

Impact of the global crisis on Malaysia's financial system

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1. Introduction

Overall confidence and stability in the Malaysian financial sector has been preserved throughout the period of the global financial crisis, underpinned by a strong financial sector and negligible exposure to subprime-related assets and affected counterparties. Ample liquidity in the financial system also mitigated the risk of systemic contagion, thus allowing the financial sector to continue providing financial intermediation and services to the economy at large. Successful reforms of the financial sector following the Asian financial crisis have further reinforced the strong fundamentals supporting a sound financial sector in Malaysia.

As a highly open economy, Malaysia was, however, not insulated from the global economic downturn. The deterioration in global economic conditions and the major correction in commodity prices in the second half of 2008 saw Malaysia's GDP moderate to 0.1% in the final quarter of 2008. The domestic economy experienced the full impact of the global recession in the first quarter of 2009, declining by 6.2%. The concerted and pre-emptive measures taken by the Bank Negara Malaysia (BNM), through the accelerated implementation of fiscal stimulus measures, supported by the easing of monetary policy and the introduction of comprehensive measures to sustain access to financing and mitigate any impact of the heightened risk aversion among banks contributed towards stabilising the domestic economy in the second quarter and its subsequent recovery in the second half of the year. The economy resumed its growth momentum in the fourth quarter, growing by 4.4%. This resulted in the economy contracting by only 1.7% in 2009. Continued expansion in domestic demand and increased external demand led to the strong growth of 10.1% in the first quarter of 2010.

2. Impact of the banking crisis on bank intermediation

The financial intermediation process in the Malaysian financial system has remained orderly throughout the period of economic turbulence, with continuing flows of credit to the real economy. Outstanding loans expanded at an annual rate of 10.1% between July 2007 and July 2009. Similarly, outstanding private debt securities (PDS) grew by 10% annually during this period. The resilience of the banking system, which accounts for 59.7% of the total assets of the financial system, was a critical factor in ensuring the continued flow of funds into the economy and providing support to borrowers confronting temporary cash flow tightness (Table 1).

The level of capitalisation of the banking system in Malaysia was at its highest historical level at the onset of the crisis. Throughout the period 2007–September 2009, the risk-weighted capital ratio (RWCR) and the core capital ratio (CCR) of the banking system in Malaysia remained above 12.5% and 9.9%, respectively. Overall profitability as indicated by the return on assets (ROA) and return on equity (ROE) was also maintained at an average of 1.6% and

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20.8% in the period 2007–08, subsequently moderating to 1.2% and 13%, respectively, for the period January–September 2009, while remaining in positive territory as business conditions slowed significantly in tandem with the general contraction of the Malaysian economy.

During this period, the aggregate credit quality of the banking system’s financing portfolios did not experience any significant deterioration. In contrast, total non-performing loans (NPLs) declined by 33.4%, while the net NPL ratio improved to 2.1% as at September 2009 from 4.6% recorded at the beginning of 2007. This can be attributed to the concerted efforts taken by the BNM to enhance the credit risk management infrastructure and underwriting practices in the period following the Asian financial crisis. In addition, banking institutions have been actively managing their balance sheets and asset quality through stringent provisioning policies and write-offs of irrecoverable loans. As a result, the financing loss coverage ratio for the banking system as a whole rose to about 90% of NPLs (2006: 64.6%) as at September 2009.

Table 1

Banking system: key financial indicators

	1996	1997–98	2006	2007	2008	Jan–Sep 2009
Number of institutions	89	80–86	42	47	33*	33*
Average total assets per institution (USD)	2.8bn	2.1bn	11bn	11.2bn	11.7bn	11.9bn
Risk-weighted capital ratio	10.6%	10.5%	13.5%	13.2%	12.6%	14.5%
Core capital ratio	9.0%	8.9%	10.7%	10.2%	10.6%	12.9%
ROA	2.0%	–0.9%	1.3%	1.5%	1.5%	1.2%
ROE	27.5%	–12.3%	16.2%	19.8%	18.6%	13.0%
Net NPL ratio	3.0%	13.2%	4.8%	3.2%	2.2%	2.1%
Gross NPL ratio	3.9%	18.7%	8.5%	6.5%	4.8%	4.4%
Financing loss coverage ratio	N/A	55.1%	64.6%	77.3%	89.0%	89.7%

* including nine domestic banking groups and three foreign banking groups.

