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HOW MALAYSIA WEATHERED THE FINANCIAL CRISIS: POLICIES AND POSSIBLE LESSONS

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ABSTRACT

HOW MALAYSIA WEATHERED THE FINANCIAL CRISIS: POLICIES AND POSSIBLE LESSONS

Malaysia, along with other Southeast Asian countries, suffered the worst of the 1997 Asian financial crisis. The experience of that crisis had not faded when Malaysia entered the 2008 crisis in a relatively strong position as far as government and corporate balance sheets where concerned. A key factor contributing to Malaysia's ability to respond to the 2008 crisis was the buildup of ample foreign exchange reserves. Given its lower exposure to foreign debt, there was little currency mismatch. In order to derive benefit as well as shield this country from increasingly deeper integration into the world trade and financial system, Malaysian policymakers will need to remain open to pragmatic and flexible policies. These include targeting asset inflation and a willingness to "lean against the wind". While government and corporate balance sheets are healthy, household balance sheets are an area of concern. The ratio of household debt to disposable income in Malaysia, driven by an increase in house prices and a deterioration of the housing affordability index in major urban cities is an area of concern.

KEYWORDS: Malaysia, 1997 Asian financial crisis, 2008 crisis

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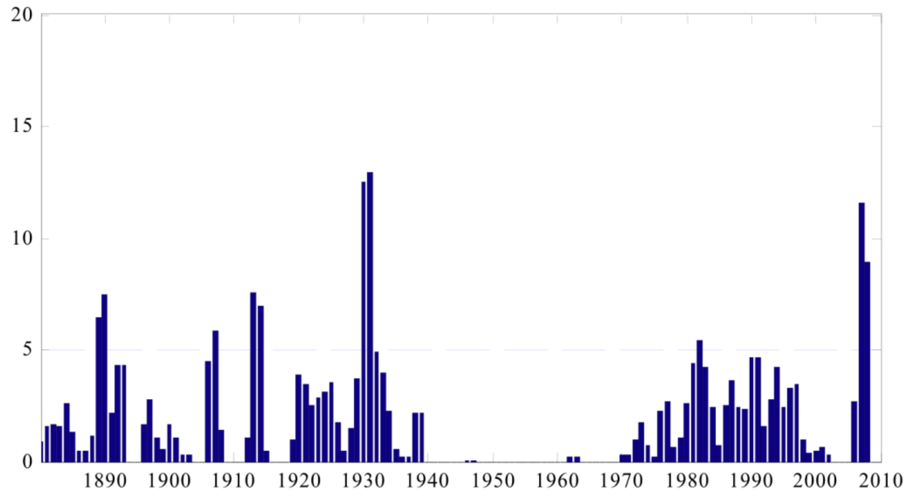
1. INTRODUCTION

Financial crises have been occurred with increasing frequency after the advent of financial liberalization and deregulation in the 1970s. Between 1970s and 2007, there have been 124 banking and financial crises worldwide, compared to the infrequency of such crisis when banking was regulated and capital flows were controlled from 1940s to 1970s. See Figure 1.

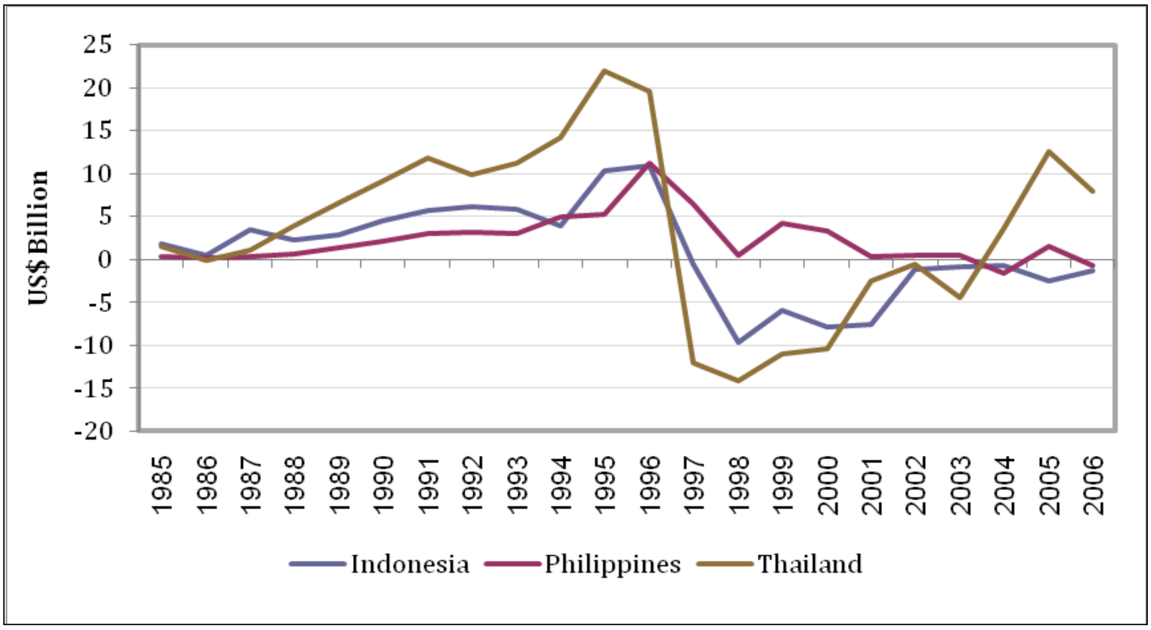
Figure 1: Weighted 2-period Moving Sum of Banking Crisis Frequencies: 1880-2009



Source: Bordo and Landon-Lane, 2010

Malaysia and other Southeast Asian countries experienced their worst financial crises from 1997 to 1999 as a result of financial deregulation. IMF and the United States government pushed for liberalization of capital accounts and banking sectors in developing countries. Unregulated capital flows coupled with pegged exchange rates brought a surge of capital flows into Southeast Asian economies taking advantage of arbitrage opportunities. Figure 2 shows the net flow of private capital into and out of Southeast Asia before and after the Asian Financial Crisis, causing havoc to the financial and economic stability of these countries.

Figure 2: Net Capital Flows – Indonesia, Philippines, Thailand



Source: IMF, International Financial Statistics

Malaysia was not spared this calamity even though its external debt burden was not onerous. In 1997, the ringgit plunged from RM2.4 to a low of RM4.9 to US$1. Net portfolio investment shrunk RM22 billion, from positive RM10.3 billion in 1996 to negative RM12.9 billion in 1997. This led to a collapse of the stock market, the ballooning of foreign debt, massive corporate defaults and non- performing loans resulting in a banking crisis.

