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## Malaysia's pathway through financial crisis

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MALAYSIA'S PATHWAY THROUGH FINANCIAL CRISIS

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GEG WORKING PAPER 2004/08



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## **Introduction**

The 1997-98 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 pre-crisis level of indebtedness in Malaysia was very high, the level of foreign exposure was far less – as a share of GDP, and especially, as a share of the open economy's extraordinarily high export earnings. Unlike other countries in the region, Malaysia's level of foreign liabilities did not exceed its foreign exchange reserves, and therefore, Malaysia was not in need of emergency credit facilities, including from the IMF. After the severe banking crisis of the late 1980s, Malaysian prudential regulation had been improved and had not been as badly undermined by liberalisation pressures as in the other three economies. In brief, Malaysia was the one country involved in the East Asian crisis, which did not involve the IMF.

This paper examines the political economy of the Malaysian crisis of 1997-98.<sup>1</sup> It explains why Malaysia was less vulnerable to crisis than its neighbours– not least because a severe banking crisis in the late 1980s and reforms undertaken in its aftermath had led to pre-emptive 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.

The paper also argues that Malaysian economic policy during the crisis went through four distinct phases: an early phase of destructive policies led by Prime Minister Mahathir, then a shift to economic orthodoxy led by Finance Minister Anwar Ibrahim, followed by a return to reflationary policies, and finally ending in the imposition of a capital control regime. While these policy shifts have been portrayed as the result of struggle of ideologies between a nationalist prime minister and his more market-oriented finance minister, I argue that the ideological differences between the two men have been greatly 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 had oscillated around RM2.5 against the US dollar during the first half of 1997<sup>2</sup>, with some arguing that it was slightly overvalued.<sup>3</sup> After the Thai baht was floated on 2 July 1997, like other currencies in the region, the ringgit came 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 it against the greenback for a few

days before the futile ringgit defence 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 ever level by January 1998 - by almost half of the value it had held at 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, 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 rose 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 the ringgit 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. Inappropriate political rhetoric and policy measures by the political leadership exacerbated the situation.

Foreign and domestic speculators exacerbated 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 liberalisation, fund managers have an increasingly greater variety of investment options to choose from and can move their funds much more easily than ever before, especially with the minimal exit restrictions Malaysia 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.

## **Key Decisions**

The Malaysian government's response was characterised by three key decisions. First, there was a rejection of the global capital markets, which had brought about the crisis, coupled with attempts to reassert Malaysia's sovereignty over economic policy. Subsequently, Malaysia adopted a very orthodox macroeconomic plan (albeit without IMF assistance) but then reversed that plan as its contractionary impact was felt. Finally, Malaysia decided to apply capital controls.

## **The Reassertion of National Control over Economic Policy-making**

The initial Malaysian government's response to the crisis was led by the Prime Minister who railed against the country's economic situation. Prime Minister Mahathir portrayed the collapse in the ringgit as being exclusively due to speculative attacks on Southeast Asian currencies.<sup>4</sup> 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 the markets and threatened to exacerbate the situation until he was finally reined in by regional government leaders, and perhaps even his cabinet colleagues. The partial truth of his statements was not enough to salvage his reputation in the face of an increasingly hostile Western media. Mahathir came to be demonised as the regional ‘bad boy’.

Mahathir’s early policy responses to the crisis 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 was the normal practice), ostensibly to check ‘short-selling’, which was exacerbating the stock market collapse. This ill-conceived measure also 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. The mid-October 1997 announcement of the 1998 Malaysian Budget was perceived by investors reflecting ‘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’. Although the fund was never properly institutionalised, even more government-controlled public funds – including the Employees Provident Fund (EPF) and Petronas – 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 co-operative (KUB), and the country’s largest conglomerate (Renong), previously controlled by his party and believed to be ultimately controlled by his confidante Daim Zainuddin.

