

THE NEW ECONOMIC POLICY AND FINANCIAL REFORMS IN MALAYSIA, 1997-2009

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Abstract

The focus of this paper is on the effect of the New Economic Policy on the reforms to the financial system in Malaysia that have taken place since the 1997 East Asian Financial Crisis. The paper discusses the reforms that were introduced to stabilize and strengthen the financial system and the institution of capital controls and a fixed exchange rate to stabilize the exchange rate in the context of the New Economic Policy. The paper discusses the reform measures that were taken to improve the balance sheet of banks and corporations and to protect depositors. The reforms were efficiently executed and the banking system and financial system are stable and banks have increased their lending over time. However, the financial system still remains susceptible to a terms of trade shock because the financial system persists as a relationship based system rather than a market based system although efforts have been made to strengthen the corporate governance of the financial institutions. However, corporate governance reforms are consistent with the objectives of the New Economic Policy and there is resistance to introducing reforms that converge with Anglo-Saxon norms of corporate governance.

Keywords: financial reform, Malaysia, financial system

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1. Introduction

The focus of this paper is on the impact of the New Economic Policy and nationalism on financial reforms after the 1997 East Asian Financial Crisis after which the Malaysian economy contracted in 1998 and did not recover until 2000. The recovery was due mainly to the recovery in global demand for electronics and not because the reforms instituted in the financial sector made Malaysia more competitive. In fact Malaysia resisted market opening reforms that were focused on dismantling the New Economic Policy and creating an economy in the mirror image of the American economy. The effect of the 1997 currency and financial crisis was not only felt in the financial system but also on the real economy. There were efforts to create reforms in the financial system that comprises of banks, the bond markets, the equity and derivatives markets, development finance institutions, the insurance industry, the pension and provident fund and the mutual funds. The main sources of finance in Malaysia are the banks, the bond markets and the equity market. However, this paper will argue that the reforms were not complete because the government did not want to dismantle the New Economic Policy which is an ethnic based policy but paradoxically has brought political stability and high rates of economic growth to Malaysia since independence in 1957. The reforms recommended by the International Monetary Fund included restructuring the banking systems in East Asia which it diagnosed as being the main cause of the 1997

currency crises. According to the IMF the fragility of the banking system was due to short term over-borrowing by the banking systems in East Asia resulting in the twin problems of currency and maturity mismatches. The USA also diagnosed the banking crisis as due to crony capitalism whereby relationship lending had led to an explosion of non performing loans when exports began to grow at a declining rate towards the end of 1996. The hedge funds fled East Asia because declining exports gave them the cue that the East Asian countries will not be able to finance their external debt because of the widening current account deficit.

The Japanese and American governments who were the key players in the region before the 1997 East Asian crisis had different interpretations of the crisis. The Japanese saw it essentially as a trade related crisis because of its massive Foreign Direct Investments in East Asia including Malaysia. They were more interested in reviving the economy rather than restructuring the economies as was the mission of the IMF who worked on the instructions of the US Department of Treasury. The Japanese government was therefore more sympathetic to the view that the tapering of the rate of growth of exports as a result of the cyclical downturn in the world electronics industry in 1996 was the root cause of the crisis. The expectation that exports will decline overtime persuaded foreign banks that had provided short term financing to the Malaysian banks to withdraw their loans when in fact the Malaysian banks would have desired a roll over of the credit. The Malaysian banks

like other banks in East Asia had used the short term loans to finance long term investments and did not have the liquidity to finance their short term debt to foreign banks especially when the Malaysian Ringgit had devalued steeply

The American government was more interested in the welfare of the foreign (especially American) hedge fund managers because of the vast amounts of US pensions that were managed by these hedge fund. As a result the American government was more interested in creating a safe haven for American hedge fund investments in East Asia. It can be said that while Japan focused on reviving the real economy, the Americans were more interested in the financial sector because the vast majority of Americans were investing in stocks and bonds. The fund managers had crowded into East Asia in the beginning of the 1990s but fled by 1996 because they feared that the export led East Asian boom was going to collapse. Foreign Portfolio Investments (FPI), which had peaked in the KLSE in 1993-1994 took flight as a result of the banking panic and the subsequent devaluation of the ringgit. This led to the further depreciation of the ringgit, which had an adverse effect on the balance sheet of the corporations (Krugman, 1998) and the capital adequacy of the banks.