2. INTRODUCING IMF POLICIES

Because of the relatively low level of foreign indebtedness, Malaysia did not apply for any IMF assistance. Nevertheless, it followed the standard IMF prescription in facing the crisis. On the macro-economic policy front, it raised interest rates with the view of stemming capital outflows, the currency was floated to allow for free capital flows, and it reduced public expenditure by 18%. On the financial sector side, it changed the definition for non-performing loans from 6-months arrears to 3-months arrears. Unfortunately, with the implementation of these policies, what started as a financial and currency crisis, soon became a full-blown economic crisis.

Aggregate domestic demand declined in 1998 for the first time since 1986, due to a significant negative contraction in private investments by 55% and private consumption by 10%. The real economy contracted 14%, with GDP growth plunging from positive

7.7% in 1997 to negative 6.7% in 1998 . The stock market plummeted by over 70% and the ringgit fell to its lowest of RM4.9 to US$1 in January of 1998.

3. MAHATIR'S COUNTER-STRATEGY[1]

By early 1998, it was clear the IMF macro-economic policies of pro-cyclicality were not working. Dr. Mahathir, then Prime Minister of Malaysia, changed direction, set up the National Economic Action Council and centralized decision-making and policies. In July 1998, he launched the National Economic Recovery Plan that was seen as an alternative to the IMF orthodox policies. The objectives of this plan were to stabilize the local currency, restore market confidence, maintain financial markets stability, restructure corporate debt, recapitalize and restructure the banking sector and revitalize the economy. These policies were implemented in stages.

To counter the recession, on the monetary and financial sector front, Bank Negara reduced interest rates gradually from 11% in July 1998 to 6% May and 3% in December 1999. The statutory reserve requirement was also lowered from 13.5% in July to 4% by October 1998. The non-performing loan definition was changed back to 6 months arrears instead of 3 months. Bank Negara also set targets for banks to increase their loans to 8% by 1999.

4. FOREIGN EXCHANGE RATE POLICIES

Malaysia is a highly open economy with external trade (exports and imports) constituting over 200% of its GDP. Hence the stability of its currency is crucial for its external trade. Prior to and during the crisis, the ringgit was traded off shore and the higher interest rates paid to off-shore ringgit deposits encouraged an outflow of the ringgit. Mahathir banned off-shore market trading of the ringgit and gave depositors a grace period to repatriate their off-shore ringgit deposits back to Malaysia. At the same time in September 1998, he fixed the ringgit exchange rate to US$1 to Ringgit 3.8.

5. SELECTIVE CAPITAL CONTROLS

He further introduced selective capital control measures that were strongly opposed by the IMF at that time. For foreign institutions and persons, a one-year moratorium from the purchase date of shares was imposed on repatriation of proceeds from the sale of those shares. The aim was to discourage speculative short-term trading in local shares. Ringgit loans to non-residents banks and stock broking firms were

[1] For detail discussion of Malaysia's policies in weathering the Asian Financial Crisis, see, Khor (2011).

stopped. Restrictions were imposed on transfers of ringgit funds in external accounts held by non-residents. Measures were also introduced to control conversion of ringgit to other currencies. Except for trade payment purpose, Malaysian residents were allowed to make payment to non-residents or make investments of up to the equivalent of RM10,000, above which they had to obtain prior approval from the Bank Negara. Residents were not allowed to obtain ringgit credit facilities from non-residents. Resident companies were prohibited from foreign loans unless their revenue were also in foreign currency to prevent currency mismatch – a major cause in the Asian financial crisis.

The ringgit was still freely or easily convertible for purposes of trade, inward foreign direct investments, and repatriation of dividends and profit from the foreign direct investments. What the government wanted to discourage was speculative short-term portfolio and other investments by foreign residents and the flight of capital by local residents, though the effectiveness of the latter objective is debatable.

6. EXPANSIONARY FISCAL POLICIES

To resuscitate the economy, the government embarked on an expansionary fiscal policy. In July 1998, it unveiled a fiscal stimulus package of RM2 billion that turned the budget from a surplus of 2.5% of GDP in 1997 to a deficit of 1.8% in 1998 and 3.2% in 1999.

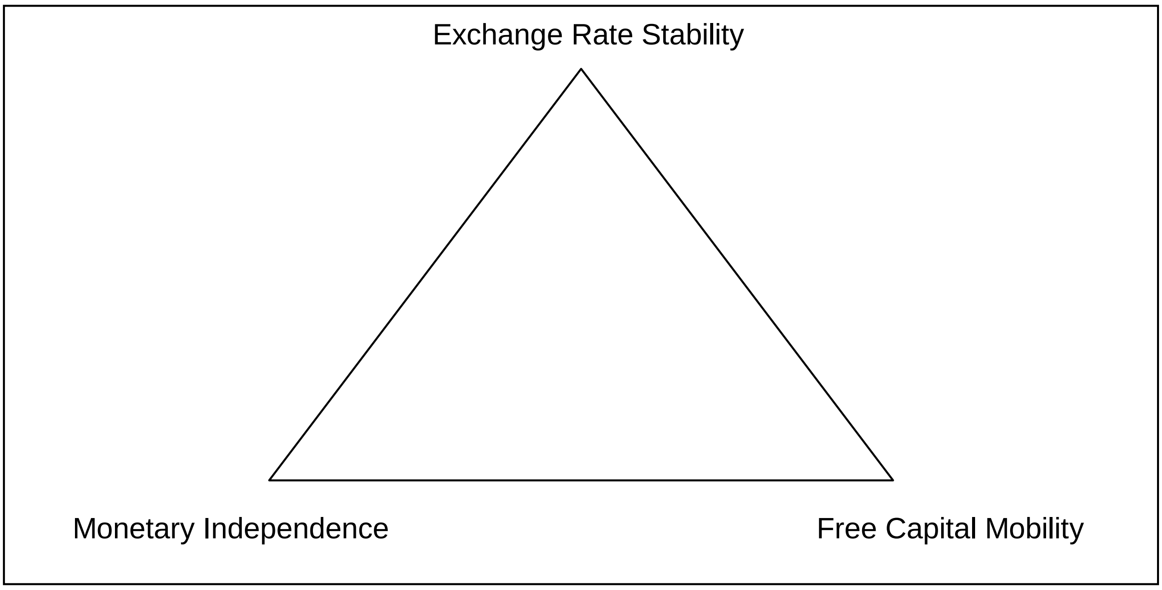
7. SETTING UP DEBT RESTRUCTURING AGENCIES

Finally, on the corporate front, the government established a number of agencies to help restructure both financial and non-financial institutions. It provided guarantee of banking deposits and decided not to close down troubled financial institutions that would have aggravated the financial crisis, but to consolidate, restructure and to recapitalize them. To this end, two government agencies, Danaharta and Danmodal, were set up. Danaharta (the debt restructuring agency) was set up in June 1998 to take over non-performing loans from banks, and to restructure and manage them. Danamodal was set up in August of 198 to recapitalize and restructure troubled financial institutions. In addition, a Corporate Debt Restructuring Committee was established to assist corporations negotiate and restructure debt with their creditors.

