FINANCIAL AND POLITICAL CRISIS OF MALAYSIA

Hadley Leavell, Sam Houston State University
Leroy Ashorn, Sam Houston State University
Balasundram Maniam, Sam Houston State University

ABSTRACT

Malaysia was the envy of many other emerging and developing nations after the late 1980's because of its double digit growth in GDP and economic prosperity. Malaysia and its neighbors were called the "Asian Miracle" because of their tremendous growth rate and economic stability. However, all of this came to a sudden halt starting in July 1997 when their currencies tumbled and their stock markets went down with them. Foreign investors started getting out and domestic investors moved their money overseas. Malaysia, who started down the path of free capitalism in the eighties, has now adopted some restrictions and currency controls which the prime minister claims are necessary to get back on track. The purpose of this study is to analyze the current financial crisis and political turmoil that Malaysia experienced from July 1997 to 1999. The study looks at how the financial crisis brought about the political instability in the country and also the friction between the prime minister Mahathir Mohamad and deputy prime minister Anwar Ibrahim. Anwar Ibrahim, who is also the finance minister, was fired from his post because his views concerning economic policy and political freedom are different from that of the prime minister.

INTRODUCTION

What began as a speculative attack on the Thai Baht quickly spread to the Philippines, Indonesia, South Korea, Hong Kong, and Malaysia. Although it also affected Singapore and Taiwan, the impact was much less severe. It was the speed and the severity with which the currencies fell that caught many by surprise. Within a three-month period (July - October 1997), the Thai Baht had fallen close to 40%, the Philippine peso and the Malaysian Ringgit by about 27%, the Indonesia Rupiah by 40%, and South Korean Won by about 35% against the United States (U.S.)

dollar. What began as a speculative attack on currencies quickly turned into a stock market meltdown and triggered a regional banking crisis. It also caused political instability in some countries.

These countries and their central banks attempted to defend their currencies but quickly gave up and chose the alternative of floating their currencies. Many blamed the crisis on contagion. While the contagion argument is a plausible and relevant one, it ignores the many differences among the Asian economies that have suffered. Furthermore, the contagion argument glosses over the underlying macro economic weaknesses that were evident in these countries.

This paper is presented in four sections. Section one is the introduction to the research question and its background. Section two is the literature review. Section three discusses the crisis in depth and what Malaysia has done to get out of it, followed by an update on the crisis and the political situation in Malaysia. Finally, section four provides the conclusion and summary of the study.

LITERATURE REVIEW

The Asian financial crisis seems to have more far-reaching consequences than its two predecessors - the European monetary crisis of 1992-93 and the Mexican peso crisis of 1994-95. It has been approximately two years since the beginning of the financial crisis in the Asian region. Its effects have been felt in parts of Latin America, Europe, and United States (*Houston Chronicle*, October 7, 1998). President Clinton, in his speech at the meetings of the finance ministers of the Asia Pacific Economic Cooperation (APEC) conference in November 1997, called it “a glitch in the road.” More recently however, he called it “the worst financial crisis in half the century” (*The Wall Street Journal*, September 24, 1998). Everyone was more concerned and worried that its effects may be more far-reaching than it was initially thought. In fact, it was predicted that some of these countries would have their worst recessions since World War II. For instance, it was estimated that Indonesia’s Gross Domestic Product (GDP) will drop by a surprising 15 percent in 1998 (Krugman, 1998 a)

The world economy, which grew at approximately 3 percent per year in the 1980's but then slowed to 2 percent in the 1990's, differed significantly from the Asian countries which grew at approximately 8 percent in the 1980's and then 10 percent in the 1990's. With such phenomenal growth rates, these countries were the envy of other developing nations. The “Asian Miracle” became the description for this period of economic growth. During this time period, most Asian countries transformed their pre-industrial (i.e., agriculture based) economies to more industrial-based economies.

Many factors contributed to this transformation. Some of the Asian countries pursued policies to increase the literacy rates in their economy, while others encouraged labor intensive foreign investments (Zaman, 1998). Trade and financial liberations followed as these nations developed, and the standard of living improved in these countries (Krueger, 1997). They pursued aggressive economic policies, which implied higher risk exposure. The success in achieving the rapid growth can be attributed partly to their ability to maintain relatively stable currency exchange rates. The stable currency exchange rates, together with favorable tax codes, were magnets for bringing a large pool of foreign investors into these countries. Investments came in the form of foreign direct investment (FDI) and investments by foreign portfolio managers who managed many international and emerging market funds.

