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From Miracle to Realities: The Malaysian Economy in Crisis

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FROM MIRACLE TO REALITIES: THE MALAYSIAN ECONOMY IN CRISIS[1]

1. Introduction

On July 2nd, 1997, the Thai Central Bank abandoned all efforts to defend the baht's peg with the US dollar, despite repeated denials that it would resort to such an action. The consequent depreciation of the baht triggered financial instability in the countries of the region, while even more distant economies felt tremors. In a panic reaction, market sentiments turned against the region as a whole.

The massive outflow of short-term capital that ensued forced even economies like Malaysia, which had 'strong fundamentals', to take a second look at weaknesses that might have otherwise gone unnoticed. As noted by the Finance Minister in his address to the US Council on Foreign Relations on April 15, 1998: "The truth is that no less than five years ago, ... when hordes of global fund managers were stampeding Asia, it was evident that the economies of the region were growing too fast....Voices of caution were drowned by the sounds of triumphalism ....[T]he convergence of accumulated rigidities in the economic, social and political spheres caused the stresses to develop into a large scale systemic crisis" (NST, April 17, 1998). Literally, in the twinkle of an eye, the Malaysian miracle had evaporated, leaving hard-nosed realities demanding urgent attention.

A key step in reviving the Malaysian economy is the restoration of confidence of bona-fide investors. This can be achieved only if Malaysia demonstrates clearly that she has taken note of these weaknesses and is moving resolutely towards addressing them.

2. The Challenges

The current challenges facing the Malaysian economy arise from five broad areas. These are:

- Large capital flows, especially of short-term variety
- Managed float of the exchange rate
- Rapid expansion of lending by the banking sector and private sector borrowing from abroad
- Growing current account deficit
- Impaired confidence in the economy

[1] This paper was given as a guest-lecture by Prof. Suresh Narayanan on DIR's Annual seminar 20 August 1998 titled "Globalization and Social Change: Inclusion or Exclusion" at Dronninglund Slot. The paper has been co-edited by Suresh Narayanan, Lai Yew Wah, Abdul Rahim Ibrahim, Chua Soo Yean and Chan Huan Chiang from the University Sains Malaysia. Narayanan, Lai and Abdul Rahim are Associate Professors at the School at the School of Social Sciences. Chan is an Associate Professor at the Centre for Policy Research while Chua is a Lecturer at the School of Social Sciences. This paper has been developed from a memorandum submitted to the National Economic Action Council of the Malaysian Government, through the Malaysian Economic Association, in April 1998.

Although these are inter-related, and the fifth factor is more a consequence than a cause, it will be useful to review them separately.

2.1 Large Inflows of Capital

The significant surge in capital inflows to developing countries like Malaysia, since the early nineties, was due to several factors: structural and fiscal policies which were conducive to FDI, tightening monetary policies which resulted in the interest rate differentials in favour of the developing countries and external influences such as low interest rates, and little or no growth in the developed economies. Additionally, the liberalisation of financial markets in developing economies in recent years facilitated the movement of short-term capital across borders.

Long-Term Capital Inflows

Capital inflows to Malaysia, specifically private long-term capital (or foreign direct investment), have always played a prominent role in accelerating economic growth. Prior to 1980, net capital inflows were insignificant and were mainly in the form of foreign direct investment (FDI) in import-substituting industries. During the decade of the eighties, long-term capital inflow (which comprises official long-term capital and FDI) rose significantly from RM2.3 billion in 1980 to RM9.2 billion in 1983, before moderating to RM6.6 billion in 1984 and thereafter dropped to RM2.7 billion in 1989 (see Table 1).

This significant increase in net long-term capital inflow during the period 1981-83 is attributable to the counter-cyclical policies adopted by the government. The public sector borrowed heavily and played an active and direct role in economic development, in connection with the National Economic Policy.

The implementation of the privatisation program and the subsequent economic recovery in 1987 enabled the prepayment of much of these external borrowings. These factors, coupled with a policy shift to domestic borrowing, resulted in a net outflow of official long-term capital during 1987-92. However, from 1993, due to a significant increase in external borrowings by the non-financial public enterprises (NFPEs), the official long-term capital reversed its trend from a net outflow to a net inflow.

FDI (corporate investment) in the long-term capital account has been increasing steadily throughout the eighties. Except for a brief period of decline due to the economic recession in the mid-eighties, FDI flows to Malaysia increased from RM2.0 billion in 1980 to RM6.3 billion in 1990, averaging an annual growth of 12 %. The significant increase in FDI during the period 1988-90 was the result of the Promotion of Investment Act, 1986, the relaxation of the regulations on foreign ownership of equity, and the realignment of exchange rates after the Plaza Accord of 1985.

FDI continued to surge in the nineties, increasing from just under RM11 billion in 1991 to RM12.9 billion in 1993 due to the world economic recovery. It moderated to about RM11 billion a year during 1994-96.

The long-term capital outflow counterpart of FDI is direct reverse investment (DRI). Data on DRI flows are captured by the Central Bank's Cash Balance of Payments Reporting System (see Table 4). The main component of DRI is equity investment. DRI were not significant in the eighties but picked up since the early nineties. Equity investment abroad amounted to only RM 203 million in 1985 but surged to RM 799 million in 1991 and subsequently to RM 6.5 billion in 1996. As long as the investment is for manufacturing activities, it will generate trade and thus bring benefits to both the host and recipient economies. But much of the reverse investment from Malaysia is in real estate and infrastructure, which do not generate the desired externalities in the form of production and trade.

Table 1: Net Capital Inflows to Malaysia, 1980-1996
(in RM million)

Year	Official Long-Term Capital				Corporate Investment	Balance on Long-Term Capital	Private Short-Term Capital			Errors and Commissions
	Federal Government	NFPEs	Others	Total			Commercial Banks	Others	Total	
1980		340	-30	310	2089	2299	1253	-314	939	-1713
1981		2942	-26	2916	2934	5850	643	-557	86	-1623
1982	4741	736	-308	5169	3263	8432	-557	883	326	-963
1983	4403	2028	-147	6284	2926	9210	482	-745	-263	-976
1984	3218	2334	-861	4691	1869	6560	992	-1280	-288	-2043
1985	1339	962	203	2504	1725	4229	-164	1034	870	-168
1986	1611	20	493	2124	1262	3386	-1050	1003	-47	1322
1987	-2438	7	-39	-2470	1065	-1405	-2320	171	-2149	147
1988	-3094	-1984	-24	-5102	1884	-3218	-2498	-416	-2914	289
1989	-1038	-1631	853	-1816	4518	2702	1137	425	1562	-358
1990	-787	-2064	15	-2836	6309	3473	2286	-930	1356	3015
1991	106	-740	-31	-665	10996	10331	3605	1530	5135	-395
1992	-3170	389	-95	-2876	13204	10328	9249	2708	11957	81
1993	-3134	4277	-164	979	12885	13864	10875	3056	13931	9370
1994	-4757	5373	-136	480	11394	11874	-13306	4821	-8485	425
1995	-1635	7457	12	5834	10347	16181	229	2183	2412	-4306
1996	-2177	2844	54	721	11270	11991	8562	2639	11201	-3970

