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Malaysia's Crisis
Was It Different?

Rudi Dornbusch

> Then the unexpected happened. The Asian miracle was shattered almost overnight and suddenly once fawning economists argued that all it really had been was a bubble, over-inflated by corruption, cronyism and bad loans. Asians were not only impoverished but were blamed for impoverishing themselves.
> —Mahathir bin Mohamad (1999, 47)

The Asian crisis came as a big surprise to all: investors, credit rating agencies, international institutions, and, not least, officials in the crisis countries. There is no question that the long-run performance, hard work, high saving rates, and seemingly competent officials all added up to create a powerful presumption that all was well.[1] They gave assurance that problems, if any, would be isolated and manageable, and because everyone held that belief, everyone reinforced everyone else's unquestioned beliefs. There was equally no question that, once the weakness in balance sheets revealed itself, everyone's skepticism was profound, and their willingness to remain invested was undermined. In preceding crises there had been little surprise; after all, crises tended to occur in the usual suspects of Latin America, which never came as a surprise. This time, the crisis struck the Asian miracle, but the mechanisms differ little.

What differs in the case of Malaysia, however, is the forceful reaction of the leadership and the departure from traditional postcrash responses. Prime Minister Dr. Mahathir bin Mohamad staged a dramatic rejection not only of speculators and the international capital market but also of international officialdom. He took recourse to financial restrictions with quite a bit of grandstanding and, indeed, claimed that the country was successful in averting worse consequences and recovering precisely because of these measures. He obviously and righteously delighted in sticking a finger in the

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1. Of course, there was a discussion about the productivity of Asian economies, but that concerned the sacrifice in achieving growth, not the vulnerability that made for the imminent crisis.

eye of the International Monetary Fund (IMF) and Group of Six (G6) treasuries.[2] It remains to be explored whether his claim is indeed appropriate or whether it is primarily the domestic grand-standing of a weakened and challenged leadership that uses international issues to deflect attention from severe domestic political problems.[3]

The Malaysian case deserves attention not only on its own terms but also because the presumption of capital controls in response to crises—failing an early and gracious arrival of the IMF—has become far more of a concern. After all, how can a finance minister assert that it is good policy for the country to experience a meltdown, as a matter of principle, to accommodate departing investors? Moreover, if it could be demonstrated that this policy had an appreciably positive effect in a crisis, policy makers would have to change their views and welcome such a development. Of course, a presumption of capital controls would create a very trigger-happy international environment. It might be argued, with some merit, that the environment is already explosive and that what is missing is a good response. Hence, it is no surprise that countries incline toward the *national solution,* and it does make for good rhetoric.

In evaluating the Malaysian experience, it must be understood that two crises were unfolding simultaneously for this country. One was the Asian financial crisis, which brought down countries with vulnerable financial structures. The other was the domestic political crisis that arose from the challenge to Mahathir by the deputy prime minister and finance minister, Anwar Ibrahim. In the eyes of the leadership, the political crisis must have seemed at least as critical as the financial crisis; indeed, the financial crisis offered a means to sustain and reinforce political control by creating an economic state of siege and policy response. It surely is not a coincidence that Anwar was deposed literally the day after capital controls were imposed.

If capital controls have not delivered economic results clearly superior to those of IMF assistance, that does not mean they failed on the political side. The attacks on speculators who were alleged to have undermined the Asian dream and the Malaysian model were central to the effort to ward off challenges to Mahathir's leadership. These attacks were intended to convince their audience that the economic development model (including the 2020 vision and the ambitious public investment programs) was right and that the rest of the world was wrong. For the time being, they have been effective in this effort.[4]

2. I cite G6 because Japan is not on record as questioning Malaysian policy responses. On the contrary, it participated with them and led the call for an Asian IMF and new and different policy responses to regional financial crises.

3. See Haggard (2000), Haggard and Low (2000), and Terence Gomez and Jomo (1999) for the political setting and its link to capital controls.

4. See Mohamad (1999), where Mahathir presents the case.

9.1 Capital Controls

In the 1930s, Nazi Germany invented capital controls, and soon, in an environment of capital flight and competitive depreciation, much of Europe adopted controls as well. The system become pervasive and accepted. Indeed, in the move toward rules paralleling the establishment of the IMF and the rebuilding of a more open world economy, capital account convertibility was not part of the picture. It came to the fore much later, after 1958, when Europe gradually and unevenly shifted to full convertibility. The usual suspects, France and Italy, took until the late 1980s to make the transition. Britain did not abolish exchange control until the Thatcher government, and in Japan or on the periphery the transition took even longer. Opening the capital account became the focus of U.S. financial policy in the late 1980s and particularly of the Rubin-Summers treasury, whose agenda was opening financial services trade and domestic financial deregulation. Repressed finance gave way to an opening of domestic finance and to more substantial freedom for cross-border flows.

The case for integrated international capital markets is just like that for open trade: a more efficient allocation of resources achieved by competition, diversification opportunities, and equalization of risk-adjusted returns. In addition, just as in the case of open trade, an overwhelming case can be made that restrictions to capital flows create a hotbed of privilege and corruption around exceptions and loopholes. Finally, the expectation is that an open capital market—and the accompanying international standards, regulation, and supervision—will do a better job at allocating capital than politicized and corrupt local arrangements.