However, the "Asian Miracle" turned into an "Asian Nightmare" by the middle of 1997. Plunging currencies and stock markets put the economies in a deep freeze, making these countries' survival difficult (Economist, 1998). No one anticipated the Asian financial crisis to be this severe. Though there were a few researchers like Paul Krugman, an economics professor at MIT, who were skeptical of the "Asian miracle," investors and portfolio managers were too engrossed in the high growth and high returns economies of these nations, to see the warning signs (Krugman, 1998a). Although the entire region had enjoyed decades of strong growth and rising standard of living for its people, they also had some common problems that led to this crisis (Ruben, 1998).

Initially, the impact of the Asian crisis on other economies around the world was down played by many. This was particularly the case with the U.S. economy, which was robust and did not show any signs of slowing down due to this crisis. Most popular press suggested that the impact on the U.S. economy would be minimal (*Houston Chronicle*, March 18, 1998 and *The Wall Street Journal*, April 14, 1998). However, with the continued persistence of the crisis, and the release of recent trade figures, the outlook for the U.S. economy looked less rosy than before. Even Federal Reserve chairman Alan Greenspan remarked that the Asian crisis "has not shown any evidence of stabilization, and we do not know how far it's going to carry or what its spillover will be" (*The Wall Street Journal*, July 23, 1998).

Bergsten (1997) proposed some remedies for this crisis by spelling out tough structural changes that Asian countries must make in order to stabilize their economies. As an example, he stressed that the Asian economies must undertake steps to reform and strengthen their financial institutions in order to improve transparency and supervision. He also added that the political leaders must eliminate the close relationship between them, the banks, and other commercial entities. Maskooki (1998) looked at the crisis strictly from South Korea's perspective and analyzed why the crisis took such a toll on the Korean economy. He concluded that

Korea's deregulation of the nation's capital market in the absence of an efficient and globally integrated capital market increased the volatility of their currency.

Litan (1998) suggested that Asia's troubles are not insoluble and the IMF can help "fix" the economies using his remedies. He spelled out a three-step program of *triage, liquidation* or *merger*, and *workouts* for the troubled corporations and banks.

Noland (1998) discussed the origins of the Asian financial crisis, the prospective impact of events in Asia on the U.S. economy, and the implications of these developments for the architecture of the international financial system. He outlined four causes of the crisis: exchange rate misalignment, weak financial institutions, export slowdown, and a moral hazard problem. He also predicted that the events in Asia will reduce the growth rate of the U.S. GDP from 0.5 to 1.0 percent from its current level, over the next two years. Other studies on this Asian crisis include Miller (1998), Tobin (1998), and Sato (1998).

Prior to 1997 other emerging nations looked at the Asian countries as a model for economic success. However, in early 1997 the Asian economies began their meltdown, with collapsing currencies and plunging stock markets. The magnitude of the crisis began to accelerate in July 1997. Table I is a chronology of the crisis that caused panic in Asia from January 1997 to January 1999. Many of the countries had to seek the help of IMF for emergency loans (see Table I). The table also shows the date/event that triggers the currency devaluation and stock market downturns.

Although there are common causes of the financial crisis in many countries around the world, it is the consequence of the crisis on each of these countries that is most important. For instance, Thailand's problems can be attributed to external debt and increasing current account deficits. Thailand's central bank had external obligations of $14.6 billion when the mid-1997 crisis induced it to cease pegging the baht to the dollar (Bardacke and Crawford, 1997).

Malaysia's problems can be summarized by the policies pursued by prime minister Mahathir Mohamed. Malaysia had not put its cheap domestic and foreign labor to good use. For years, it had allocated resources to prestigious projects (i.e., skyscrapers, big highways, and development projects) which, to a large extent, had not contribute to the productivity and performance of the Malaysian economy. The Malaysian financial institutions continued to lend furiously to sustain these projects.

Table I: Chronology of Malaysian/Asian Financial Crisis

Date	*Event/Description*
Jan. 23, 97	*Major South Korean steel maker defaults on loan.*

