Malaysian Journal of Economic Studies Vol. 44 No. 2, 2007 ISSN 1511-4554

Commentary

The Return of Soros: Revisiting Malaysian 'Facts' about the Asian Crisis

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Abstract: Objective evaluation of evidence about Malaysia's experience during the Asian Crisis a decade ago reveals widely held Malaysian perceptions to be misleading if not downright erroneous. Most importantly, while turning its back on the IMF did not bring Malaysia the disaster many predicted, neither could this approach be credited with saving Malaysia's economy. Countries that bit the IMF bullet recovered as quickly as Malaysia did. The similarity of policies adopted by Malaysia and IMF-assisted countries may account for this lack of differentiation. The credit given to capital controls is likewise exaggerated. When it came to proximate cause, blaming speculators may be politically convenient, but makes little sense given that short-term speculation is part and parcel of well functioning capital markets, contributing both to booms as well as busts. Finally, the belief that Malaysia fared better than other Crisis-hit Asians is based on the presumptions that other countries suffered greater collateral damage and that Malaysia's fundamentals were sounder, both of which are not well supported by existing data.

Keywords: Asia, capital controls, financial crisis, fundamentals, macroeconomic management, speculators
JEL classification: G18, E44, E61

Introduction

The return of George Soros to Malaysia in December 2006, almost a decade after the Asian Crisis he was alleged to have engineered, is an opportune moment to reflect on and put to rest the events surrounding what must have been the most traumatic experience this country has endured since the Second World War. It is also time to re-examine widely-held perceptions of the event by Malaysians. These perceptions have been abetted by the 'facts' presented in official circles and disseminated by a docile media, and, for a variety of reasons, largely unchallenged by the country's intelligentsia. But do these 'facts' stand up to statistics and analytical scrutiny? Let us look at a few major widely-held Malaysian views.

'Fact' 1: By refusing IMF assistance, Malaysia escaped a disastrous fate. Looking back at the absence of turmoil and the quick recovery of the economy from the depth of Crisis, Malaysia's unorthodox approach certainly appears to be vindicated. Indeed, this thesis has been the theme of a book published by the Institute of Strategic and International Studies (Tourres 2003). It is certainly true that compared to the IMF's early remedies, Malaysia suffered far less pain than did Indonesia at least. But the proof of the above 'fact' cannot be founded on this truth alone. Lee and Tham (2007) explained the

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milder impact on Malaysia in terms not of these policies but of the country's sounder fundamentals. That most of Malaysia's exports were by multinationals insulated the country from a sharper contraction.[1] They could have gone further. Since Malaysia's manufactured goods exports were heavily concentrated in electronics products, the strong demand from the US (in preparation for Y2K) until the burst of the tech bubble in 2001 saved the country from greater pain.

Additionally, the IMF vs. no-IMF alternatives turned out not to be as mutually exclusive as it has been made to appear. Major steps that Malaysia took – the cleanup of bank debt, improving governance, and even the expansionary budget[2] – were precisely the measures pushed by the IMF on Indonesia, South Korea and Thailand. Thanks partly to the IMF's measures, these three countries recovered no later, and in Korea's case earlier, than Malaysia. Indeed, while a case could have been made against the IMF's requirement for the break-up of government or government-endorsed monopolies on the grounds of social stability, the use of substantial public funds to bail out politically connected companies like Renong, MISC and Malaysia Airlines could not have been the most obvious method of social protection. Likewise, the argument for protection of domestic capital needs to be seen in this light. In real terms, the only policies Malaysia pursued that were distinct from what the IMF prescribed were capital controls and the currency peg.

In the rush to condemn IMF policies, it is largely forgotten that the programmes were not always forced on an unwilling Asian leadership. While Indonesia's Suharto was clearly disconcerted by the Fund's insistence on ending food subsidies and dismantling monopolies, South Korea's newly elected Kim Dae Jung saw the Fund's insistence on flexible labour markets as consonant with his new government's position, at least in the beginning. These attitudes help explain the contrast in the manner IMF-mandated reforms were implemented. Suharto veered between support for and resistance to these reforms before finally losing his grip on power. Unfettered by such doubts, the South Korean government implemented the IMF program religiously. The Thai government elite were likewise committed to the IMF program, although it was hampered by an unstable political coalition which eventually fell.