Source: Bank Negara Malaysia.

In general, the Malaysian banking system entered the current global financial and economic crisis from a much stronger position compared to the Asian financial crisis. The consolidation and restructuring of the banking industry together with improvements in the governance structure, risk management framework, infrastructure and practices, as well as the capacity building undertaken as part of the banking sector reforms following the Asian financial crisis, have significantly strengthened the foundations for financial stability. Moreover, the Malaysian banking system operates within a diversified financial system, with a developed capital market. Total bonds outstanding accounted for 86% of GDP, providing an alternative funding source for the economy. The funding sources for businesses are evenly balanced between the equity and bond markets and the banking sector, thus diversifying credit risk concentration away from the banking system, which in turn provides the banking system with added capacity to withstand stress and shocks.

Another factor which prevented excessive risk-taking was the “originate and hold” business model adopted by banking institutions in Malaysia, where credit risks are retained within

institutions' balance sheets. This served to align incentives with prudent risk-taking and ensured that lending institutions continued to vigilantly assess the repayment capacity of borrowers and monitor the quality of the loan throughout its tenure. The increase in the risk weight of non-performing housing loans to 100% since March 2005 under the regulatory capital framework further strengthened incentives for banks to maintain high-quality loan portfolios. The legal requirement for all foreign institutions in Malaysia to be locally incorporated, with capital committed to support Malaysian operations and obligations, also limited any contagion effects of stresses faced by foreign-domiciled parent banks located in the countries severely affected by the crisis.

These combined conditions enabled the banking sector to continue performing its financial intermediary role. As at end-September 2009, outstanding loans were growing at an annual rate of 7.2%, with a loan approval rate² of 71.6% (Table 2). In particular, outstanding loans to businesses remained stable, amounting to USD 85.9 billion as at end-September 2009, while outstanding loans to households continued to record steady growth. This was also supported by the lower cost of financing following the 150 basis point (bp) reduction in the overnight policy rate (OPR),³ which helped to sustain the demand for credit. With consumer confidence improving towards the second half of 2009, the purchase of big ticket items such as cars rebounded as more consumers took advantage of the lower cost of financing and the introduction of newer car models.

Table 2
Banking system: outstanding financing

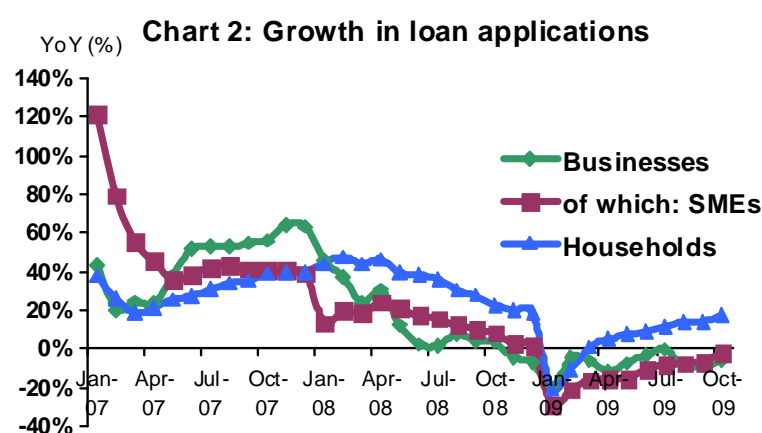
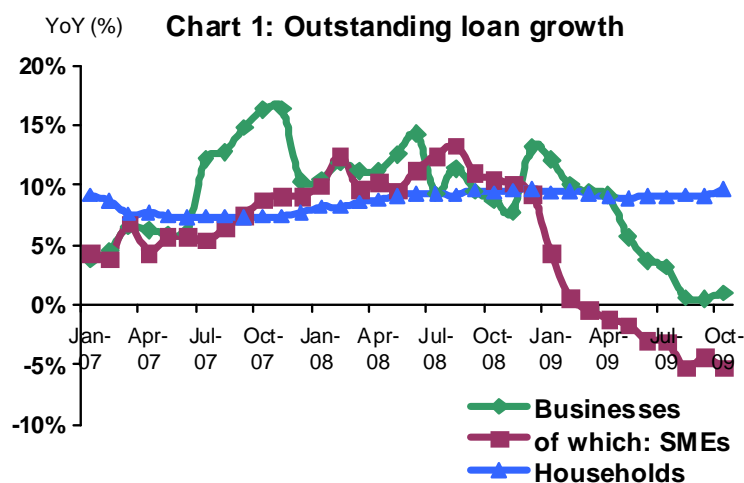
	USD billions		Annual change (%)	
	Sep 2009	Dec 2008	Sep 2009	Dec 2008
Total	219.8	209.7	7.2	12.8
Businesses	85.9	85.4	0.5	13.2
<i>Large businesses</i>	51.6	49.3	4.0	16.2
<i>SMEs</i>	34.4	36.0	-4.3	9.3
Households	120.7	113.5	9.1	9.7

