

HOW MALAYSIA WEATHERED THE FINANCIAL CRISIS: POLICIES AND POSSIBLE LESSONS

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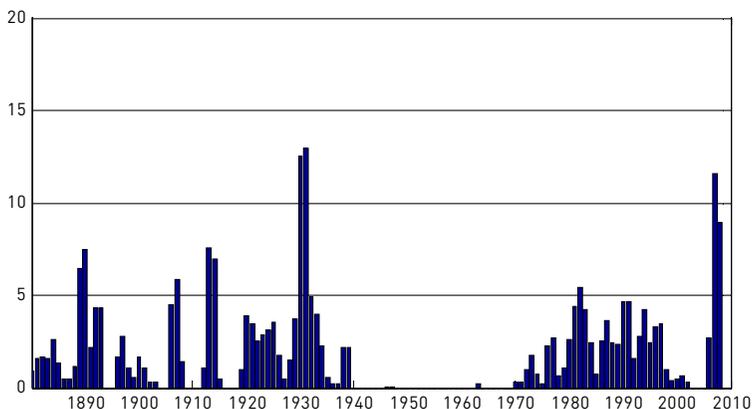
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INTRODUCTION

Financial crises have occurred with increasing frequency since the advent of financial liberalisation and deregulation in the 1970s. Between 1970 and 2007, there were 124 banking and financial crises worldwide; between the 1940s and the 1970s, when banking was regulated and capital flows were controlled such crises were much less frequent (see Figure 1).

Figure 1: Weighted two-period moving sum of banking crisis frequency



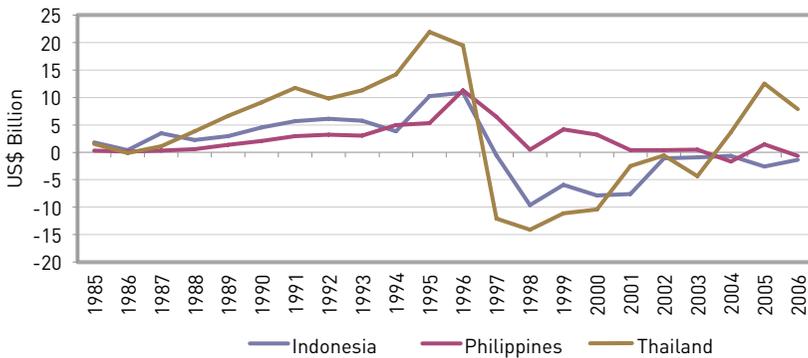
Source: Bordo and Landon-Lane (2010).

Malaysia and other Southeast Asian countries have experienced two major financial crises in the past two decades: the first from 1997 to 1999, known as the Asian financial crisis, as this is where it originated; and the second an offshoot of the recent global financial crisis which originated in the US. Strictly speaking, the second crisis to hit Asia was more a trade and gross domestic product (GDP) growth crisis rather than a financial crisis, because most Asian countries, including Malaysia, rebuilt their banking and financial sector after the Asian financial crisis to be more resilient and hence were able to avoid a financial meltdown.

Our analysis of the impact of the recent global financial crisis on Malaysia therefore begins with an understanding of the Asian financial crisis of 1997–9 and how it shaped this crisis. Malaysia, like most Southeast Asian countries, suffered this, its worst financial crisis, from 1997 to 1999 as a

result of the wholesale and uncritical adoption of financial deregulation, in both capital accounts and the banking sector, pushed by the International Monetary Fund (IMF) and the US. Unregulated capital flows coupled with pegged exchange rates brought a surge of capital flows into Southeast Asian economies which were taking advantage of arbitrage opportunities. Figure 2 shows the net flow of private capital into and out of Southeast Asia before and after the Asian financial crisis, causing havoc to the financial and economic stability of these countries.

Figure 2: Net capital flows—Indonesia, Philippines and Thailand, 1985–2006 (US\$ billions)



Source: IMF International Financial Statistics.

Malaysia was not spared this calamity, even though its external debt burden was not onerous. In 1997, the ringgit plunged from RM2.4 to a low of RM4.9 to US\$1. Net portfolio investment shrunk RM22 billion, from positive RM10.3 billion in 1996 to negative RM12.9 billion in 1997. This led to a collapse of the stock market, the ballooning of foreign debt, massive corporate defaults and non- performing loans, resulting in a banking crisis.

INTRODUCING IMF POLICIES

Because of its relatively low level of foreign indebtedness, Malaysia did not apply for any IMF assistance. Nevertheless, it followed the standard IMF prescription in facing the crisis. On the macroeconomic policy front, it raised interest rates with the view to stemming capital outflows, the currency was floated to allow for free capital flows and public expenditure was reduced by 18 percent. On the financial sector side, Malaysia changed

the definition for non-performing loans from six-month arrears to three-month arrears, following international standards. Unfortunately, with the implementation of these policies, what started as a financial and currency crisis soon became a full-blown economic crisis.

