

## **THE 1997-98 FINANCIAL CRISIS IN MALAYSIA: CAUSES, RESPONSE, AND RESULTS<sup>†</sup>**

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*This paper argues that the 1997-98 financial crisis did not hit Malaysia because the economic fundamentals of the country were weak. It was the result of massive unpredictable flight of short-term portfolio investment from the region including Malaysia. The paper assembles evidence, and employs econometric tools to support the contention. It maintains that the choice of the country to impose selective capital controls for remedying the situation was efficacious, and proved fairly rewarding. It also makes a few observations from an Islamic angle that may help forestall the occurrence of such crises in future.*

### **1. INTRODUCTION**

The 1997-98 Asian financial crisis originating from Thailand struck one country after another in almost no time, Malaysia being among the later victims. The literature has since been full of books and articles on the subject. However, much has not been written exclusively about the Malaysian experience. The position of the country has largely been examined in comparative discussions on the subject. Such discussions, though useful, often tend to generalize the analysis beyond reasonable limits. Economic structures, social environment, political settings, and international relations of the countries that were caught in the turmoil have been much diverse to allow meaningful comparisons between them on the causes of the crisis, their response to it, or the results they obtained.

Furthermore, the studies dealing with the crisis have mostly relied on the yearly or at best the quarterly data that was available for required variables from different sources. At times, it was perhaps the nature and periodicity of the data one could lay hands on that dictated the model form, or the issues one selected for discussion. However, the crisis being essentially a *short-term* phenomenon even the use of

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monthly data could rarely capture the *genesis* or the *abruptness* of the event the authors sought to explain. Also, the difference in the quality, coverage, and periodicity of the data available for various countries detracted much from the utility of making comparisons.

For the above reasons, the material one comes across in the current literature discussing the causes of the crisis in Malaysia, her policy response to it, and the results she obtained carries little conviction and is at times misleading. The present study essentially is specific to the country. It uses *weekly* data for the selected variables: stock market indices, interest rates, and foreign exchange ratios. The main source for the data has been the Business section of the New Strait Times, Kuala Lumpur, and comprises of the closing quotation for each Tuesday.<sup>1</sup> If the Tuesday quotation was not available for any reason, the closing quotation of the day nearest to it was taken. Thus, the work has important distinctive features.

The main objectives of this paper are to investigate (i) if the primary cause of the crisis in Malaysia was the flight of foreign capital from the country, or her weak economic fundamentals, (ii) if the imposition of exchange controls was an efficacious response to the malady, and (iii) if the results of the controls have really been rewarding for the country.

The paper consists of seven sections including the present one. Section 2 discusses briefly the background of the crisis, and touches upon its genesis. Section 3 provides some key economic indicators for Malaysia to see if her fundamentals were indeed weak to invite trouble. Section 4 deals with the causes of the crisis. Using Shazam computer package, it employs econometric tools to see if the speculative outflow of foreign capital could be blamed for the debacle? The analysis essentially is explanatory. Section 5 outlines the Malaysian response to the crisis while Section 6 evaluates its results. Section 7 refers to some policy changes that followed the recovery; it makes suggestions for Muslim countries in the light of Malaysian experience, and contains a few concluding remarks.

## 2. THE BACKGROUND

World economies have seldom worked smoothly, more so after the 1930s. The virulence of fluctuations in economic activities has increased in more recent decades, and the causes underlying them seem to have changed in relative importance. Finance seems to precede and dominate the real factors in the current experience. With the increasing liberalization of the domestic financial markets in the developing economies and the opening up of these markets to the outside investors, a significant and fast growing component of foreign private capital flows

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<sup>1</sup> A random sample of each day's closing quotations showed smaller variation for Tuesday compared with others.

takes the form of portfolio investments. The funds involved constitute no less than one-third of the net overall resource flows to the emerging capital markets of the developing countries.<sup>2</sup> Between 1990 and 1998 direct foreign investment flows to these countries became five times larger, but portfolio investment flows during the period jumped to 15 times of their initial value. For example, in the case of South East Asia and Pacific the latter went up from US \$148 million in 1990 to US\$ 2701 million in 1998. For Malaysia, they went up from US \$ -947 million to US \$ 278 million over the period.<sup>3</sup>

