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The Malaysian Experience in Financial-Economic Crisis Management

An Alternative to the IMF-Style Approach

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Chapter 1

GENERAL BACKGROUND TO THE ISSUE

(a) The Onset of Financial Crisis: Some Elements

In the 1980s and 1990s, many developing countries fell into an external debt-led financial crisis. In the first generation of these crises, the inability to service debt was due to a combination of factors, including depression in commodity export prices, increase in the price of oil imports, a rapid increase in foreign loans and the inability to utilise these loans productively or appropriately.

In the 1990s, several more countries (including the more economically advanced of the developing countries) experienced financial crises. A major cause of many of these second-generation crises was the inappropriate design and implementation of capital account liberalisation. Some countries that had hitherto succeeded in attaining high economic growth rates and in using export expansion for this growth, faced difficulties in managing rapid liberalisation in financial flows.

In 1997 several East Asian countries began to experience serious financial problems. Due to financial deregulation, they had received large inflows of capital, including bank loans (denominated in foreign currencies) and portfolio capital (especially foreign purchase of equity in the local stock exchanges). A significant part of the foreign loans was not channelled to activities that yielded revenue in foreign exchange, and thus a mismatch occurred, at least in the short term, so that pressures built up on foreign reserves.

In some of these countries, in this situation of increased financial fragility, currency speculators took advantage of the deregulated environment (that allowed them to function), borrowed in local currency and sold the currency short against the US dollar.

In Thailand, the Thai central bank sold dollars against the baht in an attempt to maintain the baht's exchange rate level. When its foreign reserves dried up, and it could no longer defend the baht, the local currency depreciated sharply. This made it even more difficult for the country to service its high foreign debt. The Thai crisis spread via "contagion effect" to other East Asian countries.

In Indonesia, there had also been a rapid build-up of foreign loans, especially to the private sector. There was a very sharp depreciation of the rupiah (at one stage its value against the US dollar had fallen by more than 80 per cent), rendering the country unable to meet its foreign loan obligations.

In South Korea, following financial deregulation and liberalisation when the country prepared to join the Organisation for Economic Cooperation and Development (OECD), private banks and companies had also accumulated huge quantities of foreign loans. Due to a sharp depreciation of the won, the country also experienced debt-servicing difficulties.

In Malaysia, the ringgit came under speculative attack and also declined significantly. However, the country had not liberalised its capital account to the same extent as the other three countries, at least in one important respect, i.e. local companies were allowed to obtain foreign loans only with Central Bank permission, which would be given only if and to the extent that the borrower could show that the loan would be used for activities that would yield revenue in foreign exchange that could be used for loan servicing. Partly as a result of this restriction, Malaysia's debt situation remained manageable, although the situation was also fragile, as there was also a possibility of debt-servicing difficulty if the ringgit depreciated even more sharply, or if there was a rapid enough outflow of capital.

(b) Orthodox IMF-Style Policy Response

On the verge of external debt default, Thailand, Indonesia and South Korea sought the assistance of the International Monetary Fund (IMF) and World Bank for loan assistance. Credit was forthcoming on condition that the recipient countries agreed to adopt a package of policies, embodied in successive Letters of Intent. The main elements of the loan conditionalities were common to the countries. They included the following:

- Floating of the currency.
- The capital account should remain open, and in fact financial liberalisation should be deepened. Capital controls were not allowed.
- Foreigners and locals were allowed to take out and bring in funds with no or little restriction.
- Sharp increase in the interest rate (to counter inflation and to maintain investor confidence in the local currency).
- Contractionary monetary policies.
- Austere fiscal policies.
- There should be no or minimal government financial assistance to local banks and companies facing difficulties. In Indonesia and Thailand, the governments were asked to take measures to close down several financial institutions.
- Liberalisation of foreign ownership in local assets and companies, e.g. Thailand raised its limit on foreign ownership of local banks from 10 to 100 per cent; South Korea raised the foreign ownership limit in local companies listed on the stock exchange from 10 per cent eventually to 100 per cent, and Indonesia's Letter of Intent specified allowing foreign ownership of plantations and wholesale trade.
- Privatisation of state enterprises and agencies and state economic activities.
- Reduction or elimination of state subsidies.

Some of these policies contributed to transforming the financial crisis into an economic recession and crisis. The contractionary interest rate, monetary and fiscal policies depressed domestic demand and adversely affected GDP growth. The closure of some banks, without guarantee that the government would protect deposits in other banks, led to a general decline in depositor confidence in the banking system. The high interest rates strained the ability of companies to service their loans, and this in turn increased the banks' incidence of non-performing loans. Thus the macroeconomic policies impacted significantly on the viability of the micro-economy, and the crisis in the financial economy was transformed into a crisis in the real economy.

Many local enterprises closed down, and many thousands of jobs were lost. The rates of unemployment and poverty rose significantly. The deteriorating condition of the real economy in turn adversely affected the confidence of investors (both foreign and local). The value of shares in the stock market fell significantly. There was a flight of foreign and local capital abroad, facilitated by the liberal capital account regime. Despite the rise in interest rates, the local currency's exchange rate continued to be low or declined further (especially in Indonesia). The open-door policy to foreign ownership as a result of the IMF-World Bank loan conditionality enabled foreign companies to more easily purchase local assets often at bargain prices. The government in Indonesia reduced or eliminated some subsidies, resulting in price increases in fuel and in transport fees, giving rise to social instability.

These orthodox policies, and also their adverse effects, have also been experienced in other countries hit by financial crises, such as Argentina and Turkey. Because the policies have not worked, they have been the subject of increasing criticism and disillusionment.

(c) Needs and Goals of a Country Facing Crisis

A country undergoing a financial crisis caused by capital account liberalisation would like to be able to adopt policies that meet the following goals:

- Stabilisation of the exchange rate, or in any case:
  - — the prevention of so sharp a currency depreciation that it faces a crisis in debt servicing;
  - — the prevention of currency exchange volatility that makes it difficult or impossible for businesses that rely on trade to predict costs or revenues.
- Maintenance of capital funds in the country, and creation of conditions that prevent outflow of foreign or local capital.
- Lowering of interest rates, or maintaining relatively low interest rates, in order that:
  - — businesses can continue servicing their loans;
  - — consumer demand can be kept up or increased in order to maintain or increase effective demand.
- An increase in government expenditure, to give a boost to effective demand.
- Expansionary credit and monetary policy, in order to:
  - — encourage viable businesses to maintain or increase their investment;
  - — encourage maintenance or growth of consumer demand.
- Relative stability of consumer prices.
- Increase in the financial and economic viability of enterprises, and of the banks and banking system.
- Maintenance of employment and of the meeting of social needs (health, education, welfare, etc.).
- Maintain policy space and flexibility to decide on issues such as the degree of opening up to foreign ownership, privatisation, subsidies, trade and trade liberalisation.

