Global Governance 12 (2006), 489–505

Pathways Through Financial Crisis: Malaysia

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Malaysia did not turn to the International Monetary Fund for assistance when pressure from the 1997–1998 East Asian financial crisis hit the country. The country was less vulnerable than its neighbors, not least because it had earlier imposed limits on foreign borrowing and prudential regulations and supervision of the banking sector. Although Malaysia's pathway through the 1997–1998 crisis included an orthodox adjustment program of the type the IMF would have required, this program was soon reversed in favor of reflationary monetary policies and the imposition of a short-term capital control regime. These responses took place against a backdrop of political intrigue and drama, but they reflected an underlying pragmatism and recent history of using capital controls and of not turning to the IMF.
KEYWORDS: Malaysia, Anwar Mahathir, capital controls, currency and financial crisis, Asian crisis.

The 1997–1998 East Asian crisis, triggered by the collapse of the Thai baht in July 1997, led to a currency crisis, a financial crisis, and then economic recession in most countries of the region. However, the Malaysian economy and population were not as adversely affected as their counterparts in Thailand, South Korea, and Indonesia. While the precrisis level of indebtedness in Malaysia was very high, the level of foreign exposure was much lower—as a share of gross domestic product (GDP) and, especially, as a share of the open economy's extraordinarily high export earnings. Unlike in other countries in the region, Malaysia's level of foreign liabilities did not exceed its foreign exchange reserves, so the country was not in need of emergency credit facilities, including from the International Monetary Fund (IMF). After the severe banking crisis of the late 1980s, Malaysian prudential regulation had been improved and had not been as badly undermined by liberalization pressures as in the other three economies. In brief, Malaysia was the one country involved in the East Asian crisis that did not involve the IMF.

In this article, I examine the political economy of the Malaysian crisis of 1997–1998.[1] I explain why Malaysia was less vulnerable to crisis than its neighbors—not least because a severe banking crisis in the late 1980s and reforms undertaken in its aftermath had led to preemptive reform,

which limited foreign borrowing and ensured greater banking prudence. Nevertheless, in the 1990s, Malaysia was vulnerable to contagion because the authorities had encouraged massive, easily reversible portfolio investments, especially in its stock market. However, its vulnerability was mitigated by the use of capital controls applied in September 1998.

I also argue that Malaysian economic policy during the crisis went through four distinct phases: an early phase of "defensive" policies, led by the prime minister, Mahathir Mohamad; economic orthodoxy, led by then finance minister Anwar Ibrahim; reflationary fiscal policies, also led by Anwar; and, finally, reflationary monetary policies, with a capital control regime imposed by Mahathir. While these policy shifts have been portrayed as the result of an ideological struggle between a nationalist prime minister and his more market-oriented finance minister, I argue that the ideological differences between the two men have been overstated. Rather than given to ideological extremism, Malaysian crisis management was underpinned by considerable pragmatism and flexibility, which allowed for a speedy recovery. The high-profile clashes between Mahathir and Anwar had more to do with the former's fears of a palace coup by the latter than with fundamental disagreements about how to handle the financial crisis.

The Crisis

After the value of the Thai baht collapsed in mid-1997, currency speculators turned their sights on other economies in the region perceived to have maintained similarly unsustainable US dollar quasi-pegs for their currencies. The Malaysian ringgit (RM) had oscillated around RM2.5 against the US dollar during the first half of 1997,[2] with some arguing that it was slightly overvalued.[3] After the Thai baht was floated on 2 July 1997, the ringgit, like other currencies in the region, came under strong pressure, especially because Malaysia, like Thailand, had maintained large current account deficits during the early and mid-1990s. The monetary authorities' efforts to defend the ringgit actually strengthened it against the greenback for a few days before the futile ringgit defense effort was abandoned by mid-July, having allegedly cost some RM9 billion (then over US$3.5 billion). The ringgit was then floated, following the Thai baht, Indonesian rupiah, and Filipino peso, and fell to its lowest level ever by January 1998—to almost half the value it had held against the US dollar in mid-July 1997.

Devaluation lowered the foreign exchange value of Malaysian assets, including share prices. The stock market fell severely, with the main Kuala Lumpur Stock Exchange (KLSE) Composite Index (KLCI) dropping from over 1,300 in the first quarter of 1997 to less than 500 in January 1998, then to around 300 in August 1998 and to 262 on 2 September 1998, after

the initial announcement of the capital control measures the day before. The stock market collapse, in turn, triggered a vicious cycle of asset price deflation involving the flight of foreign as well as domestic portfolio capital. Lower asset prices also caused lending institutions to make margin calls, requiring additional collateral. Foreign lenders became more reluctant to roll over their short-term loans. Interest rates also increased, for a variety of reasons, exacerbating the effects of reduced liquidity.