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, causing the stock market to collapse by a fifth – or RM70 billion – in the next three days. The bailout alienated Finance Minister Anwar Ibrahim and prompted him to distance himself from Mahathir’s policies and to consider adopting modified IMF – type pro-cyclical measures.

The situation was initially worsened by the perception that Mahathir (and Daim Zainuddin) had taken over economic policy making from Anwar, who had succeeded in endearing 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 pre-empting the intended role and impact of the National Economic Action Council (NEAC). The NEAC was 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 lines of policy-making 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 (Without the IMF) and their Rejection**

As the economic situation deteriorated in the second half of 1997, Finance Minister Anwar became more receptive to IMF policy advice. In this, he was strongly, but quietly supported by other government officials, and apparently by the entire cabinet during Mahathir's absence at the weekly cabinet meeting of 3 December 1997. When Anwar was considering cutting government spending by ten per cent after the first 1998 Budget announced in October 1997, then Government Economic Adviser Daim Zainuddin, who was responsible for economic liberalisation in the mid-1980s, suggested a twenty per cent reduction, ending in a compromise 18 per cent announced in early December 1997.

In early December 1997, the Finance Minister Anwar Ibrahim began to reassert control over economic policy. After securing full cabinet support (in Mahathir's absence, in early December 1997), Anwar implemented a series of orthodox policies, not unlike those conventionally regarded as IMF solutions.<sup>5</sup> The central bank, Bank Negara, raised its three-month intervention rate from 8.7% at the end of 1997 to 11.0% in early February 1998. Drastic 18% reductions were made in budgeted government expenditure. Loans in arrears were redefined as non-performing loans after three months, instead of the previous six months. Bank statutory reserve requirements were also raised and tighter definitions of non-performing loans were enforced.<sup>6</sup> These measures almost certainly exacerbated the recessionary tendencies already setting in throughout the region. Anwar approved the tighter fiscal and monetary policies from late 1997, in line with market expectations as much as IMF recommendations.

Malaysia's orthodox measures deepened the impact of the crisis. The massive ringgit devaluation imported inflation into Malaysia's very open economy. Over-zealous efforts to check inflation exacerbated deflationary tendencies. The stock market collapse (by more than half since its peak in the first quarter of 1997) adversely affected both consumption and investment through the '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 the restructuring in the wake of the crisis was not well-conceived and unlikely to serve its intended ends. The authorities' push for the rapid merger and consolidation of banks and finance companies was seen as a political move to favour Daim. The consolidation was made all the more difficult by the uncertainties due to the turbulence, but facilitated by the financial sector's vulnerability and reliance on the authorities for debt restructuring and bank re-capitalization.

Early official responses seemed to smack of 'denial' and 'bailing-out' politically connected corporate interests, which inadvertently served to exacerbate the

growing problem, 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 recession.

In the second quarter of 1998, Finance Minister Anwar Ibrahim dramatically change course, 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 Ibrahim and his supporters.

In May 1998, Anwar announced various policies to reflate the economy through counter-cyclical 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 Indonesia's 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 IMF and of Western interests, 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 to the US dollar at RM3.8 to the greenback, compared to the pre-crisis rate of around RM2.5. The Prime Minister then dismissed 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 any significant permanent damage, as predicted by most critics.<sup>7</sup>

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 pre-crisis problems in Malaysia were less serious, owing to strengthened prudential regulations after the late 1980s' banking crisis. 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 limited exposure to foreign bank borrowing while their neighbours 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 merely due to financial interests seeking arbitrage and other related opportunities, or corporate interests seeking cheaper and easier credit. Bank of



International Settlements (BIS) regulations greatly encouraged short-term lending. Meanwhile, even European and Japanese banks generally preferred dollar-denominated lending over alternatives. Criticism of 'bad lending' to East Asia before the crisis should therefore not only focus on the borrowers and domestic regulations, but also on lenders and the rules regulating international lending.

