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MALAYSIA'S: 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 Mohamad (1999, p.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. No question, the long run performance, hard work, high saving rates, seemingly competent officials all added up to creating a powerful presumption that all was well and that any problems, if at all, would be isolated and manageable. And, since everybody held that belief, everyone was reinforced in his or her unquestioned beliefs by everybody else. No question either that once the weakness in balance sheets revealed itself, everybody's skepticism was profound and their willingness to remain invested undermined. All that is a bit different from all the preceding crises where it is more the usual suspects of Latin America who surprise, but the mechanisms don't differ much.

What differs in the case of Malaysia though is the forceful reaction of the leadership. 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 plus the claim that the country did better in recovering because of precisely these measures—so to speak, a finger in the eye of the IMF and G-6 treasuries.[1] 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 domestic political issues.[2]

The Malaysian case deserves attention not only on its own terms but because the presumption of capital controls in response to crisis – failing an early and gracious arrival of the IMF—has become far more of a presumption. And 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 trigger-happy and what is missing is a good response. Hence, no surprise, it is the *national solution* that countries lean toward.

[1] 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.

[2] See Haggard and Low (2000) for the political setting and its link to capital controls.

If capital controls have not delivered clearly better economic results, that does not mean for a minute that they failed on the political side. The show-trial style attack on speculators who undermine the Asian dream and the Malaysian model were a central move in the effort to ward off challenges to Mahathir's leadership and the claim that the model, including 2020 and the public investment programs were right, and that the rest of the world was wrong. They were fully effective in this.[3]

To make some progress on these issues, three questions might be answered:

- 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, 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, less volatility.

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

It is as well to anticipate our 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 Fed rate cuts that put an end to the crisis atmosphere in world markets. But the reverse case equally holds; there is no evidence that capital controls or failure to apply an IMF program so far had obviously detrimental effects.

THE BACKGROUND

It is helpful to put a setting for the Malaysian events. The relevant time frame goes 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.

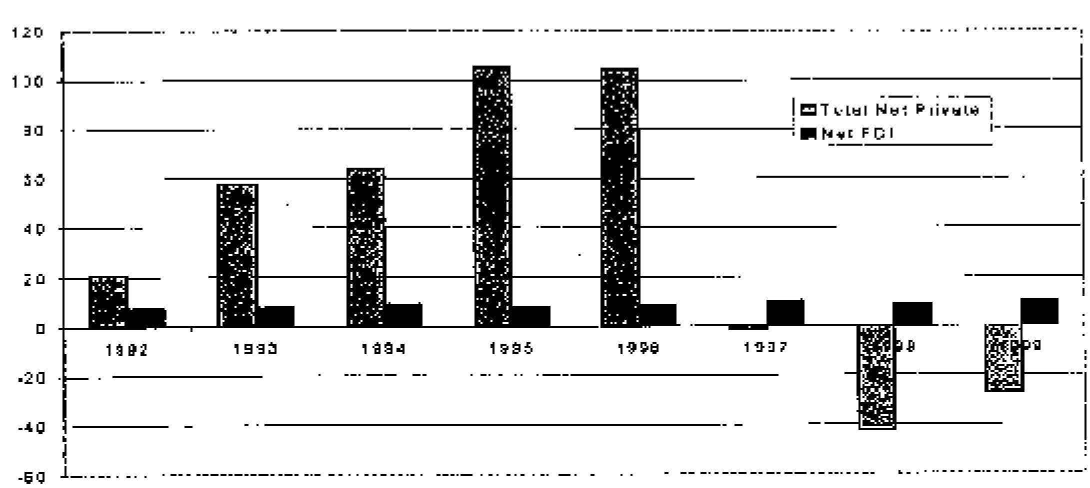
May-July 1997	Pressure on Thailand, exchange control, 2-tier market, Devaluation.
July	Philippines go to a float, Malaysia abandons support for the ringgit, Thailand goes to the IMF
August	Thailand suspends 42 banks, Indonesia abandons rupiah support, Malaysia restricts short selling, Indonesia restricts credit for rupiah trading

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

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
Jan 1998	Malaysia announces full deposit guarantees
Jan-Aug	IMF packages revised, financial restructuring, downgrading
May	Indonesia's Suharto steps down
August	Russian crisis
September	LTCM crisis, Malaysia imposes capital controls
Sept- November	Fed 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 FDI but 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 surpluses in the crisis economies.