Like the currencies of other crisis-hit economies, the ringgit fluctuated wildly until mid-1998, weeks before it was fixed at RM3.8 against the US dollar on 2 September 1998. Much of the downward pressure on the ringgit was induced by regional developments as well as by adverse perceptions of the regional situation. Ill-advised political rhetoric and policy measures by the political leadership exacerbated the situation.[4]

Foreign and domestic speculators fueled the panic as investors scrambled to get out of positions in ringgit and other regional currencies. This caused currencies to fall yet further and with them the stock and other markets, constituting a rapid vicious circle. With financial liberalization, fund managers had an increasingly greater variety of investment options to choose from and could move their funds much more easily than ever before, especially with the minimal exit restrictions the Malaysian and other authorities in the region had prided themselves on. The nature and magnitude of hedge fund operations, as well as other currency speculation, undoubtedly exacerbated these phenomena, with disastrous cumulative consequences.

Malaysia's Management of the Crisis

The Malaysian government's response was characterized by three key decisions. First, there were ill-advised attempts to assert Malaysia's sovereignty over market forces and economic policy. Subsequently, Malaysia swung to orthodox macroeconomic policies (albeit without IMF assistance), but then retreated from that stance as its contractionary impact was felt. Finally, Malaysia decided to apply capital controls to support reflationary monetary policies.

The Reassertion of National Control over Economic Policymaking

The initial Malaysian government's response to the crisis was led by Prime Minister Mahathir, who portrayed the collapse of the ringgit as being due exclusively to speculative attacks on Southeast Asian currencies.[5] In September 1997, Mahathir declared that "currency trading is unnecessary, unproductive and immoral," and argued that it should be "stopped" and

"made illegal." More damagingly, he threatened a unilateral ban on foreign exchange purchases unrelated to imports (which never happened). All this upset "market sentiment" and seemed to exacerbate the situation until he was finally reined in by regional government leaders and his cabinet colleagues.[6] The partial truth in his rhetoric was not enough to salvage his reputation as a maverick in the face of an increasingly hostile Western media, and Mahathir came to be demonized as the regional bad boy.

Mahathir's early policy responses to the crisis probably made things worse. In late August 1997, the authorities *designated* the top 100 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 said to be exacerbating the stock market collapse. However, 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 unfavorable 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 perceived by "the market" as reflecting "denial" of the gravity of the crisis and its causes, ostensibly including "populist" fiscal deficits (which was not the case).

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 bailout facility designed to save "cronies." Although the fund was never institutionalized, government-controlled public funds—including the Employees Provident Fund and Petronas—were later deployed to bail out some of the most politically well-connected and influential individuals and organizations, including Mahathir's eldest son; the publicly listed corporation set up by Mahathir's party cooperative (KUB); and the country's largest conglomerate (Renong), previously controlled by the prime minister's party and believed to be ultimately controlled by his confidant Daim Zainuddin.[7]

The protracted United Engineers Malaysia (UEM)-Renong saga from mid-November 1997 was probably most damaging. The nature of this bailout—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, causing the stock market to collapse by a fifth—or RM70 billion—in the next three days. The bailout prompted the embarrassed finance minister (Anwar Ibrahim) to distance himself from Mahathir's turn to promarket policies and to IMF-recommended, procyclical measures.

The situation was initially worsened by the perception that Mahathir (and Daim Zainuddin) had taken over economic policymaking from Anwar,

who had endeared himself over the years to the international financial community. However, measures introduced by the finance ministry and the central bank from early December 1997 were perceived as preempting the intended role and impact of the National Economic Action Council (NEAC). The NEAC had been established in late 1997 and was chaired by the prime minister, with Daim in charge as executive director. Daim was later appointed minister with special functions, operating from the prime minister's department, in late June 1998. Daim's return to the front line of policymaking generated doubts about who was really in charge from early 1998. 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 Orthodox Package of Policies and Its Rejection

As the economic situation deteriorated in November 1997, Finance Minister Anwar became more receptive to IMF policy advice. In this, he was strongly, but quietly, supported by other senior government officials and, apparently, by the entire cabinet before Mahathir's late arrival at the weekly cabinet meeting on 3 December 1997. When Anwar announced in mid-October 1997 after the first announcement of the 1998 budget that he was considering cutting government spending by 10 percent, Daim Zainuddin, government economic adviser at the time and the person who had been responsible for economic liberalization from the mid-1980s, suggested a 20 percent reduction, ending in a compromise of 18 percent announced in early December 1997.