The Malaysian experience also challenges the widespread presumption that the East Asian crisis was solely due to foreign bank borrowing, which could have been avoided by greater reliance on the capital market, especially stock markets. 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. Malaysian bank vulnerability during the crisis was not so much due to foreign borrowing, but instead to extensive lending for stock market investments and property purchases, as well as their reliance on shares and real assets for loan collateral.

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 largely due 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. The disruptive effect has been exacerbated by the fact that portfolio capital inflows tend to build up slowly, while outflows tend to be 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 build-up 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. 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 argue that the September 1998 controls sought to avert yet another crisis in the making.<sup>8</sup> 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 sought to and succeeded in defusing this pressure.

The efficacy of the Malaysian controls was largely due to their effective design. At the time, many market sceptics did not consider the Malaysian authorities capable of designing and implementing such controls, but later conceded that they were proven wrong. The controls addressed the problem identified by Kaplan and Rodrik,<sup>9</sup> and were subsequently revised from February 1999 and lifted after a year. The authorities reviewed their assessment of the situation and sought to demonstrate their flexibility and responsiveness to changes, and thus commitment to being market and investor friendly. Most importantly, they emphasised from the outset that the measures were directed at currency speculation, and not FDI. Although FDI to

Malaysia has declined since 1996, this has also 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 have argued that the Malaysian capital controls provided a 'screen behind which favoured firms could be supported'.<sup>10</sup> 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, 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 portfolio investors expected the September 1998 measures to principally benefit crony companies, causing their share prices to appreciate much more than others.

The government emphasised efforts to bolster the stock market, which many blame for the government-controlled Employees' Provident Fund's loss 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 pre-polls effort to improve investor sentiment and raise funds through stock market operations for the ruling Barisan Nasional coalition's 1999 electoral war chest is 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, 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, but effectively also reducing transparency and accountability besides facilitating corrupt tender awards.

Opponents of the capital controls introduced in September 1998 have tended to exaggerate their likely adverse effects, which have not really been as manifest as they were wont to claim. On the other hand, proponents of the control measures have 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 only came out of the recession from the second quarter. And while the recovery in Malaysia was stronger than in Thailand and Indonesia, South Korea performed better. There is little proof that Malaysia's performance was due to the capital controls, which have largely been amended and dropped except for the dollar peg and related currency controls since September 1999.

Confidence in the Malaysian government's policy consistency and credibility was seriously undermined by the apparent reversal of policy in September 1998, 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 then Prime Minister

Mahathir's declared intention to retain the regime until the international financial system is reformed, which hardly seems imminent. This was not helped by unnecessarily hostile and sometimes ill-informed official rhetoric, though the Mahathir administration sometimes 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.

## **Who Paid?**

Who bore the economic burden of the financial crisis in Malaysia? The ringgit devaluation raised the prices of consumer as well as producer imports, particularly during 1998. Food prices seem to have been especially adversely affected, reflecting the high import content in the national food bill. These effects disproportionately hurt the poor and those on fixed, ringgit-denominated incomes.

The effects of higher producer prices due to currency devaluation are varied. For example, although electronic exports have a very high import content, the ringgit devaluation had the effect of reducing the cost of value added in Malaysia. And in so far as internal transfer pricing is the norm within transnational production chains, it is actually quite possible that currency devaluation would enhance competitiveness. But there are a variety of 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, LTCM collapse and Wall Street scare of the previous month caused the US Treasury to agree to a strengthening and stabilisation 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/US\$ from 2 September 1998 had a similar intent, though with the benefit of hindsight, the Malaysian initiative appears somewhat redundant.