8. EVOLUTION OF MONETARY AND CAPITAL FLOWS CONTROL POLICIES

According to conventional economic theory, it is not possible for a country to control both its interest rates (through its monetary policies) and foreign exchange rates under a regime of free capital flows. This is because with free and unimpeded capital flows, a lower interest rate would encourage outward capital flows and hence a lower exchange rate, and vice versa. This is termed the “impossible trinity”. See figure 3

Figure 3: Impossible Trinity



The primary objectives of the Malaysian government’s monetary and capital control policies are to ensure stability in the ringgit-foreign exchange rate so as not to disrupt trade flows; at the same time to maintain a steady and relatively low interest rate to sustain economic growth.

In choosing the appropriate monetary and other less conventional instruments to achieve the above objectives, the government is guided by pragmatism and flexibility. Hence its monetary and foreign exchange rate policies have undergone several transitions.

8.1. 1997-2000

During the Asian Financial Crisis (1997-2000), Malaysia faced large depreciation of the ringgit and massive capital flight even though it raised domestic interest rates. To stem this outflow and depreciation, the government fixed the value of the ringgit at

RM3.8 to US$1 to manage the impossible trinity problem. This allowed it to lower interest rates to stimulate the economy without worrying about capital flight or currency volatility. When the economy started to recover in 1999, capital and currency controls were gradually relaxed and finally removed. In February of 1999, the one-year moratorium on repatriation of profits from share sale was replaced by a 10% exit levy on the sale proceeds on a graduated scale.

8.2. 2001-2005

From 2001 to 2005, it relaxed its capital controls but still maintained the pegged ringgit to control foreign exchange rate. But at the same time it also resorted to monetary instruments, via sterilization and its reverse, to smoothen out the effects of capital flows. In 2001, the exit levy was altogether abolished. Residents were gradually allowed to operate foreign currency accounts and to invest abroad. As the economy recovered, capital began to flow back into the country. In 2003, net portfolio investment was positive ringgit 4.2 billion up from negative ringgit 6.5 billion a year earlier and surged to RM33 billion in 2004.

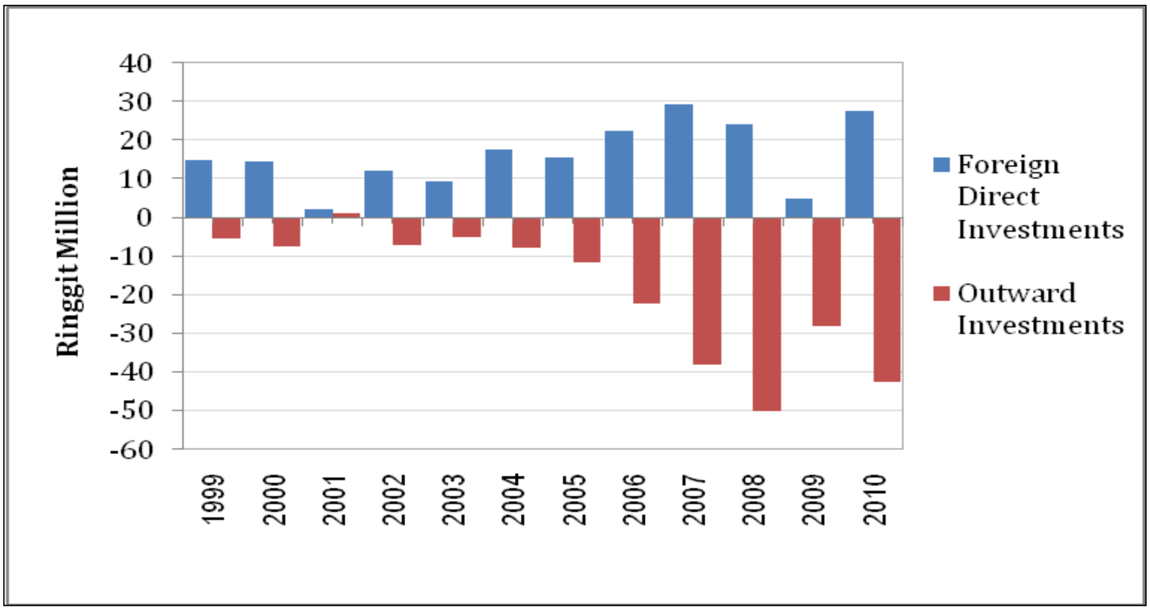
8.3. 2005 onwards

From 2005 onwards, the exchange rate and capital flows policies were almost fully liberalized. Capital controls were removed; the pegged ringgit was lifted in July 2005 and changed to a managed float system but the ringgit remain non-internationalized i.e., there were limits for non residents to borrow in the local currency.

9. POST-ASIAN FINANCIAL CRISIS

The country now faced a different set of conditions. Current account surplus have been rising steadily every year since 1999 averaging over 10% of its GDP. This was not matched by an equivalent financial and capital account deficit; consequently the country's reserves have been rising from RM117 billion in 1999 (US$31 billion) to RM336 billion (US$100 billion) in 2007. Besides using monetary instrument, namely sterilization, to mop up the excess liquidity, it has also reversed its policy of not allowing residents to invest abroad. Allowing outward investments by residents is another way of mopping up excess dollar liquidity. We therefore witnessed a significant outflow of direct investments by residents from 2005 onwards. In fact outward direct investments are greater than inflow of foreign direct investments such that net direct investments are negative from 2007 onwards. See Figures 4 and 5.