Thus, Anwar began to reassert control over economic policy from early December 1997. After apparently securing full cabinet support, Anwar implemented a series of orthodox policies not unlike those conventionally regarded as IMF solutions.[8] The central bank, Bank Negara, raised its three-month intervention rate from 8.7 percent at the end of 1997 to 11.0 percent in early February 1998. Drastic 18 percent reductions were made in budgeted government expenditure. Loans in arrears were redefined as nonperforming loans after three months, instead of the previous six months. Bank statutory reserve requirements were also raised, and tighter definitions of nonperforming loans were enforced.[9] These measures almost certainly exacerbated the recessionary tendencies already setting in throughout the region. Anwar approved the tighter fiscal and monetary policies from December 1997, in line with market expectations as much as with IMF recommendations.

Malaysia's orthodox measures deepened the impact of the crisis. The massive ringgit devaluation imported inflation into Malaysia's very open economy. Overzealous efforts to check inflation exacerbated deflationary tendencies. The stock market collapse (by more than half from its peak in

the first quarter of 1997) adversely affected both consumption and investment through a negative "wealth effect." Credit restraint policies adopted by the government from December 1997 further dampened economic activity. The depreciated ringgit increased the relative magnitude of the mainly privately held foreign debt as well as the external debt servicing burden.

Fortunately, prudent central bank regulation and managed consolidation of the banking sector helped avoid financial sector collapse, though much restructuring in the wake of the crisis was not well conceived and was unlikely to serve its intended ends. The authorities' push for the rapid merger and consolidation of banks and finance companies was seen as favoring Daim. The consolidation was made all the more difficult by the uncertainties due to the turbulence but was facilitated by the financial sector's reliance on the authorities for debt restructuring and bank recapitalization.

Early official responses seemed to smack of denial and of bailing out politically connected corporate interests, which inadvertently served to aggravate the growing problems, including declining confidence in official policy. While the orthodox policies from late 1997 onward may have served to signal some checks on cronyism, they also exacerbated the deflationary consequences of declining domestic and regional demand. Thus, what began as a currency crisis soon generated a financial crisis, which in turn led to a recession.

In the second quarter of 1998, Finance Minister Anwar Ibrahim dramatically changed course again, turning away from contractionary measures and instead reflating the economy through spending policies designed to stem the downturn. By this stage, however, a political drama had begun to unfold as Prime Minister Mahathir and his supporters came increasingly into conflict with Anwar and his supporters.

In May 1998, Anwar announced various policies to reflate the economy through countercyclical budgetary means. Some analysts suggest that this second policy reversal began even earlier, from late March 1998, when the central bank's annual report for 1997 was announced. Politics soon intervened, however. Mahathir, shocked by the surprise resignation of Indonesian president Suharto in May 1998, began to worry about the foreign media's calls for Anwar to replace him and about the increasingly independent and critical stance of the Anwar camp. Mahathir began to portray Anwar as a stooge of the West, especially of the IMF, and the finance minister was finally sacked from the cabinet on 2 September 1998.

The Introduction of Capital Controls

On 1 September 1998, the Malaysian authorities introduced capital and other currency controls. The ringgit exchange rate was fixed at RM3.8 to the US dollar, compared to the precrisis rate of around RM2.5. The prime minister

then dismissed the deputy prime minister and finance minister, Anwar Ibrahim. The imposition of capital controls on outflows was clearly an important challenge to the prevailing orthodoxy, especially as promoted by the IMF. While the contribution of the controls to the subsequent V-shaped recovery is moot, it is nevertheless clear that they did not cause the significant permanent damage that most critics had predicted.[10]

Capital controls did not slow Malaysia's recovery. The 1998 collapse was less pronounced in Malaysia than in Thailand and Indonesia, while the recovery in Malaysia was faster in 1999 and 2000. Of course, the precrisis problems in Malaysia were less serious, owing to strengthened prudential regulations after the banking crisis of the late 1980s. Strict controls on Malaysian private borrowing from abroad generally required borrowers to demonstrate likely foreign exchange earnings from the proposed investments to be financed with foreign credit. Hence, although Malaysia had the most open economy in the region after Hong Kong and Singapore, with the total value of its international trade around double its annual national income, its foreign borrowing and the share of short-term loans in total borrowing were far less than in the more closed economies of South Korea, Indonesia, and Thailand.

The Malaysian authorities had limited exposure to foreign bank borrowing, while their neighbors in East Asia allowed, facilitated, and even encouraged such capital inflows from the late 1980s. The vulnerability of East Asian economies to such borrowing was not due merely to financial interests seeking arbitrage and other related opportunities, or to corporate interests seeking cheaper and easier credit. Bank for International Settlements (BIS) regulations greatly encouraged short-term lending. Meanwhile, even European and Japanese banks generally preferred dollar-denominated lending to lending in the borrower country's currency. Criticism of "bad lending" to East Asia before the crisis should therefore focus not only on the borrowers and domestic regulations, but also on lenders and the rules regulating international lending.