Table I: Chronology of Malaysian/Asian Financial Crisis

Date	Event/Description
Feb. 5, 97	Thai company (Somprasong) missed payments on foreign debt.
Mar. 28, 97	Central bank of Malaysia (Bank Negara) restricts loans to property and stocks to head off a crisis.
May 14-15, 97	Baht comes under attack by speculators who decided Thailand's slowing economy and political instability meant it was time to sell. As the crisis started affecting the Philippines, the central bank of the Philippines raises the overnight rate 1.75% points to 13% and dumps dollars.
July 2, 97	The bank of Thailand announces a managed float of the baht and calls on the IMF for "technical assistance". This devalues baht by about 15-20%. This triggers for the Asian financial crisis. The Philippines Central Bank defends its peso heavily.
July 8, 97	Malaysia's Bank Negara intervenes to defend its ringgit heavily. The Indonesian rupiah starts to fall as Jakarta widens its rupiah trading band from 8 to 12%. July 14, 97. The IMF offers the Philippines $1.1 billion in financial support under the fast track regulations drawn after the 1995 Mexican crisis. Malaysian central bank abandons the defense pf the ringgit.
July 24, 97	Asian currency meltdown. The baht, peso, ringgit, and rupiah all fall heavily as confidence in the region deteriorates rapidly.
July 26, 97	Malaysian Prime Minister called hedge fund manager George Soros the 'moron' responsible for the attack on the ringgit.
July 28, 97	Thailand seeks the help of IMF.
Aug. 11, 97	IMF unveils a rescue package for Thailand including loan totaling $16 billion from the IMF and Asian countries.
Aug. 13, 97	The Indonesian rupiah comes under severe attack and hit at historic low of 2,582 to the dollar. Central bank intervene heavily.
Aug. 14, 97	Indonesia abolishes its system of managing the exchange rate through the use of a band and allows it to float. Rupiah plunge to 2,755.
Aug. 15, 97	Speculators attack Hong Kong dollar, overnight interest rates up 150 points from previous day to 8%. Stock market also falls rapidly.
Aug. 20, 97	IMF approves a $3.9 billion credit for Thailand. The package now totals $16.7 billion. Brunei adds $0.5 billion to the bailout package, making it $17.2 billion.
Sept. 4, 97	Philippines peso drops to record low of 32.43 to a dollar. Malaysian ringgit falls below the 3.0 to the dollar. Government delays multi-billion dollar construction projects.

Table I: Chronology of Malaysian/Asian Financial Crisis

Date	Event/Description
Sept. 16, 97	Indonesia says it will postpone projects worth 39 trillion rupiah.
Oct. 8, 97	Indonesia says it will ask for IMF help.
Oct. 20, 97	The Hong Kong market suffers its heaviest drubbing ever, where the index plunge almost 24%. The South Korean won also begins to slump rapidly in value.
Oct. 27, 97	After regaining 718 points on Oct. 24, the Hang send index loses another 646 points (6%). The loss ripples through the global market. DJIA posted its single biggest point loss ever, falling 554 point (7.18%). Stock markets in Brazil, Argentina and Mexico saw their biggest single day loss.
Oct. 31, 97	IMF unveils Indonesia's rescue package for about $40 billion, although front-line defense is $23 billion.
Nov. 8, 97	The South Korean stock market dropped, and the currency lost 14% of its value and reached a all-time low of 979.90 against the dollar.
Dec. 4, 97	IMF approves a $21 billion loan for South Korea
Jan. 5, 98	Malaysian ringgit, Thai Baht, Philippines' peso, and Indonesia's rupiah all dropped to new lows against the dollar.
Jan. 7, 98	Malaysian ringgit, Thai Baht, Philippines' peso, and Indonesia's rupiah all dropped to new lows against the dollar.
Feb.10, 98	Southeast Asian currencies skyrocketed against the dollar amid indications the Indonesia may peg the value of its currency to the dollar. Indonesia may set up currency board.
Feb. 16, 98	Asian currencies suffered in the face of growing international resistance to Indonesia's plans to adopt a currency board.
Feb. 19, 98	Latest U.S. monthly report suggest the Asian crisis may start to affect the U.S. economy.
Mar. 4, 98	Malaysian stock market lost almost 4% of its value stemming from the new one of its premier banks have severe financial problems.
Apr. 7, 98	Japanese prime minister admits Japan's economic crisis is one of the worst since World War II.
May 21, 98	President Suharto of Indonesia resigns after 32 years in power following riots
June 12, 98	Japan's economy sinks into a recession.
June 15, 98	Dow Jones falls 2.4 percent following panicky selling in Asia as the weakening yen renews that Asia's economic troubles could spread.

