Malaysian Financial Crisis of 1997-1999

EC250 – Professor Ball

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Background:

Situated in Southeast Asia, Malaysia is a small country of about 28 million people. Gaining its independence from the British Empire in 1957, it is now governed by a parliamentary democracy with a constitutional monarch on the federal level and divided into thirteen states. Each of the thirteen states has its own assembly and government which the chief minister leads. Like the United States government, the Malaysian government values the importance of the separation of powers at both the Federal and State level. The parliament is divided into three components: the Yang di-Pertuan Agong, the Senate, and the House of Representatives. In general, the parliament's duties include making amendments to existing federal law, examining government policies, approving government expenditures, and approving new taxes.

The economy has traditionally been fueled by its natural resources, but is expanding in the sectors of science, tourism, commerce and medical tourism. The abundant natural resources include petroleum, liquefied natural gas, tin, and minerals. In an effort to diversify the economy and make Malaysia's economy less dependent on exported goods, the government has pushed to increase tourism in Malaysia. As a result, tourism has become Malaysia's third largest source of income from foreign exchange, although it is threatened by the negative effects of the growing industrial economy, such as the large amounts of air and water pollution along with deforestation. Malaysia has had one of the best economic records in Asia, with GDP growing an average 6.5 percent annually from 1957 to 2005 (See Figure 6). The country has a nominal GDP of $255.3 billion which is expected to continue to grow by 5-6 percent through 2011.

The Central Bank of Malaysia (Bank Negara Malaysia) was established in 1959 by the Central Bank of Malaysia Act of 1958 (revised in 2009). This outlines goals and roles for the Central Bank including low and stable inflation, development of the financial system's infrastructure, and banker and advisor to the Malaysian government. The Bank Negara Malaysia also issues the Malaysian currency, the ringgit. Within the Central Bank, there is a governor who serves as the chief executive the Bank and is assisted by three deputy governors and seven assistant governors. In addition, there are 39 separate departments which are divided into seven divisions and each of the assistant governors is responsible for each one.

Major Exports & Imports:

Malaysia has been a trade hub for centuries. They have been a huge commercial center for Chinese, Arab, and Indian merchants. Today, Malaysia has healthy trade relations with many countries, especially the United States. They are also one of the founding members of The Association of Southeast Asian Nations (ASEAN) for trade promotion. They have signed free trade agreements with such countries as China, Japan, Pakistan and New Zealand. The exports and imports of Malaysia were very correlated for most of the time in the 1990's until the crisis in

1998. During the crisis, exports and imports started to deviate from each other with exports increasing at a faster rates than imports due to the devaluation of the currency.

Malaysia was once the world's largest producer of tin, rubber, and palm oil. During late 2000's, their export industry was weakened by an economic recession. During this time, total exports fell by about 40 billion Malaysian Ringgits. Currently, the main products that Malaysia exports include electronic equipment, petroleum, wood and wood products, palm oil, rubber, and textiles. Major imports include machinery, chemicals, vehicles, plastic, iron and steel products and electronics.

In-depth Analysis:

The data analyzed focuses on time periods ranging from from 1990 to 2004 because Malaysia experienced a balance of payments crisis amid the East-Asian economic collapse that began in 1997. The time period mainly explained in the analysis is from 1997-1999. The following study attempts to explain the reasons for this collapse and why Malaysia made the choices that it did. Although most of the data used is annual, it clearly shows the fluctuations in the money supply, international reserves, the overnight interest rate (monthly), GDP, the current account and financial account, and the MYR/USD exchange rate. Most of the data used comes from the database of the Central Bank of Malaysia, Bank Negara Malaysia.

Malaysia experienced rapid economic growth between 1970 and 1990 and then entered into an economic decline. Before the crisis, Malaysia deregulated foreign direct investment (FDI) to allow for greater foreign ownership of domestic companies, and to increase incentives for companies to invest in Malaysian resources over other Asian nation's resources. This provided Malaysia with an enormous influx of foreign capital investment, which was then poured into real estate and equity and ultimately resulting in an asset-price bubble and largely over-inflated stock prices. This put Malaysia in a vulnerable position that would eventually be exposed.

