

MALAYSIA'S SEPTEMBER 1998 CONTROLS: BACKGROUND, CONTEXT, IMPACTS, COMPARISONS, IMPLICATIONS, LESSONS

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In 1997, the Interim Committee of the IMF agreed that the Fund's Articles of Agreement be amended to include currency convertibility for capital transactions. First mooted in its April meeting, the decision was confirmed in Hongkong in September after the East Asian currency and financial crises had begun in Thailand, spreading immediately to the rest of Southeast Asia, in July. Since then, Fund officials have reiterated that capital account liberalization should become one of its basic objectives (Fischer 1998).

Ironically, this decision was made and later confirmed as the world's first serious capital account crisis was building up and after it later broke. It is now generally agreed in East Asia, if not elsewhere, that the Fund exacerbated the crises by insisting on inappropriate policies. In early 1998, three spokesmen of the Washington Consensus – Alan Greenspan, Larry Summers and Michel Camdessus – blamed the crises on East Asian corporate governance malpractices. Since then, there has been no explicit mea culpa from the protagonists involved, although it is now grudgingly acknowledged that financial liberalization has not contributed to growth in emerging markets (Prasad *et al.* 2003).

In September 1998, the Malaysian authorities introduced capital and other currency controls. This was clearly an important challenge to the prevailing orthodoxy, especially as promoted by the Fund. While it is moot how crucial the controls were for the subsequent V-shaped recovery, it is nevertheless clear that they do not seem to have caused any significant permanent damage, as predicted by some critics. Different sides in the debate now invoke the 1998 Malaysian controls for all kinds of purposes, often contributing more heat than light.

This study seeks to explain the circumstances in which the controls were introduced as well as assess their nature and impact before drawing some general lessons of relevance to other emerging market economies. In considering the context, the paper considers the recent evolution of the Malaysian financial system and regulation in the decade preceding the outbreak of the crisis in mid-1997. Early Malaysian policy responses from July 1997 until September 1998 are then considered. This is followed by a detailed consideration of the nature of the control measures and an assessment of their efficacy. Finally, the actual significance of the Malaysian controls is emphasized before drawing some policy lessons.

The first Addendum provides an introductory review of the range of different capital control measures, while the second summarizes the Malaysian controls on inflows introduced and withdrawn in 1994. Several figures and tables are provided in the appendices to provide regional comparisons of relevant macroeconomic and financial trends in Malaysia and the three other crisis-hit East Asian economies – Thailand, Indonesia and South Korea -- that sought and received IMF emergency credit with attached conditions ostensibly 'owned' by the governments concerned through signed Letters of Intent

Capital Flows and Crisis

For several decades, foreign capital inflows into Malaysia have augmented the high domestic savings rate to raise the domestic investment rate as well as Malaysian

investments abroad in the nineties. Compared to most of its neighbours in the East Asian region, the Malaysian central bank authorities were generally more cautious and prudent about financial liberalization, both domestically and internationally. Malaysia experienced a severe banking crisis in the late 1980s, following the mid-1980s' recession and stock market collapse, when 'non-performing loans' (then defined on a six-month basis) reached 30 per cent of total commercial banks' lending portfolios. In 1989, the authorities legislated the Banking and Financial Institutions Act (BAFIA) that sought to improve banking supervision and regulation.

The Bank for International Settlements (BIS) and other banking regulations as well as other banking practices inadvertently encouraged short-term debt – compared to medium- or long-term debt – in the exposure of OECD countries-based banks, especially to emerging markets or developing countries. Loans for less than a year only required 20 per cent capital backing compared to full (100 per cent) capital backing for loans for a year or more. Further, the degree of Malaysian exposure to such short-term debt was partly mitigated by more prudent central bank regulations, supervision and enforcement, as well as limiting foreign borrowings by Malaysian banks as well as corporations.

Compared to the others, much more Malaysian debt was long-term – rather than short-term – in nature. Monetary policy as well as banking supervision in Malaysia had generally been much more prudent compared to the other crisis victims. Banks in Malaysia had not been allowed to borrow heavily from abroad to lend in the domestic market, as in the other economies. Such practices involved currency and term mismatches, which increased financial system vulnerability to foreign bankers' confidence as well as pressure on the exchange rate pegs. Thus, Malaysian central bank regulation and earlier consolidation of the banking sector helped ensure its greater robustness compared to its neighbours.

Malaysia accumulated relatively less foreign borrowings than most other crisis-hit countries with a smaller proportion of debt of short-term maturity. For instance, in June 1997, short-term debt as a share of total reserves for Malaysia was approximately 60 per cent, significantly lower than South Korea (more than 200 per cent), Indonesia (about 170 per cent) and Thailand (just under 150 per cent). The costs of hedging foreign loans in Malaysia were relatively lower compared to its neighbours besides Singapore, though there are anecdotal claims that the central bank actually discouraged Malaysian external borrowers from hedging their debt.

Malaysia's total external debt to foreign exchange reserves ratio was becoming dangerously high before the crisis, reaching 139.6 per cent in 1996 before jumping to 298.2 per cent in 1997 (Jomo 2001: Table 5.13). As the economic recession deepened in 1998, foreign borrowings decreased to 1996 levels, after peaking at RM29.2 billion in 1997. With a lower proportion of short-term loans compared to the other East Asian economies hit by the crisis, fluctuations in foreign bank borrowings in Malaysia have been less severe.

In the early and mid-1980s, FDI inflows were significantly augmented by increased inflows of portfolio capital, mainly to invest in the booming stock market accompanying the decade long boom from the late 1980s induced by FDI from Japan and the first generation newly industrialized economies, especially Taiwan and Singapore. Such inflows were encouraged by the promotion of 'emerging market economies' by the international financial institutions from the late 1980s after the international sovereign debt crisis of the early and mid-1980s following the Volcker/US Fed-induced world recession.

Thus, there was considerable, but partial and uneven financial liberalization dating back to the eighties, which was slowed by the mid-1980s' stock market scandals and

recession as well as the subsequent banking crisis. While exercising caution and prudence with regards to private sector foreign bank borrowings, the authorities actively encouraged development of the capital market in Malaysia.

Official efforts included considerable promotion of the Kuala Lumpur's 'newly emerging' stock market, growing central bank speculative activity abroad (until it lost at least sixteen billion ringgit after the sterling collapse of September 1992) and greater capital account convertibility. By splitting from the Stock Exchange of Singapore (SES), the Malaysian authorities ensured that such flows directly entered the Kuala Lumpur Stock Exchange (KLSE). Such portfolio capital inflows were far more significant in Malaysia than foreign bank borrowings, which were officially discouraged by the central bank authorities who generally required evidence of significant foreign exchange earnings from deployment of such external loans.

Malaysia thus succeeded in attracting considerable capital inflows during the early and mid-1990s. But unlike Korea, Thailand and Indonesia, where foreign bank borrowings ballooned in the early and mid-1990s, such inflows were far more modest in Malaysia. However, Malaysia was far more successful in attracting portfolio capital flows, which are arguably even more volatile than bank borrowings. Hence, unlike other crisis-affected economies that attracted considerable, mainly short-term US dollar denominated bank loans, albeit from continental European and Japanese banks, Malaysia's vulnerability was primarily due to the volatility of international portfolio capital flows into its stock market.

International financial liberalization succeeded in generating net capital inflows into Malaysia, and much of East Asia during the early and mid-1990s, unlike many other developing and transitional economies that experienced net outflows. Increased foreign capital inflows reduced foreign exchange constraints, allowing the financing of additional imports, and thus, inadvertently encouraging current account deficits. Such foreign capital inflows into Malaysia also adversely affected factor payment outflows, export and import propensities, the terms of trade and capital flight, and thus, the balance of payments. But financial liberalization also exacerbated systemic instability and reduced the scope for the developmental government interventions responsible for the region's economic miracle.

A major role for FDI appears to have been officially encouraged in Malaysia in order to reduce reliance on ethnic Chinese capital and its likely political consequences. Malaysia's heavy dependence on foreign direct investment in gross domestic capital formation, especially manufacturing investments, has limited the development of domestic entrepreneurship as well as many other indigenous economic capabilities by requiring greater reliance on foreign capabilities, often associated with some types of FDI. Hence, FDI domination (well above the average for developing countries) of internationally competitive manufacturing weakened domestic industrialists, inadvertently enhancing the dominance of finance capital and its influence over economic policy making.

In contrast to limited influence of Malaysian industrial capital, finance capital was clearly far more influential in Malaysia, enhanced by the country's British colonial inheritance and more recent American cultural influences favoring finance over industry. The influence of financial interests was enhanced by the many and extensive investments of the Malaysian authorities in the financial sector, more than any other sector of the Malaysian economy, partly due to previous interventions to bail out banks after earlier financial crises. The stock market and other property asset price bubbles due to capital inflows induced 'wealth effects' which benefited much of the middle class as well. However, there is no evidence that these portfolio capital inflows actually contributed to domestic capital formation and thus growth rates, rather than asset price bubbles and

consumer binges.

After mid-1995, the Southeast Asian currency pegs to the US dollar – which had enhanced the region's competitiveness as the dollar declined for a decade after the 1985 Plaza accord – became a growing liability as the yen began to depreciate once again. The overvalued currencies became attractive targets for speculative attacks, resulting in futile, but costly defences of the Thai baht and Malaysian ringgit, and the rapid regional spread of herd panic called contagion.

