Malaysia And The Asian Turmoil

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ABSTRACT

This paper attempts to draw out a framework to examine the Malaysian experience in the recent financial crisis. In achieving the objective of the study, this paper provides a systematic analysis of the nature of the crisis in Malaysia, the socio-economic impacts of crisis in the country, and the actions taken by the government to rebuild the economy after the crisis. Specifically, this paper discusses the exchange control measure adopted in Malaysia as one of the necessary measures to address the fallout from the regional financial crisis. In the final section, this paper suggests important indicators that may serve as signals for another potential crisis.

I. INTRODUCTION

Malaysia has undergone four major crises since independence: the 1971-73 oil crisis, the 1980-81 commodity or second oil crisis, the 1985-86 electronic crisis, and the recent financial crisis (1997-98).¹ The causes as well as the effects of the four crises are distinguishable. The most recent one has received overwhelming attention, not only because of the greater impact of the recent crisis on Malaysian economy compared to the

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previous crises, but also because the causes and management of the crisis differ from those in previous crises.

In brief, the 1971-73 downturn occurred at a time when the country was at its early stage of rapid economic expansion. The tremendous surge in oil prices following the world oil crisis and subsequent slowdown and recession in industrialized countries affected Malaysia’s export, which jeopardized the country’s expansion. A few years after the first crisis, the Malaysian economy plunged once more. The commodity crisis in the early 1980’s was inevitable as a result of the second oil crisis that lasted from the late 1970s. In addition, the abrupt drop in commodity prices and the surge in the domestic and external debt as well as government budget deficits created short run financial imbalances and strains in the conduct of fiscal and monetary policies in the country. In 1983 and 1984, Malaysia’s economy started to show signs of recovery. The Gross Domestic Product (GDP) growth rates for these two years were above 5% in average. Behind the illusion of strong growth, however, the economy plunged into its first recession with negative growth for the first time since independence in 1957. The GDP growth rate was negative 1.1% in 1985. The primary cause of the economic crisis was the sharp decline in prices of electronic and commodity products due to slackening world economic growth and weak international demand for these products. Malaysia was affected by the weak demand for electronic goods, because, prior to the recession in 1985, the government actively encouraged Malaysian manufacturers to produce electronic and electrical products. As the recession in 1985 was induced mainly by the declining prices of electronic goods, it has bound to have an exaggerated impact on Malaysia’s overall GDP performance.

The recent financial crisis that started in mid-1997 is the worst crisis Malaysia has experienced since independence. Despite the fast and destructive effects of the crisis on the economy, however, Malaysia achieved economic recovery with amazing speed. The V-shaped recovery for the economy, as shown in Appendix 1, raised the curiosity of interested individuals on what actually happened to Malaysia during the crisis. In view of the lack of complete examination of the evolution of the Malaysian economy during the financial crisis, this paper attempts to provide a descriptive analysis of the recent crisis in Malaysia, by sketching out a framework for understanding the nature and consequences, as well as the management, of the crisis in Malaysia. To this end, Section II analyzes the causes of crisis in Malaysia, Section III looks at the impacts of crisis on the Malaysian economy, and Section IV discusses actions taken by the Malaysian government to overcome the turbulence. More specifically, Section V looks at the exchange control measure under the Exchange Control Act 1953, and Section VI presents the indicators of crisis, which if heeded, could prevent the potential of another crisis.
II. CAUSES OF THE MALAYSIAN CRISIS

Many debates have been devoted to discussing the causes of the current economic crisis in Asia. Two important hypotheses have resulted from these discussions. According to the first hypothesis, panic was the key reason for the turmoil. Sudden shifts in market expectations and loss of confidence were the most important causes of the outbreak of financial chaos in Asia. In contrast, the second hypothesis argued that the recent crisis reflected an unsustainable deterioration in macroeconomic fundamentals and poor economic policies in the affected Asian countries. According to the second view, structural factors triggered the currency and financial problem.

