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MALAYSIA: WAS IT DIFFERENT?

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ABSTRACT

In the Asian crisis of 1997-98 some countries followed IMF prescriptions for stabilization and recovery. Malaysia went another route, placing an emphasis on capital controls. Did this strategy work out to lower the costs of the crisis and foster a more rapid recovery as claimed by some observers and notably the Malaysian authorities? It remains to explore whether that claim is indeed appropriate or whether it is primarily domestic grand standing of a weakened and challenged leadership which uses the international issue to deflect from severe domestic political problems.

In evaluating the Malaysian experience it must be understood that for this country two crises were unfolding simultaneously. One was the Asian financial crisis that brought down countries with vulnerable financial structures. The other one was the domestic political.

The paper concludes that there is no evidence of a better performance and not surprisingly so. Capital controls were imposed after the crisis was over, as interest rates in all Asian crisis economies, including Malaysia, were already declining rapidly and as US interest rate cuts fostered a more stable environment.

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MALAYSIA: WAS IT DIFFERENT?

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"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 Mohamad (1999, p.47)

The Asian crisis came as a big surprise to all: investors, credit rating agencies, international institutions, and not least of all, officials in the crisis countries. No question, the long run performance, hard work, high saving rates, seemingly competent officials collectively created a powerful presumption that all was well.[1] They gave assurance that problems, if any existed at all, would be isolated and manageable. And, since everybody held that belief, everyone reinforced everybody else in his or her unquestioned beliefs. No question either that once the weakness in balance sheets revealed itself, everybody's skepticism was profound and their willingness to remain invested was undermined. Preceding crises contained few surprises because they involved the usual suspects from Latin America. This time round it was miracle Asia, but the mechanics did not differ much.

What did differ in the case of Malaysia was the forceful reaction of the leadership and the departure from traditional post-crash responses. Dr. Mahathir staged a dramatic rejection not only of "speculators" and of 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 suffered less and recovered more quickly precisely because of these measures. He obviously and righteously delighted in sticking a finger in the eye of the IMF and G-6 treasuries.[2] It remains to explore whether that claim is indeed appropriate or whether it is primarily the domestic grand standing of a weakened and challenged leadership using the international issue 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. How after all can a finance

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[1] Of course, there was a discussion about the productivity of Asian economies but that had to do with the sacrifice in achieving growth, not the vulnerability that made for the imminent crisis.
[2] G6 because Japan is not on record as questioning Malaysian policy responses. On the contrary, it participated and led the call for an Asian IMF and new and different policy responses to regional financial crises.
[3] See Haggard (2000) and Haggard and Low (2000) for the political setting and its link to capital controls.

minister stand up and assert that it is good policy for the country to experience meltdown, as a matter of principle, to accommodate departing investors? Moreover, if it could be demonstrated that it had an appreciably positive effect on dealing with a crisis, policy makers would even have to come around 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 what is missing is a good response. Hence, no surprise, it is the *national solution* that countries lean toward and it does make for a good rhetoric.

In evaluating the Malaysian experience it must be understood that for this country two crises were unfolding simultaneously. One was the Asian financial crisis that brought down countries with vulnerable financial structures. The other one was the domestic political crisis arising from the challenge to Dr. Mahathir Mohamad by the deputy prime minister and finance minister, Anwar Ibrahim. The political crisis, in the eyes of the leadership, 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 situation and policy response. It surely is not a coincidence that capital controls were imposed one day, and Anwar was literally deposed the next.

If capital controls have not delivered clearly better economic results, that does not mean that they failed on the political side. The show-trial style attacks on speculators who were alleged to have undermined the Asian dream and the Malaysian model were a central move in the effort to ward off challenges to Mahathir's leadership. They were put in place to claim assertively that the economic development model, including the 20/20 vision and the ambitious public investment programs, were right and that the rest of the world was wrong. For the time being, they have been effective.[4]

Capital Controls

In the 1930s, Nazi Germany invented capital controls and soon, in an environment of capital flight and competitive depreciation, much of Europe moved to controls. The system become pervasive and accepted. Indeed, in the move to rules in the context of the IMF and the rebuilding of a more open world economy, capital account convertibility was not part of the story. That came much later, after 1958, when Europe gradually and unevenly shifted to full convertibility. The usual suspects, France and Italy, took until the late 1980s. Britain, for example, took until the Thatcher government to abolish exchange control, and in Japan and on the periphery it took even longer. Opening the capital account became the mantra of US financial policy in the late 1980s and, particularly, in the Rubin-Summers US Treasury with an agenda of 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

[4] See Mohamad (1999) where Dr. Mahathir's presents the case.

open trade, 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.

