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Malaysia in the Global Economy: Crisis, Recovery, and the Road Ahead

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Crisis, Recovery, and the Road Ahead

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This article offers an analysis of contemporary economic development in Malaysia, focusing especially on the causes and consequences of the 1997 Asian Financial Crisis. Malaysia offers an excellent case study in international development due to its role as an export-dependent developing country with a high degree of integration in the global economy. In attempting to determine why Malaysia was enveloped by a financial crisis in July of 1997, a two-level political economy approach is used to separate international policy influences from domestic influences. My findings suggest that a combination of ill-advised, full capital account liberalization (Washington Consensus / international influence) combined with imprudent handling of massive short-term capital inflows (domestic) in the late 1980s and 1990s led to a currency devaluation that resulted in a financial crisis and, consequently, a crisis of Malaysia's real economy. This study identifies three specific policy choices made by the Malaysian government as instrumental in creating crisis-prone conditions: a fixed exchange rate, an open capital account, and monetary policy autonomy. Among foreign and domestic investors, this policy regime created a false sense of confidence in the stability of Malaysia's economy. Since the crisis, Malaysian policymakers have come to recognize that a developing country's vulnerability in the sometimes-volatile global economy cannot be completely eliminated. Under its current leadership, Malaysia has wisely sought to lessen its vulnerability through confidence-building measures in the banking and corporate sectors, diversification of the domestic economy through a focus on commodity and service expansion, and the implementation of more prudent macroeconomic policies. This line of research is valuable as it highlights the evident virtues and dangers of a developing country's economic integration into the global economy.

Over the course of the last fifteen years, Mexico, Thailand, Malaysia, South Korea, Indonesia, Russia, Turkey, and Argentina have all been struck by financial crises. Two remarkable characteristics of this recent phenomenon include the "developing" status of the affected countries and the fact that their respective crises have tended to coincide with financial

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liberalization measures. Such reforms allowed international investors seeking high returns the freedom to invest in high-risk developing economies.

In his essay on the "Causes and Consequences of Recent Crises," Peter Kenen differentiates between the "push" factors of international capital flows and the "pull" factors:

> The growth of private capital flows to developing countries in the early 1990s reflected the "push" of events in major industrial countries (competition and rising costs in domestic markets and an economic slowdown in the US due to rising interest rates) and the "pull" factors of developing countries (cheap and efficient offshore production as well as capital account liberalization).[1]

The U.S. Treasury, the World Bank Group, and the International Monetary Fund (IMF) played the central "push" role in lobbying specific developing countries during the 1980s and 1990s to open up their capital markets to foreign investment. Their advice was rooted in a free-market ideology that saw markets as self-correcting and most efficient when unaffected by government intervention. The financial liberalization measures were manifested in a policy regime consisting of exchange-rate stability, an open capital account, and high interest rates set to attract bank investment. Together with recommendations for deeper trade liberalization, sound fiscal policy, and microeconomic reform, these Western-based policy prescriptions for economic growth in developing countries came to be known collectively as the Washington Consensus. Only in the aftermath of their implementation were certain elements of the Washington Consensus implicated in developing country crises.

For Malaysia, the potential volatility of this regime was realized in 1995 when U.S. and Japanese policymakers agreed to initiate a controlled appreciation of the dollar — to which the Malaysian ringgit (MR) was pegged — relative to the yen. The indirect effect of the initiative was an appreciation of the MR, which then had a number of damaging spillover effects on Malaysia's economy, including a decline in export competitiveness, an expanding current account deficit, and an increasingly unsteady exchange rate regime.

In trying to understand the root causes of the 1997 Asian Financial Crisis, it is critical to note that the magnitude of portfolio capital that flowed into the region from 1985 to 1997 was without precedent. With the ascendance of President Reagan in the United States and Prime Minister Thatcher in the United Kingdom in the 1980s, deregulation, liberalization, privatization, and overall smaller government became the mantras of their economic policy, both at home and abroad. Although the Washington Consensus carried with it deep implications for reform in the U.S. and U.K., it was revolutionary when adopted by the newly named "emerging markets" of the developing world. The international trade of goods and services in Southeast Asia had been well established for decades, but the unfettered flow of bank loans and portfolio capital was a large-scale, first-trial experiment. One school of thought blames senior policymakers at the U.S. Treasury, World Bank Group, and IMF for prematurely promoting capital account liberalization and precipitating a financial crisis. In truth, key financiers within the Asian Crisis countries themselves laid the groundwork for financial collapse via gluttonous foreign borrowing and impulsive regional investment.

Instead of banking the massive influx of foreign capital that came into Malaysia during the late 1980s and early 1990s, Malaysian bankers and investors reacted by pouring the money into real estate and equity shares, eventually resulting in an asset price bubble and an over-inflated stock market. It was only a matter of time before investors sensed an untenable exchange rate and asset market. Malaysia's subsequent economic collapse began with massive capital disinvestment, progressed to a forced currency devaluation and financial crisis, and ended with a crisis of the real economy (goods and services) marked by severe unemployment and a deep recession.

Considering the devastating impact that the 1997 Asian Financial Crisis had on Malaysia's real economy, it is important to ask why the crisis occurred and how/if such an event can be avoided in the future. This paper attempts to answer these questions by taking a two level political economy approach in examining Malaysia's contemporary economic development. By separating international-level influences from those on the domestic level, the effects of trade and financial liberalization on Malaysia's political economy become clearer. And by disentangling the political and economic elements of Malaysia's development path, the justification for specific policy decisions can be more thoroughly understood.

The organization of this paper is as follows: The next section provides historical background on Malasia's contemporary economic development. This is followed by discussion of the 1997 Asian Financial Crisis and the role that three specific policy choices played in precipitating that event: a fixed exchange rate, capital account liberalization, and monetary policy autonomy. A discussion of the crisis-recovery process and the pressing economic issues currently facing the Malaysian government follows. The paper concludes with considerations of the plight of developing countries in an increasingly global economy.

