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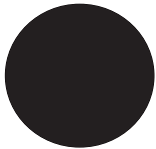

Malaysia and the Myth of Self-Regulating Markets

John A. Miller

Malaysian Eclipse: Economic Crisis and Recovery
Jomo K. S., ed.
London and New York: Zed Books, 2001.

It seems altogether fitting that *Malaysian Eclipse* edited by Jomo K. S., the Malaysian political economist and long-time critic of Kuala Lumpur officialdom, would appear in the same year that Beacon Press reissued *The Great Transformation*. In his forward to this new edition of the renowned economic historian Karl Polanyi's classic study of the myth of self-regulating markets, Joseph Stiglitz, the Nobel-prize-winning former chief economist of the World Bank, calls the East Asian economic crisis of 1997–98 "the most dramatic illustration of the failure of self-regulating markets."[1]

The myth of self-regulating markets is the topic of the *Malaysian Eclipse* as well. What Jomo and his coauthors write about the Malaysian experience with the neoliberal agenda, especially financial and capital market liberalization, will be instructive to those who study economic development in East Asia and elsewhere.

Malaysia is especially well suited for the study of the effects of financial liberalization and of "self-regulating" markets on economic development. First, as the World Bank's East Asian miracle report pointed out nearly a decade ago, Malaysia, Thailand, and Indonesia, the second-generation NICs (newly industrializing countries) of Southeast Asia, relied more heavily on markets and less heavily on government interventions than had the first generation of East Asian NICs, especially South Korea.[2]

Second, Malaysia was a favorite destination of financial capital, capturing more of the capital that flowed into the newly emerging markets during the 1990s than any other developing economy.

Third, Malaysia oversaw its recovery not with International Monetary Fund–administered austerity measures but with its own policies that included a highly controversial experiment with capital controls. That move made Malaysia, and especially its firebrand prime minister Mohammed Mahathir, an object of derision in orthodox financial circles but a champion for others seeking an alternative to financial-market-dictated economic development.

Jomo is a well-established voice in the Malaysian political debate. He is the author of a veritable bookshelf full of studies of Malaysian economic development that seemingly cover each turn in Malaysian public policy since the mid-1980s. Economic journalists and researchers regularly seek him out for a critical assessment of Malaysian economic policy. That was certainly true for economic journalist James Goodno and myself when we were conducting research on the limits of poverty alleviation in Malaysia for the book we

are writing about rapid growth, economic crisis, and poverty in Southeast Asia.

This collection of essays, all but one authored or coauthored by Jomo, provides the kind of convincing and nuanced analysis that journalists and economists have come to expect from him. To be sure, *Malaysian Eclipse* is critical of the free-market ideology of the International Monetary Fund (IMF), the U.S. Treasury, and the economics profession. But it is also damning of the conspiracy theories and self-serving rhetoric of economic nationalism offered up by Prime Minister Mahathir, frank in its assessment of the limits of capital controls, and fully cognizant of the corroding effect of cronyism on the Malaysian economy.

Mahathir has served as Malaysia's prime minister for two decades now. Through skillful political manipulation, he has held together a coalition of ethnic Malays, the majority population, and the ethnic Chinese business class in a national alliance dominated by the United Malays National Organization (UMNO). While fairly regular multiparty elections have forced some accountability upon him, Mahathir's authoritarian rule has amassed power in the executive branch and used an internal security act to jail opponents. An emerging Malay bourgeoisie has benefited from his political patronage. At the same time, Mahathir has been a long-time advocate of privatization, a fact that should not be obscured by his railing against international speculators during the 1997–98 economic crisis or Malaysia's experiment with capital controls.

Jomo's determination to strike out on an independent path is clear even in his acknowledgements. Jomo dedicates *Malaysian Eclipse* to Anwar Ibrahim, the now-jailed former finance minister and opposition leader. Jomo met with Anwar in May 1998, in the midst of the crisis and just four months before Anwar was ousted from office on sexual misconduct charges. The dedication is a bold move and a politically risky one given the arrests that have taken place since Anwar was jailed. Jomo's ability to get away with it underscores his prominence in Malaysia as well as the limits of Malaysian authoritarianism.