Table I: Chronology of Malaysian/Asian Financial Crisis

Date	Event/Description
June 17, 98	Federal Reserve along with Japan's central bank move into market to bolster yen, giving immediate lift to Japanese currency and U.S. stock market.
Aug. 20, 98	Malaysia's central bank's (Bank Negara) governor and his deputy resigned after their differences with the prime minister on the direction of the country's monetary policy
Sept. 1, 98	Malaysia imposes currency controls
Sept. 2, 98	Malaysia's Deputy Prime Minister and Finance Minister Anwar Ibrahim is sacked after months of economic policy difference with prime Minister Mahathir. He was charged with corruption and sexual impropriety.
Sept. 9, 98	Japan cuts interest rates.
Sept. 14, 98	Clinton calls it "worst financial crisis in half century."
Sept. 20, 98	Anwar Ibrahim was arrested at his house. His supporters marched to demand the Prime Minister's resignation.
Oct. 17, 98	Police forcibly broke up a rally of thousands in support in central Kuala Lumpur, capital city of Malaysia.
Nov. 2, 98	Anwar Ibrahim trial began.
Nov. 15, 98	U.S. Secretary of State Madeleine Albright visits the wife of Anwar Ibrahim.
Nov. 17, 98	U.S. Vice President Al Gore support the reform movement during his visit to Malaysia to attend the APEC meeting.
Jan. 13, 99	Anwar's charges were amended to mainly corruption, leaving sodomy and sexual impropriety out.
Jan. 14, 99	Anwar's case adjourned for holidays, will resume Jan. 26.
Feb. 4 , 99	Malaysian government lifted the 12-month ban on the repatriation of foreign investments in the stock market and established a series of exit taxes in its place.
Feb. 5, 99	Malaysian government further relaxed some of the capital controls it imposed five months ago to restrict money flowing out of the country and destabilizing the economy.
Sources:	Http:/www.cnn.com/world/9801/15/asia.chronology.reut. The Wall Street Journal, Various issues 1997-1999. Financial Times, Various issues 1998-1999.

South Korea's problem was that its economy was crippled by debt. When the four major corporations which controlled South Korea experienced problems, the entire economy experienced problems. Benefitting from major financial reforms to attract foreign investors, the Philippine's economy joined the fast-growing Asian economy much later than the other countries. However, preexisting foreign debt made this fledgling economy vulnerable to the crisis.

Unlike most of the other Asian countries where financial problems were the major contributors to the crisis, Indonesia's biggest problem was political corruption. The former first family (President Suharto) had controlled vital parts of the economy (i.e., financial institutions, large corporations) and did not allow markets to develop. The lack of market discipline and corruption are the main causes of Indonesia's downfall.

CAUSES OF THE FINANCIAL CRISIS IN MALAYSIA

Although many explanations given for the causes of this crisis, one can identify several main reasons that precipitated the crisis: overvaluation of currencies, competition from Japan and China, current account deficit, and too much foreign debt, moral hazard problem and weak financial institutions, a slowdown of exports, and financial panic.

Like many other Asian countries, Malaysia's official exchange rate policy was one of pegging the ringgit to the U.S. dollar. Its currency became overvalued due in part to the decision of other regimes in the region to adopt fixed exchange rates and the related large capital inflows in the 1990's. This pegging policy worked well until 1997, when it became clear that this currency was severely overvalued. This overvaluation was a harbinger of a crisis in the making as indicated by research in this area. Goldfajn and Valdes (1997) examined whether overvaluation and expectations are predictors of currency crises. Using a simple Consumer Price Index (CPI) adjusted measure of overvaluation, they found that over valuations are good predictors of impending crisis.

The objective of rates pegged to the dollar is logical in that it keeps the domestic currency stable and thereby reduces the currency exposure of domestic importers and exporters. This was an important consideration for Malaysia because its economy is dependent on foreign trade. However, pegged exchange rate systems require careful management to avoid problems which can lead to financial crisis.

There are several problems associated with maintaining pegged rates that have an insidious way of creeping in unnoticed. One problem is that a policy of maintaining a peg reduces domestic policy flexibility -- particularly monetary policy. To maintain a peg, domestic policies must be in line with those of the country to whose currency the domestic currency is being pegged. Deviations would put stress on the pegged rate. If policies have deviated sufficiently to cause underlying economic fundamentals to be very different, the pegged rate becomes vulnerable to a speculative attack.

A second problem is that, as a result of the peg, the domestic currency becomes over or undervalued against other currencies as the peg currency moves. With policy makers focusing attention on movements against the peg currency, appreciation/depreciation against the other currencies often does not get the proper amount of attention. Over time the nation's competitiveness gets eroded which shows up as current account and balance of payments problems.