Although a tremendous amount of work reports on the costs of trade distortions, little is available on the issue of restricted capital accounts.[5] For example, no evidence that countries with open capital accounts (other things being equal) grow faster has been reported, nor has the converse been the case. There is, however, work showing that countries with high black-market premiums (meaning that capital controls are binding) do perform more poorly. However, these premiums reflect not only controls but also macroeconomic instability, and hence may not be conclusive.

We might approach the question of the effects of controls somewhat differently by asking what we would expect from a country imposing controls on capital flows. In the long run, in the absence of regulatory and tax distortions, we would expect controls to imply a less effective allocation of resources and hence less growth or diversification. In the short term, controls play quite a different role. If they are imposed in the midst of a crisis, unan-

5. Even the evidence on trade is not unambiguous. See Brock and Durlauf (2000), Rodriguez and Rodrik (1999), and Doppelhofer, Miller, and Sala-i-Martin (2000).

ticipated and temporary, they will work in the sense that they stop outflows, reduce pressure on the exchange and interest rates, and hence avoid a state-of-siege situation that results in excess bankruptcy and disruption. They are analogous to a suspension of trading on the New York Stock Exchange or the Nasdaq or to a bank moratorium—they stop the run and offer time to set things straight.[6] Economists' concern with ad hoc capital controls is less with the description offered here than with the feared implication that they will become a substitute for setting things straight. Malaysia is, of course, a case in point. The major question, obviously, is whether the issue is to gain time or to make lasting changes in freedom of resource allocation. The former endeavor deserves much attention, whereas the latter is politically attractive but lacks economic support.

Moving now to the question of Malaysian controls, what might be argued? Supporters would no doubt claim that in the absence of controls the collapse would have been far deeper, the recovery much more difficult, the lasting damage far more profound. If this is the case, a capital-control country—other things being equal—will look much better than the other countries that are exposed to the same initial shocks but respond with orthodoxy rather than controls. Specifically, to make some progress on these issues, we should answer these three questions:

- On the eve of the crisis, was Malaysia appreciably different in its vulnerability from other crisis countries? If so, is that the possible explanation for its purported success in dealing with the problem?
- Did the policy measures—banking, stock market, and capital controls; business subsidies—perform significantly better than in other economies? Better performance means higher growth, less volatility, and less-pervasive bankruptcy without any offsetting large increases in public debt.
- Is there an indication of lasting costs, or benefits, to the policy choices?

It is as well to anticipate our conclusion. The costs or benefits of capital controls remain ambiguous, despite their ostensible success in Malaysia. In actual fact, Malaysia had more favorable preconditions, it did not perform appreciably better than other crisis countries, and the timing of controls coincided with the reversal of the appreciation of the yen, the end of the crisis elsewhere, and Federal Reserve rate cuts that put an end to the crisis atmosphere in world markets. Nevertheless, the reverse case equally holds.

6. In the aftermath of the 1987 stock market decline, the Brady Commission reviewed the question of suspending trading and came out in support of circuit breakers as a means to restore markets. On the Nasdaq, trading is suspended for companies for whom information is unavailable. These cases seem to present an interesting analogy for defensible limited-time capital flow suspensions. If a circuit breaker lasts half an hour on the New York Stock Exchange, the equivalent for an emerging-market capital flow suspension might be a month.

There is no evidence that capital controls or the failure to apply an explicit IMF program so far had obviously detrimental effects.

9.2 The Background

It is helpful to examine the context of the Malaysian events. The relevant time frame extends from the Thai problems that began in spring of 1997 to the interest rate cuts administered by the Federal Reserve in the aftermath of the Long-Term Capital Management (LTCM) problem and the Russian crisis. Various Asian economies joined the crisis progressively.

May–July 1997	Pressure on Thailand, exchange control, two-tier market, and devaluation occur.
July	The Philippines go to a float; Malaysia abandons support for the ringgit; Thailand goes to the IMF.
August	Thailand suspends forty-two banks; Indonesia abandons rupiah support; Malaysia restricts short selling; Indonesia restricts credit for rupiah trading.
October	Indonesia goes to the IMF; Malaysia announces austerity budget; Hong Kong dollar comes under attack.
November	Korea abandons won support and goes to the IMF.
December	Rescue package is designated for Korea.
January 1998	Malaysia announces full deposit guarantees.
January–August	Asian IMF packages are revised; financial restructuring and downgrading take place.
May	Indonesia's Suharto steps down.
August	Russian crisis occurs; yen peaks.
September	LTCM crisis occurs; Malaysia imposes capital controls; Deputy Prime Minister Anwar Ibrahim is deposed.
September–November	Federal Reserve cuts rates by 75 basis points.