Source: Bank Negara Malaysia.

Notwithstanding the progressive deterioration of global conditions and the heightened uncertainty in the domestic economic outlook, the banking sector in Malaysia was well-placed to maintain a "business-as-usual" posture with respect to risk management policies and standards. Risk mitigation responses were mainly pre-emptive in nature and largely took the form of more intensive surveillance and on-the-ground monitoring of small- and medium-scale borrowers, and the retail segments comprising credit cards and hire purchase facilities for cars, which were experiencing a slight uptick in the level of delinquencies. Banking institutions were also forthcoming in facilitating the rescheduling or restructuring of debt repayment obligations of deserving borrowers facing temporary cash flow constraints. These pre-emptive measures prevented premature defaults among such otherwise creditworthy borrowers.

² Loan approval rate = approved loans/(approved loans + rejected loans).

³ Overnight policy rate = the interest rate set by the BNM at its monetary policy meetings. From November 2008 to February 2009, the rate was reduced three times from 3.5% to 2%.



Source: Bank Negara Malaysia.

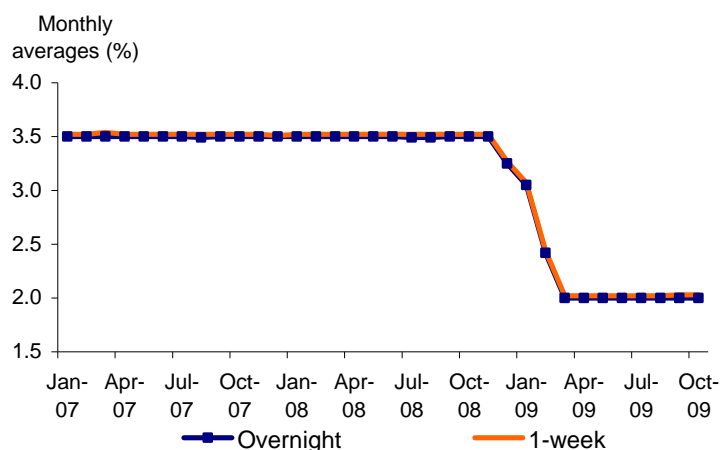
To ensure the uninterrupted flow of funds to the real sector, the BNM intensified its engagements with various stakeholders, including financial institutions, trade associations and businesses, beginning as far back as the early part of 2008 when conditions in the global economy appeared to be worsening and increasingly fragile. These engagements proved to be particularly effective in bridging information gaps between financial institutions and businesses, and encouraging a better appreciation among financial institutions of the issues facing businesses. This in turn supported the rational credit decisions of financial institutions in relation to new and additional facilities as well as requests for the restructuring of outstanding facilities.

3. Impact on the domestic money and debt markets

Money market

Ample liquidity has been maintained in the domestic money market. Activities in the ringgit interbank market were unaffected, and the overnight and one-week domestic money market rates remained stable, ranging between 1.99% and 2% since April 2009 and within a tight spread (Chart 3).

Chart 3: Interbank money market rates



Source: Bank Negara Malaysia.