A third, and perhaps the most insidious, form of problem arises when the domestic currency gets to be overvalued in real terms even though the nominal exchange rate is at, or near, the peg rate (i.e., within the band). This typically happens when domestic policies have been much 'looser' than that of the pegged country. It is this kind of problem that increases a currency's vulnerability to attack

Malaysia faced all of the above mentioned problems. First, over the period 1995 - 1997, the US dollar had appreciated gradually against the Malaysian Ringgit. This had to do with strong economic fundamentals and low inflation rates in the U.S. As such the Ringgit also appreciated against other currencies. This certainly affected the export competitiveness of Malaysia. Part of the increases in current account deficits were probably due to this currency appreciation (Maniam, 1999). The second problem of deviating economic policies was also evident. Countries where the crisis existed undertook policies that were far more expansionary than that of the US. This is particularly evident in the case of average annual M2 growth rate which for the seven year period for Malaysia was 15.5%, compared to 2.14% for the U.S. This means that the annual difference in monetary growth rate was more than 7 times. Obviously with such high level of deviation, exchange rates had to change. However, the fact that nominal exchange rates were maintained near peg levels meant that real exchange rates became overvalued. This is accentuated further by deviations in inflation rates (see Table II).

The average annual inflation rate for Malaysia was 4.00% while it was 2.6% for the U.S.. At these rates, Purchasing Power Parity (PPP) would have required the Malaysian Ringgit to devalue. However because the rates were pegged, the results were overvaluation. To determine the extent of exchange rate deviation from parity, the real exchange rate was computed for Malaysia. This was determined using the standard PPP equation as:

$$e^* = e_0 [(1 + i_h) / (1 + i_f)]$$

e^*	=	*The parity exchange rate for 1996.*
e_0	=	*Average exchange rate for 1990.*
i_h	=	*Average annual home country inflation (Malaysia) for 1990 - 1996.*
i_f	=	*Average annual inflation for U.S.*

The percent over- or undervaluation was then computed as: $[(e^* - e_0) / e_0] \times 100$. Using the PPP approach, Malaysia's currency was overvalued by 12.5%. Applying the same approach, it is determined that the currencies of Thailand, Indonesia, Korea,, Hong Kong, and Taiwan were overvalued. Only the currency of Singapore was undervalued. Such overvaluation was a factor in the worsening of the current account balances of many countries, including Malaysia, in the region. Although the extent of the exchange rate overvaluation varied across countries, the need to adjust the current account position of the countries led to expectations of depreciations (against the dollar) in the region as a whole (Roubini, 1998).

Table II: Malaysia's Various Statistics

Year	1991	1992	1993	1994	1995	1996	Avg
Annual M2 Growth Rate (in %)	12	16	17	20	15	21	17
Annual Inflation Rate (in %)	4	5	3	4	3	3	4
Current Account Deficit (% of GDP)	-9.08	-4.06	-10.11	-11.51	-13.45	-5.99	-6.3
Saving-Investment Gap (% of GDP)	-8	-4.7	-5.3	-7.3	-9.5	-5.5	-6.2
Domestic Credit Growth (%)	18.5	16.6	12.3	14.8	29.5	27	19.5

Source: J.P. Morgan, World Financial Markets and Data Stream International

The current crisis can be also attributed to competition from other nations. Schuler (1997) argues that Malaysia (and other Southeast Asian countries) was being squeezed between competition from Japan on one end and China on the other. In the low wage, labor intensive manufacturing sector, China is replacing the Malaysia and other Southeast Asian countries as the country of new capital. Labor cost in Malaysia and other Southeast Asian countries were on the increase and some of them (especially Malaysia and Singapore) even had severe labor shortages. Kwan (1997) analyzed the product composition of exports from these countries and suggested that their exports are very similar to Chinese exports. This was a major disadvantage to Malaysia and others, since they must contend with China's competitive advantage to produce these products. Simultaneously, Japan had become a even larger competitor for Malaysia and other Southeast Asian countries because the yen had depreciated continuously since the mid 1990's making its goods cheaper relative to the Malaysian Ringgit and other Southeast Asian countries' currencies

Another important cause of the crisis was the huge current account deficit of Malaysia. The earlier Table II shows a large and growing current account deficit for Malaysia since 1990. As an example, the 1995 Malaysian current account deficit was 13.45 percent of its GDP, which is significantly higher than the six-year average of 6.3 percent. The other Asian countries have also run relatively large current account deficits since the 1990's. For example, over the 1990's, Thailand had a cumulative current account deficit equal to 36 percent of its 1996 GDP (Bhattacharya, Claessens, and Hernandez, 1997).

Many of the Asian countries, including Malaysia, experienced a huge property boom in the first half of 1990's, typically financed by cheap Japanese Yen borrowing. Larger current account deficits and reliance on short-term capital inflows increased the vulnerability of these economies to external shocks. Also, private foreign borrowing often constituted a major source of external financing. This short-term borrowing in foreign currencies led to a very large accumulation of foreign liabilities (Corsetti, Pesenti, and Roubini, 1998).