While there is a huge amount of work reporting on the costs of trade distortions, little is available on the issue of restricted capital accounts.[5] For example, there is no evidence that countries with open capital accounts grow faster (other things equal). Nor is there evidence of the converse. There is work showing that countries with high black market premia (meaning capital controls are binding) perform relatively poorly. But these premia certainly reflect not just 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 would we 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 and/or less diversification. In the short term controls play a quite different role. If they are imposed in the midst of a crisis, unanticipated and temporary, they will work in the sense of stopping outflows, reduce pressure on the exchange rate/interest rate and hence avoid a state-of-siege situation with the resulting excess bankruptcy and disruption. They are quite analogous to a suspension of trading on the New York stock exchange or the Nasdaq or 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 is whether the intention is to gain time or whether it is to lastingly change freedom of resource allocation. The former deserves much attention; the latter is politically attractive but has no 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 harder, and the lasting damage more profound. With this in mind, a capital control country – other things equal – would look much better than the other countries exposed to the same initial shocks but responding with orthodoxy rather than controls. Specifically, to make some progress on these issues, three questions might be answered:

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[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).

[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 which information is unavailable. These seem an interesting analogy for defensible limited-time capital flow suspensions. If on the New York stock exchange a circuit breaker lasts a half hour, perhaps the equivalent for an emerging market capital flow suspension is one month.

- On the eve of the crisis, was Malaysia appreciably different in its vulnerability from other crisis countries? If so, that is possibly the explanation for the claimed success in dealing with the problem.

- Did the policy measures – banking, stock market, capital controls, and business subsidies – make for a significantly better performance than in other economies? Better performance means higher growth, less pervasive bankruptcy without offsetting large increases in public debt, and less volatility.

- Is there an indication of lasting costs, or benefits, of the policy choices?

To anticipate the conclusion, the costs or benefits of capital controls remain ambiguous. Malaysia had more favorable preconditions, it did not do appreciably better, and the timing of controls coincided with the reversal of Yen appreciation, the end of the crisis elsewhere, and Fed rate cuts that put an end to the crisis atmosphere in world markets. However, because the costs are ambiguous, there is no evidence that the institution of capital controls or the failure to apply an explicit IMF program has yet resulted in any obvious detrimental effects.

THE BACKGROUND

It is helpful to place the Malaysian events within a broader timeline. The relevant time frame runs from the Thai problems starting in spring of 1997 to the interest rate cuts administered by the Fed in the aftermath of the LTCM problem and the Russian crisis. Various Asian economies joined the crisis progressively.

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May-July 1997	Pressure on Thailand, exchange control, 2-tier market, Devaluation.
July	Philippines go to a float, Malaysia abandons support for the ringgit, Thailand goes to the IMF
August	Thailand suspends 42 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, HK Dollar under attack
November	Korea abandons won support and goes to the IMF
December	Rescue package for Korea
January 1998	Malaysia announces full deposit guarantees
Jan.-Aug.	Asian IMF packages revised, financial restructuring, downgrading

May	Indonesia's Suharto steps down
August	Russian crisis, Yen peaks
September	LTCM crisis, Malaysia imposes capital controls, Deputy Prime Minister Anwar Ibrahim deposed
Sept.-Nov.	Fed cuts rates by 75 basis points