The Malaysian experience also challenges the widespread claim that the East Asian crisis was due solely to foreign bank borrowing, which could have been avoided by greater reliance on the capital market, especially stock markets. While the implications of capital flows to stock markets undoubtedly differ from those of foreign bank lending, such portfolio capital flows are even more easily reversible than short-term foreign loans. Malaysian bank vulnerability during the crisis was due not so much to foreign borrowing as to extensive lending for stock market investments and property purchases and to their reliance on shares and real assets for loan collateral.

Considering the high savings rates in the region, there is no evidence that portfolio capital inflows significantly contributed to productive investments

or economic growth. However, the reversal of such flows proved to be very disruptive, exacerbating volatility. Their impact has been due largely to the wealth effect and its consequences for consumption and, eventually, investment. When such capital flow reversals were large and sustained, they contributed to significant disruption. Worse still, while portfolio capital inflows built up slowly, outflows were much larger and more sudden.

Such outflows from late 1993 had resulted in a massive collapse of the Malaysian stock market. The early 1994 introduction of controls on inflows sought to discourage yet another buildup of such potentially disruptive inflows. However, these were withdrawn after half a year, following successful lobbying by interests desiring renewed foreign portfolio capital inflows to enhance stock market recovery. If the early 1994 controls had not been withdrawn, the massive buildup in 1995–1996 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.

E. Kaplan and D. Rodrik argue that the September 1998 controls sought to avert yet another crisis in the making.[11] They suggest that the Singapore-based 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 undoubtedly sought to defuse this pressure and were successful in doing so.

The efficacy of the Malaysian controls was due largely to their appropriate and effective design. At the time, many market skeptics did not consider the Malaysian authorities capable of designing and implementing such controls, but some later conceded that they had been proven wrong. The controls addressed the problem identified by Kaplan and Rodrik[12] and were subsequently revised in February 1999 and lifted after a year. The authorities reviewed their assessment of the situation and demonstrated their flexibility, responsiveness, and, thus, commitment to being market and investor friendly. Most important, they emphasized from the outset that the measures were directed at currency speculation, and not at foreign direct investment (FDI). Although greenfield FDI to Malaysia declined after 1996, a global decline from 2000 also affected the Southeast Asian region as a whole (including Singapore), with China and a few others being the only exceptions.

S. Johnson and T. Mitton have argued that the Malaysian capital controls provided a "screen behind which favoured firms could be supported."[13] If true, the analysis would have to shift to the other measures introduced to provide such support, since the controls only provided a protective screen. However, their evidence points to significantly greater appreciation of the prices of shares associated with the surviving political leadership in the month right after the introduction of controls—that is, before other support

could have been provided except in a small minority of cases. Hence, an alternative interpretation more consistent with their evidence is that portfolio investors expected the September 1998 measures to benefit primarily crony companies, causing their share prices to appreciate much more than others—in other words, that it was a self-fulfilling prophecy.

The government emphasized efforts to bolster the stock market, for which many blame the government-controlled Employees Provident Fund (EPF) of over RM10 billion in 1998. The EPF and other Malaysian government–controlled institutions are believed to have bought about RM2 billion of Malaysian stock through Singapore- and Hong Kong–based brokers to give the impression of renewed foreign investor interest in the Malaysian market.

A deliberate prepolls effort to improve investor sentiment and raise funds through stock market operations for the ruling Barisan Nasional coalition's 1999 electoral war chest has also been widely suspected. With political support from the middle and propertied classes—desperately needed by the regime—and with its credibility significantly eroded by the political crisis since mid-1998, efforts to boost the stock market were considered crucial for electoral success. In May 1999, for example, the first finance minister, Daim, urged government officers to spend government allocations more speedily, while the second finance minister announced the suspension of tender procedures, ostensibly to accelerate government spending. This effectively reduced transparency and accountability, and facilitated corrupt tender awards.

Opponents of the capital controls introduced in September 1998 exaggerated their possible adverse effects, which were generally averted. Proponents of the control measures have also not been able to demonstrate that the controls were responsible for the delayed, but strong, recovery. The three worst affected economies all registered positive growth from early 1999, whereas Malaysia did not come out of the recession until the second quarter. And while the recovery in Malaysia was stronger than in Thailand and Indonesia, South Korea performed even better. There is little proof that Malaysia's recovery was due to the capital controls, which were soon amended and dropped in 1999. The dollar peg and related currency controls were abandoned when China did so in mid-2005.

