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MALAYSIA'S ALTERNATIVE APPROACH TO CRISIS MANAGEMENT

Mahani Zainal Abidin

The severity of the crisis and the speed of its recovery surprised not only the affected countries but the market as well.[1] After a decade of high economic growth supported by an outward-looking strategy, active participation by foreign investors and prudent fiscal policy, the East Asian economies had been touted as the global growth centre for the next century. Within six months of the onset of the crisis in July 1997, the affected East Asian economies were threatened with economic implosion and hardship. Their economic contraction in 1998 was the worst ever experienced. Similarly, the recovery also came swiftly, if only to some. In 1999, most of the crisis-hit countries grew between 4 and 10 per cent. Short-term capital, which had drained from the region, flooded back, thus pushing the stock markets past their pre-crisis levels.

The Malaysian experience of fall and recovery generally follows that of other affected countries. The initial impact of the crisis was delayed and Malaysia managed to register a reasonably strong growth rate of 7.7 per cent in 1997. The severity of the crisis was really felt in the first quarter of 1998 when the gross domestic product (GDP) declined by 3.1 per cent, but by the third quarter the GDP fell by 10.9 per cent, its largest contraction. This sharp contraction was caused by the collapse of aggregate demand by 20.3 per cent, which primarily came from a decline of private sector investment of 50.5 per cent. Higher cost of funds and shortage of credit, excess capacity, and the expectation of decreasing consumption triggered cut-backs in private investment. Although there was a reduction in public consumption (–7.2 per cent), public investment (0.4 per cent), and private consumption (–7.5 per cent), these were relatively small compared with the drop in private investment. But unlike some other crisis-hit economies, the severe economic contraction in Malaysia did not translate into hyperinflation and widespread unemployment. In 1998, inflation rose to 5.3 per cent, double that of 1997, and unemployment climbed to 3.2 per cent from 2.5 per cent.

Apart from the GDP contraction, the most striking effects of the crisis were the steep depreciation of the ringgit and the massive short-term capital out-

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flow. On 14 July 1997, the Malaysian government floated the ringgit after finding the existing *de facto* exchange regime to be unsustainable. With the flotation, the ringgit slipped from RM2.50 to the U.S. dollar prior to the crisis to its lowest level of RM4.88 on 7 January 1998. In 1998, RM21.7 billion of short-term capital left Malaysia. One effect of the massive outflow of short-term capital was the collapse of the equity market. The Kuala Lumpur Stock Market (KLSE) lost 80 per cent of its market valuation: from a high of RM917 billion in February 1997, the KLSE market valuation sank to RM182 billion in September 1998 when the selective capital controls were imposed. In index terms, the KLSE composite index fell from 1271 points to 262 points during the same period.

The deflationary effect of the regional contagion had weakened the demand for Malaysian exports. But the sharply devalued ringgit increased export revenue even though in terms of volume, exports had decreased. This is shown when a comparison is made between export growth measured in ringgit and in U.S. dollar. In ringgit terms, exports increased by 29.8 per cent in 1998, but in U.S. dollars they declined by 2 per cent. In contrast, imports only grew by 3 per cent due to dampened consumer demand and low investment. As a result of high export revenue and a slowdown in imports, Malaysia recorded a large trade surplus of RM69 billion, or 24 per cent of the GDP.

The crisis started as an exchange rate depreciation, but had soon pushed the economy into recession and finally threatened the stability of the financial system. The collapse of the stock market, reduced economic activities, high interest rates, a credit crunch, and credit restriction increased the level of non-performing loans (NPLs) in the banking sector and eroded the banks' capital base. The banking sector's NPLs jumped from 4 per cent in 1997 to a high of 15.8 per cent in August 1998.

Measures to Overcome the Crisis

As an initial response to the crisis, Malaysia had embraced a tight fiscal and monetary policy in the second half of 1997. But these measures did not produce the expected results and the economy continued to deteriorate by the end of 1997 and in early 1998. Domestic conditions (such as a high domestic debt of about 160 per cent of GDP) and the low level of short-term external debt (15 per cent of GDP) enabled Malaysia to seek a different set of policies to revive the economy. Malaysia adopted six key strategies:

- relaxation of the tight fiscal policy to boost the domestic economy
- easing the monetary stance
- reform and restructuring of the financial and corporate sectors
- selective capital controls
- liberalization
- corporate governance

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Fiscal Policy

Since the private sector was unable to spur growth during the crisis period, the public sector had to take the initiative to generate economic activities by increasing its consumption and investment. For this purpose, the budget stance was reversed from a surplus of 3.2 per cent of GDP in 1998 to a deficit of 6 per cent in 1999. Fiscal stimulus programmes were undertaken in agriculture, low- and medium-cost housing, education, healthcare, infrastructure, rural development, and technology upgrading.