Starting in 1997, a few East-Asian nations began experiencing economic difficulties beginning with the collapse of the Thai baht on July 2. Due to the strong ties between many Asian nations such as Indonesia, South Korea, the Philippines, and Malaysia, many of them began experiencing issues with their individual economies as well. In particular, Malaysia faced speculation of the Ringgit within days of the Thai baht collapse. The Ringgit lost more than 50% of its value due to a speculative attack and fear of contagion. Over the course of a few months the exchange rate jumped from 2.5 MYR/USD to over 4 MYR/USD (See Figure 2). At the same time, the overnight rate jumped from 8% to about 40% (See Figure 4), leading to a general sell-off on the markets and rating downgrades. During the crisis the Malaysian economy severely contracted, GDP shrunk by 7.4 % (See Figure 6). The domestic stock market index (KLSER) lost 50% of its value, falling from 1,200 points to below 600 points; and the recently inflated housing market contracted by almost 24%. All of the affected countries turned to the IMF for loans and economic plans to contain the damage except for Malaysia. They focused their attention on conventional stabilization techniques. Eventually, they resorted to capital controls to ease monetary and fiscal policies without harming their currency too much.

To combat a total collapse of the Malaysian economy, the central bank began by focusing on the interest rate. They aimed to lower the interest rate on the Ringgit by increasing the money supply (See Figure 3). The money supply bottomed out in mid-1998 which was when interest rates were at their highest. Soon after, money supply began increasing and the interest rates began decreasing. A decrease in the interest rate could potentially create an adverse affect of devaluing the Ringgit to levels in which Malaysia would begin to default on their debts. To offset this, the central bank decided to move from a flexible monetary regime to a fixed monetary regime. Before the crisis, the Malaysian central bank conducted a managed float of its currency. In October of 1998, the Malaysian Ringgit was set to a fix with the US dollar (See Figure 2). This allowed the Malaysian government to try to prevent any further devaluation of the Ringgit. In addition to fixing the exchange rate, the Malaysian central bank sought to prevent further speculation by banning foreign trade of the Ringgit and introducing capital controls to regulate outflows and inflows. Thus, targeting the interest rate gradually evolved into many other major policy changes.

Malaysia experienced a sudden stop of capital inflow shortly after the economic collapse began. Tight liquidity and excess capacity led to this rapid decline in foreign capital inflow while private investment generally contracted due to the large uncertainly of the Ringgit’s value. This sudden stop created a surge in the current account (See Figure 5). The surge in international reserves in 1997 (See Figure 1) is evidence of the sudden stop, as Malaysia had to finance their current account with their reserves since foreign capital flow had declined. As seen in Figure 5, the current account account and financial capital account deviate tremendously beginning in 1997 - 1998. The sudden stop in foreign capital flows led to a steep decline in financial capital account (FKA), and a steep increase in the current account as exports soared from the depreciation of the Malaysian Ringgit. The peak in the international reserves signals the start of a fixed monetary regime. This crisis is similar to the 2008 financial crisis. The Malaysian central bank and Danaharta, Malaysia's national asset management company, began buying banks bad loans to keep banks solvent.

What Malaysia ultimately experienced was a balance of payments crisis, which is apparent due to their sharp change in reserves sparked by a change in expectations about the future exchange rate and the sudden stop of capital inflows. There was a sudden deterioration in the FKA due to the sudden stop of capital inflows and a surge in the current account (See Figure 5). This led the foreign exchange (FOREX) market to expect the Ringgit to devalue in the future and to adopt a new fixed exchange rate that was higher than the current fixed exchange rate, however, the domestic interest rate remained where it was - still below the expected return on foreign assets. This difference caused excess demand for foreign currency assets in the FOREX market, so to continue holding the exchange rate where it was the central bank had to sell foreign reserves (Figure 1) and thus shrink the domestic money supply (Figure 3).

The basic macroeconomic policy “trilemma” can be used to explain how Malaysia suffered an economic crisis. There are three common objectives within monetary policy: exchange rate stability, free capital flow, and independence of monetary policy. Only two of these goals can be reached at any given time. Malaysia chose to adopt exchange rate stability and monetary autonomy while banning capital flow. They made this decision following the unsuccessful institution of more conventional monetary policy tools such as anti-inflationary measures and reduction of excess liquidity through sterilization. By prohibiting the free movement of capital, interest rate parity does not need to hold, so Malaysia could lower domestic interest rates without it affecting their currency. In addition, banning free capital flows allowed the Malaysian central bank to minimize the speculative pressure on the ringgit. The structure of the Malaysian banking system as well as prudential regulations within the country gave strong supervisory and control powers to both the Malaysian central bank and the Malaysian government. For this reason, however controversial the decision to ban capital controls was, it proved to be an effective monetary policy tool in containing the crisis of 1998.

