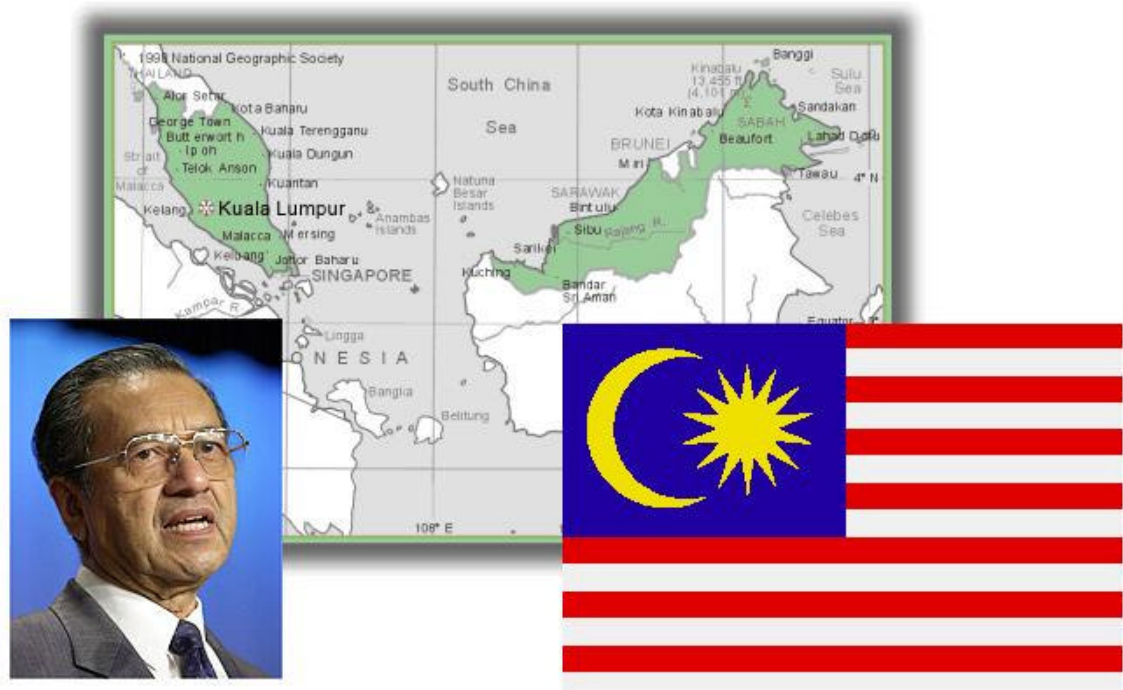


Malaysia

? An Asian Tiger's Lessons from the Crisis, and Future Steps?



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OVERVIEW

Malaysia was created in 1963 through the merging of Malaya (independent in 1957) and the former British Singapore (West Malaysia), and Sabah and Sarawak in north Borneo, (East Malaysia). The first three years of independence were marred by hostilities with Indonesia. Singapore separated from the union in 1965.

As an emerging economy Malaysia has been a success. From 1970 to the mid-1990s its investment ratio was among the highest in the Asian region. This increasing investment shifted the economy from agriculture and mining to manufacturing and production of high technology electronics equipment. Because initial development was financed with public money, by the early 1980s growth was accompanied by increasing budget deficits and public debt. Today, exports (technology, oil) dominate the economy, and agriculture contributes only 10% of GDP, making Malaysia unique among developing countries.

1997-1998 CRISIS¹

Despite relatively favorable financial conditions in Malaysia in 1997, panic in the Southeast Asia region resulted in the collapse of the Ringgit from 2.6 to the dollar in July 1997 to 4.7 in January 1998. The Kuala Lumpur equity index fell from approximately 1000 to 300 and non-performing loans in the banking sector climbed to over 12 percent. Unlike most crises in developing countries, Malaysia did not have a short-term debt problem, experienced no excessive capital outflow, and was never forced to drastically deplete Central Bank reserves. Instead, the main reason for the steep decline in the ringgit was currency speculation in the offshore market located in Singapore.

The Malaysian government took action against this type of destabilizing speculation by first limiting to \$2 million Malaysian bank currency swaps with non-residents in transactions unrelated to trade. The result, however, was a shift in borrowing to the Singapore offshore market (done purely for speculative purposes). The Malaysian government thus decided to make offshore ringgit transactions illegal in order to shut down the destabilizing Singapore market. In addition, measures were taken to prevent non-resident ownership of ringgit balances held abroad, making it impossible to settle ringgit contracts except through Malaysian banks in Malaysia. A final step toward insulating the domestic situation was the introduction of a fixed exchange rate (at 3.8 ringgit to the dollar).