Thanks partly to these voluntary and mandated reforms and partly to the continued good health of Western markets, both Thailand and South Korea, which followed its recommendations, emerged from the Crisis no worse off than Malaysia. Indeed, South Korea recovered faster than Malaysia and Thailand, recording lower unemployment rates and non-performing loans, more rapid build-up of international reserves and stock market capitalization, and repaid the IMF loan ahead of schedule.[3]

The logical conclusion should be that regardless of the motives and the extent of their success, Malaysia's policies were not so unorthodox after all and the IMF alternative not the disaster many made it out to be.

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[1] A Government of Malaysia-World Bank Corporate Sector Survey on the impact of the Asian Crisis confirmed that domestically-oriented firms were harder hit than export-oriented firms.

[2] After pushing fiscal contraction, the IMF, under heavy criticism from American scholars, including Jeffery Sachs and Joseph Stiglitz, eventually changed course on its harshest medicine. In February 1998, the IMF reversed its previously mandated budget surplus of 1 percent of GDP for Thailand to a fiscal deficit of 2 percent of GDP. A similar adjustment had been made to its conditionality for Indonesia a month earlier. The fiscal constraints were eased for Korea in February and May 1998 (IMF 1999).

[3] See Bacha (2004) for details of each country's recovery.

'Fact' 2: Capital Controls Saved Malaysia.

If Malaysia's reforms were not so different from the IMF's, the imposition of capital control certainly was. Western neo-liberal critics immediately predicted economic collapse, raging inflation and black markets. Rating agencies cut Malaysia's sovereign risk ratings from the A+ to A- band with a 20 per cent risk weight to the BBB+ to BBB- band with a 50 per cent risk weight (Cailloux and Griffith-Jones 2000, Table 12). They were never more wrong. At the time capital controls were imposed, in September 1998, Malaysia had already seen the bottom of the downturn and the beginning of a mild recovery, thanks to banking and other financial reforms already underway and the end of the panic phase of capital flight.

Why were controls imposed so late? One (economic) argument saw the imposition of controls as a response to intense speculative activity over the Ringgit and Malaysian stock markets at the time (Krugman 1999). Such activity stemmed from Bank Negara's abandonment of all attempts to bolster the Ringgit from the periodic outbursts of defiant political rhetoric, and from conflicting signals sent out by the leadership in the throes of the power struggle between Dr. Mahathir and Anwar Ibrahim.[4] A more intriguing explanation was that these controls, far from being imposed for economic reasons, was in fact part and parcel of that leadership struggle, with Anwar favoring the IMF line while Mahathir signaled just the opposite tact – an expansionary fiscal policy behind capital controls (Haggard and Low 2000). A more sinister interpretation is if these controls had facilitated the bail-out of political allies.[5] Whatever the explanation, it was certainly not to stem the Crisis, by then a year old.

However, if the controls were not the disaster its critics claimed, did they contribute to Malaysia's recovery? Jomo's (2002) assertion that these controls were ineffective because they were tantamount to "bolting the stable doors after the horses have fled" missed the point. By the time Malaysian controls were imposed, conditions in the rest of the Crisis-hit countries had stabilized and recovery begun. Even Indonesia's free-fall had bottomed. Thailand's economy had turned the corner and South Korea's was posting solid gains. Real interest rates in these countries were not that high during the worse of the Crisis (Berg 1999, Figure 7a and p. 31). Improving conditions permitted these interest rates to fall further. And thanks to continued American prosperity and the need to prevent contagion from the Russian, Brazilian and LTCM fallout, interest rates in the US and the rest of the developed world were *falling* during this period too.[6] Neither Thailand nor South Korea, which imposed no capital control, saw capital flight during this period.

The weight of evidence suggests that whatever the proximate reason for instituting capital controls, they had little to do with the capital flight that sank the Crisis economies, and therefore could not be credited with the country's recovery. At the same time, since they did no harm, *these capital controls were economically benign.* The decision to impose the controls might have been deemed necessary given the circumstances of the

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[4] An excellent account of this is provided by Haggard and Low (2000) who adopted a political economy perspective of these controls.