The background of the Asian crisis includes the large buildup of capital inflows in the first half of the 1990s—not foreign direct investment (FDI) but bank loans and portfolio capital (see IMF 1999b). The crisis involves the sudden drying up and reversal of these flows in 1997 and the resulting macroeconomic pressures of currency depreciation, high interest rates, output decline, and financial stress. This reversal in capital flows is shown in the accompanying figure for the Asian crisis economies as a group. The coun-

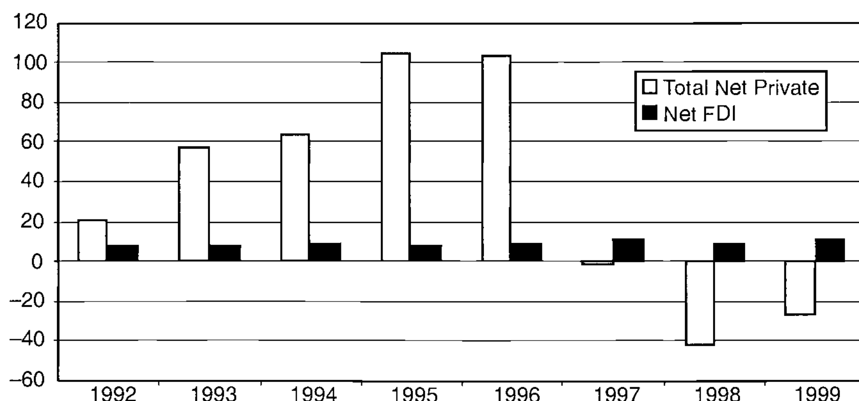

Fig. 9.1 External capital flows for crisis-Asia (US$ billions)

terpart of the reversed capital flows is a reserve loss and current account surpluses in the crisis economies.

The pressure for outflows soon reached all economies. Within six months following the Thai debacle, Indonesia, Malaysia, the Philippines, and Korea had been hit, and Hong Kong had come under attack.

One summary measure of events is the path of real gross domestic product (GDP). After performing well up to 1996, growth declined in 1997 as the economies shifted toward crisis. In the following year, 1998, output declined everywhere; by 1999, recovery was under way. By 2000 even per capita GDP is above precrisis levels. Judged by these standards, the crisis was as short as it was deep. However, other measures show more lasting damage, including an impaired banking system, a significantly higher public debt everywhere, and a loss of growth momentum, accompanied by the resulting temptation for governments to step in. Another measure that might indicate differential performance is the real exchange rate. One might argue that in a capital outflow crisis, other things being equal, countries with controls suffer a less extreme real depreciation. That argument is not borne out by the accompanying figure.

9.3 A Closer Look at Malaysia

This paper does not address the immediate reason for the crisis. Chapter 16 in this volume offers a summary of the vulnerability factors—misaligned real exchange rates, nonperforming loans in the banking sector, and the funding risk of the national balance sheet due to excess debt or mismatches of maturity and currency denomination.

With the pressure of capital outflows and increases in interest rates—already under way since early 1995—and poorer export performance, growth did give way. Ultimately, industrial production declined, only resuming

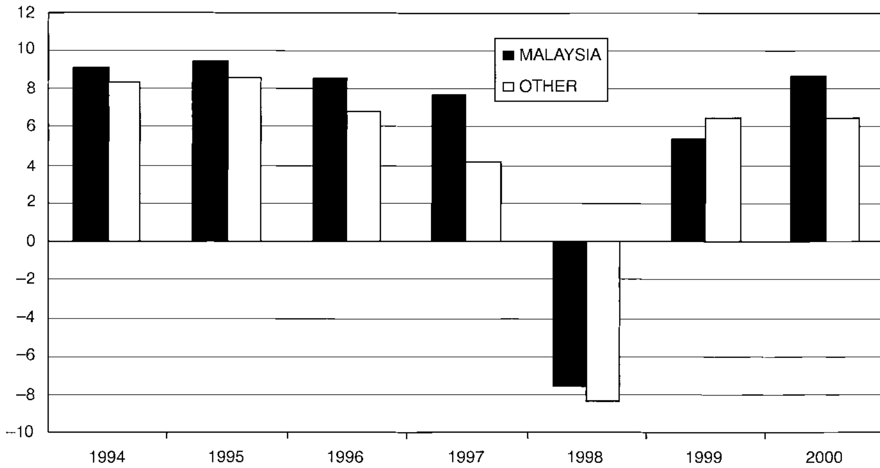

Fig. 9.2 Malaysia and other crisis countries: GDP growth

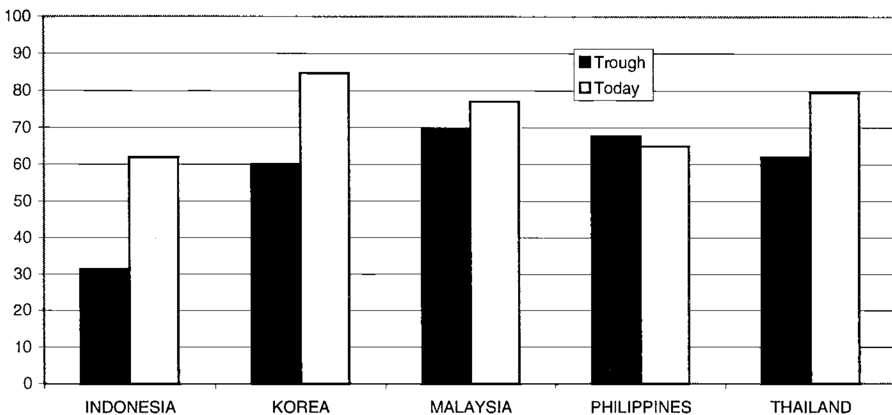

Fig. 9.3 Real exchange rate (January 1970=100)

growth in early 1999; investment as a share of GDP fell sharply, to only half its previous level; the stock market fell sharply; and the real exchange rate depreciated substantially.