It should be recognised that it is difficult to formulate and implement policies that can meet all or many of the above goals. Often, there are policy trade-offs. For example, lowering the interest rate may have a positive effect on the financial position of enterprises and on effective demand, but may reduce the incentive to save in the local currency and lead to capital outflow and currency depreciation (under conditions of an open capital regime and a floating exchange rate). On the other hand, a deliberate increase in interest rates (an important plank of the IMF package) is intended to maintain or increase investor confidence in the currency and in the economy generally, but would have an adverse effect on the micro-economy as firms and banks suffer a deterioration in their financial situation, and this in turn undermines investor confidence.

When there are policy trade-offs, in that one policy tool can lead to both positive and negative effects, it is important to seek more policy tools in order that more of the goals can be met. The IMF package has been unable to meet many of the policy challenges and goals as the policies did not fulfill the needs of the real economy, and they also did not resolve the problems in the financial economy. They also had damaging effects on economic institutions, including local enterprises and banks. This raises the question of whether an alternative approach can be found that works better than the IMF policies and avoids their damaging effects.

Chapter 2

BACKGROUND TO THE MALAYSIAN CRISIS AND RESPONSE

(a) The Malaysian Crisis: The Start

Shortly after the Thai currency was floated and devalued sharply, there was a "contagion effect" on the Malaysian economy.

The first effect was via the exchange rate. The Malaysian ringgit (RM) had for several years been relatively stable at around RM2.40-2.50 to the US dollar. It steadily depreciated to 2.80, then to 3.00, 3.20, 3.50, 4.00, 4.20 and reached a low point of 4.88 on 7 January 1998. For a while, it appeared possible that the 5.00 level would be breached.

The drastic decline was significantly caused by speculation, as speculators sold the ringgit "short". There were at least two mechanisms for this short-selling: (i) the speculator sold the ringgit in the forward market at the current exchange rate with a view to delivering the ringgit at a future date; or (ii) the speculator borrowed ringgit in order to sell it presently and hold dollars. These actions contributed to the weakening of the ringgit as the demand for the US dollar increased.

When the ringgit depreciated, the speculators could reap the profit. In case (i), the speculator delivers the agreed ringgit amount at the previous rate and obtains the agreed dollar amount, which in turn can now be exchanged for greater amounts of ringgit (since the ringgit has since depreciated). In case (ii), when the time comes for the speculator to repay his ringgit-denominated loan at the previous exchange rate, he needs to use only a part of the dollars he has accumulated (as the ringgit has now depreciated) and the balance of the dollars is his profit.

Speculation on the ringgit was carried out not only in the local markets but also abroad as the ringgit was being traded in overseas markets, such as Singapore.

The currency depreciation had several negative effects. Firstly, it increased the burden of external debt servicing. At the start of the crisis, the country's external debt servicing position was rather comfortable. However, the depreciation increased the debt burden in that the debtors had to pay more in local currency amount; several large Malaysian companies that had taken foreign loans made large losses. Secondly, the continuous changes in the exchange rate were very destabilising as traders and enterprises were unable to conduct business in a predictable way as the prices of imports and exports (in local currency terms) kept changing. Thirdly, the prospect of continuous decline in the ringgit's rate contributed to a sharp fall in the value of shares in the stock market and the inflow of foreign portfolio funds in the stock market was reversed. One positive effect was that those involved in exports (including producers of commodities such as palm oil and petroleum) obtained higher incomes.

Due to the serious adverse effects of currency depreciation, stabilising the ringgit became perhaps the over-riding concern of the policy makers during the crisis.

Another major effect on the economy was the very steep decline in the value of shares in the stock market. The Kuala Lumpur Stock Exchange (KLSE) index fell from a high of over 1,000 in July 1997 to a low point of 262 in September 1998. This affected the credit-worthiness of many companies and individuals that had used the value of their shares as collateral for loans; it thus also affected the banks. The fall also had a negative effect on consumer sentiment and spending as investors saw their wealth dwindling.

The third major concern was the prospect of large capital outflows as the confidence of foreigners and residents in the economy fell. This concern increased the more the values of the currency and shares in the stock market declined. The main form of short-term capital flows in Malaysia had been portfolio capital, rather than credit. There was a large reversal of foreign portfolio capital flows at the early stage of the crisis. Net quarterly flow of portfolio capital turned negative in the second quarter of 1997 for the first time since 1991, and total net outflow in the first three quarters of the year was over US$11 billion (Athukorala 2001: p61).

The main mechanisms conveying the "contagion effect" were financial in nature rather than in the real economy of production or trade.

(b) Initial Response: Orthodox Policy

As the external debt situation was under control, Malaysia could choose whether or not to turn to the IMF for loans to boost the external reserves to a more comfortable level. The government decided from the start that it would not do so, as it was concerned that many of its existing policies (for example, regulation of foreign ownership, assistance to local companies, subsidies, price controls, and economic and social policies relating to ethnic communities) would be affected by IMF conditionality.

Nevertheless, for about the first year of the crisis (mid-1997 to mid-1998), Malaysia on its own accord followed an orthodox IMF-style approach in responding to the crisis. This included: (i) allowing the currency to float with minimal intervention; (ii) maintaining an open capital account regime; (iii) a sharp increase in the interest rate; (iv) a tightening of monetary policy; and (v) a drastic reduction in government budget expenditure.

On 5 December the then Finance Minister announced a set of policies that included an 18 per cent reduction in government spending, postponement of several pending public sector investment projects, and cutting government ministers' pay by 10 per cent. The Central Bank increased the inter-bank lending rate from the pre-crisis level of 7.6 per cent to 8.7 per cent in December 1997, 10 per cent in January and 11 per cent in February 1998. (Athukorala 2001: p65). The criterion for banks' non-performing loans was changed from six months in arrears to three months, which was meant to strengthen prudential supervision but had the effect of tightening credit flows.