Historical Overview of Malaysia

For the last sixty years, a majority of Malaysia's population has been composed of indigenous Malays, with Chinese Malaysians and Indian Malaysians occupying the minority roles. A deep-seated source of inter-ethnic tension around the time that Great Britain granted Malaysia colonial independence in 1957, the three groups were separated by geography, occupation, and income. Most of the Chinese were involved in the urban-based tin mines, the Indians cloistered in self-contained semi-rural plantation, and Maylays serving as and largely remaining peasants in rural areas.[2]

In the lead-up to British withdrawal, the Malay political party, known as the United Malay National Organization (UMNO), sought to secure the leading role in the new government. But British hesitance to negotiate the terms of independence with a single, ethnically based party led to the development of a tripartite alliance composed of the UMNO, the Malaysian Chinese Association (MCA), and the Malaysian Indian Congress (MIC) in 1954. From the mid-1950s onward, the Alliance promoted a mixed economic development strategy, designing and implementing government-funded industrial policy while attempting to attract foreign direct investment (FDI).

Malaysia's production profile in 1955 showed manufacturing holding an 8 percent share of GDP, agriculture a 40 percent share, and mining, construction, and other services a 52 percent share.[3]

As global demand for Malaysia's commodities began to flag in the aftermath of the Korean War boom, a 1955 World Bank mission to the country recommended "an import substitution industrialization (ISI) strategy through tariff protection; encouraging local industrial entrepreneurship, attracting foreign capital, offering new tax and other incentives, the provision of industrial estates, and infrastructural development."[4] Malaysia heeded the advice and enacted a major economic reform plan shortly after gaining independence.

The government expended a great deal of energy throughout the 1960s guarding tariff barriers designed to facilitate the development of indigenous manufacturing industries specializing in consumer goods production, mainly food, wood, chemical, and rubber products. Problematically, the Malaysian producers failed to achieve international competitiveness, exported little and contributed minimally to job creation. Furthermore, the limitations of ISI — domestic market saturation and a rising current account deficit — were quickly becoming apparent, leaving government officials with no choice but to pursue a more immediate and direct export-oriented economic strategy predicated on FDI.

Interestingly, the UMNO and MCA approved of FDI for different reasons. In the case of the UMNO, FDI was a means to counterbalancing the ongoing expansion of Chinese capital, whereas for the MCA, foreign investment ensured the predominance of a free-enterprise market system at a time when communism was developing a strong root system in the region. Most importantly, the trend of FDI in Malaysia in the 1950s signified an initial step toward its integration into the global economy as well as the beginning of its dependence on foreign capital for economic growth.

FDI during the 1950s and 1960s was mainly directed at natural resource extraction as outside investors were attracted to Malaysia's abundant rubber and tin endowments. Unfortunately, the Malaysian government's failure to achieve greater economic diversification meant that by 1969, rubber and tin still accounted for almost 80 percent of the country's gross export earnings,[5] leaving ethnically-based income inequalities largely unchanged in the decade following independence. Despite healthy economic growth and the beginning of essential commodity diversification, the wealth-creating benefits of growth were distributed to a narrow group consisting of foreign corporations, Chinese businessmen, and a few privileged Malays. As unemployment remained high in the midst of growing prosperity, inter-ethnic tensions erupted into a series of violent street riots in May of 1969.

With UMNO leadership in a precarious position, an effort was made by soon-to-be Prime Minister Abdul Razak Hussein to cobble together a more robust coalition representing the diverse interests of the Malays, Chinese, and Indians. In reality, the resulting coalition, named the Barisan National (BN), emerged as an UMNO-dominated political body. K.S. Jomo and Terrence Gomez elaborate on how a methodical erosion of governmental checks and balances, among other things, have reinforced the UMNO's political hegemony through the years:

> The UMNO-led Barisan Nasional has been firmly consolidated in power and periodically re-legitimized by increasingly gerrymandered national elections. And with amendments to the national constitution to curb the powers of the judiciary and constitutional monarchs — giving the UMNO leadership greater hegemony over the state — the political sphere has been reorganized to serve their interests and priorities better. This has involved the transfer of assets, other sources of income, and significant control of the national economy to the politically influential.[6]

The first formally articulated strategy designed to promote Malay interests was the 1970 New Economic Plan (NEP). It was constructed to pull up the majority Malay demographic to a more prosperous and involved position in the domestic economy.

The UMNO described the main objective of the NEP as a "restructuring of Malaysian society so that the existing identification of race with economic function and geographical location could be reduced and eventually eliminated."[7] The government sought to achieve this goal by carrying out land reform, funding an integrated rural development scheme, promoting human capital formation across the Malay community, and most importantly, creating a Malay business community that would ideally occupy a 30 percent share of the domestic corporate sector by 1990.

In short, the NEP was an affirmative action program intended to redistribute wealth in favor of indigenous Malays. While the potential for corruption and cronyism became magnified and ultimately was realized under the NEP, the socioeconomic benefits of GDP growth under the plan were remarkable, as the poverty rate fell from 49 percent in 1970 to 17 percent in 1990.[8]

It was no coincidence that this growth took off at a time when the government began executing the Second Malaysia Plan (1971–1975), its first formal planning effort based on export-oriented industrialization (EOI). The centerpiece of the plan was a strategy to attract FDI from large multinational corporations and regionally focused investors with a smaller market share. Generous incentive packages comprised of investment credits, tax concessions, fast-track permitting, and access to various infrastructural facilities were offered to prospective outside investors. In addition, "foreign companies were allowed to set rules and regulations limiting worker rights with special strict regulations."[9]

By the mid-1970s, a significant structural change began to take place in Malaysia's economy thanks to steadily rising FDI. More specifically, the electronics/electrical and textiles/apparel sectors emerged as the leading manufactured exports. Nearly all of these advances came courtesy of foreign companies, a situation that eventually gave way to a dual industrial structure comprised of internationally competitive, export-oriented foreign companies in one enclave of the economy and internationally uncompetitive, domestically-oriented indigenous industries protected by government regulations in another area.