Much of the macroeconomic scene involves the problems of banks and firms whose balance sheets are unprepared for exchange rate movements, slowdowns, or recessions. The responses of restructuring, bailing out, and subsidizing are certainly part of the controversial legacy. However, this part of the recovery process does not differ importantly from that of other economies, in which none of these responses took place promptly, decisively, or successfully.

Table 9.1 Malaysia: Economic Indicators

	1990–95	1995	1996	1997	1998	1999	2000
Growth	8.9	9.8	10.0	7.5	–7.5	5.4	8.5
Inflation	3.7	3.2	3.3	2.9	5.3	2.8	1.5
Investment[a]	37.5	43.6	41.5	42.9	26.7	22.3	24.1
Budget deficits[a]	–0.4	3.2	3.9	6.1	–0.9	0.2	–2.6
Current account[a]	–5.8	–9.7	–4.4	–5.6	12.9	16.0	12.1
External debt ($Bill)		34.3	39.7	47.2	42.6	43.6	45.0
% of GDP		38.7	39.3	47.1	58.8	55.2	50.4
% short term		19.1	27.9	25.3	17.8		
Reserves ($billions)		23.8	27.0	21.7	26.2	30.9	33.2

Source: Goldman Sachs, except % short term (IMF 1999c).
[a]Percent of GDP

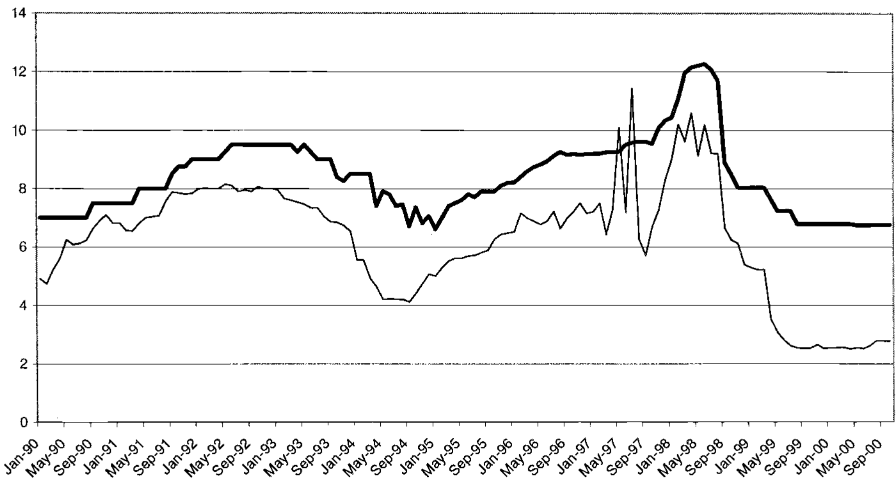

Fig. 9.4 Malaysia: Money market and lending rates

Fig. 9.5 Malaysia: Stock market (index January 94=100)
Source: Datastream.

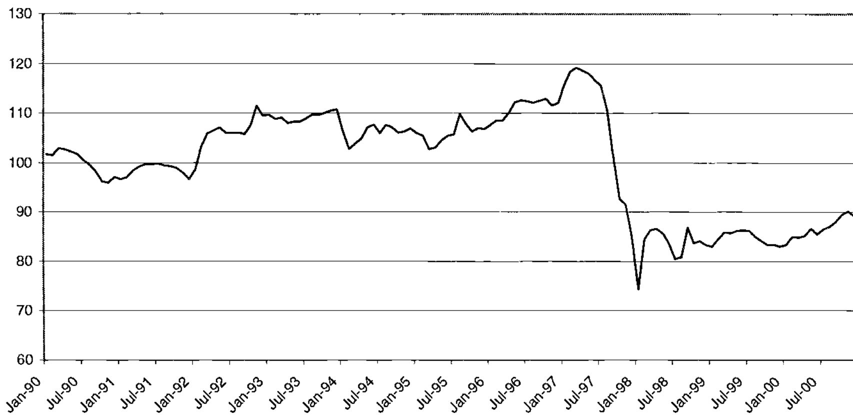

Fig. 9.6 Malaysia: Real effective exchange rate (JPMorgan Index 1990=100)

9.4 Capital Controls and Their Effectiveness

One possibly critical difference between Malaysia and other crisis economies in the region was its imposition of stringent capital controls on 1 September 1998. This went further than the Thai measures, which had already been suspended by then, and the credit measures that had been used elsewhere to avoid financing capital flight. The details of the capital controls essentially involved the mandatory repatriation and one-year holding of offshore ringgit funds as well as restrictions on outflow.[7] These controls were partially relaxed in February 1999 to become a system of graduated exit taxes. FDI flows throughout were exempt, and the exchange rate was fixed. The drastic attack on capital flows had the effect of stopping capital flows in both directions, as shown in figure 9.8, which uses portfolio flow data (made available by State Street Associates).