Aggregate domestic demand declined in 1998 for the first time since 1986, owing to a significant negative contraction in private investments (by 55 percent) and private consumption (by 10 percent). The real economy contracted 14 percent, with GDP growth plunging from positive 7.7 percent in 1997 to negative 6.7 percent in 1998. The stock market plummeted by over 70 percent and the ringgit fell to its lowest of RM4.9 to US\$1 in January of 1998.

MAHATHIR'S COUNTER-STRATEGY

By early 1998, it was clear that the pro-cyclical IMF macroeconomic policies were not working. Dr. Mahathir, then Prime Minister of Malaysia, changed direction, set up the National Economic Action Council and centralised decision making and policies. In July 1998, he launched the National Economic Recovery Plan, seen as an alternative to orthodox IMF policies. The objectives of this were to stabilise the local currency, restore market confidence, maintain financial market stability, restructure corporate debt, recapitalise and restructure the banking sector and revitalise the economy. These policies were implemented in stages.

To counter the recession, on the monetary and financial sector front Bank Negara loosened monetary policy by reducing interest rates gradually from 11 percent in July 1998 to 6 percent in May 1999 and 3 percent in December 1999. The statutory reserve requirement was also lowered, from 13.5 percent in July 1998 to 4 percent by October 1998. The non-performing loan definition was changed back to six-month arrears instead of three months. Bank Negara also set targets for banks to increase their loans by 8 percent in 1999.

FOREIGN EXCHANGE RATE POLICIES

Malaysia is a highly open economy, with external trade (exports and imports) constituting over 200 percent of its GDP. Hence the stability of its currency is crucial for its external trade. Prior to and during the crisis, the ringgit was traded offshore, and the higher interest rates paid to offshore ringgit deposits encouraged an outflow of the currency. At the height of the crisis in 1997 and 1998, speculation drove the offshore ringgit interest rate in Singapore to between 20 and 40 percent a year compared with an

11 percent onshore ringgit interest rate (Fane, 2000). Mahathir banned offshore market trading of the ringgit in September 1998 and gave depositors a grace period to repatriate their offshore ringgit deposits back to Malaysia. At the same time (September 1998), he fixed the ringgit exchange rate to US\$1 to RM3.8.

SELECTIVE CAPITAL CONTROLS

Mahathir further introduced selective capital control measures that were strongly opposed by the IMF at that time. For foreign institutions and persons, a one-year moratorium from the purchase date of shares was imposed on repatriation of proceeds from the sale of those shares. The aim was to discourage speculative short-term trading in local shares. Ringgit loans to non-resident banks and stock-broking firms were stopped. Restrictions were imposed on transfers of ringgit funds in external accounts held by non-residents. Measures were also introduced to control conversion of the ringgit to other currencies. Except for trade payment purposes, Malaysian residents were allowed to make payments to non-residents or make investments of up to the equivalent of RM10,000, above which they had to obtain prior approval from Bank Negara. Residents were not allowed to obtain ringgit credit facilities from non-residents. Resident companies were prohibited from foreign loans unless their revenue was also in foreign currency, to prevent currency mismatch—a major factor in the Asian financial crisis.

The ringgit was still freely or easily convertible for the purposes of trade, inward foreign direct investment (FDI) and the repatriation of dividends and profit from FDI. What the government wanted to discourage was speculative short-term portfolio and other investments by foreign residents and the flight of capital by local residents, although the effectiveness of the latter objective is debatable.

EXPANSIONARY FISCAL POLICIES

To resuscitate the economy, the government embarked on an expansionary fiscal policy. In July 1998, it unveiled a fiscal stimulus package of RM2 billion which turned the budget from a surplus of 2.5 percent of GDP in 1997 to a deficit of 1.8 percent in 1998 and 3.2 percent in 1999.

SETTING UP DEBT RESTRUCTURING AGENCIES

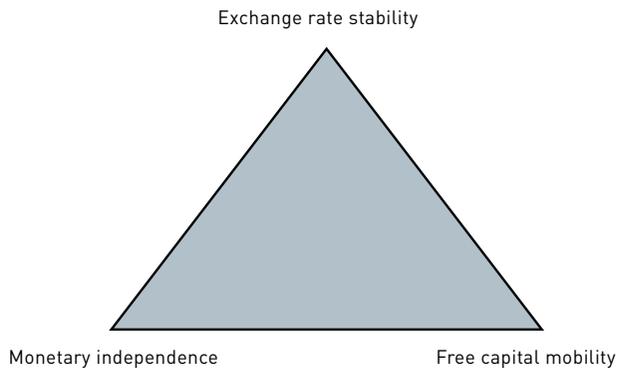
Finally, on the corporate front, the government established a number of agencies to help restructure both financial and non-financial institutions. It provided guarantee of banking deposits and decided not to close down troubled financial institutions that would have aggravated the financial crisis, but rather to consolidate, restructure and recapitalise them. To this end, Danaharta (the debt restructuring agency) was set up in June 1998 to take over non-performing loans from banks, and to restructure and manage them. Danamodal was set up in August of 1998 to recapitalise and restructure troubled financial institutions. In addition, the Corporate Debt Restructuring Committee was established to assist corporations in negotiating and restructuring debt with their creditors.