Monetary Policy

For the economy to stabilize and grow, there must be sufficient liquidity and a reasonable level of interest rates which will allow companies to borrow again and resume their activities. Relaxation of the monetary policy included:

- Reduction of the statutory reserves requirement from 13.5 per cent in February 1998 to 4 per cent in 16 September 1998. This injected RM38 billion into the banking system.
- The lowering of interest rates: the base lending rate was reduced from the peak of 12.27 per cent in June 1998 to 6.79 per cent by October 1999, while average lending rates were consequently decreased from a high of 24 per cent in February 1998 to 7.91 per cent in October 1999.
- The period for classification of loans as NPLs was changed back to six months in September 1998 from three months in March 1998.

Reform and Restructuring of the Financial and Corporate Sectors

An asset management company (Danaharta) was established in June 1998 to manage the NPLs of financial institutions. Its main objectives were to remove NPLs from the balance sheets of financial institutions at fair market value and to maximize their recovery value. This would free the banks from the burden of debts that had prevented them from providing loans to their customers. As the capital base of banks had been affected by the decline in share prices and by the NPLs, these banks needed to be recapitalized. For this purpose the Special-Purpose Vehicle (Danamodal) was set up to recapitalize and consolidate the banking sector, that is, to inject capital into banks facing difficulties. This would restore the resilience of banks, increase their capacity to grant new loans, and consequently speed up the economic recovery. To complement the restructuring of the financial system by Danaharta and Danamodal, the Corporate Debt Restructuring Committee (CDRC) was set up in August 1998 to facilitate debt restructuring of viable companies. The aim was to minimize losses to creditors, shareholders, and other stockholders and avoid placing viable companies into liquidation or receivership and to enable banking institutions to play a greater role in the rehabilitation of the corporate sector.

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Stabilization of the Ringgit

The Malaysian response to the East Asian crisis created some controversy when it implemented selective capital control measures on 1 September 1998. The selective capital controls have two inter-related parts: the stabilization of the ringgit and the restriction of the outflow of short-term capital. Stability of the currency is guaranteed by pegging the ringgit to the U.S. dollar at a rate of RM3.80:US$1.00. For the fixed exchange rate system to work, the outflow of short-term capital had to be controlled. Specifically, the measures are:

- All settlement of exports and imports must be made in foreign currency.
- Travellers are allowed to import and export ringgit not exceeding RM1,000 per person.
- Export of foreign currency by resident travellers is limited to a maximum of RM10,000.
- Residents are required to seek prior approval for remitting funds in excess of RM10,000 for overseas investment purposes.
- Residents are permitted to obtain credit facilities in foreign currency up to the equivalent of RM5 million. Any amount exceeding the permitted limit would require prior approval.
- Residents are not allowed to obtain credit facilities in ringgit from non-residents except with prior approval.
- Proceeds in ringgit received by non-residents from the sale of any security must be retained in the external account and be converted into foreign currency after one year.
- The ringgit is not a legal tender outside Malaysia.

Thus, the capital control measures affect the transfer of funds among non-residents, import and export of ringgit by travellers (both residents and non-residents), and investment abroad by Malaysian residents. Similarly, non-residents are restricted from raising credit domestically for the purchase of shares. Non-resident portfolio investors are required to hold their investment for at least twelve months in Malaysia. The outflow of short-term capital was also restricted with the banning of Central Limit Order Book (CLOB) International.[2]

The selective capital controls were modified effective 15 February 1999 when the quantitative control (the requirement that proceeds from the sale of ringgit assets be kept in the country for one year) was replaced by a price-based regulation. The new control on capital flows is governed by a graduated exit levy system based on the length of time that the funds are kept in Malaysia.[3] Further relaxation was introduced on 21 September 1999 on the exit levy where the two-tier system was reduced to a flat rate of 10 per cent on profits repatriated.