Confidence in the Malaysian government's policy consistency and credibility was nonetheless temporarily seriously undermined by the apparent reversals of policy from July 1997 until September 1998, after years of successful investment promotion efforts. The controls regime was thus seen as the culmination of an extended period of inconsistency of government policy, and this perception probably had some adverse medium-term, indeed long-term, consequences.[14] The problem may have been exacerbated by then prime minister Mahathir's declared intention to retain the regime

until the international financial system was reformed, which hardly seemed imminent. This was not helped by unnecessarily hostile and sometimes ill-informed official rhetoric,[15] though the Mahathir administration sought to "improve" its international image through various initiatives, especially after September 11, 2001.

Hence, the government phased out the September 1998 and subsequent capital and currency control measures in light of their ambiguous contribution to economic recovery, changing conditions, and the adverse consequences of retaining the measures. The National Economic Action Council's later efforts to revise the 1 September 1998 measures—thus undermining their main original intent (to deter panic-driven capital flight)—reflected the pragmatism and flexibility of the Mahathir regime despite his rhetoric, and probably limited damage to foreign investor sentiment. His successor, Abdullah Ahmad Badawi, has gone much further in becoming more conformist on the international economic policy stage, quickly distancing his leadership from his predecessor's.

The Economic Aftermath of the Crisis

Malaysia's financial crisis and the way it was managed had both economic and political implications for the country. The economic consequences were manifold. The ringgit devaluation raised the prices of consumer as well as producer imports, particularly during 1998. Food prices seemed to have been especially adversely affected, reflecting the high import content in the national food bill. These effects disproportionately hurt the poor and the vast majority on fixed, ringgit-denominated incomes.[16]

The effects of higher producer prices due to currency devaluation were varied. For example, as electronic exports have very high import content, the ringgit devaluation probably reduced the labor costs of adding value in Malaysia. This might not show up in trade statistics, as internal transfer pricing is the norm within transnational production chains. Thus, currency devaluation could enhance competitiveness, but there are other possible outcomes and effects from higher producer import prices due to currency devaluation.

The exchange rate instability that followed the July 1997 currency floats made planning especially difficult for enterprises with international exposure. Instability in the region subsided from around September 1998 after the Russian crisis and the Long-Term Capital Management (LTCM) collapse, and the Wall Street scare of the previous month caused the US Federal Reserve to agree to a strengthening and stabilization of the yen and other East Asian currencies. In Malaysia, the imposition of selective capital controls

and the pegging of the ringgit to the US dollar at RM3.8 on 2 September 1998, had a similar intent; though with the benefit of hindsight, the Malaysian initiative appears somewhat redundant.

The banking crisis of the late 1980s in Malaysia had led to stricter prudential regulation that limited the vulnerability of the banking system to crisis. Stricter prudential regulation and supervision of borrowing from abroad limited the extent of Malaysia's financial crisis in 1997–1998. Hence, Malaysia avoided the forced closure of banks and financial institutions that occurred in Indonesia, Thailand, and Korea, thus sparing bank depositors from absorbing the losses they were forced to bear in the other three economies.

After reaching a peak of around 1300 in February 1997, the decline of the Malaysian stock market index was greatly exacerbated by the currency crisis and its effects on the banking system. It had fallen by about four-fifths, or 80 percent, to reach its nadir of 262 on 2 September 1998, the day after the announcement of capital controls. Its greater collapse came with the relatively much higher stake of foreign portfolio investors in the Malaysian capital market, especially on the first or main board of the Kuala Lumpur Stock Exchange. The proportionately higher capitalization of Malaysia's share market meant that the adverse wealth effect of this collapse was probably greater than elsewhere in the region. Likewise, the recovery of the stock market after September 1998 had a significant positive wealth effect, reflected in increased domestic consumer demand.

Besides the stock market, the property sector was adversely affected by asset price deflation, with significant consequences for bank loans. The reversal of the property sector's fortunes also adversely impacted the construction sector as well as construction materials industries. The casualties included employment by—as well as the very survival of—construction and supplier firms, some of which were saved by the post-September 1998 increase in public works contracts, which allegedly favored the politically better connected.

Malaysia's recession continued through the last quarter of 1998 and the first quarter of 1999, lagging behind the recoveries of the three economies under IMF tutelage, including Indonesia. However, by the end of 1999, Malaysia's recovery was stronger than that of its Southeast Asian neighbors, lagging behind only Korea's. But so many things were going on that one cannot 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.