As this massive amount of foreign capital flowed into the local financial institutions they became more liberal in their investment and lending practices. Banks extended unsound loans, including a fundamental mismatch between short-term funding, foreign currencies, and lending for long-term projects of questionable merit. To compound the above mentioned problems, the core to all countries in the region is the close link between governments, banks, and corporations. Governments, with the assistance of banks, supported fundamentally unsound investment practices by corporations. The lack of transparency and supervision in the financial systems masked the serious nature and extended the problem. This problem manifested itself in Malaysia in the closing and merging of local banks in the 1997 and 1998. One of the largest problem institutions was Bank Bumiputra Malaysia Berhad. In early 1999, the bank was merged with Bank of Commerce creating Bumiputra Commerce Bank Berhad -- the second largest commercial bank in Malaysia (*Star*, February 15, 1999).

Just as in many other emerging nations, Malaysia's practices of loan classification and provisioning were too "loose and relaxed." There were too many loans to bank directors, managers, and their related businesses with serious credit risk. This problem termed "crony capitalism" was compounded by the excessive ownership of banks by the government or other government involvement. Additionally, local banks had the perception that their operations and practices were backed by government promises of bailout in case of insolvency. As a result of the perceived government backing, foreign banks and investors also began to finance these questionable projects where the project's riskiness was not properly weighted. In short, inadequate supervision of the activities financed by these capital flows, imprudent government intervention, and lack of transparency in the financial institutions were blamed for this crisis (Corsetti, Pesenti, and Roubini, 1998).

Another cause of the crisis was the slow down of exports from Malaysia. As can be seen in Table III, many emerging economies in Asia, including Malaysia, experienced a significant slowdown in merchandise export receipts in 1996. For Malaysia merchandise export growth was only about 6.5 percent in 1996 after an impressive growth rate of 20.3 percent in 1995. With continuous economic growth rate in the early 1990's, the Malaysian economy overheated and the only way for both banks and businesses to keeping paying the bills was to export more. However, the export market began to shrink for two reasons. First, the influx of foreign capital into Malaysia caused its currency to appreciate against the U.S. dollar. Instead of letting the market determine the currency's true value, the government of Malaysia pegged its currency to the U.S. dollar, so that it would remain price-competitive when exporting goods and services. Another reason that caused the export market to shrink was China's devaluation of its currency (Renminbi) in 1994. This made its goods and services more competitive in the world market. Japan's devaluation in 1995 only compounded the problem for Malaysia (Ng, 1998).

The financial panic by the investors was another reason for this crisis, or at least one that accelerated it. When the U.S. dollar started to rise against most of the world currencies, including the Malaysian Ringgit, Malaysian exports became more expensive and less competitive on the world market. It became the opinion of the international banks and traders that the Ringgit would have to be devalued to revive exports. However, the government of Malaysia tried to resist, knowing that devaluation would cripple firms which had borrowed, in dollars, to finance everything from high-rise buildings to growth oriented projects. Knowing that the Malaysian currency would not withstand market forces, traders started selling the Ringgit in the forward market hoping to profit from the devalued Ringgit in the future.

Table III: Merchandise Export (annual percentage growth)		
Countries	1995	1996
Indonesia	13.4	9.7
Malaysia	20.3	6.5
Philippines	28.7	18.7
S. Korea	30.3	3.7
Thailand	23.1	0.5

Source: IMF, International Financial Statistics
IMF, World Economic Outlook

The Malaysian government with the help of the Central Bank (Bank Negara) bought Ringgit and sold dollars in an effort to avoid devaluation. However, after the inventory of dollars was sold and these stabilization efforts ceased, foreign investors withdrew capital, local companies hedged hard currency exposure, exporters stopped bringing their export earnings home, and citizens moved their savings abroad (Ruben, 1998). This series of events brought stock prices and land values down sharply around the country and put a severe strain on business. This led to a reduced or negative economic growth of the Malaysian economy.

The U.S. and other developed nations were concerned about this crisis because of its spillover effects into other markets. The U.S., together with the IMF and Asian Development Bank, had been deeply involved in providing assistance to many of the nations in the region (Ruben, 1998). The IMF responded to the crisis by helping Indonesia, Korea, and Thailand arrange economic reform programs intended to restore public confidence in these countries. They also approved some Standard Drawing Rights, sanctioned 26 billion dollars of IMF financial support for reforms in these countries, extended the Philippines existing IMF support program, and intensified its consultations with other members, both within and outside the region, to contain the crisis (IMF, 1998). Malaysia refused the IMF financial package, claiming that they could take care of the crisis without the IMF's assistance. Malaysia did not want the IMF to dictate monetary or fiscal policy and/or force them to make structural changes in the financial system.

