CAPITAL MOBILITY, CRISIS AND ADJUSTMENT
A MALAYSIAN CASE STUDY

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The International Centre for the Study of East Asian Development, Kitakyushu

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Abstract: This paper examines the role of international capital mobility in making countries susceptible to financial crises and the use of capital controls as a crisis management tool, in the light of the Malaysian experience through the recent financial crisis. It is argued that further liberalization of capital account transaction and aggressive promotion of portfolio inflows in a context of growing macroeconomic imbalances and loosening financial prudence made Malaysia vulnerable to the currency crisis in mid-1997. As against the dire predictions by many observers, capital controls imposed in October 1998 have assisted crisis management along Keynesian lines. Whether the controls have played a 'special role' in delivering a way of a *superior* recovery outcome in Malaysia compared to the IMF-program countries will continue to remain a point of contention. But there is little doubt that the this pragmatic policy choice was instrumental in achieving recovery while minimising economic disruptions and related social costs. However, other countries should be cautious in deriving policy lessons from Malaysia because a number of factors specific to Malaysia seem to have significantly conditioned the outcome of the capital-control based recovery package.

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ABBREVIATIONS

BLR	base lending rate
BNM	Bank Nagera Malaysia (the Malaysian Central Bank)
CPI	Consumer price index
PPI	Producer (wholesale) price index
FDI	foreign direct investment
IMF	International Monetary Fund
KLSE	Kuala Lumpur Stock Exchange
KLCI	Kuala Lumpur Composite Index
MGS	Malaysian government securities
MNE	multinational enterprise
NEP	New Economic Policy
NPL	Non-performing loan
RM	Malaysian ringgit

Conventions

---	Not available
--	Zero or negligible
$	United State dollar

Unless otherwise stated all monetary units are in nominal terms.

1

INTRODUCTION

> 'Capital is increasingly internationally mobile, and the rest of the world's pockets are very deep relative to a small country's capital market and absorptive capacity' (Dornbusch and Edwards, 1994, p. 103)

Every major economic crisis stimulates rethinking of fundamental paradigms in economics. A key focus of the 'brainstorming' triggered by the Great Asian Crisis of 1997-99 has been on the role of international capital mobility in making countries susceptible to crises and the rationale behind the use of capital controls as a crisis management tool. This study seeks to contribute to this debate by examining the Malaysian experience through the crisis. Malaysia provides an interesting case study given its significant capital market liberalisation prior to the onset of the crisis, and its bold move in September 1998 to break with the ideological consensus in crisis management that has governed international financial relations over much of the post-war period. Everyone is watching Malaysia at the movement to learn whether its radical policy shift would prove to be a viable alternative to the conventional market-centered approach to crisis management.

State of the Debate

The orthodox thinking on capital account convertibility that held sway during the Bretton Woods era was rather cautious of liberalisation initiatives in developing

countries.[1] The consensus view was that capital account opening should be done cautiously and only after substantial progress has been made in restoring macroeconomic stability, liberalising the trade account, labour market reforms and establishing a strong regulatory framework to foster a robust domestic financial system. Abrupt dismantling of capital controls at an early stage of reforms without achieving these pre-conditions was thought to be a recipe for exchange rate overvaluation, financial fragility (distorted domestic financial institutions) and eventual economic collapse. This view received ample empirical support from dismal economic outcomes of haphazard liberalisation reforms in many Latin American Countries, in particular countries in the Southern cone, in the late 1970s (Corbo and de Melo 1987).

There was, however, a clear shift in policy emphasis in favour of greater capital account opening from about the late 1980s, with the IMF and the US Treasury adopting as a basic tenet of their policy advocacy for developing countries (Bhagwati 1998a, Rodrik 1999).[2] This new policy emphasis was reflected in a major decision by the International Monetary Fund (IMF) to pursue capital account opening as one of its

[1] The literature on this subject is vast. For authoritative surveys with extensive referencing to the relevant literature see McKinnon (1991), Edwards (1984) and Krueger (1984).

[2] Causes of this shift in policy emphasis, despite the strong main-stream position in support of careful sequencing of reforms (as outlined in the previous paragraph), still remain unclear. Bhagwati (1998) argues that the 'Treasury – Wall Street complex' (the confluence of people and thoughts between Wall Street, the US Treasury and the IMF) was the driving force behind it. Some identify the weakening of operational relations between the World Bank (which has continued to stick to the orthodox policy advocacy) and the IMF (whose policy stance has always been predominantly 'balance of payments centered' as a key factor. To others it is simply a part of the resurgence of free-market ideology following the collapse of the Iron Curtain.

operational objectives. In September 1997, at its annual meeting in Hong Kong, the Interim Committee of the International Monetary Fund (IMF) adopted a statement requesting the executive board of the Fund to work on an amendment to the IMF Article of Agreement with a view to extending the definition of currency convertibility in the Fund's Articles (which is currently limited to current account transactions) to capital account transactions as well.

The push towards capital market opening in developing countries has, however, come under serious reconsideration, in the aftermath of the onset of the Asian currency crisis. The fact that several of the Asian nations most affected by the crisis had for some years received substantial flows of foreign capital has raised questions about the role of capital inflows in creating the conditions that generated the crisis or favoured its dissemination. There has been a huge swing in informed opinion towards thinking that those countries which still maintain closed capital account regimes should undertake the liberalisation of short-term capital movements only gradually and with extreme caution (Bhagwati 1998b, Eichengreen 1999, Radelet and Sachs 1998, Williamson 1999). And even the IMF, despite its flirting with mandatory capital-account convertibility, has recently become more sympathetic to this cautious approach to capital account opening (IMF 1999b, Fischer 1999 and 1998).

There is no consensus on the policy options for the East Asian ‘crisis countries’ (Thailand, Indonesia, Korea, Malaysia and the Philippines) and a few other developing countries, which have already embraced considerable capital account

convertibility. The majority opinion is that these countries must contemplate taking precautionary measures against possible disruptive effects of volatile capital flows, instead of making a u-turn to capital controls. There is, however, no consensus among these economists as to whether precautionary measures should be adopted by individual countries on their own initiative or though an international initiative to reform the international financial architecture.

Krugman (1998 and 1999) added variety to the debate by arguing in favour of the Keynesian advocacy of using capital controls as a means of regaining macroeconomic policy autonomy in countries where the currency crisis has rapidly translated into painful economic collapse. Despite endorsement by some notable economists (eg. Stiglitz 1999, Corden 1998, Folkerts-Landau 1999), this advocacy has met with skepticism on grounds of adverse implications for investor confidence, difficulties involved in the actual implementation of such controls and inefficiency spillover.

Purpose and Scope

The present study intends to inform the policy debate on capital account convertibility in developing countries, relating to both timing and sequencing of economic liberalisation reforms and the use of capital controls in crisis management, through a case study of Malaysia. Malaysia provides an excellent laboratory to investigate these issues, given the nature of policy shifts relating to capital account opening immediately before and after the onset of the crisis. The considerable buildup of short-term borrowing and massive foreign investment in share dealing in Malaysia in

the mid-1990s, which presumably set the stage for the onset of the crisis, followed hard on the heels of significant liberalisation initiatives. In this, the Malaysian experience is remarkably similar to that of the other 'crisis' countries in the region. However, Malaysia is unique among these countries in terms of the strategy that it has chosen to manage the crisis. Unlike the other four countries in East Asia (Thailand, Indonesia, Philippines and South Korea) which were forced to follow the conventional (IMF) reforms, Malaysia responded to the crisis by taking an unorthodox (and risky) policy posture whose key elements were capital controls and expansionary macroeconomic policy.

There is no single well-specified model that can be used to address the issues at hand. The only meaningful research strategy available to us is to undertake an intensive 'case study' in the context of a broad analytical framework developed by combining the standard open-economy macroeconomic theory and counterfactuals derived from the existing empirical literature on policy response to financial crises in other countries. This approach aims to develop a comprehensive *analytical account* of the onset of the crisis, policy responses and economic adjustment, through a careful examination of cause-and-effect relationships between both economic and political variables as they relate to the interactions of capital flows and macroeconomic performance. Thus, much of the study may be regarded as 'story telling informed by theory'.

To gain perspectives, the Malaysian experience will be compared and contrasted where relevant with that of Thailand and South Korea (henceforth referred

to as Korea). These two countries, which have closely followed the conventional (IMF) reform in response to the financial crisis, provide ideal comparators for a study of the outcome of the unorthodox (capital-control-based) Malaysian response to the crisis. Indonesia and the Philippines are not covered in the comparison for the following reasons. In Indonesia political instability and social upheaval interrupted crisis management during most of the period under study. In the Philippines, economic disruption caused by the mid-1997 speculative attack was relatively small because it had not accumulated volatile foreign capital and had not experienced a real estate boom or a share market bubble to the extent that had occurred in the other four countries.

It is of course too soon for a *definitive* analysis of the financial crisis in Malaysia and the effectiveness of the country's dramatic policy shift in crisis management. The developments set in train in Malaysia and elsewhere in the region by the outbreak of the crisis are still unfolding and dilemmas of policy choice that the crisis posed are still being tensely debated. However, there is value in attempting an interim review of the 'Malaysian experiment' during its first full year of implementation for informing the on-going policy debate and setting the stage for systematic analysis in the future.

The study is structured as follows. Section 2 provides an overview of capital account liberalisation in Malaysia during the post-independence period as part of significant outward-oriented policy reforms. Section 3 examines patterns of capital flows in the lead-up to the crisis, focusing on the interplay of international capital

mobility and domestic macroeconomic policy and regulatory regimes in determining the country's vulnerability to the crisis. Section 4 discuses the onset of the crisis in Malaysia and the initial policy responses, highlighting their political and institutional underpinnings. It also examines the nature and severity of economic collapse and the factors that set the stage for the October 1998 policy turnaround. Section 5 describes the new policy package. Section 6 looks at the recovery process under the new policy orientation. Section 5 examines the role of capital controls in the recovery process. The final section draws inferences and policy lessons.

2

PRE-CRISIS CAPITAL ACCOUNT REGIME

Malaysia's development success is widely attributed to its long-standing commitment to maintaining overall a pro-market and outward-oriented policy stance.[3] Despite the early emphasis on import substitution and aborted attempts in the 1970s to promote heavy industries via public sector participation, Malaysian policy makers, by and large, stayed clear of quantitative import restrictions as a policy tool. Tariff rates were relatively high in the 1960s, but they were reduced progressively across the board in the ensuing 20 years. Although exporters were required to convert foreign currency sales proceeds into local currency (ringgit) within six months, this was not a binding constraint on production for export because the import trade regime remained highly liberal. Despite mandatory approval procedures, the exchange rules relating to all current account transactions remained liberal. With this policy orientation, Malaysia achieved Article VIII status (for current account covertibility) under the IMF Articles of Agreement on 11 November 1968, becoming the forth Asian country to enter this country league after Hong Kong (15 February 1961), Japan (1 April 1964) and Singapore (9 November 1968).[4]

A natural companion to outward-oriented trade policy was a firm commitment to the promotion of foreign direct investment (FDI). FDI approval procedures and

[3] For details see Athukorala and Menon (1999) and the works cited therein.

restrictions on foreign equity ownership were very liberal by developing country standards even in the 1950s and 1960s at a time when hostility towards multinationals was the order of the day in the developing world. The emphasis on FDI promotion received added impetus with a notable shift in development policy towards export-oriented industrialisation in the early 1970s. In 1970 legislation provided for the establishment of special export processing zones, which provided 100% foreign ownership and exemption from general labour legislation (including employment quotas for *bumiputras* (ethnic Malays)) for export-oriented investors.

The Malaysian policy regime relating to non-FDI capital inflows and outflow of capital, too, was much more liberal throughout the post-war period, compared to most other developing countries (Williamson and Mahar 1998). However, liberalisation in this sphere was generally more cautious and gradual by Malaysia's own historical record of trade liberalisation. Most restrictions on short-term overseas investment by residents were removed in the 1970s. By the turn of the decade residents were free to place deposits abroad, lend to non-residents, purchase immobile properties or invest in foreign equity, provided such investments are not financed from borrowing in Malaysia. But there was one important exception: Bank Negara Malaysia (BNM) (the Central Bank) continued to monitor foreign currency borrowings by residents and domestic borrowing by non-residents under borrowing/lending ceilings stipulated in foreign exchange regulations (Yusof *et al* 1994, BNM 1994, Williamson 1999). By the end of the decade, the ceilings on foreign currency borrowing by residents and domestic borrowing by non-

[4] All other [pre-crisis] high-performing economies in East Asia achieved Article VIII status much later: Thailand: 4 May 1990, Philippines: 8 September 1995, South Korea: 1 November 1988 and Indonesia: 7 May 1988 (IMF 1997).

resident controlled companies stood at 1 million and 10 million Malaysian ringgit (RM) respectively.

Further liberalisation of impediments to portfolio capital inflow was an important element in policy reforms initiated in the late 1980s. As part of the government's objective of promoting the Kuala Lumpur Stock Exchange (KLSE), foreign share holdings of local brokerage firms were increased from 30% to 49%. Tax rates for both foreign and local fund managers were reduced from 30% to 10%. In October 1990, the Malaysian government launched a program to develop Labuan Island as an International Offshore Financial Centre. It was envisaged that, with the Asia-Pacific Region fast emerging as the fastest growing region in the world, Labuan would play a key role in enhancing the attractiveness of Malaysia as a world investment center (BNM 1994, pp. 45-47). Licensed offshore banks, offshore insurance entities and other offshore companies operating in Labuan were declared as non-residents for exchange control purposes. This initiative enabled these institutions to freely operate foreign currency accounts and move funds into and out of Malaysia without being subject to any exchange control monitoring. Licensed offshore banks were also permitted to accept deposits and grant loans in foreign currency. Investment guidelines were liberalised to allow Malaysian fund management companies to form joint ventures with foreign fund management companies. Management companies of unit trust funds located in Labuan were permitted to invest in Malaysian securities.

Generous tax exemption was granted to companies incorporated in Labuan and their expatriate employees. [5]

The ongoing process of capital account opening was temporary halted in 1994 as the ringgit came under strong buying pressure as the booming economy created expectations about the currency's increasing strength. From late 1993 speculators bought ringgit in large amounts, increasing short-term deposits and forward transactions. In order to avoid an adverse effect on export competitiveness from a sharp exchange rate appreciation, BNM imposed a number of restrictions on capital inflows during January-February 1994. These restrictions included ceilings on external liabilities of commercial banks, a ban on sales of short-term debt instruments to foreigners, restricting ringgit deposits of foreign institutions to non-interest-bearing accounts, prohibiting non-trade-related currency swaps, and a new maintenance charge on non-interest-bearing foreign deposits (World Bank 1996, pp.67-68, BNM 1999b, pp. 288-291).

Once speculative pressure subsided and the exchange rate returned to the level of late 1993, BNM gradually removed the controls and freed up capital flows, completely lifting all restrictions by August 1994 (World Bank 1996, p. 67-68). These capital controls appeared drastic and, like in the case of recent capital control episode (to be discussed below), led to considerable speculation about capital flight from Malaysia (and from other East Asian countries). In particular, there was a

[5] By end of 1996, 47 banks, 5 insurance and re-insurance companies and 3 fund management companies had been incorporated in Labuan.

widespread concern about a possible future contraction in foreign investment flows to Malaysia, both portfolio investment and FDI. Against these gloomy predictions, capital inflows to the country continued to expand at an increasing rate during the ensuing three years.

3

CAPITAL FLOWS AND SIGNS OF VULNERABILITY

Foreign capital inflows to Malaysia have historically been dominated by foreign direct investment (FDI). Even in the first half of the 1990s, FDI accounted for almost 70% of total net capital flows (Table 1). There was a boom in the amount of FDI coming into the country, particularly from the mid-1980s. Between 1987 and 1991 FDI inflows increased by almost tenfold. From 1991 until the onset of the recent financial crisis, the volume of FDI flowing to Malaysia remained higher than to any of the other ASEAN countries.[6]

As FDI inflows were more than sufficient to finance the current account deficit and to generate a surplus in the basic balance, there was no need for the nation to resort to large-scale external borrowing. At the same time, as already noted the Malaysian Central Bank, unlike its counterparts in Indonesia, Thailand and Korea, continued to maintain prudential regulations on foreign borrowing by the corporate sector. Consequently there was no significant accumulation of foreign currency borrowing in the lead-up to the crisis in Malaysia (Table 1). Malaysia's foreign debt remained between 30-25% of GNP while the debt-service ratio (the ratio of debt

[6] The Malaysian experience with attracting FDI has been discussed in detail elsewhere (Athukorala and Menon 1999).