However, Malaysia did not significantly change its policy towards foreign ownership in the same manner or degree as Thailand, Indonesia and South Korea (although there was some liberalisation of foreign investment policy in manufacturing). Malaysia also retained its socially-oriented policies on price controls for some essential items and subsidies.

The orthodox interest rate, fiscal and monetary policies were aimed at shoring up the confidence of the financial markets and investors. It was believed that if the investors were impressed that the government was serious in tackling the crisis by adhering to the IMF-style prescription, then the ringgit would stabilise, the stock market would recover and there would not be serious capital outflows.

In some ways the Malaysian policies were even more stringent than the IMF policies prescribed for the other three countries. For example, the cut in government budgeted expenditure by 18 per cent was drastic indeed.

However, the orthodox policies did not set the economy on the road to recovery. On the contrary, the macroeconomic policies were contractionary, and converted the initial financial problems into an economic recession. The jump in interest rates raised the debt servicing burden of local companies. Thus the micro-economy financial crisis spread from companies that had taken foreign loans to the far larger number of companies that had taken local-currency loans. In turn the banking system was hit by an increase in non-performing loans and some banks came under stress. Consumer demand fell as interest rates on consumer loans (especially for houses and motor vehicles) rose. The deterioration in the companies' performance contributed to the depressed state of the stock market, and this in turn adversely affected the position of the companies, the banks and the state of consumer demand. The real economy was badly affected as real GDP growth turned from plus 7.7 per cent in 1997 to minus 6.7 per cent in 1998 (Bank Negara Annual Report 1998: p236).

The deterioration in the real economy in turn had a negative effect on investor confidence, on the value of the currency, on stock market performance and on capital outflows. Local citizens were channelling their savings abroad, attracted by higher deposit rates offered by banks in neighbouring Singapore for bank accounts denominated in Malaysian ringgit.

After the contractionary monetary and fiscal policies were introduced at the end of 1997, some of them were reversed over the next several months, in response to the deterioration of the real economy. For instance, the Central Bank, Bank Negara, eased its monetary policy by reducing the statutory reserve requirement and by reducing the three-month intervention interest rate, whilst fiscal policy also became expansionary. In September 1998, measures were taken to fix the exchange rate and for selective capital controls.

(c) Developing the Malaysian Alternative Strategy

As both the financial and the real economy deteriorated, the government decided to adopt a different economic strategy. This new strategy was not adopted all at once, but stage by stage and part by part as developments unfolded.

Firstly, on the institutional side, a National Economic Action Council (NEAC) was formed in January 1998 to take overall charge of economic crisis management. Previously the Finance Ministry took the lead in managing the crisis, and now the decision-making centre shifted to the Prime Minister's Department which hosted the NEAC. The Council was chaired by the Prime Minister and comprised several Federal Ministers, the Chief Ministers of the state governments, several government agencies, and representatives of industry. It had an executive committee led by the Prime Minister and included the Deputy Prime Minister, Finance Minister, Executive Director of the NEAC Secretariat and some key economics-related officials (including the Central Bank Governor, the Director General of the Economic Planning Unit and the Secretary General of the Treasury) and a few individuals. A new NEAC Secretariat was established in the Prime Minister's Department, with an Executive Director and full-time staff drawn initially from the Economic Planning Unit (the country's main planning agency), and it was also serviced by a

Working Group of five individuals drawn from business and academia.

The establishment of this high-powered Council with almost over-riding authority to deal with the economic crisis on an emergency basis, was a central and structural aspect of the Malaysian model of crisis management. Eventually it was the NEAC that drew up an alternative medium-term strategy to deal with the crisis. But it also intensely monitored all aspects of the economy and made decisions on a day-to-day basis. The NEAC executive committee chaired by the Prime Minister met every day for several hours to receive feedback on implementation and effects of policy decisions and to make decisions on new measures. The NEAC was also able to cut through the usual territorial compartmentalisation of the various Ministries and agencies, and take decisions in a coordinated way.

The evolution of the alternative Malaysian strategy took several phases, including the following.

After the NEAC's establishment in January 1998, its Executive Director, Working Group and Secretariat undertook an intensive consultation over several months with representatives of many economic, commercial, financial and social sectors and with some non-governmental organisations, to determine their problems and obtain their views and policy suggestions.

A National Economic Recovery Plan was then formulated and launched on 23 July 1998. Its objectives were to stabilise the currency, restore market confidence, maintain financial market stability, strengthen economic fundamentals, continue the equity and socio-economic agenda, and revitalise affected sectors. The Plan comprised a new approach to fiscal and monetary policy. The Plan's implementation also covered structural and institutional issues, including recapitalisation of the banking sector, dealing with the non-performing loans, and corporate debt restructuring (Economic Planning Unit 1998).

Various measures were taken from the beginning to the middle of 1998 to reverse the contractionary monetary and fiscal policies that had been introduced towards the end of 1997.

On 1 September 1998, measures were announced by the then Prime

Minister Dr Mahathir Mohamad relating to the currency and to mobility of capital flows. They were aimed at stabilising the level of the local currency (through fixing of the exchange rate to the US dollar); preventing overseas speculation on the value of the local currency and local shares (by banning the overseas trade in these); and reducing capital outflows (through selective capital controls). This set of measures was a watershed as until then it had been almost taboo for economists let alone governments to even discuss capital controls. By coincidence, a week earlier the American economist Paul Krugman had broken the intellectual taboo by advocating that Asian countries should adopt exchange controls, in an article in *Fortune* magazine.

The Malaysian move involved measures to regulate the international trade in its local currency and regulate movements of foreign exchange, aimed at reducing the country's exposure to financial speculators and the growing global financial turmoil. The policy package included officially fixing the ringgit to the US dollar, deinternationalising the trade in the ringgit, a one-year moratorium on the outward transfer of foreign-owned funds invested in the local stock market, and strict limitations on the transfer of funds abroad by local residents.

The rationale for the move was explained by Dr Mahathir in a television interview on the day the measures were announced. Asked whether the exchange control measures were regressive, he said they were not so, but instead it was the present situation, where currency instability and manipulation was prevalent which was regressive. He said that when the world moved away from the Bretton Woods fixed exchange system, it thought the floating rate system was a better way to evaluate currencies. "But the market is now abused by currency traders who regard currencies as commodities which they trade in. They buy and sell currencies according to their own system and make profits from it but they cause poverty and damage to whole nations. That is very regressive and the world is not moving ahead but backwards." He added the Malaysian measures were a last resort. "We had asked the international agencies to regulate currency trading but they did not care, so we ourselves have to regulate our own currency. If the international community agrees to regulate currency trading and limit the range of currency fluctuations and enables countries to grow again, then we can return to the floating exchange rate system. But now we can see the damage this system has done throughout the world. It has destroyed the hard work of countries to cater to the interests of speculators as if their interests are so important that millions of people must suffer. This is regressive."