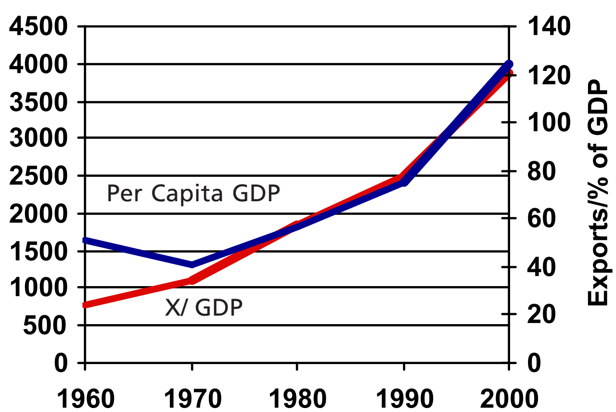
From an economic standpoint, the persistence of dualistic development in Malaysia during the 1970s, 1980s, and 1990s was counterproductive to the goal of developing internationally competitive indigenous industries. The arrangement served a major political purpose, allowing the Malay-dominated government to easily insert the historically impoverished Malay community in industrial development.

By the start of the 1980s, a number of trade-related problems began to affect Malaysia's economic standing, especially its economic dependence on international demand for its chief exports. This problem was illuminated during a recessionary trend among major industrialized countries in the early 1980s. As Malaysia's export earnings stagnated, the government altered its development plan to jumpstart growth, returning again to an ISI strategy.

The launching of the Fourth Malaysia Plan (1981–1985) signaled a major policy shift whereby the government promoted the heavy industries program through public sector investment under the Heavy Industries Corporation of Malaysia.[10] The intention of this shift was to generate forward and backward linkages in domestic industry value chains, thus achieving deeper integration and higher value added in-country. Government-assisted industries included the national car manufacturer (Proton), steel mills, petrochemical plants, and cement factories. Over the course of the 1980s, their performance was weak, again reflecting the inability of the Malaysian government to generate internationally competitive indigenous industries or at least cut off the inefficient ones. A major part of the problem was the government's continued use of tariff protection to nurture its infant industries, many of which remain under the control of Malay nationals. To this day, over twenty years later, the same "infant" industries still enjoy some form of government protection, an impediment to the critical structural transformation of Malaysia's economy, yet a political necessity to sustain the UMNO's dominance.

To their credit, policymakers in the Malaysian government continued to push the expansion of the manufacturing sector through the mid-1980s, relying mostly on FDI to create employment and stimulate economic growth through EOI. To attract more investors, the government further deregulated FDI, allowing for greater foreign ownership of domestic companies and sweetening the incentive structure to edge out other developing countries competing for the same investment. With the help of the 1985 Plaza Agreement in which the Japanese yen underwent a controlled appreciation relative to the U.S. dollar (to which the MR was pegged), Malaysia saw FDI skyrocket from 325 million MR in 1986 to 6.2 billion MR in 1990.[11]

Fig. 1 Per Capita GDP Growth and Exports as a % of GDP, 1960–2000



Source: World Bank

This investment played a central role in facilitating GDP growth rates that averaged 7 percent from 1970–2000.[12] Malaysia was able to attract more than $80 billion USD over the course of the 1980s and 1990s, turning it into one of the world's most export-dependent economies and accelerating the structural transformation of its economy from a reliance on extractive resource industries to more value-added manufacturing activities.[13] Figure 1 illustrates the simultaneous growth of per capita GDP and exports as a percentage of GDP in Malaysia from 1960 to 2000.

Meanwhile, on the international scene an economic policy shift began to emerge as the major industrial countries, most notably the United States and United Kingdom, started touting the ensured benefits of a more hands-off approach to regulating the global economy. In the early 1980s, the Reagan and Thatcher administrations began strongly emphasizing the need for greater trade and financial liberalization, privatization of state owned enterprises (SOEs), and overall smaller government involvement in the economy. Both leaders began casting this message across the globe, utilizing top level policymakers within the U.S. Treasury, the IMF, the World Bank Group, and the General Agreement on Trade and Tariffs Organization (GATT) to convince or, in some cases, force developing countries to open up their markets to foreign investment. Columbia University economist Jagdish Bhagwati has referred to this lobbying mechanism as the Wall Street–Treasury Complex,[14] a classification rooted in the fact that top level employees of the U.S. Treasury, IMF, and World Bank Group have always held strong ties, if not former jobs, within the private investment and banking firms on Wall Street. In the past twenty years, these relationships have translated into a synchronization of policy imperatives between powerful private investors and highly influential Washington policymakers, imperatives later dubbed the "Washington Consensus" by John Williamson of the International Institute of Economics.

The Washington Consensus consists of several conditions: trade liberalization, financial liberalization, privatization of SOEs, public spending cuts to reign in deficits, and the elimination of barriers to FDI.[15] The message sent to developing countries by the Wall Street–Treasury Complex was clear: Open your markets to foreign investment and you will be rewarded with economic growth.

Even though Malaysia had already satisfied a number of these conditions by the mid-1980s due to its long-standing outward orientation, the government still held a strong role via regulation of the domestic banking sector, oversight in the workings of SOEs, and maintenance of its fiscal commitment to ethnic redistribution. But with a heady vision of massive capital inflows fueling already exceptional economic growth, Malaysian policymakers made their move.

From the mid-1980s onward, government officials began streamlining the public sector (cutting welfare spending and funding for regulatory agencies), privatizing SOEs, and incentivizing foreign portfolio investors with the elimination of capital gains and dividend withholding taxes.[16] These reforms were expressed in the 1990 New Development Plan (NDP), a policy initiative marked by a dramatic shift in government priorities "from equality to growth."[17] K. S. Jomo has published extensively on the details of this shift. In reference to privatization measures, he writes:

> Privatization basically involved the transfer of existing assets from public to private hands, with no necessary addition of capacity, and therefore absorbed scarce private sector financial resources without enhancing economic capacity. With "know-who" becoming more important than "know-how," cronyism undermined the development of entrepreneurship and other capabilities.[18]

Such cronyism was widespread and an unmistakable remnant of the NEP, a plan that explicitly sought to increase the corporate involvement of indigenous Malays relative to Chinese Malaysians. Moreover, various measures went well beyond increased corporate involvement.