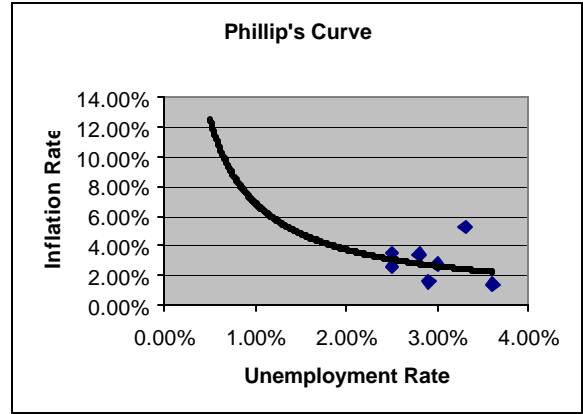
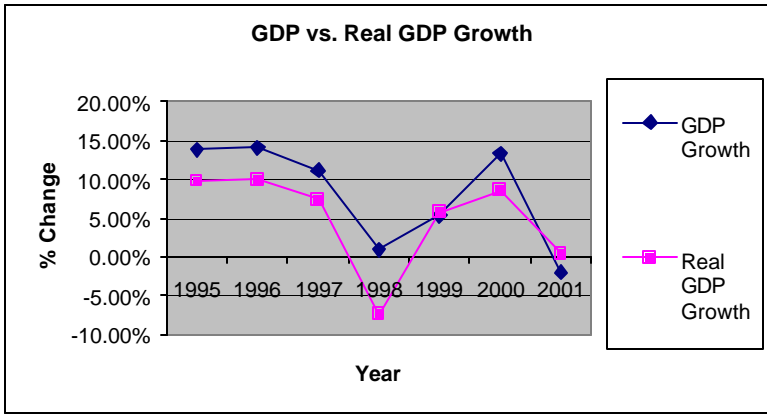
Malaysia's crisis response policies have generally been considered successful, and it is important to note that long term flows and FDI were not regulated, and the currency was always fully convertible for commercial transactions with Malaysian banks. Also important is that these measures were not introduced under emergency conditions to control capital outflows, or to support unsustainable macroeconomic policies. Instead, the crisis was allowed to run its course, and changes were made under relative post-crisis calm. Rapid recovery in Malaysia has allowed the progressive removal of crisis-control measures as early as February 1999. Their success was confirmed by the fact that very little capital outflow occurred when the last of the controls were lifted in September 1999, an amount that actually flowed back in during the first quarter of 2000.

CURRENT MACROECONOMIC SITUATION

GROWTH

With the exception of 1998, Malaysia has seen real GDP growth in each of the last seven years. In 2001, though, Malaysia experienced negative growth in nominal GDP, GDP/capita and real GDP/capita. The Ringgit's appreciation against regional currencies, coupled with the 2001 world recession resulted in decreased exports and caused this GDP decline.

¹ Adopted from UNCTAD's Trade and Development Report of 2000, "Malaysia: Rationale and Effects of Capital Controls," p. 54, available at: <http://www.unctad.org/en/docs/tdr00ch1&4.en.pdf>.

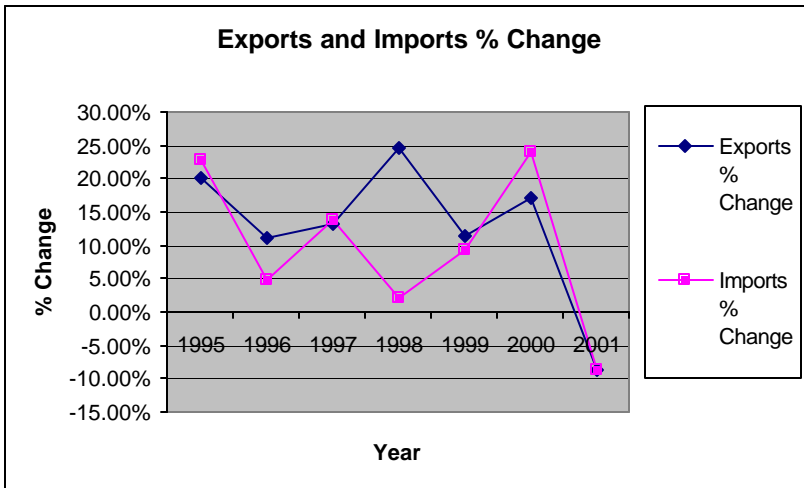


UNEMPLOYMENT & INFLATION

In 2001 Malaysia experienced its highest unemployment rate in seven years. Still, at 3.6%, its unemployment rate is not unwieldy. Inflation peaked in 1998 at 5.27%, and since then has steadily decreased. In 2001, Malaysia reached a seven year low of 1.4% inflation. Plotting Malaysian inflation rates against their corresponding unemployment rates, a trend line estimate of the Phillip's Curve illustrates a relatively small trade-off between inflation and unemployment. This Phillip's Curve estimate implies that monetary authority goals of limited inflation are in line with market expectations.