Leading up to the financial crisis in Malaysia, the current account deficit was roughly 8% of GDP. At the peak of the financial crisis this deficit reached 10% of GDP. However, the increasing deficit was quickly reversed once the capital controls were implemented by the Malaysian government. Coupled with the undervalued Ringgit, Malaysia was able to turn itself around as a major export economy, and turn its current account deficit into an account surplus by the end of 1998. During the same year, GDP turned around from a growth rate of -7.4% to growth rate of 6% (See Figure 6). It appears that the capital controls and stimulative interest rates helped heal the Malaysian economy after its collapse in 1997.

The devaluation of the Ringgit spurred a surge in exports that helped the Malaysian economy begin to recover in 1999. The tech bubble increased global demand for electronics and investor confidence began to pick up. This increase in exports can be seen in the drastic increase of the current account after the Ringgit was fixed to the U.S. Dollar. The Ringgit was actually undervalued at 3.8 to the US dollar and ultimately gave way to a boost in exports, a current account surplus, and a re-capitalization of foreign exchange reserves. Malaysian officials sought to prevent any bank runs by creating a government-backed agency, Danamodal, in January of 1998. Danamodal pumped 11 billion Ringgit into the economy under the condition that more than 70 banks undergo consolidation. They were formed into ten “anchor” banks and twenty specialist lending institutions. Capital controls were also replaced by a price-based exit tax in February of 1999 and eliminated in May of 2001. More recently, Malaysia has sought to lessen its vulnerability to crises through confidence-building measures in the banking and corporate sectors, diversification of the domestic economy through a focus on commodity and service expansion, and the implementation of more prudent macroeconomic policies.

A major lesson to be learned from the Malaysian economic crisis is the important presence of contagion. Even those countries that seem to be on a never-ending track of prosperity are subject to crises generated in other nations. Many East-Asian nations experienced such great growth prior to 1997 that it ultimately blinded them to the huge vulnerabilities they were putting themselves up against. There were no clear indicators of the impending economic collapse that would have provoked Malaysia to put its guard up prior to 1997.

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Figure 1: International Reserves