[5] See Johnson and Mitton (2001) which interpreted Malaysian stock movements from the onset of Crisis to the imposition of controls as supporting this line of thinking.

[6] In the last quarter of 1998, the FED reduced interest three times by a total of 0.75 per cent while Europen central banks also reduced interest rates.

moment, but history and hindsight shows that decision not to be material, let alone vital, to Malaysia's economic survival.

'Fact' 3: Speculators are to Blame for Malaysia's Crisis.

The image of greedy speculators ever ready to attack the Ringgit for pure gain and inflict misery on millions is now part of the Asian Crisis lore among Malaysians (see, for instance Wong 2006). But this statement is actually about two separate if related sets of villains – speculators of foreign exchange and speculators in financial markets. The first group would take in Soros and his ilk, according to Dr. Mahathir at the time of the Crisis. The argument goes that by triggering an attack on the Ringgit, these speculators panicked the stock markets, causing their collapse. Linden (1997) provided an account of the attack on the Baht, noting that among these speculators were well-known names like Citibank. He also reported that some traders/speculators sustained heavy losses in the process. However, compared to the Baht, evidence of an attack on the Ringgit was as sparse as that on the Baht was extensive.

Even without the Ringgit being attacked, would the depreciation of the Thai Baht alone have unnerved speculators in the Malaysian stock markets? The answer is most certainly yes; the depreciation of the Baht would have increased the *risk* of a similar fate befalling the Ringgit, which was similarly hitched to a rising US dollar in an economy that had already experienced five years of substantial current account deficits. These comparisons could not have been lost on short-term investors/speculators. Thus, an attack on the Baht, even without one on the Ringgit, would have been sufficient to panic Malaysian markets. Add this to fiscal deficits, and the problem of the 'twin deficits' now famously applied to the US meant that a correction was only a matter of time. The collapse of the Baht only hastened this correction.[7]

This brings us to the second group – speculators in financial markets. All financial markets have traders deploying a variety of instruments to realise short-term gains. Some are arbitrageurs, whose objective is to make money from price differences between two related assets, such as interest rates between two countries or financial markets. But there is a fine line between arbitrage, considered not only a legitimate but an economically productive financial pursuit, and speculation, which is apparently not.[8] Thus, carry trades and Repos are legitimate short-term instruments that can be liquidated at short notice. So are emerging market funds, which flooded in after the Cold War ended. As a growing 'emerging' market, Malaysia had its share of them. These short-term investors would have been, and were, the first to leave town. Much has been written about their motives. But a large body of opinion, expressed famously by Bhagwati (1998), was that far from being calculating and heartless, they were just ignorant – hence, financial markets are susceptible to herd behaviour and panic.

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[7] My thanks to Lee Kiong Hock for pointing this out. See also Bouchet, Clark and Groslambert (2000).

[8] Almost prophetically, the *Economist* (1996) published in February1996 a paper explaining the difference between arbitrage and speculation, comparing an arbitrageur to a middleman. It also argued that both arbitrageurs and speculators have legitimate roles to play in markets.

Yet herd behaviour is symmetric. The same speculators who caused such pain with their stampeded exit had, just before, poured funds into the Malaysian stock markets, creating the investment bubble, and making some companies and the speculators themselves very rich. In the political rhetoric against speculators, this fact was conveniently forgotten. Just as the fact that not all speculators were foreign.

Nor should speculators shoulder the entire blame for the sell-off of the Ringgit. Malaysian companies and companies operating in Malaysia scrambled to buy dollars with the Ringgit as the Baht fell. Exporters hoarded dollars offshore while importers settled their purchases early. And inadequately hedged Malaysian companies, like their Thai counterparts, scrambled to cover their currency positions (Lipsky 1998). This lack of hedging was abetted by the long-standing USD:Ringgit currency peg, but a potential disaster when the peg risked being undone.

To summarise, while it is politically convenient to blame speculators, the economic reality is more complex. *Currency trading and short-term capital flows occur for a variety of reasons, many based on sound economics. There is no distinct group that can be identified as speculators. Blaming the Crisis on speculators makes no more sense than crediting them with the country's success, which fairness demands.*

'Fact 4': Malaysia had Sound Fundamentals.