In Malaysia, the recent economic crisis began in the financial sector, causing a major havoc on the stock market, exchange rates, and the banking sector in the country. The crisis started with sudden withdrawals of short-term capital from the country following the floating of Thai’s Baht in July 1997. This withdrawal then created a wave of uncertainty and volatility in the foreign exchange and equity markets. Panic-stricken investors started to pull out short-term capitals in large scale, causing a steep depreciation of currency and forcing interest rates to skyrocket. Major investment plans were postponed because of the sharp increases in interest rates and many businesses were faced with the risk of bankruptcies and non-performing loans. The deep drop in the economy abetted a severe downturn in share and other asset prices, particularly property prices, because of the over-exposure of the property sector, which was fueled by speculative demand for properties during the period before the crisis. The breakdown in the financial sector immediately took a heavy toll on the real economy, leading to an unprecedented contraction in GDP of 7.5%, a rise in inflation rate to over 5% and high unemployment level in 1998. Unemployment rose from 2.6% in 1997 to 3.9% in 1998, with the number of retrenched workers peaking at 12,335 in July 1998.4

Far before the crisis happened in 1997, there were skeptical views about the Asian economic miracle in general and Malaysia’s high and sustainable growth in particular. With regard to this issue, Paul Krugman has predicted that Asia would eventually run into diminishing returns because of the weak performance in the productivity levels and because of poor economic policies and fragile financial systems in most Asian countries.5 Asian countries, in the years before the crisis, relied too much

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on short-term foreign currency denominated debt. In addition to that, according to most analysts, the main problem in Asian countries and primarily in Malaysia was not macroeconomic but structural bottlenecks. Some slowdown in Malaysia was inevitable because of the breakneck pace of the development in the country since the mid-1980s. When the slowdown interacted with weak financial oversight, sizable short-term international capital inflows to the private sector, and erosion of confidence of the country, the crisis resulted. Despite its relatively strong fundamentals, lower debt service ratio, high savings, and a comfortable reserve position compared to its neighboring countries, coupled with less short-term capital inflows, Malaysia had been placed in the same basket as other countries identified as facing similar problems of the same magnitude. Therefore, when the crisis happened in the neighboring countries in the region, the contagious effect quickly spread to Malaysia.

From the Malaysian experience, the fundamental sources of the recent crisis are the combination of poor economic policies and structural factors plus financial panic. In addition to the slowdown in growth due to structural bottlenecks, declining productivity, and limitations in appropriate macroeconomic management, the recent financial crisis was undoubtedly closely associated with both the vulnerabilities of short-term capital flows into the Malaysian economy and activities of currency traders that led to the wild swings in the value of the national currency. Although the sudden outflow of short-term capital perpetrated havoc on the financial system, it was basically the market overreaction and herding rather than Malaysia’s weak macroeconomic performances that caused the exchange rate, share prices, and asset prices to plunge more severely.

III. IMPACTS OF THE FINANCIAL CRISIS ON MALAYSIAN ECONOMY

Before the outbreak of the crisis, Malaysia experienced years of rapid economic growth, with real GDP growth of 8.5% between 1991-1997, inflation rates generally below 4% for the same time period and unemployment rates less than 5%, high savings (approximately 40% of GDP), and low external debts. Moreover, rising per capita income reduced the incidence of poverty and increased the size of the middle class in the country. The poverty rate fell from 16.5% to 6.1% during this time. As a result of sound macroeconomic performance, the standard of living of all Malaysians improved greatly. The favorable macroeconomic

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7 Id.
environment in the country also attracted large capital inflows, on both long-term and short-term bases. These capital inflows, although enhancing the rate of economic growth, contributed to the appreciation of asset prices both in terms of property and shares. This appreciation induced general buoyancy over the country’s prospects.

The outburst of the crisis in mid-1997, however, caused a sudden change in the perception towards the country’s economic prospects. This loss of confidence in Malaysia’s ability to meet the challenges ahead, in turn, dramatically changed the country’s economic performance. The financial crisis has, in fact, adversely affected Malaysia’s real economy and its financial and social sectors.