The funding structure of the Malaysian banking system is predominantly deposit-based (about 70% of total funding) and denominated largely in domestic currency. This is used to fund ringgit-denominated assets which support domestic real sector activities. The depositor base is equally balanced between wholesale and retail deposits, thus providing greater funding stability to banks. The banking system also maintains a comfortable loan-to-deposit ratio, which averaged 77.3% for the period July 2007–September 2009. Notably, banking institutions are now less dependent on the interbank market compared to the period prior to the Asian financial crisis. For most of the period July 2007–September 2009, banking institutions were net interbank lenders to the BNM, with average net interbank placements of USD 47.1 billion by the banking system, underscoring the ample liquidity in the system. As at September 2009, total net interbank placements with the BNM stood at USD 45.3 billion, which was available to banks to meet any liquidity needs.

Banking institutions in Malaysia have, since 1998, been required to comply with dynamic minimum liquidity requirements. Under this requirement, all maturing assets and obligations are analysed by maturity buckets, with banking institutions required to maintain surplus liquidity of 3% for the one-week bucket and 5% for the one-month bucket after taking into account historical adverse behaviour assumptions. The overall liquidity buffer of the banking system remained well above comfortable minimum levels throughout the period July 2007–September 2009 (Table 3). In October 2008, as a pre-emptive measure, the BNM's ringgit liquidity facility was extended to all insurance companies and takaful operators to ensure that any surge in liquidity needs by insurance companies could be met in the event of an unanticipated increase in redemptions or surrenders of insurance policies. No insurance company or takaful operator has utilised this facility given the continued stability and confidence in the financial system. The extension of the blanket guarantee on all deposits by the government in October 2008 also provided added confidence to depositors, averting any unusual surge in deposit withdrawals.

Table 3

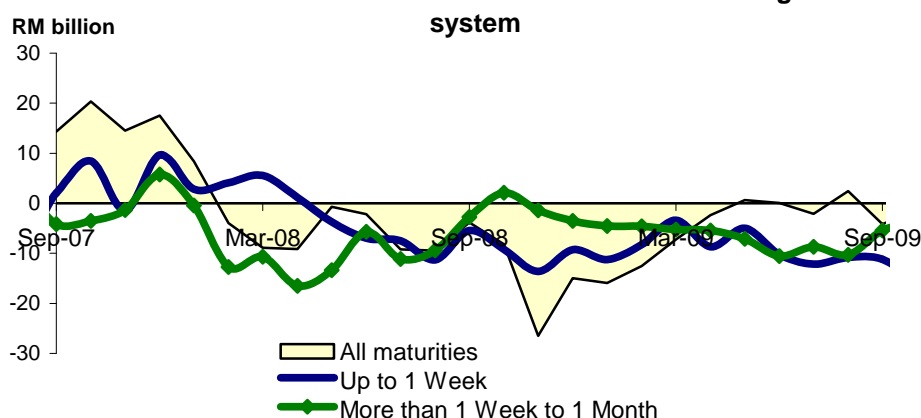
Liquidity indicators

		Jun 07	Dec 07	Jun 08	Dec 08	Jun 09	Sep 09
Liquidity buffer (% of total deposits)	< one week	14.4	15.1	12.9	14.2	16.3	16.4
	< one month	18.9	21.2	18.9	16.7	17.7	16.6
Liquidity surplus (USD bn)	< one week	28.4	31.5	29.1	34.0	39.9	41.5
	< one month	37.3	44.3	42.5	40.2	43.3	41.8
Net interbank placements with the BNM (USD bn)		44.3	49.7	57.3	46.9	46.6	45.2
Loan-deposit ratio (%)		75.5	76.2	76.0	77.7	78.3	78.9

Source: Bank Negara Malaysia.