According to the canons of IMF policy and commitments, the imposition of capital controls was, of course, a radical measure. Whatever the reason it was imposed, Mahathir justified it with a quotation from Paul Krugman: "[E]xtreme measures might be needed for extreme times" (see Mohamed 1999, 106). In his justification for dispensing with classical financial rules, he might equally well have quoted Keynes: "[I]t is better for reputation to fail conventionally than to succeed unconventionally."

Where controls decisive in producing this turn of events, or was it taking place anyway? It is readily seen from the graph above that the stock market recovery turns in September, as does the recovery of industrial production. The same is true for short-term interest rates. It is tempting, therefore, to see the imposition of capital controls as the turning point. However, as the IMF

7. See IMF (1999a, 54–56; 1999c). For further references to Malaysian capital controls, see Ariyoshi et al. (2000), Edison and Reinhart (2000), Kaplan and Rodrik (chap. 8 in this volume), and Koay (2000).

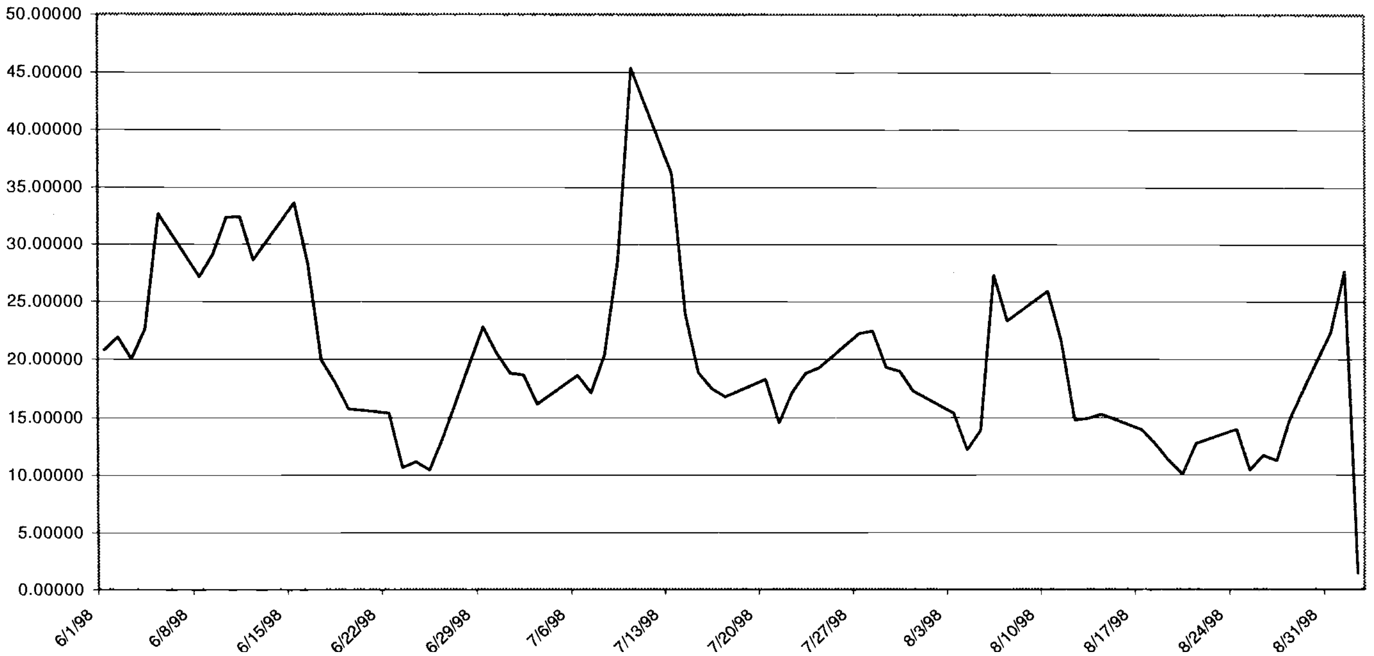

Fig. 9.7 Malaysian offshore daily rates (% per annum)

