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International Islamic University of Malaysia

2003

Islamic Economic Studies
Vol. 10, No. 2, March 2003

THE 1997-98 FINANCIAL CRISIS IN MALAYSIA: CAUSES, RESPONSE, AND RESULTS – A REJOINDER[*]

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I read with interest the comments of the two reviewers –Mohamed Ariff and Faiz Mohammad published in the *Islamic Economic Studies* Vol. 9, No.2, March, 2002 on my paper "The 1997-98 Financial Crisis in Malaysia: Causes, Response, and Results". The comments are quite interesting, and add to our understanding of the complexity of the issues under discussion.

I

My basic difference with the reviewers is this: they maintain that weaknesses of the sort piling up in the economy over the years invited the currency attack, while I have reason to believe that it came to Malaysia independently of her fundamentals, rather eroded them in its aftermath. I stick to this position regardless of comments.

Let me preface my response to the learned comments by stating briefly the background to the argument of the paper. When the downturn struck Malaysian economy in July 1997 a fierce debate both inside and outside the country ensued as to what in fact *caused* the debacle: external speculative attacks on the currency of the country or her weak economic fundamentals? Malaysia blamed it on the first, foreign speculators, while most of the early writers on the subject focused on the second.[1] Later on many economists and international agencies found greater truth in the Malaysian position. I did not realize at the time of writing that the paper put across the issue so straight and barefaced that the argument it advances could be misunderstood. The comments of both the reviewers centre on Section 4 of the paper dealing with the issue: they are not in much disagreement with the rest of the argument. *Interestingly, the solution they accept to be valid was strictly linked to the cause of the malady that they slighted.* I discuss the two comments in turn.

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[*] The author is grateful to his colleague Syed Nasir Raza Kazmi in the Department of English who looked into the language of the manuscript. However, the usual disclaimer applies.
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[1] See Jomo (1997) for an interesting debate on the point.

II

Ariff has no disagreement with the hypothesis of the paper that the financial crisis in Malaysia was triggered by the speculative flight of capital from the country. He also subscribes to the results of the statistical exercise validating the hypothesis. There also are no differences between him and the author on the efficacy and effectiveness of the policies the country chose to meet the crisis. He too underlines the distinct position of the Malaysian economy in the region. His points of departure from the argument of the paper are not many, or of much consequence. Nevertheless some of his observations call for a closer scrutiny.

He finds the paper somewhat biased in that it presents an "official version" of what caused the crisis and that Malaysia was not an innocent victim. I do not think the formulation was in any way tilted. If the analysis based on facts and an appropriate technique led me to a conclusion that turned out supportive of the so-called 'official position', there was little that I could do about it. In any case, official assessment of a position need not always be devoid of reality. Furthermore, holding capital flight to be the *primary* cause of the trouble does not necessarily mean shifting of "the blame entirely to the rest of the world" as Ariff feels. For me, it was a matter of *relative* weight, not of exclusion. There may have been weaknesses in the economy, for no economy is free of weaknesses. The point is that these weaknesses did not *initiate* the trouble; capital flight did. Our results especially of Table 6 in the original paper clinch the point. Incidentally, I noticed that the table did not appear in the printed version[2]. So we produce it below as Table 1 for ready reference. The table is to be read with the first paragraph on page 8 of the paper.

TABLE 1

Results of Granger F test for Bi-variate Causality

Sample	Pre-crisis Period			Crisis Period		
	1-30			1-63		
	F Statistics	t-value	Result	F Statistics	t-value	Result
Null Hypothesis H_o						
KLCI dnc \$-RM (2)	2.3684	2.17	Reject H_o	(3) 3.5702	1.82	Reject H_o
\$-RM dnc KLCI (1)	0.6235	2.17	Accept H_o	(3) 0.9664	1.82	Accept H_o

Note: t-values are at 10% level of significance. The numbers in the brackets are the optional lag lengths as chosen by the FPE criteria. (dnc means does not cause).

The above results unmistakably show that capital flight was essentially responsible for the debacle Malaysian economy experienced during 1997-98. The

[2] The Table got deleted inadvertently in the process of page making. We apologize for the error. (Editor)

sequence precisely was to sell equity in the stock market and use the released ringgits for buying dollars in the foreign exchange market to be taken out. In contrast, those who believe that internal weaknesses invited the currency attacks have yet to produce *conclusive* evidence on the point.