Source: Department of Statistics, Balance of Payments Report, *various issues.*
Bank Negara Malaysia, Annual Report, *various issues.*

Short-Term Capital Inflows

Like most developing countries, short-term capital flows into Malaysia in the eighties were insignificant. In fact, from Table 1, it is noted that from 1983 to 1988 (except for 1985), the country experienced a net outflow in short-term capital (which mainly consist of changes in the net foreign asset position of the banking sector and portfolio investment). This net outflow was due to the unfavourable domestic interest rate vis-à-vis foreign rates and the expectation of a depreciation of the exchange rate. By 1990, the interest rate differential turned to Malaysia's favour, resulting in large external borrowings by commercial banks and the release of their external assets.

During the period 1991-93, following the world-wide trend, there was a strong surge in short-term capital flow to Malaysia. Undoubtedly, the sustained high economic growth with low inflation throughout the early nineties, the sound monetary and fiscal policies, financial liberalisation, the rapid development of the local bourse were among the factors which led to this potentially damaging upsurge. Perhaps, the stronger pull factors were the favourable interest rate differential, the opportunities for making quick returns from the buoyant stock market and the expectation of the appreciation of the ringgit. Short-term capital inflow increased dramatically to RM13.9 billion in 1993 from RM1.4 billion in 1990.

Table 2 clearly indicates the significant differential between domestic interest rates and the US interest rate. With regard to the exchange rate, the ringgit appreciated against the US dollar in 1992 due to the weakening of the dollar following a further decrease in the US interest rates and massive dollar sales by the Federal Reserve. Although the ringgit had appreciated, short-term capital inflow continued to be significant due to the wide interest rate differential (as represented by the discount rate on 3-month Treasury Bills) in favour of ringgit funds and the bullish performance of the Malaysian stock exchange (Table 3).

Table 2: Malaysia-US: Discount Rate Differential and Exchange Rate

Year	Discount Rate Differential (%)	Exchange Rate(RM/US $) (% change) [1]
1987	-3.3	4.4
1988	-3.1	-8.1
1989	-1.7	0.5
1990	-0.6	0.04
1991	3.2	-0.9
1992	4.5	4.5
1993	3.5	-3.5
1994	-1.0	5.6
1995	0.2	0.7
1996	1.4	0.5

[1] Negative indicates depreciation

Source: Bank Negara Malaysia, Monthly Statistical Bulletin, *various issues*.

Table 3: Indicators of Kuala Lumpur Stock Exchange

Year	Composite Index (year end)	Market Capitalisation (RM billion)	Net P/E Ratio (for Composite Index)
1990	505.92	131.66	20.32
1991	556.22	161.39	21.27
1992	643.96	245.82	21.90
1993	1275.32	619.64	39.24
1994	971.21	508.85	25.09
1995	995.17	565.63	24.25
1996	1237.96	806.77	26.83
1997	594.44	375.80	11.28

Source: Bank Negara Malaysia, Monthly Statistical Bulletin, Feb. 1998.

In terms of the composition of these short-term flows, the published balance of payments data do not distinguish between flows for portfolio investment and the net foreign asset positions of the banking sector. However, the importance of portfolio investment can be inferred from Table 4, which gives the flow of funds for capital transactions. The data are tabulated by Bank Negara's Cash Balance of Payments Reporting System, on a cash basis rather than on a transaction basis[2]. For the period 1992-93, portfolio investment, on a cash basis, was the most important component of total capital inflow. The bulk of portfolio investment is for transaction in share and corporate securities in the booming KLSE which, by then has become a major regional stock exchange (see Table 3).

[2] The data presented here are therefore not strictly comparable to the data in Table 1.

Table 4: Inflow and Outflow of Funds (Net) for Capital Transaction
(RM million)

Year	Total Capital Flows	Equity Investment	Portfolio Investment	Loan Received from Non-Residents	Loan Repayment	Others
1991	593	3845	-1925	2956	-4381	98
1992	9933	2748	8156	4835	-6165	359
1993	25648	1305	24005	6956	-6285	-333
1994	14130	2821	10834	10252	-10738	961
1995	4883	-367	2890	10337	-8289	312
1996	8686	851	10591	11225	-13550	-431

Source: Bank Negara Malaysia, Monthly Statistical Bulletin, *various issues*.

Capital inflows bring benefit to recipient economies since they provide external financing and help bridge the savings-investment gap. The inflows also lower domestic interest rates and provide the impetus for further investment and growth. However, excessive surges in capital inflows, especially short-term capital, are a matter of concern since they cannot be sustained and can result in overheating and macroeconomic instability. The potential problems include a deterioration in the current account, upward pressures on prices of goods, properties and financial assets, and the exchange rate. Moreover, the economic damage arising from a sudden reversal of the inflows can be devastating. Needless to say, the massive speculative inflow of short-term capital during the period, 1991-93, threatened the stability of the economy.

In early 1994, the Central Bank took the commonly-used measures in response. It first intervened in the foreign exchange market and bought up US dollars. This, in turn, created excess liquidity as the domestic money supply increased. The Bank therefore 'sterilised' the impact of foreign exchange intervention by raising the statutory reserve requirement and engaging in Open Market Operations to reduce the domestic money supply. Additionally, the Central Bank imposed tough administrative measures including redefining the eligible liabilities base to include funds secured from abroad for computation of the statutory reserve and liquidity requirements, prohibiting the sale of short-term monetary instruments to non-residents and raising the cost of holding foreign deposits.

The measures succeeded in restoring stability in the financial sector. The money supply (M3) which expanded rapidly in 1992 and 1993 (at 19.6% and 23.5% respectively), due to the flush of short-term foreign funds, began to ease in 1994, moderating to a growth rate of 13.1%. The gradual run-down of the speculative flows in fact resulted in a net outflow of RM8.5 billion by the end of 1994 (see Table 1).