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Liberalization

Although the focus of the recovery measures has been on the expansion of the domestic economy through fiscal stimulus and easing of the monetary policy, Malaysia also realizes the importance of long-term foreign capital inflow. Malaysia liberalized selected sectors where it is comfortable with foreign presence and it can maximize the gains from foreign capital injection:

- In the manufacturing sector, the Malaysian government relaxed the rule on equity ownership by allowing 100 per cent foreign ownership for investments made before 31 December 2000.[4]
- It allowed 61 per cent of foreign ownership in the telecommunication sector but this will have to be reduced to 49 per cent after five years. Prior to the crisis, there was a 30 per cent limit on foreign ownership in telecommunications, stockbroking, and insurance industries.
- It allowed foreign ownership in stockbroking companies to be increased to 49 per cent while for the insurance sector the limit was raised to 51 per cent;
- Foreigners were permitted to purchase all types of properties above RM250,000 in new projects or when the projects are less than 50 per cent completed. Previously, there were restrictions on foreigners buying landed properties.

Corporate Governance

The crisis highlighted the need to strengthen corporate governance, which is a much more difficult and lengthy process than the other measures introduced. More importantly, it requires the political will and commitment to guarantee that corporate governance framework is fully and effectively implemented. Malaysia has adequate laws and regulations to govern its public and private sectors. However, additional measures were introduced to further strengthen governance and there were calls for more effective execution. The additional measures are:

- improve transparency and disclosure standards
- enhance monitoring and surveillance
- enhance accountability of directors of companies
- protect the rights of minority shareholders
- review codes and acts such as the Securities Industry Act to eliminate any weaknesses that can lead to breaches of the Act
- make changes in the rules of the KLSE and its clearing and depository system to ensure orderly and transparent trading of securities.

The government also established a committee on corporate governance and this committee has produced a comprehensive report on measures to enhance governance.

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Sustainability of the Recovery

When Malaysia experienced a quick and sharp recovery in 1999, many analysts questioned its sustainability. The Malaysian recovery process, which began in the second quarter of 1999, initially looked weak. The 1999 GDP was initially estimated to grow only by 1 per cent but as recovery indicators firmed up, this forecast was revised upwards to 4.3 per cent in October 1999. The real 1999 GDP growth rate announced in early 2000 was 5.4 per cent and the estimated growth for 2000 was increased from 5 per cent to 5.8 per cent.[5] Market forecasts of the Malaysian economic recovery were more bullish than the early estimates made by the Malaysian government — for example, the Malaysian Institute of Economic Research forecast 1999 GDP growth at 4.8 per cent while Goldman Sachs forecast it at 5.2 per cent. The International Monetary Fund also expected a strong growth of 6 per cent for Malaysia in 1999.[6] Nevertheless, it is useful to analyse the sources of the recovery and its possible downside risks.

The external sector was the engine of recovery with its strong performance reviving domestic production. In addition, the large trade surplus provided the liquidity needed to boost domestic consumption and strengthened international reserves. Revival of domestic demand also helped the recovery, although domestic private investment was still weak. The selective capital controls deterred short-term capital inflow but foreign direct investment (FDI) continued to come in. An essential element of the recovery was the management of the non-performing loans (NPLs) and the recapitalization of financial institutions. In short, a strong recovery was made possible and sustainable by both external and internal factors, as indicated below:

- External sector: In 1999, Malaysian exports increased by 12 per cent in U.S. dollar terms, one of the strongest among crisis-hit economies. On the other hand, imports growth was still slower, at 9 per cent. Consequently, Malaysia registered its largest trade surplus of RM72 billion in 1999, or 27 per cent of the gross national product (GNP). The strong trade balance has bolstered significantly the current account position, so that in 1999 the current account surplus was RM47 billion, or 17 per cent of the GNP. The large export proceeds that are locked in by the selective capital controls provide the liquidity to revive domestic demand and strengthen the international reserves position. The country's international reserves increased from US$20.2 billion in August 1998 to US$33 billion in January 2000.

  Export growth has been driven by a boom in the global electronic industry and strong imports by a vibrant U.S. economy. Any downturn in the electronic cycle and a slowdown of the U.S. economy, which may dampen the demand for Malaysian exports, can weaken the recovery. However, this risk is minimized by the continuing expansion in the

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global electronic industry, which is fuelled by the exploding demand for information technology products and activities. Furthermore, the U.S. economy has proven to be very resilient as its ongoing growth is predicated on productivity gains and price stability.