After the Thai baht was floated on 2 July 1997, like other currencies in the region, the ringgit was under strong pressure, especially because, like Thailand, Malaysia had maintained large current account deficits during the early and mid-nineties. The monetary authorities' efforts to defend the ringgit actually strengthened the national currency against the greenback for a few days before the futile ringgit defence effort was given up by mid-July. The failed ringgit defence effort is widely believed to have cost over nine billion ringgit.

The ringgit fluctuated wildly until mid-1998, weeks before the ringgit was fixed at RM3.8 against the US dollar on 2 September 1998. While much of the downward pressure on the ringgit was external, inappropriate political rhetoric and policy measures exacerbated the situation. Malaysia's foreign exchange reserves depleted rapidly from July until November 1997, before improving in December, and especially after the imposition of capital controls in September 1998.

Massive portfolio capital inflows during the early and mid-1990s had fundamentally transformed the nature of Malaysia's capital market. While holding an estimated third of the stock of the largest hundred companies comprising the Kuala Lumpur Stock Exchange (KLSE) Composite Index (KLCI), foreign institutional investors moved the Malaysian market. Malaysian institutions were generally too small in comparison, while the larger Malaysian institutions generally took longer-term stock positions and were less inclined to be involved in short-termism and speculation, reflected in much more active day-trading, for example. Needless to say, 'retail' investors had little real influence on the market, but generally exacerbated market volatility by more speculative behavior and greater tendencies of following – and thus exacerbating – the market's irrational exuberance or pessimism.

Much more global in outlook, foreign fund managers were generally more inclined to consider investing in Malaysia against alternative options elsewhere in the world. Thus, they were probably key to the phenomenon referred to as 'contagion' involving cross-border investment trends. As outsiders operating with apparently limited information and incentive packages encouraging conformism and 'followership', especially in the face of uncertainty and market downturns, they were also more likely to contribute to 'herd' behavior. Hence, the Malaysian stock market was the most vulnerable to both irrational exuberance and pessimism among the four most crisis-affected economies. Not surprisingly, the KLCI fell most during the East Asian crisis despite government interventions and the greater role of government controlled investors in the stock market who sought to limit and offset the downward slide.

The magnitudes of gross inflows and outflows reflect the much greater volatility of these flows, often obscured by focussing on net flows. But even the net flow data indicates the relative size of these flows. A net sum of over RM30 billion of portfolio investments flowed out in the last three quarters of 1997, much more than the total net inflows from 1995, and equivalent to almost a fifth of annual GNP. This exodus included RM21.6 billion of shares and corporate securities, and RM8.8 billion of money market instruments. In just one quarter, from July to September 1997, a net RM16 billion of portfolio investments left the country.

These differences have lent support to the claim that Malaysia was an ‘innocent bystander’ which fell victim to regional contagion for being in the wrong part of the world at the wrong time. Such a view takes a benign perspective on portfolio investment inflows, and does not recognise that such inflows are even more easily reversible and volatile than bank loan inflows. Contrary to the ‘innocent bystander’ hypothesis, Malaysia's experience actually suggests the greater vulnerability of its heavier reliance on the capital market. As a consequence, the Malaysian economy became hostage to international portfolio investor confidence. Hence, when the government leadership engaged in rhetoric and policy initiatives that upset such investor confidence, Malaysia paid a heavy price as portfolio divestment accelerated. The Malaysian stock market dropped dramatically from almost 1,300 in February 1997 to a low of 262 in early September 1998, eighteen months later.

Policy Response and Deepening Crisis

The resulting precipitous asset price collapses – as the share and property market bubbles burst – undermined Malaysia’s heavily exposed banking system for the second time in little over a decade, causing economic recession. IMF prescriptions and conventional policy-making wisdom urged government spending cuts in the wake of the crisis. Conventional policy making ‘wisdom’ – including IMF prescriptions – raised interest rates and otherwise ‘tightened’ monetary and fiscal policies (e.g. by cutting government spending) in the wake of the meltdown to further transform what had started as a currency crisis into a full-blown financial crisis, then into a crisis of the real economy as the Southeast Asian region sharply went into recession in 1998.

It is worthwhile to emphasise at the outset that Malaysia’s experience differed from those of other East Asian crisis-hit economies in at least four respects. First, although prudential regulation had deteriorated with financial liberalization, especially since the mid-eighties, the situation in Malaysia had been checked by the policy responses to the late 1980s’ banking crisis. Hence, Malaysia was forced by circumstances to become more cautious at a time when the other crisis-affected East Asian economies were pursuing international financial liberalization. Second, although the Malaysian banking system had contributed to asset price inflation, and was thus severely affected by the crisis, Malaysian banks and corporations had far less access to international borrowing than their counterparts in other crisis-affected economies. Unlike the others, foreign bank loans did not figure as significantly in the Malaysian crisis, whereas capital market flows, especially into and out of the stock market, figured more prominently. Third, as a consequence of its lower exposure to private bank borrowings from abroad, Malaysia was not in a situation of having to go cap in hand to the International Monetary Fund (IMF) or to others for emergency international credit facilities. Fourth, for most of the second half of 1997, and again from mid-1998, the Malaysian authorities deliberately pursued unconventional measures in response to the deteriorating situation, with rather mixed results.

Hence, while there are important parallels between the Malaysian experience and those of its crisis-affected neighbours, there are also important differences. It is tempting to exaggerate the significance of either similarities or contrasts to support particular positions or arguments when, in fact, the nature of the experiences do not allow strong analytical or policy conclusions to be drawn. For example, whereas South Korea, Thailand and Indonesia experienced positive growth in the first quarter of 1999, Malaysian economic recovery only began in the second quarter. Critics then were very quick to blame Malaysia’s unorthodox measures for its later recovery. Conversely, the Malaysian regime has been equally quick to claim success for its approach on the basis of

limited evidence of Malaysia's stronger recovery – than Thailand and Indonesia, though not South Korea – in 1999 and 2000, which critics have just as readily attributed variously to a technical rebound, the pre-Y2K electronics boom and 'unsustainable' government measures including large budget deficits and massive government spending to compensate for the shortfall of private investments.

The ringgit's collapse was initially portrayed by Malaysian Prime Minister Mahathir as being exclusively due to speculative attacks on Southeast Asian currencies. In a study published in mid-April 1998, the IMF acknowledged that currency speculation precipitated the collapse of the baht, but denied the role of currency speculation in the collapse of the other East Asian currencies. While currency speculation *per se* may not have brought down the other currencies, contagion undoubtedly contributed to the collapse of the other currencies in the region not protected by the large reserves held by Japan, China, Taiwan, Hong Kong and Singapore. Contagion – exacerbated by the herd-like panicky investment decisions of foreign portfolio investors who perceived the region as much more similar and integrated than it actually is (e.g. in terms of trade or investment links, or even structural characteristics) – quickly snowballed to cause massive capital flight.

As acknowledged by Mahathir, the ringgit probably fell much further than might otherwise have been the case due to international market reactions to his various contrarian statements, including his tough speech in Hong Kong on 20 September 1997, at a seminar before the Joint World Bank-IMF annual meeting. Arguing that 'currency trading is unnecessary, unproductive and immoral', Mahathir argued that it should be 'stopped' and 'made illegal'.

Most damagingly, he seemed to threaten a unilateral ban foreign exchange purchases unrelated to imports by the Malaysian authorities (which never materialised). Even before his Hong Kong speech, Mahathir had railed against George Soros (calling him a 'moron') and international speculators for weeks, even suggesting dark Western conspiracies to undermine the East Asian achievement. Thus, Mahathir's remarks continued to undermine confidence and to exacerbate the situation until he was finally reined in by other government leaders in the region, and perhaps, some of his cabinet colleagues and kitchen cabinet advisers.

The Prime Minister's partly – but not entirely – ill-founded attacks reinforced the impression of official 'denial', with blame for the crisis attributed abroad. The fact that there was some basis for his rantings was hardly enough to salvage his reputation in the face of an increasingly hostile Western media. Thus, until Soeharto's illness (in December 1997) and subsequent recalcitrant behaviour (in the eyes of the IMF and the international financial community) in 1998, Mahathir was demonised as the regional 'bad boy'. Meanwhile, some other governments in the region had little choice but to go 'cap in hand' to the IMF and the US and Japanese governments, in desperate efforts to restore confidence and secure funds to service their fast-growing 'non-performing' foreign debt liabilities, although they were mainly privately-held.

Other official Malaysian policy responses did not help. In late August 1997, the authorities *designated* the top one hundred indexed KLCI share counters. Designation required actual presentation of scrip at the moment of transaction (rather than later, as had been the practice), ostensibly to check 'short-selling', which was exacerbating the stock market collapse. This ill-conceived measure adversely affected liquidity, causing the stock market to fall further.

The government's threat to use repressive measures against commentators making unfavourable reports about the Malaysian economy strengthened the impression that the government had a lot to hide from public scrutiny. Anwar's mid-October 1997

announcement of the 1998 Malaysian Budget was seen by 'the market', i.e. mainly foreign financial interests, as only the latest in a series of Malaysian government policy measures tantamount to 'denial' of the gravity of the crisis and its possible causes.