Table 1: Malaysia: Net Capital Inflow,[1] 1990-1997

	1990	1991	1992	1993	1994	1995	1996	1997	1990-96
Total: US$ million	1789	5584	6607	10799	1235	7612	9416	2729	6149[2]
% of GDP	4.2	11.9	11.3	16.8	1.7	8.7	9.5	2.8	13.9
Composition	100	100	100	100	100	100	100	100	100
Official long term	-58.7	3.5	-0.9	-3.6	11.8	-1.1	-1.1	60.6	-3.1
Private	158.7	96.5	100.9	103.6	88.2	101.1	101.1	39.4	103.1
FDI	130.6	71.5	78.1	46.4	335.2	55.2	53.7	187.3	69.5
Portfolio	-10.6	-12.6	46.8	92.4	433.6	28.2	37.1	-370.8	53.8
Bank credit	38.7	37.6	7.5	-34.7	-680.5	19.0	10.3	222.9	-15.0

Notes:

1. Net capital flows comprise net direct foreign investment, net portfolio investment (equity and bond flows) and official and private bank borrowings. Changes in national foreign exchange reserves are not included. For each country, the difference between total and private flows represents net official flows.
2. Annual average.

Source: Bank Negara Malaysia, *Monthly Statistical Bulletin*, Kuala Lumpur (various issues).

Table 2: Malaysia: External Debt, 1990-1998

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1990-96
Total: US$ billion	17.0	18.5	21.9	26.9	28.1	34.0	39.0	60.8	40.8	26.3[1]
% of GDP	39.6	39.3	37.7	41.9	38.7	38.9	39.2	62.2	91.8	39.3
Composition	100	100	100	100	100	100	100	100	100	100
Medium and long-term debt[2]	90.4	85.9	76.5	75.0	80.7	80.9	74.3	74.7	82.2	79.6
Federal government	53.9	49.9	37.4	28.0	20.1	15.7	10.7	7.6	9.3	27.0
NFPEs[3]	25.7	22.9	20.4	24.6	27.7	32.2	29.9	30.7	33.3	26.9
Private sector	10.8	13.2	18.7	22.4	32.9	33.0	33.7	36.4	39.5	25.7
Short-term debt[4]	9.6	14.1	23.5	25.0	19.3	19.1	25.7	25.3	17.8	20.4
Banking sector	9.6	14.1	23.5	25.0	13.4	13.3	17.4	18.9	12.3	16.8
Non-bank private sector	0.0	0.0	0.0	0.0	6.0	5.8	8.3	6.4	5.5	3.6
External debt service ratio[5]: Total	8.3	6.9	9.3	6.4	5.5	6.6	6.9	5.5	6.7	7.1
Federal government	---	2.7	4.2	2.8	1.4	1.4	1.1	0.7	1	2.3

Notes:

1 Annual average.

2 Debt with a tenure of more than one year.

3 Includes both government guaranteed and non-guaranteed debt of non-financial public enterprises (NFPEs).

4 Debt with a tenure of one year and below.

5 Repayment and interest payment of external debt as a percentage of gross exports of goods and services.

--- data not available.

Source: Compiled from Bank Negara Malaysia, *Monthly Statistical Bulletin*, March 1999, Kuala Lumpur.

Table 3: Malaysia: Stock of Mobile Capital and Foreign Exchange Reserves, 1990-1998

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Mobile capital[1], US$ billion	6.3	6.5	12.4	23.9	27.7	31.9	38.9	31.0	18.0
Mobile capital, Composition(%):	100	100	100	100	100	100	100	100	100
Short-term debt[2]	26	40	41	28	20	20	26	50	40
Banking sector	26	40	41	28	14	14	17	37	28
Non-bank private	0	0	0	0	6	6	8	13	13
Portfolio investment	74	60	59	72	80	80	74	50	60
Foreign exchange reserves, US$ billion	10.0	11.1	18.5	29.7	26.0	25.5	27.9	21040	25.4
Reserve cover of									
Short-term debt[3]	610.5	426.9	363.9	443.8	469.3	399.7	275.9	134.2	352.8
Total mobile capital[4] (%)	158.7	170.5	148.7	124.2	94.0	79.9	71.8	67.8	141.2

Note:

1 Short-term debt + portfolio investment

2 Debt with a tenure of one year and below.

3 Stock of short-term foreign debt as a percentage of foreign exchange reserves.

4 Stock of mobile capital as a percentage of foreign exchange reserves. This ratio had declined to 55.8% by end June 1997. The increase in the annual figure for 1997 compared to 1996 simply reflect the depletion of the stock of portfolio investment which occurred at a rapid rate than the decline in foreign reserve following the speculative attack on the ringgit in July that year.

Source: Compiled from Bank Negara Malaysia, *Monthly Statistical Bulletin*, Kuala Lumpur (various issues).

payments and interest payments to export earnings) varied in the range of 8.5% to 6.3% during 1989-1996, both were very low by developing country standards. (Table 2). There was, however, an explosion in foreign capital flows to the Malaysian share market from the early 1990s. This new form of reliance on foreign financing combined with weaknesses in corporate governance (discussed below) quickly overwhelmed prudential bank borrowing practices to generate financial fragility.

Surge of Portfolio Inflows

Capital market liberalisation initiatives in Malaysia in the early-1990s coincided with the growing enthusiasm of hedge funds and other institutional investors for investing in emerging-market economies (World Bank 1997). Thus, there was a significant increase in the net inflow of portfolio investment. They accounted for 45% of total annual capital inflow in 1996, up from 13% in the previous year. The volume of 'volatile capital', defined to cover both short-term borrowings and portfolio capital, had increased to sizable levels by the mid-1990s, resulting in an erosion in the country's ability to defend against a speculative attack on the domestic currency, Ringgit (Table 3 and Figure 1).[7] Foreign exchange reserves as a ratio of the stock of mobile capital (' the reserve cover' of mobile capital) declined from over 150% in the early 1990s to 63.3% by mid-1997.

Increased foreign equity investment fueled a share market boom in Malaysia from the late 1980s. By the mid-1990s, with a market capitalisation of around $200 billion, the Kuala Lumpur Stock Exchange was the third largest in the Asia Pacific

[7] For a discussion on the rationale behind this 'reserve adequacy' measure see Athukorala and Warr (1999).

Region after Tokyo and Hong Kong. There were days when the turnover on the KLSE was higher than that in New York. By the mid-1990s, share market capitalisation in Malaysia of over 90% of GDP was substantially higher than in any country in the world. At the onset of the crisis, foreign investors accounted for only 30 - 40% of the activities in the market. However, the actual influence of foreign participation on the expansion and operation of the share market was probably much greater than suggested by this figure because local investors always followed foreign investors as market leaders. The share market expansion was also inexorably linked with the domestic banking system. Lending for share market activities turned out to be a major source of bank credit expansion (discussed below).

In sum, by the mid-1990s, the Malaysian had become the depository for a massive volume of volatile capital, in particular portfolio investment (Figure 1). The economy was experiencing a share market bubble in which both foreign investors and domestic banks played a pivotal role. In this context, there was a strong *possibility* for a reversal of capital inflows (triggered by a speculative attack on the currency, as happed in the second half of 1997) to generate economic collapse through wealth contraction and banking sector instability. However, this possibility would not have translated into a massive financial crisis and economic collapse had it not been for some serious pitfalls on the domestic policy front. Policy slippage in three key areas of domestic economic management were particularly important – corporate governance, financial system and fiscal policy.

Poor Corporate Governance

In Malaysia, like in other crisis-hit countries in East Asia, the expansion of the share market was not accompanied by initiatives to redress underlying weaknesses of corporate governance (Searle 1999). Most of the listed companies in Malaysia continued to be tightly controlled by a handful of powerful families. These families often retain majority stakes even in public companies. Moreover, in many cases the interests of company bosses and politicians were closely interwoven. Manipulation of inter-company share transactions in order to augment profit in privately owned companies (at the expense of listed companies) was a common occurrence in the Malaysian corporate world. Such malpractice made share trading vulnerable to financial panic because unconnected (minority) shareholders had every reason to worry about how they would be treated in the event of a market downturn.

Foreign investors were providing funds to Malaysian firms with high debt ratios and long-term alliance relationships, which would not have been acceptable in the West. The extent of subsequent portfolio capital outflows owed much to the realization that much of the capital should not have been committed in the first place. When the foreign participants started pulling out to avoid currency risk following the onset of the currency crisis in mid-1997, the local players panicked. Based on past experience, the minority shareholders were naturally concerned that they might be the hardest hit in troubled times (*Economist* 1997).

Financial Fragility

The Malaysian banking system has historically been sturdier than its counterparts in most countries in the region. For instance, capital adequacy ratios of Malaysian banks were the highest in Southeast Asia other than Singapore. By the mid-1990s the average capital adequacy ratio for all banks has remained over 10%. Some banks boasted ratios of 14%, compared with a 8% ratio recommended by the Bank of International Settlement. There was also a requirement that all banks set aside 1% of total outstanding loans as a general provision, in addition to specific provisions made for problem loans (1.5%). Non-performing loans in the banking system fell from 5.5% in 1995 to 3.9% in 1996. Foreign currency exposure of the banking system remained low thanks to the BNM policy of specifying stringent net open positions on foreign borrowing. By mid-1997, the aggregate net open positions (foreign currency denominated bank liabilities net of such assets) of the banking system was less than 5% of total bank liabilities (BIS 1998).

Despite this apparent soundness, in the lead-up to the crisis there was a massive accumulation of outstanding domestic credits in the banking system, with a heavy exposure to the property sector (broadly defined to include share trading and the real estate sector) (Soros 1998). The rate of growth of bank credit to the private sector rose from 12% per annum during 1990-94 to over 26% during 1994-96. Total outstanding credit as a ratio to GDP increased from an average level of 85% during 1985-89 to 120% in 1994 and then to over 160% when the financial crisis broke out in mid 1997. This was the highest credit buildup (increase in 'private sector leverage') among the countries in East Asia (Athukorala and Warr 1999). A massive credit

buildup of this nature invariably limits policy makers' reluctance to use the interest rate as a policy tool in the event of a speculative attack on the currency (Soros 1998, Radelet and Sachs 1998).

Beneath rapid credit growth was a growing concentration of new lending in the property sector. By the end of 1996, total credit to the property sector accounted for around 40% of total outstanding bank credit. It is believed that this share could be much higher (around 55%) if unclassified loans to conglomerates which are normally used to finance property are appropriately taken into account. The increased exposure to the property sector further weakened the financial position of the banks as this lending led to a property glut in the country. By the end of 1997, more than 5.8 million square feet of new office space was under construction in the Kuala Lumpur metropolis, on top of 5.6 million square feet of space available at the time (*Far Eastern Economic Review*, 10 April 1998, p. 60).

Historically BNM had maintained a reputation among the central banks in newly independent countries in the British Commonwealth for strict pursuance of the colonial mould of conservative monetary policy and banking regulation (Bruton 1993). However, in a context of a credit boom that had government backing at the highest political level (see below), the role of BNM naturally diminished to that of a passive observer of an impending crisis. BNM repeatedly pointed to the risk of rapid credit built up with a heavy concentration in property and share trading loans in the banking system in its annual reports of 1994, 1995 and 1996. However, it failed to take any

action to redress the problem other than some limits on lending to the property sector and share market dealings introduced in March 1997.

Perhaps the most vivid evidence of a policy conflict between BNM and the Prime Minister's Department emerged from the policy dialogue within the ruling party in the lead-up to the announcement of an IMF-style crisis management package by the then Finance Minster Anwar Ibrahim on 5 December 1997 (see below). The following quotation from a commentary in the *Far Eastern Economic Review* on the cabinet meeting of December 3 that approved the policy package makes interesting reading.

> '[At the meeting] Anwar presented position papers dating back to 1995 that revealed that both the Finance Minister and the Central Bank had warned of potential economic problems ahead. These included an overheating economy, megaprojects that could strain the country's resources, and unproductive Malaysian investment abroad. Having set the stage, the Finance Minister then asked the cabinet to sanction his tough medicine.'

It is important to note that the credit boom occurred in a context of growing dominance of local banks (and the diminishing role of foreign banks) in the banking system. Despite significant initiatives in financial liberalisation, controls on the entry of foreign banks into the economy remained intact. In the early 1980s, the Central Bank ruled that only local banks could open new branches. There was also a '60/40 borrowing guideline' for foreign firms operating in Malaysia, stipulating that these firms raise at least 60% of their finances with local banks. With activities of foreign

banks artificially frozen, new deposits gravitated towards local banks. By the mid-1990s foreign banks held about 30% of total bank deposits in the country, down from over 70% in the early 1980s. A greater role for foreign ownership would have provided the banking system with new capital, better management practices and access to foreign lenders in the last resort in the event of a financial crisis (Goldstein 1998).[8]

Fiscal Excesses

Throughout the post-independence era until the early 1990s, the Malaysian government maintained a reputation for sound fiscal management, maintaining a substantial surplus of revenue over current expenditure (Corden 1996, Salleh and Meyanathan 1993). Throughout this phase, budgetary restraints on operating expenditure had been an important aspect of fiscal policy. Budget deficits were always kept within prudent limits while minimising the use of borrowed funds. When overall deficits arose occasionally when development expenditure exceeded the current surplus, they were financed from non-inflationary domestic sources, in particular private savings accumulated in the Employees' Provident Fund. Fiscal discipline had reduced further the nation's dependence on foreign financing. Unlike in many other developing countries, the budget deficits were, therefore, not a source of inflation. The success of macroeconomic management has been reflected in a very

[8] This point receives support from the data released by Danaharta (the government body set up in June 1988 to acquire bad debts from banks) relating to the recapitalisation needs of the Malaysian banking system after the crisis. None of the foreign banks operating in the country were on the list of troubled banks (Danaharta 1999).

low rate of domestic inflation in Malaysia (as noted above) by the standards of other countries at the same stage of economic development.

However, the period following Prime Minister Mahathir's Vision 2020 statement early this decade has been characterised by some fiscal excesses the intensity of which has increased over the years. As a result of the 'big growth push' to propel Malaysia to developed-country status by the year 2020, public investment expenditure surged pushing the total investment to GDP ratio to 46% in 1997, which was the highest in the region at the time.

The total cost of various infrastructure projects under construction by 1996 was $62 billion. These projects included Southeast Asia's most modern airport ($3.6 million) capable of handling 25 million passengers a year and an ultramodern administrative capital, Putrajaya ($8 billion)[9]. These projects were mostly contracted to private companies in the patronage network, which provided the political base of support for the regime. These companies soon became the dominant players in the share market. The construction boom also contributed to the credit boom as providing 'easy' credit to the construction companies from politically connected banks and other 'captive' financial institutions was an implicit condition built into the contractual

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[9]. Despite these massive investment projects, the consolidated Government budget of Malaysia continued to remain in surplus in all years during 1993-97. However, the surplus was basically a 'revenue surplus', a reflection of a faster revenue growth compared to expenditure growth in a booming economy.

arrangements.[10] Another source of public expenditure blowout was an aggressive overseas investment promotion campaign, implemented with the direct involvement of Prime Minister Mahathir as part of desire to promote Malaysia's image as an economic leader in the third world. With a modest start in the early 1990, annual overseas investment (mostly in construction and real estate development) by Malaysian companies increased to $3 billion (amounting to almost 50% of total FDI inflows) by 1996. Off-budget financial support, mostly in the form of government sponsored bank loans, was a key element of the incentive package offered to these investors.

Direct government influence on bank lending in Malaysia, of course, has a long history dating back to the launching of the New Economic Policy in 1970, which aimed to restructure business ownership in favour of *Bumiputra* companies (Searle 1999). The point made here is that such influence grew out of proportion and turned out to be a major source of macroeconomic instability and financial fragility under Mahathir's 'big push' towards the Year 2020.

[10] Apart from providing the setting for the credit boom and the share market bubble, the massive government expenditure on infrastructure projects led to yet another source of vulnerability of the economy to a currency attack, namely the appreciation of the real exchange rate (Athukorala and Warr 1999).