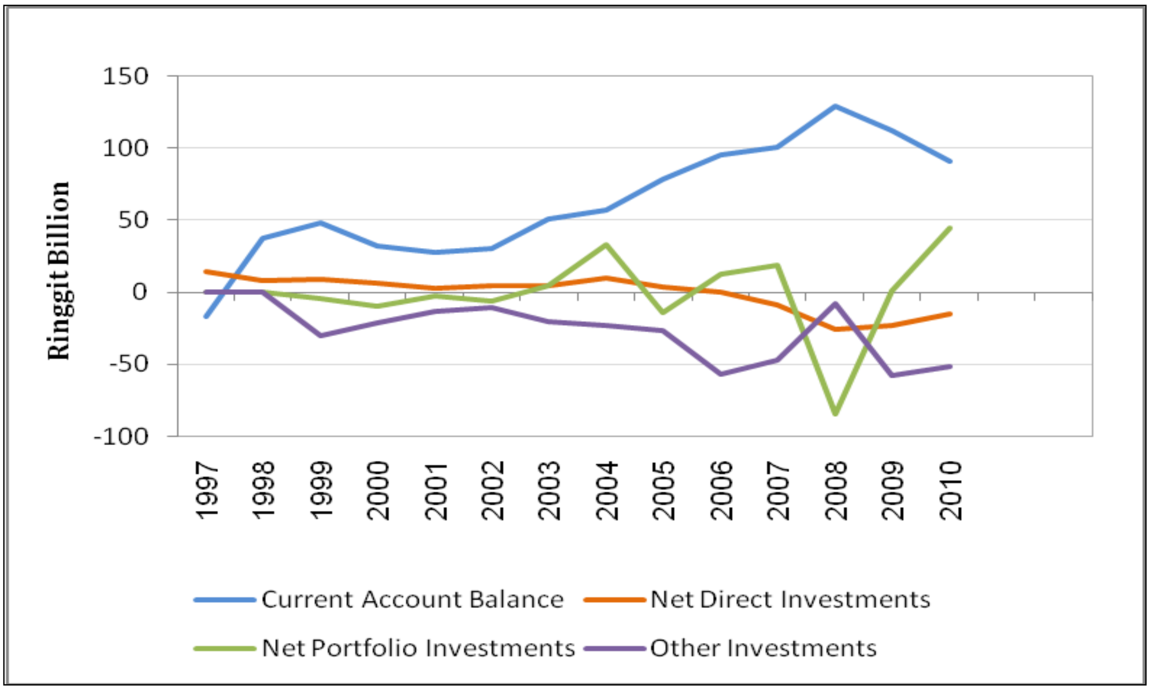
Figure 4: Outward Investments and Foreign Direct Investment, 1999-2010



Source: Bank Negara, Monthly Statistical Bulletin

The largest category of net outflow of capital comes from "other investments" which represent mostly deposits or placement of assets abroad by domestic financial institutions. The net outflow of other investments averaged over RM20 billion annually between 2003 and 2005 and more than doubled to RM56 billion in 2006.

Figure 5: Balance of Payment, 1997-2010

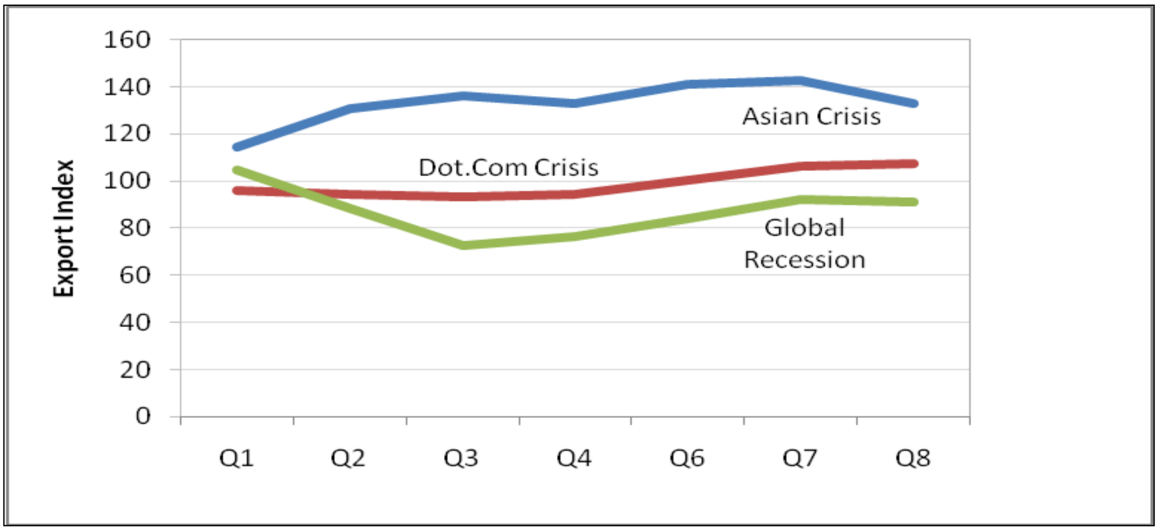


Source: Ibid

10. MALAYSIA IN THE PRE-GLOBAL FINANCIAL CRISIS PERIOD

Malaysia entered the latest global financial crisis from a position of relative strength both in terms of its national balance sheet, as well as its corporate balance sheet. What could be of some concern down the road is the strength of its households' balance sheet. Helped by a positive external environment, the country instituted a right mix of macro-economic, monetary, and financial sector policies that facilitated its recovery from the Asian financial crisis. Exports led the way to recovery. Figure 6 compares the performance of the export sector in the three recent crises. In both the Asian Financial Crisis and the recent global financial crisis, government monetary and fiscal stimulus programs plus exports demand led the way to recovery.