Generally, the economy registered a negative growth rate of 7.5% in 1998, while per capita income contracted by over 1.8% during the crisis period. In the Kuala Lumpur stock exchange market, the Composite Index declined sharply by 44.9% during the period of July 1, 1997 to December 31, 1997. The index recorded an 11-year low point of 262.70 on September 1, 1998, while KLSE market capitalization declined by about 76% to RM181.5 billion between the July 1, 1997 to September 1, 1998. Interest on non-performing loans has picked up, and the cost of funds rose to as high as 20% per annum in early 1998. As a result, corporate performance dipped heavily. The net non-performing loan over total loans ratio rose to 9% at the end of 1998. Malaysians who had been used to enjoying good times suddenly had to endure belt-tightening measures to survive the crisis. In brief, the present crisis has nullified the government’s effort undertaken in the past three decades to enhance the Malaysian standards of living.

This paper next examines some of the effects of the crisis, which includes contraction of the economy, the unemployment and price effects, the decline in private investment, the instability of the value of Ringgit and effects on the corporate sector, as well as the social impacts of the crisis.

The contraction of the state economy as measured by the real GDP represents the clearest indication of the impact of the financial crisis on the Malaysian economy. This impact became particularly evident at the end of 1997, when the real GDP began to slow down. At the beginning of

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8 Id. pt. III(i).
9 Id. pt. III(vi).
10 Id. pt. III(vi).
11 Id. pt. III(viii).
12 BANK NEGERA MALAYSIA, supra note 4, at 586.
1998, the real GDP growth rate even registered negative, a rare event that had not occurred since 1985. As a result of the contraction in economic growth, per capita income declined by 1.8%, from RM 12,051 in 1997 to RM11,835 in 1998. Additionally, the contraction in GDP slowed employment growth and increased unemployment as well as retrenchment. In 1998, the unemployment rate increased to over 5% from 2.6% in 1997, while employment declined by 3.0% compared to the positive growth of 4.9% and 4.6% in 1996 and 1997, respectively. The construction sector suffered the greatest decline, dovetailing by 16.9%. The decline was mainly due to the government’s postponement of the implementation of several projects to reduce the pressure on government deficits. In comparison, the manufacturing sector declined slightly, by only 3.6%. In the manufacturing sector, the impact of the crisis as a consequence of Ringgit depreciation varied among different industries. In this regards, the resource-based industries with high export and low import content have in fact benefited from the depreciation of Ringgit in terms of higher export receipts from exchange rate valuation gains. On the other hand, domestic-oriented industries with high import content, such as the transport equipment industry has been adversely affected by the crisis. In general, the effect on the manufacturing tended to be more moderate compared to the construction sector in the country.

From the start of the crisis in 1997 to mid-May 1998, a total number of 43,838 workers were retrenched. Among those who lost their job, 30,152 occurred in the first five months of 1998. Retrenchment, in this time period, resulted from the sharp slowdown and reduction in production activity, and from the bankruptcies of some firms. Even though there were limited job opportunities in 1997 and 1998, the unemployment rate in the crisis period did not really reach an emergency level. This is because other industries in the economy that faced labor shortages for quite some time, for example, manufacturing, plantation, and some services sub-sectors, were still capable of absorbing some of these retrenched workers. Although the unemployment problem was not an exigent issue during the crisis period, the increased number of unemployment during that period imposed important social effects on the country, such as increased crime rate.

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14 See id. pt. III(ii).
15 SAMUEL & CHENG, supra note 3, at 117.
16 Id. at 157.
17 White Paper, supra note 7, pt. III(ii).
While employment declined, the general price level, as measured in terms of the CPI increased, peaking at 6.2% in June 1998.\textsuperscript{18} Price pressures, arising mainly from the depreciation of the Ringgit, greatly affected imported items. Among all items, food prices registered the largest price increase. “The Producer Price Index (PPI), which measures the average rate of change in prices by domestic producers of commodities and those paid by Malaysian importers, also rose sharply.”\textsuperscript{19} The increased inflation rate has reduced the consumers’ purchasing power to a substantial extent besides reducing the country’s competitiveness in the export market.