The dedication alone challenges the usual reading of Malaysian economic policy debate as pitting Anwar's neoliberal leanings against the economic nationalism of Mahathir. That view was one Mahathir was only too happy to promote. After Anwar's dismissal and arrest, the Mahathir camp branded him an "ill-informed stooge of the IMF and other foreign interests" and made him the scapegoat for the austerity programs the government undertook in the initial months of the crisis. And those charges stuck. For instance, at the time, a friend of mine and fellow political economist was fond of referring to Anwar as "the *Wall Street Journal's* favorite Asian leader."

Jomo came away from his meeting with Anwar with quite a different impression of the finance minister. Anwar, as Jomo remembers him, was in command of the economic issues and open to criticism. In fact, shortly after their meeting, Anwar announced policies intended to reflate the economy, a policy Jomo had advocated during their May get-together. Anwar, Jomo argues, had been no more an advocate of privatization than Mahathir, who had championed those policies throughout the 1990s. On top of that, Anwar had actually administered Malaysia's 1994 experiment in capital controls. And at the onset of the crisis, Anwar had favored smaller cuts in the government budget than those pushed for by Daim Zainuddin, the long-time Mahathir ally, who took Anwar's place as finance minister.

The chapters that follow offer a direct challenge to the neoliberal agenda of financial liberalization in the developing world. Jomo and his coauthors identify an "ill-timed and ill-sequenced" liberalization of Malaysia's banking system and financial markets as the "root cause" of Malaysia's economic crisis. They make their case in

chapters that recount the story of the transformation of the Thai currency crisis to a regional financial crisis and then an economic crisis with the help of IMF-imposed austerity policies; document the breakdown of prudential oversight of Malaysia's banking sector and the rush to liberalize Malaysia's financial markets beginning in the late 1980s; and trace the unprecedented inflow of portfolio investment in Malaysia and its reversal during the crisis.

In the fall of 1997, the currency crisis that began in Thailand reached Malaysia. The ringgit, the Malaysian currency, would lose nearly two-fifths of its value by August 1998. The stock market fell even more severely, with the main Kuala Lumpur Stock Exchange composite index losing three-quarters of its value over the same period. The net inflow of capital into Malaysia was cut in half as net portfolio investment turned highly negative and remained negative through 1998. The Malaysian economy slowed during the second half of 1997, then crashed in 1998, contracting by 6.7 percent. Construction, real estate, and manufacturing were all hard hit. Employment contracted across the economy and jobs for foreign workers disappeared. Still, all told, the economic crisis did less damage in Malaysia than in either Thailand or Indonesia. And unlike the Indonesian economy, which remained mired in crisis, the Malaysian economy began to recover during 1999, growing 4.3 percent, about one-half the rate it had averaged over the previous decade.

These chapters dispute the IMF contention that the Malaysian crisis was "homegrown" and could be chalked up to faulty macroeconomic management. Jomo and Rajah Rasiah, a Malaysian economist who has written extensively about foreign capital flows into Malaysia, establish that at the onset of the crisis Malaysia's "first order macroeconomic conditions" were in good shape and were characterized by sustained rapid growth, relatively mild inflation, and fiscal discipline. What plagued the Malaysian economy was a persistent current account deficit dangerously financed by short-term capital flows. Unlike Thailand and Indonesia, which relied on borrowing from foreign banks to cover much of their current account deficits, Malaysia turned to the capital markets to finance its current account deficit, for prudential regulation limited bank borrowing from abroad. When the crisis hit, both types of short-term capital flows—foreign bank lending and stock buying—reversed themselves with little regard for the actual strength of these economies. But, as Jomo and his colleagues establish, Malaysia's closer regulation left its banking sector in better shape and thereby muted the impact of the crisis in Malaysia.