Meanwhile, the IMF had been forced to revise its debt conditionalities and policy advice to allow fiscal reflationary efforts involving budgetary deficits, from mid-1998, in the East Asian economies under its tutelage. Ironically, of the four economies, only Malaysia had a (small) budget surplus in

1997, although it was the only one not formally under any IMF program. Although it is difficult to assess and compare the effects of such fiscal measures, it is quite possible that the V-shaped economic recoveries achieved by the major crisis-hit economies of East Asia in 1999—despite the IMF's own predictions of protracted slowdowns and gradual U-shaped recoveries—were due mainly to these fiscal reflationary efforts.

The capital control measures were only part of a package of measures to manage the crisis and to revive the Malaysian economy. Focusing solely on the control measures ignores the significance of other measures. The IMF imposed different policy packages on the other East Asian economies that sought emergency credit facilities from the Fund. To varying extents, the various national authorities differentially implemented the packages as well as other policies not specified in the packages. Such policy implementation was often the outcome of hard-fought battles in which different fiscal capacities; different negotiating, implementation, and enforcement capabilities; and different national experiences influenced the outcomes.

In Malaysia, Danaharta, an asset management company, was established by the government in mid-1998 to "take out" large nonperforming loans from the worst-affected banks and financial institutions. This—together with recapitalization of severely decapitalized banks by a companion agency, Danamodal—served to restore liquidity to the banking system. Although banks became more careful about lending for property purchases, the government introduced higher lending targets for share purchases to boost the stock market, with positive wealth effects raising domestic demand, helped by expansionary fiscal policies.

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 regional environmental factors—such as El Niño, La Niña, and large and protracted forest fires—had greater effects on agricultural output than the financial crisis itself.

Forced bank mergers in the wake of the crisis seemed conceived to favor politically influential interests and were considered unlikely to achieve their ostensible purpose. The authorities' push for the rapid merger of banks and financial companies did not seem designed to enhance efficiency and competitiveness beyond achieving some economies of scale and reducing some wasteful duplication and redundancy. While financial sector consolidation may be desirable to achieve economies of scale in anticipation of further international financial liberalization, the acceleration of its pace in the wake of the crisis only seemed conceived to take advantage of the financial institutions' weakness and vulnerability during the crisis.

The Political Aftermath of the Crisis

While recovery elsewhere in the region was accompanied by regime change, Malaysia's trajectory was more complex. When a political crisis exploded in September 1998, some commentators too rapidly presented it as a failed attempt at a palace coup coupled with a clash of economic ideologies and beliefs about how best to manage Malaysia's financial crisis.[17] Prime Minister Mahathir was held up as the embodiment of antiglobalization and antineoliberalism. Anwar Ibrahim, the finance minister he sacked, was held up as an IMF apologist, neoliberal, and monetarist. Both caricatures were wrong.

Anwar was undoubtedly more inclined to cater to "market sentiment" and to take IMF advice after the worsening situation under Mahathir's leadership. However, prior to his dismissal, it was Anwar who began reversing the policies of late 1997, when government spending started to rise again despite reduced tax revenue and monetary policy began to be relaxed. Anwar increased public spending, especially to provide credit for investments in food agriculture to small businesses and the poor (microcredit). He also sought to increase liquidity by reducing reserve requirements as well as banking margins. With an estimated RM25–30 billion in Singapore, the Malaysian monetary authorities could not altogether prevent interest rates from rising with the much higher rates available in the island republic. However, although interest rates rose after the crisis began, and especially from December 1997, the increase never exceeded three percentage points, or 300 basis points.[18]

Mahathir, for all his criticisms of global capital, was the instigator of Malaysia's economic liberalization from the mid-1980s, with considerable help from then new finance minister Daim Zainuddin.[19] Both Mahathir and Anwar were populists, albeit of different types, and have deployed nationalist and anti-Western rhetoric at different times. While Anwar largely abandoned old-style anti-Western rhetoric, perhaps to assuage a West that had long been suspicious of his Islamic credentials, Mahathir continued to invoke it, especially after the outbreak of the 1997–1998 crisis. Besides such differences in personal and political style, Anwar has had a record of greater interest in social safety nets and poverty reduction policies—in contrast to Mahathir's more trickle-down approach to growth, modernization, and progress, through more intimate government-private business relations (Mahathir's "Malaysia Incorporated," now vilified as cronyism). Arguably, cronyistic considerations had influenced government policy responses to the crisis in the second half of 1997.[20]

The introduction of capital controls in September 1998 was certainly not the issue that divided the two, despite ill-informed media claims to the contrary. Controls on inflows had previously been introduced in early 1994 while Anwar was finance minister,[21] so there is little reason to believe that

he was dogmatically committed to full capital account convertibility. Although the control measures and their efficacy have been assessed in detail,[22] most such economic discussions have not seriously examined the politics behind them, including the possibility that the 1–2 September 1998, measures were principally intended to preserve Mahathir's grip on power in the face of a foreign-supported palace coup attempt led by Anwar.