- Industrial production: After a twelve-month decline, industrial production expanded by 3.8 per cent in February 1999. By June 1999, the industrial production index had increased by 8.3 per cent and reached a peak of 23 per cent in November 1999. Within the industrial sector, manufacturing was the fastest-growing sector, with growth of 19.5 per cent in the third quarter of 1999. The construction sector has yet to enter a period of expansion, but its fall has been arrested as it recorded a small growth rate of 0.9 per cent in the third quarter of 1999. The expansion of industrial activities has helped Malaysia to contain the level of unemployment to 3 per cent during the crisis period.
- Loan growth: Interest rates have also decreased significantly: for example, the base lending rate was reduced to 6.79 per cent in October 1999 from a high of 12.27 per cent in June 1998. The lower cost of borrowings has saved many businesses from bankruptcies, and put a lid on the level of NPLs.[7] The low level of interest rate, however, did not spur loan growth and the government set a target of 8 per cent loan growth for 1998 and 1999 to encourage financial institutions to resume their intermediation role. For 1998, the banking sector did not meet the loan growth target and this raised doubts about the sustainability of the recovery process. But low loan growth is not uncommon during the early stage of recovery because of the excess capacity that emerged as a consequence of high investment during the pre-crisis period and the collapse in production during the crisis. The revival of industrial production has raised the average rate of capacity utilization to 80 per cent and loan disbursement will only increase when excess capacity has been exhausted.
- Aggregate consumer demand: Among the economic components, consumer demand was the slowest to recover. Although the demand for some consumer durables such as vehicles recovered quickly, others such as commercial property remained sluggish. However, following the increase in liquidity and the return of market confidence, consumer demand recovery became stronger in the second half of 1999 and this is shown by a higher rate of increase in imports and house purchases and a larger collection of sales tax.
- Inflationary pressure: Malaysia was successful in containing the upward price pressures during the crisis. The consumer price index rose from 2.7 per cent in 1997 to 5.3 per cent in 1998 but had declined to 2.8 per cent in October 1999. There were concerns that liquidity from fiscal stimulus and trade surpluses, which is confined in the domestic economy by the selective capital controls, would quickly push up inflation. The

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existence of excess capacity, particularly in the property sector, will absorb much of the liquidity; and the capacity to expand output by increasing foreign labour will also reduce the inflationary pressure.

- Short-term capital flows: One of the dire predictions concerning the selective capital controls was that there would be a massive foreign capital outflow at the end of the twelve-month locking-in period, on 1 September 1999. However, this deadline was a non-event, with only an outflow of US$800 million, which was well below the projected outflow of between US$5 billion and US$7 billion. Nevertheless, the stock market performance was lacklustre until December 1999. The KLSE rebounded strongly from the first week of the year 2000 because foreign institutional funds came in to take a position before the reinstatement of Malaysia in the Morgan Stanley Capital International (MSCI) index in May 2000. The Kuala Lumpur Composite Index rose from its low of 262 points on 2 September 1998 to 1009 points on 24 February 2000. In terms of market capitalization, it has increased by 304 per cent from RM181 billion to RM732 billion during the same period.
- Long-term capital flows: FDI continued to flow in after the introduction of the selective capital controls: approved FDI investment in the first half of 1999 was RM7 billion as compared with RM6.8 billion during the same period in 1998. Unlike other crisis-hit economies, the long-term foreign investment into Malaysia is encouraged mainly for the manufacturing sector while liberalization in non-manufacturing areas is still limited.
- Financial and Corporate Sector Restructuring: Malaysia's effort in financial sector restructuring, particularly the work done by Danaharta and Danamodal, is considered as one of the key factors in overcoming the crisis. On the other hand, although there are some successes, corporate debt-restructuring is slow due to the nature and complexity of the process.

(a) Danaharta

Danaharta has successfully completed the first phase of its mandate — to carve out the NPLs. As at 31 December 1999, it had acquired a total of RM45.5 billion NPLs, reducing the level of NPLs in the banking sector to 12.4 per cent. The purchase of the NPLs was completed in six months, much faster than the original time target of one year. Financial institutions have had to take losses from the sales. The average discount rate for NPLs was 57 per cent. The second stage of Danaharta operation is asset management. Thus far, Danaharta is in the final stages of resolving NPLs worth about RM17.6 billion. Danaharta's role of taking over the NPLs is critical in removing the stress from the banking system while at the same time avoiding depressing the market prices of the assets used as collateral for the bad loans. In carrying out its tasks, Danaharta has to balance a number of objectives — not to warehouse

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the NPLs, maximize recovery value, not to depress market prices when it sells the assets, and provide a return to Danaharta's capital.