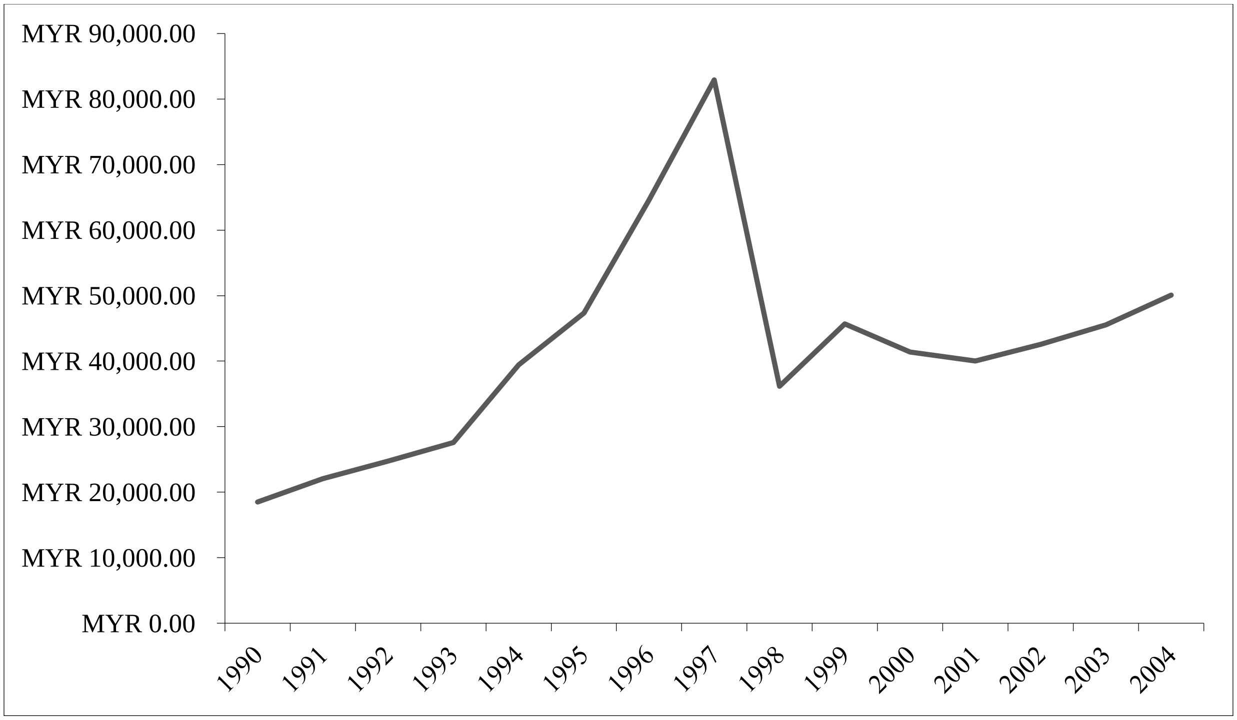

Figure 2: Exchange Rate (Malaysian Ringgit to US Dollar)

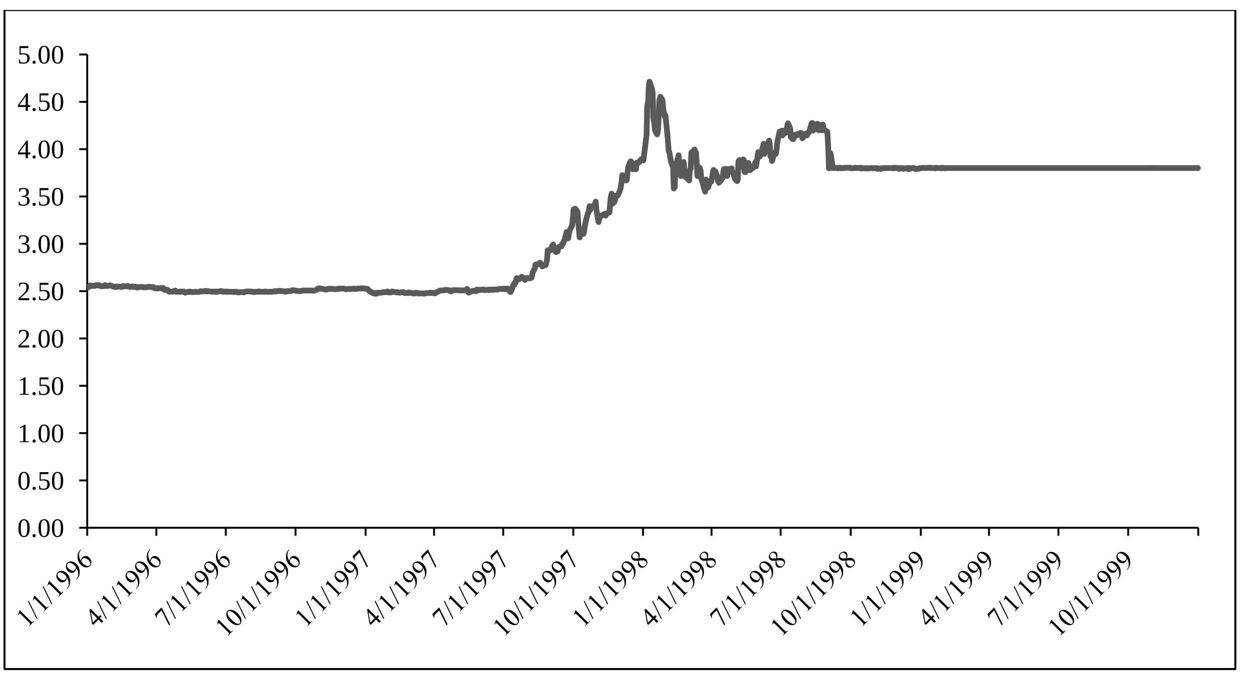

Figure 3: Money Supply (M1)