Ariff argues that the crisis was not a temporary phenomenon stating that "the crisis far from being *short-term* in nature is not really over despite the 1999 recovery and further expansion of the affected economies in 2000". Here one must spell out the criteria or the time frame for what could be considered as a return to normalcy. If one is free to extend time without limit, market economies may be seen in a state of perpetual crisis. The position taken on the time dimension of the crisis is not tenable either on linguistic or conventional grounds.

In common parlance the notion of crisis implies a very short duration, a turning point, and a decisive moment characterized by instability, suspense, insecurity and difficulty in an economy.[3] It has an element of surprise, shock, and suddenness. Sentiment dominates the business behavior, not logic.[4] Strong fundamentals too may not work: even the US has not been free of crises. Fundamentals do not guarantee immunity from the contagion.[5] With the passage of time, rationality tends to overcome sentiment and the crisis passes off. The literature on the subject also underlines the *short-term* nature of the crisis. The reviewer himself uses the word in the same sense in the latter part of his observations (p.19). The short-term nature of the crisis deflates many of his comments.

The 1997-98 economic turmoil in East Asia has no doubt earned several descriptions in the literature: currency crisis, balance of payment crisis, and financial crisis. However, most of the writers on the subject maintain that the

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[3] *The Oxford English Dictionary* defines *crisis* as "3. A vitally important or decisive stage in the progress of anything; a *turning point*; also, a state of affair in which a decisive change for better or worse is imminent; now applied esp. to times of difficulty, insecurity, and suspense in politics or economics." Likewise, the *Webster's Third International Dictionary* provides these meanings of the word: "2a: the *point of time* when it is decided whether an affair or course of action shall proceed, be modified or terminate; *turning point* 2c: the *immediate* sequel to the culminating point of a period of prosperity and rising markets at which the business organization is *severely strained* and *forced* liquidation occurs. 3a: an *unstable* state of affairs in which a *decisive change* is impending...." (emphasis added).

[4] J.M. Keynes, writing during the Great Depression, put emphasis on the volatile psychological factors that caused business cycles, and thought them beyond rational explanations; to emphasize the point he dubbed them as 'animal spirits'. More recently Alan Greenspan called this factor as an 'irrational exuberance' In the recent East Asian crisis irrational exuberance gave way to irrational pessimism, a withdrawal of confidence, and a run on economies with very open capital markets (Stiglitz 1998, 13).

[5] See Jomo (1998, 18).

debacle started as a *financial* crisis, and eventually led to serious consequences for the East Asian economies including Malaysia.[6]

In the present context, the fact that there were signs of an impending crisis is of little value. Ariff himself agrees that "no one could predict its timing or intensity" (p.18). And this is why no one did fire a single warning shot announcing the arrival of the calamity. Nor could any one tell what steps, when, and by who had to be taken to pre-empt the oncoming turmoil.

Furthermore, what Ariff lists under the so-called signs (p.18) is not entirely correct or relevant. For example, a rising incremental capital-output ratio (ICOR) does not necessarily testify to misallocation of resources or inefficiency in their use.[7] An internal debt is no burden on the community as a whole, external debt is. But the latter was never more than 64% of the GNP in the years preceding the crisis, and was mostly well covered by the foreign reserves of the country. The total debt-service ratio to exports too did not cross 6.7% during the period.[8] One important characteristic of East Asian economies has been the high domestic savings primarily contributing to their fast growth. Foreign capital did play a role but to a lesser extent than in other developing regions. Table 2 reveals the Malaysian position around the crisis period. It shows that high domestic savings have been the *main* source of financing her economic development in more recent years. The investment-savings gap was, of course, negative and rising for some years but it was not alarming.[9] The economy has maintained a uniform rate of internal savings despite the crisis. Probably, this was one contributory factor to its coming out of the tunnel faster.

TABLE 2

Savings and Investment as Percentage of GNP: Malaysia

	1996	1997	1998	1999	2000
Gross Domestic Capital Formation	43.5	45.5	28.1	23.9	29.4
Gross National Savings	38.9	39.1	42.0	41.1	39.5
Balance on Current Account	-4.6	-6.3	12.9	17.1	10.0

Source: Bank Negara Malaysia Annual Report 2000.

Malaysian economy is run largely by private enterprise; its share in the total fixed investment of the country rose from 62.6% in 1980 to 64.5% in 1990. The pace has since been quite brisk, the private sector's share in total investment

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[6] Ibid p.2

[7] See n. 7 of the paper under review p.5.

[8] See Bank Negara, Malaysia Annual Report, 2000 Table A.21, p.26.