The Malaysian government's view of the crisis was similar to that of the Japanese government's view of the crisis. Mahathir had made it clear that the crisis was created by Soros and unscrupulous hedge fund managers supported by western governments and financial institutions. While the American government criticized East Asia for practicing crony capitalism, Mahathir criticized the American government for supporting the hedge funds and the IMF to impoverish East Asia by creating the conditions for a fire sale of assets in East Asia including Malaysia (The Irrawaddy, 1997). Some mainstream economists in fact broke rank with the American establishment by agreeing with Mahathir that the American government had conspired with hedge fund managers and the Wall Street in ripping off East Asia. Among the most vocal critics of American policy were Stiglitz (1998), Bhagwati (1998) and Wade and Veneroso (1998) who elaborated the Treasury-Wall Street Complex theory whereby the Federal Reserve Bank collaborated with Wall Street by making cheap credit available for hedge funds to invest in East Asia to create a bubble which they could profiteer from being the first one to be out or "sell and run." (yet to be changed)

2. What is to be done?

The East Asian crisis faced a liquidity problem as capital began to flee the crisis affected East Asian countries including Malaysia, Thailand, South Korea and Indonesia. They looked at the IMF as a Lender of Last Resort to provide them the liquidity that they needed. However, the IMF was not forthcoming although in the past it had acted as the Lender of Last

Resort to other countries that had liquidity problems. As the hedge funds and banks withdrew their money from East Asia and sold the ringgit, the value of the ringgit fell sharply. The Central Bank of Malaysia did intervene to support the ringgit but being a small country with limited foreign reserves was not able to stop the slide in the value of the ringgit. The Japanese looked with concern as it was dependent on East Asia for its market. If East Asia was to go into recession it will not be able to consume Japanese goods. To support the ringgit and other East Asian currencies that were under speculative attack, the Japanese government suggested the setting up of the Asian Monetary Fund (AMF) to act as a Lender of Last Resort and provide the much needed liquidity to the East Asian countries. This positive move was objected to by the American government because it wanted the Asian countries to work with the IMF and restructure their economies in line with the IMF conditionalities, that is to create a market economy in East Asia. If the Asian countries would follow the prescriptions of the IMF then the IMF would provide the much needed liquidity. The AMF as envisioned by the Japanese and Asian governments would not be involved in restructuring the economies but would just provide liquidity support. Hence the AMF was an attractive solution to the East Asian countries affected by the crisis. However, the US government with the support of China was able to put a stop to the Japanese initiative of setting up the AMF. It was clear that America wanted to dictate terms in East Asia so as to reduce the transaction costs of its production and financial transactions in East Asia including Malaysia. America was more interested in restructuring the economies from what it imagined to be feudal economies to market economies.

The IMF mission consistent with the objectives of the American government was to create a well functioning market economy where loans would be disbursed on a cost benefit basis rather than on relationships based on cronyism and corruption. The indiscriminate disbursement of bank loans and relationship banking was diagnosed by the IMF as having caused the asset bubble in East Asia because of over investments in property development and the purchase of stocks in poorly structured and inefficient stock markets dominated by insider trading and privileged information. The bubble burst because the foreign banks had recalled their short term loans because global demand for electronics were expected to fall after 1996. Malaysia was over dependent on electronics as a source of export earnings. The withdrawal of bank loans led to panic among the managers of mobile capital which was invested in the Asian stock markets. The outflow of foreign portfolio investments and bank loans overwhelmed the inflow of FDI causing a current account deficit that could not be financed by a positive net capital inflow as there was the case when exports were booming.

The adverse effect of a massive capital flight was rising interest rates in the East Asian countries

including Malaysia. The sharp rise in the interest rate was approved by the IMF to attract back capital into the crisis affected economies. However, it did not work that way because the banks faced a problem because there were defaults on its loans. The higher interest rates increased the cost of debt service to the corporations that had borrowed from the banks. The economy was also contracting because Malaysia followed the IMF prescription of a tighter fiscal and monetary policy. This meant that domestic consumption would be adversely affected and this fed back into eroding the profits of large corporations, which in turn undermined their ability to service their bank loans. The default on bank loans led to the sharp increase in the Non-Performing Loans (NPLs) in the banking system. The rising NPLs and the stock market crash resulted in the rapid erosion of bank capital. The banks were in need of resolving their bad loans and also in need of re-capitalization. Instead of focusing on the behavior of the foreign banks and hedge funds that took flight as opportunists, the IMF put the blame for the capital flight on the “Asian model of Capitalism,” which it alleged was the root cause of the crisis. The Asian Model was described as non-transparent, corrupt and inefficient as it was based on cronyism and relationship banking. If the economy was competitive and information was complete and accurate there would not be an asset bubble or investor panic.