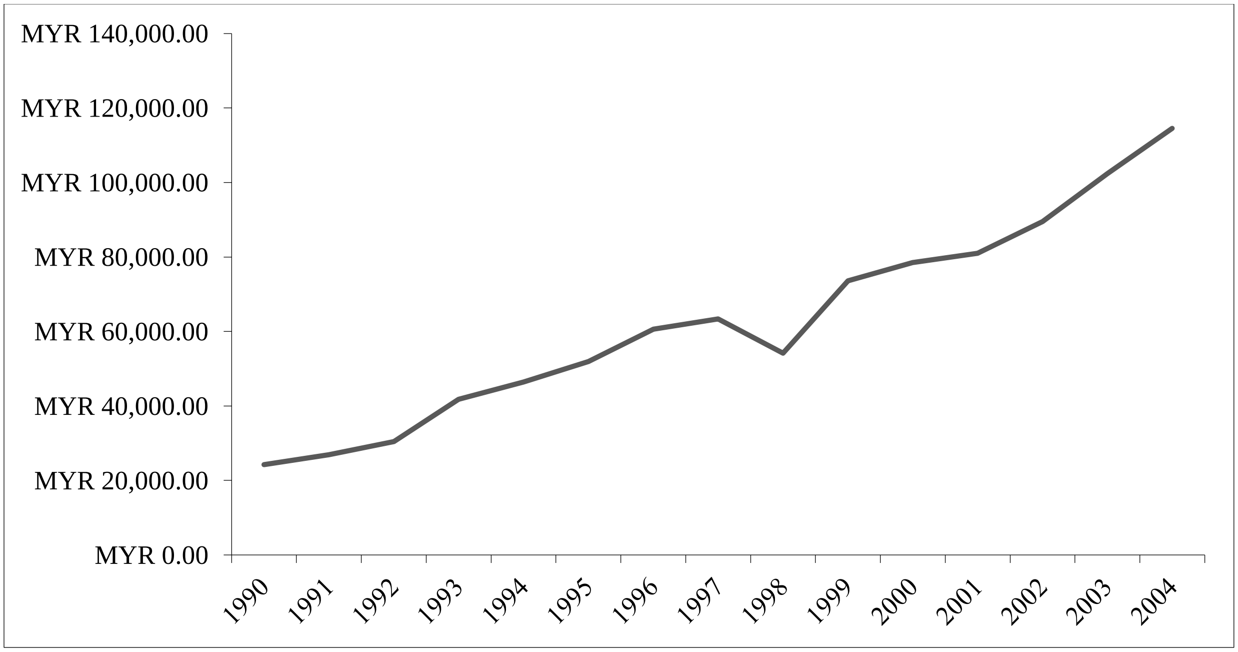

Figure 4: Monthly Overnight Interest Rates

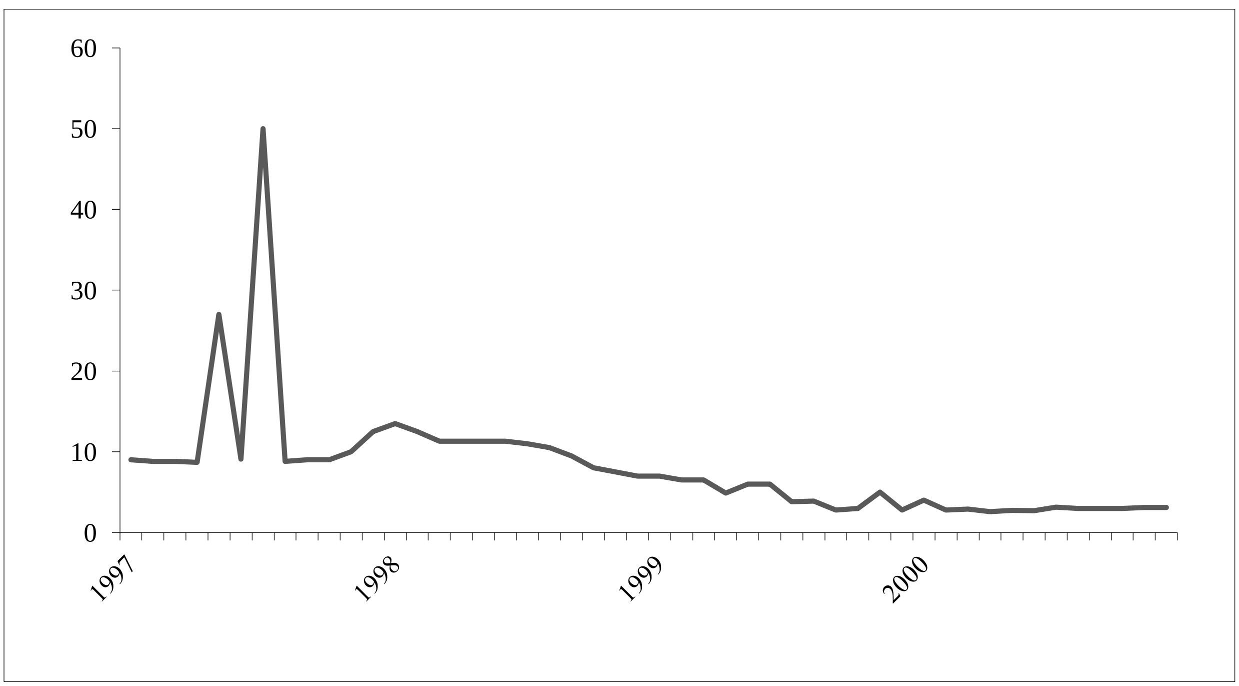