Highly lucrative patronage networks between UMNO party members and a narrow base of wealthy Malay businessmen reinforced the UMNO's political dominance. Yoshihara refers to this narrow base of wealthy Malays as the crony capitalists, "a group of rent-seeking, private sector businessmen who have benefited enormously from close relations with government leaders by obtaining not only protection from foreign competition, but also concessions, licenses, monopoly rights, and government subsidies."[19] This symbiotic relationship satisfied both parties but yielded serious market distortions in the process. While government support succeeded in promoting the socioeconomic mobility of Malays in the short run, their general failure to develop internationally competitive businesses over the long term resulted in subsidy dependence. As usual, such market distortions primarily hurt consumers, with long-term effects inhibiting important structural transformations in the Malaysian economy. Additionally, Malaysia's small size in combination with its relatively shallow indigenous industrial base magnified the vulnerabilities that go along with a high degree of export dependence, namely terms of trade fluctuations, occasional current account deficits, and reliance on potentially transient FDI for economic growth.

It is instructive to note that Malaysia's economic growth was most robust when the government was promoting EOI through FDI. The trend of GDP growth in Malaysia was consistent with the growth of the manufacturing sector, a sector dominated by foreign companies producing electronics and apparel for export.[20] Greater than 50 percent of GDP growth from 1987 to

1997 came directly from manufacturing, with foreign firms accounting for over 75 percent of manufactured exports.[21] Furthermore:

> By the late 1980s, it became clear that manufacturing development had been predicated on the import of intermediate and capital goods. Although manufactured exports offered some stimulus to investment and employment in manufacturing, their high import content applying especially to electronics/electrical and textiles/apparel made for low local value-added and low net foreign exchange earnings.[22]

Coupled with its dualistic industrial structure, Malaysia's dependence on imported inputs for export production comprised the two major structural weaknesses of its economy at the dawn of the 1990s. Both weaknesses had the potential to incur serious balance-of-payments problems if foreign companies decided to invest elsewhere or if there was an unanticipated currency appreciation. The latter scenario was realized in the mid-1990s when an agreement between the United States and Japan forced an appreciation of Malaysia's currency via its peg to the U.S. dollar. As Malaysia became a less attractive option for FDI due to the terms of trade shock, balance-of-payments problems eventually materialized, leaving the country in a precarious position.

The foundation of this activity was the Malaysian central bank's commitment to maintaining the MR's virtual peg to the U.S. dollar in tandem with the government's commitment to maintaining an open capital account and high interest rates to attract bank funds, a highly dangerous policy trio in the context of massive and easily reversible short-term capital inflows.

The 1997 Asian Financial Crisis

The Malaysian Ringgit and Currency Exchange

In his book *International Money and Finance*, Ramesh Ramsaran writes:

> The appropriateness of an exchange rate regime is determined by the structural characteristics of an economy and by policy objectives. The exchange rate links the domestic economy to the international economy, and therefore it plays a critical role in determining the ultimate impact of internal or external shocks.[23]

Malaysia's high level of engagement with foreign investors from the time of its independence in 1957 left little choice regarding the type of exchange rate regime it would adopt. A fixed exchange rate is preferable in a country with an internationally oriented developing economy for one main reason: exchange rate stability establishes confidence in the minds of domestic import/export businesses and foreign investors. A predictable exchange rate is essential to the success of an export-oriented development strategy.

In order to maintain a fixed exchange rate, the currency must be pegged to a "hard currency" such as the U.S. dollar, the Japanese Yen, or the Euro.

As each of these three hard currencies operate under floating exchange rate regimes, the pegged currency is essentially floating as well. In this case, the policy of a peg acts simply to convey monetary discipline. Central bank regulators in Malaysia maintained the MR as a virtual peg to the U.S. dollar from 1974 until 1997, a policy that benefited its economy at times while adversely affecting it on other occasions. Malaysian policymakers had minimal control over the price of their currency, a necessary sacrifice in order to participate in an increasingly global economy.

Following the 1985 Plaza Agreement between the United States and Japan in which a controlled depreciation of the U.S. dollar relative to the yen was agreed upon, the Malaysian economy benefited from a favorable rise in its terms of trade. Because production and exports became relatively cheaper in Malaysia compared to Japan and a number of other "first tier" newly industrialized countries in the East/Southeast Asian region, Japanese and Taiwanese companies invested heavily in Malaysian production facilities. FDI rose from 325m MR in 1986 to 6.2b MR in 1990, bestowing immense foreign exchange reserves on Malaysia's central bank.[24] This allowed the government to close its current account deficit, demonstrate solid macroeconomic fundamentals, and move forward in its new plan to attract foreign investment in the Malaysian stock market (KLSE).

While the first U.S.-Japan currency intervention rewarded Malaysia's dollar-pegged MR policy, a subsequent agreement between the same countries in April of 1995 highlighted its inherent risk. On this occasion, the compromise was reversed as central bank regulators in the United States and Japan agreed to initiate a controlled appreciation of the dollar relative to the yen. The natural result in Malaysia was a simultaneous appreciation of the MR, making FDI less attractive.[25] This contributed to a deepening current account deficit, serious concern on the part of foreigners who had invested in Malaysia's stock market and banking sector, and an acceleration of FDI to China and India. Malaysia's economy had become hostage to the confidence of international investors.