While ringgit liquidity was not a concern, the domestic financial system was affected by the global tightening in USD liquidity. The impact was, however, manageable, as holdings of USD-denominated assets by Malaysian banking institutions remained small and mostly in highly liquid USD treasury assets with exposures partly hedged through currency swaps. As at September 2009, the total (on-balance sheet) foreign currency assets of the Malaysian banking system stood at USD 24.1 billion, or 6.1% of total assets. In response to the tight USD liquidity environment, banking institutions actively trimmed down the size of their foreign currency denominated exposures in order to narrow the negative USD mismatch (Chart 4). As a result, the cumulative USD liquidity mismatch position of the banking system narrowed substantially from the peak observed in November 2008. The BNM also ensured adequate USD liquidity to facilitate trade-related transactions. The existence of bilateral and multilateral currency swap arrangements with regional countries, including a bilateral currency swap arrangement with the People's Bank of China, further supported the availability of sufficient liquidity for intra-regional trade and investment activities.

Chart 4: Cumulative USD mismatch in the banking system



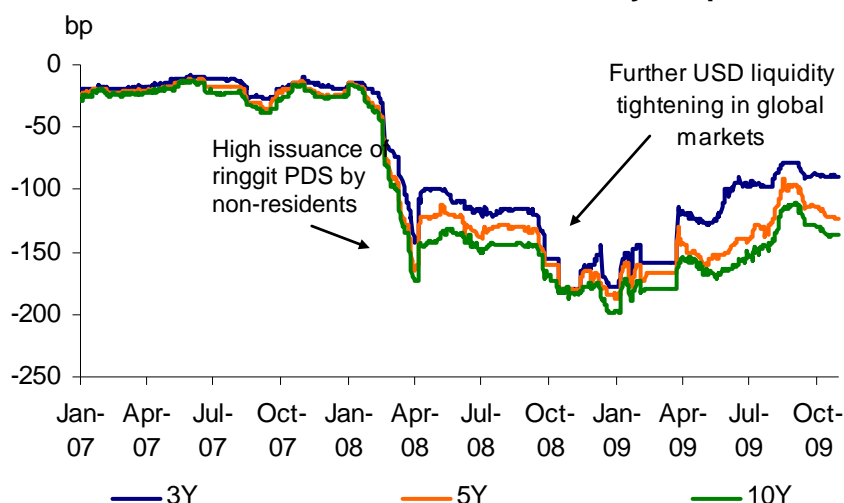
Source: Bank Negara Malaysia.

Cross-currency interest rate swap market

Developments in the cross-currency interest rate swap (CCIRS) market reflected the global shortage of USD liquidity and increased USD borrowing costs. Higher demand for USD in early 2008 saw the significant widening of basis spreads with a greater number of

non-resident issuers turning to the domestic PDS market to take advantage of the overall lower cost of funds (Chart 5). Basis spreads normalised after April 2008 as some non-resident issuers deferred planned issuances of new PDS as rising yields and the higher cost of swapping to USD translated into higher overall issuance costs. Basis spreads widened further in September and October following the failure of several global financial institutions, which resulted in the accumulation of USD assets by global financial institutions and rapid deleveraging. This contributed to further USD liquidity tightening in international markets. In 2009, basis spreads eased but remained at elevated levels.

Chart 5: MYR-USD cross-currency swap



Source: Bloomberg.

Debt securities market

In the domestic capital market, movements in yields were largely dictated by domestic considerations. Externally driven factors had a limited impact on yields.

Government debt market

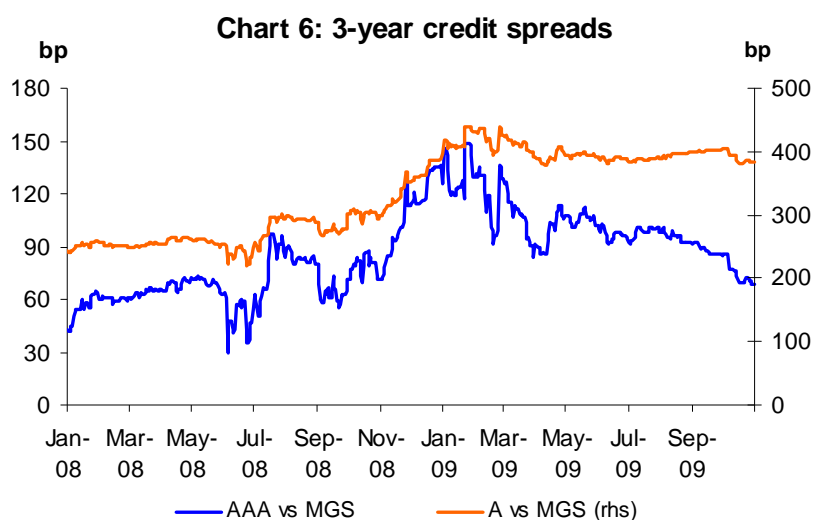
Developments in the government bond market in 2008 were influenced mainly by inflation expectations following higher commodity prices, the reduction in fuel subsidies by the government, and concerns over the growth outlook. Yields trended upwards during the first half of 2008 and peaked in the middle of the year anchored by expectations of monetary policy tightening. At the same time, the unwinding of portfolio investments by foreign investors kept yields at elevated levels. This trend reversed in September 2008 as inflation expectations eased substantially and concerns over the growth outlook domestically and globally resulted in heightened risk aversion among investors. For the rest of 2008, government bond yields continued to trend downwards, consistent with the reduction in the policy rate and “flight to quality” behaviour.