THE EVOLUTION OF MONETARY AND CAPITAL FLOW POLICIES

According to conventional economic theory, it is not possible for a country to control both its interest rates (through its monetary policies) and foreign exchange rates under a regime of free capital flow. This is because, with free and unimpeded capital flows, a lower interest rate would encourage outward capital flows and hence a lower exchange rate, and vice versa. This is termed the “impossible trinity” (see Figure 3).

The primary objectives of the Malaysian government’s monetary and capital control policies are to ensure stability in the ringgit foreign exchange rate so as not to disrupt trade flows, and at the same time to maintain a steady and relatively low interest rate to sustain economic growth.

Figure 3: The impossible trinity



In choosing the appropriate monetary and other less conventional instruments to achieve the above objectives, the government is guided by pragmatism and flexibility. Hence monetary and foreign exchange rate policies have undergone several transitions.

1997–2000

During the Asian financial crisis, Malaysia faced a large depreciation of the ringgit and massive capital flight, even though it raised domestic interest rates. To stem this outflow and depreciation, the government fixed the value of the ringgit at RM3.8 to US\$1 to manage the impossible trinity problem. This allowed it to lower interest rates to stimulate the economy without worrying about capital flight or currency volatility. When the economy started to recover in 1999, capital and currency controls were gradually relaxed and finally removed. In February of 1999, the one-year moratorium on repatriation of profits from share sale was replaced by a 10 percent exit levy on the sale proceeds on a graduated scale.

2001–5

From 2001 to 2005, the government relaxed capital controls but still maintained the pegged ringgit. But at the same time, it also resorted to monetary instruments, via sterilisation and its reverse, to smoothen out the effects of capital flows. In 2001, the exit levy was abolished altogether. Residents were gradually allowed to operate foreign currency accounts and to invest abroad. As the economy recovered, capital began to flow back into the country. In 2003, net portfolio investment was positive RM4.2 billion up from negative RM6.5 billion a year earlier; it surged to RM33 billion in 2004.

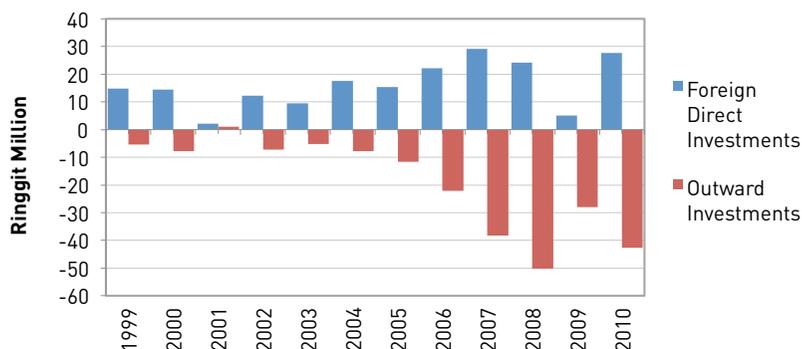
2005 ONWARD

From 2005 onward, the exchange rate and capital flow policies became almost fully liberalised. Capital controls were removed and the pegged ringgit was lifted in July 2005 and changed to a managed-float system, but the ringgit remained non-internationalised, that is, there were limits to non-residents borrowing in the local currency.

POST-ASIAN FINANCIAL CRISIS

The country now faces a different set of conditions. Current account surpluses have been rising steadily every year since 1999, averaging over 10 percent of its GDP. This has not been matched by an equivalent financial and capital account deficit; consequently, the country's reserves rose from RM117 billion (US\$31 billion) in 1999 to RM336 billion (US\$100 billion) in 2007. Besides using monetary instruments, namely sterilisation, to mop up the excess liquidity, the government has also reversed its policy of not allowing residents to invest abroad. Allowing outward investments by residents is another way of mopping up excess dollar liquidity. Malaysia therefore witnessed a significant outflow of direct investments by residents from 2005 onwards. In fact, outward direct investments became greater than the inflow of FDI such that net direct investments were negative from 2007 onwards (see Figures 4 and 5).