Two features of portfolio investment funds may be noted. Higher profit expectations, however formed, keep them running from one country to another. Computers turn over a trillion US dollars around the financial markets of the world every twenty-four hours. An abrupt diversion of even a fraction of this amount to or out of a small country like Malaysia could make her stock and forex markets quite jittery. Furthermore, it may not always be easy to distinguish such funds from the genuine long-term investments at the point of time when they are entering a country. They unfold their true character when they start moving out. When the tide is rising, these funds tend to create an illusion of staying longer than they might through a roll-in effect: the incoming flows replacing the out-going ones at a faster rate. The illusion at times leads to the financing of long-run projects by short-term funds. The abruptness of change in the magnitude and direction of foreign funds during the Asian crisis can easily be gauged by the information provided in Table 1 below.

**Table 1**  
**Net Private Capital Flows in Five Asian Economies\***

	(US \$ billion)		
<b>Years</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>
Private Flows (net)	<b>93.1</b>	<b>-12.1</b>	<b>-9.4</b>
Non-debt flows	<b>19.1</b>	<b>-4.5</b>	<b>7.9</b>
Foreign direct investment	7.0	7.2	9.8
Portfolio equity investment	12.1	-11.6	-1.9
Debt flows	<b>74.0</b>	<b>-7.6</b>	<b>-17.3</b>
Banks	55.5	-21.3	-14.1
Non-bank	18.4	13.7	-3.2

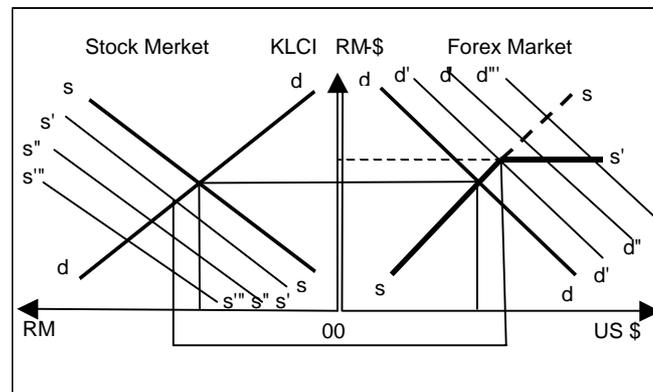
Source: IIF. Capital flows to emerging market economies, January 1999.

\*Include Indonesia, Singapore, Malaysia, Thailand, and Philippines.

<sup>2</sup> Short-term speculative capital mostly parks in portfolio investment consisting of foreign purchases of stocks, bonds, certificates of deposits, and commercial papers of the developing countries. Between 1989 and 1993 total portfolio flows increased by more than 700% to \$55.8 billion, mostly through newly formed 'country' mutual funds subscribed to by individual developed country investors, and by large DC-based pension funds. (Todaro P. 544).

<sup>3</sup> The calculations are based on the information provided in UNDP Human Development Report 2000, Table 15 pp.210-213.

Table 1 leads to the hypothesis that in a small open economy like Malaysia the flight of short-term capital during the 1997-98 crisis *could have lead* to a sequence of events involving the selling of shares by foreigners in the stock market and taking the sale proceeds to the currency market for buying the US dollars to be taken out, the process leading to a down turn in both the markets. Though we could not get capital flows data for the relevant weeks to strengthen the argument, there is evidence supportive of the contention. The short-term capital account of the country recorded an extra-ordinary net outflow of funds – RM 11.3 billion in 1997, and 21.7 billion in 1998 (Bank Negara Report 1998, p.43). Probably bulk of this amount left the country during the sixty-three weeks of the crisis period.



**Fig. 1: Stock-Forex Market Interaction**

Figure 1 depicts the interaction between the stock and forex markets on the basis of our hypothesis, and is self-explanatory. To fix ideas we may put the message of the figure in a bivariate model:

$$\text{\$-RM rate} = \alpha + \beta \text{ KLCI} + u \quad (1)$$

Here,  $u$  is a catch variable allowing for the influence of all other variables except KLCI that may have affected the \\$-RM rate during the period. We shall return to the equation later.