Dr. Mahathir added the Malaysian measures were aimed at putting a spanner in the works of speculators, and taking speculators out of currency trade. He said: "The period of highest economic growth was during the Bretton Woods fixed exchange system. But the free market system that followed the Bretton Woods system has failed because of abuses. There are signs that people are now losing faith in this free market system, but some countries benefit from the abuses, their people make more money, so they don't see why the abuses should be curbed."

Chapter 3

ELEMENTS OF THE MALAYSIAN ALTERNATIVE STRATEGY

(a) General

The Malaysian alternative strategy comprised several aspects. They were not developed all at once, but stage by stage as a response to the developments in the crisis, and as the initial policies proved inadequate.

The elements of the Malaysian strategy included:

- The core macroeconomic policies of interest rates, monetary policy and fiscal policy, and a financing plan. These were essential to prevent the real economy from further deteriorating, and to get recovery going.
- Stabilising the exchange rate. This was essential to prevent further destabilisation, to enable the macroeconomic policies to be implemented, and to prevent difficulties in servicing the external debt.
- Closing down the overseas trade in the local currency and the local stock market, in order to prevent overseas speculative activities.
- Regulating capital flows, particularly short-term capital outflows by foreigners and local citizens. Measures included an initial one-year moratorium on outflow of foreign portfolio capital and foreign-owned financial assets denominated in ringgit. Restrictions were placed on capital transfers by local citizens and companies. The restrictions did not apply to the flow of funds relating to foreign direct investment, nor to trade.
- Maintaining financial stability by deciding on a policy of not closing

down financial institutions facing difficulties, and announcing that the government would guarantee deposits placed in banks and finance companies.

- Restructuring and recapitalising the banking and corporate sectors in order that there be a recovery in the micro-economy.
- Revitalising the various economic sectors affected by the crisis.
- Maintaining certain key economic and social policies, in particular the regulation of foreign ownership of assets, subsidies and price controls, and policies relating to distribution and balance among local ethnic communities.

(b) The Core Macroeconomic Elements

(i) Reduction in interest rates

During the initial year of the crisis, interest rates for loans had shot up to as high as 25 per cent. This had choked business. The interest rate was brought down as a key component of the alternative strategy. The Central Bank 3-month intervention rate was reduced from 11 per cent at end-July 1998 to 6 per cent on 3 May 1999. According to the United Nations Conference on Trade and Development (UNCTAD) (2000: p57), "after the introduction of capital controls, interest rates were reduced further throughout 1999, falling to some 3% in December, compared to 5% in Thailand, 6.7% in Korea and 13% in Indonesia." The base lending rate of the banks was reduced from 12.3 per cent in June 1998 to 7.75 per cent in December 1999.

(ii) Expansionary monetary/credit policy

During the initial phase of the crisis, credit flow had slowed to a trickle. The alternative strategy was aggressive in measures to increase liquidity in the system. The government took measures to increase liquidity in the banking system and then urged banks to increase credit to the private sector. The government reduced the Statutory Reserve Requirements (the funds which banks are required to maintain with the Central Bank as a prudential measure) from 13.5 per cent to 10 per cent in February 1998, 8 per cent in July 1998 and 4 per cent in October 1998. This released significant liquidity to the banks. The government also set a target for the banks to increase their loans by 8 per cent in 1999. To ease the pressure on the banks, the government also reverted to the original definition of non-performing loans as loans not serviced for 6 months (instead of the more stringent 3-month criterion that had been introduced after the crisis broke out).

(iii) Expansionary fiscal policy

The initial contractionary fiscal policy (which had planned to cut government expenditure by 18 per cent in December 1997) was reversed. In July 1998 a fiscal stimulus package was announced, involving additional development expenditure of RM7 billion allocated to agriculture, housing, education, health and rural development; and a RM5 billion infrastructure development fund was set up to finance infrastructure projects. The federal government had a budget surplus equivalent to 0.8 per cent of GNP in 1996, and this rose to 2.5 per cent of GNP in 1997. Reflecting the expansionary measures, the fiscal position then turned into a budget deficit of 1.8 per cent in 1998, which increased to 3.2 per cent in 1999 and 5.5 per cent in 2001. (Ministry of Finance 2001, Bank Negara 2002).

(c) Stabilising the Currency

(i) Fixing the exchange rate

Stabilising the exchange rate became about the most important objective. The NEAC studied the experiences of many countries. It was decided to adopt a fixed exchange rate system, i.e., fixing the ringgit to the US dollar. This would not be done through a Currency Board system (as adopted by some other countries) because in this system the country's money supply would be linked to the level of the country's foreign reserves. In the Malaysian system, this linkage is not made. The exchange rate chosen was RM3.80 to US$1, which was about the rate at the time the then Prime Minister announced the adoption of a fixed exchange rate system in September 1998. The Central Bank uses this rate to exchange dollars with ringgit in its dealings with the commercial banks and other authorised financial institutions, and they in turn are required to use this rate in their currency dealings with the public. The ringgit-dollar rate has remained the same ever since. The government has announced several times its intention to stick to the same rate for as long as possible (i.e., if this does not cause the ringgit to be too over-valued or too under-valued, especially in relation to concerns for export competitiveness) so that there will be a high degree of predictability. Up to now, there has not been any "black market" or parallel trade with a different rate. The predictions especially by international analysts (voiced when the Malaysian system was introduced) that a fixed exchange rate system would result in misalignment and a black market have not been borne out, at least till now.

The fixing of the exchange rate has been important for stabilising the financial situation. Perhaps its most important role, however, is that it allows the government to take monetary and fiscal policies on the basis of their own merit without being constrained by fears of a fall in the value of the currency if the funds analysts do not approve of the measures. The exchange rate fixing also reduces the opportunity for speculation.