Government bond yields reversed in the early part of 2009, especially at the longer end of the curve, due to concerns over the potential oversupply of government bonds following the unveiling of two stimulus packages totalling USD 18.3 billion by the government. Nonetheless, demand for government debt issuances remained healthy, as evident in the firm bid-to-cover ratio for the papers (average HI 2009: 1.85 times, average H1 2008: 1.98 times).

Private debt securities market

Movements in private debt securities (PDS) yields broadly mirrored that of government securities during the first half of 2008. In mid-2008, however, announcements on the proposed imposition of a windfall tax on independent power producers,⁴ the potential reduction in toll rates and the possible cap on water concessionaires' profits, which would have affected around 25% of outstanding PDS in the domestic capital market, severely dampened investor sentiment. This caused market liquidity to decline and yields to heighten. Subsequent communications by the government which clarified the measures, as well as the withdrawal of the proposed windfall tax in early September 2009 improved investor sentiment, especially for higher-rated issuers.

Towards the end of 2008 and in early 2009, developments in the PDS market centred on concerns over the credit outlook of the corporate sector, leading to the widening of credit spreads. As risk aversion heightened, yields, especially for lower-rated PDS (A-rated and below), rose significantly (Chart 6). Despite the recent improvements in trading liquidity, credit spreads for A-rated PDS remained elevated due to concerns over the credit quality of lower-rated issuers.



* MGS = Malaysian government securities.

Sources: Bloomberg; Bank Negara Malaysia.

4. Pre-emptive and comprehensive measures to bolster confidence, preserve financial stability and ensure continued access to financing

Given the high degree of interconnectedness between the Malaysian and the global financial system, Malaysia acted swiftly to implement pre-emptive and precautionary measures to preserve the stability of the financial system and ensure the continuity of credit flows. This included specific and targeted measures to preserve confidence and address the highly vulnerable segments and potential areas of stress:

⁴ Independent power producers are privatised power producers, initiated by the government in 1995, to deliver the immediate national power security needed to maintain GDP growth.

- extending a blanket guarantee on all ringgit and foreign currency deposits with commercial, Islamic and investment banks and deposit-taking development financial institutions regulated by the BNM through the Malaysia Deposit Insurance Corporation. The guarantee is in force until December 2010 and extends to all domestic and foreign banking institutions operating in Malaysia;
- extending access to the BNM's liquidity facility to insurance companies and takaful operators regulated and supervised by the BNM;
- ensuring banks' accessibility to USD liquidity for trade financing purposes; and
- intensifying engagement with industry players, businesses and large corporate as well as trade bodies.

Efforts were mainly targeted towards ensuring that businesses and households continued to have adequate and uninterrupted access to financing.

Improving and broadening access to financing

Support to small- and medium-sized enterprises (SMEs)

Financing for the SME sector, which accounts for 99% of the total number of business establishments in Malaysia, is mainly supported by the domestic banking system. The share of SME financing currently accounts for 40% of total business financing granted by the banking system (1998: 27.1%). On average, SME financing expanded by 5.9% during the period 2007–September 2009.