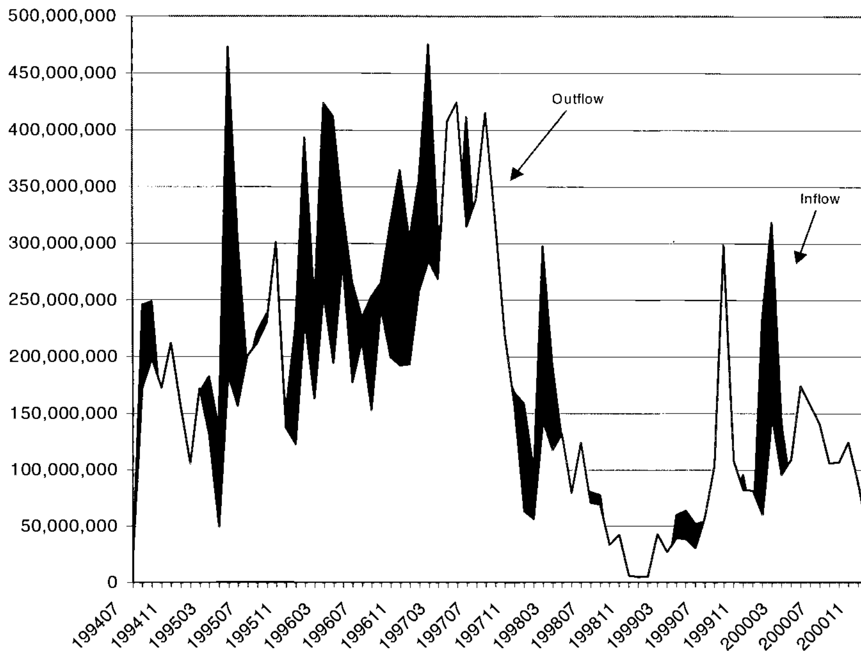

Fig. 9.8 Malaysia: Portfolio flows

has rightly argued, at the time that capital controls were imposed, markets had already settled in Asia and interest rates had started to decline—and would soon do so everywhere under the impact of Federal Reserve rate cuts and a reduction in jitters. In fact, rates in Korea and Thailand had fallen by August to half their June levels, and the same was true in Malaysia.

In fact, as we see from the *offshore* rates for Malaysia and thus the interest rates faced in the open market, which reflect depreciation expectations, much of the pressure had subsided before the 1 September imposition of capital controls. By August, the offshore rates had, in fact, declined to around 10 percent, far below the crisis level. Interestingly, the spike in the graph at the end represents the time the controls were put in place and reaches 28 percent on 1 September! Thus, the claim that the pressure continued unabated is simply not borne out by offshore interest rates. On the contrary, the advent of controls raised rates. The political interpretation of the controls thus deserves more attention.

9.5 Should Malaysia Have Done Better?

Another way of approaching the question of non-IMF policies and the claim that Malaysia performed well with such policies is to ask how the country compared to others in vulnerability. Two issues influence perfor-

Table 9.2 Vulnerability Indicators in 1996

	Stock Market Cap/GDP	Debt/Equity Ratio	Private Bank Credit/GDP	Short-Term External Debt/Reserves
Indonesia	40.0	310.0	55.4	177.0
Korea	28.6	518.0	57.6	193.0
Malaysia	310.0	150.0	89.8	41.0
The Philippines	97.3	160.0	49.0	80.0
Thailand	55	250	100	100

Source: World Bank (2000, 70).

Table 9.3 Nonperforming Loans and Increased Public Debt in 1999

	NPL/Total	NPL/GDP	Increase in Public Debt/GDP (%)
Indonesia	55	22	68.6
Korea	16	23	20.7
Malaysia	24	35	16.0
Thailand	52	53	34.6

Source: IMF (1999a), World Bank (2000).

mance: initial conditions and policy responses. If performance was not substantially different across different countries, one might argue whether it should have been simply because initial conditions were significantly more favorable or unfavorable to start with. In particular, very bad balance sheets would imply more difficulty in dealing with the crisis and hence poorer performance. On the other hand, better vulnerability indicators would mean less stress and hence better performance.

Tables 9.2 and 9.3 show a series of vulnerability indicators. In table 9.3, Malaysia looks relatively good in the debt-equity ratio of the corporate sector and, importantly, the ratio of short-term external debt to reserves. Both the stock market GDP ratio and the private credit GDP ratio are high. These were, indeed, vulnerable areas because the high valuation reflected the vast amount of bank credit lent to stock purchases (7 percent of GDP).

In table 9.3 we look at the status of the banking system by 1999. Malaysia looks relatively favorable in nonperforming loans as a share of total loans. As a ratio of GDP, however, these numbers are high, reflecting the large share of private credit relative to GDP. In Malaysia compares favorably in cleanup cost, all the more so because the Korean numbers almost certainly understate the cost of restructuring the banking system and the corporate sector.

Table 9.4 looks at some numbers for debt and debt structure in the corporate sector. Again, in no way does Malaysia stand out unfavorably. Public debt in 1996 is higher than in Korea or Indonesia, but certainly not alarmingly so; the banking system and private investment (with or without crony-

Table 9.4 Public Debt, Bank Strength, and Corporate Debt Structure in 1996

	Public Debt/GDP	Bank Strength Rating	Debt/Equity Ratio (%)	Short-Term Debt/ Total Debt
Indonesia	22.9	D	188	54
Korea	8.8	D	355	57
Malaysia	36.0	C+	118	64
The Philippines	105.1	D+	129	48
Thailand	15.7	D+	236	63

Source: IMF (1998, 36), Asian Development Bank (1999, 27), World Bank (2000, 70).

ism) were financing the development strategy, unlike in Latin America. However, Malaysia initially shows a better-rated banking system, lower debt and equity in corporations, and a maturity of debt that is not substantially shorter than elsewhere.