As stated by the then Prime Minister when introducing the measures in September 1998: "With the introduction of exchange controls, it would be possible to cut the link between interest rate and the exchange rate. We can reduce interest rates without speculators devaluing our currency. Our companies can revive." He added the country would not be affected so much by external developments such as the crisis in Russia.

(ii) Measures to prevent overseas speculation and trade in the ringgit (i.e., deinternationalising the currency)

Measures were taken to reduce and eliminate the international trade in ringgit, and to repatriate back to the country a large amount of ringgit-denominated financial assets (such as cash and savings deposits) that were held abroad in overseas banks and other institutions. The measures mainly comprised the non-recognition or non-acceptance of such assets in the country after the expiry of a one-month period, i.e., local financial institutions were not allowed to accept the entry of such assets after the deadline. (Permission to repatriate after this deadline would however be given under certain conditions.)

This measure also effectively put an end to the offshore trade in the Malaysian ringgit and in assets denominated in ringgit (including the operation and holding of ringgit-denominated bank accounts abroad).

Explaining the move to make the use of offshore ringgit invalid, Dr. Mahathir said normally it was offshore ringgit that was used by speculators to manipulate the currency. The speculators hold the ringgit in foreign banks abroad and have corresponding amounts in banks in Malaysia.

(d) Selective Capital Controls

(i) The initial measures in September 1998

Several measures were introduced on 1 September 1998 to regulate the outflow of funds.

Measures aimed at foreigners and foreign-owned funds included the following:

- Non-residents holding shares on companies listed in the local stock exchange would have to retain the shares or the proceeds from the sale of shares for a minimum period of one year from the purchase date. The objectives of this measure were to discourage foreign speculative short-term trade in local shares, and to prevent capital outflow at least for a one-year period.
- Domestic credit facilities to non resident correspondent banks and non resident stockbroking companies were no longer allowed (previously domestic credit up to RM5 million was allowed).
- Conditions were imposed on the operations and transfers of ringgit-denominated funds in external accounts, including those held by non-residents. Transfers between external accounts held by non-resident corporations and individuals residing outside Malaysia required prior

approval for any amount (previously freely allowed). Transfers from external accounts to resident accounts would require approval after 30 September 1998. Sources of funding external accounts were limited to proceeds from sale of ringgit instruments and other assets in Malaysia, salaries, interest and dividend and sale of foreign currency.

Measures aimed at local residents included the following:

- Resident travellers were allowed to import ringgit notes up to RM1,000 only and any amount of foreign currencies, and to export only up to RM1,000 and foreign currencies only up to RM10,000 equivalent.
- Except for payments for imports of goods and services, residents were freely allowed to make payments to non residents only up to RM10,000 or its equivalent in foreign currency (previously the limit was set at RM100,000).
- Investments in any form abroad by residents and payments under a guarantee for non trade purposes required approval.
- Prescribed manner of payment for exports would be in foreign currency only (previously it was allowed to be in foreign currency or ringgit from an external account).
- Residents required prior approval to make payments to non residents for purposes of investing abroad for amounts exceeding RM10,000 equivalent in foreign exchange.
- Residents were not allowed to obtain ringgit credit facilities from non residents.

It should also be noted that the ruling, in existence before the outbreak of the crisis, prohibiting local companies from obtaining foreign-currency-denominated loans from abroad unless these were for activities that earned foreign exchange, remained in force.

The capital controls were selective in that they covered movements of funds in the capital account. In the case of foreigners, they covered mainly some aspects of portfolio investment. In general, the ringgit was still to be freely (or at least easily) convertible to foreign currencies for trade (export receipts and import payments), inward foreign direct investment (FDI), and repatriation of FDI-related capital and dividends by non-residents. In the case of local residents, the capital controls covered a wider range of activities, and in fact the aim of preventing the flight of local-owned capital was to be just as important (if not more) than the controls imposed on foreign-owned funds. However, there was no control on currency convertibility by local residents for purposes of trade. Convertibility up to a certain limit was also allowed for certain other purposes, such as the financing of children's education abroad. But convertibility for autonomous capital movements for several purposes not directly related to trade was to be prohibited or limited.

(ii) Subsequent amendments and relaxation

The capital control measures were amended and in effect relaxed subsequent to their introduction on 1 September 1998.

With effect from 15 February 1999, the requirement that proceeds from the sale of ringgit assets be maintained by foreigners in the country for one year was replaced by an exit levy on assets owned by foreigners.

- For capital brought in before 15 February 1999, an exit levy was imposed on the principal at the following rates: 30 per cent for maturity period of 7 months; 20 per cent for 9 months; 10 per cent for 12 months; and zero levy for capital exceeding the 12-month maturity period.
- For capital brought in after 15 February 1999, an exit levy was imposed on the profits at the following rates: 30 per cent for maturity period of less than 12 months, and 10 per cent for maturity period of more than 12 months.

A further amendment and relaxation was made on 21 September 1999. Irrespective of when the capital was brought in, an exit levy with a single rate of 10 per cent was imposed on profits repatriated by foreigners.

On 1 May 2001, this 10 per cent exit levy was also abolished.

The limitations on outflow of residents' capital remain.

(e) Stock Market Measures and Closure of Overseas Trade in Malaysian Securities

The Kuala Lumpur Stock Exchange (KLSE) established new measures from 1 September 1998. One major aim of the measures was to reduce possible capital leakage out of the country through the stock market. Among these measures were:

- Clearings in securities traded on the KLSE were to be undertaken only through the KLSE or a recognised stock exchange and through the KLSE trading system.
- New disclosure requirements, including the beneficiary owners of shares, must be identified in all dealings; and each Central Depository System account operated by a nominee must have only one beneficiary.
- Stockbroking companies could engage only in direct off-market dealings such as crossing and married deals.
- All new issues of shares were to be made by crediting the securities into the Central Depository System accounts of securities holders.

The measures taken in effect caused the closure of existing secondary markets abroad that conducted trade in stocks of companies listed on the KLSE, as henceforth trade would be limited only to the KLSE. A major aim of the measure was to prevent speculation or manipulation of KLSE share prices and transactions from outside the country and to prevent the outflow of capital through the sale of Malaysian shares outside the country. The shares of 112 companies listed on the KLSE had been traded since 1990 in the Central Limit Order Book International (CLOB) based in Singapore, which was in effect an offshore market for Malaysian securities. The CLOB market was also linked to the ringgit offshore market as CLOB shares were used as collateral by currency traders dealing in ringgit.