[9] It was not more than 6.3% of the GNP in 1997 while domestic savings stood at 45.5% even in that year of crisis.

climbing to 72.78% by 1997.[10] To the extent that internal forces are held responsible for the crisis, the blame must fall on the private sector. It is strange that when a developing economy is flourishing the economists would sing praises for the private enterprise, but when it comes to trouble they pick up the stick to beat the official profligacy.

It is sometimes argued that the recovery in Malaysia was the result of good luck, not of good policy: If recovery in the US had not increased demand for the electronic and electrical goods from Malaysia the economy would have remained "stuck in the mud." The argument is misleading. The rate of growth in the US was *falling* around the crisis (Table 3) and refutes the contention of recovery there pulling the Asian economies out of the mire. Table 3 also shows that Malaysian exports of these goods to the US in 1999 were almost the same proportion of her total exports as in 1998 when they did rise substantially due to the *devaluation* of the ringgit and helped recovery as expected. The proportion declined in 2000 but the Malaysian economy remained buoyant. In any case, the proportion was never more than about a fifth of the total exports of the country. The claim that a rise in just 20% of exports did the trick would look like a case of the tail wagging the dog.

TABLE 3

Place of Electronic and Electrical Goods from Malaysia in her Exports (Amounts in Million RM)

		1996	1997	1998	1999	2000	2001
Merchandise Exports of Malaysia	(A)	158540	178945	237649	271730	317908	285316
Exports of Electronic and Electrical Goods to the USA	(B)	25502	30283	47572	55477	59736	52117
(B) as percent of (A)		16.09	16.92	20.02	20.42	18.79	18.27
Rate of Growth of US Economy %		3.6	4.4	4.3	4.1	4.1	1.2

Source: Bank Negara Annual Report 1999 A.12 A.13 and A.14; 2000 and 2001 A.7, A.8, A.9 and A.32.

III

Interestingly, Faiz Mohammad agrees that the crisis was a *short-term* phenomenon and hails as remarkable the recovery of the economy from the financial turmoil in less than three years. He considers the policies pursued to achieve the objective as appropriate and effective. However, he too is critical of our view on the causes of the crisis. His main complaint is that the author worked with insufficient and selective data to prove that mainly the flight of capital from the country, not the weak fundamentals, caused her discomfiture. I have already

[10] World Development Report 1998/99 Table 16, p. 220 and 2000/2001, Table 16, p.304.

answered this criticism in the foregoing discussion. Here I would like only to add that mere claims are no argument: there was no purposive *selection or omission* of data for erecting the model.

I do not subscribe to the view that mainly the economic and financial developments in the country caused the trouble. So their critical analysis hardly fell within the ambit of my argument (pp. 21-22). I have rather maintained that these developments, being long run, were not very relevant to the case. Table 1 of the original paper presented the *background* data to highlight the abrupt change in the direction of capital flows not to establish "the cause of crisis" (p.22).[11] Table 2 presented some real economy indicators of Malaysia for the reader to see that the basic macro variables of the economy were quite sound on the eve of the crisis, deteriorated *because* of the crisis, and showed signs of improvement after taking remedial steps. Likewise, Table 3 showed that nothing was alarming until 1996 on the financial front as well, and Ariff supports this view (p.19). What was happening before 1996 was essentially history for the *suddenness* of the crisis. It could hardly be linked to the debacle in a causal chain of relationships. At least I could not think of the way to accomplish the task. Tracing of long run trends in macro variables to explain economic *shocks* hardly benefits. Who did or could explain, for example, the fall of the mighty dollar during the seventies in the face of *oil shocks* as resulting from the weaknesses in the macroeconomic fundamentals of the US?

The paper had put the hypothesis to be tested in the form of an equation. Figure 1 (reproduced below for ready reference) was merely a schematic depiction of its operation mechanism. It was never meant, for *proving* that capital flight ushered in the financial crisis in Malaysia.

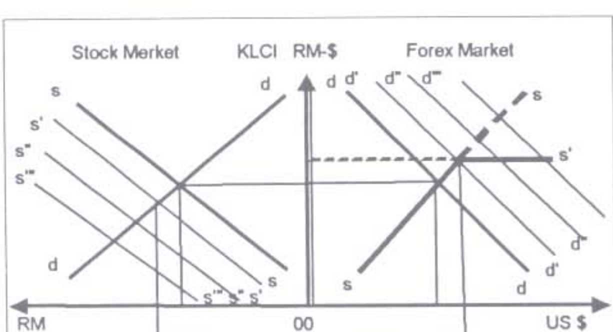

Fig. 1 Stock - Forex market interaction

The figure is easy to understand, rather self-explanatory. The left hand side shows that increasing sales of equity in the stock market continually pushed the

[11] The cause of the crisis was the 'crisis of confidence' as explained in note 3 above.

supply curve downward, bringing down the KLCI and releasing ringgits which the circuit lines show being taken to the currency market on the right hand side for buying dollars, pushing up the demand curve for them and raising in the process the ringgit price of the dollar on each round i.e. leading to the depreciation of the former.