### 3. ECONOMIC FUNDAMENTALS

Malaysian economy has largely been on a sound footing since independence. It had enjoyed high growth, full employment, and low inflation rates for about a decade before it was taken over by the 1997-98 financial crisis. Initially, many economists, and financial institutions including the IMF blamed the turmoil on the weak macro fundamentals of the countries in the region. Informed opinion did change about Malaysia later, but many at home and abroad continued to maintain

the earlier position. Table 2 presents some *real* economy indicators for the country.

**Table 2**  
**Real Economy Indicators for Malaysia**

	(Amount in RM billion)			
	1996	<b>1997</b>	<b>1998</b>	1999
GDP at constant prices	183.3	<b>197.1</b>	<b>182.3</b>	193.4
Real GDP (% change)	10.0	<b>7.5</b>	<b>-7.4</b>	6.1
Rate of national savings (% of GNP)	38.9	<b>39.4</b>	<b>41.9</b>	40.8
Rate of investment (% of GNP)	43.5	<b>45.3</b>	<b>28.2</b>	23.9
Investment saving ratio	1.12	<b>1.15</b>	<b>0.67</b>	0.59
Balance on current account	-11.2	<b>-15.8</b>	<b>36.8</b>	47.4
Net international reserves	70.0	<b>59.1</b>	<b>99.4</b>	117.2

Source: Based on Bank Negara Report 1999, Tables A.6, A.9 and A.10.

Prior to the crisis, Malaysian economy was a flourishing one in real terms. It grew at an average rate of 8.7% during 1990-97.<sup>4</sup> The rates of inflation and unemployment remained low. Domestic savings were around 40% of the GNP for the years 1995-97; investment rates were even higher.<sup>5</sup> Though the balance of payments was in deficit during the period, it was a small fraction of the GNP, and was amply covered by the foreign currency reserves with the central bank. Presumably, the only weakness of the economy during the years was the financing of long-term capital-intensive projects by the short-duration capital inflows. The change in the nature of projects undertaken led to a continual rise in the capital output ratios.<sup>6</sup> But the rise could not necessarily be taken as evidence of inefficient allocation of resources or wasteful expenditure. Perhaps current prosperity was being extended to future generations.<sup>7</sup>

<sup>4</sup> World Development Report 1998/1999 Table 11.

<sup>5</sup> See Table 2: The investment saving ratio was 1.15, and the gap was as large as 5.9% of the GDP showing significant dependence of Malaysian economy on foreign capital.

<sup>6</sup> See Ariff (1998, Chart 5 p.37) for the rising trend in both the average and incremental capital-output ratios in Malaysia in more recent years, especially since 1989.

<sup>7</sup> ICOR rates do not provide for necessary lags between investment and changes in output and can thus be interpreted to suggest either a decline in investment quality, diminishing returns to new investment during the process of capital deepening, or a lag between the heavy investments spending during the 1990s or an increase in growth. In Malaysia the last factor has probably been dominant as highly capital intensive projects like the new administrative complex, LRT, twin towers, north-south express way, and the massive KLIA were all undertaken during the decade (See Radelet and Sachs p.40).

There was no observable weakening of the financial structure as well. For example, in 1996, the year just preceding the crisis, the budget surplus was 4.2%, and external debt about a half of the GNP. The external debt service ratio was no more than 6.9% of exports. The overall loan deposit ratio for the banks stood at a safe 89.3% for the same year. Table 3 shows the deterioration that took place in the variables in the wake of the crisis.

**Table 3**  
**Financial Indicators 1996-99**

	1996	1997	1998	1999
Public sector overall balance as % of GNP	4.2	6.5	-1.3	0.2
External debt as % of GNP	57.0	86.7	93.6	86.9
Debt-service ratio as % of exports (end year)	6.9	5.5	6.4	5.3
Overall loan-deposit ratio	89.3	92.7	91.4	84.1

Source: Bank Negara Repots 1998, Table 1.2, P.3; 1999, Table 1.2, P.3.