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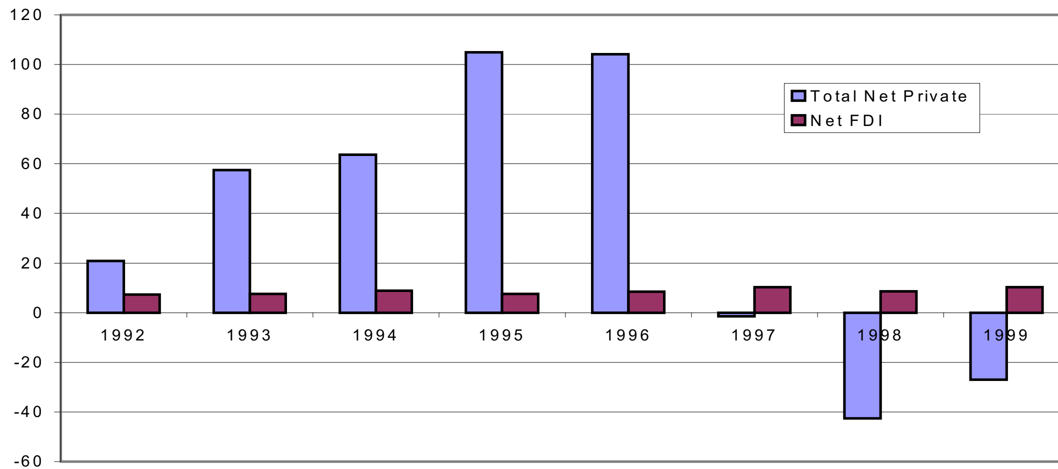
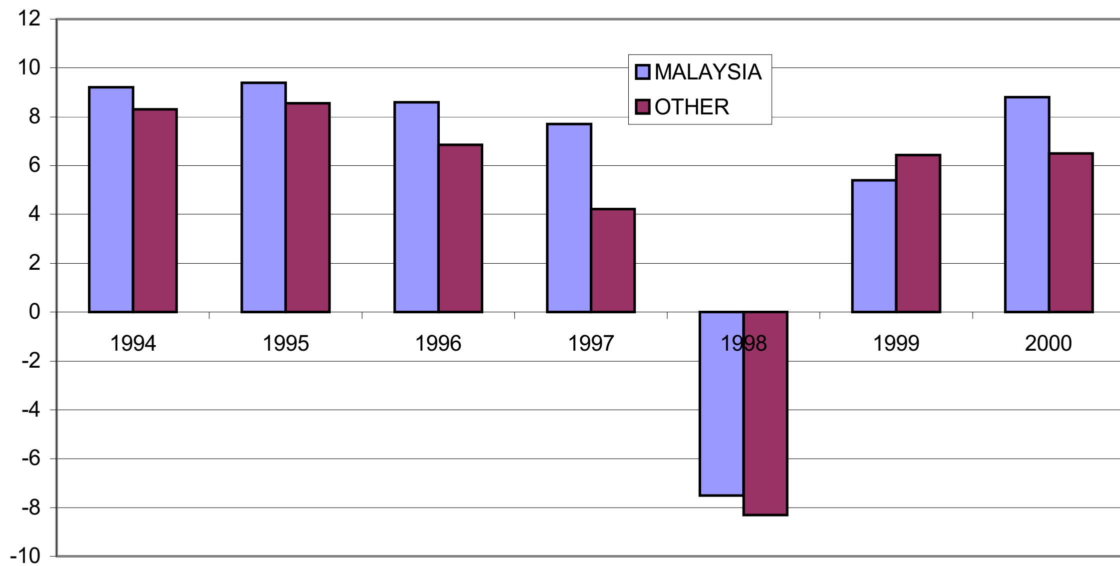
The background of the Asian crisis includes the large buildup of capital inflows in the first half of the 1990s, not FDI but rather bank loans and portfolio capital. The crisis involves, in 1997, the sudden drying up and reversal of these flows and the resulting macroeconomic pressures of currency depreciation, high interest rates, output decline and financial stress. This is shown in the accompanying figure for the Asian crisis economies as a group. The counterpart of the capital flows is a reserve loss and current account deficits in the crisis economies.