4

ONSET OF THE CRISIS, POLICY SLIPPAGE AND ECONOMIC COLLAPSE

For over five years prior to the onset of the recent currency crisis, the exchange rate of the ringgit varied in the narrow range of 2.36 to 2.51 ringgit per US dollar. When the Thai baht came under heavy speculative attack in mid-May, the ringgit also experienced heavy selling pressure. BNM responded with massive foreign exchange market intervention; it sold close to $1.5 billion to prop up the ringgit. It held the ringgit firmly through continued market intervention for another week and then gave way to market forces in July 14 by floating the currency. With the ability to defend the currency dramatically reduced, and without any indication as to the depth of the impending crisis, letting the exchange rate to float was indeed the only sensible policy.

Between the first week of July 1997 and 7 January 1998 (Figure 2) when the currency slide hit bottom (MR 4.88 = $ 1), the ringgit depreciated against the dollar by almost 50% (Figure 2). After showing some signs of stability during February and March, the exchange rate continued to deteriorate with wider swings in the following months (until it was fixed at the rate of MR 3.80 = $ 1). This contrasted with the experience of Thailand and Korea where from March onwards currencies showed signs of stabilising at higher levels.

In a proximate sense, reversal of foreign capital was the key factor behind the exchange rate collapse. In a significant departure from the experiences of the other four East Asian crisis-countries (Thailand, Indonesia, Korea and the Philippines), in Malaysia it was portfolio capital that accounted for virtually all of this reversal (Figure 3).[11] The net quarterly flow of portfolio capital turned negative in the second quarter of 1997 for the first time after 1991 and total net outflow in the first three quarters of the year amounted to over US$11 billion. By contrast, net short-term bank borrowing *increased* by about US$3 billion during this period.[12] Reflecting the massive reversal of portfolio capital flows, the share market tumbled in tandem with the exchange rate collapse. Between July 1997 and mid-January 1998, the all ordinary index of the Kuala Lumpur Stock Exchange (KLSE) fell by over 65%, wiping off almost $225 billion of share values (Figure 4), the biggest stock market plunge among the five 'crisis' countries in East Asia (Athukorala 1998).

[11] When all five countries are taken together, the banks that accounted for the bulk of the massive reversal of capital flows. Between 1996 and 1998 total net bank credit shrank by almost $80 billion compared to a decline in portfolio equity inflows by $ 10 billion (Williamson 1999, p. 19).

[12] Unless otherwise stated, data reported in this paper come from the *Monthly Statistical Bulletin* (various issues) of Bank Negara Malaysia.

Muddling Through

As noted, Malaysia, unlike Thailand, Indonesia and Korea succumbed to the crisis with low foreign debt exposure of its banking system. For this reason, the Malaysian policy markers were able to 'muddle through' without an IMF-sponsored rescue package.

The initial response of the Malaysian government to the outbreak of the currency crisis was one of denial. Given the perceived soundness of economic fundamentals, Prime Minister Mahathir's immediate reaction was to pounce on the villains: currency speculators. By implicating the American financier George Soros (a Jew of Hungarian origin) in the speculative attack, he complained about a Jewish conspiracy to jeopardize the Malaysian miracle. At the IMF and World Bank annual meetings in Hong Kong in late September, Dr Mahathir stated that currency trading (beyond what is required to finance trade) was 'unnecessary, unproductive and immoral', and that 'it should be made illegal'.[13] Dr Mahathir continued his attack on speculators in domestic and international forums, including the Annual Asia-Pacific Economic Cooperation (APEC) summit on 18 November in Vancouver and the Commonwealth Heads of Government Meeting in Birmingham in the same months. Almost every attack by Mahathir against his perceived enemies precipitated a further sliding of the ringgit.

[13] George Soros responded to Mahathir saying that 'interfering with the convertibility of capital at a moment like this is a recipe for disaster' and that Dr. Mahathir was 'a menace to his own country'. For excerpts from the statements made by Mahathir and Soros at the IMF meetings, see FPB (1997).

Even more damaging to investor confidence than the Prime Minister's attacks on speculators were several initiatives to directly intervene in share market operation with a view to punishing speculators (Hale 1997). On 27 August, the KLSE banned the short-selling of 100 blue-chip stocks and rules were introduced to discourage the sale of stocks: sellers were required to deliver physical share certificates to their brokers before selling and the settlement period was reduced from five to two days. On 3 September, the Prime Minister unveiled a plan to use funds from the Employees Provident Fund (EPF) to prop up share prices by buying stocks from Malaysian shareholders – but not foreigners – at a premium above prevailing prices. These moves backfired, triggering a massive sell-off of stocks in KLSE and undermining sentiment on other regional bourses. Ironically, government-sponsored share purchases were seen by market participants, both local and foreign, as an opportunity to get rid of Malaysian shares, rather than a reason for holding onto them.

There was some retreat from this 'unorthodox' policy posture during the ensuing months as the crisis deepened. The ban on short selling was lifted in early September. In the same month, the government announced the postponement of some grandiose infrastructure projects amounting to about to $10 billion of investment commitments. The Budget for 1998 unveiled on 17 October contained some measures to reduce the current account deficit through selective import duties and a 'buy Malaysia' campaign. However, the government failed to come up with a coherent program of reforms to deal with the crisis.

After a period of policy indifference of over five months, a major policy package was announced by the then Finance Minister Anwar on 5 December 1997.

The key elements of the package included cutting government spending by 18%, postponing indefinitely all public sector investment projects which were still in the pipeline, stopping new overseas investment by Malaysian firms, freezing new share issues and company restructuring, and cutting salaries of government ministers by 10%. With these measures, the previous budget forecast of economic growth (7%) was lowered to 4%-5%. According to many commentators this statement was 'IMF policy without IMF'.[14] However, the Government quickly backtracked from this policy stance in favour of ad-hoc counter-cyclical measures with a view to 'avoid a recession-deflation spiral' (BNM 1999a, p. 4). Given the heavy domestic credit built up in the economy, increases in interest rates (market determined, rather than policy driven) coupled with rapid contraction in economic activity quickly reflected in a massive build-up of non-performing loans in the banking system and corporate failures. On 5 May 1998, Prime Minister Mahathir made it clear that he disagreed with the IMF 'on the need to raise the interest rate further'. A National Economic Recovery Plan designed to manage the crisis without IMF involvement and primarily through domestic demand expansion was announced in mid-July (NEAC 1998).

[14] This policy statement undoubtedly marked the most important economic policy shift in the decade. However, it was not, comparable to the comprehensive IMF-supported policy packages in Thailand and Korea. There was no commitment to raising domestic interest rates to support the currency and to tame inflation. Nor was any concrete strategy proposed for restructuring the financial system.

Resort to a contractionary monetary policy to supplement the significant fiscal austerity measures was ruled out by the heavy reliance of the economy on bank credit. An increase in interest rates was bound to have a severe effect on the debt-ridden private sector firms - and the viability of their banks - which were already suffering from the burst of the real estate bubble and the share market crash. Moreover, given the intimate link between business and government forged under the New Economic Policy (NEP), the positive stabilising impact on the ringgit of the interest rate had to be weighed against its negative effect on politically connected business groups.

In March 1998, an Asset Management Corporation was set up to undertake restructuring and recapitalisation of the banking system. But difficulties in obtaining the required funds precluded concrete policy initiatives. BNM continued to cushion the banking sector and debt-ridden companies (against the liquidity squeeze caused by the share market crash and capital outflow) by keeping a lid on interest rates and injecting liquidity into the system by printing money.

From the onset of the crisis there was an apparent conflict between Dr Mahathir and his deputy and Finance Minister (and heir apparent), Mr. Anwar Ibrahim, over how to manage the crisis. Following Mahathir's attack on speculators at the IMF-World bank meeting in Hong Kong, Anwar quickly acted to assure the international investment community that the government would not introduce capital controls. This suggested a policy disagreement at the top for the first time. Subsequently, measures to tame speculators were announced in September by Dr. Mahathir alone, and Anwar never expressed a view on them. The December 1997

austerity package was announced by Anwar and Mahathir openly tried to disassociate himself with its orthodox policy posture. In presenting the policy package, Anwar quoted from position papers dating back to 1995 to support the view that the financial crisis was not simply a sporadic speculative attack (as widely alleged by Mahathir), but both the Central Bank and the Finance Ministry had repeatedly warned about impending economic problems. In all these instances the international news media speculated of a possible rift between the two. Many observers are of the view that this apparent conflict contributed to policy indecisiveness in tackling the crisis, and reduced the effectiveness of whatever policy measures were taken by increasing the 'political risk premium'.

Economic Collapse

By August 1998, the economy was in recession and there were no signs of achieving currency and share price stability. According to national account estimates released in the last week of August, the economy had contracted by 6.8% in the first quarter of 1998, compared to a 2.8% contraction in the previous quarter.

As the combined outcome of the property market crash and massive capital outflows, non-performing loans in the banking system began to increase. According to BNM data, the proportion of non-performing loans in total bank assets increased from about 2% in July to 3.6% in December 1997 and then to 11.8% in July 1998. Market analysts believe, however, that the problem is much more severe than the official figures suggest, as many companies have begun to roll over debt as part of their survival strategy. Independent estimates of the non-performing loan ratio ranged

from 25% to 30% by mid-1998 (Heibert 1998, *Financial Times*, 22 August 1998, Soros 1998, p.144).

Credit contraction propelled by worsening balance sheets of financial institutions begun to impact domestic consumption and investment demand. To make matters worse, the much hoped for export-led recovery was not on the horizon, despite massive improvement in competitiveness achieved through currency depreciation. Business confidence of manufactures as measured by the Business Confidence Index (BCI) of the Malaysian Institute of Economic Research (MIER) had dipped sharply for three consecutive quarters starting in the second quarter of 1997. MIER's consumer sentiments index (CSI) released in July 1998 was at all-time low for the decade (Figure 5). Worsening business confidence led to a large outflow of short-term capital in the first quarter of 1998. Net private short-term capital registered a deficit of US$2.3 billion in that quarter, a reversal from the net inflow of one billion in the previous quarter (Table 4). Because of these capital outflows, the recession-induced current account surplus did not result in an improvement in the foreign reserve position. This was in contrast to the experience of the four IMF-program countries (Thailand, Indonesia, Philippine and Korea) where international reserve positions significantly improved from late 1997 primarily because of the widening current account surpluses.

Table 4: Malaysia : Balance of Payments, 1997Q1-1999Q4 (US$ million)

	1997	1998Q1	1998Q2	1998Q3	1998Q4	1999Q1	1999Q2	1999Q3	1999Q4
Exports	77829	17330	17422	19135	19531	18237	20490	22014	23792
Imports	73716	14446	13689	13756	13602	14079	15711	17071	18579
Trade balance	4034	2883	3733	5379	5929	4158	4779	4943	5213
Services and transfers (net)	-9071	-1240	-1536	-2079	-2851	---	---	---	---
Current account	-5037	1643	2197	3300	3078	---	---	---	---
Long-term capital (net)	6764	372	785	-667	1202	---	---	---	---
Basic balance	1727	2015	2982	3109	4723	---	---	---	---
Private short-term capital (net)	-4034	-2317	-1185	-1207	-589	---	---	---	---
Error and omission	-1569	-162	-1560	4226	1032	---	---	---	---
Overall balance =									
Change in foreign reserves	-3876	-464	-102	1128	4723	1537	3500	500	-163
Foreign reserves	21040	19800	19698	20826	25549	27086	30586	31086	30923

Source: Compiled from Bank Negara Malaysia, *Monthly Statistical Bulletin*, Kuala Lumpur (various issues)

A striking feature of capital flight from Malaysia from about early 1998 was that it largely took the form of ringgit flowing (rather than foreign currency) into Singapore. These flows were triggered by very attractive money market rates of between 20-40% in Singapore, which provided a hefty premium over a domestic rate of about 11% coupled with a weakening exchange rate for the ringgit.[15] As much as RM 35 billion ($ 8.2 billion) had ended up in Singapore at the height of the crisis in mid-1998 (Ariff 1999). This amounted to over 150% of the total domestic supply of currency (M1) and 70% of M2 in Malaysia. Thus policy makers became increasingly concerned about the 'internationalisation' of the national currency which carried a potential threat to economic stability and monetary policy autonomy. The strong demand for offshore ringgit and the consequent build-up of offshore ringgit deposits increased the vulnerability of the ringgit, undermining the effectiveness of monetary policy (BNM 1999b, Chapter 14).

[15] Why ringgit deposits fetched such high offshore rates (in Singapore) remains a puzzle. One possible explanation is that this was because of high demand for ringgit by hedge funds, which were trying to close out their short positions in that currency (EIU 1998).

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CAPITAL-CONTROL BASED RECOVERY PACKAGE

Economic collapse in the fist half of 1998 propelled a serious re-thinking of policy directions by the Malaysian government. Choices available to the Malaysian government had become severely limited, however. As BNM correctly observed in its *1998 Annual Report*, the root cause of the worsening economic situation was the market perception that Malaysia would be less committed to structural reforms as it was not under an IMF program (p.5). However, entering into an IMF program was not politically acceptable to the Malaysian leadership.[16]

Given the intimate link between business and government forged under the New Economic Policy (NEP) over the previous two-and-a-half decades, the positive stabilising impact of such a move had to be weighed against its negative effect on politically connected business groups and sociopolitical stability of the country (Crouch 1998). Macroeconomic policy that aimed to adjust the economy through

[16] A widely expressed view in pro-government news commentaries in Malaysia is that Malaysia was not eligible for IMF support even if it wanted to seek such support because of its relatively strong balance of payments position and relatively lower foreign debt (BNM 1999, p. 5; NEAC 1999, p. 1). This view is not consistent with actual facts related to both Malaysia's economic conditions and general IMF practices in assisting member countries in the event of an economic crisis. The Philippines, for example, has continued receiving financing from the IMF, even though its balance of payments position is relatively sound (compared to Thailand and Korea) and external debt burden is low. Balance of payments need is only one of the eligibility criteria, and even in relation to that Malaysia's reserves have not been that extraordinarily high. If wanted, Malaysia could have entered an IMF program with financial support for crisis management, involving recapitalisation of banks and corporate restructuring.

market-determined interest rates was bound to have a severe effect on the debt-ridden private sector firms and the viability of their banks. Prime Minister Mahathir summed up his position on this issue as follows:

> "…If we do not lower interest rates, not only will companies, but also banks and the government will encounter financial difficulties. When our financial position becomes very serious, we will have no option but to seek IMF assistance. We will then be subject to IMF's dictates." (Government of Malaysia, 1998, p. 13)

Aggressively easing monetary conditions to boost aggregate demand and to provide the highly leveraged domestic firms with a breathing space would have intensified capital flight, weakening the ringgit further and precipitating the share market collapse. To make matters worse, a planned attempt to issue sovereign bonds in the USA and Europe to raise US$2 billion for implementing the banking-sector restructuring program had to be shelved in late August because of unanticipated downgrading of Malaysia's credit rating by international rating agencies.

In this context, Dr. Mahathir opted to abandon policy tinkering along the IMF lines in favour of the conventional Keynesian recipe of stimulating the economy through fiscal and monetary expansion. This strategy essentially involved insulating the domestic interest rate from short-term capital mobility through capital controls[17].

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[17] To set the stage for the policy turnaround, Anwar (who has been pushing reforms along the IMF lines) was sidelined from the policy scene by appointing Daim Zainuddin (Mahathir's long time policy adviser) as the Minister of Special Functions, a portfolio newly created for handling crisis management. On September 3, Anwar was removed from the positions of Deputy Prime Minister and Finance Minister. He was subsequently expelled from the United

The use of temporary capital control as a tool of stabilsation policy is not new to Malaysia. As noted, 1993-94 BNM successfully used capital inflow controls without experiencing an adverse effect on Malaysia's long-term prospects for attracting foreign investment (section 2). As early as 30 July 1997 (two weeks after the speculative attack on Ringgit) Dr Mahathir in fact hinted in a news briefing following a cabinet meeting that the government was contemplating capital controls as a possible policy alternative (*Far Eastern Economic Review* 1997).