The final devastating blow was dealt by the collapse of the Thai baht. Walden Bello offers a detailed account of the crisis' onset:

> With too many baht chasing too few dollars, there was huge pressure for devaluation. The scent of panic attracted currency speculators. . . . The Bank of Thailand initially sought to defend the baht by dumping its dollar reserves on the market, but by July 2, after losing at least 9 billion USD of its 39 billion dollar reserves, it had to throw in the towel. Speculators spotted similar skittish behavior among foreign investors in Manila, Kuala Lumpur, and Jakarta, where the same conjunction of commercial bank over exposure in real estate, weak export growth, and a widening current account deficit was stoking fears of a currency devaluation that could devastate their investments. By October [of 1997], the Philippine peso, the

> Malaysian ringgit, and the Indonesian rupiah were still on a downspin as capital continued to exit, resulting in a catastrophic combination of skyrocketing import bills, spiraling costs of servicing the foreign debt of the private sector, heightened interest rates spiking economic activity, and a chain reaction of bankruptcies.[26]

Along with highlighting the risk of a policy upholding exchange rate stability and an open capital account in a developing country, this story is also an excellent illustration of the interdependence that financial openness has imparted among highly industrialized countries and those still in a developing state. In the case of the 1997 Asian Financial Crisis, that interdependence resulted in a significant transfer of wealth from developing to developed countries.

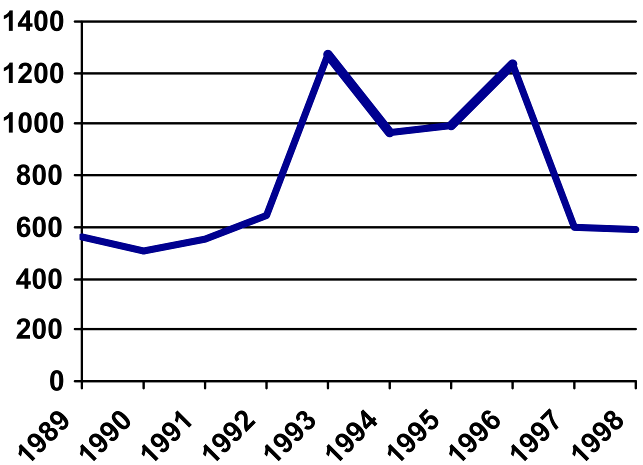
Capital Account Liberalization

The previous section attempts to explain the relationship between a country's choice of exchange rate regime and its policy on capital account convertibility, that is, the ability of foreign and domestic investors to convert the currency of their home country into or out of the currency of the country they wish to invest in or disinvest from. Total liberalization of a country's capital account to capital inflows covers four main areas: FDI in "bricks and mortar," foreign purchase of domestic assets such as business interests or real estate, foreign investment in domestic stocks and bonds, and foreign lenders' access to domestic borrowers, who can borrow short term or long term.[27] Liberalization of capital outflows can be a different issue altogether, as it involves either domestic investment abroad or foreign disinvestment.

A general consensus has been reached regarding the differing volatility of these four types of international capital flows. In their study on "The Effects of Financial Globalization on Developing Countries," Prasad et al. cite extensive empirical evidence in noting that "FDI constitutes the least volatile category of private capital flows to developing countries, which is not surprising given its long term and relatively fixed nature." The authors go on to write, "Portfolio flows tend to be far more volatile and prone to abrupt reversals."[28] While such findings are generally consistent with the contemporary history of Malaysia's capital account policy, one cannot assume FDI to be a long term luxury, especially with the ascendance of China and India, two developing countries with unmatched low-cost labor reserves and increasingly prosperous domestic markets.

Historically speaking, Malaysia's policy on capital account transactions became increasingly liberal from 1972 — when the government sought to attract FDI by opening free trade zones — up until the early 1990s, when the government incentivized foreign portfolio investment by eliminating capital gains and dividend withholding taxes.[28] The distributive aspect of these decisions was clear-cut: Malaysian policymakers sought the attention and money of FDI and foreign mutual fund managers, embracing an economic strategy predicated on foreign investment. In fact, a major attraction of FDI in Malaysia remains in the form of heavy government restrictions on labor unions, a policy that has obstructed wage increases and preserved the country's labor-based comparative advantage to a certain extent.

Fig. 2 The Kuala Lumpur Stock Exchange Index 1990–1998



Source: International Finance Corporation (IFC)

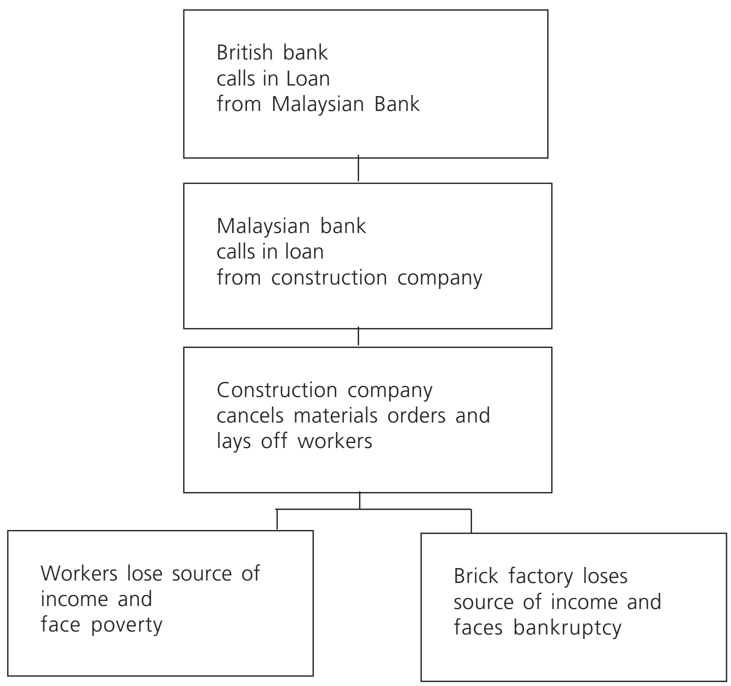
In contrast to Malaysia's efforts to invite FDI, full liberalization of the Malaysian stock market over the course of the late 1980s and early 1990s was more of an externally induced policy decision, driven by the relentless lobbying of Western governments, the IMF, and the International Finance Corporation (IFC), the private investment arm of the World Bank. Chin Kok Fay and Jomo K. S. explain the agenda driving outside pressure:

> From the late 1980s, mutual funds, hedge funds, and other institutional and even individual investors were keen to invest in the rapidly growing economies of East Asia, where growth performances contrasted favorably with the prolonged slow growth, if not recessions, of the advanced industrial economies in Europe and elsewhere.[30]

Malaysian policymakers were not disappointed by their decision as they watched the main index of the KLSE rise from 506 in 1990 to a peak of 1238 in 1997. Figure 2 illustrates this trend. From the perspective of international investors, Malaysia's commitment to exchange rate stability, an open capital account, and solid macroeconomic fundamentals exemplified the perfect investment climate.