It was clear that the IMF saw that corruption and cronyism and not the speculative activities of the hedge funds was at the root of the currency crisis. To eliminate corruption and cronyism it wanted to dismantle the social institutions including the New Economic Policy that bred corruption and cronyism and resulted in the misallocation of resources. In doing this it was guided by the Coase theorem that said that if there are property rights in goods and services including financial assets, these property rights would be bought and sold if there was a well functioning market and if the rights of agents were protected by a strong independent judiciary. In such a market if transaction costs were zero or close to zero the resources will flow to the most valued users or uses and society will be able to maximize its output or wealth. It did not matter as to who initially owned the rights because in a well functioning market economy, it will flow to the most valued users or uses. Such a system will also be able to maximize efficiency and productivity. As a corollary if bank financing had been allocated on rational cost-benefit or were based on present value calculations then resources will be allocated such that the asset bubble will not occur.

So the IMF recommended a shift from relationship based or cronyism based banking to rational banking based on neo classical principles and for project financing to be based on net present value calculations and not on connections. The IMF's suggestions including the need to embark on an austerity drive and increase the interest rate to stop the massive capital flight to defend the value of the

ringgit was initially embraced by the Malaysian government just after the crisis and was implemented until it was clear that the IMF prescriptions were causing problems rather than generating growth.

However, the IMF prescription of increasing the interest rate sharply contributed to rising NPL ratios in the banking system as firms found it difficult to repay loans and hence defaulted giving rise to problems of moral hazard as a result of the initial adverse selection by the banks. Defaults on loans eroded the capital base of the banks and although there were no bank runs there were rumors of impending bank runs that were halted by implicit government guarantees to protect all deposits in the absence of deposit insurance. The lack of adequate bankruptcy laws also prohibited the banks from using the bankruptcy ordinance to recover their capital from defaulting corporate and non-corporate clients. The threat of the closure of firms and banks and the threatening security consequences of dismantling the NEP and the thirty odd years of social engineering that was perceived to have maintained the political stability of an ex colony of Britain persuaded the then Prime Minister, that is, Mahathir Mohammad to abandon the IMF prescriptions and instead of further integrating the Malaysian economy with the world economy, he decided to isolate the economy from global finance and capital movements until the economy stabilized and recovered. Mahathir decided to avoid distress sales of domestic assets and institutions to foreigners as had occurred in Thailand and South Korea. He was also keen to maintain and implement the New Economic Policy and he was encouraged in doing so by Martin Feldstein (1998) who argued that the IMF had no mandate to initiate social engineering in member countries and to change social structures that were inimical to the development of the market economy.

The Malaysian economy had to grapple with several issues that threatened the financial stability of the economy. If weaknesses in the system as argued by the IMF caused the crisis, then Malaysia would be subject to increased scrutiny from the international financial system and would be classified as risky as it was when it implemented capital controls although the capital controls were endorsed by leading neoclassical economists such as Paul Krugman (1998) and Joseph Stiglitz (1998).

The capital flight that occurred in 1997 comprised essentially of a massive outflow of FDI owned by hedge funds and short term bank loans from Japan and Europe that were used to finance long term investments in Malaysia. The hedge funds withdrew possibly because the banks withdrew or they withdrew because they felt the declining foreign reserves coupled with a slowing down of the rate of growth of exports made Malaysia a credit risk. If exports were declining, Malaysia could not do much about it because it is a small economy in relation to the USA, Japan, and Europe. It was also heavily dependent on the exports of electrical and electronics

goods. However, as a result of increasing demand for its agricultural products and the boom in oil prices after the Iraq war plus the recovery in electrical and electronics products helped place Malaysia in a better credit rating.

If the recovery of the growth of exports were out of the control of the government, the issue then became as to what the government can control and influence that might create prevent the recurrence of the banking and financial crisis of 1997. Many suggestions have been put forward including (i) tightening the prudential regulations of banks so that they do not borrow short term excessively from foreign banks and lend them on a long term basis to the construction sector; (ii) improve hedging techniques of banks and financial institutions that borrow in foreign currency; (iii) improve risk management and solvency and stability of the system by improved risk management strategies and by implementing Basel 2; (iii) introduce deposit insurance as a method of ensuring that banks do not rely on implicit government guarantees; (iv) strengthen corporate governance of financial institutions; (v) move from merit based to disclosure based listing in the stock market.

3. Prudential Regulation of Banks

The poor regulation of banks is one of the reasons attributed for the occurrence of the currency crisis. The banks were it is alleged were not cautioned on the excessive short term debts they incurred in borrowing at low interest rates from foreign banks and lending them long term at higher interest rates to the property sector. Malaysia at the time of the crisis focused on prudential regulation whereby the regulator does not focus on enforcement but on compliance. When a regulator finds a rule is violated, the first reaction is not prosecution but rather counseling or guidance. An effort is made to make the regulated understand the regulator's policies. One of the benefits of prudential regulation is that regulated firms are more willing to disclose problems and institute voluntary fixes with the regulator's guidance. It avoids enforcement action and adverse publicity. Bank Negara Malaysia has regulated banks by counseling them not to borrow excessively from foreign sources. It has been noted that the ratio of external debt to GDP in Malaysia was low compared to other crisis affected countries in East Asia at the time of the crisis.