On the investment side, generally, private investment shrunk as a result of uncertainties arising from volatile exchange rates. Furthermore, a sharp decline in local and external demand and tight liquidity positions encountered by most investors since the onset of the financial crisis in July 1997 discouraged investment activity by the private sector.\textsuperscript{20} Foreign Direct Investment (FDI), which is “measured in terms of the value of applications in the manufacturing sector and applications for investment incentives from the hotel, tourism and agriculture sectors to the Malaysian Industrial Development Authority (MIDA),” declined between January 1997 and December 1998.\textsuperscript{21}

The instability of the exchange rate has been the prime cause of havoc in the economy. The exchange rate of the Ringgit against most currencies has declined greatly. For instance, the Ringgit depreciated by 35% against the U.S. dollar between July 1, 1997 and December 31, 1997, reaching its lowest point on January 7, 1998.\textsuperscript{22} For the performance in the stock prices, the Kuala Lumpur Stock Exchange Composite Index (KLSE CI) declined by 44.9% during the period July 1, 1997 to December 31, 1997.\textsuperscript{23} After a slight recovery in the first quarter of 1998, the index slid again to an 11-year low of 262.70 points on September 1, 1998.\textsuperscript{24} Between July 1, 1997 and September 1, 1998, KLSE market capitalization fell by about 76% to RM181.5 billion.\textsuperscript{25} Several factors affected

\textsuperscript{18} BANK NEGARA MALAYSIA, supra note 4, at 586.
\textsuperscript{19} White Paper, supra note 7, pt. III(iii).
\textsuperscript{20} Id. pt. III(iv).
\textsuperscript{21} Id.
\textsuperscript{22} Id. pt. III(v).
\textsuperscript{23} Id. pt. III(vi).
\textsuperscript{24} Id.
\textsuperscript{25} Id.
movements of stock prices on the KLSE, including exchange rate fluctuations, developments in the regional economies and a sharp loss of confidence in emerging markets by international investors. The crisis adversely affected the corporate sector, demonstrated by the decline in the number of new companies registered and the increase in the number of companies closing. The rate of non-performing loans (NPLs) in the banking system increased drastically following the slowdown in economic activities and the increase in interest rates, which raised the cost of funds to as high as 20% per annum in early 1998.

Considering the social implications of the financial crisis, the issue that has received most attention so far is the effect of the crisis on the country’s standard of living and eventually on the government’s poverty eradication efforts. Before the crisis, the incidence of poverty among Malaysians decreased from 8.9% in 1995 to 6.1% in 1997. During the crisis, however, the economic downturn intensely affected efforts to sustain this rate of reduction. The economic contraction, coupled with the increase in inflation rate, had resulted in limited employment and income-earning opportunities. Consequently, the incidence of poverty increased to 7.0% in 1998. “The poor performance of the KLSE also seriously constrained the ability of the corporate sector to acquire financial assistance through the stock market,” because the fall in share and property values “adversely affected the value of collateral provided by businesses for the loans they had procured.” In addition to all the adverse effects on the market, rising interest rates increased debt service commitments for both businesses and the public. For example, monthly repayments for a housing loan or an overdraft of RM100,000 increased by approximately 20%.

As the National Economic Action Council (NEAC) noted in its 1999 White Paper, Malaysia has been quite successful in preventing what

26 Id.
27 Id. pt. III(vii).
28 Id. pt. III(viii).
29 Id. pt. III(x).
30 Id.
31 Id.
32 Id.
33 Id.
34 Id.
could potentially have been extreme effects of the crisis despite the crisis’s wide range of effects on the Malaysian economy, particularly in terms of meeting the National Development Policy targets. Unlike some economies in the region that have experienced high inflation, mass poverty, massive bankruptcies, and civil unrest, Malaysia underwent only a relatively mild shock during the financial crisis. Malaysia’s success has been made possible by relatively strong initial conditions, both in terms of the real economy and the financial sector as well as the prompt and prudent measures introduced by the Malaysian government during the crisis.

IV. ACTIONS TAKEN BY THE MALAYSIAN GOVERNMENT

In response to the crisis, Malaysia initially implemented measures akin to the standard International Monetary Fund (IMF) prescriptions for crisis economies, such as raising interest rates, reducing government expenditure, and tightening monetary policy. The IMF exercised these measures as standard remedies to rescue countries affected by crisis in all circumstances regardless of the nature and impacts of the crisis. After applying these medicines to the Mexican economy in the mid-1990s, the IMF garnered praise for successfully putting Mexico’s economy on the recovery path. In Malaysia, however, these austere economic policies caused severe liquidity problems in the corporate sector, thereby, constraining company performance, worsened the real economy, and created anxiety among the people.