CURRENT ACCOUNT

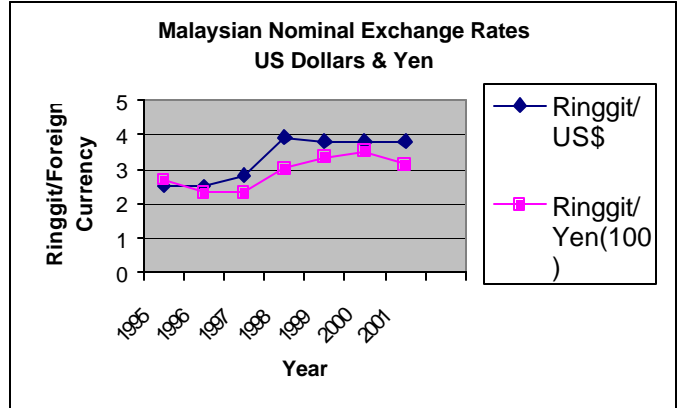
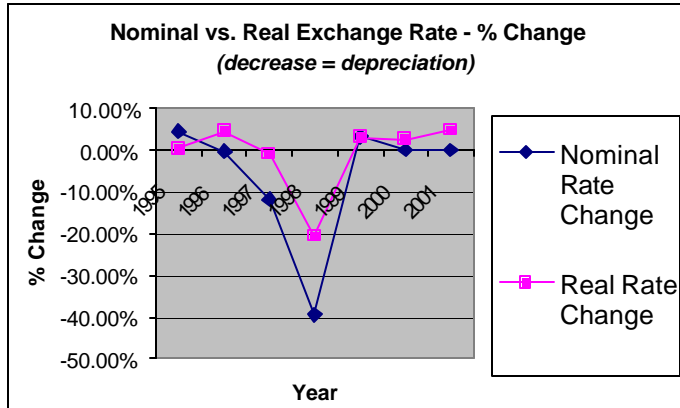
The current account has been in surplus since 1998 and net exports have been positive since 1996. Though positive, net exports have been fallen in 2000 and 2001. The depreciation in 1997 caused a large increase in exports (24.7%) in 1998, while imports grew a modest 2.1%. Exports increased in 1999 and 2000, but at a slower pace than in 1998. Imports during 1999 and 2000 grew at a faster pace than in 1998. In 2001 Malaysia experienced negative growth in both imports and exports (about -9%). Notice that imports decreased twice after the crisis, but for different reasons. The first import reduction was the result of a sharply depreciated Ringgit. The second import reduction was necessary to maintain positive net exports and sufficient foreign reserves.



EXCHANGE RATE

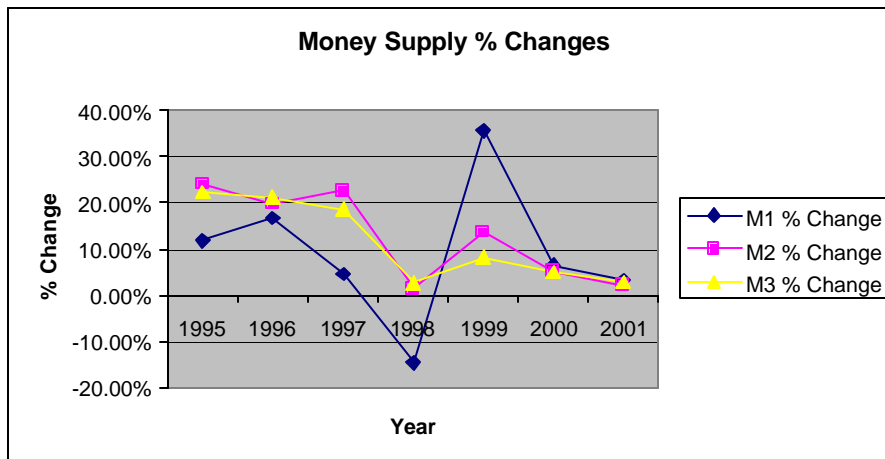
From 1996 to 1998, the Malaysian Ringgit depreciated against the U.S. Dollar. It appreciated in 1999, however, when Malaysia converted to a fixed exchange rate regime. Since then, the nominal exchange rate has remained fixed to the U.S. Dollar at 3.8 Ringgit/U.S. Dollar. While this nominal rate has remained unchanged since 1999, the Ringgit saw real appreciation against the US Dollar in 2000 and even greater real

appreciation in 2001. The Ringgit also appreciated against the Yen in 2001, creating a difficult environment for Malaysian exports.



MONEY SUPPLY

From 1995 to 2001, the money supply grew at a varied pace. In 1998, M1 actually shrank, only to grow by 35% in 1999. M2 and M3 saw steady decline in growth after 1997. Since 1999 M1, M2 and M3 have all grown, but by decreasing rates versus the previous year.



FOREIGN RESERVES

Foreign Reserves declined in 1997, increased sharply in 1998, but declined again in 2000. In 2001, Malaysia saw about a 3% increase in foreign reserves.

CURRENT PROBLEMS OF MALAYSIA

PROBLEM 1

Malaysian exports are heavily based on electronic equipment. The slowdown in the world economy has led to a decrease in exports.