Although Malaysia like other countries in the region liberalized its financial markets, it ensured that external debt was maintained at a relatively low level. Bank Negara had required that private companies needed to get its approval to borrow foreign-currency loans in excess of RM5 million. The policy was to approve loans that could generate sufficient foreign exchange to service the debt and repay the principal when due. Corporations were also not permitted to raise external funds to purchase properties in Malaysia. However, some corporations were badly

affected by the sharp depreciation of the ringgit in 1997 and 1998 as they had accumulated a large amount of foreign debt apparently with the approval of Bank Negara Malaysia. The bulk of the short term debt was borrowing by commercial banks, which was probably fully hedged against contracts with their exporting clients although some of the short term external loans were used to finance long term property development. Despite the external borrowing Malaysia's external reserves of RM83.7 billion at the end of 1997 was well in excess of its external debt of RM57.7 billion.

4. External Reserves

The National Economic Recovery Action Plan (NEAC, 1998) that was released in 1998 emphasized that it was vital for Malaysia to maintain very high levels of foreign reserves to service the country's external debt and insulate the economy from another currency attack. It set a standard of raising the level of the external reserves to the equivalent of five months of retained imports. In 2005, Malaysia's total external reserves were about RM 265 billion or nearly 7.5 times its total imports (Bank Negara Malaysia, 2006: P14). It has however been highlighted by some observers that this high level of external reserves may be counter productive as it may represent an opportunity cost as the reserves could be used to generate higher returns than just being held in US dollars, euros, the yen or pound sterling.

5. Capital Controls

The availability of high external reserves and internal resources enabled the Malaysian government to initiate homegrown solutions to the currency crisis that was threatening economic sustainability and political and social stability of the country. To insulate itself from the IMF and the speculators, the government had to introduce capital controls, institute a fixed exchange rate regime and de-internationalize the ringgit. Without capital controls and a fixed exchange rate regime, the government would not be able to conduct an independent monetary policy. Capital controls and a fixed exchange rate regime were introduced on September 1, 1998. On the same day the ringgit was de-internationalized to stop speculative activity on the ringgit in offshore markets. The new economic environment after capital controls and the institution of a fixed exchange rate regime the government was able to lower interest rates that helped to reduce debt servicing burden of the corporations, which in turn contributed to strengthening the capital base of the banks. The availability of credit at low interest rates and the ability of the government to direct bank lending into critical sector helped stimulate the economy. The government also used fiscal policy to inject more funds into the economy to further stimulate the

economy. It also obtained low cost funds for its stimulus package by borrowing from Japan.

The capital controls, the new exchange rate regime and the de-internationalization of the ringgit apparently served the purpose of stabilizing the value of the ringgit and the economy. The economy recovered at the same time as the other East Asian countries due to the recovery of the demand for electronics goods and the recovery of the world economy. The capital controls were gradually relaxed and in July 2005, following the lead provided by China, Malaysia switched its exchange rate regime from a fixed exchange rate regime to a managed float. The ringgit remains de-internationalized although there has been some policy deliberations that it might be internationalized in the near future.

Since the currency crisis of 1997, when there was a sharp withdrawal of Foreign Portfolio Investments (FPI) from Malaysia, there has been very little interest shown in the local bourses by foreign fund managers. This has been because of the institution of capital controls and policy statements that discouraged FPI from creating volatility in the local bourses. Trading has been thin in the local Bursa Malaysia largely because about 40% of the capitalization of the Malaysian stock market is due to Government Linked Corporations. The peaks and droughts of the local exchange are provided by the inflow of FPI. Foreign funds began to be attracted into Malaysia especially after the “Liberalization of the Foreign Exchange Administration Policies” (Bank Negara Malaysia, 2007). As a result the Kuala Lumpur Composite Index (KLCI) reached an all time high in 2007.

The inflow of FDI into Malaysia has also slowed down although foreign equity restrictions were eased after the currency crisis of 1997. According to the UNCTAD, global FDI inflows increased by 29% to US\$916 billion in 2005. The inflow into South, East and Southeast Asia increased by 19% to US\$165. However, the inflow of FDI into Malaysia declined by 14% to US \$3.75 billion in 2005. The other ASEAN countries saw an increase in the inflow of FDI. This has been attributed to the relative competitiveness of the Malaysian investment climate (UNCTAD, 2007). It may be possible that Malaysia has lost its competitiveness in attracting labor intensive investments and is not as competitive as the other countries which have a pool of more skilled labor. Malaysia has problems in transiting from a labor intensive economy to a knowledge and skill intensive economy.