The Malaysian government's policy on foreign bank borrowing deserves special attention since it most likely saved the country from having to approach the IMF following the 1997 crisis. After the mid-1980s collapse of a large domestic bank, the government implemented the Banking and Financial Institutions Act (BAFIA) of 1989, an initiative that heavily restricted private foreign borrowing. The BAFIA essentially prevented Malaysian banks and individuals from becoming overexposed to short-term foreign borrowing, a problem that forced South Korea, Indonesia, and Thailand to seek IMF assistance following the 1997 crisis.

Fig. 3 The Process of Calling in a Bank Loan



Source: Brian Baltimore, International Political Economy Lecture, University of Massachusetts, Boston Ma, April 22, 2004

Malaysian banks were far from prudent in handling the enormous sum of foreign capital that flowed into the economy during the boom of the 1990s. Frivolous and excessive lending for investment in non-tradeables such as real estate and stock shares "aggravated the current account deficit — with greater imports but no corresponding exports — and fuelled an asset price bubble."[31] Considering the fact that much of Malaysia's lendable funds at the time originated from easily reversible foreign portfolio investment or actual foreign loans, the subsequent insolvency of a number of Malaysian banks came as no surprise when capital flight began in 1997. Figure 3 offers an example of how a foreign bank's decision to call in a loan — one symptom of financial panic — can have ripple effects throughout a developing country's real economy.

Most importantly, Malaysia's external liabilities did not exceed its foreign exchange reserves, a condition that saved the country from having to submit to IMF conditionalities in return for a bailout package. As mentioned above, this was largely a result of government regulation on foreign borrowing. Here is a crucial lesson for other developing countries as they continue to reformulate their economic policy after devastating crises: the government must play a role in monitoring private foreign borrowing. In South Korea, Thailand, and Indonesia, premature deregulation of the banking sector planted the seed for financial crisis further on down the road. An eventual mismatch between short-term liabilities and existing assets coupled with the instability of regional exchange rates was the inevitable consequence of over exposure.

At the heart of the Asian financial crisis was an unsustainable commitment by regional governments to open capital accounts and fixed exchange rates. The interdependent relationship between a country's policy on capital account transactions and its exchange rate regime becomes clearer when one considers that in order for a foreigner to conduct any one of the aforementioned capital account transactions in any country (FDI, portfolio and bond investment, asset investment, and lending), the investor must convert the currency of their home country (i.e. U.S. dollars) into the currency of the country they seek to invest in (i.e. MR). This is where the concept of foreign exchange reserves comes in.

In order for a country to conduct international business, its central bank must maintain a reserve of hard currencies sufficient to facilitate the convertibility of its domestic currency into hard currency when an investor decides to remove their money or recall a loan. Because the value of a country's exchange rate is a function of demand for its currency, foreign investment or disinvestment directly affects it. But in a country like Malaysia where the central bank maintains its commitment to exchange rate stability and rules out revaluation, massive capital inflows translate into a massive increase in the domestic money supply, leading to suspected undervaluation and inflationary pressure. The converse is true during phases of capital outflows.

In Malaysia's case, the massive capital inflows during the first half of the 1990s created the perception of an undervalued MR. Such perceptions facilitated even greater capital inflows as investors speculated on the prospect of revaluation at a higher rate. Instead, the Malaysian central bank kept its commitment and simply allowed the domestic money supply to rise with increased capital inflows, the consequence of which was over-investment in real estate and the stock market and an asset/stock market bubble. The subsequent chain of events began with capital flight due to suspicions of an over-inflated economy and continued with heavy foreign speculation on devaluation of the MR. When the central bank's attempt to support its currency failed, devaluation was the only option, resulting in a financial crisis and a deep economic recession.

Macroeconomic Policy Autonomy

As the master architect of the Bretton Woods Institutions, John Maynard Keynes saw "financial markets as driven essentially by speculative behavior and likely to impose constraints on national policy autonomy. He therefore argued for capital controls."[32] During the 1970s and early 1980s when Malaysia had not yet exposed its market to short-term portfolio capital, policymakers enjoyed free reign in the design of macroeconomic policies. For example, the government responded to the early 1980s commodity price collapse by investing in domestic infrastructure projects and running a fiscal deficit. This expansionary policy maintained employment levels and protected the real economy from the prospect of a damaging recession.

By contrast, the policy shift of the late 1980s that occurred with the introduction of the NDP lessened the appeal of fiscal policy as a macroeconomic management tool. According to policymakers in the upper echelons of the U.S. Treasury, World Bank Group, and IMF, excessive public spending was inefficient and likely to yield market distortions. Budget deficits were seen as counterproductive to establishing investor confidence and hence discouraged in the name of a "less intrusive" public sector. Monetary policy was also subjugated to the demands of international investors; domestic interest rates in Malaysia were kept high to attract foreign bank investment. The Malaysian government thus sacrificed the only direct means by which it could counter natural fluctuations in the business cycle of its economy.

In fact, the combination of capital account liberalization and monetary policy subjugation has been implicated as one of the major factors contributing to the asset price bubbles in the East Asian countries affected by the 1997 crisis. More specifically, Prasad et al. find that "the procyclical nature of international capital flows appears to have had an adverse impact on consumption volatility in developing economies. One manifestation of this procyclicality is the phenomenon of sudden stops of capital inflows."[33] This point can be extended to include the procyclicality of capital outflows, the substance of which drained foreign exchange reserves in Thailand, Malaysia, Indonesia, and South Korea in 1997.