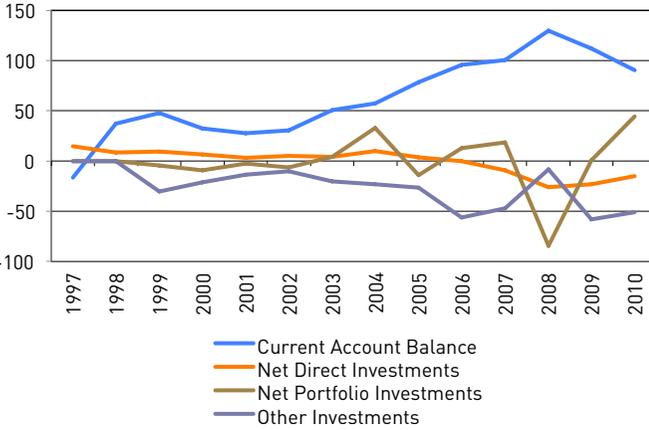
Figure 4: Outward investments and FDI in Malaysia, 1999–2010 (RM millions)



Source: Bank Negara Monthly Statistical Bulletin (various years).

The largest category of net outflow of capital comes from “other investments”, which represent mostly deposits or placement of assets abroad by domestic financial institutions. The net outflow of other investments averaged over RM20 billion annually between 2003 and 2005 and more than doubled to RM56 billion in 2006.

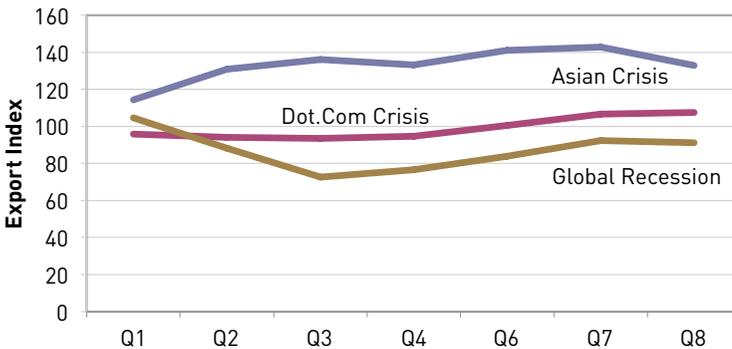
Figure 5: Balance of payments in Malaysia, 1997–2010 (RM billions)



Source: Bank Negara Monthly Statistical Bulletin (various years).

Malaysia entered the latest global financial crisis in a position of relative strength in terms of both its national and its corporate balance sheet. What could be of some concern down the road is the strength of its households’ balance sheet. Helped by a positive external environment, the country instituted the right mix of macroeconomic, monetary and financial sector policies to facilitate its recovery from the Asian financial crisis, with exports leading the way. Figure 6 compares the performance of the export sector in the three recent crises (including the dot.com crisis). In both the Asian financial crisis and the recent global financial crisis, government monetary and fiscal stimulus programmes plus export demand led the way to recovery.

Figure 6: Performance of Malaysian exports in three recent crises

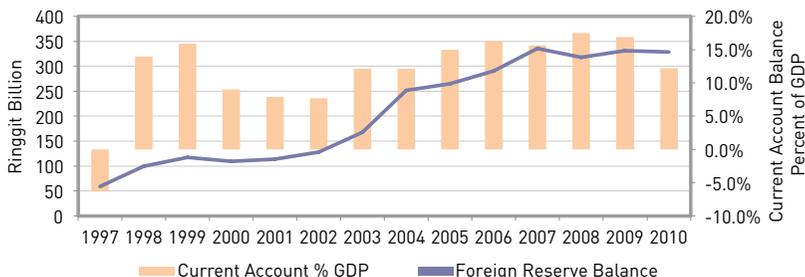


Source: Authors’ own calculations.

STRONG CURRENT ACCOUNT BALANCE AND FOREIGN RESERVES

Malaysia's current account balance rose from a deficit of RM17 billion in 1997 to a positive of RM37 billion in 1998. From 2003 onwards, this surplus has exceeded RM50 billion yearly. Even when the global financial crisis hit Malaysia in 2008, the country's current account surplus was over RM130 billion, dipping to RM112 billion and RM90 billion in 2009 and 2010, respectively. Its foreign exchange reserves have been rising steadily, from RM59 billion in 1997 to RM328 billion in 2010 (see Figure 7). Reserves peaked at RM410 billion in June 2008 and plunged to RM320 billion at the height of the crisis in December 2008, but soon stabilised at RM 316 billion in 2009, adequate to finance 7.6 months of import and 3.9 times its short-term external debt (Bank Negara, 2009).