A post-Cabinet meeting announcement, on 3 September 1997, of the creation of a special RM60 billion fund for selected Malaysians was understandably seen as a bail-out facility designed to save 'cronies' from disaster. Although the fund was never properly institutionalised as announced, and government officials later denied its existence, government-controlled public funds, mainly from pension funds, the Employees Provident Fund (EPF), Petronas and Khazanah, have been deployed to bail out some of the most politically well-connected and influential, including Mahathir's eldest son, the publicly-listed corporation set up by his party cooperative (KUB) and the country's largest conglomerate (Renong), previously controlled by his party and believed to be ultimately controlled by him and then government Economic Adviser, Mahathir confidante, and later, second-time Finance Minister Daim. The protracted UEM-Renong saga from mid-November 1997 was probably most damaging. The nature of this 'bail-out' – to the tune of RM2.34 billion – gravely undermined public confidence in the Malaysian investment environment as stock market rules were suspended at the expense of minority shareholders' interests, with the KLSE losing RM70 billion in market capitalization over the next three days.

The situation was initially worsened by the perception that Mahathir and Daim had taken over economic policy making from Anwar, who had endeared himself over the years to the international financial community. Daim's return to the frontline of policy-making caused ambiguity about who was really in charge from early to mid-1998, and about what to expect. Some measures introduced by the Finance Ministry and the central bank from early December 1997 and in late March 1998 were also perceived as pre-empting the likely role and impact of Mahathir's National Economic Action Council (NEAC).

The establishment of the NEAC had been announced in late 1997 to be chaired by the Prime Minister, with Daim clearly in charge as executive director. Daim was later appointed Minister with Special Functions, operating from the Prime Minister's Department, in late June 1998 – right after the annual UMNO general assembly. He was subsequently made First Finance Minister in late 1998, with his protégé Mustapha Mohamad serving as Second Finance Minister while retaining the Ministry of Entrepreneurial Development portfolio.

The issue of IMF intervention in Malaysia has become the subject of some exaggeration, as various groups have rather different perceptions of the IMF's actual record and motives. For many of those critical of Malaysian government policy (not just in response to the crisis), IMF intervention was expected to put an end to all, or at least much, which they considered wrong or wished to be rid off. In the wake of the protracted wrangling between the IMF and Soeharto's government in Indonesia, this pro-IMF lobby in Malaysia saw the IMF as the only force capable of bringing about desired reforms which domestic forces could not bring about on their own.

Ironically, some of them failed to recognise that the measures introduced from December 1997 were akin to what the IMF would have liked to see. These measures (*White Paper*, Box 1, pp. 25-26) included:

- Bank Negara raising its three-month intervention rate from 8.7 per cent at the end of 1997 to 11.0 per cent in early February 1998;
- drastic reductions in government expenditure; and
- redefining non-performing loans as loans in arrears for three months, not six months as before.

Such contractionary measures helped transform the financial crisis into a more general economic crisis for the country.

Tighter monetary policy from late 1997 exacerbated deflationary pressures due to government spending cuts from around the same time. Thus, contractionary macroeconomic policy responses also worsened the situation. Given the massive currency devaluation in Malaysia's very open economy, the rise of inflation at this time was virtually unavoidable, with little to be achieved by such tight macroeconomic policy. Of course, such policies were also intended to stem the capital flight facilitated by the long-standing official commitment to capital account convertibility. But again, there is little evidence of success in conditions of contagion and herd behaviour.

The Malaysian Government's *White Paper on the Status of the Malaysian Economy*, issued on 6 April 1999, sums up many factors contributing to the ongoing economic crisis as well as most policy responses. However, it did so by whitewashing Mahathir's and Daim's roles in worsening the crisis, and instead implied that Anwar Ibrahim was solely responsible for all domestic policy errors. Conversely, Anwar is not credited with a second U-turn by attempting to reflate the economy by fiscal means from May 1998 and for establishing the key institutions for financial restructuring and recovery such as Danaharta, Danamodal and the Corporate Debt Restructuring Committee (CDRC). However, the White Paper did show how foreign investments were selectively encouraged to protect and save interests the regime favoured, including those who had contributed to causing the crisis. In any case, its tendentious account of recent developments then still fresh in the minds of most readers not only contradicted some facts, but was also unlikely to inspire the investor confidence so badly needed to ensure economic recovery. Subsequent abuses of the debt workout process further undermined its integrity and the overall credibility of the recovery strategy.

At the time, most observers still remembered that Mahathir's KLCI 'designation' ruling had drastically reduced liquidity in the stock market, precipitating a sharp collapse in late August 1997 and necessitating its cancellation a week later. Similarly, the UEM reverse take-over to bail out Renong in mid-November 1997, apparently supported by Mahathir and Daim, had resulted in a 20 per cent stock market contraction of RM70 billion in three days! Mahathir's rhetoric about various western conspiracies against Malaysia and the region further undermined international confidence and the value of the Malaysian ringgit.

The gravity of the crisis and the difficulties of recovery were clearly exacerbated by injudicious policy responses, compromised by nepotism and other types of cronyism, though there is little persuasive evidence that cronyism, in itself, led to or precipitated the crisis -- as alleged by US Fed chairman Alan Greenspan, then US Deputy Treasury Secretary Larry Summers and IMF Managing Director Michel Camdessus -- in early 1998. All this transformed the inevitable 'correction' of the overvalued ringgit into a collapse of both the ringgit and the Kuala Lumpur stock market as panic set in, amplified by 'herd' behaviour and 'contagion'. Government efforts to 'bail-out' politically influential business interests and to otherwise protect or advance such interests -- usually at the expense of the public (the public purse, workers forced savings, taxpayers or minority shareholders) -- exacerbated the crisis by undermining public and foreign confidence.

Thus, fourteen months after the East Asian currency and financial crises began with the floating of the Thai baht in July 1997, Malaysian Prime Minister Mahathir Mohamad introduced several controversial currency and capital control measures. In the last quarter of 1998, the regional turmoil came to an end as East Asian currencies strengthened and stabilized after the US Federal Reserve Bank lowered interest rates

enough to check capital flight to the US. In the first quarter of 1999, Thailand, Indonesia and South Korea posted positive growth rates, while Malaysia's recession went into its fifth quarter. However, by the end of 1999, of the four, Malaysia's recovery was second only to Korea's, with their stronger recoveries continuing into 2000.

The September 1998 Package

The measures introduced on 1 September 1998 were designed to (Rajaraman 2001):

- *kill the offshore ringgit market*, by prohibiting the transfer of funds into the country from externally held ringgit accounts except for investment in Malaysia (excluding credit to residents), or for purchase of goods in Malaysia. The offshore ringgit market could only function with externally held ringgit accounts in correspondent banks in Malaysia. Thus, offshore ringgit deposits could no longer be used for this purpose. Offshore banks required freely usable access to onshore ringgit bank accounts to match their ringgit liabilities, which the new ruling prohibited. Holders of offshore deposits were given the month of September 1998 to repatriate their deposits to Malaysia. This eliminated the major source of ringgit for speculative buying of US dollars in anticipation of a ringgit crash. Large-denomination ringgit notes were later demonetised to make the circulation of the ringgit currency outside Malaysia more difficult.
- *close off access by non-residents to domestic ringgit sources* by prohibiting ringgit credit facilities to them. All trade transactions now had to be settled in foreign currencies, and only authorised depository institutions were allowed to handle transactions in ringgit financial assets.
- *shut down the offshore market in Malaysian shares* conducted through the Central Limit Order Book (CLOB) in Singapore.
- *obstruct speculative outward capital flows* by requiring prior approval for Malaysian residents to invest abroad in any form, and limiting exports of foreign currency by residents for other than valid current account purposes.
- *protect the ringgit's value and raise foreign exchange reserves* by requiring repatriation of export proceeds within six months from the time of export.
- *further insulate monetary policy from the foreign exchange market* by imposing a 12-month ban on outflow of external portfolio capital (only on the principal; interest and dividend payments could be freely repatriated).

Malaysia had so free a capital account regime leading up to the 1997 crisis, that there was even an offshore market in ringgit, perhaps the only case of an offshore market in an emerging market currency' (Rajaraman 2001). Rajaraman (2001) argues that the offshore ringgit market developed, mainly in Singapore, because of the absence of a domestic market for hedging instruments. The offshore ringgit market developed in response to non-residents' demand for hedging instruments when import and export settlements were still ringgit-denominated to exempt Malaysian based importers and exporters from the need to hedge. With imports and exports now dollar-denominated as part of the package of exchange control measures of September 1998, developing such a domestic market for hedging instruments has been postponed indefinitely. However, she insists that such markets will have to be developed over the long term as there will eventually be a need for hedging instruments once the peg is abandoned.

This offshore ringgit market then facilitated exchange rate turbulence in 1997-98. Recognising this, the September 1998 measures sought to eliminate the offshore market to insulate domestic monetary policy from the foreign exchange market during the crisis, in order to lower interest rates. Although several factors contributed to the rise in ringgit interest rates from the second half of 1997, the offshore ringgit market facilitated

speculative offshore borrowing of ringgit to finance dollar purchases in anticipation of a crash in the ringgit's value. High interest rates had devastating consequences for the real economy and its banking institutions, already overexposed to share and property lending.

The policy package is generally recognised as comprehensive and cleverly designed to limit foreign exchange outflows and ringgit speculation by non-residents as well as residents, while not adversely affecting foreign direct investors.¹ The measures were also effectively enforced by the central bank. In so far as the package was successful, this has often been attributed to Malaysian conditions, particularly the adequacy of its foreign exchange reserves, its lower exposure to foreign debt and strong economic fundamentals.