On 16 September 1998, the Stock Exchange of Singapore discontinued the trading of Malaysian shares on CLOB and subsequently a deal was made between the two stock exchanges whereby the CLOB shares were released into the KLSE and the CLOB share holders could again trade in those shares.

(f) Restructuring the Financial System and Corporate Debt

(i) General

A major threat posed by the crisis was the serious destabilising effect on the banking and financial system. As local companies and consumers faced difficulties in servicing their loans due to the initial raising of interest rates, the sharp currency depreciation and the recession in the real economy, the incidence of the banks' non-performing loans (NPLs) increased sharply. It was estimated by the NEAC that total NPLs in the banking system would be RM74 billion (15.5 per cent of gross loans outstanding) by end-1998 and would rise to RM100 billion (19.7 per cent) by end-1999.

As public confidence eroded, there was a need to restore confidence and prevent a run on the banks. Also, several banks that had come under pressure had to be recapitalised or face insolvency. Measures were taken to deal with these problems. Firstly there were measures to restore public confidence through a government guarantee of deposits and a decision not to close downtroubled institutions. Secondly, a set of three new agencies was created: Danaharta, an asset management company to manage NPLs; Danamodal, a special agency to recapitalise weak financial institutions, and the Corporate Debt Restructuring Committee (CDRC), a committee to restructure corporate debts. These three agencies worked together to try to resolve the inter-related problems in a coordinated way.

(ii) Government guarantee of depositors' funds

Due to erosion of public confidence in the local financial institutions, many depositors at the end of 1997 began to shift their assets from local-owned to foreign-owned banks, and abroad. To prevent a potential run on some of the banks or a run on the local banks in general, the government announced that it would guarantee the depositors' funds in the commercial banks and licensed finance companies. This restored depositors' confidence.

(iii) Decision not to close down financial institutions in trouble

The government decided it would not order the closure of any commercial bank or licensed finance company that was suffering financial difficulties. Instead other measures would be taken to restore their viability. This also helped maintain public confidence in the financial system.

(iv) Establishment of Danaharta

This government-owned company was formed in June 1998 to buy up or transfer NPLs from the banking system; to manage, restructure or dispose of the acquired loans and the assets attached as collateral; and to maximise the recovery value of the acquired assets.

Danaharta's initial funding of RM13.2 billion came mainly from bonds issued to the selling banking institutions (RM8.2 billion) and from government contribution (RM3 billion) and government loans (RM2 billion). By end-2000, Danaharta had taken over RM47.5 billion of NPLs and at an average discount of 56 per cent of the nominal loan value (Mahani 2002: p150). Viable loans were restructured; for non-viable loans, the assets attached as collateral were restructured (involving the sale of the collateral or the business); and foreign loans were sold. At end-2000, Danaharta expected to collect recovery proceeds of RM23.8 billion.

Due to its operations, the banking system's NPLs peaked at 13 per cent of total loans in April 1999, which was far below the market expectations that NPLs would rise to the rate of 20 per cent or 30 per cent.

(v) Establishment of Danamodal

This agency was established in August 1998 as a subsidiary of the Central Bank with the aim of recapitalising financial institutions under financial stress of inadequate capitalisation. Its functions were to assess recapitalisation requirements of the banks, undertake the recapitalisation exercise, restructure the affected institutions and monitor performance. Danamodal raised RM10.7 billion of funds for its work (RM7.7 billion through issue of its bonds; and RM3 billion seed capital from the Central Bank). By mid-1999, Danamodal had injected RM7.59 billion to assist in recapitalising ten financial institutions. The injected funds were all initially in the form of "exchangeable subordinated capital loans" (ESCLs). Of the RM7.59 billion, a total of RM3.9 billion has been repaid and Danamodal funds remain in only three institutions. In these remaining institutions, the original ESCL loans have been transformed into preference and ordinary shares (RM2.6 billion) and subordinated bonds (RM500 million) and the rest retained as ESCL loans (RM1.1 billion) (Mahani 2002: p157-169).

Danamodal's work helped in recapitalising and reviving several troubled institutions and prevented what could have been the closure of some of them. The amount of public funds used by Danamodal was relatively small as most of its financing was through its own bonds, and moreover over half of the loans have been repaid by the recapitalised financial institutions. Also the rates of return for Danamodal's investments have been 7.5 per cent for the ESCLs, 12 per cent for shares owned, and 10 per cent for subordinated loans (Mahani 2002: p165). These rates are relatively high.

(vi) Establishment of the CDRC

The CDRC was established in July 1998 to assist in resolving large corporate debts by creating a forum for creditors and borrowers for debt restructuring workout through voluntary agreement. Its steering committee comprised Finance Ministry and Central Bank officials, and representatives from the legal, accounting and banking professions. Later, representatives of the creditor banks joined the committee.

The process involved four phases: an initial debtor-creditors meeting to agree on a temporary informal standstill and appoint a creditors' committee; consultants are appointed to review the company's status and recommend action; a formal standstill agreement is made and restructuring plans agreed on; the creditors' committee reports progress to the steering committee.

The CDRC's work started slowly and it faced some challenges, including the fact that (unlike Danaharta and Danamodal) it did not have statutory powers and the workout arrangements were of a voluntary nature. In the next few years, however, it achieved a significant number of completed cases. By mid-2001, 73 applications had been received by corporations for debt workout. Of these, 21 were withdrawn or rejected (mainly because they were unviable businesses) and 9 were transferred to Danaharta. The remaining 43 cases involved a total of RM38 billion in debts. Of these, 33 cases involving RM28 billion in debts had been completed, and another two cases involving RM1 billion had been resolved with Danaharta's assistance, leaving 8 outstanding cases involving RM9 billion in debts. The CDRC was able to conduct debt workouts involving several large corporate debts. A limitation was that the CDRC only accepted applications from companies that it assessed to be still viable, and which had over RM50 million of debts. Thus, the CDRC dealt only with large companies with big debts, whilst small companies requiring a similar debt workout exercise were left out (Mahani 2002: p170 -173).

(g) Maintaining Some Basic National Policies and Socio-Economic Goals

A major part of the Malaysian alternative strategy was that it maintained several key aspects of the overall national development policies that had been in place before the crisis. Some of these policies had been part of the central tenets of Malaysian political and socio-economic life, sometimes involving a compact among the various ethnic communities.