"If the capital outflow was the main cause of the crisis, then what caused the capital outflow" is doubtless a pertinent question. The paper did not go much into the details of the matter. For, there had already been a well-researched recognition in the literature that currency speculators played a leading role in the Asian financial crisis.[12] Many of the references in the paper endorse the viewpoint, which Ariff put so succinctly as "currency attacks" (p.18). The paper under review too blamed the debacle on unbridled speculation, fueled by the panic among traders; contagion provided the transmission circuit for the nations (pp.8-9).

Faiz Mohammad feels that four years' data that the paper provides concerning some real variables of the Malaysian economy were insufficient to capture dynamic changes in its macro fundamentals. I have already explained my position on the data presented in the three tables. Long run analysis of economic trends lay outside the ambit of my work and could have been of little value to the main theme of the paper. Also, one need not mix up the distinctive case of Malaysian fundamentals with the overall regional trends.[13] The opening paragraph of the paper clarifies the position on the point.

Again, more relevant for investors is the fact of increase in the *volume* of merchandise exports not the *fluctuations* in the rate of increase in that volume (p.22): Malaysian exports rose continually since 1995 until dipping in 2001.One must have noted that foreign direct investment to the region kept on rising during 1996-98 despite the crisis; the culprit was the volatile short-term portfolio investment (see Table 1 of the original paper, p.3). The latter was led by inexplicable fear not by the state of economic fundamentals.

A small open economy like Malaysia could certainly not remain unaffected by the investors' perceptions about the region as a whole. The argument of the paper nowhere negates that fact. It only holds that it was contagion, which primarily transmitted the malady to the country (p.8-9) her fundamentals being what they were.

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[12] Here is an illustrative remark from Stiglitz: "Even if the East Asian countries had sound financial systems and good policies, the crisis could still have occurred because of the runs on currencies and vicious cycles to which they give rise. All you need is instability in beliefs" (1998, 13).

[13] Ariff rightly points out that it is wrong to place Malaysia in the same league as Indonesia and Thailand, which may be termed as basket cases.

The financial crisis can doubtless be looked at in a regional context, and the significance of that context can hardly be denied. However, country specific studies like the present one have their own justification and fall in a somewhat different category. I am afraid the reviewer missed this vital difference in his formulations although the introductory section of the paper had made the point quite explicit. In this perspective I do not think that the Malaysian economic fundamentals could have been studied more appropriately by applying the time series and panel data on a variety of key economic variables for the period before the crisis. The econometric model, the crucial element in the argument of the paper and covering a period of about 90 weeks, is in the well established tradition of the subject.

I am, indeed, intrigued by the reviewer's statement that changes in the stock and currency markets are the two sides of the same coin, and therefore a high positive correlation as the paper has established is a foregone conclusion (p.23). I am not aware of a theoretical basis for the relationship to be so close and universal. Nor did I come across any authentic documentation on the point. Moreover, the relationship between the KLCI and \$-RM rate is not studied in isolation but in conjunction with the manipulations in the monetary and fiscal policies of the country during the period. Chapter 7 –'The Currency Control' -- of Mahathir's book listed in the references makes public some interesting information that provides further support to the thesis of the paper.

IV

To conclude, a word about the big picture, which Ariff rightly says, one should not miss. This picture, however, is that foreign exchange spot transactions worldwide are today worth more than 70 times the total value of international commodity transactions. The financial sector is becoming increasingly divorced from the real economy. Its potential to inflict injury on the real sector is on the increase with the proliferation of instruments and markets. In this picture 'liberalization versus national liberty', not the fundamentals, is *the* issue. It is becoming imperative to consider measures like imposition of a Tobin tax on foreign exchange transactions to curb speculative activity and allow more elbowroom to developing countries in designing their fiscal and monetary policies in the light of their requirements. The course Malaysia charted to meet the crisis should be seen as a small step in that direction. Faiz Mohammad makes a welcome suggestion to minimize financial instabilities through conscious effort to promote equity-based interest-free economic structures.

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