6. Principle Based Regulation

Malaysia is moving away from rules-based regulation to principle-based regulation (Zamani, 2007) following the flaws in the rule based regulation made explicit by the Enron scandal, which showed that a rules based accounting may provide a road map for abuse. It has been shown that firms including financial firms can produce an unreasonable result

although they strictly adhere to accounting rules as was the case with Enron. When this happens auditors are helpless because their role is to certify as to whether the financial statements produced by the management of the firm have strictly followed the rules despite the outcome which maybe unreasonable. A lot of firms exist to advise other firms on how to benefit from loopholes in the system. In the case where rules are detailed and where there is very little room for interpretation the auditor is powerless but the regulated is all powerful.

The principle based regulation hopes to shift the power from the regulated to the regulator. Even if all the rules were strictly adhered to but the outcome was unsatisfactory from the shareholders’ point of view or the consumers’ viewpoint or adversely affected the welfare of society the regulators can question the conduct of the regulated. Bank Negara Malaysia now doubt has been inspired by the success of the Financial Services Authority (FSA) in the United Kingdom in regulating banks that attracted a lot of financial activity to London.

The principle based regulation provides broad guidelines and the desired outcome and provides the freedom to the financial institutions to chart their own path to these results.. The regulators are entrusted with (i) promoting innovation and competition; (ii) maintenance of strong financial services market; (iii) respect for management decisions.

The regulated are provided the following guidelines (i) focus on results or outcomes; (ii) fulfill statutory obligations to industry and consumers; (iii) manage conflict of interest between their firms and customers and between one customer and another; (iv) conduct their business with integrity; (v) ask regulators for principles and not prescriptions; (vi) observe proper standards of market conduct; (vi) pay due regard to the interests of customers and treat them fairly.

Bank Negara Malaysia hopes that the principle based regulations will provide more power to the regulators to safeguard the integrity of the financial system. The less detailed the rules, the greater the power of the regulatory agency to interpret the meaning of the rule and to enforce it. Consistent with the adoption of the principle based regulatory system Bank Negara has encouraged the banks and financial institutions to follow procedures laid out by the International Accounting Standards Board (IASB) and not the rules based Financial Accounting Standards Board (FASB).

7. Risk Based Regulation

The focus of risk based regulation is on protecting the industry against systemic risk. The regulator will focus on the largest firms or banks, that is, banks or firms in which financial difficulties could have systemic effects. In order to reduce or manage systemic risk Malaysia has adopted a Malaysia has adopted a Risk Based Capital Framework and a risk

based supervisory regime in accordance with Basel I, which was developed by the Bank for International Settlements. However, taking into account the effects of the currency crisis on the banking industry, Malaysia has decided to adopt Basel II, which came in the wake of the 1997 East Asian financial crisis and was finalized by the Bank for International Settlements (BIS) in June 2004. The Basel II Capital Accord which replaced the Basel I Capital Accord of 1988 is different because unlike Basel I it does not focus on a single risk measure to measure credit and market risk and to determine the capital adequacy ratio. Basel I also adopts a one size fits all philosophy with no material gradation of risk and is a very general in its approach in structuring risk. However, Basel II provides a more comprehensive process with increasing risk sensitivity. It also adds up operational risk as a new charge and promotes banks internal risk management methodologies. Basel II also incorporates supervisory review and market discipline as part of the risk assessment process

Malaysia is lagging behind in implementing Basel II probably because the structure of the banking industry and the economy is not amenable to rapid institutional or social change in view of the need to achieve the objectives of the New Economic Policy. Also unlike Europe no pan-regional regulatory framework exists that can put pressure on countries like Malaysia and China to speed up the process. Malaysia has been classified together with China, India, Indonesia and Thailand as being emerging financial markets compared to the more developed financial markets in the Asia Pacific countries, that is, Australia, Japan, Singapore, Hong Kong and Thailand. Malaysia is only expected to implement Basel II in 2010 whereas Taiwan, India, Hong Kong, Japan and Singapore are expected to implement Basel II by 2007. Indonesia, Australia and Thailand have announced that they will implement Basel II by 2009.

Malaysia is not expected to have an aggressive time frame to implement Basel II although the NPL problem arising from the 1997 East Asian financial crisis has been resolved and the capital adequacy ratio has been reinstated with the assistance of the Corporate Debt Restructuring Committee, Danaharta and Danamodal and as a result of mergers between solvent and not so solvent banks or between large and small banks. The delay in implementing Basel II may be attributed to the following: (i) local banks need time to collect additional data required by the new rules; (ii) Bank Negara Malaysia has adopted a strategy of more gradual enhancement for risk management frameworks for all banking institutions and (iii) because the government's directed bank credit program may not be compatible with the needs of Basel II.