Malaysian political leaders were justifiably concerned that some of these policies would have to be jettisoned if the country had to turn to the IMF for loans, as these policies would probably have to be changed under IMF loan conditionality. Asked if the IMF would be unhappy with the Malaysian exchange rate and capital control measures, Dr Mahathir replied that the IMF's actions had benefited foreign companies but were not in the country's interests. "They see our troubles as an opportunity for foreign companies to do business without any conditions. It says it will give you money if you open up your economy, but doing so will cause all our banks, companies and industries to belong to foreigners."

Thus, an important component of the Malaysian strategy was to ensure that it would be able to maintain several of its national policies. Among these policies were the following:

- The country could retain its policy of regulating the entry and degree of participation of foreign companies and investors in the domestic economy. Malaysia has one of the most liberal policies towards foreign investment. However, it also has a complex and sophisticated set of policies regulating foreign participation. The Malaysian crisis response strategy did not involve a significant change in policies towards foreign ownership. Moreover, the exercise of restructuring financial institutions and local corporations mainly involved local institutions and players. This was unlike the situation of countries undergoing reforms with IMF assistance, where opening up to foreign participation was a major plank of IMF conditionality.
- The government was able to assist locally-owned companies and financial institutions that were facing financial difficulties or imminent insolvency. In countries undergoing IMF reforms, assistance to local institutions in economic difficulties was not allowed in many cases or frowned on. There is a heated debate on whether the state should come to the assistance of corporations and banks during a crisis, or whether they should be allowed to collapse. The debate was also heated in Malaysia, where there were accusations that in the corporate and banking rescue plans, the government favoured certain businessmen associated with factions of the ruling party, especially regarding the terms of debt settlement or asset restructuring. However, by not going to the IMF, the country had the option of determining its own policies on assistance to local institutions. The restructuring exercises had a fair rate of successes.
- The policy of striving for balance in the distribution of assets and equity between locals and foreigners and among the local communities (known in Malaysia as the New Economic Policy) was basically maintained.
- The government was also able to maintain socially-oriented policies such as controls on prices of some essential consumer items and subsidies on a few consumer items, as well as to farmers (for example, government

fertiliser subsidies to rice farmers). In some countries receiving IMF loans, some price controls or subsidies were reduced or withdrawn, causing social unrest.

- The government was also able to maintain its own policies on privatisation, and on the extent and rate of financial and trade liberalisation.

Chapter 4

SOME LESSONS AND CONCLUSIONS

(a) Lessons from the Malaysian Experience

There are some interesting lessons from the Malaysian policy response to the crisis.

(i) There are alternatives to the IMF conditionality package. There are alternatives to the IMF's loan conditionality policy package that can possibly be formulated and tried out. The Malaysian case shows that such an alternative approach exists, and can be applied in a relatively successful manner with good results.

(ii) Having policy space and flexibility is important to a developing country. The Malaysian experience also shows that if a country is able to avoid turning to the IMF, it can be free of the straightjacket of the IMF's mainly one-size-fits-all policies, and can choose its own policies and also change them if they are found to be unsuitable. Malaysia initially took on several elements of the IMF fiscal and monetary policies but when these damaged the real economy the country was able to change to a different approach.

(iii) A coherent anti-crisis strategy should be seen as an integrated package of its elements and policies. Policy makers often (even constantly) grapple with policy dilemmas as there are multiple goals and the same policy instrument meant to achieve one goal may impact negatively on another or other goals. In a situation where there are many complex trade-offs, it is useful to "think outside the box" and seek other policy tools.

In the Malaysian case, it is useful to analyse and appreciate the various policy elements as parts of an integrated approach, and as parts of a whole policy package. Thus, each element should be considered not only on its own merits or for its own role to achieve a particular goal, but also for its function of having an effect on another element or on another goal. A particular element or policy may not have the same successful intended effect, unless accompanied by or done in conjunction with some other element of policy. Thus, the inter-relationship of the elements and the interaction with one another should be appreciated.

For example, lowering the interest rate was important for rescuing the micro-economy, and reviving the real economy, but doing so would have brought down the ringgit's exchange rate and threatened the country with a debt default situation. The interest rate had therefore to be decoupled from the exchange rate. A new policy instrument, i.e. fixing the exchange rate, was thus introduced.

However, this alone would have been insufficient as: (i) speculation on the currency could still take place in ringgit offshore markets; and (ii) there was still the possibility of capital flight that could pose a threat to the foreign reserves position and also make maintenance of the exchange rate unsustainable. Thus, besides the fixing of the exchange rate to the dollar, the stabilisation of the currency also required two additional policy instruments: (i) ending the overseas speculation by banning the currency's trade abroad; and (ii) introducing selective capital controls to regulate the outflows and inflows of funds. Thus, starting from just one major policy goal (reviving the local companies and the local economy) and a single policy tool (interest rate reduction), we end up with several other policy tools and goals.

(iv) Financial openness poses serious dangers to developing countries and can be avoided. Too much openness in the financial sector can make a developing country vulnerable to financial speculation, to sudden or large movements of foreign capital and to volatile movements in the exchange rate. If a country were to maintain an open financial policy, it risks losing the ability to determine its own macroeconomic policies (or at least its flexibility to choose among macroeconomic policy options is seriously reduced). Thus the country may find it desirable not to have such an open financial policy.

The Malaysian experience shows that if a developing country reaches such a policy conclusion, it is possible to attempt adopting policies to limit financial openness through an array of policy tools that could include some capital controls, regulations to discourage or prevent speculation, and a fixed exchange rate system. Of course, "one-size-does-not-fit-all" also applies here, and the policies that may have been appropriate for Malaysia may not be so for other countries either because they have different conditions (economic, political, institutional, etc.) or because they have different goals.

(b) Other Conclusions

How successful was the Malaysian alternative strategy? From 1999, after the adoption of the policies, the economy recovered rather well. Real GDP, which had fallen by 7.4 per cent in 1998, grew again by 6.1 per cent in 1999 and 8.3 per cent in 2000. The growth rate slowed significantly to 0.4 per cent in 2001 due to unfavourable world economic conditions, then recovered to 4.2 per cent in 2002. The balance of payments current account, which had a RM15.8 billion deficit in 1997, turned around to surpluses of RM36.8 billion in 1998, RM47.9 billion in 1999 and RM32.2 billion in 2000. The Central Bank's international reserves had fallen from RM70 billion (US$27.7 billion) at the end of 1996 to RM$59.1 billion (US$21.7 billion) at end-1997 during the onset of the crisis. It increased to RM$99.4 billion or US$26.2 billion (1998), RM$117.2 billion or US$30.9 billion (1999) and RM131.4 billion or US$34.6 billion (2002). Total external debt had risen from RM97.8 billion (40 per cent of GNP) in 1996 to RM170.8 billion (64 per cent of GNP) in 1997. It then declined to RM162 billion (60 per cent of GNP) in 1998 and to RM161 billion or US$42.3 billion in 2000 (51 per cent of GNP) before rising again to RM185.3 billion or US$48.8 billion (55 per cent of GNP) in 2002 (Bank Negara Annual Reports).