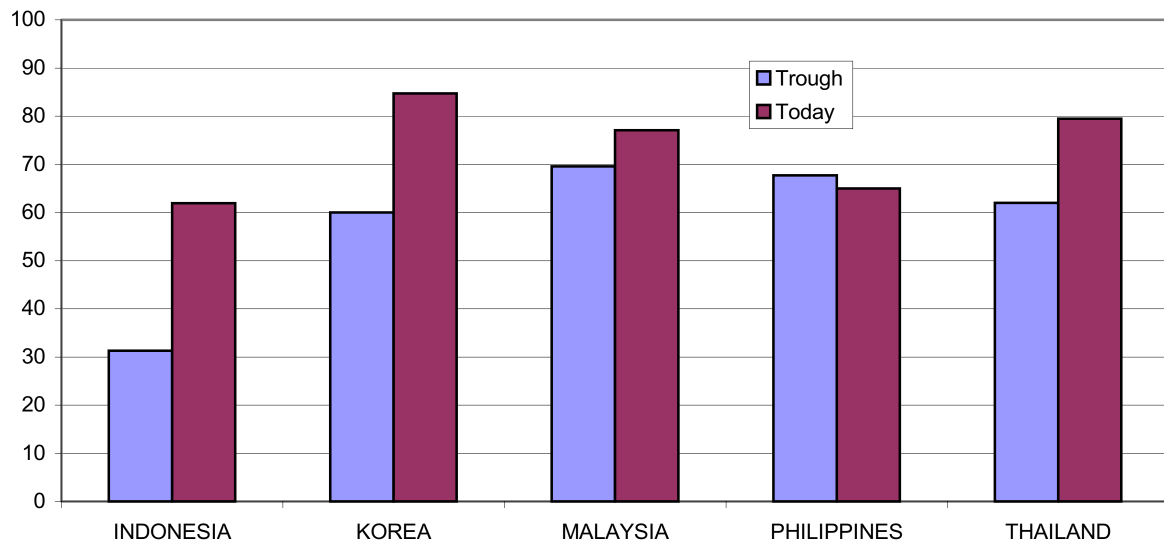


The pressure for outflows soon reached all economies. Within 6 months of the Thai debacle, Indonesia, Malaysia, the Philippines and Korea had all been hit and Hong Kong had come under attack.

One summary measure of events is the path of real GDP. From star performance through 1996, growth in 1997 was lower as the economies shifted toward crisis. The following year, 1998, involves an output decline everywhere and by 1999 recovery is underway. By 2000 per capita GDP is back above pre-crisis levels. Judged in that way, the crisis was as short as it was deep. But there are other measures that show more lasting damage, including an impaired banking system, significantly higher public debt everywhere, and a loss of growth momentum with the resulting temptation for government intervention.



Another measure that might indicate differential performance is the real exchange rate. One might argue that, other things equal, in a capital outflow crisis countries with controls should suffer a less extreme real depreciation. However, that prediction is not born out in the accompanying figure.



A CLOSER LOOK AT MALAYSIA

This paper does not address the immediate reason for the crisis. In Dornbusch (2001) there is a summary of the vulnerability factors: misaligned real exchange rates, nonperforming loans in the banking sector, funding risk of the national balance sheet due to excess debt or mismatches of maturity and currency denomination.

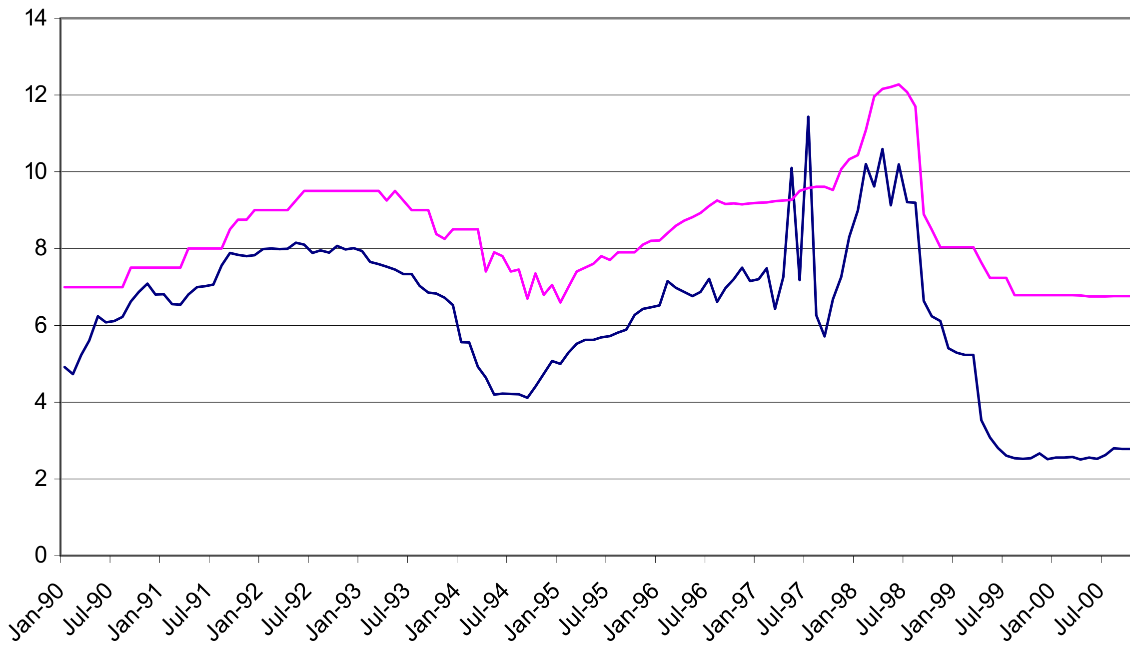
With the pressure of capital outflows and increases in interest rates (underway since early 1995), and poor export performance, growth declined and ultimately turned negative. Industrial production declined and resumed growth only in early 1999, investment as a share of GDP fell sharply to half its previous level, the stock market fell sharply, and the real exchange rate depreciated significantly.