The use of capital controls also received a measure of legitimacy from recent developments in the international economic policy debate on crisis management. In particular Krugman's (1998) controversial piece in *Fortune* that argued for using capital controls as a crisis management tool received wide attention in the Malaysian policy debate and news media.[18] There was also growing attention in the financial press to the fact that China and Taiwan, the two economies in the East Asian growth league with controls on short-term capital movements, fared much better than the rest of the region during the crisis. The recent experiences of countries like Chile and

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Malay National Organisation (the major party in the ruling coalition). On September 8, Mahathir appointed himself the First Finance Minister. This position was subsequently assigned to Zainudin, in addition to his role as the Minister of Special Functions. One interpretation of the almost simultaneous occurrence of sacking of Anwar and the announcement of new reform package is that the prime motive of the latter was to set the stage for sacking Anwar without visible display of market disappointment and precipitation of currency and share market collapse.

[18] It is however not correct to name (as some authors have done, eg. Miller 1999, Hale 1998) Krugman as the intellectual architect of the Malaysia action. Apparently the decision to introduce capital control was made by the National Economic Action Council on 6 August (Mahathir 1999), before the Krugman article appeared. Recently Krugman stated in Singapore that, 'It was a shock that while I was speculating idly about that [capital control], Dr. Mahathir was about to do it' (*New Straits Time*, 26 August 1999). See also Krugman (1999b).

Slovenia in using capital controls to manage shorter-term capital inflows also received wide attention.[19]

Capital control

As a first step, on 31 August offshore trading of shares of Malaysian companies was banned with immediate effect in a move to freeze over-the-counter share trading in the Central Limit Order Book (CLOB) market in Singapore.[20] This was followed by the imposition of comprehensive controls over short-term capital flows (1 September) and fixing the exchange rate at M$ 3.80 per US$ (2 September).

The new capital controls banned trading in ringgit instruments among offshore banks and stopped Malaysian financial institutions offering domestic credit facilities to non-resident banks and stockbrokers. With a view to stopping speculative trading in ringgit in overseas markets (predominantly in Singapore), the use of ringgit as an invoicing currency in foreign trade was banned with immediate effect and legal tender on all ringgit deposits held outside the country was abolished with effect from 30 September. A 12-month withholding period was imposed on repatriation of proceeds

[19] In a special briefing to the press following the introduction of capital controls, the Special Function Minister, Zainuddin stated that before introducing currency controls the Malaysian authorities studied systems operating in Chile, Slovenia and China (*Star*, 5 September 1998).

[20] CLOB market was an informal market for shares of Malaysian companies, which operates side by side with the formal share market (Singapore Stock Exchange) in Singapore. At the time, total value of Malaysian shares traded in CLOB amounted to US$4.2 billion (Far Eastern Economic Review, 9 March, p. 56). Short-selling of shares continued on this market after such share dealings were made illegal in Malaysia following the onset of the crisis and this was perceived by the Malaysian policy makers as a major factor behind exchange rate and share price instability. CLOB trading was also thought to contribute to ringgit outflow to Singapore. Following the Malaysian move to ban offshore trading of Malaysian company shares, the CLOB market was closed on 15 September.

(principal and profit) from foreign portfolio investment. There were also stringent limits on the approval of foreign exchange for overseas travel and investment. [21]

The new controls were confined to short term capital flows and aimed at making it harder for short-term portfolio investors to sell their shares and keep the proceeds, and for offshore hedge funds to drive down the currency (Table 5). With the exception of limits on foreign exchange for foreign travel by Malaysian citizens, there was no retreat from the country's long-standing commitment to an open trade and investment policy. No new direct controls were imposed on import and export trade. Profit remittances and repatriation of capital by foreign investors continued to remain free of control. Immediately following the imposition of capital controls, BNM did experiment with new regulatory procedures in this area. But these were swiftly removed in response to protest by these firms (Zefferys 1999).

Two notable changes were made the capital control measures in 1999. First, in early February 1999, the original 12-month holding restriction on portfolio investment was replaced with a system of repatriation levy. Under this system, there were two sets of repatriation levy, depending on whether the funds entered the country before or after February 15, 1999. For investments made before February 15, a three-tier levy was applied to the principal (the capital value) on how long the funds were retained in the country. For funds entered after February 15, there was a two-tier levy on the repatriation of profits (but not on the principal): 30% on profit made and repatriated within one year, and 10% on profit repatriated after one year. In August

[21] For a detailed listing of the new exchange control measures see Appendix A-1.

1999, the two-tier levy on profit repatriation was replaced by a unified 10% levy. Second, an agreement between the KLSE and the Singapore Stock exchange reached on 26 February 2000 provided for the transfer of the shares trapped in the CLOB market to the Malaysian stock exchange and allow trading to resume. Other than these changes, capital controls and the fixed exchange rate system have continued to provide the setting for recovery from the crisis through expansionary macroeconomic policy.

Table 5: Malaysia's Selective Foreign Exchange Controls

Transactions subject to control	Transactions not subject to control
Ringgit-denominated transactions with non-residents	Current account transactions - trade transactions denominated in foreign currency
Outflow of short-term capital - One-year withholding period until 30 August 1998 - a three-tier tax (10%, 20%, 30%) on profit remittance between September 1998 and February 1999 - a 10% tax on profit remittance since February 1999	Repatriation of profits, interests, dividends, capital gains and rental income from FDI and similar forms of ringgit assets owned by non-residents
Import and export of ringgit (carriage on person)	
Export of foreign currency by citizens (carriage on person)	General payments by residents including those for education abroad
Outflow of Malaysian investment abroad	FDI inflows and outflows

Source: BNM (1999b), Chapter 8.

The replacement of the one-year moratorium on portfolio capital has been widely interpreted in the financial press as a major backsliding from the original

capital controls. However, in reality it is a pragmatic revision to *only one* element of the comprehensive controls. The motive behind this revision, which was introduced in consultation with key players in the capital market (Merrill Lynch 1999), was to set the stage for managing capital inflows in the recovery phase. A unified tax on profit remittances from portfolio investment (levied irrespective of the period of investment) essentially has a greater incidence on short-term investment. It therefore provides not only an overall deterrent to portfolio capital inflow but also an incentive to increase the period of investment.

With the policy autonomy gained through capital controls, the government swiftly embarked on a recovery package consisting of two key elements: macroeconomic stimulants and banking and corporate restructuring.

Reflationary Policy

The federal government budget deficit increased from 1.8% of GNP in to 3.2% in 1999 and is predicted to increase further in 2000. On the expenditure side there were no major new proposals beyond some moderate increase in funds for road and rail projects. The major sources of deficit expansion were tax cuts and new tax incentives. Among them, the key element was a total waiver of income tax in 1999.[22] There were also tax breaks for industries of ‘national and strategic importance and import duty reduction on machinery and equipment imports. Benefiting from the new capital outflow controls, the government has been able to finance the deficits through issuing

[22] The waiver was part of a change in Malaysia’s tax assessment system beginning in the year 2000 from one based on income derived in the previous year to income derived in the current year.

Malaysian Government Securities (MGS) which will be absorbed largely by provident, pension and insurance funds. Only about a third of the financial needs have been raised externally, mainly from concessionary bilateral and multilateral sources.

To complement expansionary budgetary policy, BNM reduced the 3-month inter-bank rate (BNM's policy rate on which other interest rates are based) and cut the statutory reserve ratio (SRR) at successive stages in order to inject liquidity into the debt-ridden banking system. BNM also revised the formula used in computing the base-lending rate (BLR)[23] so that reductions in the intervention rate are better reflected in cost of bank credit. The other measures introduced to boost credit expansion included an announcement on 9 September of an indicative annual loan growth target of 8% for commercial banks, relaxation of credit limits on lending by commercial banks and financial companies for purchase of property and shares, a scheme for providing soft loans for purchase of cars, special loan schemes for assisting smaller industries and low-income groups, and relaxing credit limits on credit cards (BNM 1999a).

By the time of the September 1999 policy shift, the 3-month inter-bank rate had been raised from the pre-crisis level of 7.5% to 10% as part of the initial conventional response to the currency crisis. From then on it was reduced in successive stages to a mere 3.2% by the end of 1999. The SRR was reduced from 8.0% to 4.0% during this period.

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[23] The benchmark interest rate prescribed by BNM for lending institution with a view to avoiding unhealthy competition in credit markets.

When taken as a whole, a noteworthy feature of the Malaysian macroeconomic stimulant package so far has been the relatively high weight assigned to monetary policy compared to fiscal policy. One consideration behind this policy choice was the need to avoid crowding out on the private sector investment expansion/recovery, which had been adversely affected by interest rate hikes and the credit squeeze. Another, and perhaps the more important, consideration was institutional bottlenecks impinging on speedy implementation of new government projects.[24] Whatever the underlying reason may be, the greater emphasis placed on monetary policy compared to fiscal policy was presumably a major factor in the choice of capital controls as a pivotal element of the reform package. To use monetary policy for internal balance (in violation of the 'Muldell assignment' of using of fiscal policy for international balance and monetary policy for external balance) essentially requires capital controls to insulate the economy from international capital movements (Branson 1993, p. 34).

Banking and Corporate Restructuring

The new policy package placed greater emphasis on the speedy implementation of the banking and corporate restructuring programs, which were initiated in early 1998 but until then had made little progress. By the end of 1999, *Danaharta* (the National Asset management Company) had acquired a total of RM45.5 (US$12 billion) non-performing loans from the financial system, of this RM35.7 (US$ 9.4 billion) was from the banking system (amounting to 43% of total NPLs in the banking system). Reflecting this significant progress in bad debt carving out, the net NPL ratio (on a

[24] For instance, the 1999 Budget predicted a deficit of 6.1% of GNP, but as noted the outcome

six-month classification) had declined to 6.6% by December 1999 from 10.5% in August 1998. In addition to these bad debt carving out and recapitalisation schemes, BNM has embarked on merger programs for domestic finance companies and banks, with a view to improving their competitiveness. The merger program for finance companies, which aimed at reducing the number of finance companies from 39 to less than half of the number through merger and/or amalgamation with banks, has already been completed. The banking merger program aims to form 10 banking groups, each led by an anchor bank and the entire consolidation exercise is to be completed in 2000.

In the area of corporate restructuring, as at end-December 1999, *Danamodal* (the Bank Recapitalisation Company) had injected RM 5.3 ($ 1.4) billion) into ten banking institutions. The Corporate Debt Restructuring Committee (CDRC) had successfully completed the restructuring of 19 companies involving debt worth RM 14.1 ($ 3.7) billion. Restructuring schemes for another 25 cases involving debt worth RM16.2 ($4.3) billion were being implemented.

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was eventually a deficit of only 3.2% of GNP.

6

THE RECOVERY

The Malaysian economy experienced a 7.5% contraction in GDP in 1998, after 11 years of uninterrupted expansion averaging 8.0% per year. The degree of output contraction moderated to 1.3% (on an annual basis) in the first quarter of 1999 followed by a positive growth rate of 4.1% in the second quarter (Table 6). Recovery accelerated in the next two quarters, culminating in a growth rate of 7.5% for the whole year. The level of GDP is likely to surpass pre-crisis (1997) level by the first quarter of 2000. While the official annual growth forecast for 2000 is 5.4%, various independent analysts have come up with more optimistic predictions, in the range of 5% to 7.6%.

Reflecting the impact of Keynesian reflationary policy, public expenditure led the way to recovery. Both public investment and consumption started to increase in the final quarter of 1998 and recorded a significant upturn from the first quarter of 1999. Private consumption was seen stabilising in the first quarter of half of 1999 and grew strongly in the second half of the year. Private investment began to show some signs of recovery only in the last quarter of 1999. The delayed recovery of private investment is consistent with the existing excess capacity and stock overhang in the

Table 6 Malaysia: Selected Economic Indicators, 1997Q1 – 1999Q2[1]

	1996	1997	1998	1999	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Growth of GDP (%)	10.0	7.5	-7.5	5.4	8.6	8.4	7.7	5.6	-3.1	-5.2	-10.9	-10.3	-1.3	4.1	8.2	10.4
Growth by final demand category (%)																
Private consumption	6.9	4.3	-10.8	2.5	2.6	6.7	6.4	2.0	-5.4	-8.9	-14.9	-13.8	-4.3	-2.8	4.6	7.6
Public consumption	0.7	7.6	-7.8	20.1	14.6	15.2	-8.1	12.7	-16.8	3.1	2.3	-17.9	36.0	20.8	20.2	11.0
Gross domestic investment	5.8	11.2	-42.9	-6.0	6.1	32.4	13.6	15.0	-17.3	-49.0	-50.8	-50.5	-29.6	-12.6	5.1	30.5
Growth by sector[2] (%):																
Agriculture, forestry and fishing (9.8)	4.5	0.4	-4.5	3.9	1.8	3.9	-1.5	-2.1	-2.0	-6.9	-4.0	-4.7	-3.5	8.6	3.6	6.3
Industry (41.5)	11.0	10.5	-6.5	5.4	10.2	8.4	9.1	8.8	-5.6	-9.4	-16.2	-15.4	-3.1	5.7	---	---
Mining and querying (7.7)	4.5	1.0	-0.8	1.3	-0.5	2.6	1.9	8.1	0.6	0.3	1.2	5.1	-2.3	-6.0	---	---
Manufacturing (29.1)	18.2	10.4	-13.7	13.5	11.8	9.6	11.3	9.2	-5.8	-10.3	-18.9	-18.6	-1.1	10.4	19.5	25.2
Construction (4.7)	16.2	10.6	-23.0	-5.6	17.5	10.8	7.3	7.8	-14.5	-19.8	-28.0	-29.0	-16.6	-4.0	0.9	2.7
Services (48.7)	8.9	9.9	-0.8	2.9	11.4	11.7	10.6	6.4	2.2	1.9	-3.7	-3.4	0.6	0.6	4.2	6.0
Growth of manufacturing production[3] (%)	11.1	10.6	-7.2	8.9	13.3	11.6	9.6	10.1	-2.9	-8.9	-13.4	-15.4	-0.3	15.7	20.0	24.7
Export oriented (weight: 0.52)	8.8	13.1	-7.7	12.5	13.3	12.7	9.6	10.8	0.1	-5.3	-11.3	-12.2	-1.0	16.7	17.5	24.5
Domestic oriented (weight: 0.48)	16.2	14.6	-14.0	12.8	13.3	10.4	9.7	9.3	-6.1	-12.8	-15.6	-18.3	0.4	14.6	22.0	25.0
MIER consumer sentiments index (1988 = 100)	128.4	121.9	82.0	103.7	127.2	133.4	122.1	104.9	88.5	79.1	80.0	80.5	84.0	101.6	111.3	117.7
MIER business conditions Index	58.0	59.2	42.5	57.9	62.9	65.2	57.5	49.6	41.0	42.3	41.8	44.7	48.5	60.3	62.2	61.0
MIER manufacturing capacity utilisation index	81.2	83.2	59.5	80.7	87.4	86.1	87.4	85.4	80.6	76.4	76.6	76.4	77.9	92.4	92.4	92.2
Unemployment rate	2.5	2.6	3.2	3.4	---	---	---	---	---	---	---	3.4	4.5	3.3	2.9	3.0