PROBLEM 2

Malaysia's exchange rate regime pegs the Ringgit at 3.8R to the US dollar. Because it is fixed to the dollar, the Ringgit has been appreciating relative to other currencies in the Asian region, which are influenced by the depreciation of the Japanese Yen. The appreciated Malaysian currency has contributed to a decrease in exports, since Malaysia's export goods are more expensive in world markets.

ANALYSIS

The consequences of these problems are evident in Malaysia's macroeconomic data—GDP growth has sharply decreased since 2000 as a result of decreased exports.

In order to maintain its fixed exchange rate with the US Dollar, the Malaysian Central Bank must hold substantial foreign reserves (allowing it to back its currency in an exchange rate crisis). The existence of sufficient foreign reserves, then, is a necessary condition of a fixed exchanged rate.

Since the Malaysian government is currently holding sufficient foreign reserves, the fixed exchange rate regime is considered sustainable, at least in the short run. Malaysia has positive net exports and increasing foreign reserves, but decreasing imports and exports suggest that the fixed exchange rate regime could face challenges in the future.

Several developing countries have tried fixed exchange regimes to protect their currencies from excessive devaluation and speculative attack. This solution has proven useful in the short-run, but may prove more harmful to the economy in the very long-run.

Recent South American examples illustrate the problems that come with maintaining a fixed exchange regime in the long term. During one period in particular, both Brazil and Argentina pegged their currencies to the US dollar. When Brazil's economy began suffering under an overvalued currency, the government decided to give up on the fixed rate. The floating regime it adopted (with only limited Central Bank intervention) allowed Brazil to be more competitive in South America, while Argentina's fixed regime undermined the economy and led to its eventual collapse in 2002.

Fixed regimes are also vulnerable targets for speculation. For example, if the Ringgit were under depreciative pressure to the US dollar, the Central Bank would have to buy dollar denominated assets and sell Ringgit denominated assets in order to maintain the fixed exchange rate. Thus, sufficient (convincingly sufficient) foreign reserve is a requirement in a fixed exchanged system. Moreover, adopting a fixed exchange regime means giving up the ability to use independent monetary policy, since monetary policy in a fixed exchange regime is only used to maintain the exchange rate.

If the Ringgit starts depreciating against the US dollar, and the Malaysian central bank starts defensive operations, foreign reserves may be exhausted rapidly. Any economic downturn may challenge the future of the Malaysian fixed exchange rate regime.

RECOMMENDATIONS

Given the problems brought up by our analysis, we have three policy recommendations:

1. Gradually prepare its economy to adopt a floating exchange regime.

Step 1 - Malaysia should consider altering its exchange rate system away from the current peg (to the US dollar only), in favor of a peg combining a basket of currencies. Although Malaysia was able to limit the damage caused by the currency crisis through the imposition of a fixed exchange rate, this system may be harming the Malaysian economy. Reforming the fix regime by pegging to a basket of currencies (including trade competitors') helps preserve Malaysia's competitiveness on world markets. By including regional currencies, any pressure caused by US dollar strength will be offset by the currencies of Malaysia's neighbors.

Step 2 – Once the Malaysian economy stabilizes, a semi-fixed regime (crawling band, crawling peg, or fixed band) should be implemented.

Step 3 – Finally, Malaysia should look to adopt a floating exchange regime for the very long run.

Once a floating regime is instituted, Malaysia will not be forced to hold large foreign reserves ready to sustain the fixed or semi-fixed regimes. Foreign reserve monies can then be redirected toward investment in productivity and export diversification. In addition, monetary policy responses to eventual economic shocks will be made possible.

2. Maintain limited capital controls on Ringgit transactions.

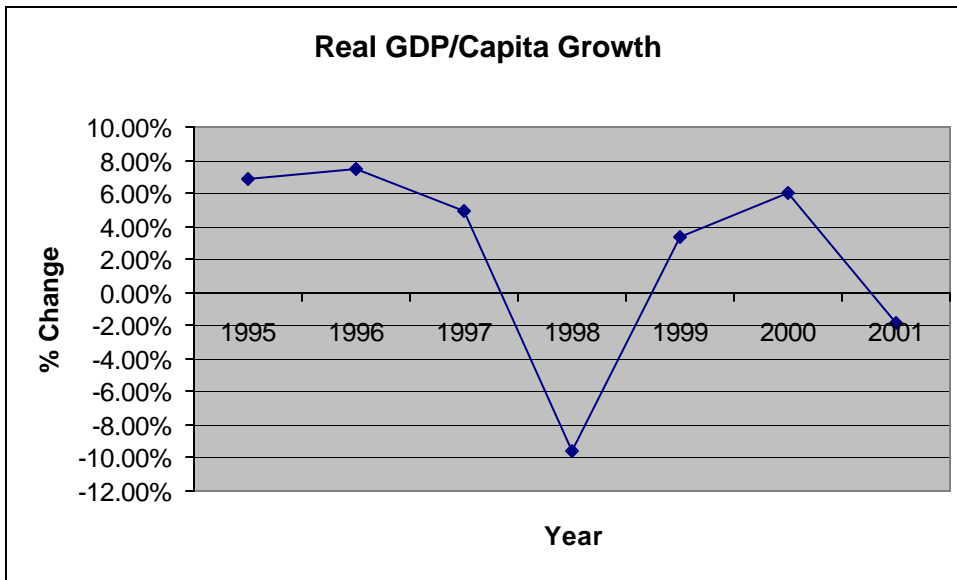
The capital controls Malaysia installed after the currency crisis were not grand in scope, but limited to transactions in the speculation market. Investment in hard currency was not restricted, nor was foreign direct investment. Its capital controls have proved effective in shielding Malaysia from speculative attacks without substantially inhibiting foreign direct investment. This kind of limited capital control to protect the local currency from speculative attacks should continue in Malaysia—with or without IMF support.