Table 1 Malaysia: Economic Indicators

	90-95	95	96	97	98	99	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 ($Bill)		34.3	39.7	47.2	42.6	43.6	45.0
% of GDP		38.7	39.3	47.1	58.8	55.2	50.4
% Short term [b]		19.1	27.9	25.3	17.8		
Reserves ($Bill)		23.8	27.0	21.7	26.2	30.9	33.2

[a]Percent of GDP [b]IMF (1999c)
Source: Goldman Sachs, except as noted

MALAYSIA: MONEY MARKET AND LENDING RATES



MALAYSIA: STOCK MARKET
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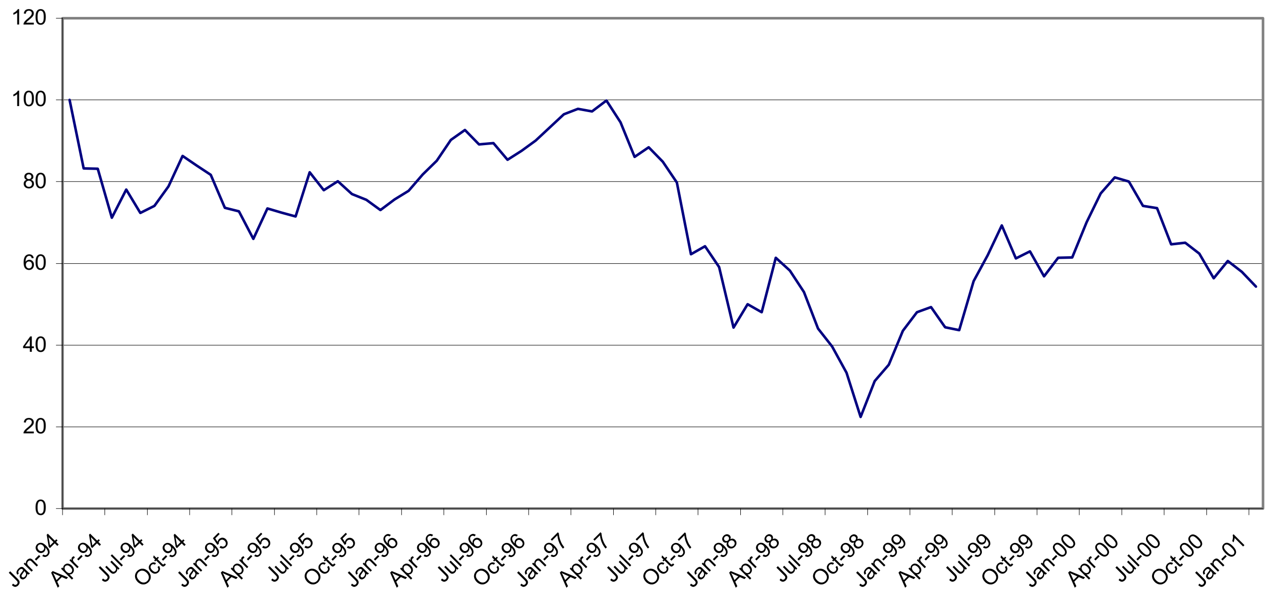
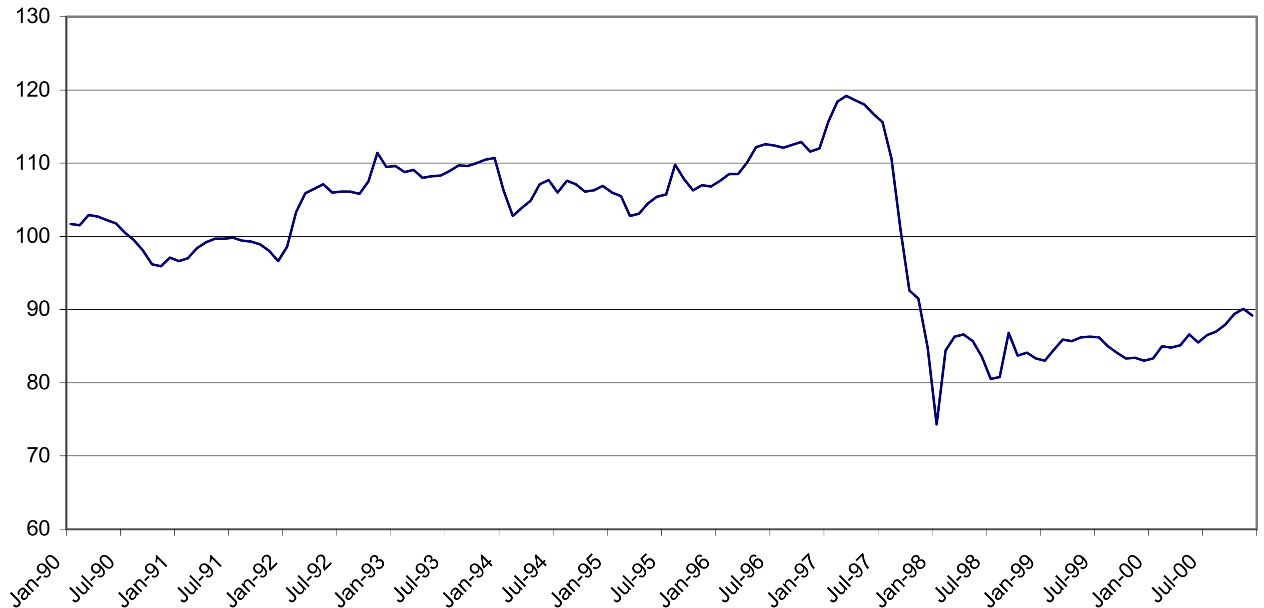