With the return of financial stability, the tough administrative measures were withdrawn at the end of 1994. No doubt the Bank was concerned about the costs of sterilisation. Although effective in the short run in neutralising some of the adverse effects, sterilisation cannot be sustained in the long-run because it is expensive for both the government and the financial sector. In effect, the Central Bank is substituting high interest-yielding domestic currency with low interest-yielding foreign currencies. The financial institutions, on the other hand, have to endure an increase in the cost of funds due to tightening monetary policy of the Central Bank. Furthermore, the induced contractionary monetary policy keeps the domestic interest rate at a high level, and this may, in turn, attract mobile capital--the source of the problem in the first place. Thus, these measures provide no long-term solution to moderating capital inflows.

While the concerns of Bank Negara were genuine, in retrospect, perhaps the tough measures were withdrawn too early for by 1996, there was a massive inflow of short-term capital again which amounted to RM11.2 billion. Furthermore, although the inflow threatened to destabilise the economy, the monetary policy adopted was more restrained compared to 1994. Tougher measures could have been adopted. While these measures might not have cushioned the economy from the current crisis altogether, they might have reduced the magnitude of the problem.

2.2 *Managing the Exchange Rates*

In recent years, Malaysia has kept her exchange rate variations between an upper and lower bound through the intervention of Bank Negara in the foreign exchange market. This system of "managed float" seemed to work well. The stable exchange rate, coupled with the increasing impact of financial liberalisation and structural reforms, contributed to her strong economic growth. As discussed previously, Malaysia is one of the emerging markets in the region that has attracted a huge amount of foreign capital (see Table 4).

However, as pointed out earlier, capital inflows tend to appreciate the ringgit and in order to maintain the exchange rate, Bank Negara intervened in the foreign exchange market from time to time, by purchasing foreign currency. Ringgit appreciation was deemed undesirable as it would diminish the country's export competitiveness and increase the import bill. Intervention by Bank Negara to prevent the *appreciation* of the ringgit accounts for the rapid increase in its foreign reserves in the 1990s. Foreign reserves increased from RM 27 billion in 1990 to RM 70 billion by 1996. (It has since declined to RM 59 billion in 1997, as Bank Negara drew down its reserves in an attempt to prevent a *depreciation* of the ringgit in the wake of the collapse of the baht.)

Buying up foreign currency resulted in an expansion of the domestic money supply and put a downward pressure on domestic interest rates. This, in turn, expanded local credit and several measures were put in place by Bank Negara to reduce domestic credit creation.

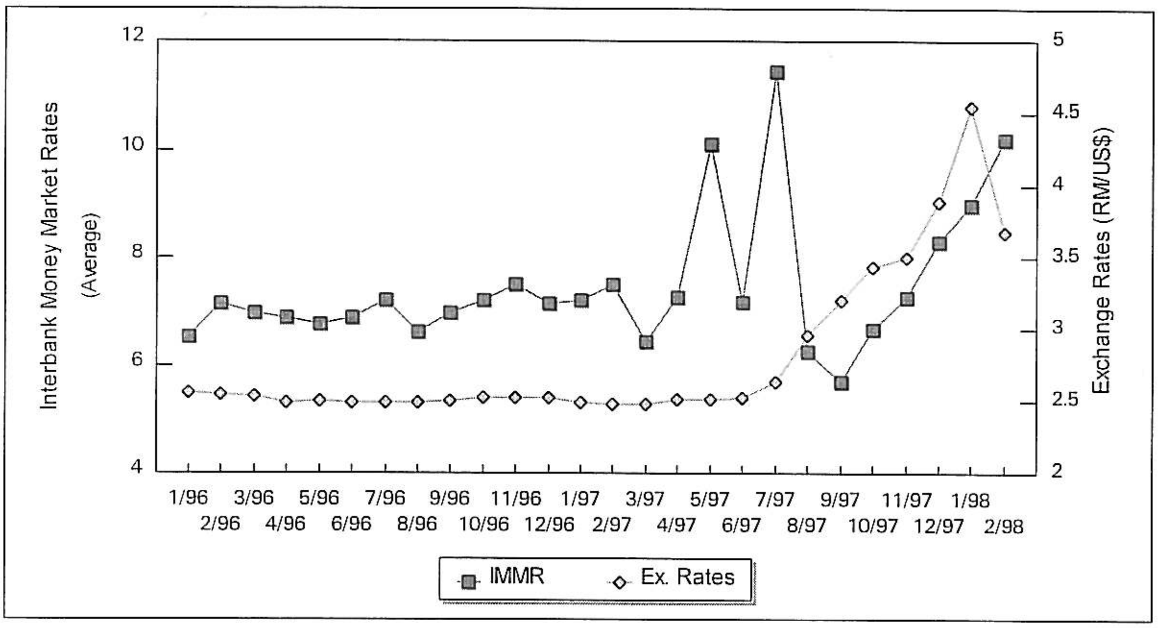
These efforts met with some success and the situation eased by 1994 (see previous discussion).

However, the US dollar began to strengthen in mid-1995, and there was speculation that currencies in the region will be devalued since their upward movement were not seen as reflecting the actual conditions of their economies. The ringgit, for example, had appreciated by 2.6% against the composite basket of Malaysia's major trading partners by the end of 1996. It appreciated against most major currencies, with the appreciation being highest against the Swiss franc (17.5%) and the yen (13.5%), but remained stable relative to the US dollar (Bank Negara Malaysia, 1997: 6).

The repeated refusals of Thailand to devalue the baht, eroded the competitiveness of its exports which recorded zero growth in 1996. The Thai GDP returned its lowest rate of growth in a decade, its current account deficit shot up and the Thai stock market lost a fifth of its value in the first nine months of 1996 (Wade and Veneroso, 1998: 6). As the suspicion that the currencies in the region were overvalued strengthened in early 1997, short-term investors, hedge-fund managers and speculators probably anticipated that prevailing exchange rates could not be sustained. The attack on the baht actually occurred in May 1997, but the Thai central bank was able to defend the baht through a substantial depletion of its foreign reserves.

The impact was felt on the ringgit as well and Bank Negara intervened to defend it. The average overnight interbank money market interest rate (IMMR) rose from the 7.3% of the previous month to 10.1% in May (see Figure 1). The upper band of the IMMR rose from 8.7% in April to a high of 27% in May. It appeared as if the Central Bank had succeeded in its efforts.