3. Diversify Malaysian exports.

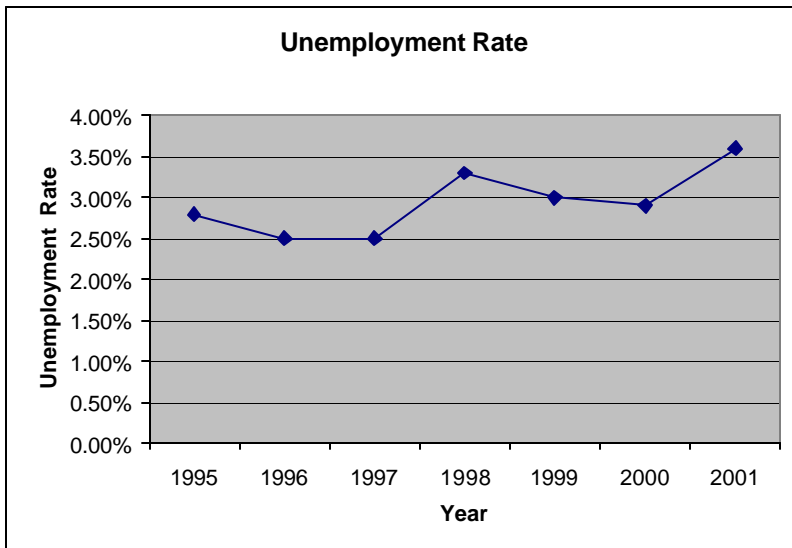
Economic prosperity and stability can hardly be achieved by financial policy alone—policies affecting the fundamentals are also required. Malaysia has made several public investments that may not help improve productivity. Examples of such investments include large highways and luxurious towers. While these investments may improve lifestyles, they do not improve productivity. Capital should be directed to projects that contribute to the diversification of exports and higher worker productivity (health and education). In particular, domestic food production should be encouraged so Malaysians will not be held captive by a depreciated currency and their need for basic foodstuffs.

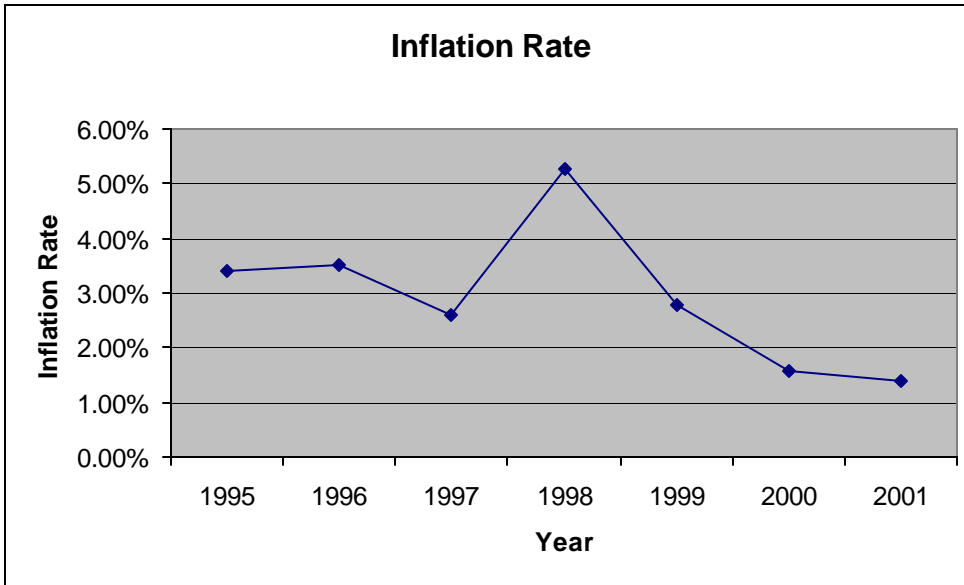
Appendix

Output & Population Growth							
	1995	1996	1997	1998	1999	2000	2001
GDP Growth	13.82%	14.05%	11.10%	0.92%	5.34%	13.27%	-1.99%
Real GDP Growth	9.77%	10.00%	7.36%	-7.37%	5.76%	8.56%	0.43%
GDP/Capita Growth	10.74%	11.36%	8.58%	-1.45%	2.88%	10.59%	-4.22%
Real GDP/Capita Growth	6.85%	7.40%	4.89%	-9.54%	3.33%	5.98%	-1.84%
Population Growth Rate	2.78%	2.42%	2.31%	2.40%	2.39%	2.42%	2.32%



