EVOLUTION OF THE MALAYSIAN FINANCIAL SYSTEM UP TO AND BEYOND THE CRISIS IN 1997

Abstract

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The Malaysian financial system is an example of commitment by the government and the central bank to develop a banking system and a capital market that are resilient, robust, and responsive to the funding requirements of a fast growing economy. Lessons were learned the hard way in the mid 1980s when recession precipitated a few bank failures and demonstrated the need for wider and more effective regulations. The system remains fundamentally sound despite the 1997 Asian financial turmoil. In the future the Malaysian financial system will have to meet further challenges posed by globalization, and by regionalism and information technology.

Evolution and Role of Malaysia's Financial System. Malaysia's present financial system started to evolve in 1959 with the commencement of operations of Bank Negara Malaysia, the central bank. The financial system inherited by Bank Negara Malaysia was rudimentary with limited regulatory powers. The banking system was dominated by three British banks and the securities market was practically non-existent. Malaysia set about to immediately develop a robust financial system that would be dominated by Malaysian institutions which could compete against foreign banks. The 1960s saw the rapid expansion of domestic financial institutions while the 1970s witnessed the emergence of merchant banking, the capital market, and non-bank financial institutions. The financial system was further diversified in 1983 with the introduction of Islamic banking

Following a 1986 collapse of several financial institutions that precipitated a crisis of confidence compelling rescue operations by the central bank, Bank Negara Malaysia was given wide powers to regulate all banking and licensed financial institutions as well as all fringe institutions involved in credit and finance. Strong recovery from the 1985/86 recession boosted confidence to develop and modernise the capital market as a source of funds for business and industrial activity. The 1990s saw the establishment of a rating agency and a Securities Commission responsible for the securities industry, financial futures and options markets, unit trust and property trust schemes, as well as takeovers and mergers.

Capital market deepening began in 1987 with the introduction of mortgage-backed bonds issued by the index national mortgage corporation, Cagamas, and continued with the launching of a stock market futures contract by the Kuala Lumpur Options and Financial Future Exchange (KLOFFE) in December 1995 and the launching of the 3-month interest rate futures contract based on the 3-month KLIBOR by the Malaysian Monetary Exchange (MME) in May 1996. The Labuan International Off-shore Financial Centre established in 1990 has attracted offshore banks, insurance companies, and trust funds. Another milestone capital market development is the anticipated launching of the Malaysian Exchange of Securities Dealing and Automated Quotations (MESDAQ) an OTC market to tap funds for high technology, capital- and skill-intensive companies with no track record.

Efficiency, Risk, and Moral Hazard. The present Malaysian financial system is found to have been generally sound over the last four decades despite a few bank failures. Bank Negara Malaysia has a wide range of powers to deal with banking institutions in financial difficulty or which are insolvent. At the same time, the central bank is prepared to protect the interests of depositors, including probably depositors at foreign controlled banks. Although mismanaged and possibly corrupt financial institutions may be allowed to fail and close down, the central bank is mandated as lender of last resort to rescue ailing financial institutions. Thus, there is a fine distinction in the support of moral hazard**.**

The efficiency of the financial system is revealed in its having successfully funded of the bulk of the country's RM 84 billion average annual private investment during the high growth period of 1991-95. On the other hand, the very large interest rate spread indicates inefficiency and unfairness in Malaysia's financial system. The large margin spread contributed to banks' profit and writing off of non-performing loans, but these came at the expense of bank customers--depositors as well as borrowers. The

slowness in liberalizing interest rates and credit is attributed to social and political considerations.

Impact of the 1997 Asian Financial Crisis. The 1997 Asian turmoil that commenced with the floating of the Thai baht on 2 July d resulted in a serious financial meltdown in Malaysia. Bank Negara Malaysia was quick to intervene to defend the ringgit against speculative attacks, but on 14 July 1997 it allowed the ringgit to float. The decision was probably based on the expectation that any depreciation would be short-lived because of the economy's strong fundamentals and on the fact that external reserves had already fallen to the IMF-recommended benchmark level of three-to-four months of import coverage. The stock market began to plummet after 30 July in response also to a series of negative financial news stories concerning other countries in the region.

The Malaysian financial system remains fundamentally sound despite the Asian crisis l, because of its strict regulatory control and generally prudent lending. The banking system's risk-weighted capital ratio is still appreciably higher than the minimum BIS guideline. And at the end of 1997 non-performing loans had not quite doubled from 3.8 percent of total loans at the end of 1996. Prudential lending guidelines issued by Bank Negara Malaysia had kept loans to the property sector to a relatively small share of total bank lending. These average performance indicators may mask the adverse performance of some financial institutions including stockbroking companies, at least seven of which have had their operations suspended.

The Malaysian economy will feel the impact of the currency turmoil. The depreciated ringgit will mean higher costs for imports, putting pressure on the domestic price level. The official GDP growth rate forecast for 1998 has been revised downwards to the 2-3 percent range. Even so, manufacturers are still operating at reasonable capacity and they have not yet reduced employment significantly.

Beyond the Financial Crisis--Four Challenges for the Future

There is a need for greater transparency and timely information disclosure on banking institutions' profile of liabilities, non-performing loans, sectoral exposure, and provisioning for doubtful debt. Such a proactive approach to inform the global market of Malaysia's sound financial system coupled with closer international cooperation could mitigate the negative effects of currency speculation and massive capital flows and reduce the likelihood of a future crisis.

Malaysia's financial institutions must prepare for heightened competition from foreign banking institutions under the WTO General Agreement on Trade in Services. Bank Negara Malaysia has pushed for banking institutions to merge to strengthen their competitive position. The central bank has devised a two-tier regulatory system that entitles institutions meeting certain requirements to preferential treatment such as participating in new capital market activities.

Regionalisation also poses a challenge to Malaysia's financial system. Calls to use ASEAN currencies for intra-ASEAN trade and to increase the use of the yen as a settlement currency in East Asia raise such issues as whether banking commissions will converge and how national monetary authorities will bear the risk of currency fluctuation.

Probably, the most challenging task confronting the Malaysian financial system is how to stay competitive, efficient, and sound in the new global financial system linked by information technology (IT). Individual financial institutions need to exploit the advances of IT to increase efficiency and create new products.

For almost four decades Malaysia has pursued its original vision of a sound and stable financial system dominated by domestic institutions that compete against foreign banks. The vision is now enlarged and focused on developing domestic institutions able to compete against foreign institutions at home as well as in the new global environment and on transforming Malaysia into an international investment centre.