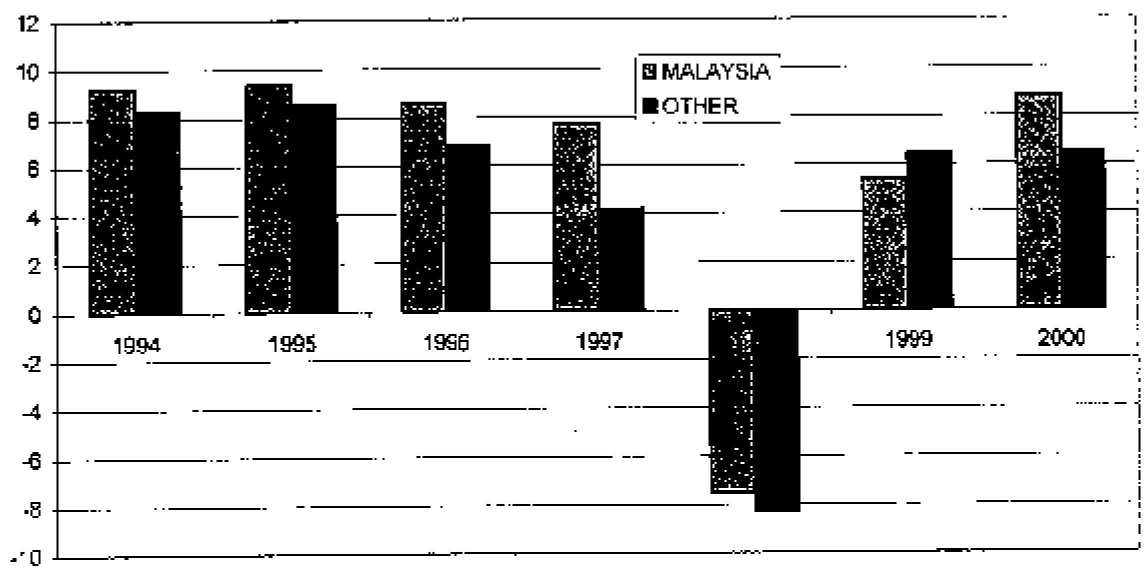
EXTERNAL CAPITAL FLOWS FOR CRISIS-ASIA (Bill $US)



The pressure for outflows soon reached all economies and within 6 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 GDP. From star performance up to 1996, growth in 1997 came off as the economies shifted toward crisis. The following year, 1998, involves an output decline everywhere and by 1999 recovery is underway. By 2000 even per capita GDP is 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, a significantly higher public debt everywhere and a loss of momentum with resulting temptation for governments to step in.

MALAYSIA AND OTHER CRISIS COUNTRIES: GDP GROWTH



A CLOSER LOOK AT MALAYSIA

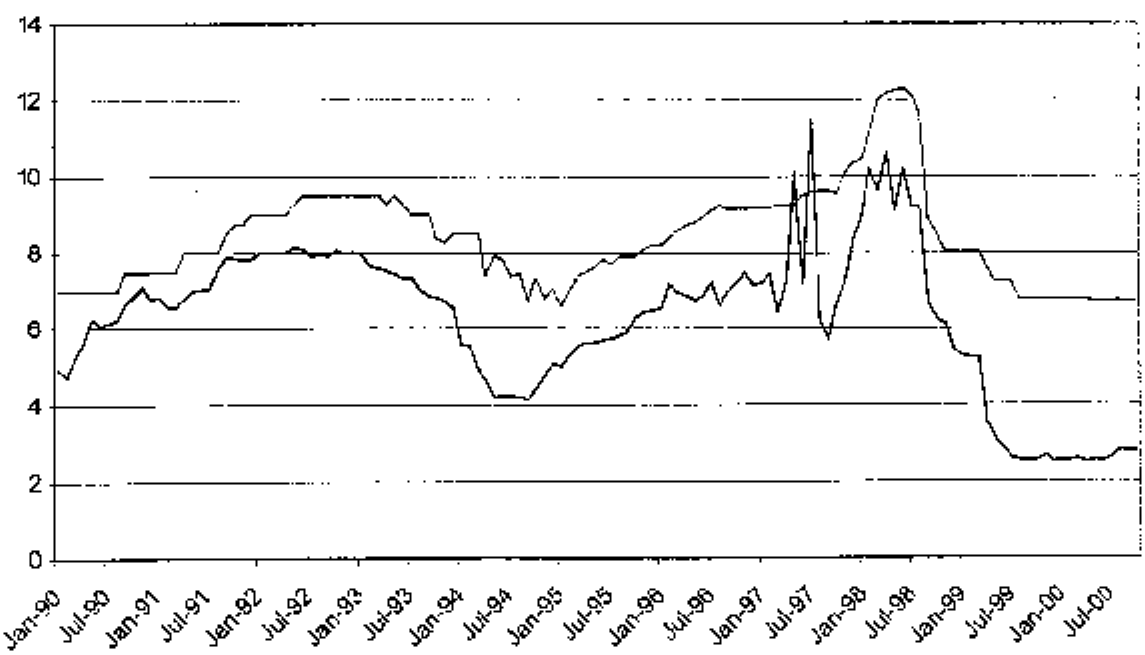
This paper does not address the immediate the immediate reason for the crisis. In Dornbusch (2001) there is a summary of the vulnerability factors—misaligned real exchange rates, nonperforming loans in the banking sector, funding risk of the national balance sheet due to excess debt or mismatches of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

