# CHAPTER 1
# INTRODUCTION

## 1.1 Overview

Over the seven years from 1990 to 1996, Malaysia had a set of expansionary, rapid growth strategies characterized by loose monetary policies. This resulted an average annual growth of M1[1] and M2[2] around 15% over the same period (Bacha, 1998). The rapid growth of the monetary aggregates increased the demand for loans. Total loans of the banking system had an averaged annual growth of 30% between 1990-1996 (Bank Negara Malaysia (BNM) Annual Report, 1996).

In addition to the rapid expansion of lending, the banking system is heavily exposed to the broad property[3] sector (BPS) and stock market sector. For the period 1990-1996, the annual average rate of lending to the BPS, 36.7% and for the purchase of shares, 63.9% outstripped the overall growth of lending, 27.4% (Narayanan, et al., 1997).

The sudden speculative attack on the Malaysian Ringgit in July 1997 which started in Thailand in May 1997 spread quickly as a `contagion' to East Asian countries (Mohamad Amin & Alavi, 1997). The foreign investors pulled out their investments immediately to avoid the currency risk. The outflow of massive amount of short term foreign capital led to the crash of the stock market and the collapse of corporations that were dependent on a booming stock market for raising equity capital and debt (Sivalingam, 1999).

The immediate policy response to the falling currency was to increase interest rate and contract credit. This aggravated the banking problem because the banks were

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[1] M1= Currency in circulation + Demand Deposit

[2] M2 = M1 + Narrow Quasi Money in which,
Narrow Quasi Money = Saving Deposits + Fixed Deposit + Repos + Foreign Currency Deposit

[3] Broad property sector comprises of construction, non-residential property, residential property and real estate

unable to collect the interest payments and loans from the borrowers (Bacha, 1998). As a result, the non-performing loans (NPLs) tripled from the 4.7% in February 1998 to 11% as at July 1998 (BNM-Monthly Statistical Bulletins, September 1999).

Various effort has been taken by the Government to rescue the banks, and among them are the formation of three special purpose vehicles, Pengurusan Danaharta Nasional Berhad (Danaharta), Danamodal Nasional Berhad (Danamodal) and Corporate Debt Restructuring Committee (CDRC). The purpose of setting up Danaharta was to acquire, manage and dispose of NPLs. Meanwhile, the purpose of setting up Danamodal was to select banks for recapitalization and to strengthen the banks by consolidating the banking system (Sivalingam, 1999). The role of CDRC, as a complement to both Danaharta and Danamodal, was to nurse corporate Malaysia back to health. Capital controls was imposed on 1st September, 1998 and the tight monetary policy was gradually eased with the aim to recover the economy as a whole, with particular to the banking sector which has landed up with burdens of NPLs as a result of the repercussion effect of the Baht currency crisis.

This paper analyzes the causes of the Malaysian banking problem in 1997, recovery measures taken to address these problem and the effectiveness of these measures on the banking system.

## 1.2 Definition of Banking Crises

Banking crisis refers to a situation in which actual or potential bank runs or failures induce banks to suspend their credit facilities or compels the government to intervene to prevent this by extending assistance on a large scale (Punyanitya, 1999). Bank failure occurs when a bank cannot pay its depositors in full, with enough reserves left to meet its reserve requirement (Bond, O'bonnon and Shearer, 1975).

Capie and Wood eds. (1987) suggest a few key elements or links in the process referred to as a banking crisis as follow:

a. fear of solvency of some banking institution(s). Insolvency could stem from mismanagement, lack of foresight, a fragile debt structure and from shortage of liquidity;
b. threats to the solvency of otherwise sound banking institution(s) because of a decline in the value of their portfolios as a consequence of the forced sale of assets;
c. bank runs precipitated by such threats to solvency. Runs on particular banks in turn could lead to a general banking panic, where the public at large, fearful of suffering severe losses on their deposits should the banks fail, or of paying a premium on currency in the event of a suspension of payments, attempts to convert deposits into currency;
d. a reduction in the money supply produced in turn by banking panics. The public's deposit-currency ratio falls and the banks reduce their deposit-reserve ratio (by reducing their loans) in an attempt to improve their liquidity positions.
e. a decline in profits and net worth, and a rise in bankruptcy follow;
f. the whole process arrested at the outset by the timely intervention of some authority (the lender-of-last-resort) that lends freely at a penalty rate or engages in open market operations.