As the real economy deteriorated further and the financial system grew increasingly unstable in 1998, the government altered its conduct and planned for reconstruction to halt the economic decline. In August 1998, the government, through the National Economic Action Council (NEAC), consulted over 200 organizations and individuals to formulate the National Economic Recovery Plan (NERP). The NERP, which was

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35 Id. pt. III, ¶ 1.
36 Appendix 2 shows the relative comparison.
37 1999 White Paper, supra note 7, pt. IV, under heading Measures Taken to Address the Crisis, ¶ 1.
39 1999 White Paper, supra note 7, pt. IV, under heading Measures Taken to Address the Crisis, ¶ 1.
launched in August 1998, presents a comprehensive framework for national economic recovery. The NERP’s recommendations have been approved by the Government and are in different stages of implementation.\textsuperscript{41} In September 1998, one month after the NERP was presented, the government implemented an exchange control measure, and in October, the government started a comprehensive restructuring of the financial sector. Relaxation of fiscal and monetary policies and the simultaneous fine-tuning of policies have, to a certain extent, released economic pressures, successfully strengthened the economic and financial sectors, and restored domestic and external stability.

Aimed at bringing about Malaysia’s economic recovery, the NERP was specifically tailored to the needs and unique circumstances of the country and society. Because Malaysia is a multiracial society, economic growth is of particular importance as the basic tool for achieving equitable distribution of income among the people. Consequently, the fundamental concern of the NERP is to restore the economy’s pre-crisis growth rate and, if possible, to exceed the pre-crisis growth performance. Specific measures were implemented to promote overall economic activities, including reducing interest rates, improving liquidity in the banking system, and reinstating public expenditures especially in critical and essential public services, such as low cost housing, education, and health care.\textsuperscript{42}

The recent financial crisis has shed light on several important issues. As identified by the NERP, the imperfect operative mechanism of the banking sector and the volatility of the international environment, particularly in the foreign exchange market, were among the major factors that contributed to the 1997 economic crisis.\textsuperscript{43} The realization that the crisis originated primarily from over-reliance on the banking sector to meet the funding needs of most economic activities and strong international influences on the domestic economy gave the NEAC clear guidance in formulating an appropriate recovery plan for the country.

The over-dependence on the banking system led to rapid growth in bank loans, with growth averaging 25% during the period before the crisis. When the crisis struck, non-performing loans (NPLs) rose sharply and paralyzed the banking sector. In this regard, the Government initiated the financial sector’s restructuring plan to reduce the risks banks were facing

\textsuperscript{41} 1999 White Paper, supra note 7, pt. IV, under heading \textit{National Economic Recovery Plan}.

\textsuperscript{42} See generally NERP, supra note 40, ch. 6.

\textsuperscript{43} See id. ch. 1, under heading \textit{Causes of the Turmoil in the Region}. 
in giving out loans and to ensure the effectiveness of the banking system in carrying out its intermediation function. As the financial crisis deepened in 1998, the deteriorating economic conditions adversely affected the asset portfolio of banking institutions, resulting in growing levels of NPLs. Consequently, banks became overly occupied with managing their deteriorating asset portfolio, thus hampering their lending activities. For the economy to recover, it is crucial that the banking sector is re-energized so that it is able to perform its intermediation function effectively. Therefore, the financial sector’s restructuring activity was perceived as the key component of recovery efforts, because it was aimed at strengthening banking institutions in Malaysia.

In strengthening the banking system, the government made significant progress toward addressing the problems of non-performing loans, the recapitalization of banking institutions and the restructuring of large corporate debts that impinged on the health of the banking system. Among the measures taken, the government established Danaharta, Danamodal, and the Corporate Debt Restructuring Committee (CDRC). To further strengthen banking institutions into strong, efficient, competitive, and professionally-managed banking entities, the government, through the Central Bank, also initiated a bank consolidation program among local banking institutions.