8. Insuring the Deposits of the Banks

Bank managers in Malaysia were not averse to taking risks because all bank deposits were implicitly

guaranteed by Bank Negara Malaysia and the government. The larger banks especially the state owned banks exhibited lending behaviour that was risky because they believed that they were too big to fail. Under the NEP the government directed credit to priority sectors and felt an obligation to save the banks in case default on bank loans led to bank runs. When the Thai Baht was devalued and the ringgit came under speculative attack in the third quarter of 1997, there was a vast amount of capital flight from Malaysia, which caused the domestic interest rate to increase. The higher interest rates caused a default in bank loans which threatened to erode the capital base of the banks and put the bank deposits at risk. It was then realized that Malaysia had no deposit insurance scheme. The National Economic Action Council (NEAC) in its report recommended the setting up of a deposit insurance corporation along the lines of the Federal Deposit Insurance Corporation (FDIC) in the United States. However, it was not until eight years after the 1997 East Asian Financial crisis, that is, on September 1 2005, that the Perbadanan Insurans Deposit Malaysia (PIDM) or the Malaysian Deposit Insurance Corporation (MDIC) was set up as an independent statutory body under the Malaysian Deposit Insurance Corporation (MDIC) Act, 2005. Under the MDIC Act, 2005 all financial institutions are deemed to be a member of the MDIC. The MDIC Act, 2005 covers both Islamic and conventional deposits. The objectives of the corporation are (i) to administer a deposit insurance system under the MDIC Act, (ii) to provide insurance against the loss of part or all the deposits of a member institution, (iii) to provide incentives for sound risk management in the financial system, and (iv) to promote or contribute to the stability of the financial system. In achieving its objectives the Corporation is expected to act in such a manner to minimize costs to the financial system. The Deposit Insurance System is an important component of the financial safety net. The Chairman according to the Act will be appointed by the Minister, who shall have private sector experience. Every financial institution is deemed by the Act to be a member of the MDIC. The corporation is not entirely independent as it would depend on the Central Bank or Bank Negara Malaysia for supervisory and regulatory assistance.

The deposit insurance system is funded by annual premiums from member institutions, where a flat rate will be imposed for the initial two years of its implementation. Thereafter, a risk differential premium framework will be implemented, consistent with the mandate of PIDM to strengthen incentives for sound risk management of its member institutions. Under the deposit insurance system, eligible deposits will be insured up to the prescribed limit of RM60,000 per depositor, per member institution inclusive of principal and interest. There will also be a separate coverage of RM60,000 per depositor, per member institution for Islamic deposits, accounts held under joint ownership and trust accounts, sole proprietorship and partnerships. It is expected that the

insurance system will provide incentives for sound risk management in the financial industry and to promote and contribute to the stability of the financial system. The insurance system is to reduce the government's 100 % implicit guarantee on deposits of state banks. Under the explicit limited deposit insurance system, state banks would be subject to the same market forces and same level of market discipline as other banks. The banks are also expected to transition to higher regulatory standards.

As part of the effort to protect the consumer, Bank Negara Malaysia in association with both domestic and foreign banks has also embarked on a 10-year consumer education program. However, in view of the government's effort to direct credit to priority sectors, there is no guarantee that the deposit insurance scheme will be able to cover all losses suffered by banks as a result of runs on banks, when there is an external currency crisis. In anticipating the ineffectiveness of the deposit insurance scheme in view of the expected recession in 2009 and 2010, Bank Negara has declared that it will guarantee all deposits.

9. Bank Consolidation

In 1999, the government embarked on a strategy that led to the consolidation of a highly fragmented domestic banking system, which comprised 71 institutions prior to the crisis, to 30 domestic banking institutions organized in 10 domestic banking groups by 2002. Although it was government driven consolidation and the merger partners and the anchor banks were chosen by the government, the government preferred to refer it as market driven. The end result of the merger activities was to increase the concentration of assets in a few banks. With increased concentration, the banks did not feel the pressure to increase efficiency or competitiveness and with cost of funds set by the Overnight Policy Rate (OPR), the gross interest margin was guaranteed as the banks colluded to set the lending rates in an oligopolistic market. Foreign competition was also restricted by the reluctance of the government to approve licenses for foreign banks with the exception of Islamic banks.

The level of domestic merger and acquisition activity in Malaysia is quite high (World Bank, 2000:97) and there is little concern that government created monopolies will be inefficient or adversely affect the welfare of consumers. Although the banking industry is not a monopoly, the three largest banks account for more than three quarters of the assets of the banking industry and the actions of these banks that are either government linked or close to the government continue to be the major sources of systemic risk in the banking industry. The evolving structure of the industry also indicates that the government owned banks are also among the largest and the most dominant in terms of lending activities. This is considered necessary to achieve the objectives of the New Economic Policy.