Figure 7: Foreign reserves and current account balance in Malaysia, 1997–2010

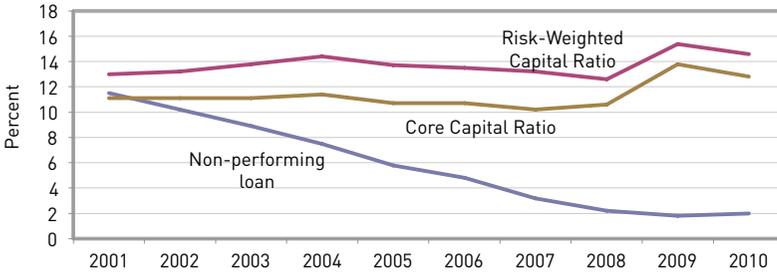


Source: Bank Negara Monthly Statistical Bulletin (various years).

HEALTHY BANKING SYSTEM

The Malaysian banking and corporate sectors emerged healthier after the Asian financial crisis (see Figure 8). Its risk-weighted capital ratio was above 13 percent from 2001 to 2010, its core capital ratio above 10 percent. Non-performing loans based on the three-month arrears classification dropped from 11.5 percent in 2003 to 2.6 percent in 2008. The impact of the crisis on the Malaysian banking system was modest, as domestic banks had negligible exposure to US subprime loans and derivatives. The corporate sector was also healthy, with little currency mismatch. Loan growth was relatively in line with GDP growth. Between 2005 and 2010, total bank loans grew at an annual rate of 8.7 percent, slightly faster than the country's GDP growth of 8.0 percent.

Figure 8: Malaysian banking indicators, 2001–2010 (%)

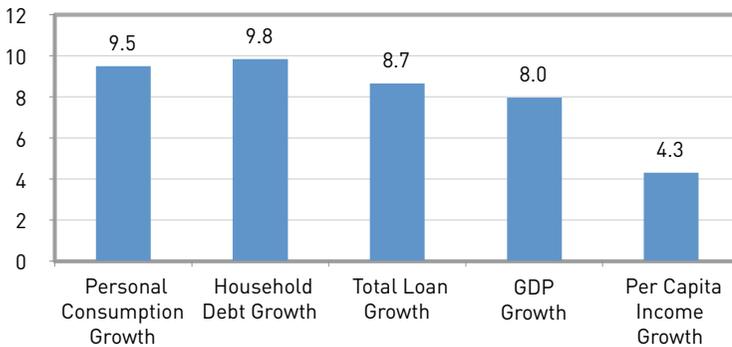


Source: Bank Negara Monthly Statistical Bulletin (various years).

HOUSEHOLD LOANS AND HOUSING ASSET BUBBLE?

What could be of concern, although we are still at an early stage, is the resilience of Malaysia’s household sector. Growth in household loans grew at an annualised rate of 9.8 percent during the same period, about 2 percent higher than GDP growth (see Figure 9). Household debt to GDP in Malaysia stood at 76 percent in 2010, but household debt to disposable income was at a high of 140 percent, higher than in the US. Meanwhile growth in per capita income was only 4.3 percent annually. Hence most of the annual growth in personal consumption of 9.8 percent is driven by debt rather than income growth. Much of the growth in household debt is driven by an increase in house prices which outpaced income growth, followed by passenger car loans which consume a substantial portion of household

Figure 9: Average annual growth on selected indicators in Malaysia, 2005–9 (%)



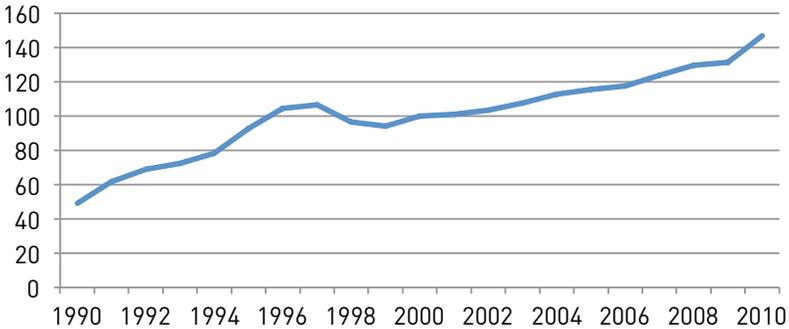
Source: Bank Negara (2009a).

income. Household loans, consisting principally of housing loans, passenger car loans, credit card and personal loans, make up 55 percent of the total banking loans. Furthermore, half of Malaysia's household disposable income is used to service household debt.

House prices in Malaysia have been rising steadily, except for a slight pause in 2008; they resumed their upward climb vigorously in 2009 and 2010 when interest rates were relaxed (see Figure 10). The average house price for the country as a whole is still quite affordable, at RM203,000 (US\$65,000), with an affordability index (average house price/average household income) of 4.1 times. But the affordability index is not sustainable in the major urban areas like Kuala Lumpur (5.9 times) and especially Penang (about 9 times). In Penang, the linked house price index rose from 100 in 2000 to 214 in 2010.