In June 1998, the government established the Pengurusan Danaharta Nasional Bhd (Danaharta) as an asset management agency to purchase and manage NPLs of financial institutions. By end of June 1999, Danaharta had completed its primary task of acquiring the NPLs of the banking system. Danamodal Nasional Bhd (Danamodal), which was set up at the same time as Danaharta, was assigned the job of recapitalizing banking institutions. By early May 1999, Danamodal completed its task of recapitalizing the banking institutions and had

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45 The merger is one of the measures implemented to strengthen the domestic banking sector to meet future challenges. From 54 financial institutions, comprised of commercial banks, finance companies, merchant banks and discount houses, 10 anchor banks existed after the merger.


invested RM6.4 billion in 10 banking institutions.\(^\text{49}\) The government
established both *Danaharta* and *Danamodal* to restore confidence in
banking institutions and to ensure that the banking system effectively
performs its intermediary function for the recovery process.\(^\text{50}\)

In addition to these two institutions, the government also
established the Corporate Debt Restructuring Committee (CDRC). In
brief, CDRC addresses corporate debt restructuring by providing to both
debtors and creditors extra-legal solutions to their debt problems.\(^\text{51}\) As the
CDRC reports, the financial crisis and unfavorable economic conditions
in July 1997 had placed many corporations in financial difficulties.\(^\text{52}\) Before
the creation of the CDRC, many publicly listed corporations had obtained
Restraining Orders pursuant to Section 176(10) of the Companies’ Act of
1965 that permitted them to restructure their companies and debts.\(^\text{53}\)
Instead of restructuring, however, an increasing number of companies
filed winding-up petitions, and many were placed in receivership
administration.\(^\text{54}\) By the end of September 1999, CDRC made significant
progress in facilitating corporate debt workouts to ensure that viable
businesses temporarily facing liquidity problems continued to have access
to financing.\(^\text{55}\)

V. EXCHANGE CONTROL ACT OF 1953

To ensure that recovery measures taken by the government
operated smoothly and met the recovery objectives, the government of
Malaysia realized that the economy needed to be insulated from further
contagious effects arising from the financial crisis, such as further

\(^{49}\) *Chairman’s Statement for Year 1999 Operations*, Danamodal Nasional

\(^{50}\) *1999 White Paper*, supra note 6, pt. IV, under heading *Financial Sector
Restructuring*, ¶ 5.

\(^{51}\) *Introduction to the CDRC*, Corporate Debt Restructuring Committee, at
company to sit down together with creditors to workout arrangement acceptable to all
parties concerned. The arrangement is informal. It has no legal status and can be called
off by either side at any time.” *Id.* ¶ 2.

\(^{52}\) *Id.* ¶ 2.

\(^{53}\) *Id.* ¶ 1.

\(^{54}\) *Id.*

\(^{55}\) *See Status And Statistic of CDRC Cases*, Corporate Debt Restructuring
decreases in the exchange rate and the value of stocks in Malaysia.\textsuperscript{56} Accordingly, the Malaysian government implemented selective exchange control measures in September 1998.\textsuperscript{57} These controls covered convertibility of the Ringgit abroad, a moratorium on the outflow of capital and profit for twelve months, a pegging of the Ringgit at RM3.80 per U.S. dollar, and restrictions on exporting Malaysian currency.\textsuperscript{58} The exchange control measures have, to a certain extent, given Malaysia breathing space for reform activities.

The exchange control measure announced by the government on September 1, 1998 sought to curb the internationalization of the Ringgit and to regain monetary policy independence. The exchange control measure was, in fact, first introduced in Malaysia in 1953 and has been in place ever since. The Exchange Control Act of 1953 confers powers on government to impose duties and restrictions in relation to gold, currency, payments, securities, debts, and the import, export, transfer and settlement of property.\textsuperscript{59} As in 1953, the Act sought to ensure that the foreign currency earning of the country is brought back and the limited financial resource of the country is used for productively.

