When stability is vital for growth

NST 23-8-2000

NO one seemed to understand what was happening and why the ringgit was depreciating against the US dollar. Prime Minister Datuk Seri Dr Mahathir Mohamad explains why and how this happened.

WHEN, in July 1997, the Malaysian ringgit came under speculative attack, the Government was totally unprepared to deal with the turmoil which ensued.

No one seemed to understand what was happening and why the ringgit was depreciating so rapidly against the US dollar.

For a long time the ringgit had been trading at around 2.50 against the US Dollar and the trading range was narrow and reasonable.

The ringgit was considered a strong and stable currency. Some, in fact, felt it was slightly undervalued.

The Government did not officially peg the ringgit to the US dollar. The rate of 2.50 per US dollar and the narrow trading range around it were determined apparently by the market.

Any volatility in the exchange rate was easily moderated by the Central Bank (Bank Negara) through minimal intervention and such interventions were few and far between.

The Malaysian Government had always believed in the importance of stability in all sectors, and the ringgit exchange rate was no exception. Stability is vital for development and growth and for the business sector to manage their businesses successfully.

The Government wants to see businesses profitable because it has a 28 per cent stake in the profits made through corporate tax.

The ringgit's exchange rate was also generally stable against the regional currencies.

Against the currencies of two of Malaysia's neighbours, Thailand and the Philippines, the ringgit was stable at one Ringgit to 10 Thai baht and one Ringgit to 10 Philippines peso.

The ringgit did appreciate against the Indonesian rupiah but this was due to the rupiah's weakness against most currencies, including the ringgit.

The Thai Baht, unlike the ringgit, was fixed by the Thai Government at about 25 baht against the US dollar.

Since the baht rate against the ringgit was steady at 10, there was a wrong perception among some that the ringgit was also pegged against the US dollar at 2.50.

On the back of the currency stability (at 2.50 against the US dollar) Malaysia was doing very well.

At the end of 1996, real GDP grew at almost 8.5 per cent per annum for 10 consecutive years and it looked like this rate of growth was going to continue for many more years.

'The Malaysian Government had always believed in the importance of stability in all sectors, and the ringgit exchange rate was no exception. Stability is vital for development and growth and for the business sector to manage their businesses successfully'

By 1997 total external trade reached more than US$158 billion, making Malaysia according to the World Trade Organisation, the 18th biggest exporting nation and the 17th biggest importing nation in the world.

The Government was enjoying a fiscal surplus. The external debt was generally low, at 40 per cent of GNP.

The current account of the balance of payments had narrowed from a deficit of 10 per cent to five per cent of GNP, and was expected to improve further. Inflation was at its lowest at 2.1 per cent.

On the financial front, the banking system was sound as reflected in the strong capitalisation and the high asset quality.

The average risk-weighted capital ratio (RWCR) of the banking system was more than 10 per cent, compared to the minimum international standard of eight per cent.

Non-performing loans, even using the stringent three-month classification, was only 3.6 per cent of total loans outstanding.

The banking system was already subject to strict international prudential standards. Almost all the 25 Core Principles for Effective Banking Supervision recommended by the Bank for International Settlement (BIS) had been adopted.

Malaysia's savings rate, at 38 per cent of GDP, was one of the highest in the world.

The national savings was sufficient to finance 95 per cent of total investment outlays. Given the happy environment, the thought of revaluing or devaluing the ringgit never occurred to the Government. Malaysia was therefore content to allow the market to determine the exchange rate.

With a rock steady economy, political stability and strong business friendly Government, Malaysia believed that the market would not destabilise the ringgit exchange rate.

Fair distribution of wealth

Since 1970, Malaysia was actively restructuring its economy in order to give every community a fair share in the wealth of the country.

The New Economic Policy had been in place since 1970 and had been followed by the National Development Policy.

The NDP was intended to further balance the economic well-being of the different communities, this time with emphasis more on quality then quantity.

The privatisation policy had resulted in catapulting a core of Bumiputera or indigenous people into the realm of big business.

Many of them were doing well. Over time, we were confident that more Bumiputera would be elevated to this level of business.

True, there were some foreigners, a few disgruntled non-Bumiputera Malaysians and some Malay socialist politicians who suggested that the New Economic Policy only benefited a few friends and family members of the Government but few took this allegation seriously.

The Malaysian Government is avowedly business-friendly. We think that a business-friendly approach is good for economic development and for increasing the Government's revenue.