Figure 1 : Interbank Overnight Money Market Rates and Exchange Rates



Source: Bank Negara Malaysia, Quarterly Economic Bulletin, *various issues.*

The second wave of attack on the baht occurred in July 1997 (when the rest of the world was focused on the return of Hong Kong to China). Thailand gave in and floated the baht. The loss of confidence in the baht increased doubts about the Malaysian and Indonesian currencies as well. Bank Negara made another attempt to prop up the ringgit — selling an estimated RM 10 billion worth of foreign reserves. The average IMMR for July hit 11.4% up from the 9.1 of the previous month (Figure 1). The rise in the upper band of the IMMR was even more dramatic - from a high of 9.1% in June to 50% in July. Bank Negara finally abandoned the efforts to maintain the exchange rate and allowed free market forces to determine it. As seen from Figure 1, the ringgit began to depreciate in the first week of July, 1997. (Note that because the exchange rate is plotted with RM as the numerator, the depreciation of the ringgit vis-à-vis the US dollar is reflected by a *rise* in the plotted line.)

Market forces are very much affected by perceptions and with the baht losing credibility, the confidence of short-term investors and speculators in Malaysia fell as well. The KLSE composite index lost about 35 percent of its value during the first three months of the crisis as these investors panicked and pulled out their investments.

2.3 *Rapid and Unbalanced Lending to the Private Sector*

The banking system (comprising commercial banks, merchant banks and finance companies) has grown very rapidly in recent years, with many new lending institutions mushrooming. For example, at the end of 1997, there were 37 banks, 39 finance companies and 12 merchant banks. In the case of finance companies, about five or six of them accounted for more than 70% of the finance business. The minimum capital funds required of finance companies is currently only RM 5 million.

Lending by the Banking System

The buoyant economy and the rapid growth of the monetary base (noted earlier) increased the demand for loans. The loan-to-deposit ratio of the Malaysian banking system has always been high and average about 90% since the late 1980s. But the highest figure for the period 1992-97, was 94%, recorded at the end of 1997. Loans of the banking system, as a proportion of GDP, stood at 152% at the end of 1997, rising substantially from 105% in 1992 (see Table 5). This is far in excess of the 60% figure reported for neighbouring Indonesia or the Philippines (cited in Euromoney, March 1998). It has been estimated that the loan-to-GDP ratio may well rise to 165% by the end of 1998 (Euromoney, April, 1998).

Table 5 : Selected Indicators of Loan Expansion of the Banking System, 1992-97

Ratio (%)	1992	1993	1994	1995	1996	1997
Loan-to-deposit	91.6	83.2	84.4	89.0	89.1	93.7
Loan-to-GDP	105.2	105.6	106.8	119.3	152.2	152.1

Source: Computed from data in Bank Negara Malaysia, Annual Report, *various issues*

Adding to the rapid expansion of lending is the overexposure of the banking system to sectors perceived as providing quick returns, such as the property sector and the stock market. Table 6 shows that total lending of commercial banks, merchant banks and finance companies expanded at an annual average rate (continuously compounded) of nearly 22% between 1992-97. More importantly, the rate of growth of lending to the property sector and for the purchase of stocks and shares outstripped the overall growth of lending. The lending for the latter grew about 2.4 times more rapidly than the growth of overall lending. While some of this high growth is attributable to the small initial base, it still represents a significant pace of growth. It is also worth noting that the rate of expansion of lending to these two sectors exceeded that of lending to manufacturing. In March 1997, Bank Negara restricted loans to property and stocks in order to ward off a crisis, but perhaps it was a little too late already.

Table 6: Direction of Lending of the Banking System, 1992-97
(RM billion)

Sector	1992	1993	1994	1995	1996	1997	% Growth 1992-97
Manufacturing	29.4	31.5	37.5	48.8	55.5	63.3	16.6
Property	48.4	53.5	58.4	73.6	95.4	139.8	23.6
Stocks & Shares	4.6	5.6	12.3	13.5	15.8	38.9	53.1
All Sectors	156.2	174.5	203.3	260.9	332.8	421.2	21.9

Source: Computed from data in Bank Negara Malaysia, Annual Report, *various issues*

Between 1992-97, the total lending by the banking system increased by about RM265 billion (Table 7). The property sector was the single largest recipient of this increase, receiving nearly 35% or RM91.5 billion. Loans for stocks and shares received about 13% of the increase, on par with the loans extended to the manufacturing sector. In fact, the increase in loans to manufacturing slowed down sharply from 1995. Part of this reduction in loans can be explained by local manufacturing firms raising funds through the issuance of shares, using internally generated funds and by borrowing abroad. The dramatic decline in the share of increased loans going to manufacturing encouraged the financial institutions to realign their priorities. This focus on property and stock market continued, despite forecasts that both sectors were peaking. For example, it was reported in June 1996 that a million square metres of office space would become available in the market by 1997-98, but it appeared not to have dampened commercial development and properties in Kuala Lumpur (see NST, June 10, 1996).

Table 7: Distribution of Increase in Lending of the Banking System, 1992-97
(RM billion)

Sector	Increase 1992-97	% Share of Increase
Manufacturing	33.9	12.8
Property	91.5	34.5
Stocks & Shares	34.3	12.9
All Sectors	265.0	100.0

Source: Computed from data in Bank Negara Malaysia, Annual Report, *various issues*

It is evident that many of the loans were given out without sufficient prudence due to at least two factors: competition between lenders to maintain or increase their share of lending and the "moral hazard" problem inherent among financial institutions whose deposits are guaranteed by the government. The standard moral hazard argument posits that any insurance against a risk induces behaviour that increases the likelihood of that very risk occurring. Hence, government guarantees encourage overexposure to risky investment. This arises out of two effects. First, since deposits are guaranteed by the government, the depositors have no incentive to monitor the lending decisions of the institutions where their deposits are placed. Second, owners and managers of these institutions have a greater incentive to lend for risky ventures because their own money is not at risk and should the investment turn bad, the government (taxpayer) shoulders the consequence.

In the Malaysian context, there is a double moral hazard element. The greater incentive to lend for risky ventures arising from government guarantees of the liabilities of the institutions on the lending side (noted above) and the second perceived 'guarantee' on the borrowing side provided by borrowers who are well-heeled and well-connected. Their connections are a reasonable assurance of their credit-worthiness. It is telling that of the RM39 billion loaned out by the banking system for share purchases in 1997, 45% was given to individuals (cited in Euromoney, April 1998).