Inflation rate (%):																
Consumer price	3.5	2.7	5.3	2.8	3.2	2.5	2.3	2.7	4.3	5.7	5.6	5.4	4.0	2.7	2.3	2.1
Producer price	2.3	2.7	10.7	-3.5	2.7	-0.5	1.0	7.2	11.9	13.9	13.9	3.9	-4.1	-5.0	-4.3	-0.5
Domestic goods	2.8	2.5	11.2	-3.9	3.0	-0.9	0.6	7.5	12.0	14.5	15.0	3.8	-4.0	-5.9	-5.0	0.7
Imported goods	0.1	2.8	9.2	-0.6	1.4	1.0	2.7	5.9	11.3	11.3	9.6	4.8	-0.3	-0.8	-1.0	-0.1
Budget deficit (central government) as % of GDP	0.7	2.4	-1.8	-3.2					30.6	31.3	30.7	36.2	36.8	38.6	38.3	37.8
Money and credit (end of period) (%)																
M2	24.3	17.4	-1.4	11.6	19.3	21.8	20.1	18.5	10.0	6.8	2.8	-1.4	3.6	13.2	17.0	17.2
Average bank lending rate (%)	10.1	10.6	12.3	8.5	10.1	10.5	10.7	11.2	12.5	13.5	12.6	10.0	9.6	8.7	8.1	7.8
Growth of real bank credit to the private sector[4]	20.9	19.8	-0.2	---	17.2	19.8	15.9	16.3	9.3	2.6	1.1	-0.2	2.1	3.6	6.2	--
Loans extended by banking system (Ringgit million)	217.8				24.6	23.2	21.2	26.5	16.9	10.3	4.5	-1.6	-4.3	-3.2	---	---
Manufacturing	48.0	70.2	42.9		17.2	16.4	18.3	18.3	19.5	13.2	10.2	0.9	-9.0	-6.1	---	---
Property	91.2	116.8	66.3		27.2	26.8	29.2	33.6	27.6	19.8	14.2	4.7	0.5	-2.0	---	---
Loans approved by the banking system (Ringgit million)																
Manufacturing					---	---	---	---	-56.4	-86.0	-68.5	-16.9	33.0	78.5	---	---
Property					---	---	---	---	-70.1	-85.7	-84.2	-62.0	22.0	67.0	---	---
Non-performing loans (NPLs) as % of total loans[4,5]	3.6	3.2	5.9	---	---	---	---	---	5.8	6.6	7.6	5.9	13.0	12.4	12.0	11.4
Share market performance																
KLSE Composite index	1134.1	978.9	517.7	692	1203	1077	815	594	720	456	374	586	503	870	736.1	763.2
Market capitalisation (Ringgit billion)	806.8	375.8	374.5	552.7	844.5	744.5	584.5	375.8	452.9	285.8	249.1	374.5	317.9	503	490.1	561
External transactions																
Merchandise exports (US$, FOB, %)	6.0	0.3	-6.9	15.7	7.6	0.4	2.7	-4.3	-10.7	-8.7	-10.9	6.5	5.5	15.3	21.5	19.2
Merchandise imports (US$, FOB, %)	1.0	0.2	-25.9	12.5	2.3	1.3	1.8	-7.6	-20.3	-33.9	-29.3	-20.2	-6.1	10.0	21.4	25.6
Current account balance as % of GDP)	-4.8	-5.3	13.0	---	-3.8	-11.3	-3.0	-2.5	6.4	11.3	17.9	16.5	16.5	19.1	---	---
Foreign reserves (US$ billion) [4]	27.0	20.8	25.6	30.9	27.7	26.6	22.1	20.7	19.8	19.7	20.7	25.6	27.1	30.6	31.1	30.9
Total external debt as % GDP[3]	38.7	43.9	42.6	42.1	---	---	---	43.9	47.9	51.2	53.0	58.8	57.8	57.7	56.9	53.3
Short term foreign debt as % of total debt[4]	25.7	25.2	19.9	14.3					25.1	22.8	19.1	19.9	19.7	18.5	17.1	14.3

Short-term foreign debt as % of foreign reserves[4]	36.9	53.7	33.2	---	54.6	48.9	37.0	33.2	30.6	25.8	23.9	23.6
Average exchange rate (ringgit per US$)	2.5	2.8	3.9	3.8	4.0	3.8	4.1	3.8	3.8	3.8	3.8	3.8

Notes:

1 All growth rates on a yea-on-year basis.
2. Sectoral share in GDP in 1996 are given in brackets.
3. Based on manufacturing production index (1993 = 100). The weight attached to each category in the total index is given in brackets.
4. End of period.
5. Non-performing loans of commercial banks only. Based on a 'six month' non-performing period.
--- Data not available.
MIER Malaysian Institute of Economic Research

Source: Compiled from Bank Negara Malaysia, Monthly Statistical Bulletin (updated for the latest quarters suing data from the Bank's web site: www. bnm.gov.my)) and MIER, *Monthly Economic Monitor* (various issues)

economy.[25] Based on some leading indicators such as notable increases in capital goods imports, project approvals and loan disbursements, private investment grew throughout the year. Net exports handsomely counterbalanced the strong pick up in import demand in the second half, and contributed to about one third of GDP growth in 1999.

On the production side, signs of recovery first emerged in the services sectors (particularly in financial services) and domestic market-oriented industries. By the second quarter of 1999 recovery had become more broad based, with export-oriented manufacturing showing impressive output growth. In 1999 both export-oriented and domestic-market oriented industries grew at a rate of 25% and accounted for 65% and 35% respectively of the total output increment in the year. The services sector grew by 6% in 1999, with all sub-sectors showing strong growth, reflecting across the board improvements in final demand, in particular robust trade performance and strong recovery in consumer demand.

In line with the strong recovery in domestic production, the employment situation has improved. According to the Survey of Retrenchments (conducted by the Department of Labour) the number of workers retrenched declined from the pos-crisis peak of 18,116 in the fourth quarter of 1998 to 7,909 in the fourth quarter of 1999. The end-of-year number of job seekers registered with the Manpower Department declined from 54,318 in 1998 to 31,830 1999. The unemployment rate in the

[25] According to the Survey of Business Sentiments of MIER, capacity utilisation in domestic manufacturing in the first quarter of 1999 was 75%, compared with the annual average 85%

economy by the end of 1999 stood at 3.4%, only 0.9 percentage points higher than the pre-crisis level.

The recovery has so far been underpinned by remarkably low inflation, despite the heavy emphasis on fiscal and monetary expansion as part of the recovery strategy. The annual rate of consumer price inflation increased from 2.7% in 1997 to 5.3% in 1998 reflecting mostly the price raising impact of massive currency depreciation. It then declined to 2.8% in 1999. The rate of inflation measured in terms of the producer price index increased from 2.7% in 1997 to 10.7% and then declined by 3.5% in 1999.

As noted, the recovery has become increasingly private-sector led, with private consumption and net exports providing much of the stimulus for output growth. Fiscal consolidation is, therefore, unlikely to be a major issue in the post-crisis Malaysian economy. The budget deficit as a percentage of GDP recorded a modest increase from -1.8% in 1998 to -3.2% in 1999. Given strong revenue growth in a rapidly recovering economy many analysts predict that the deficit is likely to decline in 2000 below the 1999 level, despite a -4.5% deficit predicted in the 2000 Budget Speech. Public debt as a percentage of GDP increased from 32% in 1997 to 38% in 1999, but the latter figure is not out of line with the average public debt situation (37.5% of GDP)) for the boom years of 1986-1996.

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for 1987-96. While there was no satisfactory indicator, excess capacity in the building and construction sector was presumably much greater.

The turnaround in real GDP growth has been accompanied by a further strengthening of the balance of payments position, driven by a more favourable external trade balance and significant inflow of long-term capital (Table 4). Boosted by strong export growth that outpaced increases in imports and the net services account balance, an unprecedented current account surplus of 15% of GDP was recorded in 1999, up from 13% in 1998. By the end of 1999 Malaysia's foreign exchange reserves stood at US$31 billion, and they provided 300% cover for total outstanding short-term debts and 200% cover for the stock of volatile capital (outstanding short-term debt + cumulating port-folio investment, as defined above) of the country. Total external debt as a percentage of GDP increased from 44% in 1997 to 58% in 1998 and then declined to 53% in 1999. The share of short-term debt in total outstanding debt declined from 25.2% in 1977 to 19.9% in 1998 and then to 14.3% in 1999.

Growing business confidence in the recovery process has begun to be reflected in an impressive rebound in trading on the Kuala Lumpur Stock Exchange (KLSE) from mid 1999. The benchmark Kuala Lumpur Composite Index (KLCI) had almost regained its pre-crisis (end-June 1997) level by end of February 2000. Market capitalisation of the KLSE increased from the historical low of RM200 billion in August 1998 to over RM700 billion in February 2000, which was only 5 percentage points short of the pre-crisis (June 1997) level. The consumer sentiment and business confidence indices of MIER were also rapidly approaching the pre-crisis levels by the end of 1999.

With emerging signs of recovery, foreign analysts have begun to acknowledge that the radical reform measures have worked well in Malaysia (or in any case are doing no demonstrable harm) against their initial skepticism. Major credit rating agencies, which downgraded Malaysia's international credit rating immediately following the imposition of capital control, have now come up with more optimistic assessments of prospects. The IMF, in its Public Information Notice on recent *Article IV Consultation with Malaysia*, commended the Malaysian authorities for 'using the breathing space [provided by the policy measures introduced in September 1998] to push ahead with a well-designed and effectively implemented strategy for financial sector restructuring'. Furthermore, with regard to macroeconomic policy some IMF Directors supported the adoption of an expansionary policy stance, which they considered appropriate to reverse the sharp contraction of economic activity, particularly in view of the absence of inflation pressure (IMF 1999a). The Washington-based private think-tank, Economic Strategic Institute recently noted that 'despite the bad press it gets as a result of Prime Minister Mahathir's critical comments about speculators, Malaysia is the best story in the region' (Economic Strategy Institute, 1999).

7

THE ROLE OF CAPITAL CONTROL IN RECOVERY

It is evident from the discussion in Section 6 that following the imposition of the capital-controls based reform package, the Malaysian economy has begun to show strong signs of recovery. But how far has the radical policy shift actually contributed to the turnaround?

Many observers have attempted to answer this question through simple comparisons of recovery experiences of crisis-hit countries using readily available performance indicators. A common inference from such comparisons is that controls have not made a 'distinct' contribution to the recovery process in Malaysia - not only Malaysia but also the other crisis-hit Asian countries, which maintained open capital accounts throughout under IMF-centered reform packages, have started to show signs of recovery (Hiebert 1999, IMF 1999b, Miller 1999, Lim 1999). This view is not quite consistent with the available performance indicators – while all crisis-hit countries have started to show signs of recovery, among the three countries under consideration only Korea has so far recorded a faster recovery rate than Malaysia. But Korea is a major industrial power with a diversified manufacturing base and national companies, which have their own international marketing networks. In terms of the stage of development and the nature of the economic structures, undoubtedly the better comparator for Malaysia is Thailand. Malaysia's recovery rate has been much faster and steadier compared to Thailand.

Table 7: GDP Growth in Asian Crisis Countries, 1995-99 (percentage change from one year before)

	Korea	Malaysia	Thailand
1995	8.9	9.8	8.9
1996	6.8	10.0	5.9
1997	5.0	7.5	-1.8
1998	-5.8	-7.5	-10.4
1999	10.2	5.4	4.0
2000[1]	6.0	5.8	4.5
1998q1	-3.6	-3.1	-9.0
1998q2	-7.2	-5.2	-12.7
1998q3	-7.1	-10.9	-13.2
1998q4	-5.3	-10.3	-6.6
1999q1	4.5	-1.3	0.9
1999q2	9.9	4.1	3.3
1999q3	12.3	8.2	7.7
1999q4	14.2	10.6	4.2

Note:
1. Official growth forecast.

Source: Asia Recovery Information Centre database,
Asian Development Bank [aric@adb.org].

The difference between the recovery experiences of the two countries become even more significant when one goes beyond the aggregate GDP growth figure and looks at other performance indicators (Table 7 and Appendix Table A-2). For instance in Thailand so far the recovery has been dominated by massive public expenditure, while in Malaysia the recovery process in relatively more broad based. Unlike in Malaysia problems in the financial sector still remain a major source of uncertainty. Non-performing loans in Thailand still account for nearly 40% of outstanding back loans and the volume of real outstanding credit is still falling.

But one should not read too much meaning into a simple statistical comparison of this nature. It ignores the important fact that the economies under consideration are vastly different in terms of the sources of vulnerability to the crisis as well as the nature of the economic structure that determine flexibility of adjustment to a crisis. Put simply, details differ in important ways from one country to another, and readily available performance indicators do not capture these differences (Cooper 1999). An inter-country comparison can, therefore, yield meaningful inferences only if economic adjustment under alternative policies is carefully studied while placing emphasis on fundamental differences in economic structures and original sources of vulnerability to the crisis. However, the time is not ripe for an in-depth comparative case study of this nature. We have to wait until the recovery process becomes well rooted and policy responses are well embedded in economic data.

In this section we therefore simply attempt a preliminary analysis of how capital controls have impacted on the adjustment process in Malaysia. Our approach is to examine whether the original expectations (mostly negative) about the fate of the reform program was consistent with the actual experience.

Monetary Policy Autonomy

A major doubt about the effectiveness capital controls as a crisis management tool relates to presumably ample scope for avoidance and evasion, which can negate the expected monetary policy autonomy (Hale 1998, Edwards 1999). The general argument here is that, the more extensive are trade and investment links, the more difficult and costly it is to control capital account transactions because of the multiplication in the number of arbitrage possibilities that arise in the course of normal business. The problem with this argument is that it is based on a misleading mixing of 'placing funds abroad retail' by manipulating current account transactions and 'exporting capital wholesale' (Williamson 1993, p. 36). There is ample evidence from both developed and developing countries that capital controls are in fact effective in substantially reducing, if not preventing, capital flows of the latter type, in particular placement abroad of institutional savings (Eihengreen 1998, De Gregorio *et al*. 1998, Radelet and Sachs 1998). The evidence from capital controls in Malaysia is consistent with this evidence.

The indications are that controls helped the government to lower interest rates and encourage a revival of domestic consumption and investment without precipitating capital flights. Following the imposition of capital control measures, the net international reserve position of the country went up from US$20.2 billion in August 1998 to US$ 29.8 billion in May 1999. Unlike the situation before the imposition of capital controls, short-term capital flows stabilised in the first quarter of 1998. Thus the foreign reserve position begun to move in tandem with the surplus in the current account. As foreign exchange controls were carefully targeted only on

short-term investment flows, and trade and FDI related transactions continued to remain liberal, the policy shift did not result in the emergence of a black market for foreign exchange.

The effectiveness of capital controls in bringing in expected monetary policy autonomy is evident from the dramatic turnaround in the differential between domestic and international interest rates following the imposition of these controls (Figure 6). The differential remained positive and varied in the range of 0.6% to 2% during the period before the onset of the crisis. Then it increased reaching a peak of 8% at the height of the crisis in mid-1987. Following the imposition of capital controls in September 1998, it tended to decline, entering the negative territory by March 1999. From then it has remained around –2.0% with little monthly fluctuations. Both the dramatic decline in the differential and its remarkable stability in recent months clearly attest to the effectiveness of controls in insulating domestic interest rates from international financial market developments.

Easing of monetary policy on the back of capital controls lowered cost of credit in the economy. The average lending rate of commercial banks from 12.2% in October 1998 to 7.8% by the end of 1999. Carving out of bad debts and recapitalisation of weak banks improved lending capacity of the banking system. At the same time corporate restructuring, though much slower in implementation than banking sector reforms, served to improve borrowing capacity of debt-ridden corporations. Reflecting the combined effect of these factors both loan approvals and disbursements, which contracted throughout 1998, began to recover from early 1999 and recorded strong growth from the second quarter of the year (BNM, 2000).

Figure 7 depicts the behaviour of real bank deposit rates in Korea, Malaysia and Thailand. Again the impact of Malaysian approach to crisis management on the domestic financial scene is vividly demonstrated. Real lending rate in Malaysia has been persistently lower, and remarkably stable from about the second quarter of 1999, compared to the other two countries. In Korea and Thailand the rates declined from about mid-1988 to the second quarter of 1999 and then started to increase.

Fixed Exchange Rate and International Competitiveness

Fixing of the exchange rate at 3.80 ringgit per US$ as part of the capital-control based recovery package was originally considered by many observers as a risky strategy. The new fixed rate was implemented as part of a policy package whose prime aim was to artificially inflate the economy through fiscal pump priming and expansionary monetary policy. Thus there was a possibility that domestic inflation might result in real exchange rate appreciation, hindering recovery in tradable (both import competing and export oriented) sectors in the economy.

By the time of writing (March 2000), almost one-and-a-half years following the policy shift, there were no indications of this pessimistic scenario unfolding. As noted, domestic inflation continued to remain low. At the same time the fixed exchange rate commitment backed by capital controls continued to cushion the economy against possible nominal appreciation as a natural outcome of the recovery process. In this context, the fixed exchange rate continued to assist Malaysian producers by improving international competitiveness.

Figure 8 compares the real exchange rate behaviour in Malaysia with that of Thailand and Korea. It is evident that Korea and Thailand begun to experience persistent appreciation in the real exchange rate from about the third quarter of 1999. By contrast the real exchange rate in Malaysia continue to experience a mild depreciation with relatively low periodic fluctuations. In Thailand and Korea, domestic price trends have been similar to that in Malaysia. Yet appreciation of the nominal exchange rate propelled by the resurgence of short-term capital flows seems to have propelled an appreciation of the real exchange rate.