To this day, Malaysians believe that the economy had 'sound fundamentals' when the Crisis overwhelmed the region. This belief fueled the government's denial of the Crisis' threat, and when it was upon the nation, provided the rationale that it was entirely the fault of foreigners. But what are these 'fundamentals'? Actually, they refer to different things in

Table 1: Selected financial sector indicators 1996–1999: four Crisis countries

Indicators	Indonesia	Korea	Malaysia	Thailand
External lending[1]				
Value in USDb as of Dec. 1996	56	100	29	70
As % of GDP		20	22	37
As % of 4 countries	23	40	9	28
Of which % short-term				
Increase 6/95-6/97	50	60	60	66
Withdrawn 6/97-6/99	86	90	80	76
Exposure to property loans (%)[2]	25-30	15-25	30-40	30-40
% fall in stock market valuation (in USD terms) 6/97-3/98[3]	50	46	79	58

[1] BIS data cited in Cailloux and Griffith-Jones (2000).
[2] Berg 1999, Table 2.
[3] Berg 1999, Table 5.

the real and financial sectors. In terms of the former, they refer to the fiscal balance, inflation management, external debt and exchange rate management, according to the World Bank's study on the East Asian Miracle (World Bank 1993). But for the financial sector, the strength of the banking sector and the robustness of financial markets are the main components.

First, let us consider financial fundamentals. At the onset of Crisis, arguments were advanced that Malaysia's banking sector was better regulated and borrowed less from overseas than those in Thailand and Indonesia, helping the country weather the storm better than its neighbours. This belief is belied by the statistics (Table 1). Bank of International Settlements (BIS) data cited in Cailloux and Griffith-Jones (2000) show Korea having the largest external debt by value (USD100 billion), but the lowest external debt to GDP ratio. By contrast, Malaysia's much smaller external debt of USD29 billion was a higher share of GDP (22 per cent) though far better than that of both Indonesia and Thailand. Additionally, Malaysia was no different than the other three Crisis countries in terms of short-term lending.

But that is not all. First, Malaysia had a higher concentration of major borrowers, the failure of any one of whom might threaten the entire banking system. Second, bank exposure to property loans was as high as that of Thailand and significantly above that of Indonesia and of South Korea (Table 1). Third, loan leverage, the ratio of private sector debt to (nominal) GDP was higher than in South Korea and Thailand, and significantly higher than in Indonesia (Berg 1999, Figure 2). Fourth, Malaysian banks borrowing through the tax haven of Labuan had loans classified as domestic even when foreign debt was contracted. The Wall Street Journal estimated this amount at some USD400 million. More importantly, the banking sector is but half the story. The other half – the Malaysian financial market – was actually more vulnerable than other Crisis countries by virtue of its much larger volume of portfolio capital, which is much more volatile than bank loans. Again, the numbers tell the story. Malaysia's stock market valuation (in USD) fell 79 per cent from June 1997 to March 1998, compared to 50 per cent for Indonesia, 46 per cent for South Korea and 58 per cent for Thailand.

What about real sector fundamentals? Here, this statement appears to be on much firmer ground. Macroeconomic management had been generally prudent, although there have been significant lapses, such as fiscal pump priming in the mid-1980s which brought the country recession, and, as earlier indicated, several years of fiscal deficits just prior to the onset of Crisis. Fiscal expansion also continued long after the Crisis was over – from perennial surpluses, budget deficits were recorded from 1998 to 2003 (Henry 2006). Likewise, the generally prudent monetary policy was blemished by Bank Negara's speculation on the British Pound (with Soros on the other side) in 1992, costing the country billions. The futile defense of the Ringgit which depleted the country's international reserves also did nothing for Bank Negara's and the government's economic management credibility.

Even more importantly, even if real sector fundamentals were sound, it is doubtful whether these sound fundamentals would have prevented Malaysia's Crisis. The Crisis did not begin in the real sector but in the financial sector with an exchange rate misalignment causing a stock market collapse, which in turn begot a banking crisis. The better real sector fundamentals might have stood Malaysia in better stead when economic depression (a real sector phenomenon) then hit. They were no defenses against a financial crisis.