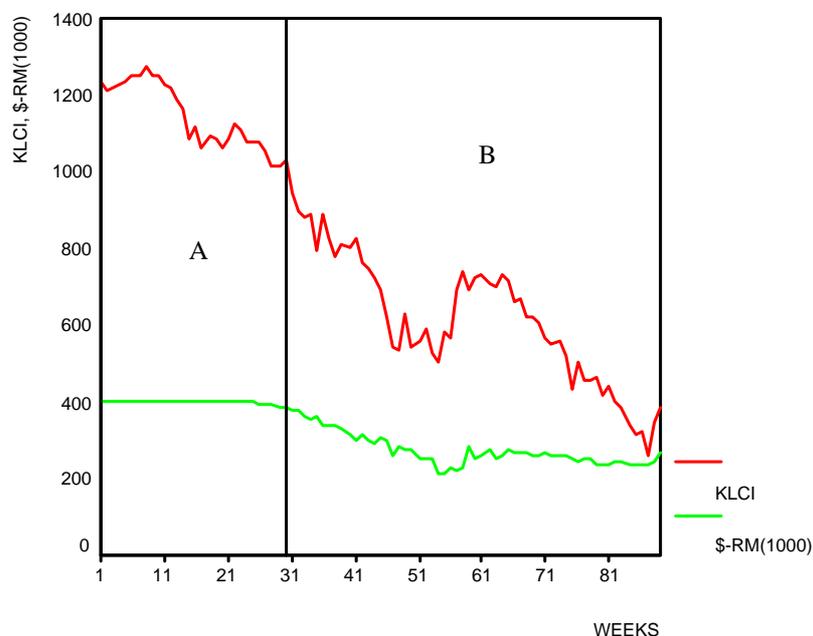
The evidence that the crisis could not be seen coming and, therefore, could not be preempted (Woo et al p.130) provides further support to the contention that it was not the weakness in the Malaysian fundamentals *per se* that caused her discomfiture. A more plausible source of trouble probably was the flight of foreign portfolio investment from the country.

#### 4. WHAT CAUSED THE DEBACLE?

In Malaysia the financial melt down started towards the close of July 1997, the first major fall in the stock prices occurring in the first week of the following month. The stock market fell by 68.58%, and the dollar-ringgit rate plunged by over 37% during the worst patch of about sixty-three weeks i.e. between July 1, 1997 and September 8, 1998.<sup>8</sup> The pre-crisis data we use here for comparison includes figures for the first four weeks of the crisis period i.e. the pre-crisis period is spread over the weeks from December 14, 1996 to July 22, 1997. In Figure 2 we separate the fluctuations in the KLCI, and the \$-RM rate for the pre-crisis from the crisis period by a demarcation line.

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<sup>8</sup> On July 29, 1997 the fifth Tuesday of the crisis period, the KLCI was 1031.61 and the \$-RM rate was 0.3946. These values were 324.17 and 2361 respectively a week earlier when controls on capital flows were imposed. These figures form the basis of our percentages here.



**Fig. 2: Fluctuations in KLCI and the \$-RM rate**

We find that the stock prices and the dollar value of ringgit had a falling trend during both the pre-crisis (section A) and the crisis period (section B). Clearly the fall in the stock prices was sharper and larger compared to the fall in the dollar value of the ringgit. More so, during the crisis period as the exchange rate essentially was affected by the flight of foreign funds while the stock market was being additionally pulled down by the herd behavior of the local speculators. The series were positively correlated, the value of the correlation coefficient for the crisis period being 0.875. However, the result of equation 1 was found vitiated by the presence of serial correlation. But the regression turned statistically significant when first differences were used. It passes through the origin. The results are as under:

$$\Delta \$\text{-RM rate} = 0.0001 \Delta \text{KLCI}, R^2 = 0.211, \text{Adj. } R^2 = 0.198, F = 16.26, \text{Run Test } Z = 2.09 \quad (2)$$

P-values (0.000) (0.000) (0.018)  
(One tailed)

However, for accepting the hypothesis that the flight of foreign capital was responsible for the crisis, we have to test the two series for unit-roots, for cointegration, and for the direction of causality. From the Augmented Dicky-Fuller test results produced in Table 4 we find that the series have no unit roots- they are stationary-when transformed to first log-differences. Table 5 shows that the relationship between the two variables also was free of cointegration.