The 1980s banking crisis in Malaysia led to stricter prudential regulation that limited the vulnerability of the banking system to crisis. Thus, stricter prudential regulation and supervision of borrowing from abroad limited the extent of Malaysia's financial crisis. Thus, Malaysia avoided the forced closure of banks and financial institutions that occurred in Indonesia, Thailand, and Korea, thus sparing bank depositors from absorbing the high costs 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 as well as its repercussions for the banking system. It had fallen by about four-fifths, or 80 per cent, to reach its nadir of 262 on 2 September 1998, on the day after the announcement of capital controls. 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 (KLSE), came its greater collapse. The proportionately very high capitalisation 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 since 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 supply industries. The casualties have included employment by, as well as the very survival of construction and supplier firms.

### **Political and Economic Implications**

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, the Malaysian recovery was stronger than those of its Southeast Asian neighbours, only lagging behind Korea. 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 not 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 were mainly due to these fiscal reflationary efforts despite the IMF's own predictions of protracted slowdowns and gradual U-shaped recoveries.

The capital control measures were only part of a package of measures to manage the crisis and to revive the Malaysian economy. Focussing 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, negotiating, implementation and enforcement capabilities as well as national experiences all influenced the outcomes.

Danaharta, an asset-management company, was established by the government in mid-1998 to 'take out' large non-performing loans from the worst-affected banks

and financial institutions. This – together with re-capitalisation of severely de-capitalised banks by a companion agency, Danamodal – served to restore liquidity to the banking system. Although banks became more careful about lending for property purchases, raised lending quotas for share purchases sought to boost the stock market, with positive wealth effects raising domestic demand, helped by expansionary fiscal policies.

Very importantly, the conceptualisation, 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 Niño’, ‘La Niña’ as well as 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 were conceived to favour politically influential interests, and 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 to achieve policy targets.

While recovery elsewhere in the region involved regime and political change, Malaysia’s failure to reform politically could well block the new dispensation the economy desperately needs. The Malaysian political crisis that exploded in September 1998 greatly obscured understanding of the 1997-98 economic crisis in Malaysia and its ramifications.<sup>11</sup>

However, by the second quarter of 1998, Anwar 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, by small businesses and the poor (micro-credit). 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.<sup>12</sup>

The political fall-out from the 1997-98 crisis greatly politicised subsequent analysis and interpretation of the crisis as well as its consequences and implications. On 2 September 1998, then Finance Minister, Deputy Prime Minister and heir apparent Anwar Ibrahim was sacked from the cabinet and then from the ruling party for alleged sexual misbehaviour. Anwar was soon also accused of having instituted IMF-type policy measures in Malaysia from late 1997 and blamed for causing the 1998 recession and exacerbating its consequences for the Malaysian economy through

such policy measures. Several major public policy pronouncements since then have supported this interpretation of the causes and consequences of the crisis.<sup>13</sup>

While Anwar was undoubtedly more inclined to cater to ‘market sentiment’ and to take IMF advice after the worsening situation under Mahathir’s leadership, his post-September 1998 demonisation by Mahathirists as an IMF stooge and agent of the West is certainly not supported by his economic policy record. Some Anwar critics would argue that he always sought popularity, which would explain his apparent pro-market stances in a job where to behave otherwise would invite approbation and adverse criticism by the powerful and influential financial media. These may well be accurate and fair criticisms, but they are of a different order altogether, and have different political implications.

Some Anwar sympathisers naïvely endorsed monetarist and other criticisms of Mahathir, and rejected all Mahathir’s criticisms of global economic inequities and international currency speculation. Meanwhile, critics of globalisation and financial liberalisation have supported Mahathir’s actions as if Mahathir’s caricatured demonisation of Anwar was true and Mahathir had always been critical of economic liberalisation, both domestically and internationally, forgetting his actual economic policy record.