Figure 6: Performance of Export in the three recent crises

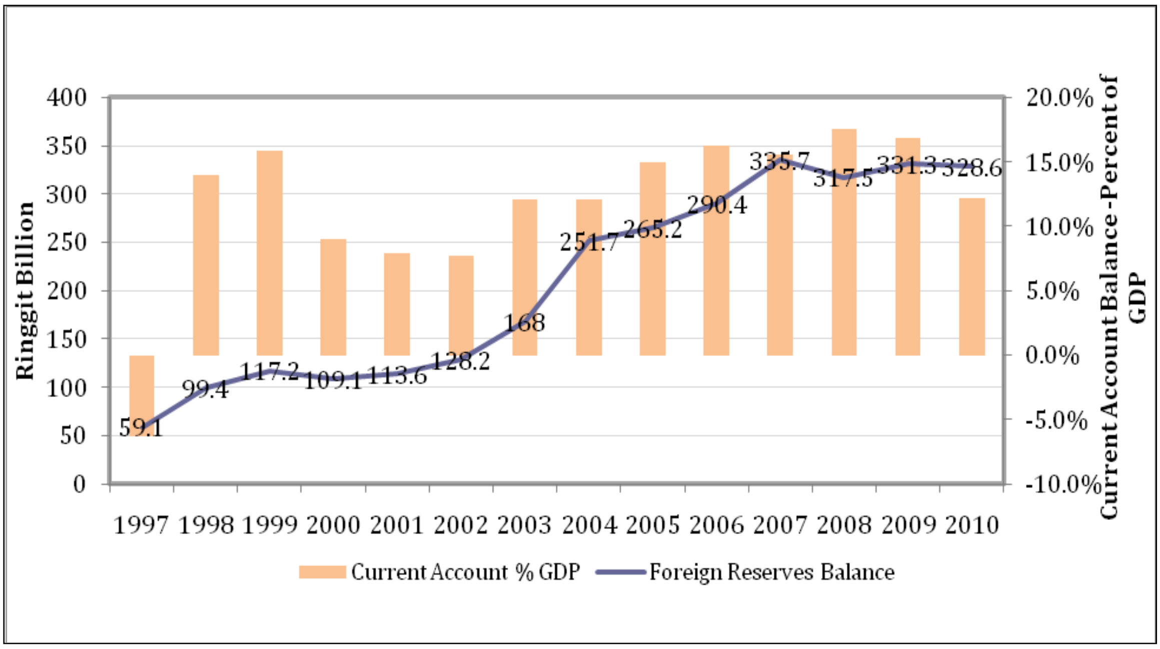


Source: Authors' own calculations

11. STRONG CURRENT ACCOUNT BALANCE AND FOREIGN RESERVES

Its current account balance, rose from a deficit of RM17 billion in 1997 to a positive of RM37 billion in 1998. From 2003 onwards, this surplus has exceeded RM50 billion yearly. Even when the global financial crisis hit Malaysia in 2008, the country's current account surplus was over RM130 billion and dipped to RM112 billion and RM90 billion in 2009 and 2010 respectively. Its foreign exchange reserves have been rising steadily from RM59 billion in 1997 to RM328 billion in 2010. See Figure 7. The reserves peaked at RM410 billion in June 2008 and plunged to RM320 billion at the height of the crisis in December 2008 but soon stabilized at RM330 billion in 2009 and 2010, adequate to finance 7.7 months of import and 3.9 times its short-term external debt (Bank Negara, 2009:4).

Figure 7: Foreign Reserves and Current Account Balance, 1997-2010

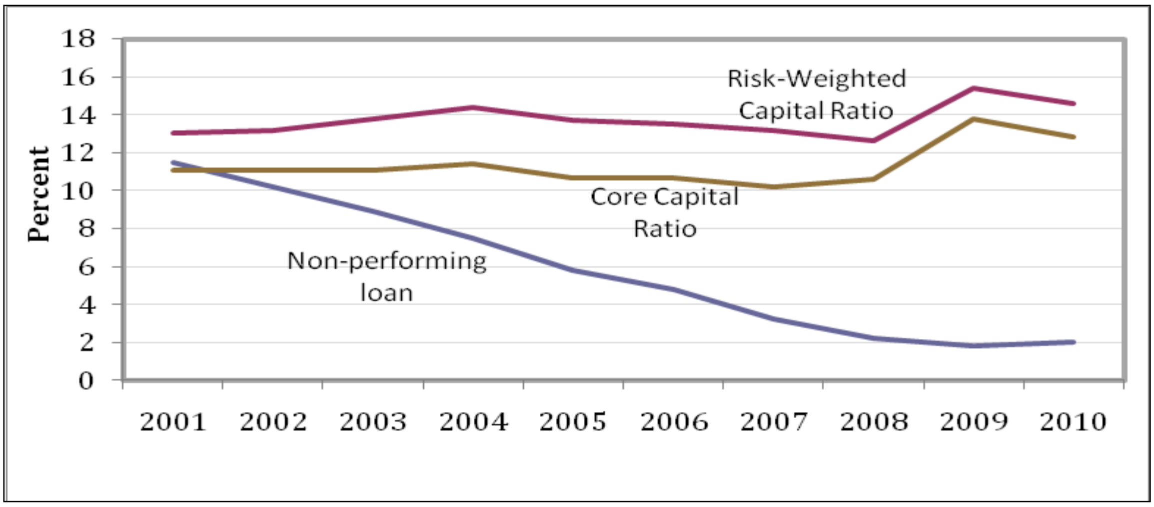


Source: BNM, Monthly Statistics Bulletin

12. HEALTHY BANKING SYSTEM

The Malaysian banking and corporate sectors emerged healthier after Asian Financial Crisis. See Figure 8. Its risk weighted capital ratio was above 13% from 2001 to 2010, its core capital ratio above 10%. Its non-performing loans based on 3 months arrears classification dropped from 11.5% in 2003 to 2.6% in 2008. The impact of the crisis on the Malaysian banking system was modest as domestic banks had negligible exposure to US subprime loans and derivatives. The corporate sector was also healthy with little currency mismatch. Loan growth was relatively in line with GDP growth. Between 2005 and 2010, total bank loans grew at annual rate of 8.7%, slightly faster than GDP growth of 8.0%.

Figure 8: Banking Indicators

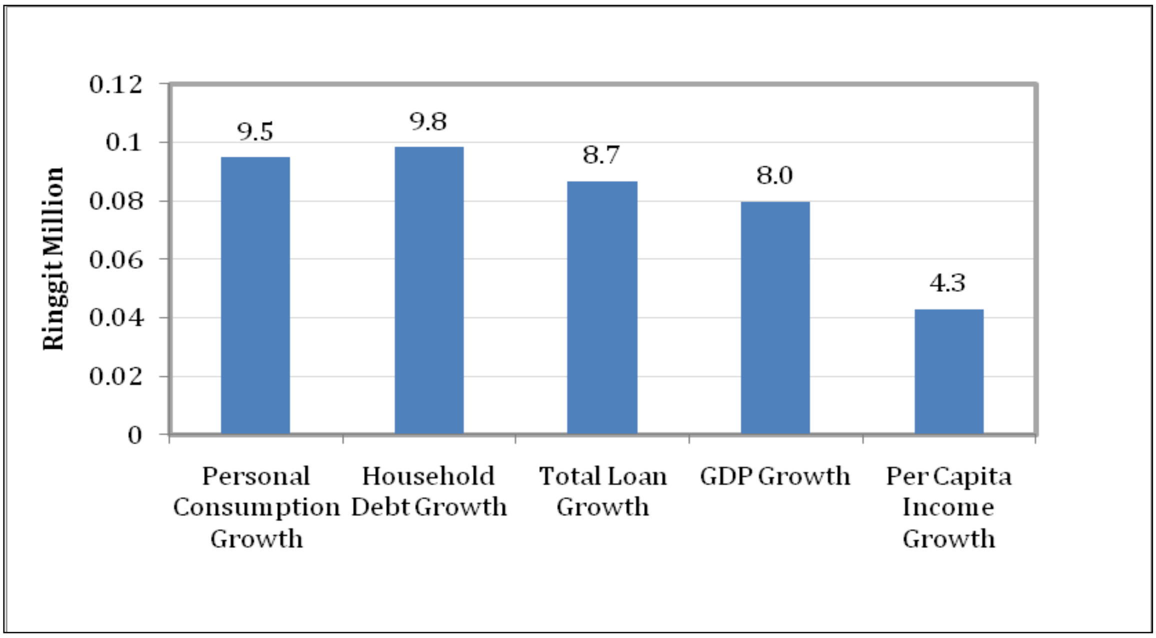


Source: Ibid

13. HOUSEHOLD LOANS AND ASSET BUBBLE?

What could be of concern, although still at an early stage, is the resilience of Malaysia's household sector. Growth in household loans grew at annualized rate of 9.8% during the same period, about 2% higher than GDP growth. See Figure 9. Household debt to GDP in Malaysia stood at 76% in 2010, but household debt to disposable income was at a high of 140%, higher than the USA. Meantime growth in per capita income was only 4.3% annually. Hence most of the growth in personal consumption of 9.8% is driven by debt rather than income growth. Much of the growth in household debt is driven by increase in house prices that outpaced income growth; followed by passenger car loans that consume a substantial portion of household income. House prices in Malaysia over the last few years have risen to unsustainable levels and the government should take measures to manage this bubble. While the central bank has raised interest rates gradually, it is constrained by the fear of derailing economic growth. Furthermore, with half of household disposable income servicing household debt, further rise in interest rates could result in default and rise in non-performing loans. Hence Bank Negara should adopt more aggressive non-monetary measures, such as tightening loan to deposit ratio, which is at a high of 95%, and introducing graduated capital gains tax based on holding period, to manage asset inflation.