**Table 4**  
**ADF Tests for Unit Roots**

Series	Pre-crisis Period		Crisis Period	
	No Trend	Trend	No Trend	Trend
<b>(a) Log –Levels</b>				
KLCI	- 0.6902	-2.3120	- 2.3120	- 0.3407
\$-RM	-1.2002	-0.6084	-2.4266	-1.6962
<b>(b) First Log-differences</b>				
KLCI	-3.5087*	-3.4588*	-4.0280*	-3.9964*
\$-RM	-2.8696*	-3.5395*	-2.7210*	-3.0582*

Note: \* significant at 10% level

**Table 5**  
**Engle-Granger Test for Cointegration**

Variables	Pre-crisis Period			Crisis Period		
	ADF Statistics	Asy. Critical Value	H <sub>0</sub> Cointeg.	ADF Statistics	Asy. Critical Value	H <sub>0</sub> Cointeg.
KLCI, \$-RM	-2.3156	-3.5	Reject	-0.9146	-3.50	Reject

Note: Critical values denote 10% level of significance.

Furthermore, the results presented in Table 6 testify that in both the periods KLCI Granger caused fluctuations in the \$-RM exchange rate, and that the reverse was not true. Thus, we find a unidirectional causation between the two variables.<sup>9</sup> This might have been the characteristic of the stock and forex market relationship in Malaysia because of her part dependence on foreign portfolio inflows and the openness of the economy. In any case, the results validate the hypothesis that it was the speculative flight of foreign capital from the country that essentially triggered the 1997-98 financial crisis in Malaysia.

The contagion was considered another culprit in the situation. It did play a role, but not entirely *within* the suffering economies. It was located *outside*, among the foreign fund managers.<sup>10</sup> Here, the theoretical links between stock prices and

<sup>9</sup> It is interesting to note that Ibrahim (2000) using data from January 1996 to June 1997 for Malaysia does not find any long-run bivariate relationship between the KLCI and the \$-RM exchange rate (p. 45). However, for the period of crisis in Malaysia Granger et al find that the relationship between these variables was characterized by a feedback interaction in which the change in exchange rate could take the lead and vice versa (p.346).

<sup>10</sup> In their interesting article Boreinsztien and Gelos (2000) explore the behavior of emerging market

exchange rates the literature provides become completely obliterated.<sup>11</sup> Once the managers were convinced that the exchange rate was out of what they *perceived* as its equilibrium value, one way speculative action was expected [Kawai (2000), p.14]. No less than US dollars 108 billion left the region within first six months of the crisis. The herd behavior of local speculators did aggravate the situation in the stock market but had little to do with the chaos in currency trading.

## 5. THE RESPONSE

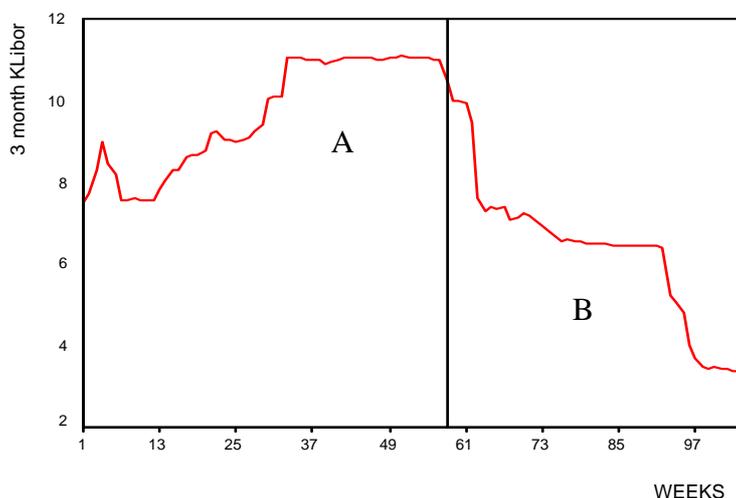
The traditional policy response to financial difficulties has been to seek assistance from the IMF for improving the situation. For such assistance the countries in trouble invariably have to undertake economic and financial reforms, impart more transparency to government spending, and make the necessary macroeconomic adjustments. They must initiate measures to revitalize their economic and monetary systems. Thailand and Indonesia took steps to remedy their weaknesses. Korea too joined in. But these countries soon found the crisis beyond their control, and decided to seek assistance from the IMF. Following the IMF conditions for the help, these countries had to implement tight monetary and fiscal policies, and had to enforce the prescribed structural reformations, particularly in the financial sector. Malaysia did not approach the IMF but tried for about a year the same measures as the institution prescribes. For example, for over a year it followed a tight monetary policy through raising interest rates. This is depicted in section A of Figure 3 that traces the course of 3-month Kuala Lumpur inter-bank offer rates that underpin the interest rates structure in the country.