Impact on Foreign Direct Investment

Many commentators expressed fear that capital controls would hamper the economic recovery by adversely affecting foreign direct investment in Malaysia (Heibert 1999, Miller 1999, Hale 1998, Hill 1998). It was argued that a policy measure that constitutes a significant departure from a long-standing commitment to economic openness could certainly have an adverse impact on the general investment climate of the country. Moreover, in Malaysia, the decision to impose controls appeared so sudden and arbitrary that it called into question the general credibility of the government's whole framework for foreign investment. However, whether this would translate into a significant reduction FDI flows remained debatable at the time. The pessimistic view was based on a false aggregation of FDI with portfolio investment and short-term bank credits. It ignore the time-honoured dictum in the balance of payments theory that, 'in terms of underlying determinants of mobility, long term investment (FDI) is quite different from 'hot money'' (Mead 1951, p. 298). FDI flows are determined by long-term considerations governing international production

decisions of MNEs, not by financial panics and related short-term economic changes which underpin hot money movement. Therefore, regarding external economic policy of a country, what is primarily important for attracting FDI is a firm commitment to the maintenance of an open current account (Bhagwati 1998).

The findings of a questionnaire survey of the impact of capital controls on manufacturing firms conducted by MIER in late 1998 are basically consistent with the latter view (MIER 1998).[26] The survey failed to detect any significant impact of new capital controls on operational and investment decisions of both local and foreign firms. The majority (about 60%) of firms indicated political stability, rather than capital controls, as the most important criteria for investing in Malaysia in the future. Over 85% of firms (90% of firms with FDI) disclosed plans to maintain investment levels in the next 1-3 years.

The prevailing view that capital controls adversely affected FDI flows to Malaysia is based on a comparison of Malaysia's post crisis experience with that of Thailand and Korea. During the post-crisis period FDI inflows to Thailand and Korea have indeed increased at a faster rate compared to those coming to Malaysia (Table 8). However, this comparison needs to be taken cautiously because in Thailand and Korea acquisition by foreign companies of assets or equity of domestic companies has been a major component of foreign capital inflows during this period. For instance during the period from 1 January to 15 April in 1999, capital inflows relating to these

[26] The 135 firms accounting for over 60% of total manufacturing output in the country responded to the questionnaire. Of these firms, 77 were with foreign capital participation (wholly foreign owned: 33; joint ventures: 44) and 56 fully locally owned.

activities amounted to US$ 27 billion in Korea and $20 billion in Thailand, compared to $2 billion in Malaysia (Goad 1999, p. 38). Unlike Korea and Thailand, Malaysia did not resort to promoting acquisition/takeover by foreign companies as part of the ongoing process of corporate and banking restructuring.

When allowance is made for this policy factor, the decline in FDI flows to Malaysia can simply be treated as part of the general decline in investment in the country following the onset of the crisis. This of view is supported by the data on proposed and approved investment reported in Table 8. Note that decline in both proposed and approved investment over the past two years is common to both foreign and domestic investment. If anything, domestic private investment has grown at much slower rate compared to FDI.

Table 8: Foreign Direct Investment[1] in Korea, Malaysia and Thailand, 1995-1999 (US$ million)

	Korea	Malaysia	Thailand
1995	1776	10580	2068
1996	2326	12285	2336
1997	2844	12894	3746
1998	5416	7104	7131
1999[2]	5831	6348	4367
1997-1	624	2833	645
1997-2	791	4745	842
1997-3	611	3101	1222
1997-4	819	2215	1037
1998-1	505	1642	2038
1998-2	1168	1552	2636
1998-3	2162	1317	1432
1998-4	1582	2594	1025
1999-1	1407	1474	1004
1999-2	1819	2646	2210
1999-3	2605	2228	1153

Notes:
1. Gross inflow.
2. Total of the first three quarters.

Source: Asia Recovery Information Centre (ARIC), Asian Development Bank (http:aric@adb.org) and Bank Negara Malaysia, Monthly Statistical Bulletin (various issues).

Table 9: Investment Applications and Approvals in Malaysian Manufacturing, 1996-99 (US$ billion)

	1996	1977	1998	1999
Applications	16.7	12.2	5.1	3.8
FDI	7.0	5.1	3.2	1.6
Local	9.7	7.1	2.9	1.2
Approvals	13.6	9.2	6.7	4.4
FDI	6.8	4.1	3.3	3.6
Private domestic	6.8	5.1	3.4	0.8

Source: National Economic Advisory Council, Malaysia (http:/neac.gov.my).

Impact on Portfolio Investment

Would portfolio investors ignore Malaysia forever as a punishment for its recalcitrant act? This question is important because, despite the disruptive to role they played in the crisis context, foreign portfolio inflows have important positive effects when harnessed in an appropriate macroeconomic setting. They contribute to expansion in domestic investment by reducing cost of equity capital and helping firms to reduce their reliance on bank-based financial intermediation (Williamson 1999).

When the capital controls were first introduced (and even after the new levy was introduced in February 15) many observers were concerned about a potential massive outflow of short-term foreign debt and portfolio investment after 1 September 1999. However, the ending of the one-year moratorium turned out to be a non-event. Total net portfolio capital outflow in the fourth quarter of 1999 amounted to only US$2.2 billion, compared to a total stock of about $10 billion potentially movable foreign portfolio investment in the country at the time the restriction was lifted (IMF 1999a, p. 98). Net outflows turned out to be positive by mid-January 2000 and the first quarter of the year recorded a total net inflow of US$ 2.4 billion (Table 10). This investment pattern suggests that investors do not find it difficult to factor in the new profit tax on portfolio investment, as ground rules are now more transparent in a context where signs of economic recovery are already clearly visible.

Table 10: Net Portfolio Capital Flows, March 1999- February 2000 (US$ million)

	Net portfolio inflow US$ million
1999 March	25.3
1999 April	126.3
1999 May	478.5
1999 June	396.6
1999 July	191.2
1999 August	-484.1
1999 September	-1076.3
1999 October	-638.6
1999 November	74.7
1999 December	-181.8
2000 January	915.4
2000 February	1132.1

Source:
Estimated from weekly data on net outstanding balances on flow of funds through external accounts published in the web-site of the National Economic Advisory Council, Malaysia [http://neac.gov.my/figures/flow.shtm]

Immediately after the imposition of capital controls, Morgan Stanley Capital International (MSCI), International Finance Corporation (IFC) (the investment arm of the World Bank) and Dow Jones removed Malaysia from their capital market indices. Lack of transparency in new measures at the time controls were imposed and uncertainty about future growth prospects of the economy were as much an issue as the nature of the controls themselves.[27] Following the introduction of market friendly changes to capital controls in and as the economy began to show clear signs of recovery IFC and Dow Jones reinstated Malaysia in their global indices by the end of 1999. MSCI is to reinstate Malaysia in its global indices by June 2000.

[27] It is pertinent to mention here that the imposition in the early 1990s of capital controls on repatriation of existing capital that involved a lock-up of 5 years did not lead to an exclusion

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CONCLUSION

The Malaysian experience has been interpreted to imply that, in the presence of volatile capital, a country can succumb to an international financial crisis, even if it had faithfully followed the conventional policy advocacy on sequencing of capital-account liberalisation (Bhagwati 1998, Furman and Stiglitz 1998, Radelet and Sachs 1998). Our analysis of policy trends and economic performance in the pre-crisis Malaysian economy does not support this view.

It is true that capital account opening in Malaysia followed current account opening. But by the time these reforms were implemented there was a clear departure from conventional macroeconomic prudence. The opening of domestic capital markets to equity investors was not appropriately combined with initiatives to improve corporate governance. Massive bank lending fueled by the public investment boom and the dramatic expansion in share trading created a highly leveraged economy. This, coupled with a share market bubble in which foreign institutional investors played a big role, set the stage for a speculative attack on the currency and the subsequent economic collapse.

Closer regulation and monitoring of private sector foreign currency borrowing by the Central Bank prevented accumulation of excessive foreign borrowing in

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of the Chilean market from these indices. Presumably this was because transparency was not

Malaysia, unlike in Thailand, Korea and Indonesia. However, this favourable feature of the policy environment was overwhelmed by haphazard capital account liberalisation, in a context of significant departure from the conventional fiscal and monetary prudence associated with a 'big push' public investment program. The erosion of policy autonomy historically enjoyed by the Central Bank as part of the growth euphoria was reflected in a massive credit buildup in the economy and significant deterioration in the quality of banks' asset portfolios.

Some commentators have referred to the imposition of controls on capital outflow by the Malaysian government as *a ritualistic locking of the barn door after the horse was stolen*. This is a misleading remark because the purpose of controls was to set the stage for monetary expansion by preventing outflow of funds, both local and foreign-owned, in response to lowering of domestic interest rate relative to world market rates. The potential threat of such an outflow was much greater in Malaysia than in the other crisis-hit countries because of the pivotal role played by the Singapore money market as a convenient alternative to the domestic market for the Malaysian investor.

Malaysia has certainly survived dire predictions made by many observers at the time it embarked a radical policy path in October 1998. Once the Malaysian authorities decided to deviate from the IMF route and follow the conventional Keynesian recipe for crisis management, capital controls seem to have provided a conducive setting for the effective pursuance of such policies. The new policy has

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an issue in Chile (Merrill Lynch 1999).

prevented massive capital outflow and permitted the sustaining of a significant interest rate differential with the rest of the world. Against the popular perception that short-term capital flows cannot be controlled in a highly trade oriented economy, the Malaysian evidence suggests these flows can be effectively regulated (at least on the margin), provided the controls are specifically targeted at capital account transactions.

So far the fixed exchange rate has helped the recovery process by preventing premature exchange rate appreciation as part of improved market sentiments about the recovery prospects. However as the recovery process gathers momentum, it will become difficult to maintain international competitiveness without shifting over to a more flexible rate.

There is no evidence to suggest that controls on short-term capital flows have adversely affected Malaysia's image as a favorable location for foreign direct investment. On the contrary, there is anecdotal evidence that foreign investors, particularly those involved in export-oriented production favour capital controls and the fixed exchange rate as sources of stability in the investment climate. The time-honoured (and yet much neglected in the current debate on crisis management) dictum that the long-term investment is determined by quite different factors compared to 'hot money' movements is reconfirmed by the Malaysian experiment. Foreign portfolio investors have not completely deserted Malaysia either. The lesson here is that the use of capital control is unlikely to have an adverse lingering effect on foreign portfolio investment, provided timely steps are taken to infuse greater flexibility and

transparency to the regulatory mechanism and the reform process brings about speedy economic recovery.

One can still dispute the argument that controls have played a 'special role' in delivering a superior recovery outcome for Malaysia (compared to the IMF-program countries) for want of counterfactuals. However, the fact remains that the new policy measures enabled Malaysia to achieve recovery while minimising social costs and economic disruptions associated with a more market-oriented path to reform. This itself is a significant achievement because maintaining social harmony is an overriding concern (quite apart from economic efficiency consideration) of economic policy making in ethically diverse Malaysia (Crouch 1998). Even if the bloody racial riots in 1969 are ignored as a distant event, the imminent ethnic conflict brought about by the modest economic downturn is the mid-1980s cannot be entirely overlooked.

Some argue that Malaysia's recovery would have been even faster under an IMF-centered policy package, because, unlike Thailand, Korea and Indonesia, it really did not have a serious crisis to begin with (*Economist* 1999, Lim 1999). This view is primarily based on Malaysia's relatively low foreign debt levels. It ignores the explosive mix of share market bubble and domestic credit boom that had developed in Malaysia in the lead-up to the crisis (Section 3).[28] In any case, the severity of a speculative attack on the currency of a country is proportional to the degree of

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[28] Interestingly, on these grounds, the international financier George Soros (1998, Chapter 7) treats the economic situation in Malaysia in the lead-up to the crisis as untenable as (if not more untenable than) that in Korea, Thailand and Indonesia.

vulnerability is not a convincing argument. If foreign lenders suspect about an impending crisis, they do not expect to be told how serious the problem may become. They will simply withdraw their funds as rapidly as possible, thus turning a suspected financial problem into a financial rout (Cooper 1998).

An important issue that we have not addressed in the paper is the long-term growth implications of crisis management behind closed doors. If the Malaysian authorities have made use of the breathing space provided by capital controls to rescue companies and banks that were rendered illiquid by the financial panic (unable to rollover short-term credit) but were otherwise viable, then the underlying growth prospects of the economy will remain intact. Alternatively, if bailouts assisted inefficient (mostly politically linked) firms whose insolvency hastened by the high interest rates and lower aggregate demand, then growth prospects would have been impaired. Such rescue operation may also induce moral hazard by encouraging firms/banks to continue engaging in risky acts, in the hope of that they will be rescued in the event of similar future crises.

There is indeed anecdotal evidence of inappropriate rescue operations (Ariff 1999, Yap 1999). But whether these costly practices are unique to the capital-control based reform process in Malaysia is a debatable issue. Similar concerns have been raised relating to banking and corporate restructuring processes in Thailand, Korea and Indonesia – countries that are riding the crisis without capital controls. Moreover, one can reasonably argue (along the lines of Krueger and Tornell 1999, for instance) that economic gains associated with the speedy implementation of banking and

corporate restructuring in Malaysia might have compensated significantly, if not totally, for these alleged costs.

It is pertinent to end this study with an important caveat. The inference that capital controls have helped crisis management in Malaysia by no means implies that Malaysia's radical policy shift should be treated as a ready-made alternative to the conventional IMF recipe by other developing countries. It is of course hazardous to draw general policy lessons from the study of an individual country case. With the benefit of hindsight, one can reasonably argue that a number of factors specific to Malaysia as well as to the timing of policy reforms may have significantly conditioned the actual policy outcome. As noted, thanks to long-standing prudential controls on foreign borrowing, Malaysia succumbed to the crisis with limited foreign debt exposure. With a vast domestic revenue base and ready access to 'captive' domestic financial sources (in particular the Employees' Provident Fund (EPF) and the oil-rich Petronas), the Malaysian government was relatively more well placed than perhaps any other crisis country to make a decisive departure from the conventional, IMF-centered approach to crisis management. The implementation of new controls was also greatly aided by a well-developed banking system, which was able to perform most of the new functions smoothly in the normal course of business.

APPENDIX

Table A-1: Malaysia: Exchange Control Measures Prior to and After 1 September1998

Transaction	Prior to 1 September 1998	New
(1) Transfers based on external accounts	Transfer between external account holders freely allowed	Transfer of any amount between external accounts requires prior approval. Source of funding external accounts are limited to: (a) proceeds from sale of ringgit instruments, securities registered in Malaysia or other assets in Malaysia; (b) salaries, wages, commissions, interests or dividends and (c) (c) sales of foreign currency. Use of funds in accounts is limited to purchase of ringgit assets in Malaysia.
(2) General payments	Residents were freely allowed to make payments to non-residents for any purpose. Amounts of RM100,000 and above were permitted provided the resident does not have any domestic borrowing (if the payment is for investment abroad), or the payment is made in foreign currency (for non-trade purposes)	Residents are freely allowed to make payments to non-residents for any purpose up to RM 10,000 in ringgit or foreign currency, except for imports of goods and services. Amounts exceeding RM10,000 require approval and are allowed in foreign currency only
(3) Export of goods	Payments to be received in foreign currency or ringgit from an external account	Payments are to be received from an external account in foreign currency only.
(4) Credit facilities to nonresidents	Non-resident correspondent banks and stock-brokering companies were permitted to obtain credit facilities up to RM 5 million from domestic banks to fund mismatch of receipts and payments in their external accounts.	Domestic credit facilities to non-resident corresponding banks and non-resident stock-brokering companies are no longer allowed.
(5) Investment abroad	Corporate residents with domestic borrowing were allowed to invest abroad up to the equivalent of RM 10 million per calendar year on a corporate group basis.	Residents with no domestic borrowing are allowed to make payment to non-residents for investment abroad up to an amount of RM10000 or its equivalent in foreign currency per transaction.