Figure 9: Average Annual Growth 2005-2009

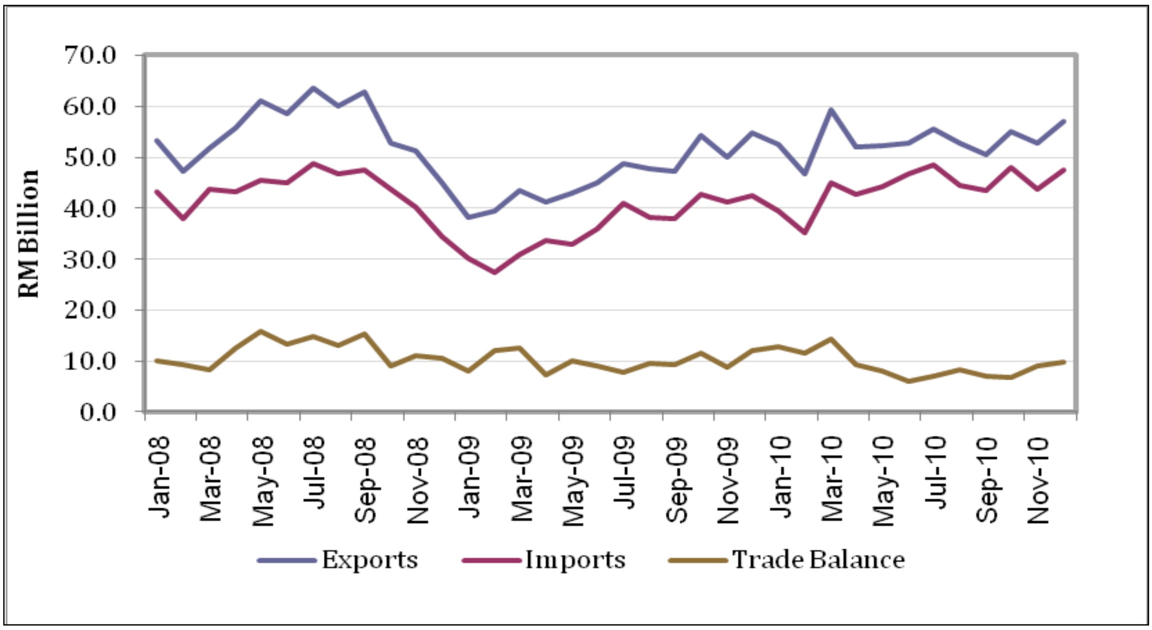


Source: Financial Stability and Payment Systems Report, 2009

14. MALAYSIA ENTERED THE RECESSION: TRADE AND INVESTMENTS SLUMPED

Despite the relative strength of Malaysia's macro-economic and banking industry condition, Malaysia was not spared the crisis. Being a highly trade dependent economy, and having almost fully liberalized its exchange rate and capital flows account after 2005, the country was hit hard in the trade and investment sectors. Malaysia's exports plunged 45% from RM64 billion in July 2008 to RM38 billion in January 2009. Imports likewise plummeted by the same percentage over this period so that the trade surplus remained positive and declined marginally. See Figure 10.

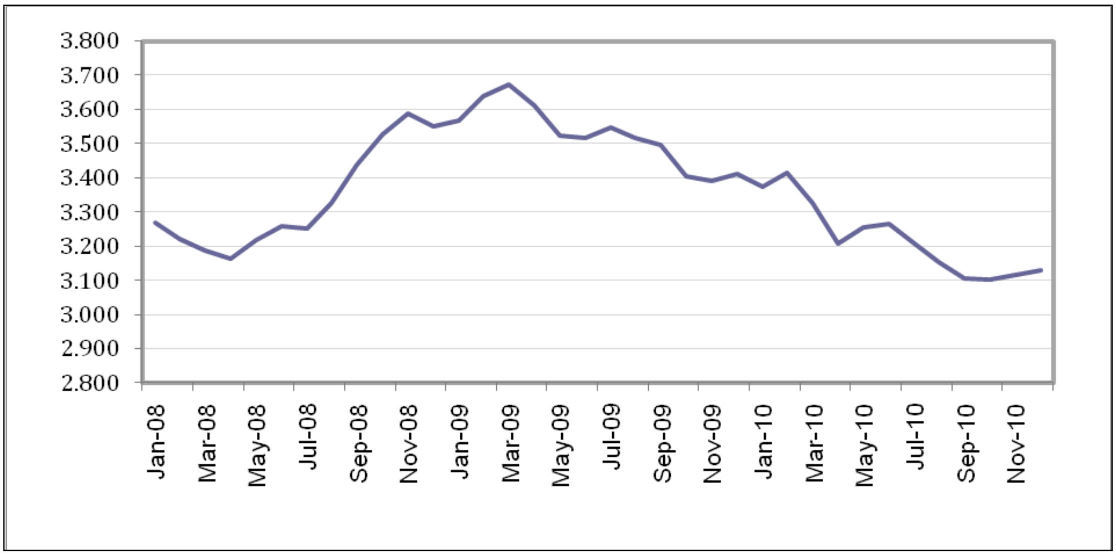
Figure 10: Malaysia's export and Import, 2008-2010



Source: Ibid

Unlike in the Asian Financial Crisis, the ringgit this time depreciated only around 10% and gradually recovered and appreciated in the post-crisis period. See Figure 11.