A political collision course between Mahathir and Anwar was set when Anwar's Malaysian *reformasi* movement took on cronyism, corruption, and nepotism, inspired by events and slogans in Indonesia leading to Suharto's resignation on 21 May 1998. Anwar's movement seemed to represent a new political tide. The finance minister and deputy prime minister had launched anticorruption initiatives while Mahathir was away in mid-1997. The foreign media were promoting Anwar as the worthy and urgently needed successor to Mahathir in the second half of 1997, in contrast to its unsympathetic coverage of Mahathir's contrarian remarks. Anwar had welcomed prominent Indonesians who had turned against Suharto in May 1998. He had vociferously criticized "corruption, cronyism, and nepotism" (KKN) at Pulau Sibu, Johor, in early May 1998. Anwar's associate, United Malays National Organization (UMNO) Youth chief Zahid Hamidi, had issued thinly veiled criticisms of the Mahathir leadership at the UMNO annual party conference in late June 1998. But all this said, there is little evidence that Anwar was conspiring to oust Mahathir.

Although many of Anwar's supporters were keen for him to take advantage of Mahathir's diminished credibility as the crisis grew,[23] there is little evidence that Anwar wanted or was prepared to do so. Indeed, Anwar had twice helped to urge Mahathir not to retire early (in 1995 and 1997, as noted by Mahathir confidant Daim at the UMNO general assembly after Anwar's dismissal). There is no evidence that Anwar had any coherent succession plan. Instead, it seems likely that heightened popular expectations (especially among Anwar's many supporters) about the prospects for regime change in Malaysia—after the mid-May 1998 events in Indonesia culminating in Suharto's sudden resignation after thirty-two years in power—encouraged increasing public dissent. The unprecedented affront (but not real threat) of Anwarist condemnations of KKN may well have nudged a previously unfazed (and perhaps ambivalent) Mahathir into the waiting arms of Anwar's enemies, who had long resented and conspired to eliminate the upstart heir apparent. The sacking of the finance minister then became inevitable.

Conclusion

During the 1997–1998 East Asian financial crisis, Malaysia was less vulnerable than its neighbors, because the authorities had limited foreign borrowing

and introduced prudential regulations and supervision following a banking crisis in the late 1980s when nonperforming loans rose to 30 percent of total commercial bank loans. Hence, Malaysia never had to go to the IMF for emergency credit facilities to cope with the crisis. However, Malaysia was nonetheless vulnerable to contagion from the crisis unfolding elsewhere in the region because of the massive, easily reversible portfolio investments in its stock market after successful government promotion of such inflows—except for capital controls on inflows lasting half a year from early 1994, after a sudden exodus of portfolio investments from late 1993.

Earlier in this article, I detailed the changing policy responses of the Malaysian authorities from July 1997, reflecting the complex and changing relations between "high politics" and crisis management; four phases of these changing policy responses were distinguished. In the second half of 1997, Mahathir was clearly in charge, resorting to various unsuccessful measures to try to contain the crisis. However, in early December 1997, with considerable support and encouragement from others, Anwar switched to more procyclical policies, apparently recommended by the IMF, which exacerbated the downturn. By the second quarter of 1998, however, Anwar turned to reflationary spending policies to stem the downturn, albeit belatedly. Finally, as Anwar was purged in September 1998, Mahathir introduced currency and capital controls to help reflate the economy.

Although this account acknowledges the different policy preferences of Mahathir and Anwar, it is argued here that Anwar was eliminated by Mahathir because the latter prime minister suspected his heir apparent of plotting to replace and embarrass him. While the apparent policy differences were real, they were also changing, on both sides, and were greatly exaggerated in most other accounts of the politics of the period. While economic analysis suggests that the contribution of controls to the subsequent economic recovery in 1999 and 2000 may actually have been quite modest, they certainly did not cause the disaster predicted by market fundamentalist prophets of doom.[24] And while the timing of the imposition of the controls helped contain the possible economic fallout from Anwar's firing, it would be wrong to attribute the controls solely to this political motive. ⊕

Notes

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1. P. C. Athukorala, *Crisis and Recovery in Malaysia: The Role of Capital Controls* (Cheltenham, UK: Edward Elgar, 2001); Stephan Haggard, *The Political Economy*

of the Asian Financial Crisis (Washington, DC: Institute for International Economics, 2000); E. Kaplan and D. Rodrik, "Did the Malaysian Capital Controls Work?" National Bureau of Economic Research (NBER) Working Paper No. 8142, presented at the NBER meeting "The Malaysian Currency Crisis," Cambridge, MA, February 2001; S. Johnson and T. Mitton, "Cronyism and Capital Controls: Evidence from Malaysia," *Journal of Financial Economics* 67, no. 2 (February 2003): 351–382; Marie-Aimée Tourres, *The Tragedy That Didn't Happen: Malaysia's Crisis Management and Capital Controls* (Kuala Lumpur: Institute of Strategic and International Studies [ISIS Malaysia], 2003).