A large part of the macroeconomic scene involves problems with banks and firms with balance sheets unprepared for exchange rate movements, slowdown, or recession. The response in terms of restructuring, bailing out and subsidizing is certainly part of the controversial legacy. But this part is not really very different from the other economies where none of this happened promptly, decisively or successfully.

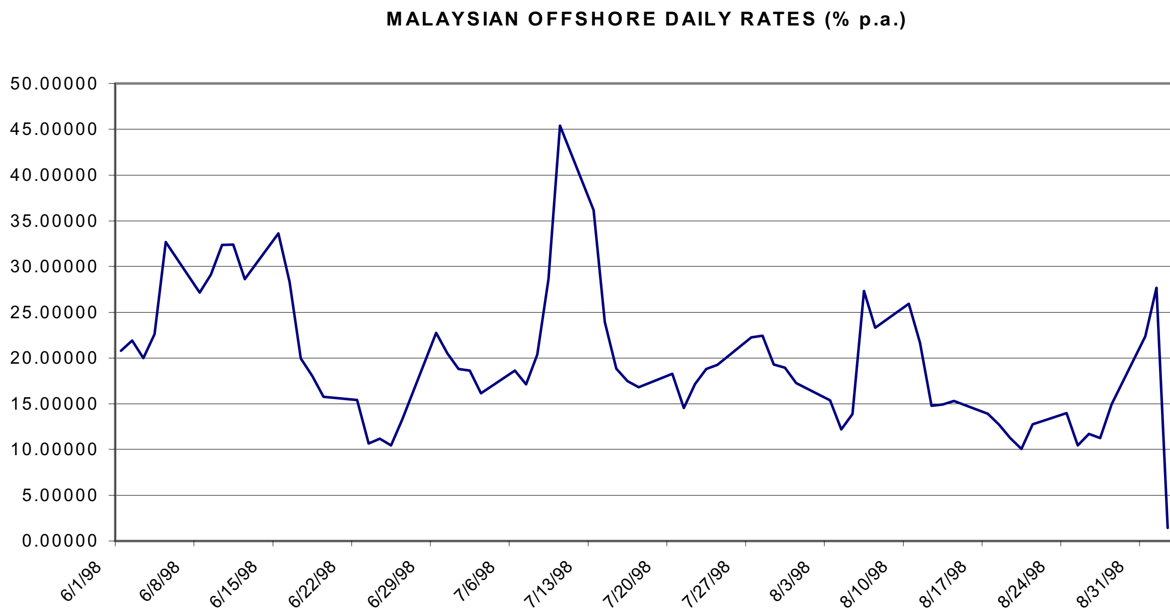
CAPITAL CONTROLS AND THEIR EFFECTIVENESS