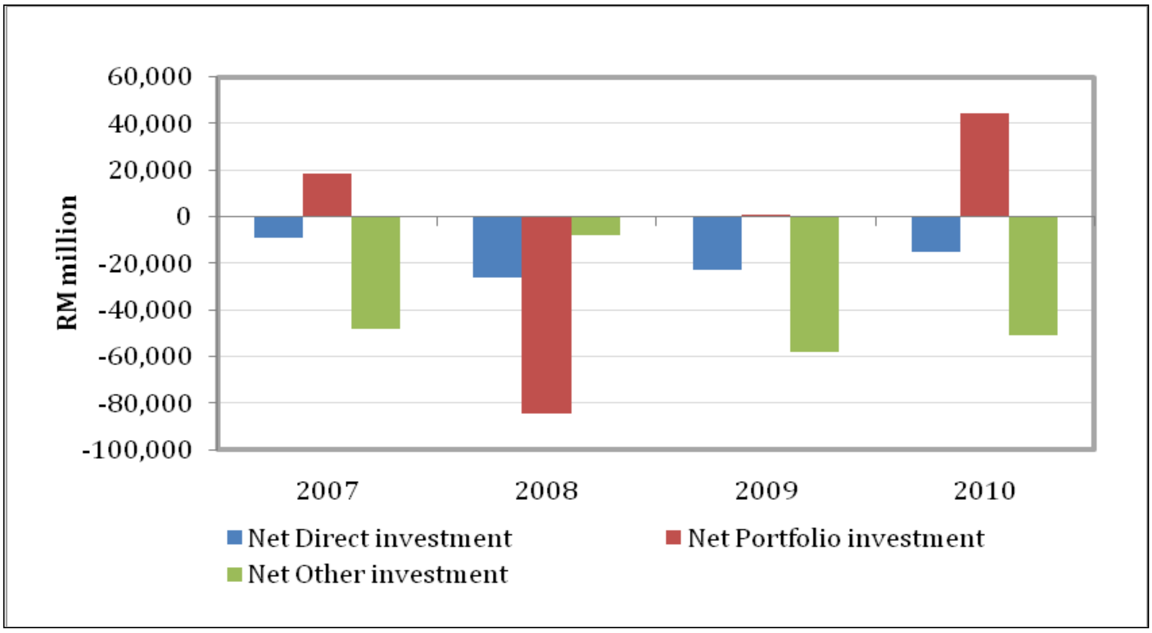
Figure 11: Ringgit-USD Exchange Rate



Source: Ibid

With almost full liberalization of its financial and capital accounts, Malaysia is now subjected to highly volatile capital flows, the most erratic being the portfolio investments. Figure 12 shows that net portfolio investments plunged RM100 billion from positive RM18.3 billion in 2007 to negative RM84.4 billion in 2008 and the Malaysian stock market likewise lost 40% of its value in the year 2008. Net portfolio investments then recovered in 2009 and surged to RM44.2 billion in 2010.

Figure 12: Net Financial Flows, 2007-2010



Source: Ibid

Significantly the banking and financial sector in Malaysia remained stable. It did not suffer a liquidity or solvency crisis. Non-performing loan ratios remained stable around 2% and the banks are well capitalized. Loan growth slowed in the second half of 2008, but picked up again by the first half of 2009.

15. IMPACT ON REAL ECONOMY

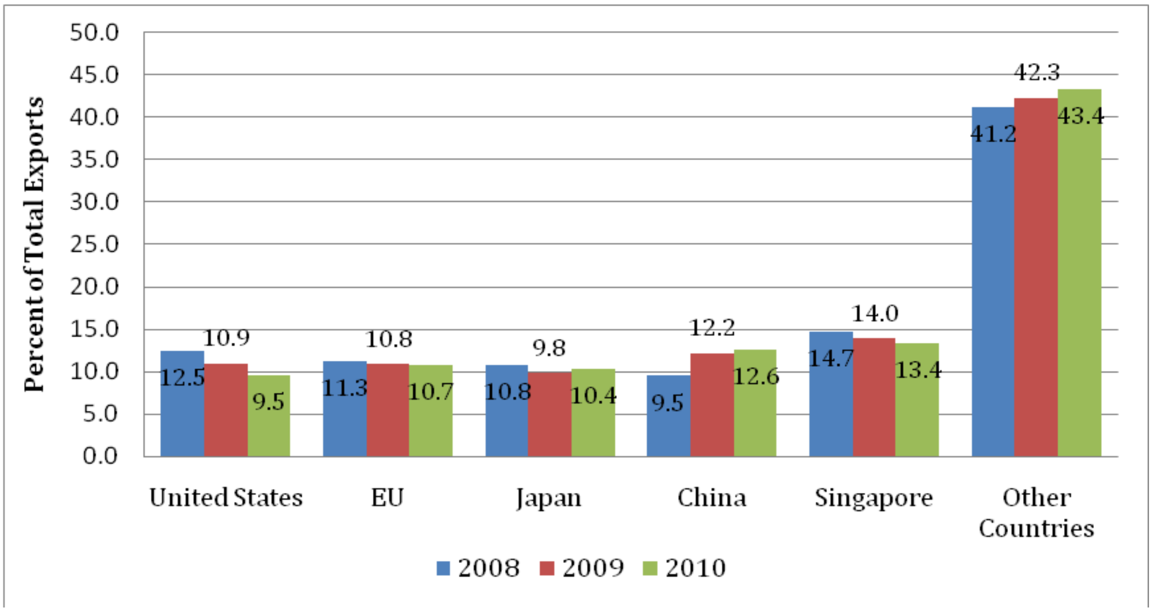
With the drastic decline in exports and spike in capital outflows, the Malaysian economy entered into a recession with GDP contracting 1.7% in 2009. Growth turned negative the first three quarters, with the economy contracting 6.2% in Q1 of 2009. Unlike what the IMF prescribed during the Asian Financial Crisis, this time around, all governments, including Malaysia's, went into high gear to implement counter-cyclical monetary and fiscal policies. Government took up the slack where private demand slumped.

16. FISCAL STIMULUS AND MONETARY LOOSENING

The government introduced two vigorous fiscal stimulus program totaling RM67 billion, equivalent to 10% of GDP, in late 2008 and early 2009. The central bank aggressively cut interest rate three times totaling 150 basis points to a low of 2.0%. It also reduced the statutory reserve requirements by 200 basis points to 1.0%. All these measures worked to stabilize the domestic economy. Private consumption, which fell 2.9% in Q1 2009, gradually improved in the second half of the year. But for the full year 2009, private sector expenditure contracted 3.4% while public sector expenditure rose 7.7% (Bank Negara, 2010:2)

On the supply side, growth in first part of 2009 was severely affected by the collapse of manufacturing exports in the second half of 2008. The services sector recorded a marginal decline while the construction sector remained positive throughout the year due to public investments and the fiscal stimulus. Fortunately for Malaysia, exports rebounded quickly in the second half of 2009 and first half of 2010. Significant to note is the shift in the direction of trade. Exports to the US declined while that to China and to other countries particularly intra-regional trade rose. See Figure 13.