With no choice but to seek IMF assistance in restructuring their external liabilities, the aforementioned countries (barring Malaysia) were then required to implement a host of economic reforms in order to receive emergency funds, reforms that were "supposed to rectify the problems that caused the crisis. The ingredients included much higher interest rates plus cutbacks in government spending and increases in taxes," policies hardly conducive to economic stimulus in a time of recession.[34]

Malaysia took an alternate path by reversing its commitment to an open capital account, pegging its exchange rate, and imposing comprehensive controls on capital outflows. Jagdish Bhagwati has taken a supportive stance on Malaysia's decision to shun the IMF prescription and reclaim monetary policy autonomy:

> Just as an import tariff enables you to segment domestic from foreign markets and to raise the domestic price above the foreign price, capital controls segment the domestic capital market from the world market and this can enable you to lower interest rates (to inflate the economy) without fearing further outflows of capital because interest rates are higher abroad.[35]

While some economists criticized the decision by the Malaysian government to impose capital controls as an excuse to protect its cronies in the financial sector, a collection of highly respected economists praised the measure as a fully justified repossession of monetary policy autonomy.[36] There is no question that capital controls raise the cost of doing business in a country and are difficult to enforce,[37] but as Paul Krugman has remarked, "that cost is minor compared with the newfound ability of developing country policymakers to contain temporary speculative attacks without having to impose punitive interest rates."[38]

Recovery and the Road Ahead

Curiously, the effectiveness of Malaysia's capital and exchange controls post-crisis is somewhat questionable. In a 2001 IMF report, Kannita Meesook explained, "the effect of the September 1998 capital controls in curtailing speculative capital outflows appeared benign because much of this capital had already left the country. . . . Nevertheless, the policies provided safety measures at a time of foreign exchange market instability."[39] On one hand, the controls were useless in stemming capital outflows, yet on the other hand, they gave the government breathing room to engineer a recovery plan focused on rehabilitation of the domestic economy. A reclaiming of monetary policy autonomy, however, was only part of the recovery process.

Due to the collapse of the MR, "the Malaysian corporate sector experienced a significant loss of wealth as the value of real estate and equities used as bank collateral fell along with demand. Corporate incomes and cash flows also declined, leaving some corporations unable to service their debts."[40] The natural consequence was a spike in the number of non-performing loans (NPLs). As this situation threatened the health of the corporate and banking sectors, the government stepped in and created an asset management company by the name of Danaharta. The company operated by acquiring the largest and most problematic NPLs from banks and forcing the responsible companies to liquidate their assets and pay off debts. As of late 2003, "Danaharta seemed well on its way to success. It expected to be able to get 57 percent of the value of its acquired and managed loans back, and even made a small profit."[41]

An overhaul of the banking system was also required post-crisis. "To prevent [the system's] collapse, all affected countries gave a blanket deposit guarantee and provided liquidity support early into the crisis."[42] But only Malaysia was successful in preventing a major bank run compared to the other countries affected by the crisis. This may be attributable to the early action Malaysian officials took to quell fears of widespread insolvency with the creation of a government-backed re-capitalization agency, Danamodal, in January of 1998. Even still, the liquidity injection provided by the agency came with strings attached. "[Danamodal] poured 11 billion MR into the system under the condition that more than 70 banks accept a wave of consolidation. The banks in question were consolidated into ten 'anchor' banks and another 20 specialist lending institutions."[43] Capital inflows into Malaysia during the boom were excessive, heightening the incentive to build more banks. Following the crisis, the proliferation of NPLs threatened the solvency of these nascent banks. Malaysia's central bank closely monitored the consolidation process so that the end result would be a small number of large banks more suited to the pressures of international competition.

The response of the global market to Malaysia's reforms might have been more positive if capital controls on portfolio disinvestment had not alienated so many investors. "Ratings agencies downgraded Malaysia, sovereign bond spreads increased relative to those of South Korea and Thailand, and Malaysia was removed from major investment indices."[44] Just as a lack of investor confidence began the crisis in 1997, it continued to plague Malaysia's economy in the aftermath. Even though the controls were intended to leave FDI unaffected, restrictions on cross-border capital withdrawal made greenfield investment much less attractive. To the cautious approval of international investors, the capital controls were replaced by a price-based exit tax in February of 1999 and eliminated altogether in May of 2001.

Malaysia began its economic recovery in 1999, as investor confidence and global demand for electronics picked up. It turned out that the newly pegged MR (3.8 to the U.S. dollar) was at an undervalued price. This gave a welcome boost to exports, facilitated a much-needed recapitalization of foreign exchange reserves, and allowed Malaysia to build a current account surplus. Beginning in late 2000, however, Malaysia's vulnerability as one of the world's most export dependent economies resurfaced. A slowdown in the global IT sector partially paralyzed Malaysia's critical electronics sector, and once more, a depreciation of the Japanese yen and other regional currencies damaged Malaysia's favorable terms of trade, resulting in a brief outflow of short-term capital.

Even though the year 2000 terms of trade shock ended up being inconsequential over the long term, it again illuminated the deeply integrated nature of international trade and finance, as well as Malaysia's inability to circumvent its downsides. The country's strategy for the future should focus on mitigating these downsides with "continued structural reforms to achieve healthy balance sheets of the banking and corporate sectors; further deregulation to promote competition and efficiency; and consistent macroeconomic policies to maintain financial stability and sustainable fiscal and external positions."[45] Notice that each of these prescriptions is geared toward maintaining favorable investor confidence and competitive industries in the global economy. It has been clear for some time now that Malaysia cannot turn back from its position as an FDI- and export-dependent developing country without facing severe economic and political destabilization.

Conclusion

This paper follows the trajectory of Malaysia's contemporary economic development in the context of an increasingly global economy. Malaysia has reaped the benefits of its generally open trade policy by finding its niche in the electronics/electrical manufacturing sector and exporting its way to middle-income status during strong cycles of global demand. A pillar of this strategy involved the successful attraction of and eventual reliance on FDI in the manufacturing sector. Despite the central contribution that this type of investment made to GDP growth in Malaysia, its abundance has waned in the last decade, owing to the rise of China and India as more attractive FDI landscapes.