While the central bank raised interest rates gradually in 2010 to control inflation, it is constrained by the fear of derailing economic growth. With half of household disposable income servicing household debt, a further rise in interest rates could result in default and a rise in non-performing loans. The central bank, however, thinks the problem is still manageable. So far, it has only lowered the loan to value (LTV) ratio to 70 percent for buyers of third residential property, leaving the market to determine the LTV ratio for other purchases. In 2008, to counteract the slowdown in housing demand, property developers raised the LTV ratio to 95 percent and introduced marketing gimmicks such as 1 percent booking fees, providing "interest-free" financing during the construction period and paying for buyers' sales transaction charges, to boost the market. In 2010 the government reintroduced modest short-term capital gains tax to tame house prices. But the tepid measures of the central bank have not had much effect in slowing down rising house prices.

Figure 10: House price index for Malaysia, 1990–2010

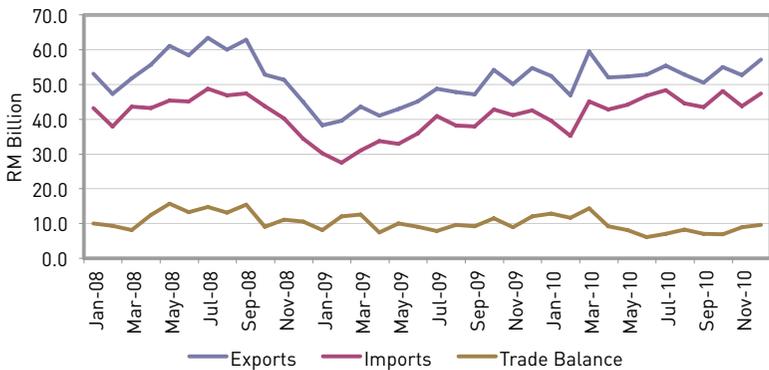


Source: NAPIC (2010).

MALAYSIA ENTERS THE RECESSION: TRADE AND INVESTMENTS SLUMP

Despite the relative strength of Malaysia’s macroeconomic conditions and banking sector, the country was not spared the worst of the crisis. Being a highly trade-dependent economy, and having almost fully liberalised its exchange rate and capital account after 2005, the country was hit hard in the trade and investment sectors. Exports plunged 45 percent, from RM64 billion in July 2008 to RM38 billion in January 2009. Imports plummeted by the same percentage over this period so that the trade surplus remained positive and declined marginally (see Figure 11).

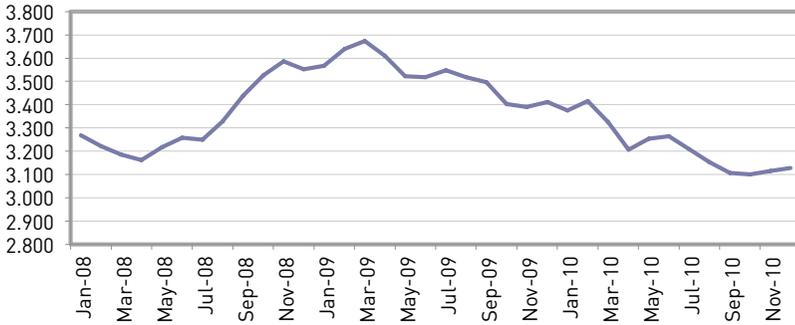
Figure 11: Malaysia’s export and imports, 2008–10 (RM billions)



Source: Bank Negara Monthly Statistical Bulletin (various years).

Unlike in the Asian financial crisis, the ringgit this time depreciated only about 10 percent, gradually recovering and appreciating in the post-crisis period (see Figure 12).

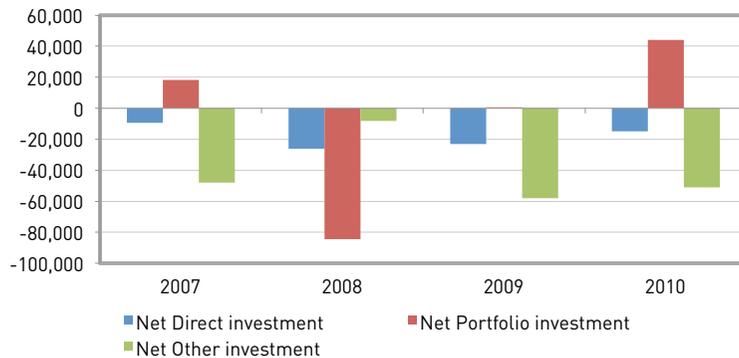
Figure 12: Ringgit-US\$ exchange rate, 2008–2010



Source: Bank Negara Monthly Statistical Bulletin (various years).