However, the slide could not be arrested. The real economy started shrinking. Many projects on the anvil had to be dropped, those in progress were slowed down, and public expenditure was curtailed. Several allowances to government employees were abolished or reduced, and many foreign workers had to leave. But neither the fiscal contraction, nor the tight money policy, the conventional tools, could ameliorate the situation. Real GDP registered a fall of about 6% during the worst span of about a year, the construction industry being among the worst sufferers.

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mutual funds using a novel database covering the holdings of individual funds over the period January 1996 to March 1999. They find that the degree of herding among funds albeit moderate is statistically significant. Herding may or may not be consistent with traditional models of rational utility maximizing behavior. Explanations that at least partly depart from the rationality paradigm are based on panics or sudden contagious changes in investor sentiment. Such changes may in turn induce a switch from a good to a bad equilibrium for a country, and induce a crisis (p.4). There is room for presumption that this was what happened in the case of Malaysia.

<sup>11</sup> For a theoretical discussion on the relationship, see Ibrahim (2000), section II, pp.37-38, and the preceding footnote.



**Fig. 3: Changes in Interest Rate Policy**

The country could still approach the IMF for assistance. But such assistance never came without restrictions, and the experience of the developing countries had seldom been encouraging. Restrictions abridged the recipient's freedom of action, at times their priorities clashed with the restructuring requirements of the IMF. There often was also a mismatch between the repaying capacity of the country and the repayment schedules [see also Hutson and Kearney (1999), pp. 408-409]. Since Malaysian economic fundamentals were not weak, policy makers considered the imposition of controls over capital outflows as a better alternative. There was nothing novel about the choice. Monetary history is replete with instances of all sorts of countries—developed and developing—using controls to regulate foreign capital movements. However, the decision was novel in one sense. It needed conviction in an atmosphere loaded with the new urges for liberalization and openness. It was a decision to swim against the current, and was quite risky.

The theory underlying controls is simple. Figure 1 shows how the ringgits released by the sale of stocks continually pushed upward the demand for dollars in the foreign exchange market raising its price in terms of the local currency. Two options were available to keep the exchange rate stable. First, as the demand for dollars, increased Bank Negara could increase the supply of dollars appropriately in the market along the flattened portion of the supply curve. Initially, the Bank did *intervene* in the market to keep transactions unhindered, spending several billion dollars in the process. But it soon found the continuation of the policy restrained by the meager size of reserves it had. Therefore, it took the second route: it decided to *restrict* the forex transactions.

On September 1, 1998 Bank Negara Malaysia announced controls on foreign capital flows to curb the speculative demand for the ringgit, and prevent its internationalization. The following day it pegged the local currency at RM 3.80 to a US dollar. The rate was 10% higher than the level the ringgit had already depreciated to. The announcement thus formalized the devaluation of the ringgit by 34%. However, Malaysian controls were quite selective, and were essentially designed to support the country's recovery plan. They left direct foreign investment untouched, and current account transactions remained fully convertible. The details of the package are now available in the Bank Negara Report 1998 (p.62).

In addition, the tight money policy was replaced with the Keynesian prescription. The cheap money policy took place of the year-long rising interest rate regime. The three-month KLibor rate fell steadily from around 10% in August 1998 to 3.25% in a short span of time<sup>12</sup> (see Figure 3, section B). Several measures were taken to increase effective demand. For example, banking institutions having the required capacity to lend were encouraged to achieve a minimum loan growth target of 8% in due course of time, conditions for lending to construction companies were eased, ceiling on loans for purchasing shares and units were relaxed, financing margin for all passenger cars was raised, and minimum monthly repayment on credit cards was reduced.<sup>13</sup>

Thus, avoiding the IMF assistance, and the accompanying tight money policy, restructuring programs, austerity measures, and other conditions, Malaysia chartered a new course to put the economy back on track. The following section takes stock of her achievements.