(b) Danamodal

Danamodal has injected RM7.59 billion into ten financial institutions, pre-empting any potential systemic risk to the financial sector. As a result, the capital adequacy ratio of the banking system was increased to 12.7 per cent. The capital injection was accompanied by absorption of losses by shareholders through reduced shareholding in troubled institutions, change in the composition of boards of directors and/or change in management. Danamodal has also appointed its representatives in the recapitalized institutions to ensure that these institutions are managed prudently and efficiently as well as to institute changes that will strengthen these institutions.

(c) Corporate Debt Restructuring Committee (CDRC)

The CDRC has received sixty-seven applications with debts totalling RM36.3 billion. Of these, nineteen debt restructuring schemes involving RM14.1 billion have been resolved. The slow progress of the work of the CDRC can be attributed to two factors. First, unlike Danaharta, which has extensive powers because it was established by an act of parliament, and Danamodal, which has the full backing of the central bank, the CDRC is only a voluntary unit that mediates between borrowers and lenders. It has no legal power to enforce any debt-restructuring solutions. Second, solutions to debt restructuring are difficult to obtain because all creditors must agree to the restructuring proposal. Banks, in particular, are reluctant to settle the debt without full repayment. Negotiations have therefore been long because even disagreement from one creditor will jeopardize the whole restructuring process.

(d) Bank Restructuring

Malaysia has moved to another stage of the restructuring process with the introduction of a merger exercise of financial institutions. As a preparation to meet the challenges of a liberalized and global financial system, Malaysia has decided that financial institutions should be merged into bigger entities to allow them to have stronger capital and a larger capacity to invest in information technology and to increase productivity. In early February 2000, Bank Negara Malaysia (the central bank) announced the consolidation of fifty-eight financial institutions into ten banking groups. Each of the banking groups may offer a complete range of financial services such as merchant banking, fund management, and stockbroking services. Plans are also under way to consolidate the stockbroking industry to create strong, efficient, and competitive stockbroking companies. These initiatives are consistent with the earlier plan of financial sector restructuring, which was announced at the beginning of the crisis, and a Financial Sector Master Plan is being formulated for this purpose.

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Was the Malaysian Response to the Crisis Different from Those Taken by the Other Affected Countries and Does It Work?

Many regard the measures taken by Malaysia to respond to the crisis as different from those taken by other affected countries. Malaysia did not follow the International Monetary Fund (IMF) assistance programme and instead it advocated a reversal of the tight fiscal and monetary policies set by the IMF for South Korea, Thailand, and Indonesia.[8] Malaysia also singled out currency speculators as the primary cause of the crisis and believed that its economy was fundamentally strong. More controversially, Malaysia imposed selective capital controls that fixed the ringgit exchange rate against the U.S. dollar and restricted short-term capital outflows.

As other crisis-hit economies have also recovered, some very dramatically such as South Korea, it is important to evaluate why the Malaysian measures differ from those taken by the other countries and whether they have worked. In particular, many doubted the effectiveness of the selective capital controls, with some critics declaring that these measures were introduced to postpone the much needed economic reform and restructuring. Even views from the multilateral agencies are mixed: the IMF, for example, concludes that it is unclear whether the selective capital controls did make a significant contribution to the Malaysian recovery process while the World Bank views the controls as giving Malaysia an opportunity to deal with the crisis. There are also concerns about the long-term effects of the controls, namely, the distortion that could be created by a prolonged pegging of the ringgit.

Malaysia initially implemented the IMF-type measures because they were supposed to restore market confidence and stabilize the economy and the exchange rate. When these measures failed to produce the expected result, Malaysia began to examine other options. Since Malaysia had relatively low short-term external debt and had adequate reserves to meet its short-term obligations, it did not have to seek IMF assistance and therefore had greater freedom to choose a set of recovery measures that could halt the economic meltdown and minimize social costs. The search for new measures started with an examination of the underlying conditions of the Malaysian economy. After the economic recession in the middle of the 1980s, the Malaysian government had decided to reduce its role in leading the nation's economic activities and made the private sector as the engine of growth. Public sector investment decreased and development expenditure was taken over by the private sector via privatization projects. The subsequent high economic growth, driven largely by the private sector, had been funded by a high level of private sector domestic debt because of restrictions on raising foreign loans.[9] Under such circumstances, a high interest rate policy and tightening of credit, which created a liquidity crunch, would choke businesses. For businesses to continue their activities and for the domestic economy to expand, it was necessary to restore liquidity and to lower the cost of funding. Furthermore, as the private sector

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was in trouble and could not continue to function as the generator of economic activities, it fell to the public sector to re-assume the role of the engine of growth, by increasing its consumption and investment to expand the domestic economy.