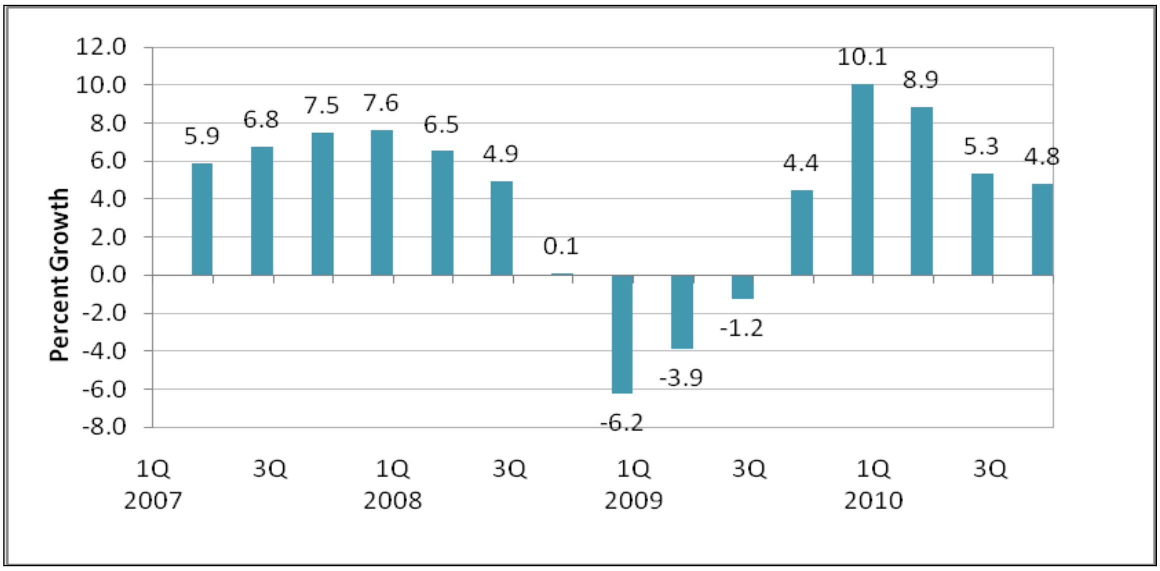
Figure 13: Direction of Trade, 2008-2010



Source: Ibid

The worldwide massive monetary and fiscal loosening brought about uneven recovery. Growth in Europe, Japan and US is weak while that in emerging countries is stronger. Malaysia's real GDP growth was negative for three quarters but rebounded strongly in the latter part of 2009 and first half of 2010. See Figure 14

Figure 14: Real GDP Growth



Source: Ibid

17. NEW CHALLENGES FOR ASIA

In fact, emerging countries now face a different set of challenges. They are not decoupled from the advanced countries; they remain firmly integrated into the world financial and trade system. Financialization of the global system and speculation are the order of the day. Capital flows instantly and incessantly in search for higher yields – the most visible are the carry trades where investors borrow in low yielding currencies such as the yen or US dollar to invest in higher yielding currencies and assets like the Australian dollar. The massive liquidity injection by the Federal Reserve Bank in the form of quantitative easing did not ease the liquidity and lending conditions in the U.S. Rather much of the funds flowed to the emerging countries that are experiencing higher growth, resulting in both appreciation of their currencies and fuelling asset inflation in the stock and property markets.

The stock market index in Malaysia, as in many other emerging countries, has now exceeded its pre-crisis peak, and the property market has been registering double-digit gains since 2009. As was stated earlier, policymakers are using both monetary and other physical instruments to rein in property prices. The inflation risks are increased with the sharp rise in food, fuel and other commodity prices. The Bank Negara governor in May 2009 warned that inflation risks could outweigh the downside growth risks in the Malaysian economy (Star, May 14, 2010). The central bank remains vigilant and will adopt measures to meet these challenges.

18. CONCLUSIONS AND POLICY LESSONS

Malaysia, like many other Asian countries, faced two major crises in the space of ten years. The first was the Asian Financial Crisis of 1997-1999 and the second the Global Financial Crisis of 2007-2009. How did it weather the crises? What lessons can be drawn from this experience?

1. Increasing integration into world trade and financial system brings with it benefits and dangers. Malaysia's economy, like most other emerging economies, is becoming more integrated, rather decoupled, from the world economy, either through trade or capital flows. Financial openness renders the domestic economy to sudden and large movements of capital and volatility in exchange rates. Exchange rates today are influenced more by capital flows than trade flows. If a country, particularly a small economy, maintains full liberalization of capital flows, such massive and volatile capital flows can undermine its monetary policies as in the case of the Asian Financial Crisis.

2. Policymakers should not be tied to IMF orthodoxy. Rather they should be pragmatic and flexible in their policies guided by overall national objectives. The fiscal, monetary and banking policies should be counter-cyclical rather than pro-cyclical. They should be willing to use different instruments other than the normal monetary instruments to attain those objectives. In the case of Malaysia, they adopted selective capital controls to stabilize their trade, capital flows and exchange rates and adapted or remove them as conditions changed. At that time, such a policy was considered heretical; yet today even the IMF is advocating selective controls as a legitimate tool to manage economic and financial stability. Today as many emerging countries face asset inflationary pressure resulting from excess liquidity created by quantitative easing and carry trades, policymakers should be willing to use additional tools to manage their currencies and capital flows

3. There is no substitute for building strong macro-economic fundamentals and healthy national, corporate and household balance sheet. Malaysia's external debt was low and there was little currency mismatch in its external debt. Another reason many Asian countries, including Malaysia, was able to weather the global financial crisis better is because of their ample foreign exchange reserves that provided them the liquidity and ability to absorb external shocks. In 2008-9, Malaysia suffered net capital outflow of about US$30 billion but the country still had US$90 billion in foreign reserves equivalent to 8 months imports and over three times its short-term foreign debt. Countries like South Korea and Indonesia that had high exposure to foreign debt, currency mismatch, and low level of foreign reserves were in more precarious positions.

4. Malaysia is highly dependent on trade and manufacturing forms the largest component of its exports. Sixty percent of its manufacturing exports come from the electrical and electronics industry. To lessen volatility, it should diversify both its export composition and export destination. We witness a discernible shift in its export destination toward intra-regional trade, particularly China.

5. The world financial system is increasingly becoming more fragile and unstable and financial crisis is at the heart of major economic crisis. Asset inflation, rather than wage or consumer price inflation, has been the driver of economic boom and bust and was the main cause of the global financial crisis. Malaysia should learn from this lesson and central banks should pay more attention to asset inflation and be willing to adopt lean-against-the-wind measures to avoid or minimize similar crisis.

6. Maintaining a prudent and sound banking system with low level of exposure to fancy financial instruments stood Malaysia in good stead. Malaysian banks had minimal exposure to collateralized debt obligations and other derivatives, were well capitalized, and stable non-performing loan ratios. The government should resist pressures to indiscriminately liberalize its financial systems or adopt the latest fad in financial innovations.

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