Western commentators, who dismiss the Malaysian policies and practices as crony capitalism, miss the financial rationale for cooperation, for long term reciprocal relations between firms, banks and the Government in a system which intermediates high savings into high corporate debt/equity ratio.

A Government, which is business-friendly, cannot help but know all the members of the business community.

We knew who was good and who was not. When bids were made for contracts or for the privatisation of Government entities, the Government could not just look at the proposals without looking at the track records of the proposers.

In any case, whatever the criteria, in the end only one bidder would win. Labelling anyone who won as a crony of the Government placed the Government in a no-win situation, since whatever decision that it made would be considered wrong, as the winner whoever he might be, would, by definition, be branded a crony.

Unlike other countries, Malaysia did not need to sell off Government assets to foreigners to raise foreign exchange to pay external debts. Therefore, in Malaysia's privatisation programme, Government entities were sold to Malaysians, particularly to Bumiputera, so as to help them make a quick entry into big business.

Foreigners were allowed only a minority share in the privatised companies.

Given the tremendous potential for profits from privatisation, foreigners were naturally frustrated and unhappy at not getting the lion's share.

Their accusation that the Malaysian Government was playing favourites was to be expected, and the Government's refusal to take notice of this criticism should be understandable.

No one would deny that there had always been some corruption in Malaysia, but the practice was neither widespread nor blatant. Officers and politicians caught for corruption were charged and punished under the relevant provisions of the laws.

Corruption in Malaysia had never been such that development or investments were hampered.

Foreigners know that they could get their approvals in reasonable time with few hassles.

In fact, Malaysia's high rate of growth is the best testimony to the low level of corruption, since in countries where corruption is rife, development, investments, and growth would be very slow. Foreign direct investment in Malaysia was one of the highest in the world.

'In fact, Malaysia's high rate of growth is the best testimony to the low level of corruption, since in countries where corruption is rife, development, investments, and growth would be very slow. Foreign direct investment in Malaysia was one of the highest in the world.'

In many instances the companies expanded and invested repeatedly. They would have gone elsewhere if the Government was corrupt or practiced cronyism.

They knew very well that had corruption and cronyism been rife, they would have to give free shares in their enterprises to selected personalities.

It was not so in Malaysia when many foreign direct investment were wholly foreign-owned, often getting their tax-free licences in less than one week.

The management of Malaysia's finance was applauded by the International Monetary Fund as late as the second quarter of 1997.

Although Malaysia had launched several big infrastructure projects costing billions of ringgit, there was no noticeable increase in foreign borrowings.

Malaysia was able to finance most of these projects from domestic sources. The Government's external borrowings were low and in many instances Malaysia even prepaid its foreign loans.

There was, therefore, no pressure on the Government to stop large projects even during the turmoil due to problems in servicing external loans.

On the contrary, foreign banks were always anxious to lend more money to the Malaysian Government before the turmoil, considering Malaysia as highly creditworthy.

The Malaysian private sector was also free from large external debts. Given that the Malaysian financial system was flush with liquidity which meant low interest rates, the major portion of the private

□ PLEASE TURN TO PAGE 16, COL 1

'Malaysia not a candidate for turmoil'

☐ FROM PAGE 14

sector's financing needs were met through domestic borrowings.

The liquidity situation was so strong that even the FDIs were borrowing a significant portion of their capital needs from local sources.

The external reserves were maintained at a high level, capable of financing more than four months of retained imports.

This high level of external reserves meant that all of Malaysia's import requirements, whether for capital goods, intermediate goods or consumption goods, could be met without resorting to external borrowings.

All in all, at the end of June 1997, the financial situation in Malaysia was very sound. It was certainly not a candidate for financial or economic turmoil.

Thai strategy fails

When the Baht was attacked in 1997, Malaysia was not unduly worried. We knew that the Malaysian financial situation was much healthier than that of Thailand.

In the case of Thailand, the residents had been borrowing large amounts of short-term offshore funds to finance long-term domestic projects.

This strategy made sense to them since the interest rate of the US dollar was much lower than the baht interest rate.

However, this strategy depended entirely on the assumption of a stable baht exchange rate against the US dollar.

The attack on the baht forced the Central Bank to go off the dollar peg and to let the market determine the rate. Immediately the baht was repeatedly devalued.

It was for this reason that the Thai Central Bank tried to defend the bath during the initial stages of the speculative attack on the currency.

The Thai Central Bank knew that once the peg goes, large companies with heavy external borrowings would suffer substantial currency losses. This is bound to cause a sharp downturn in the economy.