The failure of Sime Bank, the sixth largest financial institution in the country, is at least partly attributable to its unbridled credit expansion. Its loan-to deposit ratio of 120%, is 1.2 times as high as that of the banking system as a whole. Not surprisingly, about 22% (RM1.2 billion) of its loans went to support purchases of stocks and shares, exceeding the 15% ceiling approved by Bank Negara. A single individual was lent nearly RM1 billion. The bank reportedly lost RM1.8 billion in six months (cited from Euromoney, April 1998). Similarly, Bank Bumiputra - the second-largest bank in the country - requires recapitalisation to the tune of RM750 million, no doubt due to poor lending decisions. In a recent development, construction-based firm Wembley Industries Holdings Bhd., became the first Malaysian firm to be placed under receivership for defaulting on loans since the crisis began. Other big corporations like Renong Bhd., and United Engineers Malaysia Bhd., are reported to be in financial trouble and may require government intervention to aid them (NST, April 16, 1998).

Foreign Loans

The private sector also borrows from abroad. Data on private sector borrowing abroad show a marked increase. Short-term debts (of a year or less) of the private sector saw a nine-fold increase from RM 4.4 billion to RM 39.7 billion over the seven year period, 1990-97. Table 8 reflects the growth of short-term foreign debt between 1992-97. Total debt grew at an annual average rate of nearly 25%. While the banking sector accounted for a big share of the debt (79% in 1997), reliance of the non-banking private sector on external debt began in 1994 and has risen rapidly since. Between the three year period, 1994-97, the foreign debt of the non-banking private sector grew at an average rate of 23% per annum.

Table 8: Short-Term Foreign Debt of the Private Sector, 1992-97
(RM billion)

Sector	1992	1993	1994	1995	1996	1997	Growth
Banking	13.2	17.3	9.8	11.3	18.4	31.5	19.0 %
Non-Banking Private Sector	-	-	4.4	4,9	7.3	8.2	23.0 %
Total	13.2	17.3	14.2	16.2	25.7	39.7	24.6 %

Source: Bank Negara Malaysia, Annual Report, *various issues*

The private sector reliance on long-term external debt is even greater. The external debt of both non-financial public enterprises (NFPEs) and the private sector show an increasing trend, while external borrowing by the public sector appears to be moving in the opposite direction (see Table 9). Between 1992-97, the long-term debt of the private sector grew at an average of 42% per annum while the debt of the NFPEs recorded a 36 % rate of growth.

Table 9: Long-Term Foreign Debt of the Private and Public Sectors, 1992-97
(RM billion)

Sector	1992	1993	1994	1995	1996	1997	Growth (%) per yr.
Govt.	20.9	19.4	14.8	13.3	10.5	12.9	-9.2
NFPEs	11.4	17.0	20.1	27.4	29.2	52.5	35.8
Pr. Sector	10.5	15.5	24.2	28.1	33.5	61.1	42.2
Total	42.8	51.9	59.1	68.8	73.2	126.5	24.1

Source: Bank Negara Malaysia, Annual Report, *various issues*

Table 10 below shows the growth of total foreign debt of the private sector (including NFPEs) for the period, 1992-97. It is clear that while foreign debt as a proportion of the GDP was rising gradually in the early 1990s, it saw a steep increase between 1996 and 1997. By 1997, foreign debt of the private sector was more than half the size of the GDP.

Table 10: Total Foreign Debt of the Private Sector (including NFPEs), 1992-97

	1992	1993	1994	1995	1996	1997
Total Foreign Debt (RM bil)	35.1	49.8	58.5	71.7	88.4	153.3
GDP (RM billion)	148.5	165.2	190.3	218.7	249.8	277.0
Foreign Debt /GDP (%)	23.6	30.1	30.7	32.8	35.4	55.3

Source: Computed from data in Bank Negara Malaysia, Annual Report, *various issues*

Two factors account for this rapid increase in the reliance on borrowings from abroad. One is the relaxation of controls on companies borrowing abroad, in the wake of financial liberalisation attempts. Even so, foreign borrowing by manufacturing companies has been subjected to scrutiny and some restrictions by Bank Negara.[3] Second, mega projects executed by private entities that resorted to financing through loans from abroad. Although these projects are executed by the private sector, it is important to bear in mind that many are initiated by the public sector. Hence, the decline in public sector borrowing from abroad is offset by the increase in private borrowing by companies backed directly or indirectly by the public sector. The public sector therefore cannot disassociate itself completely from the mounting debt issue by portraying it as a private sector problem.

Wade and Veneroso (1998) suggest that the high rates of growth of ASEAN economies in the 1990s, and the promise of exchange rate stability, encouraged Western and Japanese banks to lend heavily to Asian corporations. Competing for business, these foreign lenders often ignored their own prudent limits. They argue that international bankers have a powerful incentive to 'follow the herd' because bankers who do not capitalise on obvious potential lending are seen as incompetent but tend to emerge unscathed from situations where everyone else was also making losses. In their view, the rapid financial deregulation in these economies did not allow for proper co-ordination or supervision. They argue that in the case of Thailand, when confidence collapsed, foreign lenders rushed to recall their outstanding debts and dealt a second blow to the Thai economy.

Fortunately for Malaysia, despite the growing reliance of the Malaysian private sector on foreign borrowing, the companies involved are mostly large and well-connected businesses in big infrastructure projects. Hence, unlike Thailand or Indonesia, widespread failures of corporations due to the inability to meet foreign loan obligations have not yet surfaced. However, loan repayment threatens to become a major burden to companies that have borrowed heavily from abroad, because of the appreciation of the US dollar vis-à-vis the ringgit.

2.4 Current Account Deficit

A current-account deficit is not necessarily bad. Apart from looking at the historical trend, one must look at the composition as well as the relative size of the deficits. As developing countries attempt to develop, it is natural that they face current account deficits since they often borrow to finance real capital accumulation in order to expand productive capacity.

[3]In the manufacturing sector, the average shares of the main sources of funding are as follows: internally generated funds (48%), equity-financing (14%) and debt financing (38%). About 32% of debt financing is foreign borrowing. Thus, foreign borrowings, on average, account for only 12% of financing in the manufacturing sector (Bank Negara Malaysia, Annual Report 1997: 16-17).

Over time, the productive capacity is able to generate enough exports leading to a trade surplus and thereby sustain a service account deficit arising from the large negative investment income. Nevertheless, large and sustained deficits may lead investors to become fearful of the capacity of the economy to finance these deficits and lead to short-term capital outflows. This in turn has negative consequences

The current account is made up of the merchandise and services accounts and transfers. As is evident from Table 11, the merchandise balance has always been positive, although the surplus has been getting smaller in the 1990s, with the lowest figure recorded in 1995.