## 6. RESULTS

Controls immediately arrested the outflows of capital that were causing the depletion of the Bank Negara reserves. The outflow fell substantially from US dollars 527 million in September to 269 million in October, and to 113 million in November 1998.<sup>14</sup> The KLCI also recovered fast as is evident from Figure 4. The foreign direct investment remained almost unaffected by the turmoil: it did plunge to RM 10 billion for 1998, but rose to over RM 13 billion in the following year, even as the overall share of the region in the aggregate amount declined by 17%.<sup>15</sup>

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<sup>12</sup> The change took place quite abruptly after controls were imposed, within a span of about five months as is clear from Figure 3.

<sup>13</sup> Bank Negara Malaysia Report 1998 (p. 89). Domestic credit provided by the banking sector in Malaysia rose to 106.5% of the GDP as per World Development Report 2000/2001 Table 16, p.304.

<sup>14</sup> NEAC-MTEN: Facts and Figures - Inflow and Outflow of Reserves in USD equivalent <http://vs02.Tvsecure.com/-vs02Ib5/figures/inflow.shtml> Page 1 of 2 9/5/00.

<sup>15</sup> "Flow of FDI to Malaysia up 31 pc Unctad: Overall Southeast Asia received 17 pc less", New Strait Times, October 4, 2000, p.21. However, some do suspect that the controls did quite a lot of damage to the flow of the FDI into the country. Still, how much of the fall was due to controls, and

Real GDP did suffer a steep fall of 7.4% in 1998, but registered a 6.1% growth in the following year. In the same year i.e.1999 the per capita income was almost as high as in 1997. The output of manufacturing industries expanded by 13.5%, and the unemployment rate declined to less than 3%. The devaluation of the ringgit pushed up exports by 12% while imports increased by 10%: thus the overall balance of trade showed improvement.<sup>16</sup> Part of the increase in exports, especially of electronic goods could be attributed to the recovery of the US economy, but this need not detract from the efficacy of the Malaysian response to the crisis as Malaysian exports to the US have not been more than a fifth of her total exports in recent years.

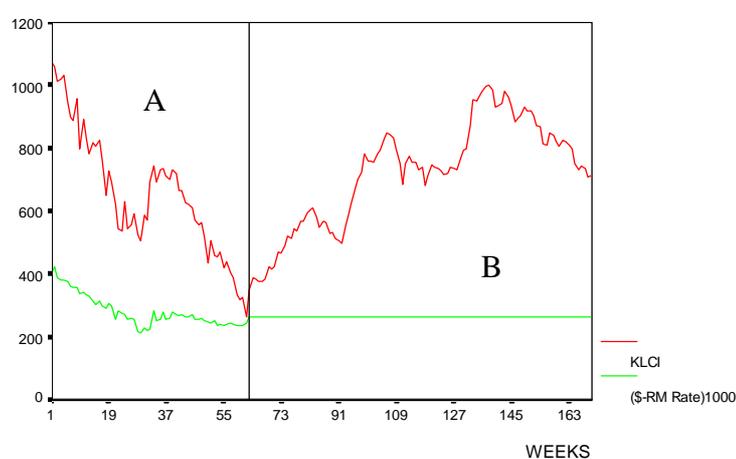


Fig. 4: KLCI and \$-RM rate during crisis (A), and after capital controls (B)

The pump-priming policy also helped. Effective demand revived, consumption expenditure, public and private, went up in *real* terms by 10.68% in 1999, and was not much lower than the figure for 1997. The income of the government also rose. Not only the cuts made during the down turn in remuneration of employees were restored; a 10% raise in their salary could also be granted. Despite the increases in expenditure, the budget for 2000 showed a surplus for the first time after remaining in the red for three consecutive years.

The countries that sought the IMF assistance also recovered. However, Malaysia came out of the crisis certainly less scarred and faster than Thailand or Indonesia, the two Asean neighbors who followed the IMF program.<sup>17</sup> The

how much was due to reassessments of country risk is impossible to quantify without surveying those involved in the FDI.

