the projects had to be abandoned half way through. These companies also faced difficulties in paying back the debts to the bankers and other related parties.

2. There were also problems relating to misallocation of investment resources rather than over consumption. This was backed by the fact that Malaysia was rated among the highest savings rate country in the world.
3. Most of the problem started with the issue of confidence rather than macroeconomic fundamentals.

Malaysia had strong first-order economic fundamentals, high saving rate, low inflation, and a large skill based. Nevertheless, it was a worrying sight when the corporate sector became defenseless and vulnerable when the currency crisis depreciated the Malaysian ringgit resulting imported resources ended up more expensive, thus making the Malaysian corporate sector left with mountains of debts to be paid. Later when financial resources started to dry up, they found themselves in great difficulties trying to maintain their presence in the competitive market. That was when the financial crisis first started a continuation from the original crisis i.e. the currency crisis. The spiral effects in the financial crisis triggered a loss of confidence in the financial system. As more and more companies started to collapse and more sectors were affected, the whole scenario than turned into economic crisis.

2.5 Economic Situation In Malaysia Prior To The Crisis

Prior to July 1997, the economies of Malaysia as well as other East Asia countries were prosperous. The prosperity in Malaysia was in a way very well distributed as Malaysia managed to reduce poverty to below seven per cent of its population. The infrastructure in Malaysia was far superior to those of other developing countries. There were plenty of jobs and unemployment rate was
very low, as a matter of a fact, workers from other countries such as Indonesia, Bangladesh and Philippine flock in to share some of the prosperity.

The statistic also indicated that there were other favourable features in the Malaysian economy prior to the crisis that took place in 1997. It had been officially reported by the Malaysian government through various sources such as the BNM report, Department of Statistic and Budget Report by the Minister of Finance that the Malaysia real GDP growth averages at 8.7 per cent per annum for the past five years leading to 1996. Inflation was recorded to be as low as 3.8 per cent for that period. It was also reported that the unemployment rate for 1996 was only at 2.5 per cent.

Malaysia has a relatively lower external debt of USD 45.2 billion equivalent to RM 114,532 million or 42 per cent of GDP just before the crisis as at June 1997. Of this amount, only RM38,355 million or 27.2 per cent represented the short term debt. It was reported that by the end of 1996, the debt service ratio was only 6.1 per cent of exports. The Malaysian savings rate was considered as one of the highest in the world at 38.5 per cent in 1996. The banking sector complemented all these good features by reporting another favourable news that the Malaysia NPLs stood as low as 3.6 per cent of total loans as of June 1997.
International Management Development (IMD) in its 1997 Annual World Competitive Year Book did identify that Malaysia had some problems here and there with its economy. Nevertheless, on the 'overall evaluation of the strength of the domestic economy at the macro level, surprisingly, Malaysia was crowned second after United States of America. This meant that Malaysia was rank higher than its neighbour, Singapore that emerged third. The report from IMD was a great honour to the Malaysian economy. Amazingly, most East Asia countries that received good rankings in the IMD 1997 reports also ended up having severe attacks to their economy. There were 244 criteria or fundamental factors that were used by IMD to rank the economy of a country. When the currency crisis, turned financial crisis and later transformed into economic crisis, IMD argued that such crises are not the result of weak fundamentals but are largely influenced by forces that have little to be associated with economic fundamentals.

Mr. Michael Camdessus, Managing Director of the IMF handled bouquets to Malaysia on the 17th. June 1997 for Malaysian achievements in sound economic management as well as the ability to have strong and superb economic fundamentals. Camdessus (1997) said in an international conference on Global Capital Flows in Los Angeles that 'Malaysia is a good example of a country where the authorities are well aware of the challenges of managing the pressures that resulted from high growth and of maintaining a sound financial system amid substantial capital flows and a booming property market'... 'Over the
last year, output growth has moderated to a more sustainable rate, and inflation has remained low. The current account deficit - which is primarily the result of strong investment spending - has narrowed substantially. The increase in the fiscal surplus targeted for this year is expected to make an important contribution towards consolidating these achievements.

As for the system of operation and transparency in the banking and financial sector, he again commented that 'The Malaysian authorities have also emphasised maintaining high standards of bank soundness. Non-performing loan ratios of financial institutions have fallen markedly in recent years; risk weighed capital ratios are above Basle recommendations'...'In an effort to increase the flow comprehensive up to date and reliable information to markets, Malaysia was also among the first to subscribe to the IMF's Special Data Dissemination Standards'.

Appendix 7 will illustrate the Malaysian pre-crisis situations.

2.6 Strengths And Weaknesses

The external dimension that proved to be the catalyst of the economic crisis in Malaysia only represented a portion of the big picture. It would be naive to ignore some of the glaring domestic dimensions that also had contributed if not directly then a substance in 'encouraging' for the crises to take place.
The Malaysian government was proud to remind both the international and domestic investors that its economic fundamentals had been strong and will be able to survive the crises. That was done with an attempt to convince investors that their interests were still protected and lots of grounds and profit makings were to be made. On the surface, the claim made by the Malaysian government was only true to certain extent. In respect to the issue of economic fundamental, it is pertinent to distinguish between two kinds of fundamentals: first-order fundamentals which are the basic elements important for maintaining immediate economic stability, and second-order fundamentals which are elements critical for sustaining long term growth and stability (Rasiah 1998). The fact was prior to 1997, Malaysia was proud to be able to sustain a strong first-order fundamental. Unfortunately, it was not the case for the second-order fundamental.