Politically, Malaysia's path has had much in common with that of its regional neighbors. Like South Korea, Singapore, Indonesia, and Taiwan, Malaysia's impressive economic development during the 1970s, 1980s, and early 1990s occurred under the heavy-handed rule of an authoritarian leader. Comprehensive restrictions on free speech, free press, fair elections, and human rights across Southeast Asia during times of rapid economic growth have caused some to question whether liberal democracy is really compatible with economic development in the early stages. Interestingly, it appears that the relatively equitable distribution of wealth engineered by a number of Asian governments during early stages of industrialization facilitated the desirable combination of productivity growth and political stability.[46] A defining policy of Malaysia's political economy through the 1970s and 1980s was the NEP, a government-led effort to create greater parity among wealthy, urban-based Chinese Malaysians and less wealthy, rural- based indigenous Malays. The overarching intent of the program was to dissolve the association between economic function and ethnic background, a divide that spawned violent uprisings in 1969.

In practice, the NEP consolidated the power of the Malay-based ruling party and led to the entrenchment of Malay interests concentrated in government-protected industries. Malaysia's homegrown corporate culture in tandem with its propensity towards import substitution policies led to a dual economy that persists to this day. On one side of the divide exist government-assisted, internationally uncompetitive import substituting firms staffed mostly by indigenous Malays. On the other side exist highly advanced foreign corporations exporting manufactured goods or operating internationally oriented service centers in tax-exempt export processing zones. Malaysia's trend of GDP growth over the past thirty-five years reveals much greater success during periods of export-oriented industrialization (FDI-led) as opposed to periods of import substituting industrialization (government-led).

More than half of Malaysia's major infant industries were uncompetitive in the global market in the late 1980s and more than two-thirds of them were domestically oriented.[47] Deep structural weaknesses in Malaysia's industrial and technical capacity are evidenced by the fact that most of Malaysia's internationally competitive industries are natural resource based and that indigenous manufacturers rely on imported inputs for production. The main factor sustaining infant industry protection remains the UMNO's drive to cement its position in power by maintaining well established patronage networks. A perfect example of this can be seen in Malaysia's domestic car manufacturer, Proton. In the past, the company has exported minimally and enjoyed protection in the form of 70 percent ad valorem tariffs on competetors' imports.[48]

Malaysia's success with trade and FDI liberalization may have made the decision to open up to foreign portfolio flows in the late 1980s easier, but the decision was largely influenced by the intensive lobbying of top level officials at the U.S. Treasury, the World Bank Group, and the IMF. While initially greeted by a flood of foreign capital, Malaysia and its neighbors displayed little prudence in their management of the unprecedented influx. Countless banks in the region overextended themselves through excessive borrowing and lending, setting the stage for a financial collapse that would eventually wreak havoc on the economic state of East and Southeast Asia in 1997–98. From a regulatory standpoint, Malaysia and its crisis-affected neighbors were ill prepared for the exposure that complete financial openness brought with it. Much of this exposure was a function of investor confidence, a notoriously fickle and destabilizing influence in developing countries.[49]

In the course of its recovery from the crisis, the Malaysian government took an unorthodox path, eventually shunning IMF prescriptions for economic reform and imposing comprehensive capital/exchange controls to reclaim monetary policy autonomy. Despite the fact that most of the damaging capital outflow had already taken place, Malaysian officials took comfort in the shelter that exchange rate and capital account stability provided. It allowed them to get their financial house in order and offer accommodating interest rates to domestic businesses, facilitating an expedient economic recovery. Since the crisis, Malaysia has wisely lessened its vulnerability to destabilizing external shocks by encouraging healthier balance sheets in the banking/corporate sectors and diversifying its domestic economy with a focus on human capital formation and service development.

In the case of Malaysia and a host of other developing countries including Mexico, Thailand, Indonesia, South Korea, Russia, Turkey, and Argentina — all of whom have been struck by financial crises in the past decade — ill-prepared capital account liberalization proved catastrophic. In a world where financial integration signifies the subjugation of real economies and policy autonomy to the whim of short-term capital flows, the real economy becomes disembedded from society.[50] This tradeoff has the potential to create enormous wealth for the capital rich while leaving those without such endowments in a significantly less advantageous position. In the words of political economist Dani Rodrik, "for countless national finance ministers, it is global markets that dictate policy, not domestic priorities."[51] For example, the interconnected relationship between a financially-open developing country's main interest rate and the health of its stock market makes the use of monetary policy as a countercyclical instrument in times of recession or inflation very difficult.

When institutional rules change in the international system as was the case during capital account liberalization in the developing countries of Southeast Asia, the political composition of those who benefit and those who lose out also changes. International bankers and portfolio investors clearly benefited from the elimination of barriers to cross border financial transactions and, for a time, so did the emerging markets of Southeast Asia as capital flowed in. But when the flows reversed, the losers were the millions of Asian citizens whose lives were destabilized by massive disinvestment and subsequent currency collapse. Developing country policymakers will be wise to internalize the lessons of past financial crises as they continue to navigate the unpredictable seas of the global economy.

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ACRONYMS

BAFIA: The 1989 Banking and Financial Institutions Act, prevented Malaysians from over exposure to short-term foreign loans
EOI: Export Oriented Industrialization
FDI: Foreign Direct Investment
GATT: The General Agreement on Trade and Tariffs, became the World Trade Organi zation in 1995
GDP: Gross Domestic Product, the sum of a country's output during a specified period
IFC: The International Finance Corporation, the private investment arm of the World Bank Group
IMF: The International Monetary Fund, an international financial institution with a mission to maintain financial stability in the world economy, established post-WWII
ISI: Import Substitution Industrialization, a policy devoted to the development of indigenous industry via trade barriers
KLSE: Kuala Lumpur Stock Exchange, Malaysia's national stock exchange
MCA: Malaysian Chinese Association
MIC: Malaysian Indian Congress
MR: the Malaysian Ringgit, Malaysia's currency
NDP: The New Development Plan, implemented by the Malaysian government in 1990
NEP: The New Economic Plan, implemented by the Malaysian government in 1970
NPL: Non-Performing Loan
SOE: State Owned Enterprise
UMNO: The United Malay National Organization
USD: The US Dollar