Unemployment & Inflation							
	1995	1996	1997	1998	1999	2000	2001
Inflation Rate	3.41%	3.50%	2.61%	5.27%	2.77%	1.57%	1.40%
Unemployment Rate	2.80%	2.50%	2.50%	3.30%	3.00%	2.90%	3.60%

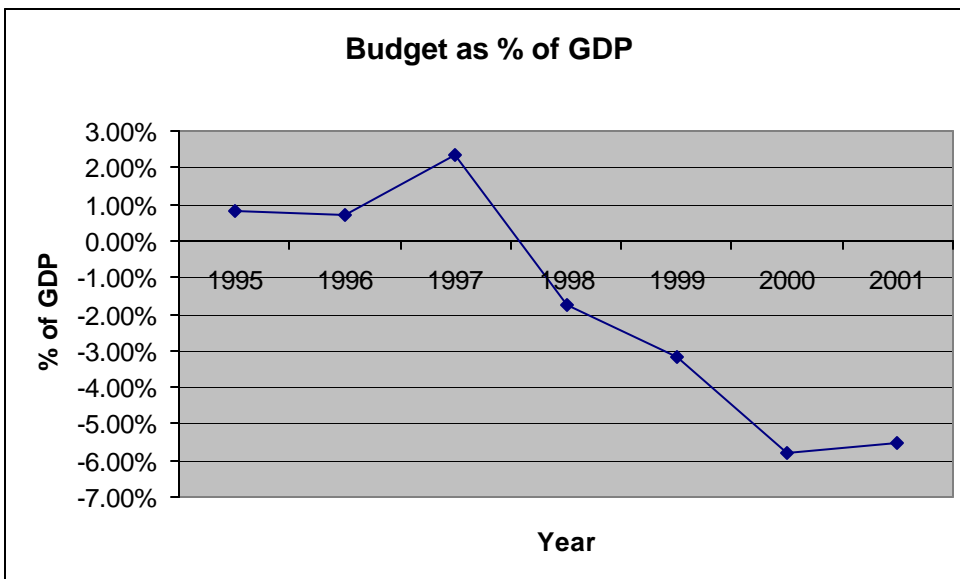




GOVERNMENT FINANCE & DEBT

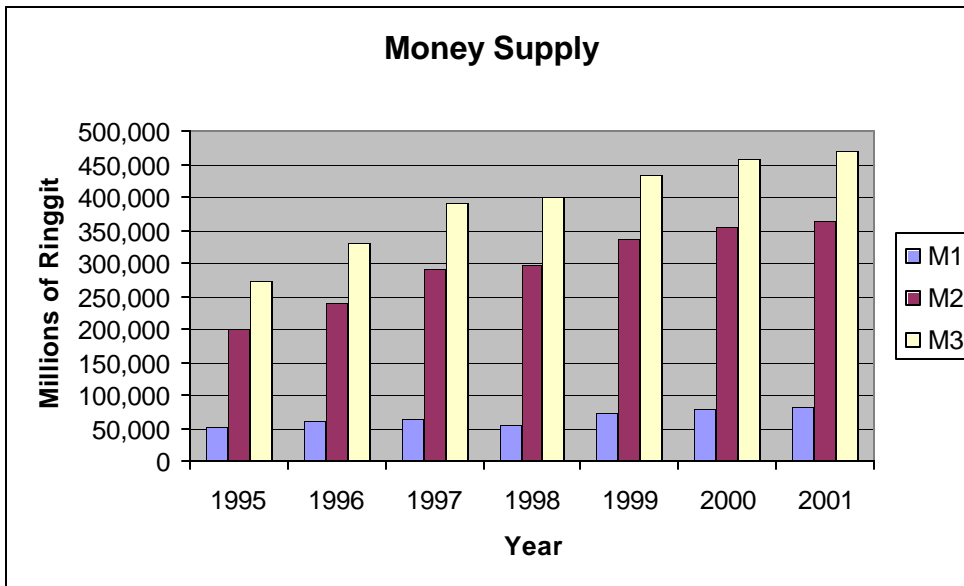
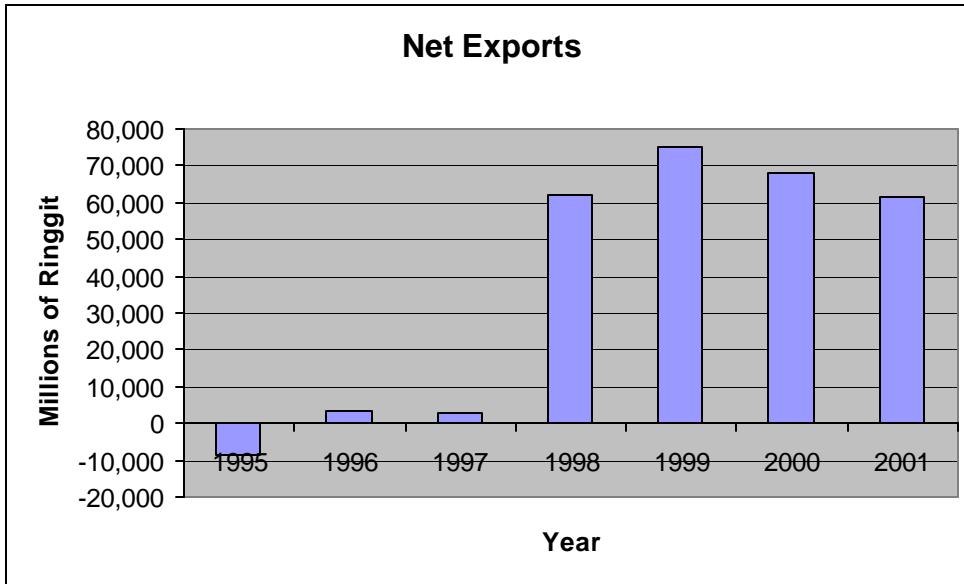
Malaysia was in budget surplus until 1998, when its revenues declined and expenditures increased. Malaysia budget deficit has grown from 1.76% of its GDP in 1998 to 5.54% of its GDP in 2001. In 2001 Malaysia narrowly reduced its budget deficit compared to 2000. Malaysia's total government debt is almost 44% of its GDP. This number has increased steadily since 1997 and is above even its 1995 level.