<sup>16</sup> Calculation based on figures taken from Bank Negara monthly statistical bulletin May 2000 (Table VIII.3 p.115).

<sup>17</sup> The recent widespread criticism of the Fund's policies in the case of Thailand, Indonesia, and Turkey is ample evidence on the point.

distinctive feature of the Malaysian response is to be seen in that the country could make people realize at home and abroad the potential of unregulated currency trading to inflict severe damage on the developing economies. It pleaded against its acceptability as an inseparable ingredient of the globalization process. That it could win wide support on the point is perhaps a much greater achievement of Malaysia than the economic gains she reaped from her policy choice. Today the country has greater respect for her economic management than ever before. This has won for her in recent times higher currency ratings,<sup>18</sup> and her real growth rate for the year 2000 has been no less than 8%. The Economic and Social Survey of Asia and the Pacific of the UN released on April 4, 2001 declared: "The experience of Malaysia suggests that capital controls can help stabilize an otherwise difficult situation". IMF now envisages imposing fewer conditions on loans granted to developing countries so that they may have greater freedom to design their recovery plans in the future.<sup>19</sup>

## 7. CONCLUDING REMARKS

We have demonstrated that the prime cause of financial crisis in Malaysia was not the weak economic fundamentals of the country. Rather, the crisis threatened these fundamentals. Compare, for example, the values of economic indicators provided in Tables 2 and 3 for the years 1996, 1997, 1998, and 1999. It was the unbridled speculative exodus of portfolio investment from the country that brought her to grief. The turmoil pushed almost overnight a flourishing economy in the mire. Malaysia used capital controls for ameliorating the situation, and succeeded. Long-run effects of the measure are difficult to assess due to their diffusion because of the fast changing global economic spectrum.

Controls were withdrawn as soon as they were no longer required. The one-year capital lock-in was allowed to lapse in September 1999, and the tax on profit remittances was also done away with soon thereafter. The currency peg alone remains. The issue of its retention, level, and form has recently been in debate.<sup>20</sup> However, its treatment can better be left for a separate paper.

The crisis has unveiled several weaknesses in the structure of the economy. Measures are being taken to remove them. For example, a master plan to make the financial sector more competitive and resilient is already in place. Special attention is being paid to agriculture and rural development to make the economy more diversified, self-reliant, equitable and less dependent on imports. There is greater emphasis on mobilizing and using more of local resources for spurring

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<sup>18</sup> The composite ICRG rating for March, for example, rose to 75.3% (World Development Report 2000/2001, Table 17, p.306).

<sup>19</sup> The IMF made the announcement in late March this year.

<sup>20</sup> On this see Ariff (2000) and also Hasan (2001), Section 5.

development. The country can no longer expect, much less rely, on the influx of foreign funds in view of the rapidly changing international politico-economic scene.

The argument of this paper will perhaps be incomplete without spelling out some broader policy conclusions from the Malaysian experience for the developing Muslim economies. Financial crises are a recurring feature of market economies; their frequency and intensity is only likely to increase in the future for a variety of reasons. The key factors dominating modern finance are the institutions of interest and speculation. Islam prohibits both, even the latter as it is being practiced today. Muslim countries are in need, as never before, of expanding interest-free financing in their economies, and must have a hard look at their laws regulating the financial markets.

A related and equally significant issue is of credit creation and its control. Both seem to have gone more awry in recent decades. In this connection the suggestion made at times of a hundred per cent reserve requirement for commercial banks could be helpful provided the needed flexibility in liquid resource availability could otherwise be ensured. Muslim economists are of late toying with the idea, albeit still hazy, of introducing gold into the monetary system not only to discipline the credit system but on a more important side in the hope of curbing capital flights across national borders to soften the rigor of financial crises. Unless the details of the proposed system are made clear, and expected results are shown to be beneficial, it does not look tenable.

The above observations are of long run import. From a shorter perspective, Muslim countries may do well to rely more on internal or mutual resources to finance development. They must strengthen their financial institutions, avoid wastages, and undertake more of welfare promoting rather than prestige enhancing projects.

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