Since the introduction of the Exchange Control Act in 1953, the requirements of the Act were increasingly relaxed over time to keep pace with the changing economic environment prevailing in the domestic as well as the global level. In September 1998, the Act was re-introduced by Malaysia on a selective basis mainly to focus on achieving the national objectives, namely to eliminate the trading of the Ringgit in the offshore market in order to cut off the activities of currency speculators from destabilizing the Ringgit exchange rate.\textsuperscript{60} The exchange control policy is a selective measure because it concentrates only on three major components. The first component is to control the transfer of funds in the external accounts, so that no foreigners can borrow Ringgit for speculative activities in the currency markets overseas.\textsuperscript{61} The second component fixes

\textsuperscript{56} BANK NEGERA MALAYSIA, supra note 4, at 600-02.
\textsuperscript{57} 1999 White Paper, supra note 6, pt. IV, under heading Selective Exchange Controls, ¶ 2.
\textsuperscript{58} Id.
\textsuperscript{59} For more information on exchange control rules, see A Guide to Exchange Control Rates, at http://www.mir.com.my/lb/econ_plan/contents/press_release/bnegara.htm. The Exchange Control Act of 1953 made Bank Negara Malaysia responsible for administration of the Act, and named the Governor of Bank Negara Malaysia as Controller of Foreign Exchange, with the power to appoint other officers
\textsuperscript{60} 1999 White Paper, supra note 6, pt. IV, under heading Selective Exchange Controls, ¶ 5.
\textsuperscript{61} Id.
the exchange rate between the Ringgit and the U.S. dollar,\(^\text{62}\) so that there is stability and certainty of key parameters in the economy to support international trade and investment decisions. The last component introduced a 12-month rule to prevent excessive short-term capital flows, which can be highly destabilizing.\(^\text{63}\)

Though initially the selective exchange control seemed to be restrictive, the government has liberalized the controls from time to time to maximize efficiency. On February 15, 1999, as a result of stronger external reserves for the country, the government imposed a graduated exit levy system to replace the one-year holding period for portfolio funds.\(^\text{64}\) The graduated exit levy was a two-tier levy system that entailed a 30% levy on profit made and repatriated within a year, and a 10% levy on profit repatriated after one year.\(^\text{65}\) The government introduced the two-tier levy system to encourage foreign investors to take a long-term view of their portfolio investment in Malaysia. On September 21, 1999, however, the government introduced a flat exit levy system, because of the difficulty in computing prices and in determining the amount of levy applicable to foreign investment. Basically, capital is allowed to move in and out of the country freely, but the profit will be subjected to a flat repatriation levy of 10%. Since the financial condition has improved over time, Budget 2001 has abolished the 10% exit levy on repatriated profit after one year.\(^\text{66}\)

The Malaysian economy has responded relatively well to the recovery measures implemented by the government. After five consecutive quarters of negative growth, four in 1998 and one in 1999, economic growth has been positive, at 4.1% in the second quarter of 1999.\(^\text{67}\) The turnaround in the second quarter of 1999 was due to the impressive recovery of the manufacturing and agriculture sectors and, in terms of demand, the external sector and public expenditures.\(^\text{68}\) In the

\(^{62}\) Id. pt. IV, under heading Selective Exchange Controls, ¶ 8.

\(^{63}\) Id. pt. IV, under heading Selective Exchange Controls, ¶ 5.


\(^{65}\) Id.


\(^{68}\) Id. at 5-6.
third quarter of 1999, the economy performed remarkably well and recorded the highest rate of economic growth since the onset of the crisis in July 1997.\textsuperscript{69} The real GDP growth doubled from that in second quarter to 8.1\% on an annual basis.\textsuperscript{70} A low rate of inflation and improved employment opportunities accompanied the economic recovery. In the third quarter of 1999, inflation reached a low of 2.3\%, while the employment situation continued to improve, as reflected by the number of new jobs created (from 26,091 in the second quarter to 36,363).\textsuperscript{71}

In short, the government’s policy initiatives have brought about the desired impact. Nevertheless, vigorous efforts will continue to be made to support the recovery process, to ensure it is more broadly based, and to further strengthen the resilience of the economy.