With the pressure of capital outflows and increases in interest rates, already underway since early 1995, and poorer export performance growth gave way. Ultimately it turned negative; industrial production declined, investment fell sharply to only half its previous level as a share of GDP, the stock market fell sharply and the real exchange rate depreciated in a major way.

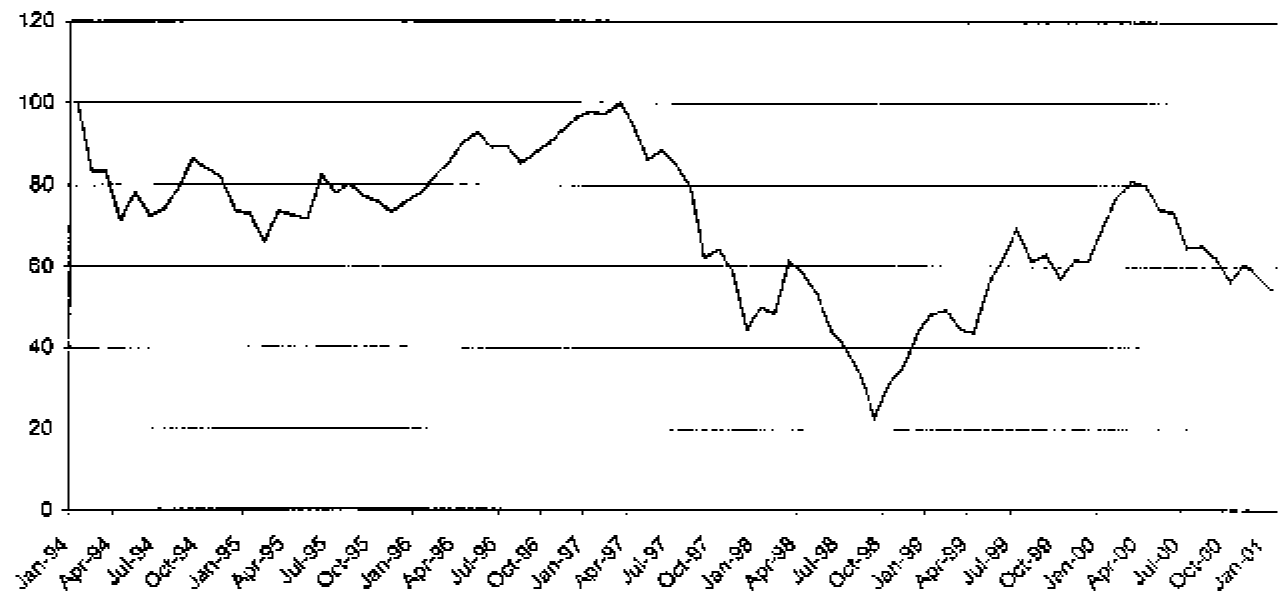
Table 1 Malaysia: Economic Indicators							
	90-95	95	96	97	98	99	2000
Growth	8.9	9.8	10.0	7.5	-7.5	5.4	8.8
Inflation	3.7	3.2	3.3	2.9	5.3	2.8	1.8
Investment[a]	37.5	43.6	41.5	42.9	26.7	22.3	24.1
Budget Deficits[a]	-0.4	3.2	3.9	6.1	-0.9	0.2	-2.6
Current Account[a]	-5.8	-9.7	-4.4	-5.6	12.9	16.0	8.7
External 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