While Mahathir initiated the turn to economic liberalisation from the mid-1980s, with considerable help from then new Finance Minister Daim Zainuddin, Anwar largely continued these policies in the 1990s.<sup>14</sup> 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 long suspicious of his Islamic credentials, Mahathir continued to invoke it, especially after the outbreak of the 1997-98 crisis. Besides such differences in personal and political style, Anwar has had a record of greater interest in social safety net and poverty reduction policies – in contrast to Mahathir’s more trickle-down approach to growth, modernisation and progress, through more intimate government-private business relations (Mahathir’s ‘Malaysia Incorporated’, now vilified as cronyism). Arguably, cronyistic considerations strongly influenced government policy responses to the crisis in the second half of 1997<sup>15</sup>.

When cronyism was joined with corruption and nepotism as the three enemies of Anwar’s Malaysian *reformasi* movement, inspired by events and slogans in Indonesia leading to Soeharto’s resignation on 21 May 1998, Anwar was unwittingly set on a collision course with Mahathir. In retrospect, there are many reasons to believe that Anwar did not fully realise what he was getting into then, and was probably carried away by the naive enthusiasm and euphoria of his impatient Malaysian supporters riding the crest of the Indonesian *reformasi* wave after its surprise success in forcing Soeharto’s ouster.

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 1994, while Anwar was Finance Minister,<sup>16</sup> so there is little reason to believe that he was dogmatically committed to full capital account convertibility. Jomo has provided detailed assessment of the nature of the control measures and their efficacy.<sup>17</sup> Such academic discussions have

not seriously considered the view 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 Ibrahim.

Although many were keen for Anwar to take advantage of Mahathir's diminished credibility as the crisis exacerbated to move against Mahathir,<sup>18</sup> there is little evidence that Anwar wanted to or was prepared to do so. Contrary to *ex post* Mahathirist claims, there is no persuasive evidence that Anwar had any, let alone a good coherent plan or program to accelerate his succession to, let alone depose Mahathir. Instead, it seems likely that heightened popular expectations (especially among Anwar's many supporters then) about the imminence of regime change in Malaysia – after the mid-May 1998 events in Indonesia culminating Soeharto's sudden resignation after 32 years in power – encouraged increasingly public dissent. The unprecedented affront (but not real threat) of Anwarist condemnations of KKN (corruption, cronyism, nepotism) 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.

Considered together with other evidence of disagreements between Anwar and Mahathir, none of this indicates any conspiracy, let alone a strategy, to oust Mahathir. After all, as Mahathir confidante Daim noted at the UMNO general assembly after Anwar's sacking, Anwar recruited Daim's help to deter Mahathir from retiring earlier, not once, but twice (in 1995 and 1997). Why should Anwar then turn on Mahathir, his erstwhile patron, when he could have effortlessly succeeded him earlier?

What is the evidence that Anwar conspired with his camp to oust Mahathir? Much is often made of Anwar's anti-corruption initiatives while Mahathir was away in mid-1997, of the foreign media promotion of Anwar as worthy and urgently-needed successor to Mahathir in the second half of 1997 in contrast to its unsympathetic coverage of Mahathir's contrarian remarks, of Anwar's hospitality to prominent Indonesians who had turned against Suharto in May 1998, of his vociferous criticisms of 'corruption, cronyism and nepotism' ('KKN') at Pulau Sibul, Johor, in early May 1998, and of then Anwar associate, UMNO Youth chief Zahid Hamidi's thinly veiled criticisms of the Mahathir leadership at the UMNO annual party conference in late June 1998.

After Anwar was sacked, he claimed, in mid-September 1998, that he was responsible for the Zahid criticisms, but investigations suggest that his role in drafting Zahid's speech was limited; there are also many indications that he was responsible for 'toning' down the criticisms. But even if he was the author of those criticisms, what was the strategy? After more than sixteen years of close association with Mahathir, could Anwar have seriously believed that Mahathir would resign due to some muted Malaysian echoes of the far more strident public criticisms of Suharto that led to the Indonesian president's resignation on 21 May 1998? Unless one assumes Anwar to be politically naïve, this line of argument is hardly persuasive or plausible.

