I Overview

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As an emerging market economy, Malaysia is clearly a success story. During the past three decades, the Malaysian government has implemented a number of medium- to long-term development plans, starting with the 20-year New Economic Policy—a development plan that strived for greater economic well-being for the ethnic Malays, or *bumiputras*—and followed by the National Development Policy in the early 1990s. More recently, the Third Outline Perspective Plan provides the general thrust of Malaysia's development strategy for the period 2001–10.

Malaysia's development plans were implemented effectively. From 1970 to the mid-1990s, the country's investment ratio was among the highest in the region, resulting in a dramatic shift in the structure of the economy from agriculture and mining to a growing reliance on manufacturing. Liberalization measures were introduced across the board that helped improve competitiveness and productivity. Much of the investment went into electronics and other export-oriented industries, while a large portion also went into nontradable sectors including capital-intensive infrastructure and the real estate sector.

The development plans were initially financed by public funds. As a result, by the early 1980s, growth was accompanied by increased budget deficits and an unsustainable level of public debt. The authorities took measures to reduce the government deficit, and successfully restored fiscal prudence. Structural adjustments were also undertaken, including an open trade and payments system that helped expand rapidly Malaysia's export base. Sustained high growth during the 1980s brought significant improvements in living standards and social cohesion. Economic diversification, coupled with deregulation and liberalization of the financial system, also helped transform the country into a middle-income emerging market by the end of that decade.

Malaysia's strong economic performance continued during the 1990s prior to the crisis. Real output growth averaged 8½ percent a year; unemployment was below 3 percent; prices and the exchange rate remained stable; and international reserves were robust. However, there were also signs of stress as exports decelerated and a large current account deficit developed in the context of a gradual appreciation of the effective exchange rate. While the investment-led growth strategy was successful in raising output and income, investment quality had deteriorated. This eventually led to major balance sheet weaknesses in the banking and corporate sectors, exposing the economy to the contagion of the Asian crisis. Similar to its neighbors, Malaysia went through a currency crisis and a banking crisis, but its low level of external debt spared it from an external debt crisis.

Malaysia's economic vulnerabilities stepped up significantly from early 1997 through the period following the onset of the crisis in mid-1997, as market confidence increasingly diminished along with the rest of the region. Large portfolio outflows took place, and equity and property values declined substantially. The ringgit came under tremendous pressure. As currency traders took speculative positions in the offshore ringgit market in anticipation of a large devaluation, the offshore ringgit interest rates increased markedly relative to domestic rates. This heightened upward pressure on domestic interest rates, intensified outflows of ringgit funds, and exacerbated banks' liquidity problems and overall financial distress. The Malaysian corporate sector experienced significant loss of wealth as a result of sharp falls in the value of real estate and equities used as bank collateral. Corporate incomes and cash flows also declined, leaving some corporations unable to service their debt.

The initial response of the authorities was to hike interest rates and tighten fiscal policy in an attempt to anchor market confidence in the financial system. In early 1998, fiscal policy was revised to a more expansionary stance. This policy mix proved to be insufficient to correct external imbalances and bring about the needed economic adjustment. The contagion effects of the crisis and the associated economic contraction were far worse than anticipated. Domestic imbalances quickly emerged as growth rates slowed and then turned sharply negative in early 1998. Market confidence faltered amid adverse regional developments and uncertainties. Anticipation of further devaluation of the ringgit heightened. By the summer of 1998, the stock market had fallen to its lowest level in recent history.

In September 1998, the Malaysian authorities launched a policy package designed to insulate monetary policy from external volatility. Measures included an exchange rate pegged to the U.S. dollar and selected exchange and capital controls, complemented by a fiscal stimulus package that stepped up capital spending. These measures permitted the subsequent lowering of interest rates. The authorities also pursued fundamental reforms in the financial and corporate sectors, including a bank consolidation program and an upgrading of prudential regulation and supervision in line with international best practices.

Malaysia's recovery in 1999–2000 was among the strongest of the Asian crisis economies, led by buoyant world demand for electronics and supported by accommodating macroeconomic policies. The external current account turned into large surpluses, allowing a buildup of international reserves. Unemployment declined, and inflation remained low. The strong growth and a gradual easing of capital controls helped improve investor confidence. The recovery was also accompanied by reduced vulnerability of the financial system. Although operational restructuring of the corporate sector has been somewhat slow, much progress was achieved with corporate debt restructuring.

Since the latter part of 2000, however, downside risks for Malaysia have increased. Heavy dependence on electronic exports made Malaysia highly sensitive to the global slowdown in information technology. Sharp depreciations of the yen and other regional currencies have resulted in a large effective appreciation of the ringgit, particularly during late March and early April 2001, leading in turn to short-term capital outflows and reserve losses. These developments, at a time when the economy was already being hit hard by the global slowdown, has adversely affected market confidence. Nevertheless, Malaysia's external vulnerability is relatively well contained: the current account continues to maintain a large surplus; short-term external debt is low; and reserves have remained adequate. Progress in financial sector restructuring has also improved the capacity of banks to manage risks.

Looking ahead, the issue is how Malaysia can better protect itself from future shocks and avoid another crisis while it seeks to regain its position as one of the fastest growing economies in the world. To these ends, its strategy should include continued structural reforms to achieve healthy balance sheets of the banking and corporate sectors; further deregulation to promote competition and efficiency; and consistent macroeconomic policies to maintain financial stability and sustainable fiscal and external positions.

The sections that follow review policy issues and aspects of economic management that have been associated with Malaysia's progress from a major crisis to a strong recovery, and their implications for the future. Section II presents a comparative review of the country's policies and performance during 1997–2000; Section III describes the study and estimation of potential output and inflation dynamics; Section IV reviews fiscal policy management; Section V discusses the capital controls introduced in September 1998 and their impact; Section VI summarizes various aspects of financial sector restructuring; and Section VII reviews developments in corporate sector reforms.