In sum, Malaysia was in no way more exposed than other crisis countries and, for that reason, should not have been doing worse. Accordingly, it cannot be argued that the effects of capital controls is contained a situation that otherwise would have been much worse than those of other countries. Once again, then, there is no evidence one way or the other.

One more question is whether Malaysia enjoys lasting benefits from the continuing capital control regime (see Bank Negara Malaysia's website for the bureaucratic aspects of ongoing circulars modifying the regime). The answer here is surely that it is far too early to judge the impact, if any. In the Exchange Rate Mechanism experience in Europe, the Netherlands paid a small but lasting price for a one-time devaluation that broke with the tradition of fixed rates on the deutsche Mark. In emerging markets, differentials reflect ongoing control regimes, macroeconomic instability, and, importantly, political uncertainties. To identify the capital control "misconduct" premium is overly ambitious.

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Comment Michael P. Dooley

I would like to underline two of the many interesting points Rudi Dornbusch makes in this paper. First, it seems to me that he is correct in arguing that politics had more to do with the imposition of controls in Malaysia than did welfare economics. Controls imposed after nonresidents have committed their funds are an excellent way to deflect blame for a financial crisis away from the authorities and onto foreign speculators. They also distance the chief executive from those who encouraged opening in the first place. This is not just an emerging-market phenomenon. President Nixon condemned the gnomes of Zurich as the Bretton Woods system of fixed exchange rates unraveled in the early 1970s.

In reviewing work on capital controls a few years ago (Dooley 1996) I

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found this to be a recurring theme. Economic analysis provides a variety of rationales for capital controls. However, economists are usually embarrassed when politicians invoke their arguments to undertake control programs that are unrelated to the theory. Moreover, once in place, control programs take on a life of their own and outlive the original rationale. This is not a new idea: Cairncross (1973) and Dornbusch (1986) argue convincingly that control programs that might once have been sensible involve substantial long-run costs. Dornbusch's warning in this paper that we will have to see if the Malaysian controls are costly is based on solid historical evidence.

Is there a sensible economic rational for the Malaysian response to the financial crisis? The answer is clearly yes. As Dornbusch points out, a suspension of payments is the classic response to a bank run. If the Asian meltdown was a liquidity crisis, an efficient way to help investors select the good equilibrium is temporarily to stop the run until they come to their senses. In the end, investors will thank authorities for doing so. Moreover, the expectation that the authorities will use controls to stop runs and the unnecessary real costs associated with them will encourage capital inflows.

I do not believe this is a useful model for the Asian crisis, but the International Monetary Fund and many others do. Thus, the question remains: If there are conditions under which capital controls can be an effective policy instrument, why do we have so little evidence that they have been utilized effectively? As Dornbusch points out, one reason is the difficulty in setting out the counterfactual. The other, I suspect, is that political economy makes the sensible use of controls an exceedingly rare event.

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Discussion Summary

Nouriel Roubini remarked that the issue of contagion was not discussed in the paper. He said that around the time that Malaysia imposed capital controls, Russia had already imposed similar measures after it devalued and defaulted. *Paul Krugman* also argued that capital controls were a good idea and urged crisis countries to impose them. Given that we know that capital

controls can be effective only when they are not anticipated, and that they can actually cause capital flight and even crises when anticipated, Roubini said that it is important to study how contagion affects the effectiveness of the Malaysian capital control policies. This is especially the case because there seems to be a risk of many emerging markets' imposing capital controls.

Roubini also said that it was important to distinguish between radical controls—such as killing offshore markets—and partial controls. One major difference between these two control policies is that partial controls "leak." For example, Thailand imposed controls in May 1997 on nonresidents' ability to borrow in the local currency, which led to a large interest rate spread between the domestic and foreign markets. These controls were effective for a short time, but the substantial difference in interest rates created a huge incentive for investors to take the money abroad for a higher rate of return, which eventually led to the collapse of the Thai baht. Similar partial control policies were in practice in Malaysia in 1998, which may have worsened the situation there by increasing the speculative capital outflow rather than reducing it.

Anne O. Krueger noted that Malaysia had a big problem in 1995, which triggered a large cut in the fiscal deficit and other policies. This brought a partial restabilization to Malaysia's economy and was the reason that Malaysia was in better shape than other countries before the crisis. Krueger suggested referring to the 1995 event in the discussion. Krueger also said that the failure of the return of foreign direct investors to Malaysia might reflect that they lost confidence in forward contracts in Malaysia after the imposition of capital controls.

Martin Feldstein raised a few questions. First, he asked whether Malaysia carried out the kinds of structural reforms that the IMF required in other countries even though it did not officially adopt the IMF program. His second question was related to a point made by *Michael P. Dooley,* namely, that Malaysia actually imposed capital controls before the official announcement of the controls. He asked if the difference between the earlier controls and the official ones merely consisted of the treatment of foreigners, as Malaysian residents could not take money out of Malaysia (while foreigners could) before the official controls were imposed in September 1998. Third, he asked what happened to the foreign creditors whose capital was frozen in Malaysia due to the controls after the controls were lifted.