However, the impact of the package can only be assessed with respect to a Malaysian counterfactual, since the various countries differed in terms of their vulnerability to the crisis. The Malaysian recovery in 1999 was weaker than South Korea's but stronger than those of Thailand and, of course, Indonesia. The speed of turnaround in the Malaysian economy – from -10.6 percent in the second half of 1998 to -1.5 percent in the first quarter of 1999, and positive growth in all the following quarters – was undoubtedly impressive, but not really better than the other East Asian crisis economies, all of which registered positive growth from the first quarter of 1999.

However, it is likely that the reduction in interest rates helped contain the increase in NPLs in the banking system. Standard and Poor estimated that NPLs would have risen to 30 percent if interest rates had not fallen as sharply as they did. Also, the Federation of Malaysian Manufacturers (FMM) noted that the exchange rate peg and reduced interest rates lowered corporate uncertainty and made business planning easier (IMF 1999; Rajaraman 2001), but again, the comparison is with the previous period, rather than trends in the other crisis economies, where exchange rate volatility and interest rates also eased from the last quarter of 1998.

The benchmark for setting the ceiling on the base lending rate (BLR) of banks – previously the 3-month inter-bank rate² – was changed to the BNM intervention rate (with the same formula as before), to enhance BNM leverage over lending rates, with the permissible margin above the benchmark reduced (by 10 percent) from 2.5 to 2.25 percentage points. The cap on the maximum lending rate was also reduced for the first time since financial deregulation began from a spread of 4 percent above the BLR, to 2.5 percent (Rajaraman 2001: Table III.4). The average lending rate fell from 11.5 percent at the end of 1997 to 9.7 percent at the end of 1998, while the one-year real deposit rate fell from 6.6 percent to 0.4 percent over the same year. As inflation subsequently declined from the 1998 peak of 5.3 percent, real interest rates rose, though nominal rates remained low.

The September 1998 measures imposed a 12-month waiting period for repatriation of investment proceeds from the liquidation of external portfolio investments. To pre-empt a large-scale outflow at the end of the 12 month period in September 1999 and to try to attract new portfolio investments from abroad, a system of graduated exit levies was introduced from 15 February 1999, with different rules for capital already in the country

¹ The Statutory Reserve Ratio (SRR) was brought down abruptly from 13.5 percent – to which it had been raised in (1996-97 to contain liquidity as part of an initially orthodox response to downward pressure on the ringgit – to 4 percent from (1998 (Rajaraman 2001: Table III.6). As banks were not keen to lend to private sector customers after the crisis began, they bought the government bonds used to finance the Danaharta asset management agency (to restore bank liquidity by taking over NPLs) and the Danamodal bank re-capitalization agency.

² The benchmark was $0.8 \text{ (3-month inter bank rate)} / (1 - \text{SRR})$ (BNM (1999)).

and for capital brought in after that date. For capital already in the country, there was an exit tax inversely proportional to the duration of stay within the earlier stipulated period of 12 months. Capital that had entered the country before 15 February 1998 was free to leave without paying any exit tax. For new capital yet to come in, the levy would only be imposed on profits, defined to exclude dividends and interest, also graduated by length of stay. In effect, profits were being defined by the new rules as realised capital gains.

As a levy applicable only at the time of conversion of ringgit proceeds into foreign exchange, and hence not a capital gains tax, it could not be offset through double taxation agreements. The 10 percent levy on profits, even on funds invested for over 12 months, was seen as generally discouraging portfolio inflows, and even equity investments in particular, since interest and dividends were exempted. The higher levy of 30 percent on gains from investments of less than a year, attracted especially heavy criticism on the grounds that potential investors would apply the higher levy rate of 30 percent to all investments regardless of actual maturity periods because of the “last in, first out” rule (IMF 1999). On 21 September 1999, the higher levy was eliminated, leaving only a single rate of 10 percent on capital gains regardless of duration of investment, which eliminated the incentive to invest longer in Malaysia. The 10 percent levy on capital gains repatriated after investing in Malaysia for more than one year was removed from 1 January 2001.

Rajaraman (2001) has argued that ‘The very criticism directed at the new package helped identify what was good about it, and more importantly, underlined why it could prove of enduring worth in reducing volatility in capital flows. It is true that the levy reduced the expected rate of return on equity to foreign investors, and thus raised the required pre-levy rate of return needed relative to other markets. This was an intended effort to reduce casual entry into Malaysia, and to ensure that capital would enter only when the fundamentals justified the expectation of a higher pre-levy rate of return.’ However, her argument does not seem to recognise that the new arrangements would not serve as an effective deterrent to capital flight in the event of panic. With the levy only imposed on profits, investors will not be disinclined to withdraw their funds from Malaysia in the event of a stock market downturn or anticipation of one, which would then become a self-fulfilling prophecy.

Credit facilities for share as well as property purchases were actually increased as part of the package. The government has even encouraged its employees to take second mortgages for additional property purchases at its heavily discounted interest rate. Although otherwise appreciative of Malaysian measures, including the role of the central bank, Rajaraman (2001) notes that the property sector ‘continues to account for 40 percent of NPLs’, and that the controls introduced ‘in 1999 to prohibit lending for construction of high-end properties came five years too late to avert the financial sector softening that was a contributory, if not the precipitating, factor in the 1997 crisis. Controls on connected lending, now in place, again came five years too late.’ Ringgit credit facilities by residents to non-residents are also allowed for up to RM200,000, well below the earlier pre-1998 limit of RM5 million, though not to purchase immovable property in Malaysia.

The offshore ringgit market was wiped out by the September 1998 measures. The exchange controls, still in place, limit access to ringgit for non-residents, preventing the re-emergence of an offshore ringgit market. Free movement from ringgit to dollars for residents is possible, but dollars must be held in foreign exchange accounts in Malaysia, e.g. at the officially-approved foreign currency offshore banking centre on Labuan.

For effective control of the capital account, Rajaraman (2001) maintains that it is sufficient that the foreign exchange accounts are held by banking institutions under the central bank’s regulatory authority since export of dollars outside the country is not

otherwise allowed. Outward portfolio flows – whether from ‘corporates’ or resident individuals – require approval, which is rarely granted, though portfolio inflows are still being encouraged by the Malaysian authorities. By late 1999, international rating agencies had begun restoring Malaysia’s credit rating, e.g. the Malaysian market was re-inserted on the Morgan Stanley Capital International Indices in May 2000. But as in Chile, the barriers can be lowered over time without a formal change of regime.

Malaysia may need to adopt a more flexible exchange rate policy adaptable to its monetary policy requirements. The dollar peg has alternatively been estimated to have either overvalued or undervalued the ringgit, depending on the strength of the greenback. It was claimed that higher import prices with an undervalued ringgit had led to lower investments than would otherwise have been the case with a floating ringgit. However, the lower investment rate since 1998 has continued despite the weaker dollar – and ringgit – since 2001. In any case, there is little evidence that the ringgit will go off the dollar peg – or even be re-pegged – while Prime Minister Mahathir remains Finance Minister, presumably until October 2003, when he is due to retire from all government posts.

Did Malaysia’s 1998 Controls Succeed?

Malaysia’s bold measures of 1-2 September 1998 received very mixed receptions. There has been a tendency since for both sides in the debate over Malaysia’s capital control measures to exaggerate their own cases, with little regard for what actually happened. Initially, market fundamentalists loudly prophesied doom for Malaysia, and after Malaysia recovered more strongly than Thailand and Indonesia, only second to South Korea, the criticisms have shifted ground, always predicting that the economic chickens must inevitably come home to roost. Besides the chequered record of Malaysian recovery, there are clearly also complications of attributing causation. Both sides often forget that capital controls are often necessary means to other policy objectives, rather than ends in and of themselves.

Proponents of capital account liberalization generally opposed them as a setback to the growing capital account liberalization of the previous two decades. For them, the measures undermined freer capital movements and capital market efficiency – including net flows from the capital rich to the capital poor, cheaper funds, reduced volatility, lower inflation and higher growth – besides encouraging reversal of the larger trends towards greater economic liberalization and globalization. Doctrinaire neo-liberals also disagree with the IMF’s interventionism, albeit minimalist, while counter-cyclical interventionists condemned the IMF’s early pro-cyclicality. The Fund’s own policy stance has also changed over time, and has often been shown to be doctrinaire, poorly informed, and heavily politically influenced, especially by Western interests, led by the US.

Most – though not all – heterodox economists have endorsed the Malaysian challenge to contemporary orthodoxy for the converse reasons, emphasizing that financial – including capital account – liberalization has exacerbated financial system vulnerability and macroeconomic volatility. More importantly, they emphasize that such measures create the conditions for restoring the monetary policy autonomy, considered necessary for engendering economic recovery. Many intermediate positions have also emerged, e.g. the IMF’s then Deputy Managing Director Stanley Fischer endorsed Chilean-style controls on capital inflows, implying that the September 1998 Malaysian controls on outflows were far less acceptable, ostensibly because of their greater adverse consequences.

The Malaysian experience suggests that the orthodoxy’s predictions of disaster (e.g. by the late Nobel Laureate Merton Miller, among others) were simply not borne out by events. However, it is much more difficult to prove that the Malaysian controls were

the resounding success claimed by its proponents. After all, the regional currency turmoil came to an end throughout the region by the last quarter of 1998, probably thanks mainly to the US Fed's lowering of interest rates (strengthening East Asian currencies) after the regional crisis seemed to be spreading dangerously westward, with the August 1998 Russian crisis and its subsequent reverberations on Wall Street, including the collapse – and Fed-orchestrated bail-out – of Long-Term Capital Management (LTCM). However, proponents of reflationary measures generally agree that fiscal measures tend to be far more effective than monetary policies in this regard.