Malaysia had the internal resources to finance expansionary fiscal and monetary policies. Following years of fiscal surpluses from higher revenue and smaller investment, the government could finance fiscal stimulus such as rural infrastructure projects. There was also adequate domestic private saving through a compulsory savings scheme (the Employees Provident Fund) as well as voluntary ones (such as insurance). In addition, there were also savings by the banking sector in the form of a requirement for statutory reserves, which were placed with the central bank and which could be used to increase liquidity in the financial system. Malaysia could also seek external financial assistance. With a high sovereign rating and a low level of official borrowings, Malaysia could seek international official financial assistance from multilateral or bilateral sources.

The socio-economic and political dimensions provided another important reason why Malaysia could not implement the measures suggested by the IMF. Malaysia is an ethnically diverse country, with a delicate social and political balance.[10] The stability of the country is very much dependent on its ability to expand the economy to meet its restructuring and distribution objectives as set out in the New Economic Policy (NEP). The economic restructuring and redistribution process gives preferential treatment to *bumiputera* (sons of the soil), who lagged in economic areas and this process is based on the assumption that the economy would continue to grow. Any attempt to remove the *bumiputera*'s special status in the name of reform and restructuring would have serious implications on national political and social stability. Moreover, a deep economic contraction would negate any achievements made to improve the economic position of the *bumiputera*. For example, the reduction of *bumiputera*'s corporate equity through the sales of troubled companies to non-*bumiputera* or foreign investors would be unacceptable. It was, therefore, imperative that the economic contraction caused by the crisis be reversed with a policy to expand the domestic economy.

Two key instruments to boost the domestic economy were the implementation of fiscal stimulus programmes and the lowering of interest rates. For these to work, it was imperative that Malaysia regained its monetary policy independence. The existence of active securities and ringgit offshore markets could erode the effectiveness of Malaysia's efforts to ease its fiscal and monetary policies.[11] Without restrictions on the repatriation of short-term capital and the ban on securities trading outside the KLSE, some of the liquidity injected in the domestic economy by fiscal stimulus programmes and the lowering of the statutory reserves requirement would have left the country and made the recovery measures ineffective. Thus, the selective capital controls, which restrict the outflow of short-term capital, were an important part of the

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recovery. In addition, the selective capital controls, which also fixed the ringgit exchange rate against the U.S. dollar, were necessary to de-link the interest rate from the exchange rate: under a floating exchange rate regime, a lowering of the interest rate would depreciate the ringgit.

Did the Measures Work?

A cursory look at the economic figures shows that the recovery measures have worked. But such an analysis is incomplete because the impact the crisis may have had on society is not included. The Malaysian recovery can be considered a success because it maintained Malaysia's social cohesion. Compared with some other affected countries, Malaysia was able to minimize the social impact of the crisis. The unemployment level was kept at a manageable level (3.2 per cent in 1998) and there was no massive retrenchment. Creative schemes such as flexible work arrangements allowed workers to seek part-time jobs while maintaining their existing jobs, thus allowing troubled companies to reduce their payroll cost without retrenching workers. Similarly, Malaysia also avoided high inflation: the highest price increases were for food items and the government introduced price controls and food subsidies to mitigate the problem. Another indicator of the social impact of the crisis is the poverty level. There was no serious increase in the poverty level in Malaysia.

As an ethnically diverse society, the success of Malaysia's recovery can also be measured by its ability to maintain social stability during the crisis. A sharp erosion of economic welfare can create tension among the various races and fuel social instability. In the Malaysian case, the situation was even more challenging because there was political instability during the crisis. However, the economic hardship was not too severe and the gains that had been made in narrowing the interethnic economic disparity and the existence of a significant middle class have averted social and ethnic tension.

In its recovery process, Malaysia has resisted the pressure to sell its assets to foreign buyers at "fire sale" prices. The crisis put tremendous stress on Malaysian corporations, many of which have high debts. As a result, many corporations, some in strategic industries, were financially troubled and needed fresh equity injection or debt rescheduling. Malaysia was reluctant to allow foreign participation in the resolution of the problems faced by its corporate sectors and only permitted foreign purchase in selected areas.[12] The preferred solution to this corporate stress is through domestic mechanisms such as the purchases of NPLs by Danaharta and debt restructuring by the CDRC. The issue of foreign purchase of Malaysian assets is particularly important for two reasons. First, if these assets were sold under stress to foreign buyers, Malaysia may not get the best value from the sales and when the economy recovers they will cost much more if Malaysia were to want to re-purchase these assets. Second, any sales that reduce the *bumiputera* corporate equity holding would be very sensitive and have wide ramifications. In some cases, corporate holdings represent the *bumiputera* institutional interest. Sales of these assets will

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negate the gains that have been made to increase *bumiputera* participation in the corporate sector.