The importance of the development of SMEs in supporting domestic-led growth has long been a focus of efforts to strengthen the resilience of the Malaysian economy. To this end, special funds were established to assist viable SMEs, provide continued support for enhancements in efficiency and productivity, and help them manage temporary cash flow problems (Table 4).

The facilities leverage on existing infrastructures and the distribution capabilities of financial institutions and special purpose institutions, such as the Credit Guarantee Corporation, established in 2005 to provide guarantees enabling SMEs to obtain credit facilities. The comprehensive institutional structure and facilities in place for viable SMEs to obtain access to financing on competitive terms have had a direct and significant impact on promoting financial inclusion in Malaysia as evidenced by Malaysia's highest global ranking by the World Bank for the last three consecutive years in terms of "Getting Credit".

As part of ongoing efforts to promote financial inclusion and improve the earning capacity of the low-income group, measures have also been taken to develop microfinancing and extend its reach and accessibility to wider segments of the population. These efforts have already yielded positive results. Outstanding microfinancing has grown by 38.2% annually since its inception in 2006, with continued growth in demand for microfinancing. Efforts are continuing to improve the accessibility of micro businesses to other financial services such as micro-takaful, micro-insurance, financial education and advisory services.

Table 4

Ensuring continued access to SME financing

Facility	Amount (USD)	Established	Objective	Remarks
SME Assistance Facility	200m	Aug 2008	To assist viable SMEs facing financial difficulties to manage temporary cash flow problems due to rising costs	Fully utilised
SME Modernisation Facility	142m	Aug 2008	To provide financing to SMEs to modernise their operations, in particular to purchase or upgrade machinery and equipment, as well as for energy-saving equipment	Fully utilised
Micro Enterprise Fund	57m	Nov 2008	To enhance access to microfinancing for micro enterprises with viable businesses	Partly utilised
SME Assistance Guarantee Scheme	600m	Jan 2009	To assist viable SMEs adversely impacted by the economic slowdown to continue obtaining access to adequate financing	Replacement of the SME Assistance and Modernisation Facilities
Working Capital Guarantee Scheme	1.4bn	Apr 2009	To assist viable companies with shareholder equity of below RM 20 million to gain access to financing in order to maintain their operations amid the challenging economic environment	Government guarantees 80% of working capital funding from banking institutions, which were fully utilised
Industry Restructuring Loan Guarantee Scheme	1.4bn	Apr 2009	To promote investments: <ul style="list-style-type: none"> • that increase productivity; • in high-value-added activities (such as research and development, and downstream agriculture activities); and to promote the greater application of green technology	Government guarantees 50–80% of funding of long-term investments obtained from banking institutions, depending on the size of shareholders' equity

Source: Bank Negara Malaysia.

Deepening capital market activity

The development of the Malaysian capital markets was one of the key strategic priorities during the 1990s and its importance was further emphasised in the aftermath of the Asian financial crisis, especially the importance of diversifying financing sources for the Malaysian economy. Led by a broad range of initiatives and policies implemented over the last decade,

Malaysian capital markets have expanded considerably since the Asian financial crisis. The ringgit bond market is now the third largest in Asia, with total bonds outstanding at 86% of GDP. The focus on Islamic finance has seen Malaysia emerge as the leading market for sukuk issuances (more than 60% of global sukuk outstanding) with a market share of 45% of total global issuances recorded for the period January–September 2009. The corporate bond market has assumed a significantly more prominent role as an alternative source of financing for the corporate sector, accounting for a quarter of total financing as at end-2008 (1997: 10%). To further enhance access to capital market financing, Malaysia established its first financial guarantee institution, Danajamin Berhad, in 2009 to provide credit enhancements to viable corporations and businesses.