Alternative view, Kaminsky and Reinhart (1999) suggest that bank crises refer to two situations:

1. Banks runs that lead to the closure, merging, or take-over by the public sector of one or more financial institutions (as in Venezuela in 1993).
2. If there are no runs, the closure, merging, take-over, or large-scale government assistance of an important financial institution (or group of institutions) that marks the start of a string of similar outcomes for other financial institutions (as in Thailand in 1996-1997).

In the case of Malaysia, banking crisis refers to situations where banks suspend their credit facility, merge with each other and with large scale government assistance to reduce high non-performing loans in the banking sector. In other words, it refers to the second situation suggested by Kaminsky and Reinhart (1999).

The cost of rescuing banks is high (Table 1.1 below). Therefore, policy-makers need to find out the causes of banking problems and resolve the problems quickly. They also need to prevent the banking crisis from occurring again.

**Table 1.1: The Cost of Rescuing Banks**

| Country | Scope of crisis | Cost of rescuing banks (% of GDP) |
|---|---|---|
| Argentina 1980-82 | 16% of assets of commercial banks; 35% of total assets of finance companies | 55.3 |
| Chile 1981-83 | 45% of total assets | 41.2 |
| Israel 1977-83 | Entire banking sector | 30.0 |
| Finland 1991-93 | Savings banks affected | 8.2 |
| Mexico 1995- | Commercial banks | 12-15 |
| Malaysia 1997-* | Commercial banks and finance companies affected | 1.3-4 |

Source: Reisen 1997, Table 7
*Fitch IBCA, Europe's International Rating Agency

## 1.3 Research Objectives

This research will mainly focus on the Malaysian banking sector, especially commercial banks, finance companies and merchant banks. The research has three main objectives:

a. To examine the causes of banking crisis in 1997;
b. To analyze the recovery measures employed to rescue the banking system;
c. To analyze the effectiveness of these measures on the banking system.

## 1.4 The Significance of the Study

The study is important for academic or non-academic towards better understanding the causes of Malaysian banking crisis in 1997 and the recovery measures employed to rescue the banks. Understanding the causes is important for policy-makers to design better policies or recovery plans to address the problem.

## 1.5 Research Methodology

Descriptive method has been employed for this research. Neither survey nor questionnaire was conducted for data collection. As reflected in the topic of this research, "Banking Crisis in Malaysia: Causes, Recovery Measures Taken and their Effectiveness", this paper is a pure descriptive paper which discusses about the history and facts (causes and recovery measures taken) as well as the immediate and impending results on the effectiveness of the measures employed.

Information obtained for analysis in this research is based on secondary data from various sources, including local & international newspapers, official publications like BNM Annual Reports, BNM Monthly Statistical Bulletins, Banker's Journal, business magazines, text books and up-to-date information gathered via Internet.

## 1.6 Limitations of the Research

There are a few limitation pertaining to this research.

a Firstly, this study relies heavily on the availability of secondary data which might incorporate some degree of manipulation to a certain extend.

b Secondly, topics discussed in this research have yet to reach a comprehensive and thorough conclusion, as banking system is just at the very early stage of recovery and still under the phases of recovery.

c Last but not least, the detail analysis and discussion is not possible due to the time constraint.

## 1.7 Organization of the Study

The organization of the study is as follows:

- Chapter 1 is the overview of the study which includes the objective of the study, significance of the study, research methodology and limitations of the study.
- Chapter 2 comprises of two sections. The first section reviews the past study causes of banking crises and recovery measures employed to rescue the banks. The second section reviews the banking system in Malaysia.
- Chapter 3 examines the causes of Malaysian banking crisis in 1997.
- Chapter 4 analyzes the recovery measures taken to rescue the banks.
- Chapter 5 analyzes the effectiveness of recovery measures on the banking system.
- Chapter 6 concludes the study and recommends some action to prevent the crisis from occurring.