

Chapter 7

CONCLUSION

A speculative attack on the government's reserve can be viewed as a process by which investors change the composition of their portfolios, reducing the proportion of domestic currency and increasing the proportion of foreign currency. This change is justified by the change in the relative yields because when the government can no longer defend its own currency, the domestic currency will depreciate. Thus, confidence is very important in keeping crises out. Contagion effect can be very detrimental.

The increasing importance of international capital flows and increasing share of imports and exports in a country's national output means that countries are more prompt to conditions beyond their control. The dividing line between macroeconomics and international monetary economics has become blur. Actions taken by a government can no longer ignore international considerations (Llewellyn & Milner 1990). If there are automatic self-equilibrating mechanism, there shall be no problem. But market-led correction will entail undesirable volatility and overshooting of key financial variables such as what has happened to the exchange rate (Dean, 1990). Excessive liquidity in the economy has caused high monetary growth. These funds have been channeled to the property sector and other non-tradable in some countries. Thus foreign money are used to finance non-productive projects. Excessive liquidity has also caused increased demands especially on non-tradable, pushing up inflation and appreciating the local currency. Competitiveness in trade is thus eroded. This is evident in the lower trade surplus, trade deficits in some cases, and current account deficits.

To avoid loose loans and other bad effects of massive capital inflows, especially short-term portfolio inflows, governments carry out open market operations but these measures have their limitations. Efforts to lessen the detrimental effects of massive capital inflows may meet with a death end. If interventions are not sterilized, monetary growth will increase and lead to domestic inflation that will subsequently cause real appreciation. If they are sterilized, domestic interest rate remains high. Capital inflows will be further encouraged and thus the pressure towards nominal appreciation will continue. It is therefore important to have sound and prudent policies in the financial sector specifically and in the management of the whole economy generally. Capital flows have become very influential in determining the exchange rate in an open economy because they are no longer determined only by demand and supply for trade but also by portfolio considerations. In turn, expected movements of asset prices, sound financial sector and policies determine portfolio considerations.

The 1998 first and second quarterly gross domestic product growth rates were negative in all countries except in Singapore, that still managed to achieve a positive growth although the second quarter GDP growth rate was much lower. The economies of other countries contracted further in the second quarter. Both Thailand (used manufacturing production growth rate) and Indonesia experienced a double digit negative growth rate while Malaysia was only slightly better with a single digit negative growth.

Volatility of these countries' currency against the greenback was the greatest in Indonesia followed by Thailand, Malaysia and Singapore. All bourses were hit badly. However, the degree in which the impact of the crises had on each bourse was not as hypothesized. The harder hit country in the financial crises did not have the harder hit stock

market. Overall, by looking at the performance of GDP growth rate and the foreign exchange rate, the country that receive the bigger impact from the crises have been Thailand, followed by Indonesia, Malaysia and Singapore in this order.

Part of the hypothesis set out in chapter one is thus proven. The hypothesis says that cautious and viable lending as well as borrowing are important for maintaining a sound and resilient financial sector in the even of any shocks in the economy. Indonesia and Thailand have suffered greatly in the financial crises because of reckless unproductive loans and high external indebtedness as a result of easy access to liquidity that comes with heavy capital inflow and procurement of financial institutions' entry into the economy. Malaysia has better performance than Thailand and Indonesia because loans are not available in such ease as in Thailand and Indonesia. Financial institutions' entry is limited and external indebtedness is low by international standards.

A large part of excess funds in Singapore comes from its domestic economy such as the current account surplus and high domestic savings, and not from foreign short-term capital. Instead of creating higher credit growth in the domestic economy, these funds are exported abroad. Without doubt, this indicates that external debt levels in Singapore are extremely low. Given the reasons, it is of no surprise that the non-performing loans ratio is less than 3% in its financial sector.

Secondly, the hypothesis that current account balance must be sustainable to avoid any crises is also true. The 1970s current account deficit Singapore was sustainable because almost half of Singapore's corresponding net capital inflows consisted of foreign direct investment that is determined by non-cyclical considerations. Thus the risk of inflows reversibility does not arise. With the completion of major infrastructure projects and

continued rise in the saving rate, Singapore has enjoyed current account surpluses since 1986. In contrast, foreign direct investment in Malaysia has not always been able to cover the current account deficit although it does have higher proportion of foreign direct investment than short-term capital compared to Thailand and Indonesia. The higher share of foreign portfolio investment into Thailand and Indonesia renders them vulnerable to high risk of fund reversibility. Furthermore, these capital inflows into Thailand and Indonesia are usually poured into the area of non-tradable such as the property sector. As a result, current account deficits have been caused by non-productive investments that render the deficits not sustainable.

The hypothesis also says that the inflation rate, M2 and M3 growth, consumption growth, gross national saving, gross fixed capital formation, export to GDP ratio, trade balance and foreign exchange reserves are vital factors to monitor because they will indicate whether the economy is overheating. Overheating will cause unrealistic asset price increment (price bubble) which form the illusion of a rosy economy. Thus, these indicators must be healthy at all times.