The actual efficacy of the Malaysian measures is difficult to assess. Supporters of the Malaysian measures emphasize that Malaysia recovered more strongly in 1999 (and 2000) than neighbouring Thailand and Indonesia, both which were subjected to onerous IMF programs. However, Malaysia's 6.3 per cent recovery in 1999 was more modest than the 10.7 per cent achieved in South Korea. It seems likely that the stronger recoveries in Malaysia and South Korea can be attributed to stronger fiscal reflationary efforts as well as increased electronics demand (probably in anticipation of the Y2K problem come the year 2000).

Since South Korea was also subject to an IMF program, one cannot attribute the different rates of recovery in 1999 to different monetary policy measures or IMF conditionalities at this stage. Before that, Thai interest rates – long well above Malaysian levels – fell below Malaysian rates after September 1998, after being well above the Malaysian rates for years (Jomo [ed.] 2001: 206, Figure 7.1). This suggests that the US Fed's lowering of interest rates did more to reduce interest rates in the East Asian region than the September 1998 Malaysian initiatives did. However, this is also consistent with the general observation that monetary policy is far less effective than fiscal measures in reflating the economy.

Malaysian Prime Minister Mahathir's September 1998 capital controls were correctly seen as a bold rejection of both market orthodoxy as well as IMF market-friendly neo-liberalism. Whereas Thailand, South Korea and Indonesia had gone cap in hand — humiliatingly accepting IMF imposed conditions — to secure desperately needed credit, the Malaysian initiative reminded the world that there are alternatives to capital account liberalization. For many, enthusiastic support for the Malaysian controls and claims of its success are crucial in the opposition to market fundamentalism as well as Fund neo-liberalism.

The capital control measures were significantly revised in February 1999. The modifications recognised some problematic consequences of the capital controls regime, and represented attempts to mitigate them. As of 1 September 1999, the September 1998 regime was fundamentally transformed with the end of the original curbs on capital outflows. There have since been no new curbs on inflows, but rather, strenuous efforts to encourage the return of capital inflows, including short-term capital.

Neo-liberal critics have claimed that the reduced inflows of foreign direct investment since 1996 have been due to the reduced credibility of the Malaysian authorities after its imposition of the September 1998 controls. However, there is considerable evidence of a decline of FDI throughout Southeast Asia, including those countries that did not close their capital accounts. The more plausible argument would be that the 1997-8 crises drew dramatic attention to Southeast Asia's declining competitiveness and attractiveness, compared to, say, China.

Meanwhile, many opponents of capital account liberalization have gone to the other extreme, with some wishful exaggeration about what the Malaysian measures actually implied and achieved. For example, one supporter has extolled the controls' ostensibly virtuous consequences for labour with scant regard for the Malaysian

authorities' self-confessed motive of saving big business interests, ostensibly in order to protect jobs for workers. The desirability of some measures is also in doubt as evidence mounts of favouritism or 'cronyism' in their implementation (Johnson & Mitton 2001) and the dubious contribution of 'rescued' interests to national economic recovery efforts (Tan 2002; Wong 2002).

So, did Malaysia's September 1998 selective capital control measures succeed? The merits and demerits of the Malaysian government's regime of capital controls to deal with the regional currency and financial crises will continue to be debated for a long time to come as the data does not lend itself to clearly supporting any particular position. Proponents can claim that the economic decline came to a stop soon after, and the stock market slide turned around, while opponents can say that such reversals have been more pronounced in the rest of the region.

Industrial output, especially for manufacturing, declined even faster after the introduction of capital controls in Malaysia until November 1998, and continued downward in January 1999 before turning around. Except for a few sectors (notably electronics), industrial output recovery has not been spectacular since then, except in comparison with the deep recession in the year before. Meanwhile, unemployment has risen, especially affecting those employed in construction and financial services. Domestic investment proposals were almost halved, while 'green field' FDI seems to have declined by much less, though cynics claim actual trends were obscured by faster processing of applications as well as subsequent reconsideration and approval of previously rejected applications (see Jomo [ed.] 2001: Figure 7.2).

As is generally recognised, the one-year lock-in of foreign funds in the country was too late to avert the crisis, or to lock in the bulk of foreign funds that had already fled the country. Instead, the funds 'trapped' were those that had not already left in the preceding 14 months, ironically and inadvertently 'punishing' those investors who had not already taken their funds out of Malaysia.

It appears that, at best, the capital controls' actual contribution to the strong recovery in 1999-2000 was ambiguous. At worst, it may have slowed down the recovery led by fiscal counter-cyclical measures and the extraordinary demand for electronics, thus explaining the weaker recovery in Malaysia compared to South Korea. In the longer term, some critics claim that it diminished the likely recovery of foreign direct investment – which compelled the authorities to seek more domestic sources of economic growth – though the evidence for this is ambiguous as the entire region has experienced diminished FDI post-crisis. More importantly, the regime remains untested in checking international currency volatility, as such instability abated throughout the region at around the same time, due to the US Fed's lowering of interest rates. Although recovery of the Malaysian share market, which had declined much more than other stock markets during the crisis, lagged behind the other (relatively smaller) markets in the region, not too much should be made of this.

Malaysia was fortunate in the timing of the imposition of capital controls if, indeed, as stated by Mahathir in his speech to the symposium on the first anniversary of the controls, it came about almost in desperation. At the time it was introduced, the external environment was about to change significantly, while the economy had seen the outflow of the bulk of short-term capital, so that in a very real sense, the regime was never tested. If the turmoil of the preceding months had continued until the end of 1998, or beyond, continued shifts and re-pegging would have been necessary, with consequent deleterious effects.

Clearly, the ringgit peg brought a welcome respite to businessmen after over a year of currency volatility. But, as noted earlier, exchange rate volatility across the region also effectively abated shortly thereafter, with the later Brazilian and other crises not renewing such volatility in the region. Moreover, it is ironic that an ostensibly nationalistic attempt to defend monetary independence against currency speculators should, in effect, hand over determination of the ringgit's value to the US Federal Reserve with the dollar peg.

If the US dollar had strengthened significantly against other currencies, Malaysia may have had to re-peg against the US dollar to retain export competitiveness. In the event, the greenback initially weakened due to the lowered US interest rates. After strengthening from 1999, it has weakened again since 2001, which has put much less pressure for re-pegging or de-pegging. For reasons which are not entirely clear, there does not seem to be any inclination for the Mahathir government to get off the peg, though it is unclear how long the peg will last after he retires in October 2003.

While interest rates were undoubtedly thus brought down by government decree in Malaysia, the desired effects were limited. Interest rates came down dramatically across the region, in some cases, even more than in Malaysia, without others having to resort to capital controls. For example, while interest rates in Thailand were much higher than in Malaysia for over a year after the crisis began, they declined below Malaysian levels during September 1998 (see Jomo [ed.] 2001: Figure 7.1).

Perhaps more importantly, loan and money supply growth rates actually declined in the first few months after the new measures were introduced despite central bank threats to sack bank managers who failed to achieve the 8 percent loan growth target rate for 1998. It has become clear that credit expansion has been a consequence of factors other than capital controls or even low interest rates. Across the region, especially in South Korea and Thailand, counter-cyclical spending also grew, again without resorting to capital controls.

The Malaysian authorities' mid-February 1999 measures effectively abandoned the main capital control measure introduced in September 1998, i.e. the one-year lock-in. While foreign investors were prohibited from withdrawing funds from Malaysia before September 1999, they were allowed to withdraw from mid-February 1999 after paying a scaled exit tax (pay less for keeping longer in Malaysia), in the hope that this would reduce the rush for the gates come September 1999. Meanwhile, in an attempt to attract new capital inflows, new investors would only be liable for a less onerous tax on capital gains.

As noted earlier, it is unlikely that the capital gains tax effective from February 1999 will actually deter exit in the event of panic as investors rush to get out to cut their losses. At best, however, it served to discourage some kinds of short-selling from abroad owing to the much higher capital gains tax rate on withdrawals within less than a year of 30 percent, as opposed to 10 percent. The differential capital gains exit tax rate may have discouraged some short-selling from abroad, but did little to address other possible sources of vulnerability and, as emphasized above, would not have deterred capital flight in the event of financial panic. In September 1999, the capital gains exit tax rate was set a uniform 10 percent, thus eliminating the only feature of the February 1999 revised controls that might have deterred short-selling from abroad.

Effectively, Malaysia remains virtually defenceless in terms of new control measures in the event of a sudden exodus of portfolio capital in future. Admittedly, however, this is not the most urgent problem for the time being, in light of the limited international interest in Malaysia's capital market. In mid-1994, as the rising stock market renewed foreign portfolio investors' interest in the Malaysian market, those who stood to

gain from a stock market bubble successfully lobbied for the early 1994 controls on portfolio capital inflows to be abandoned. This reversal later rendered Malaysia vulnerable to the flight of portfolio capital of 1997-98, reflected in the stock market collapse by about four-fifths.

By setting the peg at RM3.8 to the US dollar on 2 September 1998, after it had been trading in the range of RM4 – 4.2 per US dollar, the Malaysian authorities were then seeking to raise the value of the ringgit. In mid-September 1998, however, the other currencies in the region strengthened after the US Federal Reserve Bank lowered interest rates in the aftermath of the Russian and LTCM crises, strengthening the yen and other regional currencies. Thus, the ringgit became undervalued for about a year thereafter, which – by chance rather than by design – boosted Malaysian foreign exchange reserves from the trade surplus, largely due to import compression, as well as some exchange rate-sensitive exports. Malaysia's foreign exchange reserves depleted rapidly from July until November 1997, before improving in December, and then, especially after the imposition of capital controls in September 1998 (Jomo [ed.] 2001: Figure 5.10). Thus, the ringgit under-valuation may have helped Malaysian economic recovery, but certainly not in the way the authorities intended when pegging the ringgit in September 1998.