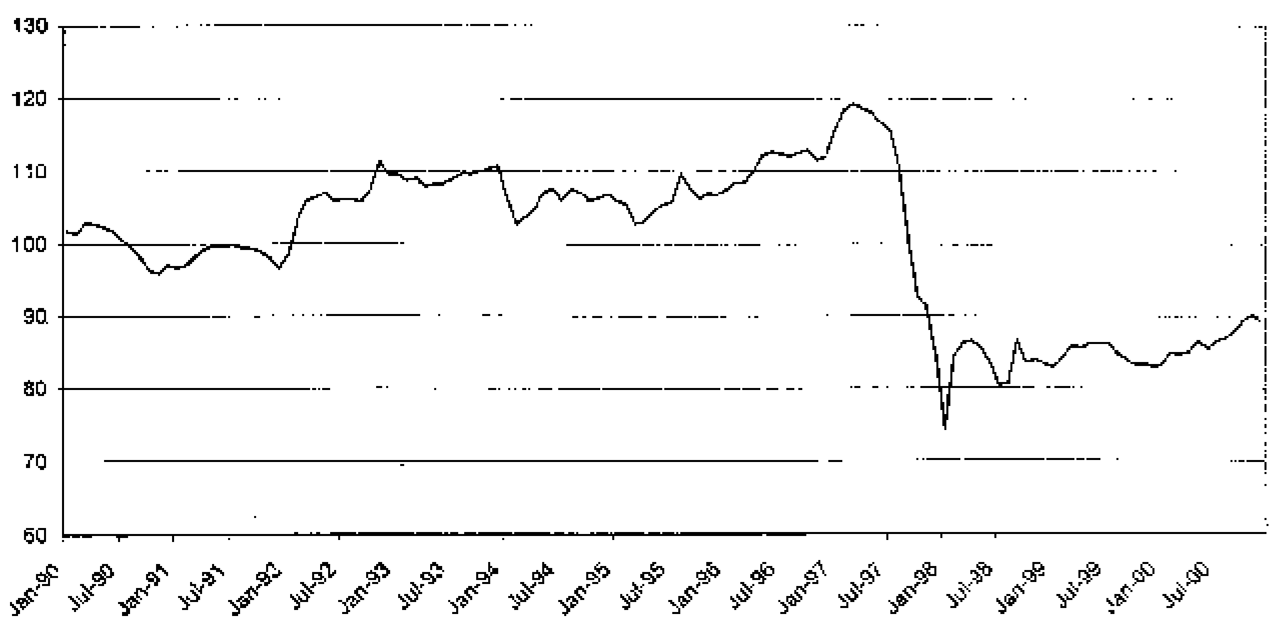
MALAYSIA: MONEY MARKET AND LENDING RATES



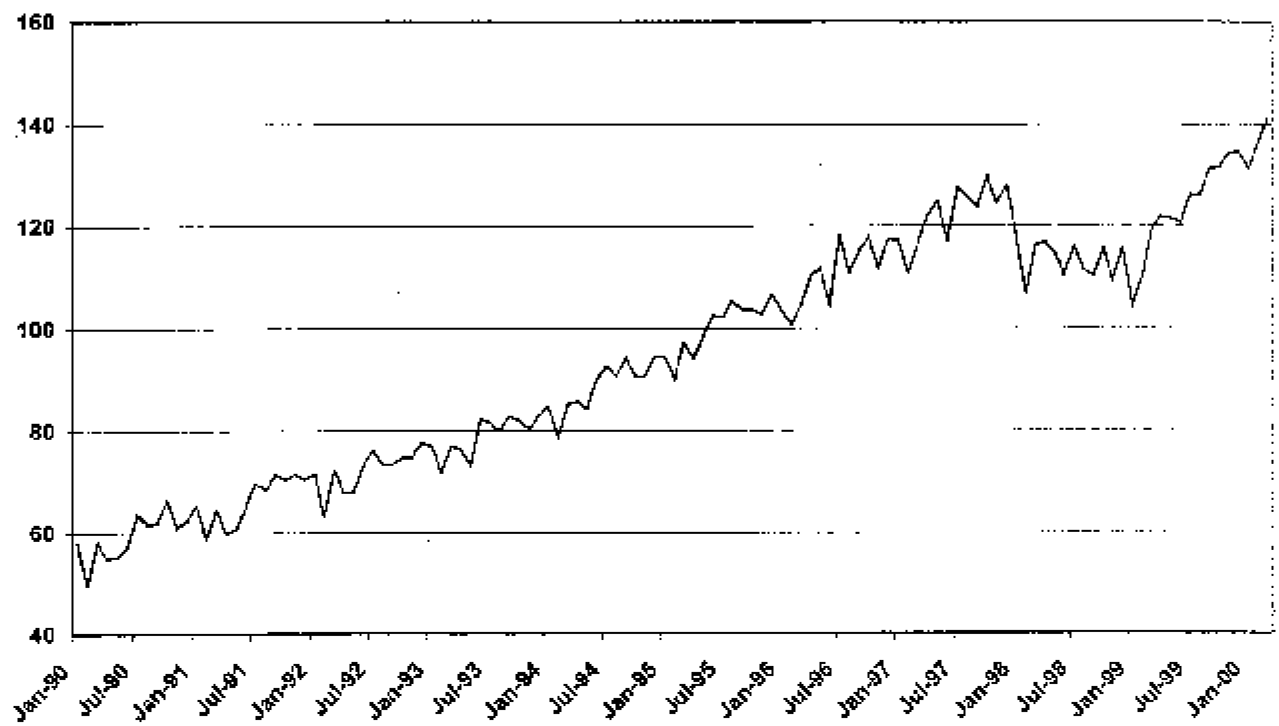
MALAYSIA: STOCK MARKET
(Index Jan 94=100, Source Datastream)