Table 11: Composition of Current Account, 1986-97
(RM million)

Year	Merchandise Balance	Balance on Services	Net Transfers	Current Account Balance
1986	8378	- 8790	96	- 316
1987	14703	- 8409	348	6642
1988	14524	- 10180	395	4739
1989	11871	- 11392	219	698
1990	7093	- 9723	147	- 2483
1991	1449	- 13195	102	- 11644
1992	8609	- 14568	337	- 5622
1993	8231	- 16670	513	- 7926
1994	4460	- 17005	-225	- 14770
1995	97	- 19407	-2515	- 21825
1996	10154	- 19470	-2936	- 12252
1997	na	na	na	- 13400

Source: Bank Negara Malaysia, Quarterly Economic Bulletin, *various issues*

The decline in the surplus in the merchandise account between 1986-96 was due to the slower growth of exports relative to imports. As is evident from Table 12, the average annual rate of increase of merchandise imports (22%) exceeded that of merchandise exports (21%) during the period 1987-96.

This period also saw a shift in the composition of exports. The share of manufacturing in total exports rose from 37% to 74%. However, the import content of manufactured goods remains high. This is evident from the relatively large share of imported intermediate goods in total retained imports (46% in 1996--see Table 12). The high import content reduces the net export earnings from the manufacturing sector. Furthermore, the share of imported manufactured goods has also increased from 66% in 1986 to 78% in 1996.

It is obvious from Table 12 that the share of import of investment goods in total retained imports increased from 29.1% in 1986 to 40.2% in 1996. But within the category of investment goods, the share of import of machinery, transport equipment and metal products declined from 65.5% in 1996 to 54.2% in 1996 (data not shown). Interestingly, the share of imports of "other" investment goods increased from 34.5% to 45.8%. This "other category" classified under "investment goods", may include some "non-productive" goods that do not generate future exports to finance future imports. The import of consumer goods, as a percentage of retained imports, has however been declining.

Table 12: Some Aspects of Merchandise Balance, 1986-96

Year	Imports			Exports	Imports
	Consumer Goods	Intermediate Goods	Investment Goods	(percentage change)	
	(as a proportion of retained imports)				
1986	21.3	49.6	29.1	-	-
1987	20.3	50.7	28.9	27.9	12.9
1988	19.8	50.3	29.9	22.7	33.5
1989	18.1	47.3	34.6	22.2	36.8
1990	16.6	45.7	37.7	16.1	28.2
1991	17.1	43.0	39.7	19.1	29.0
1992	17.1	41.1	41.8	9.4	1.7
1993	16.2	43.0	40.8	17.3	19.3
1994	16.3	43.0	40.7	47.2	30.7
1995	14.3	45.0	40.7	20.7	24.5
1996	14.3	45.5	40.2	7.5	1.2

Source: Bank Negara Malaysia, Quarterly Economic Bulletin, *various issues*

Turning to the service account, it was noted that it has always had a negative balance and these balances have been growing. The consequent deficit on the current account has not only persisted continuously since 1990, but displayed a growing trend in absolute terms. The current account deficit as a proportion of the GDP, rose from 3.8 % in 1992 and peaked to 8.5 % by 1995, exceeding the 8.1 % recorded by Thailand and the 3.6 % of Indonesia. It has moderated somewhat since then (Bank Negara Malaysia, Annual Report 1997: Table A. 26).

The largest component in the services account is "investment income" which has remained negative (Table 13). This is a natural outcome of the inflow of direct and portfolio foreign investment, which give rise to the repatriation of profits and dividends as well outflows in the form of interest payments arising from borrowing overseas. For most years, (net) private long term capital flows have been in excess of (net) investment income. Thus private long term capital flows have been financing these deficits. The other large negative component of this account is "freight and insurance", the size of which has been increasing since 1967, in spite of attempts by the government to increase domestic shipping and insurance facilities.

Table 13: Balance On Services Account
and Net Private Long-term Capital, 1986-96

Year	Net Investment Income	Net Private Long-term Capital	Net Freight and Insurance	Other Transport -ation	Travel and education	Other Services
1986	- 4597	1262	- 1306	149	- 1368	- 1478
1987	- 4824	1065	- 1185	45	- 1327	- 925
1988	- 5019	1884	- 2072	- 44	- 1403	- 1425
1989	- 5935	4518	- 3027	- 5	- 891	- 1273
1990	- 5072	6309	- 3837	- 25	632	- 1418
1991	- 6735	10996	- 4847	- 10	547	- 2095
1992	- 7920	13204	- 4265	- 355	657	- 2739
1993	- 8174	12885	- 4890	- 196	906	- 4244
1994	- 9469	11394	- 7367	441	3603	- 4197
1995	- 10562	10347	- 9028	746	4143	- 4317
1996	- 11606	11270	- 8498	1704	4856	- 5210

Source: Bank Negara Malaysia, Quarterly Economic Bulletin, *various issues*

Balances on "other transportation" and "travel and education" have shown tremendous improvements since 1986, reflecting in part the success of the tourism industry and the larger availability of educational opportunities at home. Presumably, attempts at reducing foreign tertiary education expenditure and expanding the private tertiary education will further improve this account. What is disturbing is the "other services" category, which has expanded from - RM925m in 1987 to - RM5,505m in 1996. Attempts must be made to itemise the "other services" and tackle the causes leading to such an expansion.

A current account deficit, in effect, indicates an excess of investment over savings. As can be seen from Table 14, gross national savings, as a proportion of GNP, has grown approximately 9 percentage points between 1986 - 95, while gross capital formation as a percentage of GNP has grown by 17.6 percentage points over the same period. Thus the increase in investment ratio was almost twice as high as the increase in the savings ratio. Clearly, the current account deficit is financing capital formation.

The government's overall budget is closely related to the state of the current account. The overall budget deficit of the federal government has been declining from 1986 and has been recording an overall surplus since 1993. Comparing the government overall budget and the size of the current account, it is clear that excess government expenditure accounted for the deficit or smaller surplus in the current account prior till 1990, while the current account deficit since 1991 has been due to excess private investment over private savings. Thus, it may appear that the current crisis is a "private sector problem". However, it should also be borne in mind that such a state of affairs arose partly because the private sector has been encouraged by the public sector to undertake many (mega) projects through attractive incentives.