10. Opening the market to foreign providers of financial services

The government's main motivation for resisting the IMF prescriptions at the outbreak of the 1997 financial crisis was that it feared that it would lead to the fire sale of assets including financial assets as had occurred in Thailand, Indonesia and S. Korea. The government was conscious of maintaining the New Economic policy of ensuring that at least 70% of the assets of public listed corporations were held by Malaysians. The laws of Malaysia after 1970 were amended to dissuade the entry of foreign firms in the financial services sector. Although restrictions on foreign holdings in new export oriented manufacturing projects have been relaxed after the 1997 crisis the government has been less generous in the financial services sector. The limits on foreign participation in the financial services sector has been justified by the need to develop domestic financial service providers. No new licenses have been granted to foreign or local banks except in 2003 when BNM issued three new Islamic banking licenses. The focus of the Financial Sector Master plan introduced in 2001 is to make the domestic banks larger by consolidation to face the competition from foreign institutions when the sector is liberalized in 2007. Foreign banks have also been granted more branches beginning in 2005. However, since it is government policy to direct credit to priority sectors consistent with attaining the objectives of the New Economic Policy, the government is committed to increase its share of the ownership of the banks. In fact, three of the four largest commercial banks in Malaysia are government owned banks.

11. Reforming Malaysia's Capital Markets

The Capital Market Masterplan, which was launched in 2001 was intended to be implemented over a ten year period from 2001 to 2010 and over three phases. In the first phase that is from 2001 to 2003, the Securities Commission and the government concentrated their efforts in introducing corporate governance reforms that would increase the transparency without comprising attaining the objectives of the New Economic Policy. Efforts were expanded to consolidate market liquidity and promote scale and efficiency. The existing five exchanges were also consolidated into one. The demutualization and listing of Bursa Malaysia was also completed. The listing process became more transparent as the market moved from merit based listing to a Disclosure Based Regulation (DBR). However, initially the number of new listings dropped because of the more demanding information requirements (Bank Negara Malaysia, 2006:83-84).

In Phase II of the implementation of the Capital Market Masterplan from 2004-2005, the focus was on Investment Banks and the entry of foreign stockbrokers and fund managers. The Securities

Commission also reduced the turnaround time required to process approvals. In the third phase of the implementation of the Masterplan from 2006 to 2010, the focus is on enhancing industry and market structures to improve the international competitiveness of the domestic capital markets.

12. The Malaysian Bond Market

Malaysia has had traditionally a relatively more developed government bond market in comparison to private debt securities market, which was only developed in the early 1990s and comprises today about a third of the total value of all ringgit denominated bonds traded in Malaysia. The government bonds or Malaysian Government Securities (MGS) and the Private Debt Securities (PDS) are usually denominated in large sums and bought by institutions and are thinly traded. While the MGS are risk free, the PDS are rated by independent rating agencies, whose evaluations have sometimes been questioned. One of the main constraints in the development of the bond market is the late development of a benchmark yield curve. There has been a considerable effort being focused on the development of a reliable market-based benchmark yield curve for both conventional and Islamic bond markets.

To facilitate the deepening and widening of the bond market, the government has enhanced the market infrastructure and the legal, administrative and regulatory framework and provided incentives for the development of capital market intermediaries.

In the area of bond market development, significant milestones have been achieved on many fronts. Among the infrastructure enhancements in the market for MGS are: the development of the principal

dealer system; the development of the Real Time Electronic Transfer of Funds and Securities System; the development of the Code of Conduct and Market Practices for Scripless Securities Markets. To further develop the PDS the government has introduced several reforms including: the Fully Automated System for Tendering and the Bond Information and Dissemination System. These innovations reduced transaction costs and were designed to facilitate the more active trading of bonds including mortgage backed securities or REITS that were introduced in 2004. Reforms have also been introduced to attract international investors and to develop new products. International organizations have been active in issuing ringgit denominated bonds. The liberalization of the foreign exchange administration rules since April 2004 has also encouraged the issuances of private debt securities in the Malaysian capital market by foreign entities (BNM, 2006:83-84). According to the Central Bank of Malaysia, “the growing size and maturity of the Malaysian Bond Market led to it being considered for inclusion in the Citigroup World Government Bond Index” (Bank Negara Malaysia, 2006:118).

Malaysia has also been active in strengthening the demand for ringgit denominated bonds by being an active collaborator in the Asian Bond Fund (ABF) initiative. Initiatives by the ASEAN+3 Finance Ministers has tended to have the effect of strengthening the supply of bonds through ABMI. Malaysia has also been active in the APEC Finance Minister’s process to work on the overall financial sector development including the bond market and the Asian Cooperation Dialogue (ACD) to raise political support and public awareness of the Asian Bond Market development.