MALAYSIA: REAL EFFECTIVE EXCHANGE RATE
(JPMorgan Index 1990=100)



MALAYSIA: INDUSTRIAL PRODUCTION (INDEX 1996=100)



A large part of the macroeconomic scene involves problems of banks and firms with balance sheets unprepared for recession or recession. The response in terms of restructuring, bailing out and subsidizing is certainly part of the controversial response. 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

But one critical difference with other economies was the imposition of capital controls on September 1, 1998. This went further than the Thai measures that already were suspended by then or credit measures to avoid financing capital flight that had been used elsewhere. The details of the capital controls involved essentially the mandatory repatriation of offshore ringgit funds and their locking up with a one-year holding period.[4] 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 certainly had the effect to stop capital flows, both ways, as shown in the accompanying diagram that uses portfolio flow data (made available by SSA.)

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

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

with a quote from Paul Krugman "extreme measures might be needed for extreme times."[3] 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."

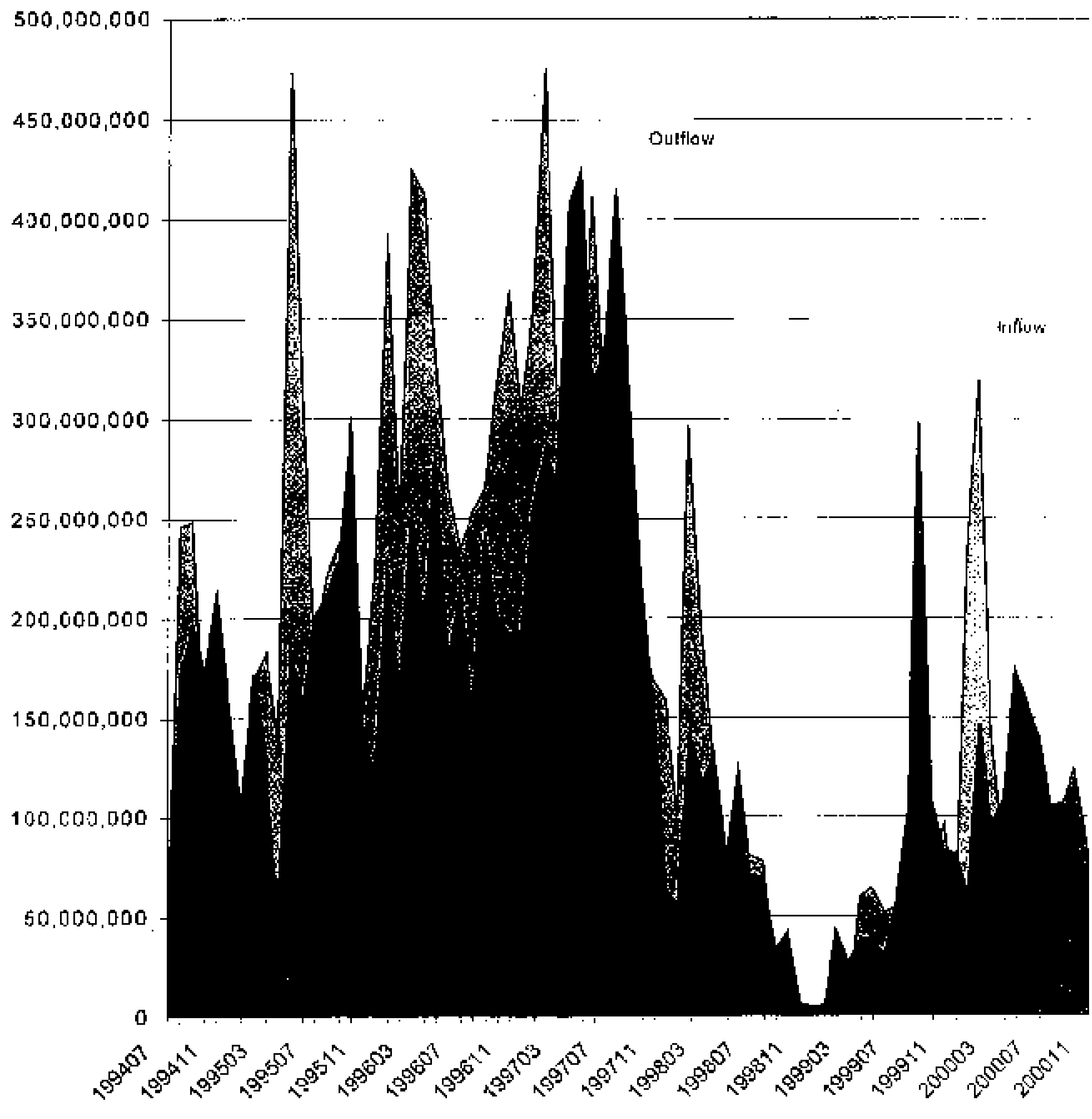
It is readily seen from the graphs above that the stock market recovery and the decline in onshore interest rates follow promptly as does the recovery of industrial production. It is tempting therefore to see the imposition of capital controls as the turning point. However, as the IMF has rightly argued, 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 ands a reduction in jitters.

SHORT TERM INTEREST RATES

	INDONESI	KOREA	THAILANE	MALAYSIA	Philippines