Growth rates of private consumption, inflation, money supply and current account balance indicate whether the economy needs to tone down its growth to avoid the imminent danger of overheating. High private consumption, inflation rates, huge money supply and current account deficit are reliable indicators to pay attention to in the management of a country. Foreign reserves should be built up as a shield against speculative attacks on the domestic currency. High foreign exchange has helped Hong Kong maintained its peg on the US dollar. High foreign exchange reserves will protect a country in periods of shock.

These macroeconomic indicators are the healthiest in Singapore. Macroeconomic indicators of Thailand and Indonesia are the least healthy. In line with the hypothesis, the Singapore fairs the best in the financial crises, with Malaysia following behind. Thailand and Indonesia received the worst impact.

However, Malaysia still suffered greatly from the depreciation of its currency compared to Singapore. Comparatively, among the four countries, Singapore has been the best in standing against the financial crises. The reasons for this difference lie in Singapore being a net world creditor while Malaysia still borrows externally and Singapore has been having current account surpluses since 1986 but Malaysia has been running account deficits in the 1990s. These deficits have been a result of non-tradable investments. Singapore also has stronger macroeconomic indicators. As a Newly Industrialized Country, it has earned itself a place in the world as having a squeaky clean, transparent and efficient administration in business and trade. All these reinforce the hypotheses stated in chapter one.

Opening the financial system always runs the risk of crisis but crisis can be forceful catalyst for reform. It will help Asean learn effectively on addressing the weaknesses in domestic economies as well as the global financial system. If a country has strong financial regulations and prudential macroeconomic policies, it will not bend so badly to currency speculation. The performance of the stock market and foreign exchange rate indicates the degree of confidence in the economy during the period of crisis.

Chapter Eight

POLICIES RECOMMENDATIONS FOR MALAYSIA

In the process of development, running current account deficits and obtaining external loans may not be avoided. However, the reason for running current account deficits and obtaining external loans have to be based on profitability and productivity, not for speculation and private interests. The current account deficit should not be a result of non-tradable investments. The source of deficit should always be crucial to determine whether the current account deficit is sustainable. Foreign portfolio investment should not be depended solely to finance a current account deficit. Once a country has established itself, there should be efforts to scale down gradually the current account deficits and external loans. Singapore's experience highlights how a country's current account position changes over time, from a current account deficit position to a capital exporter, depending on the particular stage in its economic development.

Capital inflows must be channeled to profitable investment for current account deficit to be sustainable. Excessive liquidity caused by capital inflows tempts excessive risk taking in lending. Loans that are loosely given out may not be justified by good investments. Funds may be spent on national monuments, unproductive projects and other non-tradeables. Cronyism, corruption and nepotism may further aggravate the situation. Awarding of tenders and credit should be based on caliber and ability of management. The growing list of public sector mega projects of which economic viability is questioned will eat into the share of financing needed for productive investments. Projects may be aimed at national pride but what is national pride when the current account deficit is dangerously unsustainable? The more appropriate concern should be how the foreign savings are used, not how much foreign

saving to resist. Soundness of the financial system and productive investments are indispensable for the sustainability of economic growth, more so if countries were to be active in the international capital market.

The tell tale signs to look for in ensuring good management of the economy should be the amount of external debt, non-performing loans and share of property loans and the macroeconomic indicators analyzed in earlier chapters. All of them should be kept at sustainable levels. Banks and authorities must recognize the size of the non-performing loan problem and to address them at an early stage before the condition exacerbates.

Deregulation, technological advances, financial innovation and globalization of the financial markets imply stronger competition and exposition of financial institutions to new areas of risks, including foreign exchange risk and portfolio risk in securities trading. Local financial personnel may not be trained to deal with these sudden changes. The organization and information requirements of new financial institutions need the development of a legal framework and greater intervention in encouraging the development of embryonic institutions. Risk will increase as competition becomes more intense. Liberalization will make markets more volatile and uncertain. Therefore supervision and surveillance of the financial system should be on par with financial liberalization.

Adequate information system is important. Adequate accounting system; the availability of balance sheets and profit and loss account to creditors as well as strong supporting infrastructure provide sufficient flow of information, credit appraisal and rating. Accounting and auditing are fundamental tools not only for managerial decision-making but also for lender evaluation of credit risk. Information asymmetries reinforced by lack of regulation and monitoring will produce moral hazard and adverse selection. Consistency in

implementing government policies should be adhered to. Conflicting words and actions will produce questions about the credibility of the country. Transparent government policies and creditable corporate governance are what all international investors seek for.

Externally, Malaysia can rely more on Asean currencies for trading within the Asean countries instead of the US dollar. A closer dialogue and co-operation within Asean for regional surveillance in domestic financial systems and regulatory capacities will help in dictating early signs of financial crises. The quick availability of economic and financial data that is reliable among Asean will provide information for the right decisions to be made.