Nor are Jomo and his coauthors willing to attribute Malaysia's record of rapid growth before the crisis to financial liberalization. As they point out, much of Malaysia's rapid growth predates the deluge of foreign portfolio investment during the 1990s. These authors fully recognize that economic growth in Malaysia has always been highly dependent on long-term foreign direct investment (FDI), whose levels are well above the average for developing countries, especially in the export-oriented manufacturing sector. But their econometric analysis fingers portfolio investment, not FDI, as the footloose culprit in the Malaysian crisis. In their findings, foreign portfolio investment is more volatile than FDI and even foreign bank borrowing. Furthermore, "unexpected drops" in the Kuala Lumpur Stock Exchange composite index were not followed by sudden pullouts of FDI in their study, adding to the mounting evidence that developing countries need to treat FDI and short-term capital flows differently.

Cronyism

Malaysia provides an equally good testing ground for the neoliberal contention that cronyism, not market failure, is the root cause of the East Asian crisis. Cronyism provided the financial establishment with a

ready-made explanation of how politically connected investment and bailouts of the politically powerful had caused the Asian crisis. Federal Reserve Board chairman Alan Greenspan went so far as to suggest that the Asian crisis would be eventually viewed as a milestone in the triumph of market capitalism because it rooted out these "last vestiges of mercantilism in credit allocation."

In Malaysia, cronyism is indeed widespread, if not unusually high, according to international studies. Nonetheless, cronyism provides a less than satisfactory explanation of the crisis. Jomo marshals the usual counterarguments: cronyism was a constant practice during Malaysia's four decades of rapid growth and had never before produced a financial crisis of similar magnitude. Prior to the crisis, Western financial analysts had praised these exact same practices as a source of stability for these economies.

But Jomo does not stop with a critique of the cronyism explanation of the crisis. He acknowledges cronyism eroded the sustainability of Malaysian economic growth and made its economic crisis worse. Also, drawing on Jomo's early work, completed with his fellow economist at the University of Malaya, Edmund Gomez,[3] the authors of *Malaysian Eclipse* argue that cronyism is best understood as nondevelopmental rent-seeking. Cronyism awards government contracts to (or bails out) politically connected friends, but the payment of those rents does little to contribute to the country's productive capacity or economic development. In Malaysia, cronyistic rent seeking is often part and parcel of government-supported, large-scale infrastructure projects and other ventures that are "sometimes unnecessary and often unviable," fueling rampant real estate speculation. Malaysia's government interventions, in Jomo's estimation, were far less successful than the practice of industrial policy in the first-generation NICs of Northeast Asia. In South Korea and Taiwan, government support for corporate investors was more often tied to performance standards and the potential international competitiveness of their investments.

Capital Controls

On September 14, 1998, Malaysia imposed capital controls. The decree issued by the government of Prime Minister Mahathir required portfolio investment funds to remain in the country for a year, although the controls were subsequently revised to an exit tax (with rates that varied depending on the length of stay).

For Jomo, Malaysian capital controls "remind[ed] the world that there are alternatives to capital account liberalization." He might even agree with Martin Kohr, director of Third World Network, a Penang-based nongovernmental organization, that the introduction of capital controls in Malaysia were "the biggest blow so far against the orthodoxy of laissez-faire and total freedom for financial markets."[4] But unlike Kohr, Jomo is not prepared to declare Malaysia's experiment with capital controls a successful example of "what developing countries can do to protect themselves against predatory speculators and against financial volatility."[5]

Jomo warns that the Malaysian experience with capital controls was not the unbridled success proclaimed by the Mahathir administration. While surely not "the unmitigated disaster" predicted by market fundamentalists, the evidence, according to Jomo, suggests that the contribution of capital controls to Malaysia's recovery was "ambiguous." In the wake of the imposition of capital controls, the Malaysian stock market stabilized. Foreign direct investment dropped off, although Jomo says that was due in part to the "hostile official rhetoric" of the Mahathir government. Still the Malaysian economy recovered no more slowly than the neighboring crisis-economy, Thailand, which labored under an IMF-imposed austerity program.

Much of the problem with evaluating Malaysia's capital controls is their timing.

By September 1998, the crisis was already 14 months old, and the bulk of foreign portfolio investment had already left the country. Malaysian capital controls, as Jomo puts it, "closed the stable door long after the horses had bolted." The controls had the perverse effect of restricting the movement of the capital that had remained in the country. In addition, while capital controls allowed the Malaysian authorities to bring down interest rates, those interest rate cuts had only a limited effect on the recovery because interest rates across the region had dropped by then.

