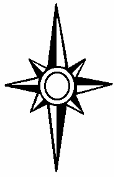

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Malaysia Taking Bitter Pills to Foster Growth

by Noordin Sopiee

On Aug. 6, after months of debate and calculation, the Executive Council of the National Economic Action Council headed by Malaysia's Prime Minister Mahathir Mohamad (which is in charge of the crisis management of the economy) made a tough decision. The five members unanimously decided to adopt the Chinese model of currency convertibility and instructed the country's central bank to make all the necessary arrangements.

On Sept. 1, the day after Malaysia soberly celebrated its 41st anniversary of independence, Malaysia's Bank Negara announced that "once there is discernible normalization of the currency and financial markets, Malaysia will return to the previous arrangement of free capital flows." Until then, there would be tight exchange control.

Economists like MIT's Paul Krugman should be pleased. Malaysia is doing exactly what he advocated in the latest issue of *Fortune* magazine. Krugman had argued that the crisis economies of East Asia had all adopted "Plan A," the traditional International Monetary Fund (IMF) medicine requiring the tightening of belts, the very tightest monetary and fiscal policy, and the tough imposition of ferocious economic austerity.

Krugman's view, indeed the emerging conventional wisdom today, is that the IMF formula simply does not work and cannot work. "Plan A" makes the problems of recovery infinitely worse, not better. Krugman and an increasing, though still small number of economists, believe that it is time to go for "Plan B," a difficult, drastic and heretical departure from economic orthodoxy: exchange control. This is exactly what Malaysia has done.

The verdict from those who have been badly hit has, understandably, been severe. Some have labeled Malaysia economically illiterate. The Malaysians are said to be feeble-minded, ignorant and stupid. Malaysia is said to be crazy, "the odd man out," a "pariah," by financial experts who apparently seem unaware that the vast majority of economies on this planet operate a system of currency control.

Anyone wishing not to insult and vilify, but to understand why Malaysia took its "temporary" but drastic step, need look no further than the headlines in the last week, indeed the main stories over the last six months. What would happen to the country – this small, very vulnerable, very open, very globalized economy – if Hong Kong lost its peg? If China devalued its yuan? If the Japanese yen plummets? If the Russian catastrophe hits Europe even harder? If Latin America collapses? If Southeast Asia goes into further free fall? If Northeast Asia continues its massive downward trajectory? And if Wall Street collapses, and the world's only really healthy economy fell to the floor?

The effects of much lesser shocks have so far been simply devastating. By early August, the dismal picture on the Malaysian economy had become all too clear to the decision-makers. In the first quarter, the economy had contracted by 2.8 percent. In the second quarter, it shrank by a further 6.8 percent. The country was in its first recession in 13 years, only its second recession in almost 50 years, its worst economic crisis since the Communist Emergency of a generation-and-a-half ago. Rightly or wrongly, for many weeks now, the decision-makers in Kuala Lumpur had come to the difficult conclusion that if "drastic" measures were not taken and taken immediately to get growth going again, the Malaysian economy would continue to drop and drop and drop, with no end in sight.

Hit by incredible falls in the value of the ringgit, a massive rise in the cost of borrowing, the withdrawal of bank lending and credit, the disappearance of the East Asian market, the toughest bargaining from the markets in North America and Europe, hurled from wall to wall by the crushing currency tornado, regional contagion, the collapse of confidence and the collapse of investment, and the entire weight of a vicious cycle from which there was no escape, it was believed that all major Malaysian companies would simply go bankrupt; the small- and medium-scale enterprises would simply die.

The decision-makers believed, rightly or wrongly that if "drastic" measures were not taken, the economy would be trapped in a slump lasting years, not months. The prime minister, who is so often accused of "denial," spoke repeatedly of a collapse that could go on for a decade, even of a national calamity from which there would be no recovery. No light at the end of the tunnel. Only more darkness.

Anyone who knows Malaysia knows that if the country had several years of severe economic recession, if it suffered a barren lost decade, it would be devastating not only to the economy but also to the entire fabric of Malaysian society. At stake was more than profit, money, jobs, standard of living and quality of life.

The decision-makers believed, rightly or wrongly, that the austerity measures introduced last year, the so-called "IMF package without the IMF" – a massive cut in government spending, a massive cut in credit expansion from nearly 30 percent to 15 percent by the end of 1998, the tightest monetary and fiscal policy – had clearly and blatantly failed. With the benefit of hindsight, these austerity measures had made the crisis much worse, not better.

Rightly or wrongly, it was felt that in order to avoid national calamity, Malaysia had to push interest rates down, to ensure the necessary liquidity, to ensure that the banks lent

(without which there wasn't a ghost of a chance to reach even the 15 percent end-of-1998 target), to prime the pump, to go for a large fiscal deficit, to prevent the total collapse of domestic demand and to do a hundred other nonmacho, nonausterity, nonbloodletting, things.

The central, inescapable problem was that all the major measures that were necessary to turn the economy around, to ensure growth and to prevent a disastrous and prolonged slump would result in massive pressure on the free-floating Malaysian ringgit. Since June 1997, the ringgit had fallen from 2.5 to the dollar to 4.2 to the dollar. Even with the status quo, without any of the essential growth measures, there was already widespread talk of the ringgit falling to 4.50, 5, 6, 8, even 10 ringgit to the U.S. dollar!

For eight long and intellectually challenging weeks, over more than 26 sessions, the Executive Council debated and discussed the specific pros and cons and the minute and large nuts and bolts of capital control before it took the very calculated decision to insulate the economy from currency turbulence in much the same way that China has been able to do. The deed is now done.

No one is under the illusion that the medicine is anything but unpleasant. Many things will change. Many, many problems will arise, but the country can now stop worrying about currency attack and massive currency turbulence. The ringgit will be stabilized. It can be expected to strengthen substantially (although it will not be allowed to get out of sync, thus forcing Malaysia to lose economic competitiveness). All the steps needed to prevent the economy dropping further, all the measures to turn it around and to get growth going once more can now be implemented.

It was absolutely clear from the very beginning that every effort had to be make to make sure that everyone understood that insulation is not isolation. Malaysia's move is not an ideological statement, not a challenge hurled even at the

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