Table A-1 continued

Transaction	Prior to 1 September 1998	New
(6) Credit facilities from non-residents	Residents were allowed to obtain ringgit credit facilities of below RM100,000 in the aggregate from non-resident individuals.	All residents require prior approval to make payments to non-residents for investing abroad an amount exceeding RM 100 equivalent in foreign currency. Residents are not allowed to obtain ringgit credit facilities from any non-resident individual.
(7) Trading in securities	There were no restrictions on secondary trading of securities registered in Malaysia between residents and non-residents and among non-residents. For transfer of securities registered outside Malaysia from a non-resident to a resident, the resident was subject to the rules on investment abroad.	Ringgit securities held by non-residents must be transacted through an authorised depositor. All payments by non-residents for any security registered in Malaysia must be made in from an external account (in foreign currency or in ringgit) All proceeds in ringgit received by a non-resident from the sale of any Malaysian security must be retained in an external account at least for one year before converting to foreign currency. All payments to residents for any security registered outside Malaysia from non-residents must be made in foreign currency.
(8) Import and export of currency notes, bills of exchange, insurance policies etc.	A resident or non-resident traveler was free to import or export any amount of ringgit notes or foreign currency notes in person. Export of foreign currencies required approval. Authorised currency dealers were allowed to import any amount of ringgit notes, subject to reporting to Bank Negara Malaysia on a monthly basis.	A resident traveler is permitted to bring ringgit notes up to RM1,000 only and any amount of foreign currencies. A resident traveler is permitted to export ringgit notes only up to RM1,000 and foreign currencies up to the equivalent of RM 10,000. A non-resident traveler is permitted to import ringgit notes up to RM1,000 only and any amount of foreign currencies. A non-resident traveler is permitted to export Ringgit notes up to RM1,000 only and foreign currencies up to the amount brought into the country.
(9) Transaction in the Labuan Offshore Financial Centre.	Licensed offshore banks were allowed to trade in ringgit instruments up to permitted limits.	Licensed offshore banks are no loner allowed to trade in ringgit instrument.

Source: Compiled from Bank Negara Malaysia, *Quarterly Bulletin*, Second Quarter 1998, Kuala Lumpur and IMF (1997).

Table A-2: Korea: Selected Economic Indicators, 1997Q1 – 1999Q4[1]

	1996	1997	1998	1999	1997				1998				1999			
					Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Growth of GDP (%)	6.8	5.0	-5.8	10.2	6.9	4.9	5.3	1.1	-3.6	-7.2	-7.1	-5.3	4.5	9.9	12.3	---
Growth rate by final demand category (%):																
Private consumption	7.1	3.5	-9.6	---	4.5	4.4	5.3	-0.1	-9.9	-11.2	-10.4	-6.9	6.2	9.1	10.3	--
Public consumption	8.2	1.5	-0.1	---	1.7	2.5	2.3	-0.4	1.3	-0.7	-0.6	-0.4	-1.7	-2.3	-1.3	--
Gross domestic investment	8.3	-7.5	-33.6	---	3.0	-4.8	-11.9	-13.3	-48.7	-43.3	-40.4	-24.2	22.5	30.3	35.1	--
Growth by sector (%):																
Agriculture, forestry and fishing	3.3	4.6	-6.3	---	5.3	4.0	3.8	5.2	6.2	-3.5	-7.0	-9.0	-7.4	5.3	4.2	---
Manufacturing	6.8	6.6	-7.4	21.8	7.1	8.5	6.8	3.4	-4.6	-10.4	-9.1	-4.7	10.3	20.3	26.8	---
Construction	6.9	1.4	-8.6	-10.1	-0.9	2.5	4.8	3.6	-3.9	-6.6	-10.1	-13.3	-14.8	-7.8	-10.0	---
Services	6.2	5.2	-2.2	---	7.8	8.3	7.5	5.1	-1.0	-3.4	-3.0	-1.3	3.3	6.0	7.6	---
Unemployment rate	2.0	2.6	6.8	6.3	---	---	---	---	5.6	6.8	7.4	7.4	8.4	6.6	5.6	4.6
Inflation rate (CPI) (%)	4.9	4.4	7.5	0.8	4.5	4.0	4.2	6.6	8.9	8.2	7.0	6.0	0.7	0.6	0.7	1.3
Growth of money and credit (end of period) %																
M2	15.8	14.1	27.0	28.4	24.7	21.1	23.6	21.1	12.1	16.3	24.8	27.0	33.7	27.1	26.9	28.4
Average bank lending rate (%)	10.0	11.9	15.2	10.8	11.4	11.4	11.6	13.6	17.3	16.9	14.8	11.9	10.6	9.8	11.5	12.2
Growth of real bank credit to the private sector[2]	14.2	13.2	3.8	17.8	17.6	15.8	11.9	14.0	9.0	5.0	5.5	3.8	12.8	15.7	17.0	17.8
Non-performing loans (NPLs) ratio (%)[2,3]	---	---	10.5	---	---	---	---	---	---	---	---	10.5	---	11.3	10.1	---
Average share price index	90.6	67.8	47.1	95.4	69.8	73.9	75.1	61.0	58.3	43.0	36.5	50.6	65.8	90.1	1113.1	112.6
Fiscal deficit as % of GDP	0.03	-0.02	-4.2	---	---	---	---	---	---	---	---	---	---	---	---	---

External transactions																
Merchandise exports (US$, FOB, %)	4.3	5.0	-2.8	9.8	-5.6	7.1	15.6	3.5	8.4	-1.8	-10.8	-5.5	-1.6	2.5	15.2	24.2
Merchandise imports (US$, FOB, %)	12.3	-2.2	-36.1	28.3	3.9	0.8	-3.8	-4.8	-36.2	-37.0	-39.9	-28.7	8.1	22.1	38.6	44.9
Current account balance as % of FOB, %)	-4.4	-1.7	12.6	---	-6.3	-2.2	-1.6	3.5	16.1	14.2	11.9	9.1	6.9	6.5	---	---
Foreign reserves (US$ billion)[2]	34.0	20.4	52.0	---	29.9	34.1	30.3	20.3	29.7	40.8	46.9	52.0	57.4	61.9	65.4	---
Total external debt as % GDP[2]	30.3	33.4	46.4	---	---	---	---	---	---	---	---	46.4	42.3	38.9	36.9	---
Short term foreign debt as % of total debt[2]	---	39.9	20.6	29.0	---	---	---	---	---	---	---	20.6	21.9	22.7	24.8	28.0
Short-term foreign debt as % of foreign reserves		312.3	59.1	50.0	---	---	---	---	---	---	---	59.1	55.5	51.8	53.5	50.0
Average exchange rate (ringgit per US$)	804.5	951.3	1401.4	1188.2	870.3	891.3	908.3	1403.5	1605.7	1394.6	1326.1	1279.3	1196.3	1188.9	1195.0	1172.5

Notes:

1 All growth rates on a yea-on-year basis.
2. End of period.
3. Non-performing loans of commercial banks only. Based on a 'six month' non-performing period.
--- Data not available.

Source: Asia Recover Information Centre database, Asian Development Bank [ARIC@adb.org] and IMF, International Financial Statistics data tapes

Table A-3: Thailand: Selected Economic Indicators, 1997Q1 – 1999Q4[1]

	1996	1997	1998	1999	1997				1998				1999			
					Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Growth of GDP (%)	5.9	-1.8	-10.4	4.0	1.1	-1.6	-2.0	-4.4	-9.0	-12.7	-13.2	-6.6	0.9	3.3	7.7	---
Growth rate by final demand category (%)																
Private consumption	6.8	-0.8	-10.6	---	8.2	3.0	-5.2	-8.6	-10.6	-14.5	-12.8	-3.9	-0.3	1.1	5.5	--
Public consumption	11.9	-3.6	4.0	---	2.2	-3.6	-0.7	-12.1	-6.4	-6.0	-11.9	15.5	1.4	15.5	3.4	--
Gross domestic investment	---	-21.7	-34.8	---	-12.3	-20.8	-21.8	-31.3	-30.6	-59.7	-41.0	-3.3	9.8	13.0	1.8	--
Growth by sector (%)																
Agriculture, forestry and fishing	3.8	-0.6	-1.3	2.9	-1.5	-0.8	-2.5	1.6	-1.2	-3.7	-0.7	2.2	-0.7	3.2	-0.2	---
Manufacturing	6.7	0.1	-11.6	11.1	3.8	5.1	-3.2	-7.5	-13.3	-13.8	-14.8	-4.1	6.6	9.5	17.4	---
Construction	7.2	-26.6	-38.8	-8.5	-31.1	-25.5	-14.3	-36.7	-28.1	-35.8	-41.6	-40.6	-24.8	-18.4	-0.6	---
Services	5.3	-1.1	-9.4	1.4	0.1	-0.2	0.7	1.2	-6.9	-11.9	-11.0	-7.7	-0.4	1.2	3.1	
Unemployment rate	1.1	0.9	4.4	---	---	---	---	---	4.6	5.0	3.4	4.5	5.2	5.3	3.1	---
Inflation rate (CPI) (%)	5.8	5.6	8.1	0.3	4.5	4.4	6.6	7.6	9.0	10.3	8.1	5.0	2.7	0.4	-1.0	0.1
Growth of money and credit (end of period) (%)																
M2	12.6	16.5	9.7	---	11.0	13.2	19.0	16.0	15.7	13.8	12.7	9.7	8.6	5.8	1.9	---
Average bank lending rate (%)	13.4	14.9	14.4	9.4	13.0	12.8	13.9	14.9	15.3	15.3	14.8	12.3	10.3	8.9	8.6	10.0
Growth of real bank credit to the private sector [2]	9.4	13.6	-11.3	---	8.4	5.1	8.4	11.3	3.4	2.5	-5.0	-11.3	-3.6	-4.0	-3.0	---
Non-performing loan (NPL) ratio (%)[2,3]	---	---	45.0	38.5	---	---	---	---	---	32.7	39.7	45.0	47.0	47.4	44.4	38.5
Average share price index	1167.9	597.8	353.9	421.1	754.2	601.4	762.3	443.7	473.1	361.5	246.0	335.0	357.1	461.8	450.5	415.0
Fiscal deficit as % of GDP	1.0	-0.3	-2.8	---	---	---	---	---	---	---	---	---	---	---	---	---

External transactions																
Merchandise exports (US$, FOB, %)	-1.9	4.1	-6.9	7.2	-1.1	2.2	7.1	6.4	-3.4	-5.2	-8.6	-9.9	-3.6	5.7	11.1	16.5
Merchandise imports (US$, FOB, %)	0.6	-13.7	-33.7	17.6	-7.7	-7.6	-1.4	-27.5	-39.8	-38.2	-34.2	-18.9	-1.0	11.7	21.9	38.0
Current account balance as % of GDP)	-8.1	-2.0	12.7	---	-4.7	-7.1	-1.9	9.6	16.5	10.2	12.5	11.7	10.8	8.6	9.3	---
Foreign reserves (US$ billion)[2]	37.7	26.2	28.8	34.1	37.1	31.4	28.6	26.1	26.9	25.8	26.6	28.8	29.2	30.7	31.6	34.1
Total external debt as % GDP[2]	49.8	62.0	76.8	---	---	---	---	62.0	70.8	75.1	78.7	76.7	70.4	66.4	66.1	---
Short-term foreign debt as % of total debt[2]	41.5	37.3	27.2	---	---	---	---	37.3	34.2	32.2	30.1	27.2	24.5	21.8	19.9	---
Short-term foreign debt as % of foreign reserves[2]	99.7	133.1	81.4	---	---	---	---	133.1	116.6	110.0	98.2	81.4	70.2	57.2	49.6	---
Average exchange rate (baht per US$)	25.3	31.4	41.4	37.8	25.8	25.6	33.0	40.6	47.1	40.3	41.1	37.0	37.1	37.2	38.4	38.8

Notes:

1 All growth rates on a yea-on-year basis.
2. End of period.
3. Non-performing loans of commercial banks only. Based on a 'six month' non-performing period.
--- Data not available.

Source: Asia Recover Information Centre database, Asian Development Bank [ARIC@adb.org] and IMF, International Financial Statistics data tapes

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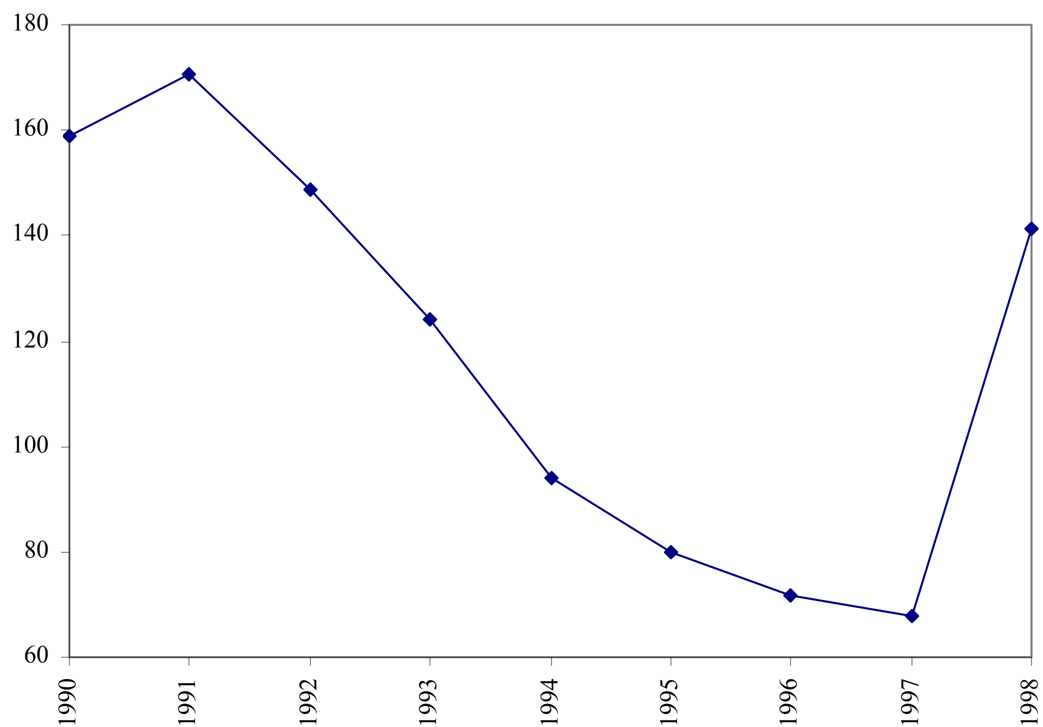
Figure 1: Foreign Exchange Reserves Relative to Mobile Capital[1]

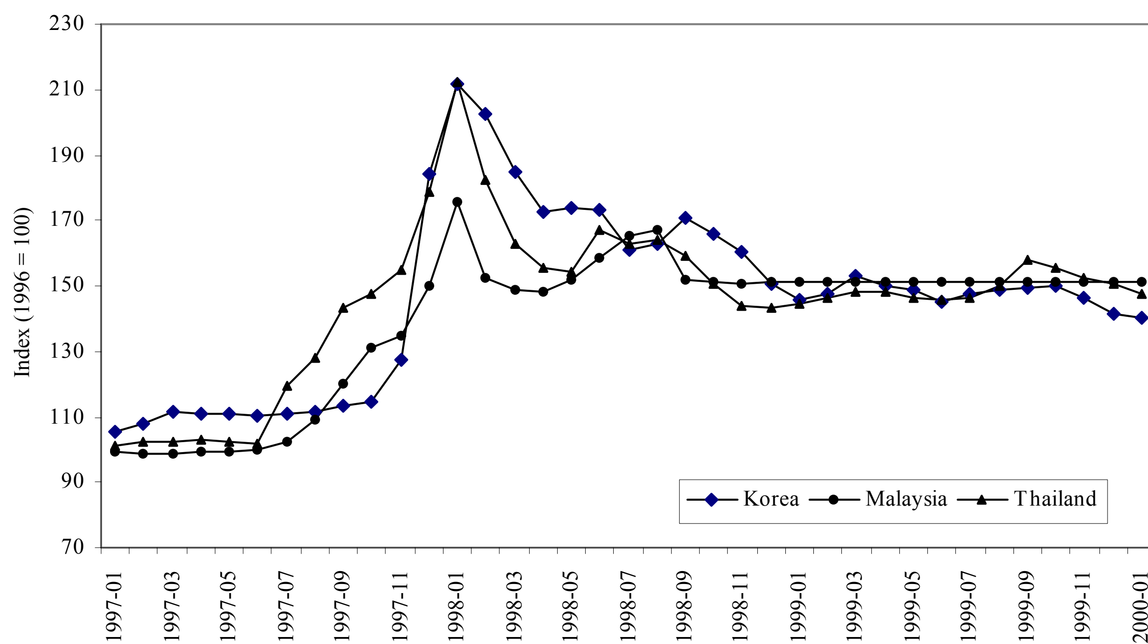


Note:

1 Mobile capital is defined as the sum of short-term foreign debt and portfolio investment.

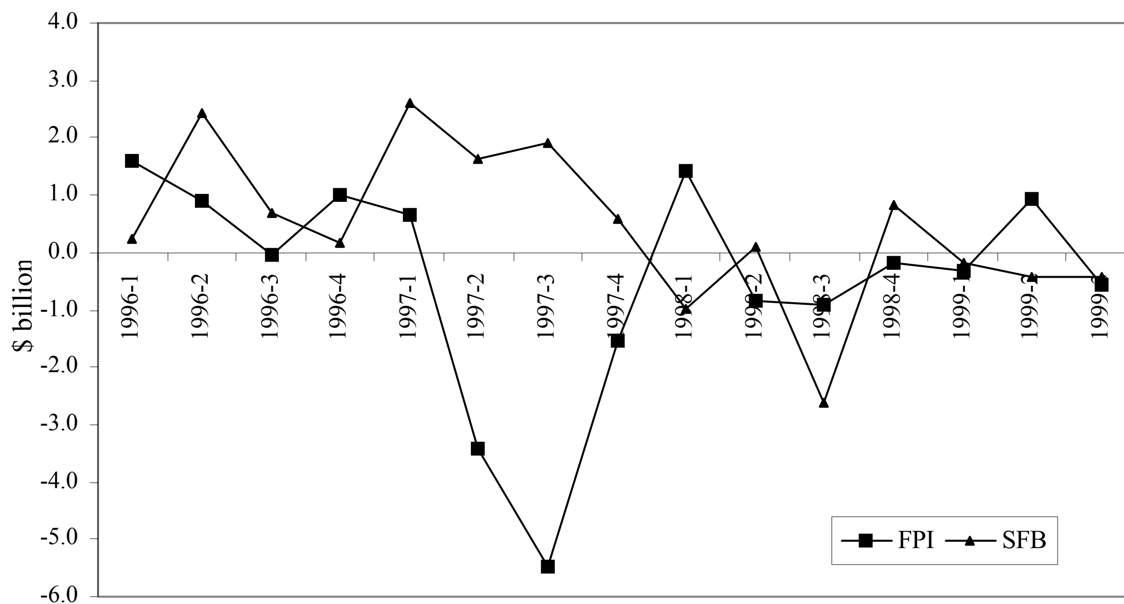
Source: Table 3

Figure 2: Exchange Rates of Korea, Malaysia and Thailand, January 1997 – February 2000 (Units of local currency per US$, 1996 = 100)



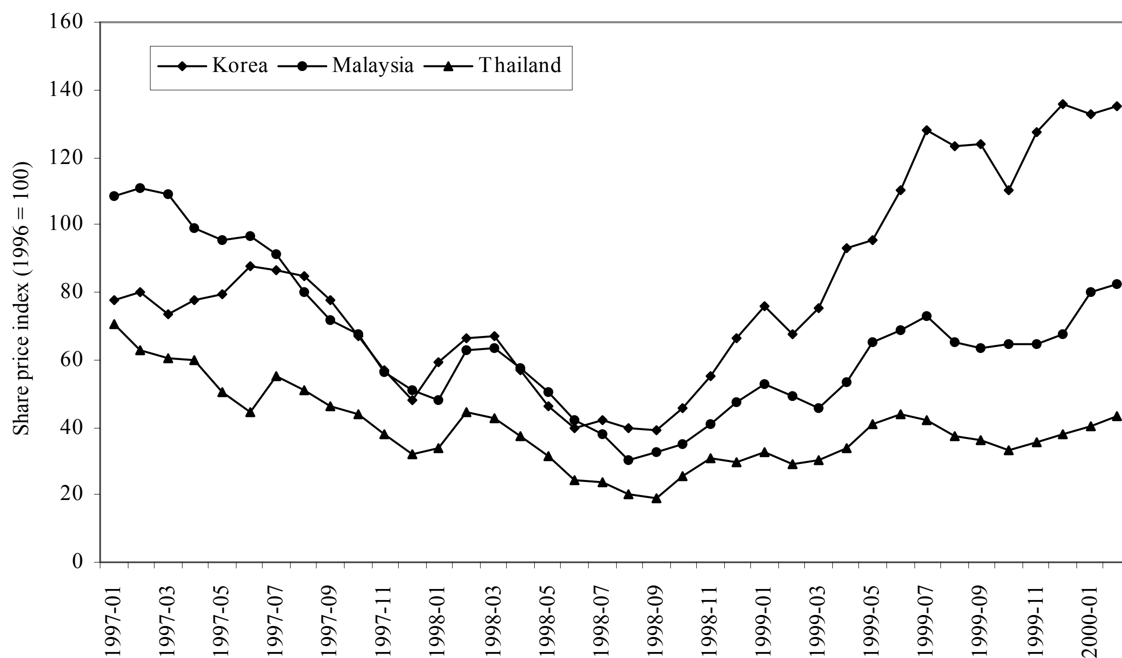
Source: Asia Recovery Information Centre Data Base, Asian Development Bank [http://aric.adb.org]

Figure 3: Malaysia: Foreign Portfolio Investment (FPI) and Short-term Foreign Borrowing (SFB), 1996q1-1999q4 (Net flows, US$ billion)



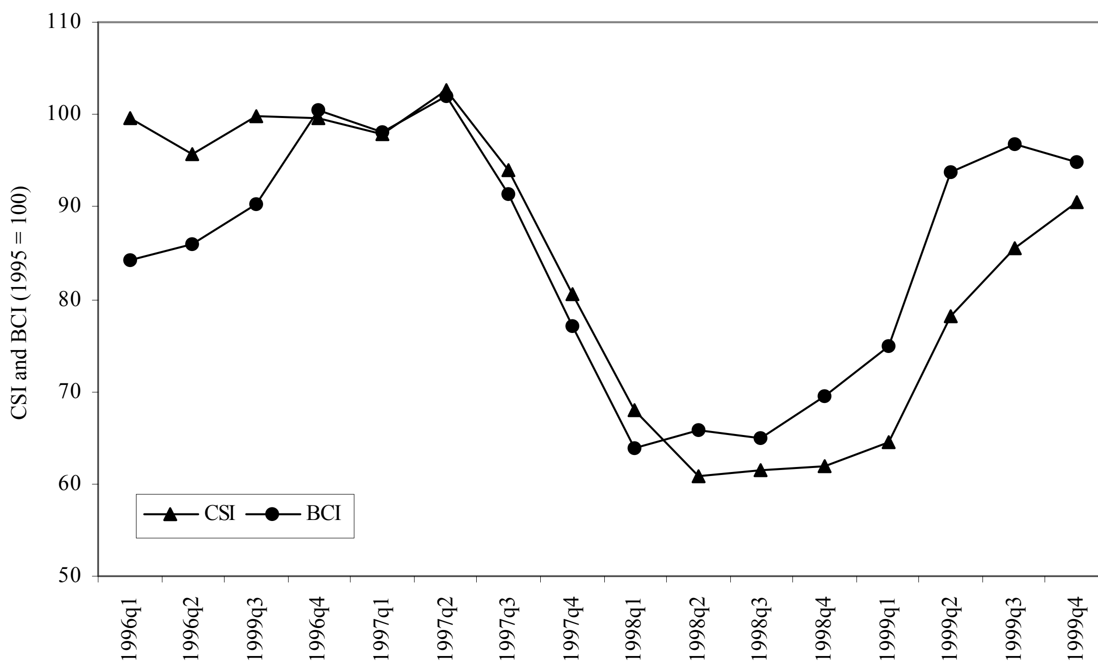
Source: Data compiled from Bank Negara Malaysia, *Monthly Statistical Bulletin* (various issues)

Figure 4: Monthly Share Price Indices of Korea, Malaysia and Thailand, January 1997 - February 2000



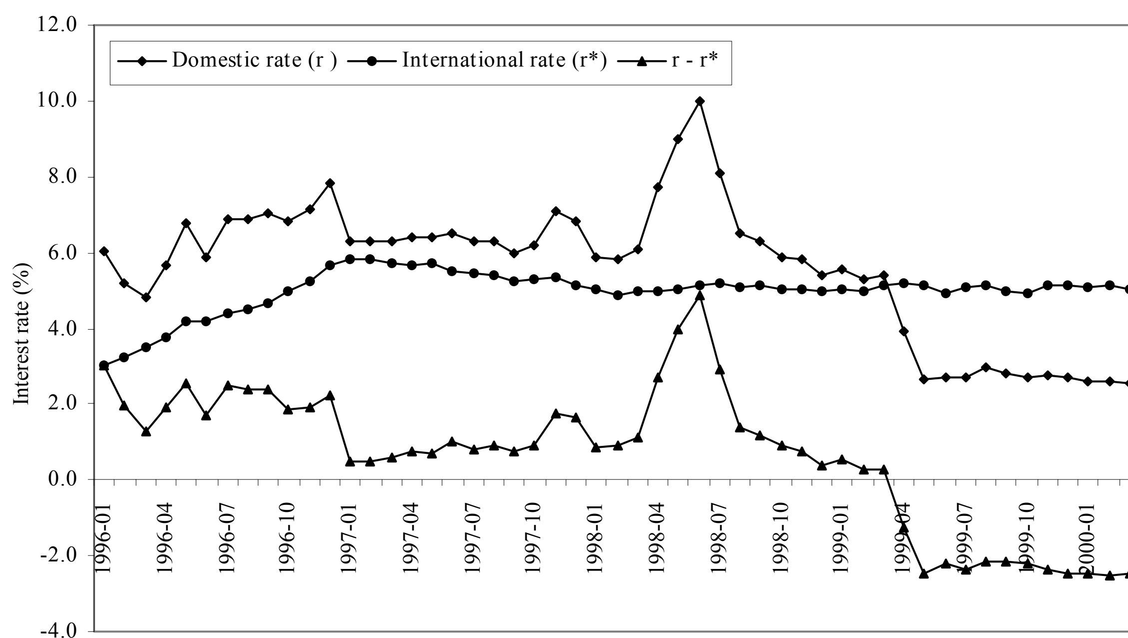
Source: Asia Recovery Information Centre Data Base, Asian Development Bank [http://aric.adb.org]

Figure 5: Indices of Consumer Sentiments (CSI) and Business Confidences (BCI), 1996q1 –1999q4 (1995 = 100)



Source: Malaysian Institute of Economic Research, *Consumer Sentiments Quarterly Report* and *Business Confidence Quarterly Report* (various issues), Kuala Lumpur. The original indices have been recast to a common 1996 base to for easy comparison.

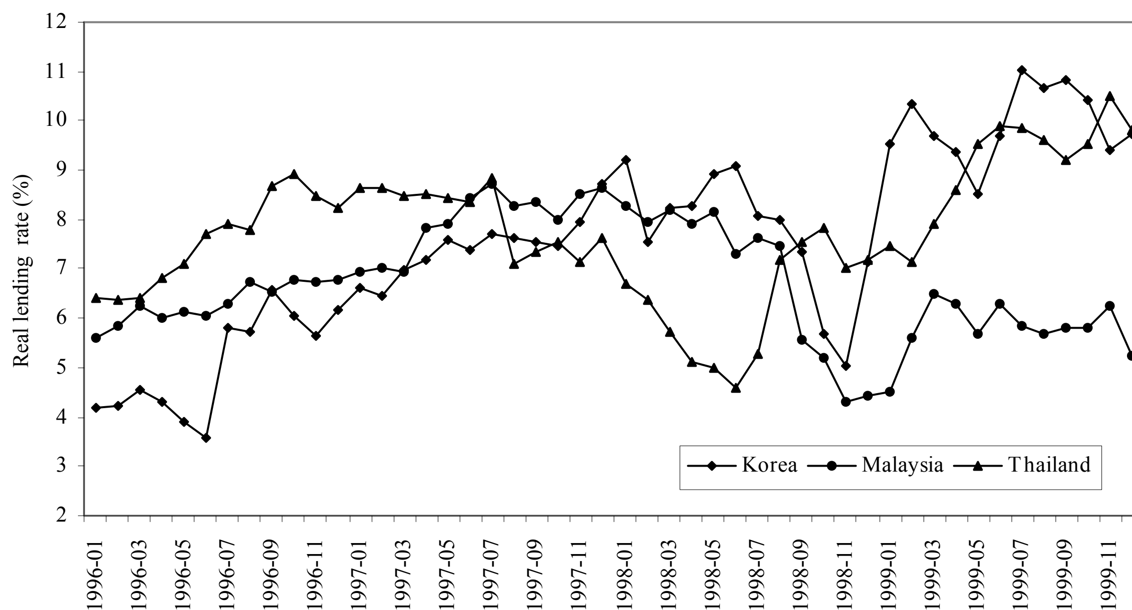
Figure 6: Malaysia: Differential Between Domestic and International Interest Rates (January 1996 - February 2000)



Note:
Domestic interest rate used here (*r*)is the three-month Treasury bill rate. The three-month Treasury bill rate in the USA is used as a proxy for international interest. rate (r^*). The time patter of the differential is remarkably resilient to the use of UK treasury bill rate as r^*.

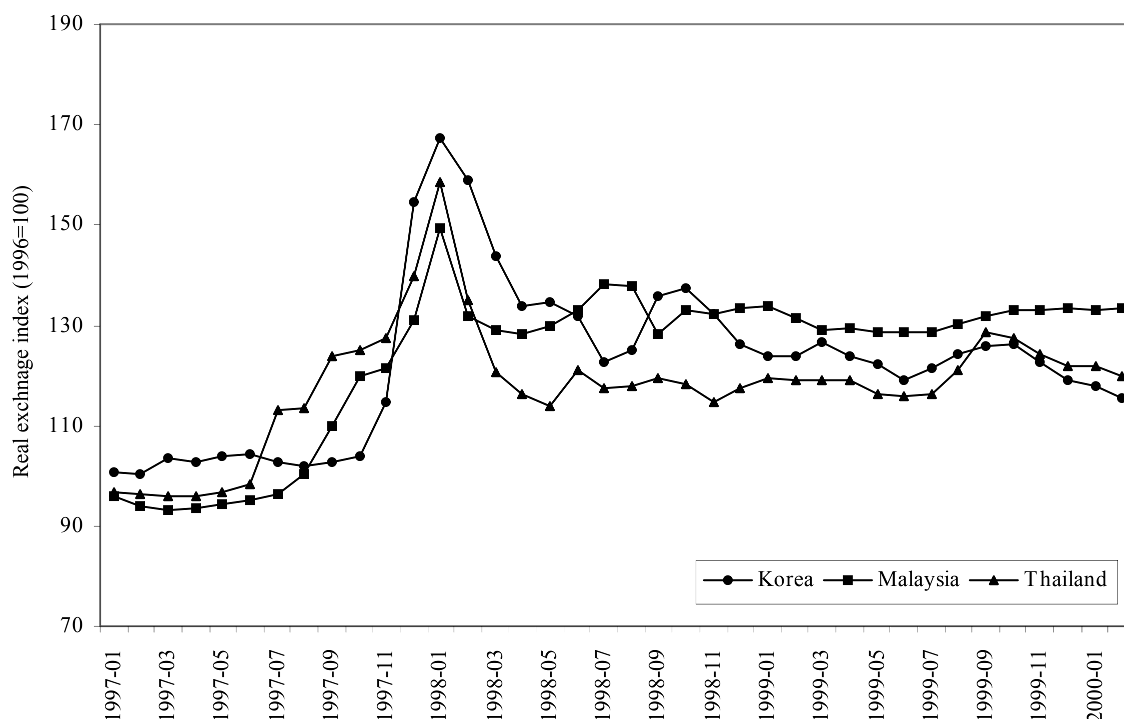
Source: Bank Negara Malaysia, *Monthly Statistical Bulletin* and IMF, *International Financial Statistics* (various issues).

Figure 7: Average Real Bank Lending Rates in Korea, Malaysia and Thailand, January 1996 - January 2000.



Source: Data compiled from IMF, International Financial Statistics (various issues)

Figure 8: Real Exchange Rate Index[1]: Korea, Malaysia and Thailand January 1997 – February 2000 (1996 = 100)



Note:

1 Producer price of the given country relative to that of its trading-partner countries - both expressed in a common currency. Producer price is measured net of food. The original index has been inverted here so that an increase in the index indicates increase in relative competitiveness (real depreciation).

Source: J.P. Morgan website <http://www.jpmorgan.com>