Title: Malaysia and 1997 Asian Financial Crisis

This paper discusses the reasons why Malaysia was affected by the 1997 Asian Financial Crisis, its policies to manage the crisis and the post crisis recovery process.

Prior to 1997, SE Asia attracted huge capital inflow, spurring the rapid growth of these economies which had maintained high interest rates attractive to foreign investors and it led to a dramatic run-up in asset prices. Thailand, Indonesia and S.Korea had large private current account deficits and the maintenance of fixed exchange rates encouraged external borrowing and led to excessive exposure to foreign exchange risk. In the mid 1990s, with the increase in US interest rates, the value of the US dollar to which many nations' currencies were pegged was increased, thus making SE Asia's exports less competitive. At the same time, SE Asia's export growth slowed dramatically in 1996, deteriorating their current account position.

Malaysia entered the Asian financial crisis with relatively strong fundamentals in general[1]. However, Malaysia was vulnerable to turnarounds in general market sentiment. Malaysia had the world's highest stock market capitalization ratio (310% of GDP[2]). The rise in equity prices had in turn contributed to a domestic lending boom, leaving Malaysia in 1997 with a domestic debt-GDP ratio (170%) that was among the highest in the world. The ringgit was rising rapidly and was over-valued, interest rates were also rising. In line with the privatization efforts of bumiputra (state-owned companies) coupled with the government's encouragement to extend generous loans, it then led to poor performing loans. As a result, with low productivity and poor economic fundamentals, the stock market dropped drastically and the ringgit was subjected to rapid depreciation due to capital outflows.

[1] IIF (1998), debt to GDP Malaysia (0.39), compared to S.Korea (0.32) and Thailand (0.55)
[2] US (116%), Korea (29%)

Unlike the other affected countries, instead of going to the IMF, the Malaysian authorities imposed a cut in interest rates, followed by sweeping controls on capital-account transactions and fixing the exchange rate at RM3.80 to US$1[3]. It also embarked on a policy of reflation. These are however contrary to the macroeconomic practices advocated by IMF[4].

Although Malaysia has recovered from the crisis, however, the effectiveness of the orthodox policies adopted in the recovery is often a debate. It was often argued that the strict capital controls had curbed the speculative mood and the ringgit was stabilised for the recovery but the controls had restricted the flow of genuine direct investments needed to spur the economy. Also prior to 1997, then-DPM Anwar had also embarked on several economic restructuring policies such as privatization of state owned companies to improve efficiency which were reaping results by then.

It had been 10 years since the Financial Crisis. After the recovery, one major change adopted by Malaysia was the shift from fixed currency peg to managed floating rate to a basket of currencies in 2005. There are currently ongoing development projects such as IDR at Johor to promote infrastructure development for future economic growth. The regulatory controls on firms and banks have improved. These factors are favourable to Malaysia as they reduce the vulnerability to another similar financial crisis. However, there are risks involved, i.e state-owned companies like Malaysia Airlines and Proton are still facing inefficiencies and are in the red.

[3] a rate that represented a 10% appreciation relative to the level at which the ringgit had been trading immediately before the controls

[4] For example, the fixing of currency to USD was actually one of the major causes of the crisis and Malaysia moved from floating rate to fixed rate unlike all other countries. Also, the cut in interest rates is also risky as while a lowering of interest rates would stimulate aggregate demand to rise, there was also a chance that lowering interest rates would worsen the situation by stimulating capital flight through which speculators would borrow ringgit at the lower rates, and buy foreign currencies to bet against a further depreciation of the ringgit.

References

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