Jomo seems convinced that "there is little to gain from maintaining the current regime of [capital] controls," and favors instead a system of closer prudential regulation intended to moderate capital inflows and deter speculative surges. These measures would include limits on foreign borrowing and a managed float of the currency with convertibility. In addition, Jomo insists that these measures need to be accompanied by greater cooperation among monetary authorities in the region. He sees this as the first step toward establishing an East Asian monetary facility dedicated, unlike the IMF, to providing needed liquidity to economies experiencing crisis. While these proposals would surely promote a new, more progressive financial architecture, abandoning Malaysian capital controls, even allowing that their effectiveness remains a matter of controversy, would surely be a mistake. Reinstating capital controls, once abandoned, especially prior to the onset of an economic crisis (when they might act effectively to avoid financial crisis) would face serious political impediments. The most powerful actors in the international economy—from international financial institutions such as the World Bank and the IMF, to the governments of the wealthy nations of the world, to the largest financial and nonfinancial corporations—all vehemently oppose the use of capital controls.[6]

Malaysian Eclipse provides the reader with important insights into how a developing country might best engage with the world economy. Emerging economies must avoid the ill-considered financial liberalization pushed by international organizations in favor of regulating short-term capital flows and limiting bank lending through prudential oversight; push the inflow of international capital away from such nontradables as real estate speculation and portfolio investment toward more long-term foreign investment; and stand ready to provide needed liquidity during economic downturns even as international investors and agencies call for corporate reforms and belt tightening.

Still, at times the reader must work hard to gain the insights offered here. Much of the problem is that as a collection of essays, the volume does not possess a single narrative. Most of the essays are derived from the contributions Jomo and his coauthors made to several well-respected studies of the East Asian crisis. As chapters, these essays are written with varying degrees of accessibility and are sometimes repetitive. Combining some chapters (e.g., the third or fourth chapters on the regulation of the banking sector and financial liberalization) and reducing others to an appendix (e.g., the technical sixth chapter on capital flows volatility) would have gone a long way toward establishing a single narrative of the Malaysian experience.

Malaysian Eclipse also never directly addresses the critics from nongovernmental organizations, such as Martin Kohr, who hold a more positive view of Mahathir's policies, especially capital controls. That is in part a by-product of cobbling together a volume of essays from agency reports focused on official policy and mainstream economic analysis. Jomo's own analysis of the Malaysian crisis and recovery would have been stronger yet had he been forced to differentiate his views from those of more economic nationalist critics of neoliberalism.

Still, whatever its shortcomings, this volume does much to foster the open debate Jomo rightly says Malaysian economic policymaking desperately needs. Beyond that, *Malaysian Eclipse* does yeoman-like service for all those concerned with "the great transformation" under way in the developing world. Its fact finding and analysis puncture the myth of self-regulating markets perpetuated by the advocates of financial liberalization, honestly assess attempts to institute economic nationalism through mechanisms such as capital controls, and point the way toward more promising alternative policies. ●

Notes

1. Karl Polanyi, *The Great Transformation: The Political and Economic Origins of Our Time* (Boston: Beacon Press, 2001).

2. The World Bank, *The East Asian Miracle: Economic Growth and Public Policy* (New York: Oxford University Press, 1993).

3. Edmund Terence Gomez and Jomo K. S., *Malaysia's Political Economy: Politics, Patronage, and Profits* (Cambridge, U.K.: Cambridge University Press, 1997).

4. Martin Kohr, "Currency Trade and Capital Controls Get Limelight" (Penang, Malaysia: Third World Network, 1999), at www.twnside.org.sg/crsis_5.htm.

5. Martin Kohr, "Tide Turning on Financial 'Free Market'" (Penang, Malaysia: Third World Network, 1998), at www.twnside.org.sg/crsis_5.htm.

6. See Arthur MacEwan, *Neo-Liberalism or Democracy? Economic Strategy, Markets, and Alternatives for the 21st Century* (New York: Zed Books, 1999).