## **Conclusion**

During the 1997-98 East Asian financial crisis, Malaysia was less vulnerable than its neighbours because the authorities had limited foreign borrowing and introduced prudential regulations and supervision, following a banking crisis in the late 1980s when non-performing loans rose to 30 per cent 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.

The changing policy responses of the Malaysian authorities from July 1997 have been detailed above, reflecting the complex and changing relations between 'high politics' and crisis management. Four phases of these changing policy responses are 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 pro-cyclical policies, apparently recommended by the IMF, only to exacerbate the downturn. By the second quarter of 1998, however, Anwar turned to reflationary spending policies to stem the downturn, albeit belatedly. Finally, after 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 suspected him of plotting to replace and embarrass him. While the apparent policy differences were real, they were also changing, on both sides, and greatly exaggerated in most other accounts of the politics of the period. Economic analysis suggests that the controls' contribution 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.<sup>19</sup> And while the timing of the imposition of the controls helped contain the possible economic fallout from Anwar's sacking, it would be wrong to attribute the controls solely to this political motive.



## Endnotes

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<sup>2</sup> Jomo K. S. [ed.] (2001). *Malaysian Eclipse: Economic Crisis and Recovery*. Zed Books, London: 5, Table 1.1

<sup>3</sup> For example, the yen fell from less than 80¥ to the US\$ in mid-1995 to over 120¥ by mid-1997, while the Deutschmark had floated against the US dollar before mid-1997.

<sup>4</sup> Cf the IMF view that currency speculation precipitated the collapse of the bath but was not a cause of the collapse of other East Asian currencies (IMF 1998).

<sup>5</sup> After tightening bank credit from December 1997, the funding 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') were increased. Nevertheless, the severe contractionary consequences of tighter liquidity have continued to slow down the economy fairly indiscriminately. See Malaysia (1999). *White Paper: Status of the Malaysian Economy*. Government of Malaysia, Kuala Lumpur, issued 6 April 1999. See: Box 1, pp. 25-26

<sup>6</sup> In a long article serialised 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 that only seemed to exacerbate the situation, especially by causing the ringgit to devalue further. See: Mahathir, M. (2000a). "When stability is vital for growth". *New Straits Times*, 23 August; Mahathir, M. (2000b). "Move that helped economic recovery". *New Straits Times*, 24 August; Mahathir, M. (2000c). "How ringgit trading was stopped". *New Straits Times*, 25 August.

<sup>7</sup> For a detailed discussion, see Jomo K. S. (2003). "Malaysia's September 1998 Controls: Background, Context, Impacts, Comparisons, Implications, Lessons". G24 paper, UNCTAD, Geneva, September.

<sup>8</sup> Kaplan and Rodrik, *Op. Cit.*

<sup>9</sup> Kaplan and Rodrik, *Op. Cit.*

<sup>10</sup> Johnson and Mitton, *Op. Cit.*

<sup>11</sup> Jomo 2001: chapter 8, *Op. Cit.*

<sup>12</sup> Jomo 2001: chapter 4, *Op. Cit.*

<sup>13</sup> For example, the 1999 official *White Paper*, *Op. Cit.*

<sup>14</sup> Gomez, E. T., and Jomo K. S. (1999). *Malaysia's Political Economy: Politics, Patronage and Profits*. Cambridge University Press, New York; Jomo K. S. (1994). *U Turn? Malaysian Economic Development Policies After 1990*. Centre for Southeast Asian Studies, James Cook University of Northern Queensland, Townsville; Jomo 2001, *Op. Cit.*

<sup>15</sup> Jomo 2001: chapter 1, *Op. Cit.*

<sup>16</sup> Jomo 2003, *Op. Cit.*

<sup>17</sup> Jomo 2003, *Op. Cit.*

<sup>18</sup> See Jomo 2001: Acknowledgements, *Op. Cit.*

<sup>19</sup> Jomo 2003, *Op. Cit.*

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