POLITICAL CRISIS IN MALAYSIA

The crisis brought many changes and new problems to the region, including political instability in Indonesia, Malaysia, and Thailand. As table I shows, several critical events took place with respect to political instability. First, the Malaysian central bank's (Bank Negara) governor and his deputy resigned over their differences with the prime minister concerning the direction of the country's monetary policy. Second, the prime minister of Malaysia (Dr. Mahathir Mohamad) forced his deputy (Anwar Ibrahim) to resign in light of this crisis and their clash over economic policies and how to "fix the economy" (*Business Week*, 1998). Three weeks later Mahathir used an internal security law to jail Anwar alleging that he had engaged in homosexual acts, which is illegal under Malaysian law and taboo in this conservative, majority-Muslim society. These political events, together with the imposition of capital controls on September 1, 1998 and the pegging of the Ringgit at M$3.80 to U.S.$1 created many uncertainties among foreign investors (*Business Times*, 1998).

The conflict between Mahathir and his deputy Anwar stemmed from their opposing views on how to get the country out of the crisis. Anwar followed the prescription of the IMF, including tight money, prudent fiscal policy, and trying to open up the economy to foreign capital to solve the problems without actually asking the IMF for assistance. Mahathir on the other hand opposed any such move because he did not want foreign intervention and knew Anwar's policies would hurt the common man on the street. Therefore, Mahathir fired Anwar and rejected his IMF-oriented policies and instead imposed currency restrictions. Also, instead of borrowing from the IMF, Malaysia decided to borrow $1.35 billion from a consortium of twelve foreign banks operating in the country (*Financial Times*, December 30, 1998).

Anwar thought that the best solution was to restructure the banks, open up competition, allow foreign capital to come in, and provide support to the economy. However, Prime Minister Mahathir regarded any foreign capital as the problem, not the solution. Hence, Mahathir reduced this dependency while Malaysia restores itself through government support -reflating the economy, cutting interest rates dramatically and protecting the currency by putting controls on it so investors cannot pull their money out.

When Anwar was jailed, his supporters rallied in the streets and demanded the resignation of Mahathir. However, Mahathir was quick to indicate that he would not resign until the economy had been restored to its pre-crisis condition. The U.S. was quick to support the unrest as indicated by the visit of Secretary of State Madeleine Albright with the wife of Anwar Ibrahim. Also, while attending a summit of Asian-Pacific countries, U.S. Vice President Al Gore praised the "reformasi" and reform process. These comments sparked criticism by the general public and the Malaysian government. The reason why the general population was not opposed to the government is that wealth is more evenly distributed in Malaysia (unlike other countries, like Indonesia) and the most people are content with the prosperity of the last decade and unwilling to gamble their material gains by taking to the streets.

Although many nations criticized Malaysia for its currency control and political problems, the government did have their supporters. For instance, Hong Kong officials gave "thumbs up" to Malaysia's selective foreign exchange (forex) controls because it is one of the ways to cushion the impact of a currency crunch (*Star*, January 7, 1999) However, they added, that adopting such an approach should be well timed to avoid exacerbating the regional currency crisis. Professor Krugman, an economist from MIT also supported Malaysia on its currency control, saying that it is a necessary measure for the short run. But, he did warned that Malaysia should not have it in place indefinitely.

In an attempt to reduce the impact of the crisis, stabilize its economy, to gain public confidence, and resume growth, Malaysia has taken some radical, corrective steps. These steps, which included imposing currency restrictions, halting currency trading, and imposing various restrictions on foreign stock investors, seem to be working. As an example, Malaysia recorded a record current account surplus of RM 14 billion in the third quarter of 1998 B up 64.7% from the surplus of RM 8.5 billion posted in the second quarter of 1998. It also saw an upward trend of foreign investors funds during the same period (*Star*, January 8, 1999). Although other trade statistics are encouraging, the long-run impact depends on how Malaysia makes the necessary changes in their financial system and other structural changes.

Discussion and Recent Developments

Although many factors contributed to the crisis in Malaysia which in turn created political instability in the country, Malaysia has been recovering steadily over the past year. Recent data from IMF suggest that the imposition on currency control has not provoked capital flight as previously feared. Many investors are returning to Malaysia, and in early 2000 alone, portfolio capital inflows to Malaysia totaled $1.8 billion. Although currency control did not have any serious short term negative effect, its long term effect is questionable (IMF, 2000).