To summarise from the above comparative review, it may well be that in some areas, Malaysian fundamentals were superior to those of other Crisis countries, but there is no real basis to claim they were sound.

'Fact' 5: Malaysia was Less Badly Impacted by the Crisis.

Arguments that Malaysia was less severely impacted by the Crisis were generally associated with its 'stronger' fundamentals and also by comparisons with its neighbours. How did the real sector fare during the Crisis? Table 2 reveals that while Malaysia's GDP growth rate reversal between 1996 and 1998 (over 15 per cent) was less than Indonesia's (nearly 22 per cent), it was not very different from those of Korea (just under 13 per cent) and Thailand (15 per cent). There is also not that significant a disparity in the rise in unemployment rates, to the extent these can be used as an indicator of economic well-being.

Beyond these aggregates, the notion that Malaysia was less adversely impacted than its neighbours is partly founded on dire predictions of these countries' plight by international agencies like the World Bank, UNDP and ILO, no less (World Bank 1998, UNDP 1999, ILO 1998)[9]. However, Jones (2000) provided persuasive arguments and evidence of the magnitude of these exaggerations with respect to unemployment and poverty incidence. His estimates showed Malaysia to have fared a little better than both neighbours during the Crisis, but then Malaysia was better-off in the first place.

Table 2: Select real sector indicators 1996–1998: four Crisis countries

Indicator	Indonesia	Korea	Malaysia	Thailand
GDP growth rate (%)[1]				
1996	8.0	6.8	8.6	5.5
1998	-13.7	-5.8	-6.7	-9.4
Unemployment rate (%)[2]				
1996	4.9	2.0	2.5	1.1
1998	5.5	6.8	4.9	5.3
Fiscal balance (% GDP)[3]				
1996	1.4	0 5	0.7	2.4
1998	-2.6	-4.2	-1.8	-3.4
Savings-investment gap (% GDP)[4]				
1996	-3.4	-3.1	-5.4	-8.1
1998	4.0	4.1	12.8	12.8
Exchange rate depreciation Jan. 97 – Jul. 2000 (%)[4]	248.2	31.5	52.6	52.8

[1] Berg 1999, Table 1.
[2] ADB (2000).
[3] Jomo (2001) Table 1.
[4] Jomo (2001) Table 6.

[9] The ADB, in its report stated that "the social impact of the Crisis … is likely to be deep and to persist long after the affected countries return to solid growth."

At the sectoral level, the impact of the Crisis was felt more in the modern urban sector than the rural. Indonesia's rural economy was and still is a much more important part of the country's economy than that of Malaysia or Thailand. Micro-level studies produced mixed results. Bresciani *et al.* (2002) showed Indonesia's agricultural sector to be much less affected than its Thai counterpart because of its lower reliance on the urban economy than the Thai. Waters, Saadah and Pradhan (2003) recorded reduction in health care utilisation in Indonesia during the Crisis years, but an increase in Thailand over the same period. Ravallion and Lokshin (2005) reported differential lasting impacts – greater in the initially better off and less unequal areas – in Indonesia.

As a final footnote, the argument that the Asian Crisis precipitated political change in Indonesia and Thailand while Malaysia suffered no such fate needed to be taken in its proper perspective. While Suharto's downfall undoubtedly made Indonesia's Crisis worse, Thailand's post-World War Two record of frequent changes of government, including that associated with the Crisis, did little to affect the country's economic advance.

Conclusion

Even a cursory survey of comparative evidence shows many accepted views among Malaysians of the Crisis to be at best dubious if not plain myths. This widespread lack of objectivity may have multiple sources. But a decade after the Crisis, major protagonists have reconciled and moved on. It is time to revisit these well accepted 'facts' with a greater degree of objectivity and less emotion than in the past. There is no longer any need to praise the Emperor's New Clothes.

Looking forward, the one lesson that should be drawn is that over the long term, the only effective means of dealing with such external shocks is to enhance both capital and labor productivity. This is especially compelling given the arrival of China and India as formidable competitors in the international marketplace. If Malaysia does not, it will be trapped in a more modest growth trajectory for years to come.

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