In response to Feldstein's first question, *Robert Dekle* cited an IMF Selected Issues paper on Malaysia, which described the financial reforms taking place in Malaysia. These reforms were similar to those in other program countries.

Kristin J. Forbes suggested including a discussion of the inefficiencies in the corporate sector before the Asian crisis, such as overleveraging and low profits, in evaluating the capital control policies. She said that one potential beneficial effect of the crisis is that it forces restructuring in the corporate

sector and induces the companies to use capital more efficiently, focusing on profitability instead of growth. She asked if there was evidence showing that capital controls prolonged this cleansing process and whether Malaysia would suffer in the long run.

Simon Johnson supported Dornbusch's critique of the methodology used in the paper by Ethan and Rodrick, in particular the timing comparison. He pointed out that there was tremendous political uncertainty in Malaysia in the summer of 1998, due to the fact that Anwar was trying to pursue IMF-type policies that were squeezing the Mahathir-connected firms. The political instability manifested itself in a fight at the party congress, and there was a serious probability of social disorders and even isolated riots. When the capital control policies were imposed and Anwar was deposed, the stock market went up, especially the Mahathir-connected firms, while the Anwar-connected firms suffered. Johnson said that this political struggle dominated everything else. *Linda S. Goldberg* supported this point by saying that it is very difficult to do any type of event study in a complex environment like this one.

Goldberg also noted that Malaysia imposed the capital inflow restriction in 1994. According to her, the theoretical literature predicts that the effects of capital controls on inflows and outflows are equivalent regardless of where the controls were imposed. She asked if one could determine the incremental effects of imposing outflow controls.

Giancarlo Corsetti suggested conducting a survey of large Japanese corporations to figure out whether the reduction of FDI to Malaysia was due to a change of strategy as a result of Malaysia's capital control policies.

Jorge Braga de Macedo drew attention to the broad social costs of the imposition of capital controls. The imposed capital controls dramatically reduced the benefits of financial globalization (in a country that was very much capitalized), sacrificing financial freedom and reducing transparency, which is socially costly on its own. He also reiterated questions regarding the political economy of capital controls, such as who administers them, and the temporary nature of these policies.

Amartya Lahiri suggested taking a different direction in the discussion. Given that we know that capital controls cannot be good in a nondistorted world, an interesting approach would ask what distortion capital controls were meant to correct and whether there was evidence of that distortion.

Rudi Dornbusch responded that Holland once devalued during the time of the Exchange Rate Mechanism, but otherwise it faithfully followed Germany. This kept their interest rate 11 basis points above that of Germany almost to the day when the European Monetary Union was introduced. Dornbusch said that in an entirely quiet world it is possible to identify an effect like this. However, if an emerging-market country sometimes defaulted and now we find a statistically significant impact, we cannot draw a causal relationship from that.

Malaysia did the "unspeakable thing," so its effect must inevitably show,

most economists with an orthodox training would say. However, the imposition of capital controls happened in the midst of the greatest crisis of the region, which makes it difficult to find the premium that is associated with it. Moreover, in Malaysia, FDI is substantial and receives special treatment, and the controls are explicitly not targeted to the long-term investors but to the three-month maturity speculators. Therefore, it is hard to find a substantial impact of capital controls unless they had a devastatingly negative effect.

Because capital controls did not really hurt, the populist demand to fight capital flight (rather than saving the economy) was enormously reinforced by Malaysia's experience. Moreover, the situation in Malaysia before the crisis was much more favorable than in other crisis countries, and Malaysia had actually followed a "shadow IMF program" the year before under intense consultation with the IMF.

Dornbusch concluded that the issue of the effectiveness of capital controls is not resolved except for the unfortunate presumption that they help politically. Malaysia's experience is historically important only because it will nourish capital controls as a politically attractive thing to do. He also said that the politics after Indonesia were formidably important in this case. The fall of Suharto meant a potential for instability and a huge redistribution from his beneficiaries to God knows whom. This is going to happen in Malaysia, but after the imposition of capital controls and the deposition of Anwar the problem was solved (or postponed) until further notice. The resolution of the uncertainty was the reason that the asset markets recovered.

Regarding the question raised by Goldberg regarding the effect of the controls on capital outflows given that there were inflow controls in place already, Dornbusch said that the difference between the two controls was that the inflow controls were anticipated whereas the outflow controls were not.

Regarding Feldstein's question as to whether capital controls were anticipated, he said that he did not believe they were. It is true, he said, that after seeing what Indonesia did to its Chinese minority, it seemed possible that the same could happen in Malaysia. In the past twenty-five years there was a systematic redistribution from Chinese to Malays, and those going bust were Malays. Dornbusch agreed that the ethnic issue was very startling in Malaysia.

Finally, Dornbusch reacted to a comment by Corsetti regarding the link between Malaysia and Japan. He pointed out that Malaysia and Japan promoted together the idea of an "Asian IMF" and the need to have extra instruments.

Dornbusch concluded that although there was no evidence one way or the other regarding the effectiveness of capital control policies, the debate will continue. It would be interesting if we found out one day whether the capital controls actually worked in some way or they were totally political, he said.

IV

Balance Sheets and "Crony Capitalism"