With almost full liberalisation of its financial and capital accounts, Malaysia is now subject to highly volatile capital flows, the most erratic being those of portfolio investments. Figure 13 shows that net portfolio investments plunged RM100 billion from positive RM18.3 billion in 2007 to negative RM84.4 billion in 2008; the Malaysian stock market likewise lost 40 percent of its value in the year 2008. Net portfolio investments then recovered in 2009 and surged to RM44.2 billion in 2010.

Figure 13: Net financial flows in Malaysia, 2007–10 (RM millions)



Source: Bank Negara Monthly Statistical Bulletin (various years).

Significantly, the banking and financial sector in Malaysia remained stable. It did not suffer a liquidity or solvency crisis. Non-performing loan ratios remained stable around 2 percent and the banks are well capitalised. Loan growth slowed in the second half of 2008, but picked up again by the first half of 2009.

IMPACT ON THE REAL ECONOMY

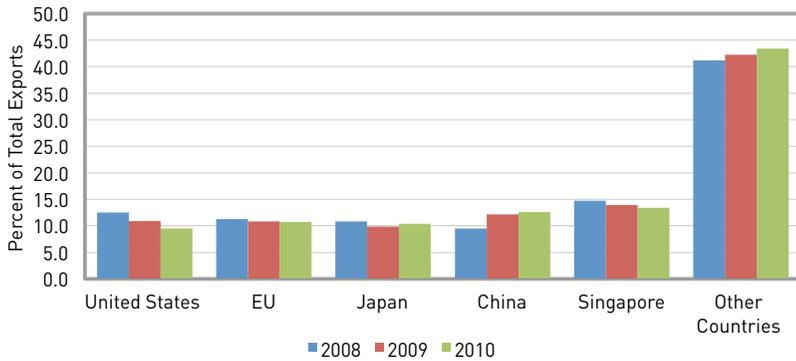
With the drastic decline in exports and spike in capital outflows, the Malaysian economy entered into a recession, with GDP contracting 1.7 percent in 2009. Growth turned negative the first three quarters, with the economy contracting 6.2 percent in Q1 of 2009. Unlike the IMF prescription during the Asian financial crisis, this time around, all governments, including Malaysia's, went into high gear to implement counter-cyclical monetary and fiscal policies. The government took up the slack where private demand slumped.

FISCAL STIMULUS AND MONETARY LOOSENING

In late 2008 and early 2009, the government introduced two vigorous fiscal stimulus programmes totalling RM67 billion, equivalent to 10 percent of GDP. The central bank cut interest rates aggressively three times, totalling 150 basis points, to a low of 2.0 percent. It also reduced the statutory reserve requirements by 200 basis points to 1.0 percent. All these measures worked to stabilise the domestic economy. Private consumption, which fell 2.9 percent in Q1 2009, gradually improved in the second half of the year. But for the full year 2009, private sector expenditure contracted 3.4 percent while public sector expenditure rose 7.7 percent (Bank Negara, 2010).

On the supply side, growth in the first part of 2009 was affected severely by the collapse of manufacturing exports in the second half of 2008. The services sector recorded a marginal decline while the construction sector remained positive throughout the year owing to public investments and the fiscal stimulus. Fortunately for Malaysia, exports rebounded quickly in the second half of 2009 and the first half of 2010. Significant to note is the shift in the direction of trade. Exports to the US declined while those to China and other countries, particularly intra-regional trade, rose (see Figure 14).

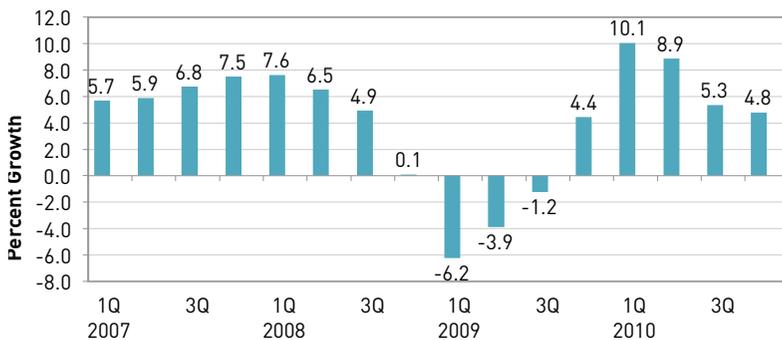
Figure 14: Direction of Malaysian trade, 2008–10 (% of total exports)



Source: Bank Negara Monthly Statistical Bulletin (various years).