Contrary to dire predictions, the selective capital controls have achieved their objectives. The "undervalued" ringgit gives Malaysian exports a price edge, resulting in double-digit export growth in 1999, a large trade surplus, and the strengthening of the current account and international reserves position. As the capital control measures only restrict the movement of short-term capital, which is normally invested in the equity market, FDI has continued to flow in. The selective capital controls were designed not to impede the current account transactions (trade transactions for goods and services), repatriation of interest, dividends, fees, commissions, and income from portfolio investments, and other forms of ringgit assets and FDI inflows and outflows (including income and capital gains). But the selective capital controls also had an important implicit objective, namely, to renew domestic confidence that had been battered by the crisis. Revival of domestic confidence was vital for the resumption of domestic economic and business activities and for social stability. With the pegging of the ringgit, domestic producers were able to restart production because exchange rate uncertainties had been removed. After making the necessary adjustments, most businesses could operate at any exchange rate level so long as there was some degree of stability. Multinational companies, which import most of their inputs and export all their products, face no foreign exchange risks when the ringgit exchange rate is fixed. As a result, the business community welcomed the fixing of the ringgit exchange rate. In an ethnically diverse society such as Malaysia, social and economic stability is critical to growth and development and thus any threat of conflict among the various ethnic groups arising from an economic slowdown must be avoided. By insulating the economy from further deterioration and stabilizing the ringgit, the government managed to revive domestic confidence, thus averting any serious social dislocation.

Malaysia has made serious efforts and registered good progress in restructuring its financial and corporate sectors. NPLs were taken out from the banking system and troubled financial institutions were recapitalized. In fact, Malaysia's efforts in these two areas have been regarded as a critical part of the recovery because they were executed efficiently, in a transparent manner and at a cost much lower than that incurred by the other crisis-hit countries. Moreover, the banking sector consolidation exercise shows Malaysia's commitment to further strengthen its financial sector and to increase efficiency. Rules governing the equity market have also been tightened to ensure a more orderly market.

Challenges

Although Malaysia has made a good recovery, it still faces the challenges of creating a competitive economy that can produce sustained long-term high growth. The recovery measures must be monitored and changed, if necessary,

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so that they do not jeopardize the long-term goals of Malaysia's economic development. The development experience of the 1990s has shown that a high-growth policy can place serious stress on the economy, causing both shortages of resources and a lower quality of life. The estimated potential growth rate for Malaysia is 6.7 per cent per annum and therefore future economic growth targets should recognize this limit. Malaysia should aim for a growth rate that is compatible with its available resources.

The fixed exchange rate regime has contributed to Malaysia's economic recovery by ensuring the efficacy of the recovery measures, providing exchange rate stability, ensuring export competitiveness, and restoring domestic confidence. Nevertheless, if the ringgit were to become overvalued as a result of a substantial depreciation of other regional currencies, the present strong export performance may cease. Conversely, foreign investors and analysts may consider the ringgit undervalued relative to other regional currencies and eventually this may lead to re-pegging at a higher level (appreciation) to reflect the strong recovery. This possibility may attract short-term capital inflows, which, together with the existing excess liquidity coming from the trade surplus, will create inflationary pressure, and ultimately result in pressures for further appreciation of the ringgit. In such a situation, the adjustment cost to the economy can be significant. Hence, Malaysia has to find an exchange rate regime that can balance two goals, namely, exchange rate stability and the need to smooth and include price and market signals in the determination of the exchange rate.

The crisis has shown that short-term capital flows, which are expected to increase, can determine a country's economic performance. Short-term capital flows are determined both by a county's economic fundamentals as well as market confidence. In a situation of uncertainties, market perception overrides economic fundamentals and as a result, even a country with strong fundamentals can suffer from capital flight. In such a situation, it is perhaps imperative to minimize the exit of capital until market confidence has returned. Thus, selective capital controls should be viewed as measures to calm the market and allow the country to put a brake on economic deterioration. However, countries must strengthen their fundamentals because capital controls can only give a temporary relief and the medium- and long-term growth prospects will only be determined by fundamentals.