One possibly critical difference between Malaysia and other crisis economies in the region was the imposition of stringent capital controls on September 1, 1998. This went further than the Thai measures (which had already been suspended) and it went further than the credit measures to avoid financing capital flight that had been used elsewhere. The Malaysian capital controls essentially involved the mandatory repatriation of offshore ringgit funds and their lockup with a one-year holding period, as well as restrictions on outflows.[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 to stop capital flows, both ways, as shown in the accompanying diagram that uses portfolio flow data (made available by SSA.)

[7] See IMF (1999a) pp. 54-56. See, too, IMF (1999c).

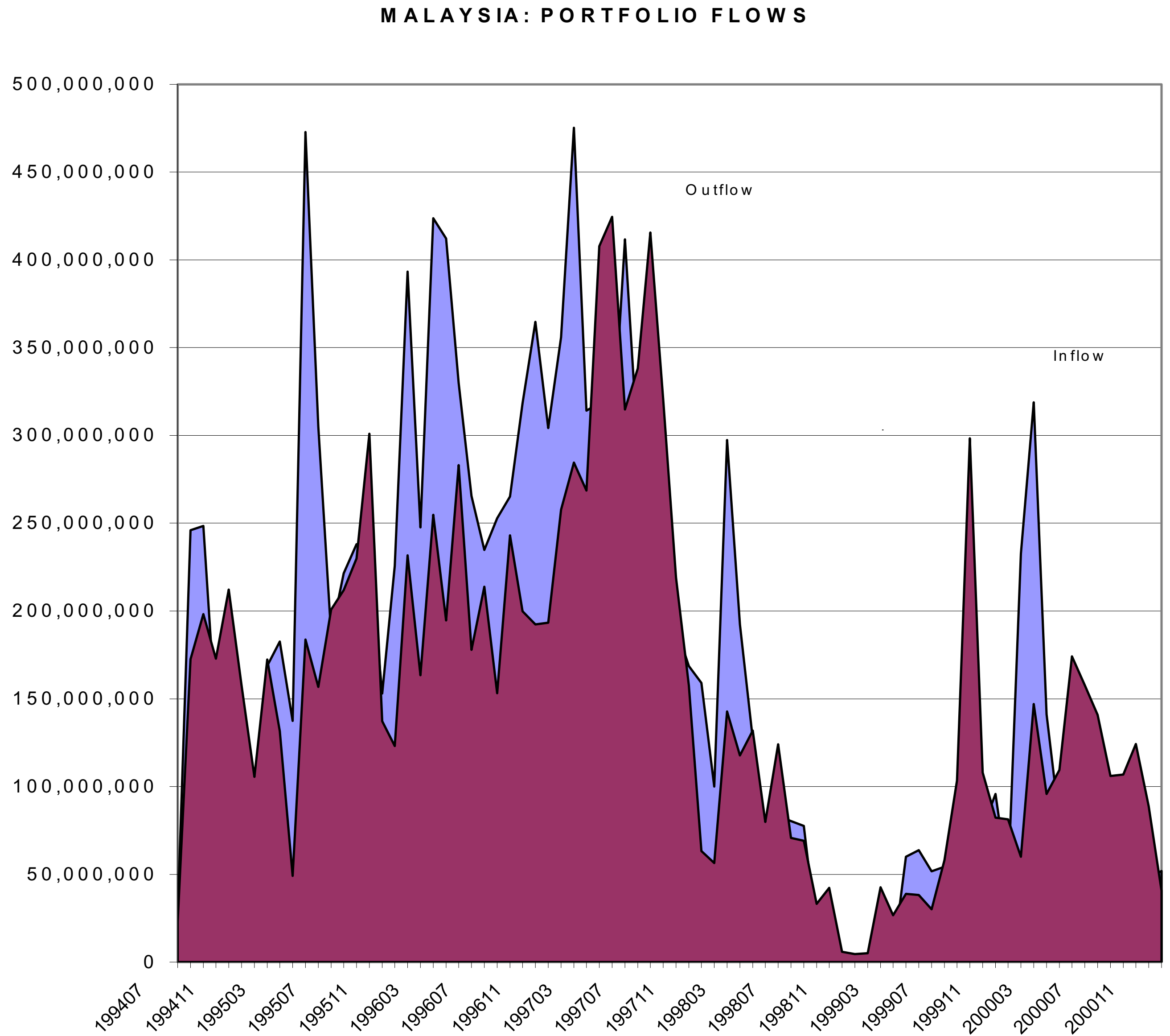
By the canons of IMF policy and commitments, the imposition of capital controls was, of course, a radical measure. For whatever reason it was imposed, Dr. Mahathir justified it with a quote from Paul Krugman "extreme measures might be needed for extreme times." (See Mohamed (2000, p.106).) He might, in his justification for opting out of classical financial rules, have quoted Keynes, "in the Street it is better accepted to fail by traditional means than to succeed by unconventional ones."