2. Jomo K. S., ed., *Malaysian Eclipse: Economic Crisis and Recovery* (London: Zed Books, 2001), p. 5, Table 1.1.

3. For example, the yen fell from less than ¥80 to the US dollar in mid-1995 to more than ¥120 by mid-1997, while the deutsche mark had floated against the US dollar before mid-1997.

4. Jomo, *Malaysian Eclipse.*

5. Cf. the IMF view that currency speculation precipitated the collapse of the baht but was not a cause of the collapse of other East Asian currencies: IMF, "Reforming World Finance: Lessons from a Crisis," *IMF Survey,* Special Supplement (19 October 1998).

6. Jomo, *Malaysian Eclipse.*

7. Ibid.

8. After tightening bank credit from December 1997, the financing of special funds for investment in food production and for small and medium industries (SMIs), as well as for car purchases (especially for the "national cars"), was increased. Nevertheless, the severe contractionary consequences of tighter liquidity slowed down the economy fairly indiscriminately. See Malaysia, *White Paper: Status of the Malaysian Economy* (Kuala Lumpur: Government of Malaysia, 6 April 1999), pp. 25–26, Box 1.

9. In a long article serialized in the *New Straits Times,* Mahathir provided a self-serving summary of Anwar's policy errors without acknowledging widespread frustration with the failure and bias of his own policy responses, which seemed only to exacerbate the situation, especially by causing the ringgit to devalue further. See Mahathir Mohamad, "When Stability Is Vital for Growth," *New Straits Times,* 23 August 2000; Mahathir, "Move That Helped Economic Recovery," *New Straits Times,* 24 August 2000; Mahathir, "How Ringgit Trading Was Stopped," *New Straits Times,* 25 August 2000.

10. For a detailed discussion, see Jomo K. S., "Malaysia's September 1998 Controls: Background, Context, Impacts, Comparisons, Implications, Lessons," G-24 paper (Geneva: UNCTAD, September 2003); S. C. Wong, Jomo K. S., and K. F. Chin, *Malaysian "Bail Outs"? Capital Controls, Restructuring and Recovery* (Singapore: Singapore University Press, 2005); and Martin Khor, "The Malaysian Experience in Financial-Economic Crisis Management: An Alternative to IMF-Style Approach" (2005), available at Third World Network website, www.twnside.org.sg/crisis.htm.

11. Kaplan and Rodrik, "Malaysian Capital Controls."

12. Ibid.

13. Johnson and Mitton, "Cronyism and Capital Controls."

14. Merton Miller, "Malaysian Capital Controls a Failure, Says Nobel Prize Winner Merton Miller," *Asian Wall Street Journal,* 9 July 1999, p. A18.

15. Jomo, *Malaysian Eclipse.*

16. Ibid. For regional comparisons, see Jomo K. S., ed., *Tigers in Trouble: Financial Governance, Liberalization and Crises in East Asia* (London: Zed Books, 1998); Jomo K. S., ed., *After the Storm: Crisis, Recovery and Sustaining Development in East Asia* (Singapore: Singapore University Press, 2004); Yilmaz Akyuz, "Causes and Sources of the Asian Financial Crisis," Third World Network Global Economy Series, No. 1 (2003), www.twnside.org.sg/crisis.htm.

17. Jomo, *Malaysian Eclipse,* chap. 8.

18. Ibid., chap. 4.

19. E. T. Gomez and Jomo K. S., *Malaysia's Political Economy: Politics, Patronage and Profits* (New York: Cambridge University Press, 1999); Jomo K. S., *U Turn? Malaysian Economic Development Policies After 1990,* Centre for Southeast Asian Studies, James Cook University of Northern Queensland, Townsville, 1994; Jomo, *Malaysian Eclipse.*

20. Jomo, *Malaysian Eclipse,* chap. 1.

21. Jomo, "Malaysia's September 1998 Controls."

22. Ibid.

23. See Jomo, *Malaysian Eclipse,* "Acknowledgements."

24. Jomo, "Malaysia's September 1998 Controls."

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