1/31/98	57.18	25.63	21.51	8.99	19.098
2/28/98	64.81	23.53	19.83	10.2	17.789
3/31/98	51.76	22.62	20.57	9.62	16.597
4/30/98	70.8	21.23	19.11	10.59	15.202
5/31/98	63.54	18.45	16.4	9.13	14.377
6/30/98	64.59	16.25	18.58	10.19	14.004
7/31/98	75.32	12.67	11.72	9.21	14.667
8/31/98	81.01	9.53	9.81	9.19	14.085
9/30/98	66.21	8.43	7.17	6.64	13.822
10/31/98	59.35	7.27	5.35	6.24	13.528
11/30/98	65.49	7.24	3.55	6.11	13.451
12/31/98	33.44	6.96	2.63	5.41	13.43
1/31/99	37.92	6.35	2.73	5.29	13.239
2/28/99	39.97	5.65	3.09	5.23	12.731
3/31/99	41.98	5.03	2.25	5.23	12.136
4/30/99	35.54	4.82	1.65	3.53	10.85
5/31/99	28.76	4.8	1.45	3.08	9.96
6/30/99	22.55	4.81	1.33	2.81	9.258
7/31/99	14.84	4.84	1.47	2.61	8.429
8/31/99	12.45	4.75	1.36	2.54	8.447
9/30/99	12.34	4.74	1.71	2.53	8.574
10/31/99	12.32	4.75	1.65	2.54	8.577
11/30/99	12.28	4.75	1.35	2.66	8.858
12/31/99	12.06	4.77	1.23	2.52	8.895
1/31/00	9.58	4.77	1.55	2.55	8.914

[3] See Mohamad (200), p.106

MALAYSIA: PORTFOLIO FLOWS



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 Malaysia looks relatively good on 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, 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 favorable, relatively, 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 some numbers for debt and debt structure in the corporate sector. Again, in no way does Malaysia stand out unfavorably. Public debt in 196 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 and Asian Development Bank (1999) p.27 World Bank (2000) p.70				

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 a situation that otherwise would have been much worse was contained by the effects of capital controls. Once again then, 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 lasting small 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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