Were controls decisive in producing the turn of events or was it happening anyway? It is readily seen from the graph above that the stock market recovery begins in September, 1998, 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 has rightly argued, at the time capital controls were imposed, markets had already settled in Asia, interest rates had been coming off and would soon do so everywhere under the impact of Fed rate cuts and a reduction in jitters. In fact, in Korea and Thailand rates had fallen by August to half their June levels. And the same was true in Malaysia.



In fact, looking at *offshore* rates for Malaysia, and thus at the interest rates faced in the open market and a reflection of depreciation expectations, much of the pressure had subsided before the September 1 imposition of capital controls. By August, the offshore rates had, in fact, declined to around 10 percent, far below crisis levels. Interestingly, the spike in the graph, at the end is at the time the controls were put in place, reaching 28 percent on September 1! Thus, the claim that the pressure was continuing unabated is simply not borne out by offshore interest rates. On the contrary, it is the advent of

controls that raised rates. The political interpretation for the controls thus deserves more attention.



SHOULD MALAYSIA HAVE DONE BETTER?

Another way of looking at the question of non-IMF policies and the claim that Malaysia did well with this prescription is to ask how the country compared to others in terms of vulnerability. Two issues influence performance, initial conditions and policy responses. If performance was not substantially different, 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 side, better vulnerability indicators would mean less stress and hence better performance.

Table 3 Vulnerability Indicators: 1996

	Stock Market Cap/GDP	Debt/Equity Ratio	Private Bank Credit/GDP	Short Term External. Debt/Reserves
Indonesia	40	310	55.4	177
Korea	28.6	518	57.6	193
Malaysia	310	150	89.8	41
Philippines	97.3	160	49	80
Thailand	55	250	100	100

Source: World Bank (2000) p. 70

Tables 3 and 4 show a series of vulnerability indicators. In Table 3, Malaysia looks relatively good on the debt/equity ratio of the corporate sector and, more 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, Achilles heels since the high valuation reflected a vast share of GDP – 7 percent – of bank credit lent to stock purchases.

In Table 4, we look at the banking system by 1999. Malaysia looks relatively favorable in terms of nonperforming loans as a share of total loans. But as a ratio of GDP these numbers are high, reflecting the large share of private credit relative to GDP. In terms of the cleanup cost, Malaysia compares favorably, more so since the Korean numbers almost certainly understate the cost of restructuring the banking system and the corporate sector.

Table 4 Nonperforming Loans and Increased Public Debt: 1999			
	NPL/Total	NPL/GDP	Increase in Public Debt/GDP (% points)
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)			

Table 5 looks at statistics 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 alarming – the banking system and private investment (with or without cronyism) was financing the development strategy, unlike in Latin America. But Malaysia shows initially a better-rated banking system, lower debt/equity in corporations and a maturity of debt that is not substantially shorter than elsewhere.

Table 5 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
Philippines	105.1	D+	129	48
Thailand	15.7	D+	236	63
Source: IMF (1998) p. 36, Asian Development Bank (1999) p. 27, World Bank (2000) p. 70				

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

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 ERM 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 DM. 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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