While the undervalued ringgit may have favoured an export-led recovery strategy in 1998-99 and since 2001, this certainly was not the intent. (Then, as now, government efforts have been focussed on a domestic-led recovery strategy.) The under-valued ringgit is said to have had a (unintended) 'beggar-thy-neighbour' effect. Due to trade competition, the under-valued ringgit is said to have discouraged other regional currencies from strengthening earlier for fear of becoming relatively uncompetitive with regards to Malaysian production costs and exports, though the evidence for this claim remains unclear. There were also fears that the weak Southeast Asian currencies might cause China's authorities to devalue the *renminbi*, which could have had the undesirable effect of triggering off another round of 'competitive devaluations', with concomitant dangers for all.

The low volume of actual capital outflows since the end of the lock-in on 1 September 1999 has been interpreted in different ways. One view was that since the stock market had recovered and could be expected to continue to rise, there was little reason to flee. A second view emphasized the role of the nominal exchange rate, which has been fixed against the US dollar at RM3.8. With the greenback perceived to be still strengthening then, there was little exchange rate risk to discourage investors from holding ringgit. A third perspective suggested that the capital controls were probably unnecessary, having been introduced 14 months after the crisis began, i.e. after most of the capital flight had already taken place.

Taking the Rajaraman (2001) argument further, Kaplan and Rodrik (2001) have argued that the controls averted another crisis that had yet to hit Malaysia. They note that the offshore overnight ringgit market (principally in Singapore) interest rates had remained at high levels (around 40 percent) for some months, putting tremendous upward pressure on domestic interest rates. A leading Malaysian neo-liberal economist, Thillainathan has disputed this assertion, claiming a very thin, and mainly speculative offshore market despite the huge amount of ringgit held abroad (reputedly RM25–30 billion). The significance of these conflicting claims can ultimately only be settled empirically.³

³ After being persuaded by Thillainathan initially, I am now more sympathetic to Kaplan and Rodrik after Thillainathan's failure to offer supporting evidence.

Conclusions and Policy Lessons

What lessons can be drawn from Malaysia's 1998 capital controls? Most importantly, the preceding examination of the circumstances preceding the introduction of the controls as well as the specific nature of the controls and their apparent consequences suggest caution in making gross generalizations. Instead, the experience urges greater attention to context and detail.

Capital controls did not cause the recovery in Malaysia to be slower than in the other crisis countries. The 1998 collapse was less deep in Malaysia than in Thailand and Indonesia, while the recovery in Malaysia has been faster after early 1999. Of course, the pre-crisis problems in Malaysia were less serious to begin with owing to strengthened prudential regulations after the late 1980s' banking crisis (when non-performing loans went up to 30 per cent of total loans). There were strict controls on Malaysian private borrowing from abroad with borrowers generally required to demonstrate likely foreign exchange earnings from the proposed investments to be financed with foreign credit. Hence, although Malaysia seemingly has the most open economy in the region after Hong Kong and Singapore, with the total value of its international trade around double annual national income, its foreign borrowings and share of short-term loans in total credit were far less than the more closed economies of South Korea, Indonesia and Thailand.

The coincidentally simultaneous timing of Paul Krugman's *Fortune* article advocating capital controls reinforced the impression that the measures were primarily intended to provide monetary policy independence to reflate the economy. However, as noted earlier, foreign developments from August 1998 also created new international monetary conditions that facilitated the adoption of reflationary policies in the rest of the region. Though Malaysia missed out on most of the renewed capital flows to the region from the last quarter of 1998, it is not clear that such easily reversible capital inflows are all that desirable. The more serious problem has been the future credibility of government policies, which many critics claim has adversely affected foreign direct investment into the country (despite official protestations to the contrary) as well as risk premiums for Malaysian bonds.

It is clear that while the Malaysian authorities had long claimed full capital account liberalization, there were in fact quite a number of important constraints preceding the 1994 and 1998 regulations. This suggests that while a country may declare having an open capital account, it is possible to have enabling legislation and administrative regulations that will qualify such openness in important ways that may well serve macroeconomic management and developmental governance. Such options may well be the most relevant options for most developing economies today when there is a great deal of pressure to maintain open capital accounts (Epstein, Grabel and Jomo 2003).

Only a few large countries enjoying greater degrees of policy autonomy for various historical and political reasons – such as China and India – are able to effectively withstand such pressures. In any case, many of the old measures for managing closed capital accounts may no longer be effective, appropriate or desirable in contemporary circumstances. This does not mean that countries should surrender whatever remaining sovereignty they may enjoy and instead opt for opening capital accounts, but rather that far more attention should be given to substance over form, to actual capabilities rather than formalities, etc.

This seems especially crucial since the IMF Interim Committee has already agreed to amending its Articles of Agreement to extend jurisdiction from the current account to the capital account. Many modern capital account management tools qualify capital account openness, rather than close capital accounts altogether. This is especially true of

so-called 'market-friendly' instruments, although it is important not to insist on 'market-friendliness', especially since counter-cyclical instruments are often especially needed to ensure macroeconomic prudence, which is usually the best way to conceptualise and legitimise such measures.

This suggests that the Malaysian authorities were right to limit exposure to foreign bank borrowings while their neighbours in East Asia allowed, facilitated and even encouraged such capital inflows from the late 1980s. It is also important to stress that the vulnerability of the other East Asian economies to such borrowings was not merely due to the greed of financial interests for arbitrage and other related opportunities, or of corporate interests seeking cheaper and easier credit. BIS regulations greatly encouraged short-term lending and even European and Japanese banks generally preferred dollar-denominated lending over other alternatives. In other words, criticism of 'bad lending' to East Asia before the crisis should not only focus on the borrowers and domestic regulations, but also on the lenders and the rules regulating international lending.

The Malaysian experience also rejects the claim that the East Asian crisis was due to foreign bank borrowings, which could have been avoided by greater reliance on the capital market, especially stock markets. While capital flows to stock markets undoubtedly have different implications than foreign bank lending, such portfolio capital flows are even more easily reversible than short-term foreign loans, contrary to the claims by their advocates. Malaysian bank vulnerability during the crisis was not so much due to foreign borrowings, but instead to their extensive lending for stock market investments and property purchases, as well as their reliance on shares and real assets for loan collateral.

While there is no evidence that portfolio capital inflows significantly contributed to productive investments or economic growth, the reversal of such flows proved to be disruptive, exacerbating volatility. Their impact has been largely due to the 'wealth effect' and its consequences for consumption and, eventually, investment. When these reversals were large and sustained, they contributed to significant disruption, if not disaster. The disruptive effect has been exacerbated by the fact that portfolio capital inflows tend to build up slowly, while outflows tend to be larger and sudden.

Such outflows from late 1993 resulted in a massive collapse of the Malaysian capital market and the introduction of controls on inflows to discourage yet another build-up of such potentially disruptive inflows. However, these were withdrawn after half a year after successful lobbying by those interests desiring yet another foreign portfolio capital-induced stock market bubble. It is likely that if the early 1994 controls had not been withdrawn, the massive build-up in 1995-96 would not have occurred and Malaysia would consequently have been far less vulnerable to the sudden and massive capital flight in the year from July 1997.

Kaplan and Rodrik (2001) argue that the September 1998 controls sought to avert yet another crisis in the making. They suggest that the Singapore-centred overseas ringgit market was putting increasingly unbearable pressure on the Malaysian monetary authorities, reflected in the very high overnight interest rate for ringgit in Singapore. The September 1998 currency control measures clearly sought to and succeeded in defusing this pressure. While this analysis has been disputed by those who claim the market was too thin to be as significant as suggested by Kaplan and Rodrik, the debate is unlikely to be settled without reference to details of the actual situation. However, their analysis points to the desirability of not allowing national currency reserves to build up abroad. In East Asia, Japan and Singapore have long resisted such internationalization of their currencies.

After over a year of considerable international monetary instability, the East Asian crisis was said to be spreading with the Russian crisis in August 1998. This, in turn, contributed to the collapse of Long-Term Capital Management (LTCM). In deciding at the end of August 1998, it was very understandable that the Malaysian authorities chose to try to stem further haemorrhage by adopting capital and currency controls. It was not possible for them to predict that US Fed would finally respond to the East Asian crisis after over a year of blaming its main victims as well as poor corporate governance in the region, supposedly rooted in 'Asian values' and manifested in cronyism and other 'bad' business practices.

However, in September 1998, it became clear that the US Federal Reserve had coordinated a private sector bailout for LTCM. Soon, it also reduced US interest rates, which stemmed, if not reversed capital outflows from East Asia, allowing East Asian currencies to rise and stabilise significantly in the last quarter of 1998. In some important regards, the suddenly improved regional fortunes rendered the Malaysian controls unnecessary, if not irrelevant, but this, of course, could not have been foreseen when the decision to adopt the measures was being made late in the previous month.