Addressing potential borrower distress

Arrangements and mechanisms to facilitate debt management and develop solutions also represent an important component of the supporting framework in Malaysia which ensures an orderly intermediation process. These mechanisms serve to avert premature defaults and the high cost of resolution of failed companies. In Malaysia, various institutional arrangements were established with specific objectives:

- **Credit Counselling and Debt Management Agency.** The agency was established in 2006 to provide assistance and advice in debt and money management as well as financial education to individuals.
- **Small Debt Resolution Scheme (SDRS).** The scheme was established in 2003 to facilitate loan restructuring and financing solutions for small businesses. In May 2009, the BNM expanded the scheme to include the debt resolution of distressed SMEs with multiple financial institutions. To date, more than 600 SMEs have benefited from this scheme.
- **Corporate Debt Restructuring Committee (CDRC).** The voluntary debt restructuring mechanism was first established during the Asian financial crisis to resolve corporate failures. In July 2009, the Committee was reinstated as a pre-emptive measure to facilitate corporate debt resolution. Given the structural change in the funding composition within the economy, the scope of the CDRC has been expanded to cover the restructuring not only of bank borrowings but also of debt securities. The expansion of CDRC's scope so as to cover the bond market is a reflection of the importance of the sector in financing the economy.

Accommodative monetary policy

The measures to enhance access to financing were also supported by an accommodative monetary policy, which was principally aimed at reducing the cost of financing and providing support to domestic demand. Since November 2008, the OPR has been lowered by 150 bp to 2%. At the same time, the statutory reserve requirement was adjusted downwards by 3 percentage points to 1% to reduce the cost of intermediation. The monetary easing was also supported by a range of initiatives to ensure that the reductions in interest rates were passed on to the economy and continued access to credit was available to both existing and new borrowers.

5. Transformation of the financial system

The Financial Sector Master Plan unveiled in March 2001 outlined the strategies to develop a resilient, diversified and efficient financial sector that not only supports but also contributes towards domestic growth. The benefits of the decade-long transformation are now being

reaped as evidenced by the relatively minimal impact of the current financial crisis and the continued resilience of the financial sector. The significant development of the Malaysian financial services sector over the last decade has spawned new financial innovations and services in support of economic activities. Apart from intermediating and supporting economic growth, the expansion of the financial sector has also played an instrumental role in generating value-added business, attracting investment and creating employment.

Malaysia has consistently adopted a careful and sequenced approach to financial liberalisation, supplemented with sufficient safeguards to ensure that the overall financial intermediation function and stability of the financial system remains intact. Supported by the progress and achievements of the implementation of the Financial Sector Master Plan, the strengthened financial sector fundamentals have positioned the financial sector to seize opportunities and embrace a more liberalised and competitive operating environment. In April 2009, the government announced a liberalisation package that included measures in both the conventional and Islamic finance sectors, which will contribute to the further development of the Malaysian financial sector and bring net benefits to the economy as a whole, while preserving financial stability.

The liberalisation measures taken by Malaysia are interesting from two aspects. First, the further opening up of the domestic market has been pursued amid the global financial crisis. Second, the policy was counterintuitive to the prevailing tendencies for countries to adopt more protectionist policies in the wake of the crisis. This was possible because of the successful reforms implemented in the financial sector in Malaysia. The liberalisation package encompasses measures that will significantly boost the financial sector's contribution to growth, including:

- the introduction of global market leaders and niche players in the domestic market through the issuance of new banking licences and takaful licences;
- higher foreign equity limits for investment banks, insurance companies and takaful operators to encourage greater participation of foreign players in domestic institutions; and
- greater operational flexibilities in the establishment of new branches by foreign institutions and in the employment of expatriates.

6. Conclusion

The impact of the current global crisis on the Malaysian financial sector has remained well contained. Efforts following the Asian financial crisis to develop effective regulatory, supervisory and surveillance frameworks, as well as the strengthened governance and risk management practices and the development of a robust financial infrastructure and safety nets have supported a resilient banking system that is well positioned to continue facilitating intermediation activities despite the difficult environment. These efforts have been further complemented by a more diversified financial system and a higher level of regional cooperation and collaboration in responding to crises. Underpinned by the strength of the financial system, the management of the current global crisis has focused on pre-emptive measures to ensure continued access to financing and to preserve confidence in the financial system.

At the same time, monetary policy has been directed at providing support for domestic demand to encourage economic recovery. In addition, fiscal policy measures have provided countercyclical support for growth and incentives aimed at stimulating private sector consumption and investment. These combined conditions significantly enhance the prospects for Malaysia to resume a strong and sustainable growth path once the global economic and financial conditions return to normal.