The Central Bank tried very hard to intervene in the foreign exchange market to support the Baht, but it failed. The Government then decided to float the Baht and immediately the Baht went into a free fall.

Malaysia promised to help Thailand overcome its financial crisis with a loan of US$1 billion (RM3.8 billion) of which US$862 million was quickly disbursed. Such was the confidence of Malaysia that it would not be affected by the Thai currency crisis, that it was even willing to provide financial assistance to its neighbour.

A month or so later, i.e. in July 1997, there were ominous talks of contagion. We were told that if the Thai baht fell, then the Ringgit would fall too.

Why? Well, the fortunes of currencies are infectious, it seems.

According to this "logic", if the baht falls, the production cost in Thailand would be cheaper than in Malaysia.

To counter this, Malaysia must devalue. And so the currency traders moved in, ahead of the "expected" devaluation, to short sell the ringgit which had not been officially pegged to the dollar.

The result was rapid trading which induced devaluation. There could have been a little devaluation due to contagion, but it would not have been so rapid and severe.

The steep fall in the ringgit exchange rate against the US dollar and other currencies was due to the currency traders' short-selling activities.

A currency has no sensors and cannot possibly know that other currencies are sick. Neither can currencies know that the Government is corrupt or practices cronyism. Currencies cannot depreciate themselves.

The currency traders depreciate the currencies, not because they fear the currency they hold would depreciate and they would lose their money, but because they see profit in shorting the currencies. Greed, rather than fear, was the motivating factor.

Feeling helpless

The currency manipulators with large amounts of borrowed funds were not interested in recognising Malaysia's strength.

They decided to make a profit on the back of this nebulous concept of "contagion". When the crisis hit Thailand, Malaysia's strong economic fundamentals were totally ignored by the market participants.

It was the refusal on their part to recognise the important differences that existed among regional economies that caused the so-called contagion to spread rapidly.

Despite stronger fundamentals, the waves of speculation on the ringgit exchange rate caused it to depreciate sharply against the US Dollar.

Then the short-term investors in the share market pulled out their capital and caused share prices to fall rapidly, aggravating the economic turmoil through rapid falls in market capitalisation.

'Malaysia promised to help Thailand overcome its financial crisis with a loan of US$1 billion (RM3.8 billion) of which US$862 million was quickly disbursed. Such was the confidence of Malaysia that it would not be affected by the Thai currency crisis, that it was even willing to provide financial assistance to its neighbour'

When the ringgit began to depreciate against the US dollar, Bank Negara initially intervened to support the ringgit, but quickly stopped intervening as it realised it was up against forces with very much superior resources.

Defending the ringgit could result in a serious depletion of foreign exchange reserves and this would undermine further the value of the ringgit.

The free fall, which could follow, would spell economic and financial disaster for the country.

The leadership of the country felt helpless. They correctly identified the currency traders as the culprits behind the depreciation of the ringgit.

As can be expected, Malaysian leaders condemned the currency traders for the rogues that they were. The Malaysian leaders were in turn condemned by about everyone, from the managers of international agencies to self-proclaimed experts and currency traders.

All these people maintained, at that time, that the cause of the currency devaluation was bad governance and all that was required to restore confidence and ensure recovery of the currency value and the economy was to replace bad governance with good governance.

They completely absolved the currency traders from any responsibility for the problems faced by the former economic tiger. These experts were convinced that the turmoil was temporary.

The Malaysian leaders were told that they knew nothing about International finance, herd instincts etc.

The Prime Minister was described as a menace to his country.

The currency traders saw themselves as powerful forces in the market and did not take kindly to criticisms of themselves.

They claim to be doing a duty to discipline recalcitrant and erring Governments. Every time they were criticised by the Malaysians, particularly the Prime Minister, they depressed the value of the ringgit further, along with those of other East Asian currencies.

The condemnation of the Malaysian leadership became widespread. At one stage, other East Asian leaders were urged to condemn the Malaysian leader, who had accused the currency traders of currency manipulation.

They claim that the Malaysian leader, with his loud mouth, was bringing down not only the value of the ringgit, but also the value of all East Asian currencies.

Leaders of the tiger economies of East Asia, therefore, dissociated themselves from the views of the Malaysian leader. Malaysia was fast becoming a *pariah* nation, to be avoided by everyone.

Currency traders

However, not criticising the currency traders did not spare the other East Asian leaders from having their currencies devalued.