Thailand, Indonesia and South Korea had received IMF emergency credit and had been initially subject to contractionary policy conditionalities, which exacerbated the regional recessions. While insisting on strict monetary policies despite their earlier deflationary impact, the Fund seemed more willing to abandon its earlier insistence on 'fiscal discipline', perhaps after belatedly recognizing that most of the East Asian crisis economies (except Indonesia) had been running budgetary surpluses for years. Thus, by late 1998, the IMF had also been forced to lift its curbs on counter-cyclical (reflationary) fiscal policies by allowing budgetary deficits.

Malaysia's recession continued over the next two quarters, through the last quarter of 1998 and the first quarter of 1999, in effect lagging behind the hesitant recoveries of the three economies under IMF tutelage, including Indonesia, in the first quarter of 1999. However, by the end of 1999, it was clear that the Malaysian recovery was stronger than its Southeast Asian neighbours, only lagging behind Korea. But so many things were going on that it is impossible to attribute the Malaysian difference, for better or worse, to the September 1998 measures alone, although this has not prevented proponents and opponents from doing so, as it suits them.

For instance, the IMF had been forced to revise its policy advice and allowed fiscal reflationary efforts with budgetary deficits from mid-1998 in the East Asian economies under its tutelage. Ironically, of the four economies, only Malaysia had maintained a (small) budget surplus in 1997 although it was not under any IMF program. It is quite possible that the V-shaped economic recoveries achieved by the major crisis-hit economies of East Asia were due to these fiscal reflationary efforts despite the IMF's own predictions of protracted slowdowns and eventual U-shaped recoveries. It is difficult to assess and compare the effects of such fiscal measures. Besides the size of the fiscal deficits, it is also important to consider other relevant factors such as the nature of the fiscal packages and the strength of domestic economic linkages and multiplier effects.

As is well known, the control measures were only part of a package of measures to revive the Malaysian economy. Focussing solely on the control measures ignores the significance of the other measures. It is logically possible for the effects of successful controls to have been wiped out by the failure of accompanying programs, or vice versa. The IMF imposed different policy packages on the other East Asian economies that sought emergency credit facilities from the Fund. And to varying extents, the different national authorities were able to differentially implement and enforce the packages as well as other policies not specified in the packages. It is important for other developing

country governments to recognise that the packages and their actual implementation were often the outcomes of hard-fought battles, in which different fiscal capacities, negotiating and implementation capabilities as well as national experiences all had bearings on the outcomes.

Very importantly, the conceptualization, financing, governance and implementation of national asset management corporations involved in bank and corporate debt restructuring were especially crucial in shaping the nature, speed and strength of national economic recovery as well as corporate capacities and capabilities. Also, it is likely that climatic and other environmental factors – such as ‘El Nino’, ‘La Nina’ as well as large and protracted forest fires -- had greater effects on agricultural output than the financial crisis itself.

The forced mergers in the wake of the crisis have been poorly conceived, if not downright biased, and less likely to achieve their ostensible ends. The authorities’ push for the rapid merger of banks and financial companies do not seem well designed to enhance efficiency and competitiveness beyond achieving economies of scale and reducing some wasteful duplication and redundancy. While the consolidation of the financial sector may be desirable to achieve economies and other advantages of scale in anticipation of further financial liberalization, the acceleration of its pace in response to the crisis seemed less well conceived except to take advantage of the financial institutions’ weakness and vulnerability during the crisis.

The efficacy of the Malaysian controls was also due to their effective design. Many market-based sceptics did not consider the Malaysian authorities capable of designing and implementing such controls, but now concede that they were proven wrong. They seemingly addressed the immediate problem identified by Kaplan and Rodrik (2001), and aspects were subsequently revised from early 1999 as the authorities reviewed their assessment of the situation and sought to demonstrate their commitment to market and investor friendliness. Most importantly, they emphasised from the outside that the measures were directed at currency speculation, and not FDI. Although FDI to Malaysia has declined since 1996, this has been true globally since the last 1990s, and of the Southeast Asian region as a whole (including Singapore), with China and a few others being the only exceptions.

Johnson and Mitton (2001; 2003) have argued that the Malaysian capital controls provided a ‘screen behind which favored firms could be supported’. If this claim is true, the analysis of how such firms were supported would have to shift to the other measures introduced in order to provide such support since the controls only provided a protective screen in this view. However, the Johnson and Mitton evidence point to a significantly greater appreciation of the prices of shares associated with the surviving political leadership in the month right after the introduction of controls, i.e. before such other support could have been provided except in a small minority of cases. Hence, an alternative interpretation more consistent with their evidence is that investors expected the September 1998 measures to principally benefit crony companies, causing their share prices to appreciate much more than others.

There are ongoing debates as to whether the continued retention of the September 1998 controls, albeit in modified forms, are in Malaysia’s best interests. The capital controls per se ended in September 1999 with a whimper, while the surviving currency controls have a different rationale, explained by Mahathir in terms of the desirability of a fixed exchange rate. In fact, for some time now, the Malaysian authorities have been trying to revive the very same portfolio investment inflows which ended in capital flight from late 1993 and again, from mid-1997. There have not been any efforts to re-introduce the controls on inflows introduced in early 1994 and withdrawn half a year later, or any

similar measures. Rather, the regime pointed gleefully to the Kuala Lumpur Stock Exchange (KLSE) Composite Index (KLCI) recovery after September 1998. Key economic policies seem to be primarily concerned with seeking to bolster the stock market, which many blame for the EPF's loss of over RM10 billion in 1998.

For many critics, the undervalued pegged ringgit has also had negative implications for a broad recovery, which depends upon imported inputs. It is not clear that the peg has really given a major boost to exports. There are costs to maintaining an undervalued ringgit, especially in the context of an economic upturn of what is still a very open economy. An undervalued ringgit may help some exports in the short term, but it also makes imports of capital and intermediate goods more expensive, thus impeding recovery and capacity expansion in the medium term. Malaysia's trade surplus has declined as the import compression due to the undervalued ringgit declined. Together with an apparently stubborn negative services balance, this has meant a reduced current account surplus with the economic upturn.

While there is a need to continue to press ahead for international financial reform as well as for new regional monetary arrangements in the absence of adequate global reform, there seems to be little to be gained by retaining the present regime of currency controls. It may even be argued that their retention provides a false sense of security as it was designed to deal with problems which are no longer around and unlikely to recur in their previous form. Instead, if the regime succeeds in attracting short-term portfolio capital, as various subsequent amendments to the regime have sought to do, it would be largely ineffective in the event of another currency and financial panic. The remaining 1998 controls on outflows can be dismantled while introducing an adequate and effective regulatory framework to reduce financial vulnerability and to moderate capital flow surges into and out of the country. Malaysia should not be completely defenceless against another round of speculative attacks. While Malaysia can afford to return to ringgit convertibility, this should be phased in with effective measures to ensure the non-internationalization of the ringgit to reduce vulnerability to external currency speculation. This can include measures such as not permitting offshore ringgit accounts as well as non-resident borrowing of ringgit.

Clearly, the Malaysian controls did not lead to the unmitigated disaster promised by its most strident critics. On the contrary, there is little evidence of any serious harm to the Malaysian economy that can be attributed to the introduction of the controls. However, this is different from asserting that the controls have had no adverse impacts whatsoever. It is difficult to prove that the continued existence of the controls have had absolutely no negative effects on desired long-term foreign direct investments, though of course, reduced FDI since 1996 cannot be attributed to the September 1998 measures. The Malaysian authorities have attributed the FDI decline since 1996 to misunderstandings and misperceptions, and have had to spend inordinate energy and resources trying to correct these 'misimpressions'.

Confidence in the Malaysian government's policy consistency and credibility was seriously undermined by the apparent reversal of policy, as were years of successful investment promotion efforts. The controls regime has thus been seen as counter-productive in terms of the overall consistency of government policy and may have had some adverse medium-term, indeed long-term, consequences. The problem may have been exacerbated by the Prime Minister's declared intention to retain the regime until the international financial system is reformed. Hence, the government phased out the September 1998 and subsequent capital and currency control measures in light of their ambiguous contribution to economic recovery and the adverse consequences of retaining the measures. This has not been helped by unnecessarily hostile and sometimes ill-

informed official rhetoric, though the Mahathir administration has since sometimes sought to ‘improve’ change its international image, especially since the events of September 11, 2001.

Since the desired reforms to the international financial architecture are unlikely to materialise in the foreseeable future, the Malaysian government should institute a permanent, but flexible, market-based regime of prudential controls to moderate capital inflows and deter speculative surges, both domestic and foreign, to avert future crises. This would include a managed float of the currency with convertibility, but no internationalization, meaning, minimally, no offshore ringgit accounts and limits on offshore foreign exchange accounts, and limits on foreign borrowings.

There is clearly also an urgent need for some degree of monetary co-operation in the region. It is now clear that currency and financial crises have a primarily regional character. Hence, regional co-operation is a necessary first step towards the establishment of an East Asian monetary facility. Only responsible Malaysian relations with its neighbours will contribute to realising such regional co-operation.

The window of opportunity offered by the capital controls regime has been abused by certain powerfully-connected business interests, not only to secure publicly funded bail-outs at public expense, but even to consolidate and extend their corporate domination, especially in the crucial financial sector. Capital controls have been part of a package focussed on saving friends of the regime, usually at the public expense. For example, while ostensibly not involving public funds, the government-sponsored ‘restructuring’ of the ruling party-linked Renong conglomerate will cost the government, and hence the public, billions of ringgit in foregone toll and tax revenue. Also, non-performing loans (NPLs) of the thrice-bankrupted Bank Bumiputera — taken over by politically well-connected banking interests — have not been heavily discounted like other banks’ NPLs, although it has long abandoned its ostensible ‘social agenda’ of helping the politically dominant Bumiputera community.