Figure 5: Current Account & Financial Capital Account

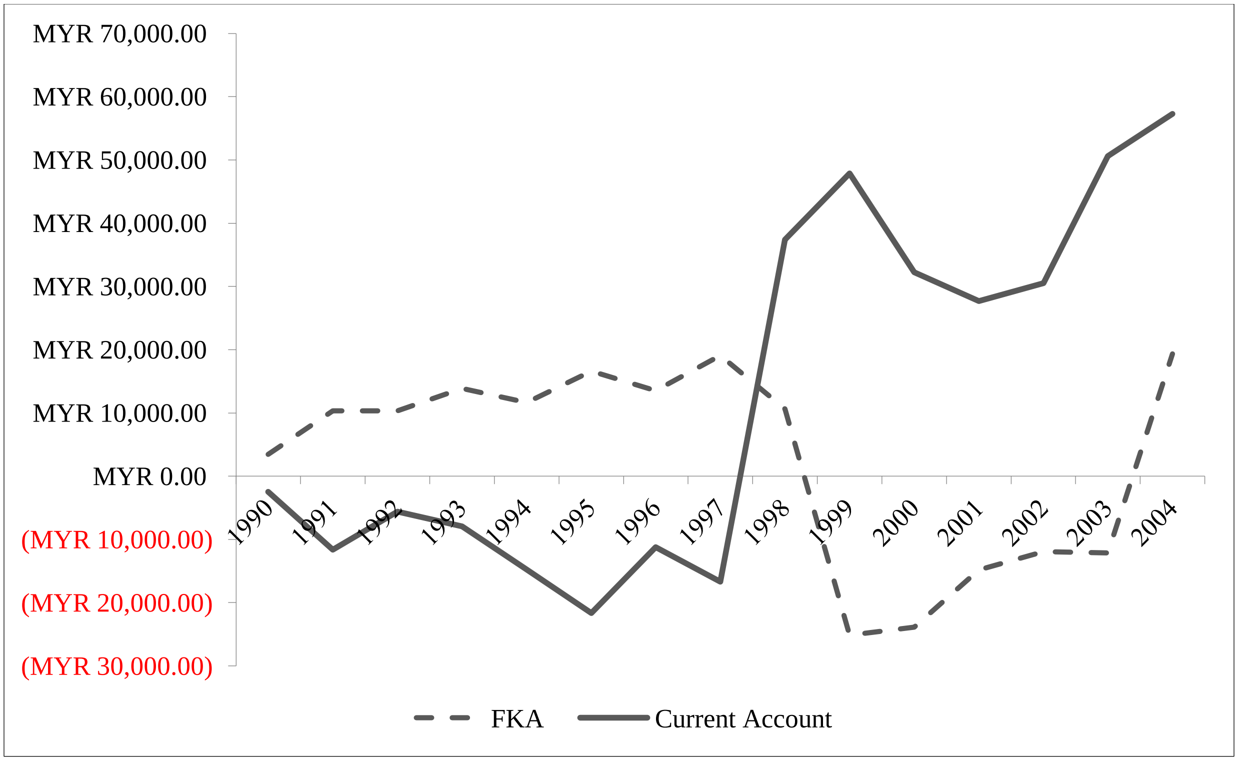

Figure 6: Gross Domestic Product (in USD)