Government Finance & Debt							
	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>
Budget Deficit/Surplus % of GDP	0.84%	0.72%	2.35%	-1.76%	-3.17%	-5.81%	-5.54%
Gov't Revenue % Change	3.01%	14.38%	12.80%	-13.73%	3.46%	5.44%	28.62%
Gov't Expenditure % Change	9.00%	15.01%	4.68%	2.14%	12.98%	19.60%	20.12%
Total Debt as % of GDP	41.07%	35.35%	31.90%	36.25%	37.42%	37.01%	43.82%



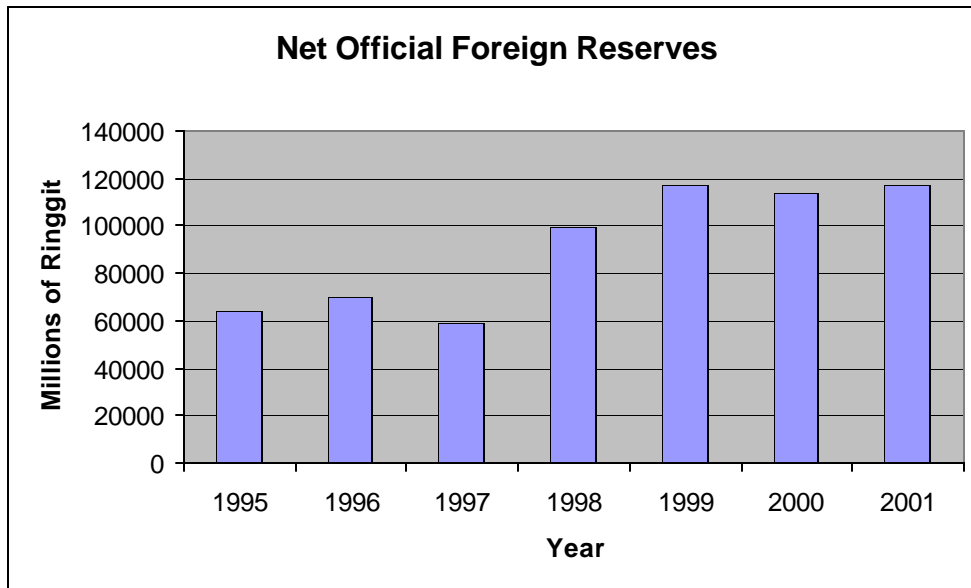
The Current Account

	1995	1996	1997	1998	1999	2000	2001
Current Account	-8,644	-4,462	-5,935	9,529	12,606	31,958	27,407
Net Exports	-8,754	3,516	2,575	62,300	75,292	68,000	61,491
Net Exports % Change	-179.32%	140.16%	-26.76%	2319.42%	20.85%	-9.68%	-9.57%
Exports % Change	20.12%	11.01%	13.14%	24.71%	11.46%	17.01%	-8.82%
Imports % Change	22.94%	4.94%	13.75%	2.01%	9.25%	23.94%	-8.68%