The stock market (Kuala Lumpur Composite Index) is also recovering quickly and approaching its pre-crisis level in terms of local currency. Main reason for such a quick rebound was the lower interest rate that was put in place and the recovery package introduced in the middle of 1998. Lower interest rates have also eased the burden of debtors and helped banks to get back on track (IMF, 2000).

The economic rebound was also aided by the increase in exports. When the government fixed the exchange rate between the Ringgit and the dollar in September 1998, this led to a trade weighted depreciation of the Ringgit by about 25 percent in real terms compared to the pre-crisis level. This in turn increased their export. In 1999 alone, merchandise exports grew by about 16 percent in U.S. dollar terms giving a trade surplus and a current account surplus for that year (IMF, 2000).

On the other hand, there are signs that recovery in some areas is slow. For instance, recovery in private sector demand has been slower but it has started gaining speed. This slow recovery is in part due to the fact that the property market is still weak and there is excess capacity in most sectors. Similarly corporate restructuring has been slow. In the same token, although Malaysia' real GDP contracted by 7.5 percent in 1998 but then grew by 5.4 percent in 1999, the per capita GDP is still below the pre-crisis level (IMF, 2000).

Overall it is expected that the Malaysian economy will grow by about 6.2 percent in 2000. Imports will pick up causing net export to fall and current account surplus will contract but will still remain in the positive side. Foreign direct investment will again pick up as investors gain confidence in the economy. Only the property market will remain weak for some time because of the excess capacity but is expected to pick in several years.

On the political front, the recent election returned Mahathir's government to power. The main reason that the general public voted to bring Mahathir's government back to power for another term is that they (the general public) are happy with the recovery to date. Except for the property market, all other indicators are pointing to an economy that is growing steadily and the outlook looks bright.

SUMMARY AND CONCLUSION

Many factors, both domestic and foreign, have contributed to the crisis in Malaysia. Domestic factors such as large external borrowing, fixed exchange rates, weak financial systems, the lack of transparency, and the country's overly ambitious investments on questionable projects have contributed to the crisis. Simultaneously, there were large private capital inflows from foreign investors who were searching for high returns. These foreign investors either underestimated the risk or did not assign proper risk to many investments. This contributed significantly to the downward pressure on the currencies. Although the financial crisis in Malaysia was caused by the factors mentioned previously, some of them had a greater impact on the economy than the others.

But recent data suggest that the economy is recovering steadily in most sectors. Since early 1999, main indicators have all been positive. For instance, the GDP has increased, nominal interest rate is much lower, export has increased with a current account surplus, government led financial restructuring has been effective and inflation is lower. Only the property sector is still weak and the corporate restructuring has been slow. On the political side, the political instability that was caused by the crisis have almost disappeared with the return of Mahathir's government back to power for another term.

This situation may also illustrate that strong determined governments can turn a bad situation around without the foreign assistance, in particular the United States or the IMF. While there are many lessons to be learned from Malaysia's economic woes of 1997-1999 and its subsequent recovery, the remaining question is when will the government lift its self-imposed exchange rate control so that market mechanisms will decide the real exchange rate.

REFERENCES

Anonymous, (1998), East Asian Economies, *The Economist*, March 7, 1998, 3-5.

Bhattacharya, A., and S. Claessens, and L. Hernandez, (1997). A Recent Financial Market Turbulence in Southeast Asia, *World Bank*, Washington.

Business Times, (1998-1999). Singapore Newspaper, Various Issues.

Clifford, M. L. and P. Engardio, (1998). Renegade Economy, *Business Week*, (September 21), 46-47.

Corsetti, Pesenti, and Roubini, (1998), What Caused Asian Currency and Financial Crisis, *NBER Working Papers*, Yale University, (March), 33-35.

Financial Times, (1997-1999), Various issues.

International Monetary Fund, (1998), World Economic Outlook, Washington, DC, (May), 1-54.

International Monetary Fund, (2000), World Economic Outlook, Washington, DC, (May).

Kruger, A., (1997), Trade Policy and Economic Development: How We Learn, *The American Review*, (March).

Krugman, P., (1998), Saving Asia: It's Time to Get Radical, *Fortune*, (Sept. 8), 1-2.

Krugman, P., (1998), Asia: What Went Wrong, *Fortune*, (March 2), 1-3.

Kwan, C. H., (1997), Causes and Consequences of Asia's Currency Crisis, *Nomura Research Institute*, Tokyo, (October).