The worldwide massive monetary and fiscal loosening brought about uneven recovery. Growth in Europe, Japan and the US remains weak, whereas that in emerging countries is stronger. Malaysia’s real GDP growth was negative for three quarters but rebounded strongly in the latter part of 2009 and first half of 2010 (see Figure 15).

Figure 15: Real GDP growth in Malaysia, 2007–10 (%)



Source: Bank Negara Monthly Statistical Bulletin (various years).

NEW CHALLENGES FOR ASIA

In fact, emerging countries now face a different set of challenges. They are not decoupled from advanced countries; they remain firmly integrated into the world financial and trade system. Financialisation of the global system and speculation are the order of the day. Capital flows instantly and

incessantly in search of higher yields; the most visible are the carry trades where investors borrow in low-yielding currencies such as the yen or the US dollar to invest in higher-yielding currencies and assets like the Australian dollar. The massive liquidity injection by the Federal Reserve Bank in the form of quantitative easing did not calm the liquidity and lending conditions in the US. Rather, much of the funds flowed to emerging countries experiencing higher growth, resulting in both appreciation of their currencies and asset inflation in stock and property markets.

The stock market index in Malaysia, as in many other emerging countries, has now exceeded its pre-crisis peak, and the property market has been registering double-digit gains since 2009. As was stated earlier, policymakers are using both monetary and other physical instruments to rein in property prices. Meanwhile, inflation risks increase with sharp rises in food, fuel and other commodity prices. The governor of Bank Negara warned in May 2009 that inflation risks could outweigh the downside growth risks in the Malaysian economy (Star, 2010). The central bank remains vigilant and will adopt measures to meet these challenges.

CONCLUSIONS AND POLICY LESSONS

Malaysia, like many other Asian countries, faced two major crises in the space of 10 years. How did it weather these and what lessons can be drawn from this experience?

1. Increasing integration into the world trade and financial system brings with it benefits and dangers. Malaysia's economy, like most other emerging economies, is becoming more integrated, rather than decoupled, from the world economy, through both trade and capital flows. Financial openness exposes the domestic economy to sudden and large movements of capital and volatility in exchange rates. Exchange rates today are influenced more by capital flows than by trade flows. If a country, particularly a small economy, maintains full liberalisation of capital flows, such massive and volatile capital flows can undermine its monetary policies, as in the case of the Asian financial crisis.
2. Policymakers should not be tied to IMF orthodoxy. Rather, they should be pragmatic and flexible in their policies, and guided by overall national objectives. Fiscal, monetary and banking policies should be counter-rather than pro-cyclical. They should be willing to use instruments other than the normal monetary one to attain these objectives. Malaysia adopted selective capital controls to stabilise trade, capital flows and exchange rates and adapted or removed these as conditions changed. At

that time, such a policy was considered heretical; yet today even the IMF is advocating selective controls as a legitimate tool to manage economic and financial stability. Today, as many emerging countries face asset inflationary pressure resulting from excess liquidity created by quantitative easing and carry trades, policymakers should be willing to use additional tools to manage their currencies and capital flows.

3. There is no substitute for building strong macroeconomic fundamentals and healthy national, corporate and household balance sheets. Malaysia's external debt at the outset was low, and there was little currency mismatch in its external debt. Another reason many Asian countries, including Malaysia, were able to weather the global financial crisis relates to their ample foreign exchange reserves, which provided them with the liquidity and ability to absorb external shocks. In 2008–9, Malaysia suffered a net capital outflow of about US\$30 billion, but the country still had US\$90 billion in foreign reserves, equivalent to eight months imports and over three times its short-term foreign debt. Countries like South Korea and Indonesia, which had high exposure to foreign debt, currency mismatches and low levels of foreign reserves, were in a more precarious position.
4. Malaysia is highly dependent on trade, and manufacturing forms the largest component of its exports. A total of 60 percent of its manufacturing exports come from the electrical and electronics industry. To lessen volatility, it should diversify both its export composition and its export destination. The crisis witnessed a discernible shift in Malaysian export destinations toward intra-regional trade, and in particular Towards China.
5. The world financial system is becoming increasingly fragile and unstable, and financial crises are at the heart of major economic crises. Asset inflation, rather than wage or consumer price inflation, has been the driver of economic boom and bust, and was the main cause of the global financial crisis. Malaysia should learn from this lesson, and central banks should pay more attention to asset inflation and be willing to adopt lean-against-the-wind measures to avoid or minimise similar crises in the future.
6. Maintaining a prudent and sound banking system with a low level of exposure to fancy financial instruments stood Malaysia in good stead. Malaysian banks had minimal exposure to collateralised debt obligations and other derivatives, were well capitalised and had stable non-performing loan ratios. The government should resist pressures to indiscriminately liberalise its financial systems or adopt the latest fad in financial innovations.

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