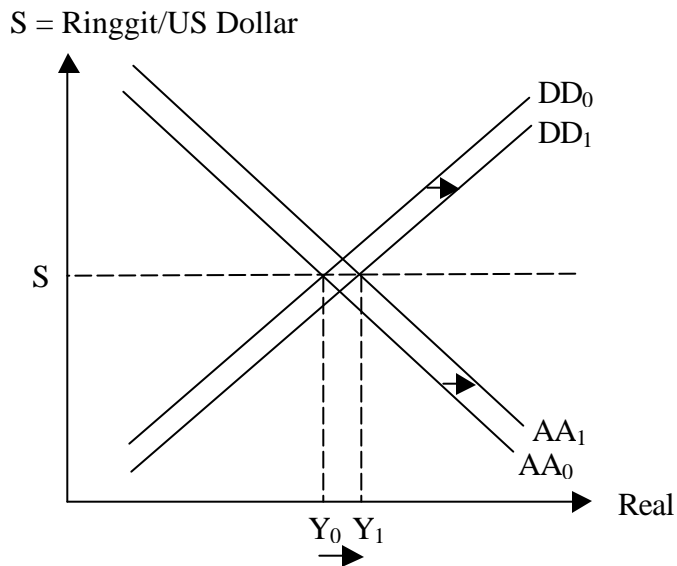


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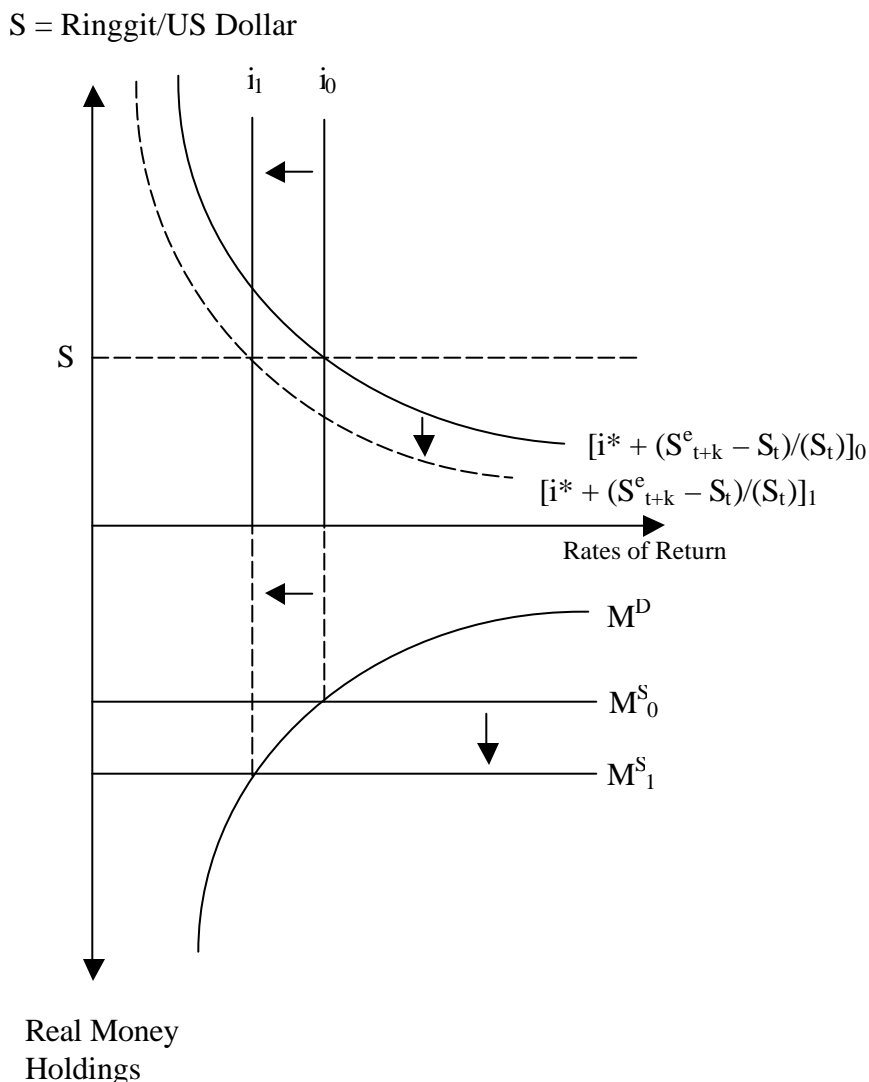


DD-AA DIAGRAM – MALAYSIA 2001



- The large increase in government expenditures (+16,410 M Ringgit) was bigger than the decrease in net exports (-6,509 M Ringgit). This is represented by a shift out of the DD curve.
- The money supply also increased moderately (3.23 % M1), causing the AA curve to shift out.
- These moderate shifts of the DD and AA curve caused a small increase in real GDP (0.43%).
- Of course, under the fixed regime, the spot exchange rate remains unchanged.

TWO-QUADRANT DIAGRAM – MALAYSIA 2001



- Since the Ringgit is fixed to the US Dollar, Malaysia must keep S constant.
- When US interest rates decline (from i^*_0 to i^*_1) as they have in 2000 and 2001, Malaysian interest rates must also decline to keep S constant.
- Malaysia achieves a reduction in its interest rate by increasing its money supply.
- Since Malaysia has been increasing its money supply and its interest rates have also declined, this theory is consistent with the data we observe.