It appeared that the future of the East Asian Tigers was in the hands of the currency speculators.

They were all going to go into an economic and financial free fall which could only be stopped if they handed over the governance of their countries' finance and economy to foreigners, specifically the IMF.

There would be no more independent Tigers and Dragons in East Asia. The 21st century was not going to be the Asian Century.

Many chose to call in the IMF. The loans the IMF gave and the reforms proposed by it were supposed to ensure recovery.

Malaysia, however, very early on saw the danger in resorting to the IMF for financial help. We were not willing to surrender the management of our economy to the IMF.

We believed the IMF did not understand local conditions, and that the problems of different countries were not the same and would not benefit from the same remedy.

More than any other country, Malaysia needed to have control over its economy. Malaysia's economic focus was not only on GDP growth, but also the distributive aspects of growth.

We wanted growth with equity, i.e. all the communities in Malaysia must enjoy equitably the economic wealth of the country.

Malaysia was involved in a very complex socio-economic restructuring. In the hands of the IMF, the need for equitable distribution of economic wealth between the races would not receive the attention that was needed.

Merely recovering would not be enough for Malaysia. Recovery must be accompanied by the equitable distribution of the economic pie between the Bumiputera and the non-Bumiputera.

A plan for recovery

Failure to do so could result in the kind of race riots which broke out in May 1969. What good would recovery do if the whole country is thrown into perpetual political turmoil and race riots?

There was no way Malaysia would surrender its economy to the IMF, even if that was the only way for the country to achieve economic recovery.

Malaysia had to find its own solution to the problems of the devaluation of the ringgit and the shrinkage in market capitalisation which could lead to the destruction of its economy.

Hence, Malaysian leaders had to rack their brains to find an alternative solution.

One of the factors which led to Malaysia's rapid growth is its ability to innovate, to plan and to implement its plans effectively.

Malaysia had regular five-year plans, long-term 20-year perspective plans and even a 30-year Vision of the future.

These were not idle dreams but were clear and practical road maps, which were all seriously implemented.

It is this ability to plan innovatively and implement the plan on a practical and pragmatic basis that enabled Malaysia with its multiracial population and serious inter-racial disparities to become stable and to achieve remarkable economic development.

Faced with the traumatic race riots of May 1969, Malaysia set up a National Action Council which devised and implemented the New Economic Policy for growth with equity.

To speed up growth, Malaysia conceived the idea of Malaysia Incorporated and very early on discarded State ownership in favour

☐ PLEASE TURN TO PAGE 17, COL 1

Rich pickings for foreign capitalists

☐ FROM PAGE 16

of privatisation.

Now faced with the economic and financial turmoil caused by external forces not within its control, Malaysia came up with the National Economic Recovery Plan, and set up a National Economic Action Council (NEAC).

Opposition leaders were brought into the NEAC. Regular briefings and discussions threw up ideas on how to manage the turmoil.

Meanwhile the currency continued to be subject to speculative attacks and kept depreciating. Despite short selling being disallowed by the Kuala Lumpur Stock Exchange, the price of the Malaysian shares continued to plunge, resulting in margin calls by banks and an increase in non-performing loans.

'Everyone was gleefully predicting that the time was near for Malaysia to go to the IMF for help and to surrender economic control to the IMF. Malaysia, it was felt, had no choice but to open up its economy to foreigners without conditions'

Policies that made situation worse

The foreign media gleefully reported the rapid devaluation of the ringgit and the steep plunge in the KLSE Composite Index. It appeared that Malaysia must in the end go to the IMF for help.

The Government was getting desperate. It had made a request to Camdessus of the IMF to call for a meeting of finance ministers from the developed and developing countries, to discuss methods to stabilise the currencies and curb the activities of the currency traders.

Camdessus told the Malaysian Minister of Finance at that time that he would hold the meeting in April 1998. But nothing happened. No meeting was held.

As the financial crisis continued, it became apparent that the Minister of Finance, aided by the Central Bank, was implementing policies which were making a bad situation worse.

The Minister of Finance and the Central Bank implemented a number of measures beginning October 1997 which appeared to reflect the views of the IMF.

A credit squeeze was announced by Bank Negara which resulted in banks withdrawing credit and creating a credit crunch. The interest rates were repeatedly increased from single digit levels to more than 12 per cent per annum.

Even companies with viable projects and confirmed export orders found it difficult to obtain financing for operations from the banks.