Table 1. Size of Emerging East Asian Local Currency Bond Markets

Market	Size 1997 \$Billion	Size 2004 \$Billion	Size 2005 \$Billion	Growth Rate 1997-2003	Growth Rate 2004	Growth Rate 2005
PRC	116.40	527.70	633.03	20.94	19.82	19.96
Indonesia	4.60	57.70	47.26	43.52	(12.18)	(18.09)
Malaysia	57.0	110.70	121.79	9.03	12.02	10.01
Philippines	16.92	35.30	41.08	11.08	16.03	16.38
Singapore	23.77	79.39	83.43	18.80	18.09	5.08
Korea	130.37	567.70	637.86	23.39	27.24	12.76
Thailand	10.47	68.00	8.32	30.64	13.79	18.11
Vietnam	-	3.78	5.20		31.39	37.68
Total	359.53	1450.27	1649.97	22.05	19.72	13.32

Source: Asian Bond Monitor, March 2006

As a result of these reforms the size of the Malaysian Bond Market has more than doubled within 8 years and has grown by more than 9% between 1997 and 2003 and by more than 10% from 2004 to 2005. As a percentage of GDP bond financing has nearly doubled from 56% of GDP in 1997 to 93.24% of GDP in 2005 (Kawai, 2006, p.7).

13. Corporate Governance

Corporate governance reforms have been instituted since 1997 by the High Level Committee set up by the government to introduce reforms to introduce reforms that will attract investors but that which are consistent with the objectives of the New Economic

Policy. A Minority Shareholders Watchdog Committee has been set up to look after the interests of the bumiputras. Malaysia's efforts at raising corporate governance standards has been commended upon by international agencies like the World Bank. According to the World Bank (2006) Malaysia's disclosure standards and transparency in transactions are relatively quite high in relation to other emerging markets. However, cases of irregularities in financial reporting persist. The Securities Commission and the government has a program to improve the standards of corporate governance by instituting reforms to (i) clearly define the role and quality of the Board of Directors; (ii) improve the composition and effectiveness of audit committees; (iii) clearly define the role of internal auditors and (iv) improve the quality of audit and (v) strengthen the oversight of audit firms. Despite these efforts there is skepticism that the government will be committed to introducing reforms since to achieve the objectives of the New Economic Policy it may be necessary to sacrifice some standards of transparency and good governance. Furthermore, the NEP has traditionally been based on patronage and this may run counter to the principles of good corporate governance.

14. Preparing for the next currency crisis

The current global financial crisis that originated in the United States' financial markets is expected to affect Malaysia differently. The contraction of consumption in the United States has reduced the demand for Malaysia's exports. Malaysia is very dependent on electronics exports to the United States and electronics exports comprise more than 80% of Malaysia's total exports. The consequence of the contraction of exports is job losses and a drop in consumption that may adversely affect the domestic industries and businesses. The current crisis is then expected to affect the Malaysian economy through the real economy but not through the financial sector as happened in 1997. However, the effect on the real economy will eventually be felt in the capital markets as foreign hedge funds and banks withdraw from emerging economies such as Malaysia, which are dependent on exports to the United States. Malaysia has introduced a US\$20 billion stimulus package to increase domestic demand for goods and services to compensate for the expected loss in external demand. If the Malaysian economy weakens considerably as a result of the current crisis and sharp drop in exports including primary commodity exports, pressure will again be put on Malaysia to dismantle the NEP and create a more market oriented economy.

Conclusion

Although the effects of the 1997-1998 East Asian financial crisis was severe and the economy contracted by 7.8% in 1998, the economy recovered in 2000 as the world demand for electronics increased

and created a surge in demand for Malaysian exports. The financial institutions and capital markets have recovered from the effects of the crisis without having to increase foreign investments in these institutions and markets. In fact Malaysia was able to recapitalize its banks and reform the financial system with its own resources and capabilities. The reforms were homegrown because increasing foreign ownership of financial institutions may imply dismantling the New Economic Policy, which formed the basis of the legitimacy of the government in power. The reforms instituted since 1997 have reduced the cost of doing business and improved the corporate governance of institutions. However, the banking and corporate sector remain vulnerable to another terms of trade shock because of inadequate risk management, large growth in loans and borrowing in foreign currency by the banks. This is because corporate governance reforms are embedded in the social, cultural, political and economic system of Malaysia to achieve the goals of the New Economic Policy. Malaysia in 2009 is entering a new period of crisis as the global credit crisis and the capital market crisis that originated from the United States is adversely affecting the export performance of Malaysia. It will go through a period of change again and it is yet to be seen as to whether international efforts to dismantle the NEP and fully integrate Malaysia into the global financial and economic system will be successful.

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