Table 14: Current Account, Federal Government Budget, Gross National Savings and Investment Ratios

Year	Balance on Current Account (RM million)	Balance on Fed. Govt. Budget (RM million)	Gross National Savings/GNP (%)	Gross Capital Formation/ GNP (%)
1986	- 316	- 7506	27.4	27.8
1987	6642	- 6153	27.5	24.7
1988	4739	- 3290	33.0	27.5
1989	698	- 3410	30.9	30.1
1990	- 2483	- 3437	30.4	32.7
1991	- 11644	- 2640	30.0	39.3
1992	- 5622	- 1243	33.1	37.1
1993	- 7926	354	34.7	39.8
1994	- 14770	4408	35.8	42.5
1995	- 21825	1860	36.5	45.4
1996	- 12252	1815	38.0	43.3

Source: Bank Negara Malaysia, Quarterly Economic Bulletin, *various issues*

Although growing current account deficits ultimately erode the value of domestic currency, confidence in the economy remained unimpaired on account of several factors. Malaysia, and indeed, the region as a whole attracted huge capital inflows. It was assumed, with some justification, that the deficits merely reflected the large inflows of foreign direct investment and the heavy reliance on imported inputs of a strongly growing economy. In addition, the public sector recorded surpluses since 1993 and the high and rising domestic savings rate strengthened this assumption. However, when confidence in the region was shaken, investors re-evaluated the current account deficit and the growing ratio of foreign debt to GDP with a different perspective.

2.5 The Confidence Factor

Despite Malaysia's impressive and real gains over the past decade, the fact remains that when investors lost confidence in the Thai economy it led to suspicions about the viability of the Malaysian economy as well. Without doubt, the fundamentals- economic, social and political- in Malaysia are more sound relative to other economies that suffered--like Thailand, Indonesia and the Philippines. This is not to deny that there were no weaknesses (as outlined above), but it is widely acknowledged that no one factor, or even all the factors taken together, could have triggered a crisis of the magnitude that we have witnessed. However, when confidence in the region failed, each of these perceived weaknesses took on bigger proportions than it otherwise would have.

3. Policy Responses

The Malaysian economy is faced with several problems: a weak financial system and the over-exposure of the banking system to one or two sectors, and a badly depreciated currency. The crisis also raises questions regarding the nature and pace of financial liberalisation and the consequent capital flows across borders. Finally, the confidence factor needs to be addressed.

3.1 Weak Financial System

The current moves to rationalise the banking and financial sector by encouraging the merging of financial institutions are laudable. This will reduce the number of players, streamline the sector, facilitate the imposition of rules and guidelines more effectively, and more importantly, increase their capitalisation. It will also reduce the extreme competition that characterised the past years that led to lending without sufficient prudence. However, it is important to bear in mind that the Japanese banking system that was reorganised through a forced merging continues to be systematically weak (NST, 4 April, 1998). Thus, banking institutions must go beyond the merger-step to rectify internal weaknesses.

The over-exposure of the banking system to sectors such as property and the stock market points to ineffective regulation by the central bank and the failure of banks to adhere to guidelines. Regulation, however, should not result in restricting competition. Furthermore, it is impractical to monitor every transaction in the banking system. Consequently, regulation should aim at creating incentives for bank owners, markets and supervisors to provide and use information efficiently and act prudently (Stiglitz, 1998).

The "moral hazard" element has to be reduced by introducing ground rules that ensure that the consequences of imprudent decisions are borne primarily by the shareholders of financial institutions. In addition strict adherence to established banking principles must be enforced. Practices such as "influence peddling" to secure loans, or the extension of "soft-loans" to preferred parties not based on the real merit of the project need to be discontinued. Bank Negara must increase its regulatory and surveillance functions to ensure transparency in the banking business.

Rather than an overall credit squeeze, there should be a free flow of credit to viable and productive activities. Higher education in scientific and technical areas, investment by SMEs (small and medium-sized enterprises), loans for expansion of strong businesses and so on should be given priority while loans for consumption should be discouraged. Although recent assurances were given that the credit squeeze was not general, it appears that bona-fide businesses are still facing difficulties securing loans.

3.2 Financial Liberalisation and Capital Flows

An important lesson that has emerged from the crisis is that while unrestricted capital mobility on a large scale provides short-term gains, it also threatens economic stability because of its direct effects on the exchange rate. Financial liberalisation cannot be hurried. Important institutional arrangements to monitor and moderate the consequences of financial liberalisation must be in place. Sudden access to the international capital market, for example, can result in debt accumulation beyond the means of the borrower. This calls for some form of regulation on capital flows and foreign borrowing, particularly, those of a short-term nature

To cushion the impact of massive capital inflows, Bank Negara resorts to sterilisation. Where financial markets are not well-developed, as in Malaysia, policy options to effect sterilisation are diminished. For example, open market operations are more effective when there is an active market for bonds.

Another advantage of a matured financial market is that it helps reduce risks by offering a wide variety of financial instruments. In the Malaysian case, although some progress has been made, for example, through the introduction of options and financial futures trading and the three-month KLIBOR (Kuala Lumpur Interbank Offer Rate) futures contract trading, further efforts are needed to introduce new instruments. These varied instruments provide genuine investors with increased opportunities to protect their investments. Deregulation and financial liberalisation should follow only when financial markets have attained some degree of maturity.

To help reduce speculative flows into the stock exchange, there must be complete transparency in terms of disclosure of information on shareholders, companies' financial position and the like. The recent UEM-Renong deal is a case in point. The apparent lack of transparency and accountability only dampened sentiments in an already-depressed market. Decisions made by the Securities Commission should be above board.

It is in Malaysia's interest to provide accurate information regarding her economy. The International Monetary Fund has called on countries to subscribe to an international data base created in April 1996, to facilitate the flow of economic and financial information in emerging markets. More than 40 countries have already subscribed to this Special Data Dissemination Standard (Summers, 1998). Such efforts should be supported and widened.

It may also be necessary to impose some restriction on capital flows. Initiatives taken in 1994, which achieved some measure of success, could be refined further. Furthermore, a tax on currency transaction, as proposed by Tobin in 1978, merits reconsideration by the international community. Also, on the international front, a new operational mechanism should be in place to monitor legitimate currency trading. The existing framework cannot cope with the magnitude of capital flows and prevent the possibility of speculative attacks on currencies. Although it may appear to be a step backward, some sort of regulation of the financial markets should be implemented to ensure orderly capital flows.