The Central Bank shortened the default period for the classification of non-performing loans from six months to three months, creating further problems for the banks and businesses.

The prudential requirements of banks were further tightened by requiring them to increase the general provision for bad and doubtful debts from 1 per cent to 1.5 per cent of total loans.

The Minister of Finance and the Central Bank further restricted consumer spending by imposing a maximum margin of 70 per cent for financing the purchase of passenger vehicles.

In addition, the maximum repayment period for the hire purchase loans for vehicles was restricted to five years.

Construction activities, which were very important for GDP growth, were also restricted by the Minister of Finance and the Central Bank. The banks were not allowed to grant loans for any property project, where construction had not yet started.

Even in the case of property projects where construction had started, the banks were urged by the Central Bank to review the viability and reduce the amount of financing.

The Central Bank, in continuing to maintain a high statutory reserves ratio (SRR) in the face of a tightening liquidity situation, was pushing even profitable banks into a loss making situation.

'The Central Bank, in continuing to maintain a high statutory reserves ratio (SRR) in the face of a tightening liquidity situation, was pushing even profitable banks into a loss making situation'

Fifty two billion ringgit worth of SRR was kept in the Central Bank earning nothing. If [illegible] to the banks it charged a [illegible] 12 per cent per annum creating unnecessary losses for the banks.

Sabotage

The Government requested the Central Bank to ease the liquidity situation by reducing the SRR from 13.5 per cent to 10 per cent.

The Central Bank complied, but immediately sabotaged the objective by withdrawing an equivalent amount from the interbank market so that, on a net basis, there was no additional liquidity in the system.

The Central Bank even went further, a few days later, by instructing the banks that whatever extra funds they had, following the reduction of SRR from 13.5 per cent to 10 per cent, had to be used to reduce their interbank borrowings rather than lending to their clients.

Therefore, the reduction in the SRR, which was intended to have a positive effect on the liquidity of the banks, was manipulated by the Central Bank to worsen further the credit crunch situation in the country.

It was pointed out to the Minister of Finance that his Ministry and the Central Bank were causing the economy to shrink, and the Government may not get sufficient revenue to run the Administration.

"But he was certain that his "virtual IMF" policy would save the economy.

By April 1998, the economic crisis in the country had worsened, with the ringgit continuing to depreciate towards 4.80 against the US dollar.

The stock market was continuing its downward slide and the credit crunch situation was becoming unbearable due to the Central Bank's tightening measures.

The Prime Minister's view, at that time, was that action should be taken by the Minister of Finance and the Central Bank to provide relief to the banks and their clients through measures that would ease the situation.

However, instead of providing relief, the Central Bank, on April 27, 1998 announced the following measures to tighten the situation even further:

(i) The minimum risk weighted capital ratio of the finance companies (who were the worst affected by the crisis) was raised from 8.5 per cent to 9.00 per cent.

(ii) The minimum capital funds of the finance companies was raised from RM5 million to RM300 million to be complied with by end June 1999 and subsequently to RM600 million by end 2000.

(iii) The single customer limit of the financial institutions was reduced from 30 per cent to 25 per cent of the financial institutions' capital funds.

Dire stress

On the fiscal side, the Minister of Finance reduced Government expenditure by 21 per cent. This virtually stopped development work altogether, as salaries, which make up 80 per cent of the Government's budget, could not be cut.

No developmental expenditure meant no contracts for many construction companies and their suppliers. This together with the other measures of the Central Bank, meant bankruptcy for many companies.

The sum effect of all the above measures was that the banks and businesses which were already suffering from the currency crisis, were pushed into a situation of dire distress.

What the Minister of Finance, together with the Central Bank, had done was to implement a virtual IMF without the IMF loans; namely a combination of tight monetary and fiscal policy, raising the interest rate to defend the exchange rate, attempting to strengthen the banking system through more stringent prudential standards and cutting down public expenditure to improve the current account balance.

As a result of the implementations of these standard IMF prescriptions, Malaysia's economy plunged deeper into recession.

Business was almost at a standstill and the Government revised downwards the expected revenue from corporate taxes for the following year. The foreign media praised the Minister of Finance for implementing a virtual IMF policy.

Everyone was gleefully predicting that the time was near for Malaysia to go to the IMF for help and to surrender economic control to the IMF. Malaysia, it was felt, had no choice but to open up its economy to foreigners without conditions.

There would be rich pickings for foreign capitalists, including those who had invested in the hedge funds.

☐ To be continued tomorrow