VI. INDICATORS OF CRISIS

Malaysia was caught in a severe and prolonged regional currency crisis that swept across East Asia in 1997. Though Malaysia had a much stronger economic and financial position than its neighbors, foreign analysts and international fund managers placed Malaysia in the same category with the other countries in the region.\textsuperscript{72} The speed and severity of the contagion effects of the East Asian financial crisis demonstrated how closely the currency and stock markets of the region are interlinked. It also suggested how the political and economic circumstances of neighboring countries affect one another, although there is no clear reason why this should be so. In Malaysia, the central players in the crisis seem to be the financial intermediaries. The crisis was brought on by financial collapse. Preventing another round of crisis, therefore, requires the government to strengthen the domestic economic and financial system to reduce their vulnerability to external shocks. The effort of restructuring financial institutions to make them more competitive ensures that the Malaysian economy will emerge stronger and become more resilient to external development.

The outbreak of the crisis and the fact that so few predicted its occurrence emphasized the need for reforming the global financial system to more effectively accommodate unpredictable destabilizing developments. A more balanced, flexible, and well-managed international

\textsuperscript{69} Id. at 1.

\textsuperscript{70} Id.

\textsuperscript{71} Id. at 9.

\textsuperscript{72} BANK NEGERA MALAYSIA, supra note 4, at 559-60.
financial system requires reducing the possibility of the outbreak of contagious crises in the future.

Though Malaysia performed relatively well compared to its neighboring countries, there were some disturbing signs in the pre-crisis economy. To prevent potential crises in the future, these signs should be given particular attention. Malaysia’s breakneck growth, as demonstrated by its growth rate exceeding its potential output since 1991, tops the list of indicators that a crisis could occur. The output gap increased during 1994-96, as actual GDP grew faster than potential GDP. This gap generated price pressures, especially in the form of wage increases above productivity gains. Instead of improvements to efficiency, growth during this period was attained through augmenting input. Augmenting input, however, is unsustainable in the long run, because input is always of scarce supply. Henceforth, the Malaysian government should focus more on efforts to increase productivity in the economy such as enhancing research and development activity, and restructuring the education system to produce skilled workers who can keep pace with the dynamic environment.

Another important indicator is the loss of efficiency in the economy, such as efficiency in the utilization of resources indicated by estimates of Total Factor Productivity (TFP) and incremental capital-output ratio (ICOR). Computations of TFP growth showed that it had been declining over the years, as growth has been driven primarily by a high rate of capital stock accumulation. During 1995-97, the investment rate had been approximately 46% of GDP. The ICOR rose from 3.0% in 1988 to more than 6% in 1997. The steeply rising ICOR, especially during the last 3 years before the crisis, indicate that the use of capital has been increasing and has been used less efficiently. The decreasing efficiency led to lower production and lower returns and, thus, created problems for sustainable economic growth for the country. The rising ICOR in recent years has also been attributed to increasing investments into capital-intensive projects with long gestation periods, leakages, and initially underutilized capacity.

Third, rising current account deficits also warn about a potential crisis. The deficit in the current account corresponds to the saving-investment gap in the economy. Despite having one of the highest savings rates in the world, Malaysia ran into current account deficit problems because of its high investment rate. The investment boom led to the current account deficit and, when coupled with the declining efficiency in capital utilization, is a legitimate cause of concern, because the current account deficit has to be financed by capital inflows.

Finally, excessive credit expansion, especially to the non-tradable sectors since 1995, the period when the economy was enjoying its highest growth, also indicated a potential crisis. Most loans were used to purchase property, stocks, and shares, as well as other consumption items, rather than for investment purposes. As a result, following the rapid expansion of credit, private domestic debt increased significantly. The increasing rapid pace of loans indicated an unsustainable development in the domestic economy and, therefore, serves as a good indicator for the possibility of a crisis.

VII. CONCLUSION

The Malaysian economy has performed well at the beginning of the new millennium, with the GDP growth rate in January 2000 achieving its highest level for the first time since the crisis occurred in July 1997. The Kuala Lumpur Composite Index breached the 1000-point mark of the pre-crisis level in mid-February 2000. Unemployment level has been brought to the pre-crisis level, while inflation, averaging at 3%, was placed under control. The relatively quick recovery of the Malaysian economy from the crisis can largely be attributed to prudent government actions in tackling the problems and to more stable and promising international developments.
APPENDIX 1


The V-Shaped Recovery in Malaysia

Source: Malaysia, Ministry of Finance, ECONOMIC REPORT (various issues).
## Appendix 2:
### International Comparison of Economic Indicators, 1997 – 1999

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