External debt service payments in 1998-2002 stayed within manageable levels, equivalent to 5.4 to 7.0 per cent of the value of exports of goods and services. The rate of inflation had risen from 2.6 per cent in 1997 to 5.2 per cent in 1998, but declined to 2.8 per cent in 1999 and to 1-2 per cent in 2000-2002 (Bank Negara and Ministry of Finance).

Most of the banks have recovered, with the level of non-performing loans and risk-weighted capital ratios within internationally accepted standards. Some local corporations may not have yet recovered fully to the pre-crisis conditions (and some may never), but many have remained economically viable.

Regarding the effects of the capital control measures, UNCTAD's *Trade and Development Report 2000* concludes that: "The success of the measures taken was confirmed by the fact that when the controls were lifted in September 1999 there was an immediate outflow of only 5.2 billion ringgit, and another 3.1 billion in the rest of the year. In the first quarter of 2000 there was a net inflow of 8.5 billion, an amount roughly equal to what had flown out at the expiry of the controls. By May 2000 total official reserve assets were $32 billion, over six times short-term debt. In December 1999 Malaysia's long-term foreign currency rating was raised to BBB and more recently the country was returned to the Morgan Stanley Capital International emerging market securities benchmark indices, indicating a normalisation of relations with international capital markets." (UNCTAD 2000: p55)

Comparisons have been made between the recovery in Malaysia and that in Thailand, South Korea and Indonesia. It is true that in Thailand and South Korea at least there has also been recovery and growth. Some analysts point out that the Malaysian policy example may have encouraged the IMF to relax its initial contractionary fiscal and interest rate policies in the three countries, and thus that the Malaysian policies indirectly assisted the recovery in these countries. The controversies on the comparison between the performance of Malaysia and that of countries undergoing IMF policies will continue. However, it cannot be denied that the Malaysian experience shows that an alternative to the IMF policy package can and does exist and that it can produce results that are at least as successful.

Can the Malaysian strategy be replicated? As stated above, "one-size-does-not-fit-all" also applies here, and the policies that may have been appropriate for Malaysia may not be so for other countries either because they have different conditions (economic, political, institutional, etc.) or because they have different goals. For a start, Malaysia did not have a problem servicing its external debts, so it had a choice of whether to seek IMF assistance. Countries facing a debt default may not be in such a comfortable situation and if they turn to the IMF for assistance, then many of the options open to Malaysia may not be available to them, unless the IMF changes its own approach.

In relation to capital controls, the policies Malaysia took were adapted to its own peculiar circumstances. The lesson is that countries can and should consider the use of capital controls as part of the array of policy tools available. There is a large range of capital controls that can be applied to inflows and outflows. It may be that to prevent a crisis, controls on inflows could be more efficient. In any case, the Malaysian regulation limiting foreign loans to local companies to only cases where the loans will yield foreign exchange earnings, has proven to be very useful in safeguarding Malaysia from the excessive and rapid build-up of short-term foreign debt that was a major factor in the Thai, Indonesian and South Korean crises.

The Malaysian capital controls were applied only to capital account outflows and mainly to local residents. There were no restrictions on trade-related transactions or transactions involving FDI and this was seen to be wise by the policy makers as Malaysia has an economy that is very trade-dependent and also very reliant on FDI and they rejected the option of capital controls that could disrupt either. Foreign funds and foreigners were affected mainly in relation to short-term portfolio investment. The measures on that were also relaxed and then abolished relatively rapidly. Countries facing a different situation could more appropriately choose to apply different controls over a different set of flows.

For a fixed exchange system and a system of capital controls to work may require some degree of institutional capacity and administrative efficiency in order to have successful implementation and prevent leakages or "black markets." Malaysia has a relatively capable administrative machinery, and this contributed to the successful implementation of the policies. Countries lacking this capacity may not be able to implement the same kind of policies so successfully. This point has often been made. However, a developing country need not be put off these policies simply because it does not have a very efficient administrative machinery. After all, there were many predictions (from the IMF, market analysts and investment funds) that the Malaysian currency policy and capital controls would not work and would plunge the country into disaster, and yet the country was able to implement the policies successfully.

Regarding the core macroeconomic policies, the Malaysian strategy was intended to follow the basic Keynesian prescription that in a recessionary situation, a package of low interest rates and expansionary monetary and fiscal policies would help revive the economy. The Malaysian strategy was unique only because the IMF conditionality appears to prohibit recipient countries from following this prescription. Many developed countries, including the United States, follow the same strategy that Malaysia did. It remains strange to neutral observers why the IMF does not allow its developing country borrowers to adopt policies that the US, its most important creditor member, adopts, but instead insists on contractionary macroeconomic policies that usually induce recessionary conditions.

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This paper takes a close look at the bold and eventually successful measures which Malaysia took in striking out on its own to deal with the financial-economic crisis that hit the Southeast and East Asian "Tiger" economies in 1997-98.

It begins by giving a background to financial crises experienced by developing countries and the adverse effects suffered by these countries resorting to IMF aid and having to adhere to its policies, and looks at the needs and goals of a country undergoing a financial crisis.

The paper then examines the prelude to the crisis in Malaysia, and examines the initial response of the Malaysian government in following the path of orthodox policy, and the different and alternative strategy it finally adopted and the unfolding of this strategy.

It describes in detail the elements of the strategy — the core macroeconomic elements, the stabilising of the local currency, selective capital controls, stock market measures and closure of overseas trade in Malaysian securities, restructuring the financial system and corporate debt, and maintaining some basic national and socio-economic goals.

It concludes by highlighting some major conclusions and lessons from the Malaysian policy response to the crisis, the first being that there are in fact alternatives to the IMF conditionality package.

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