For Malaysia, FDI will remain the driving force in promoting economic development. In 1997, corporate investment amounted to a historical-high of RM 13.9 billion despite the financial crisis. In this respect, FDI should be targeted in areas where the country has the potential to develop a competitive advantage. High tech, high value-added industries should be targeted and aggressively promoted. Alongside such efforts, the high rate of domestic savings should be used to finance new domestic investments instead of being diverted to less productive activities.

Reverse direct investment, despite being a drain on limited domestic capital, should not be discouraged. However, such investment should be in the productive sectors, which can provide access to foreign markets and promote trade. Investment in infra structural development, for example, should be limited.

3.3 Depreciated Currency

To restore the currency value requires short-run policies that involve trade-offs. High interest rates offer several short-term benefits. First, they provide greater incentives to hold on to the ringgit and promote domestic savings-both will help stabilise the value of the ringgit. Second, high interest rates also help attract foreign funds. However, this will dampen new domestic investment and burden companies already in debt. Consequently, interest rates need to be raised to strengthen the ringgit, but without worsening the recessionary tendencies already present. This suggests that high interest rates cannot be allowed to prevail for too long. Neither can they operate alone; they must be part of a broader strategy of stabilisation. Nevertheless, restoring confidence in the currency appears to be a priority because it is an important factor influencing investor confidence.

In the longer run, the policy of defending the exchange rate at a pre-determined level needs to be reassessed. Although there is no doubt that Bank Negara's policy of a managed float has worked to the country's benefit overall, it proved to be impractical and beyond the financial capability of the Central Bank in the wake of the current crisis.

A managed float requires a careful monitoring of factors that impact on the exchange rate and quick responses. With the benefit of hind sight, it is clear that policy makers were reluctant to allow the ringgit to appreciate in response to capital inflows because of the fear that it would dampen economic growth and reduce the competitiveness of our exports. Yet, some moderation of economic growth was probably needed much earlier. In 1993, the Governor of Bank Negara had called for prudent measures to moderate growth but it went largely unheeded.

There appears to be no sure way of insulating the economy against large-scale capital movements arising from increasing globalization and the integration of capital markets world-wide. However, currencies pegged at levels inconsistent with economic aggregates offer a sure bait to speculators. An extreme alternative is to allow a free float so that concerns about the future are readily reflected in the exchange rate, making speculation unprofitable. While free floating gives rise to initial uncertainty, the exchange rate will stabilise in the long run provided domestic interest rates and prices are allowed to adjust accordingly. Thus, economic policies must be disciplined and pro-active in order to minimise exchange rate volatility- a difficult exercise indeed. However, even allowing a more wider and realistic scope for exchange rate movements may go a long way in providing more accurate signals about the economy and reduce the kind of panic behaviour witnessed recently. Another extreme option is to give up an independent currency by joining (or forming) a monetary union.

3.4 Current Account

The current account deficit problem arises from the negative balances in the services account. So far, Malaysia has only been able to reduce the deficit by increasing the surplus in the merchandise balance. This calls for expanding exports, moderating imports and reducing the size of some of the items in the services account. A long-term solution is to expand the services sector.

Meanwhile the shelving of "mega" projects worth RM 65 billion is a welcome move. These projects will hopefully be subjected to strict and transparent economic scrutiny when they are revived.

Incentives to source inputs domestically and the establishment of local input suppliers will lower the import content of exports and increase net imports. The abandoning of import-intensive, non-productive investment (golf-courses, non-local theme parks and the like) will benefit the current account.

Areas of productive investment such as food growing, R&D and human resource development should be given priority. Particular attention should be given to increasing export competitiveness. The persistent current account is partly due to the disappointing growth in productivity. Productivity implies producing greater output with less inputs thereby reducing cost and increasing competitive advantage. The focus is on Total Factor Productivity (TFP) - that is, not on specific inputs but by considering all factors in combination so as to achieve greater output and growth.

An analysis of factor productivity in Malaysia (Yap, 1997) suggests that for the period 1991-95, much of the GDP growth came from capital inputs that grew about four times faster than labour inputs for most years. TFP growth was unsteady, ranging between 0.5%-1.5%. In terms of contribution to overall GDP growth, capital accounted for two-thirds or more, while labour contributed between 15%- 18% during the period. TFP's contribution was unsteady, varying from a high of 16.9% in 1991 and a low of 4.7% in 1993.

Increasing productivity by even a few percentage points can yield great benefits in terms of increased export competitiveness, lower imports, and providing a push towards a higher-technological trajectory. This implies a more careful allocation of resources so that scarce inputs are channelled to sectors that are most productive and yield high value-added.

3.5 The Confidence Factor

The immediate task is to boost confidence in the country and turn negative sentiments around. Confidence in the economy can be enhanced by transparent policies, consistent policies and policy statements, and sustained implementation of policies in place. If we appear haphazard about our assessment of the economy and its strengths and weaknesses, we cannot hope to inspire others. In this connection the cosy relationship between government, businesses and political parties needs to be redefined to assure the market that all business decisions will be fair and above board and transparent. In attempting to move the economy back on track, measures should focus on the real and big, not the small and trivial. Budget measures that raised the cost of a passport and driving licence and removed the (meagre) tax subsidy provided to parents with children studying abroad are examples of the latter.

The Southeast Asian economies are increasingly becoming a single entity. Thus, it is becoming more difficult to insulate the Malaysian economy completely from adverse contagion effects from neighbouring countries. Efforts then should be directed at restoring confidence in the region as a whole. This requires close economic co-operation among the Southeast Asian economies, especially the ASEAN-5. So far ASEAN economic co-operation has brought few tangible results. It is necessary for the region to strengthen their respective economies, promote intra-regional trade, liberalise the flow of information, financial and human resources and plan combined responses to the challenges facing the region.

4. Conclusion

Two points are worth remembering in connection with the current turmoil. In a globalizing economy, disequilibrium in macro aggregates merit early attention, even if they do not appear to be immediately threatening. Second, the fundamental soundness of the economy has not been conveyed effectively to the market due to factors such as contradictory pronouncements and the lack of transparency in financial and big-corporate dealings. This "misinformation" needs to be addressed. In an environment characterised by asymmetric information, investors "followed the herd" and the Malaysian economy was categorised as being no different from those of Thailand, Indonesia or the Philippines.

The current crisis is being described as a "blessing in disguise" in some circles. Indeed, it is time to claim the blessings and cast aside the disguise. The former is best done by firmly addressing the weaknesses in the system that have surfaced, while the latter is achieved by ensuring more transparency in decisions made in all economic, financial and administrative transactions.

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