Other elements in the Malaysian government’s economic strategy since then reinforce the impression that the capital control measures were probably motivated by political considerations as well as the desire to protect politically well-connected businesses. For example, the Malaysian ringgit’s exchange rate was pegged against the US dollar in the afternoon of 2 September 1998, hours before Deputy Prime Minister and Finance Minister Anwar Ibrahim was sacked, probably to pre-empt currency volatility and speculation after the firing. Malaysia’s 1998 experiment with capital controls has thus been seen as compromised by political bias, vested interests and inappropriate policy instruments. However, it would be a serious mistake to reject the desirability of capital controls on account of the flawed Malaysian experience.

Capital controls on outflows and other such efforts to prop up a currency already under attack may be ineffective and may actually unwittingly subsidise further speculative actions. Instead, measures to insulate the domestic banking system from short-term volatility through regulatory measures and capital controls on easily reversible short-term inflows as well as stricter prudential regulation and supervision may be far more effective and sustainable. International co-operation and co-ordination have often not only provided the best responses during crisis episodes, but have also been important for effective prudential and regulatory initiatives as well as to reduce ‘policy arbitrage’.

Addendum 1: Capital Controls

There are many different types of capital control measures, with different consequences, often varying with circumstances as much as the nature of the instruments. Until capital account liberalization from the eighties, most countries retained some such controls

despite significant current account liberalization in the post-war period. Most such measures can only be understood historically, in terms of their original purposes, and there are no ready-made packages available for interested governments.

Economists favouring capital account liberalization have made three main arguments in favour of such a policy. It is argued that capital will tend to flow from capital-rich to capital-poor economies, or between economies with different savings rates, investment opportunities, risk profiles or even demographic patterns. Capital flows thus enable national economies to trade imports in the present for imports in the future, i.e. to engage in inter-temporal trade. Capital flows also allow national economies to offset pressures to reduce imports by borrowing from abroad or by selling assets to foreigners. Such imports and borrowings may be used to enhance national economic output capacity, i.e. a country's ability to increase production in the future. The foregoing arguments are similar to those for international trade liberalization. Foreign direct investment is also expected to involve technology transfer, which should enhance industrial capabilities. Restrictions on capital flows are considered undesirable by advocates of capital account liberalization because they prevent capital from being utilised where it is most demanded.

On the other hand, advocates of capital controls emphasise the adverse effects of free capital flows on national economic policy-making and implementation, or worse still, by undermining economic stability. Any policy intended to restrict or redirect capital account transactions can be considered a capital control. These would include taxes, price or quantity controls, including bans on trade in certain kinds of assets. Hence, there are many different kinds of capital controls, which may be introduced for various reasons. The effects of specific controls may change over time and could become quite different from what may have been intended. The major reasons advanced for the introduction of capital controls have included the following:

1. Achieve greater leeway for monetary policy, e.g. to reflate the economy.
2. Enhance macroeconomic stability by limiting potentially volatile capital inflows.
3. Secure exchange rate stability, e. g. protect a fixed exchange rate or peg.
4. Correct international payments imbalances, both deficits and surpluses.
5. Avoid inflation due to excessive inflows.
6. Avoid real currency appreciation due to monetary expansion.
7. Reduce financial instability by changing the composition of -- or limiting -- capital inflows.
8. Restrict foreign ownership of domestic assets, which might cause nationalistic resentment.
9. Ensure the domestic utilization of national savings by restricting outflows.
10. Enable governments to allocate credit domestically without risking capital flight.
11. Enable domestic financial houses to attain scale economies in order to better compete internationally.
12. Facilitate revenue generation, particularly taxation of wealth and interest income; by allowing higher inflation, more revenue can be generated.

Capital controls may well be the most acceptable alternative to the destabilising effects of capital flows on inadequately regulated financial systems characteristic of developing economies. Effective regulation may be compromised by limited capabilities

and experience, fewer personnel and other resources as well as politically or otherwise compromised regulatory capacity. When a country with a fixed exchange rate experiences a net capital outflow, it can either raise interest rates or devalue. But with a sudden large capital outflow, usually associated with easily reversible capital inflows, either option is likely to exert strong recessionary pressures due to higher interest rates or further capital flight. Monetary contraction may not only dampen economic activity with higher interest rates, but may also adversely affect the economy through the (invariably government-guaranteed) banking system, which may be exposed to foreign borrowings (Kaminsky & Reinhart 1999).

Capital controls may be used to limit capital flow volatility to achieve greater economic stability by checking outflows in the event of crisis or influencing the volume or composition of inflows. Sudden massive capital outflows -- usually attributable to herd behaviour -- are more likely to occur in developing countries for various reasons. The greater likelihood of asset price changes to cause further changes in the same direction increases the likelihood of greater volatility as well as boom-bust cycles. Discouraging capital inflows would reduce the quantity of capital that might take flight at short notice. But changing the composition of capital inflows -- e.g. to favour foreign direct investments as opposed to more liquid portfolio investments -- may well better reduce such instability.

Different types of capital controls may be distinguished by the types of asset transactions they affect as well as by the very nature of the control measure itself, e.g. tax, limit, or ban. Capital controls are not identical with exchange controls though the two are often closely related in practice. Exchange controls mainly involve monetary assets (currency and bank deposits), and may be used to control the current account of the balance of payments rather than the capital account. While exchange controls function as 'a type of limited capital control, they are neither necessary to restrict capital movement nor are they necessarily intended to control capital account transactions' (Neely 1999: 21-2). Some of the major differences among the types of capital controls involve:

1. *Taxes versus quantitative controls*: Taxes rely on price or market mechanisms to deter certain types of flows. Such taxes may be on certain types of transactions or returns to foreign investment, or may even involve mandatory reserve requirements, which raise the cost of the flows concerned. Quantitative controls may involve quotas, authorization requirements or even outright bans.

2. *Controls on inflows as opposed to outflows*: Limits on inflows may allow for higher interest rates, to check money supply and inflation. Checks on outflows allow lower interest rates and greater money supply than would otherwise be possible, and have often been used to postpone hard choices between devaluation and tighter monetary policy, as with Malaysia's September 1998 controls.

3. *Controls on different types of inflows, especially in terms of expected duration*: Governments may seek to encourage long-term inflows (e.g. foreign direct investment) while discouraging short-term (e.g. bank loans or money market instruments) or easily reversible (portfolio investments) inflows.

It is important to establish at the outset what particular controls seek to achieve. With the benefit of hindsight, it is crucial to determine to what extent the measures

actually achieve their declared objectives as well as their other consequences, intended or otherwise. For instance, it is important to know whether specific controls are meant to avert crisis or to assist recovery. In its 1998 *Trade and Development Report*, the United Nations Conference on Trade and Development (UNCTAD) recommended capital controls as means to avoid financial crises. Almost as if endorsing the Malaysian measures, MIT Professor Paul Krugman recommended capital controls in his *Fortune* magazine column in early September 1998 to create a window of opportunity to facilitate economic recovery — which is a different objective, though some of the mechanisms or processes involved may not be altogether different.

Addendum 2: Malaysia's 1994 Temporary Controls on Inflows

The September 1998 capital controls were not completely unprecedented. In fact, temporary capital controls had been introduced in early 1994 after an earlier experience of massive capital flight with the sudden reversal of massive net portfolio capital inflows in 1992-3. The 1994 measures sought to deter capital inflows by taxing them, unlike the 1998 measures that restricted capital outflows. If they had not been withdrawn so soon, it is quite likely that the magnitude of capital flight from mid-1997 would have been much less, and the 1997-98 crisis would have been less catastrophic.

The controls -- introduced after the sudden collapse of the Malaysian stock market in early 1994 -- were soon withdrawn after about half a year, without introducing a more permanent regime of market-based controls that could be flexibly adjusted in response to policy priorities and concerns. The central bank saw the problem as one of excess liquidity due to the massive inflow of short-term funds from abroad due to higher interest rates in Malaysia, the buoyant stock market and expectations of ringgit appreciation. Several monetary measures were introduced during early 1994, which were gradually phased out during the course of the year. The following measures sought to manage excess liquidity, especially to contain speculative inflows, restore stability in financial markets and control inflationary measures; for a fuller account, see BNM's 1994 *Annual Report* (especially the Foreword, Boxes A to J and pp. 42-44):

- The eligible liabilities base for computing statutory reserve and liquidity requirements was redefined to include all funds inflows from abroad, thus raising the cost of foreign funds compared to domestic funds.
- Limits on non trade-related external liabilities of banking institutions were introduced; net external liabilities of the banking system declined from a peak of RM35.4 billion in early January 1994 to RM10.3 billion at the end of 1994.
- Sale of short-term monetary instruments was limited only to Malaysian residents to prevent foreigners from using such investments as substitutes for placements of deposits (this measure was lifted on 12 August 1994).
- Commercial banks were required to place ringgit funds of foreign banks in non-interest bearing vostro accounts.
- Commercial banks were not permitted to undertake non-trade-related swaps (including overnight swaps) and outright forward transactions on the bid side with foreign customers to prevent offshore parties from establishing speculative long forward

ringgit positions while the ringgit was perceived to be undervalued (this measure was lifted from 16 August 1994).

- The statutory reserve requirements of all financial institutions were raised thrice during 1994 — by one percentage point each time — to absorb excess liquidity on a more permanent basis, absorbing an estimated RM4.8 billion from the banking system.

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