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Painful `liberalisation'

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LAST Tuesday, Prime Minister Datuk Seri Dr Mahathir Mohamad announced controls to stop offshore trading of the ringgit as well as a determinedly fixed ringgit exchange rate.

These measures, complementing the National Economic Recovery Plan (NERP) announced on July 21, form a comprehensive package to steer the country out of the economic maelstrom it is in.

They are aimed at improving an economy which has suffered since July last year. The crisis was brought to Malaysia by a `contagion' effect, which was characterised by investor's nervousness when the region's currencies were attacked by speculators.

This resulted in a sudden withdrawal of foreign short term funds, resulting in a gross undervaluation of our exchange rate.

The damage has been severe. From a high of 1,271 points in Feb 25 last year, the Kuala Lumpur Stock Exchange (KLSE) Composite Index (CI) plunged to a low of 262.70 on Sept 1 this year, a fall of 1008.3 points or 79.3 per cent. The ringgit, too, depreciated from RM2.50 to the US dollar to fluctuations reaching over RM4.

The effects of the declines are beginning to show. Businesses are suffering, workers have been laid off or are receiving smaller pay-packets, a situation made worse with the steep rise in the prices of imported goods.

The implications are obvious: each of us has a stake in ensuring the success of these measures. If they fail, we lose our jobs, our spending power, all that we have spent so much effort building up.

But the sad fact is that apart from the economists, policy-makers, academicians and those who deal with economic and financial matters, the rest of us still have a poor understanding of the nature of the crisis, what's being done, what's at stake, and what we, as Malaysians, can do.

In a series of economic conferences and seminars held last month, the panels of speakers agreed on the importance of all Malaysians understanding the nature and root causes of the crisis in order to understand the why such remedial measures are being implemented.

And the problem, according to Third World Network director Martin Khor, is financial liberalisation, which results in volatility when foreign short term capital suddenly in and out of a country.

Developing countries like Malaysia possess massive potential. However, many lack the capital needed for growth, thus the need for foreign funds.

"As a result, many developing countries carried out financial liberalisation and deregulation."

This facilitated the flow of capital into the developing economies. These funds come in three forms: foreign direct investment (or FDI, where investors set up factories and other long-term facilities. The most desirable is "greenfield FDI", where the capital is used to develop new capabilities); loans (when local companies borrow from foreign banks and financial institutions); and most notably through portfolio investments (when foreigners buy local shares).

According to figures by the Bank of International Settlements, a huge capital inflow occurred in developing Asian economies as a result of financial liberalisation.

From 1994-1996, it was US\$184 billion, with US\$94 billion in 1996 and US\$70 billion in the first half of 1997. At its peak, a daily US\$2

trillion crossed borders worldwide before the crisis set in.

But only one or two per cent of this money went into foreign direct investment. "The bulk went into speculative short-term investments," said Khor.

Bank Negara's 1997 Annual Report indicates that large amounts of short-term foreign funds entered the KLSE in 1992 and 1993, pushing KLSE capitalisation to 375 per cent of Gross Domestic Product (GDP, or the total flow of goods and services produced by the economy) at end 1993.

Furthermore, spurred by low interest rates, the private sector was borrowing heavily from abroad.

Analysts had put the ratio of the banking system's lending to the Gross National Product (GNP, or GDP plus income earned from investments abroad) just before the crisis at about 150 per cent.

"The problem with this sort of capital," added Khor, "is that it can move very quickly when the speculators' or investors' perceptions change."

This sets the mood for the currency attack, which was exactly what happened when the crisis first broke in July 1997.

Sensing that the region's currency was overvalued, currency speculators led by market leaders like George Soros went in for the kill. They started with Thailand.

"What speculators do is 'shock' a currency", explained Khor. "They will borrow massive amounts of local currency and agree to pay back in US currency. When the value of the local currency falls, the speculators now have to pay back in less US dollars. This is how they make their profit."

When the operational leaders like Soros did this, others followed, dumping massive amounts of Thai baht. "This is what you call the 'herd instinct', in which a market opinion or operational leader starts to pull out, and triggers a panic withdrawal by large institutional investors and players," said Khor.

Investors, panicking at these developments, lost confidence in the region. They flocked out of the stock markets, dumping their shares for payment in a depreciated local currency, which they sold off, making the drop even worse.

Overall, according to Khor, US\$102 billion in capital left the Asian region in the second half of 1997 as a result of the crisis.

"The short term speculative capital surged in, then herded out," said Khor. "In the case of East Asia, although there were grounds to believe that some of the currencies were overvalued, there was an over-reaction by the market, and consequently an 'over shooting' downwards of these currencies beyond what was justifiable by fundamentals."

In this respect, he asks what we have really gained from this whole thing called financial liberalisation.

Universiti Malaya economics professor Dr K.S. Jomo pointed out that the crisis has demonstrated that what happens to the financial sector is becoming increasingly unconnected to the real economy.

"The economy can be growing reasonably well, but the financial indices, the stock market index, will be doing quite badly. Or you could have a relatively low rate of growth, but your stock market indices will be doing quite well. This kind of disjuncture is increasingly possible in today's globalised economy," he said.

When a developing country carries out financial liberalisation before its institutions or knowledge base is prepared to deal with the consequences, it opens itself up to the possibility of tremendous shocks and instability associated with inflows and outflows of funds. "For Asia to get out, we need to reduce deregulation and liberalisation."

Which is what the recent measures outlined by the Prime Minister aim to do. By making the ringgit valueless overseas, speculators would be starved

of the funds they need to mount attacks.

Determining a fixed rate for the ringgit will help in limiting violent fluctuations. More importantly, the ruling that the ringgit obtained from shares transactions by foreigners remains in the country for at least a year would help curtail short-term capital flights.

The results of these measures may not be felt any time soon. All the experts generally agree that monetary and exchange rate policies often take six to 18 months to be fully felt.

But as Special Functions Minister Tun Daim Zainuddin pointed out, "Now is the time for unity of purpose - all else will have to take second place in the interest of the nation."

Therefore, although these measures may be seen as radical, even extreme, by some, more importantly, the country leaders feel they are workable and necessary. We must understand why these measures have been adopted, understand their implications, and work hard for their success.

What's at stake is nothing less than our jobs, our livelihood and our children's future.

In short, it's nothing less than our continued survival.

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