In conclusion, the Malaysian recovery measures were formulated after evaluating the domestic circumstances, with the aim of reviving the economy without weakening its fundamentals. These measures were designed to respond to extreme situations and some have labelled them as market-unfriendly. The question is whether these measures have cast doubts over Malaysia's pro-business approach and created fear of policy inconsistency. Malaysia's recovery approach shows there is an alternative way to deal with an economic and financial crisis but it does not run contrary to the overall pragmatism of the Malaysian economic development strategy.

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NOTES

1. The South Korean economy was expected to grow by 8 per cent in 1999 while Taiwan, Singapore, and Thailand's growth rate was expected to range between 4 and 5 per cent. Indonesia, which experienced the worst economic recession, is estimated to grow by 1 per cent in 1999.
2. The measure that significantly affects portfolio investors requires all dealings in securities listed on the KLSE to be effected only through the KLSE or through a stock exchange recognized by the Malaysian authority. Consequently, trading of the 112 Malaysian companies on the Central Limit Order Book (CLOB) International, an over-the-counter market in Singapore, was discontinued by the Singapore Stock Exchange.
3. The aim of relaxing the twelve-month holding period is to enable foreign short-term investors to estimate the cost of investing in Malaysia. This easing of capital controls contains two parts:
   (a) For capital that was brought in before 15 February 1999, a levy was imposed on the principal at the following rates:
      - 30 per cent for a maturity period of seven months
      - 20 per cent for a maturity period of nine months
      - 10 per cent for a maturity period of twelve months
      - capital with maturity period of more than twelve months will not have to pay any levy.
   (b) For capital that was brought in after 15 February 1999, a levy was imposed on the profits made at the following rates:
      - 30 per cent for a maturity period of less than twelve months
      - 10 per cent for a maturity period of more than twelve months
4. Previously, only companies that exported all of their output were allowed full foreign ownership but with this relaxation, companies can have 100 per cent foreign equity regardless of the level of products exported.
5. The new revised figures were announced during the retabling of the 2000 Budget on 25 February 2000; see *New Straits Times*, 26 February 2000.
6. Malaysian Institute of Economic Research, "Malaysian Economic Outlook" (2000); Meesook, K.M., "The World Economic Outlook and Implications for Malaysia" (Papers presented at the National Economic Outlook 2000 Conference, the Malaysian Institute of Economic Research, 18–19 January 2000, Kuala Lumpur); and Goldman Sachs, *Asian Economic Quarterly* (Hong Kong), 1999.
7. Market analysts had predicted that NPLs in the Malaysian banking sector could reach 30 per cent because the high level of domestic debt was very sensitive to any interest rate hike. Prior to the crisis, the NPLs of the financial institutions were only 4.9 per cent but they rose to a high of 15 per cent at the height of the crisis. The reduction of interest rates and the formation of Danaharta have reduced the level of NPLs substantially.
8. These three countries had eased their tight fiscal and monetary policies in the second half of 1998 to help their economies recover from the crisis. Due to this policy shift, some analysts considered the recovery measures of these countries as not too different from those of Malaysia's, with the exception of the selective capital controls. However, there were also arguments that the IMF prescription brought along social upheaval, which inflicted substantial pain on the population in the affected countries.
9. The Bank Negara Malaysia only permits Malaysian companies to raise foreign loans if they have a natural foreign exchange hedge, such as foreign income. Consequently, companies have to raise financing in the local market, which resulted in domestic debt of about 160 per cent of the GDP.
10. Malaysia comprises 50 per cent *bumiputera*, 30 per cent Chinese, 10 per cent Indians, and 10 per cent other races. The ruling coalition, which has ruled Ma-

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laysia since Independence in 1957, consists of parties representing the major races of the country, with the *bumiputera* party, UMNO, dominating the coalition. As a result of the racial riots in 1969, a New Economic Policy (NEP) was introduced to eradicate poverty and restructure society. The key measure in the NEP was the affirmative action for the *bumiputera*, which targeted a 30 per cent equity ownership and employment by the 1990.

11. For a discussion on Malaysian securities and currency offshore markets and their influence on Malaysian monetary policy, see Mahani Z.A., "Implications of the Malaysian Experience on the Future International Financial Arrangement", *ASEAN Economic Bulletin* (Institute of Southeast Asian Studies, Singapore), forthcoming.
12. For example, Blue Circle (a British company) was allowed to purchase a cement company and British Telecom became a strategic partner of a telecommunications company.

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