

AN ASSESSMENT OF MALAYSIA'S RESPONSE TO THE IMF DURING THE ASIAN ECONOMIC CRISIS

ROSS P. BUCKLEY* AND SARALA M. FITZGERALD**

Malaysia was the only country severely affected by the 1997 Asian economic crisis that declined to adopt an IMF program. This article assesses this decision in terms of principle, and of the outcomes of the unorthodox policies Malaysia implemented. It concludes that Malaysia recovered at least as quickly as any country that implemented IMF policies and gained a number of significant advantages by charting its own course out of the crisis. Saying no to the IMF was right for Malaysia.

Malaysia was the only severely affected crisis country not to adopt an IMF program during the Asian crisis that began in 1997.¹ This article seeks to determine whether this was a wise decision.

Our analysis commences with the arguments of principle for and against Malaysia adopting the IMF's suggested economic policies, and then proceeds to consider the results for Malaysia of adopting the course it did.

The reasons for Malaysia's decision may have been emotive as well as economic. Nonetheless, with the benefit of hindsight, our analysis suggests that Malaysia's choice was demonstrably right for it in terms of principle and of pragmatism. Malaysia's policies saw it recover from the crisis at least as fast as countries that implemented IMF policies. The poor in Malaysia are significantly better off today than they would have been under IMF policies and Malaysia has benefited, in a number of other ways, from having charted its own course through the crisis.

I. MATTERS OF PRINCIPLE IN REJECTING IMF INTERVENTION

Was Malaysia's decision to reject an IMF program and chart its own course out of the Asian Crisis correct as a matter of principle?

Four principles are relevant to this issue: (i) the appropriateness of IMF policies for Malaysia, (ii) the enhancement of sovereignty and democracy, (iii) the promotion of self-determination, and (iv) the avoidance of moral hazard.

* Professor, Tim Fischer Centre for Global Trade & Finance, Bond University. E-mail: ross_buckley@bond.edu.au

** Lawyer, Australian Securities and Investments Commission. The views of the author are not necessarily those of the Commission.

¹ The Philippines did not adopt an IMF program in response to the crisis, because it was not severely affected by it. See Arsenio M. Balisacan & Hal Hill, eds., *The Philippine Economy: Development, Policies and Challenge* (Oxford, New York: Oxford University Press, 2003) at 4–5.

A. *The Appropriateness, in Principle, of IMF Policies for Malaysia*

IMF policies usually aim to open economies to the rest of the international financial system. IMF structural adjustment policies for developing economies are explained by Weissman in these terms:

The central goals of structural adjustment are to open up countries to having transnational corporations get access to their workers and natural resources, shrink the size and role of government, rely on market forces to distribute resources and services, and integrate poor countries into the global economy.²

If a country is not willing to accept this agenda in principle, it may be wise to avoid engagement with the IMF.

As the Asian crisis demonstrated, countries may suffer if they open their economies too early or too far.³ One of the major policy lessons of the crisis has been that adequate domestic prudential regulation must *precede* financial liberalization.⁴ This bias towards open economies often prevents the IMF from acting in the interests of recipient countries in instances where that country would be best advised not to open its economy further in the short-term. Soros notes that in the early 1990s the IMF put too much pressure on Asian countries to open domestic financial markets before they were properly regulated, and that this contributed to the crisis.⁵ He also notes, irrefutably, that ‘those countries that kept their financial markets closed weathered the Asian Crisis better than those that were open’, giving the example of China.⁶

There are really two issues here. The first is the pace of liberalization of a nation's financial markets—it appears almost irrefutable that the IMF has consistently pushed nations to open their financial systems before appropriate regulation was in place so that the nation could reap the benefits of such liberalization without being unduly destabilized by its consequences. It is almost as if IMF officers, in formulating their advice, too often over-estimate the extent and efficacy of the regulatory institutions in developing nations, and the strength of the rule of law climate in which they operate.

The second issue concerns when the isolation of a nation's financial system from the world might be an appropriate, albeit interim, response to a crisis. This issue we discuss later.⁷

² Robert Weissman, “Twenty Questions on the IMF”, in Kevin Danaher, ed., *Democratizing the Global Economy* (Monroe, ME: Common Courage Press, 2001) at 84.

³ George Soros, *Open Society: Reforming Global Capitalism*, (New York: Public Affairs, 2000) at 299.

⁴ Ross Buckley, “Six Lessons for Banking Regulators from the Asian Economic Crisis” in Weerasooria, ed., *Perspectives on Banking, Finance & Credit Law* (Sydney: Prospect Media, 1999) 51; Zaidansyah, “Banking and Finance Regulatory Reform, Post Asian Financial Crisis: The Case of Indonesia” in Douglas Arner & Jan-Juy Lin, ed., *Financial Regulation: A Guide to Structural Reform* (Hong Kong: Sweet and Maxwell, 2003) at 321–322.

⁵ George Soros, *supra* note 3 at 217. Also see Ishak Shari, “The 1997–1998 Financial Crisis in Malaysia and its Social Impact: Some Lessons” in Chris Nyland, Wendy Smith, Russell Smyth & Marika Viczany, ed., *Malaysian Business in the New Era* (Cheltenham, U.K.: Edward Elgar, 2001) 203 at 205; Ross Buckley, “An Oft-Ignored Perspective on the Asian Economic Crisis: The Role of Creditors and Investors” (2000) 15 B.F.L.R. 431 and Ross Buckley, *supra* note 4 at 51.

⁶ George Soros, *supra* note 3 at 298.

⁷ See text following note 37.

One reason Malaysia rejected IMF assistance was that it did not agree with IMF policies.⁸ On 19 June 1998 Prime Minister Mahathir (as he then was) said:

... if we have to resort to the International Monetary Fund assistance ... the conditions imposed by the IMF will require us to open up our economy to foreigners. There will not be any *Bumiputra* quota as the New Economic Policy (NEP) is an injustice, and unacceptable to their liberal democracy.⁹

Whilst Malaysia has always had a fairly open and market-friendly economy, this has been balanced by significant state involvement in the economy.¹⁰ Shari notes how 'state intervention has made a significant contribution to Malaysia's progress in attaining rapid economic growth and reducing poverty and income disparities'.¹¹ The useful role government intervention has played in the Malaysian economy would have been dramatically curtailed under IMF policies.

B. *The Enhancement of Local Sovereignty and Democracy*

The IMF attaches a very large number and range of conditions to its assistance. A growing chorus of critics argue that these conditions are excessive and unnecessarily curtail a country's sovereign right to determine its domestic policies.¹²

The IMF's actions profoundly affect the lives of those in the countries in which it intervenes. In imposing its policies on recipient countries it undermines the democratic process through which political representatives are elected by a country's citizens to determine the country's economic and other policies. Given the impact the IMF's policies have on recipient countries' citizens, it is reasonable for those citizens to have input into whether IMF policies are adopted.

C. *The Enhancement of Self-Determination*

In addition to protecting its sovereignty, rejecting IMF assistance allowed Malaysia to develop and demonstrate its capacity for independence and leadership. It has been noted that the Malaysian community "... has developed a new level of confidence in its ability to adopt and sustain innovative policies even when these strategies challenge the international financial community".¹³ Such national confidence serves a developing nation. Indeed, such national confidence is an important facilitating element in the exercise of sovereignty.

Developing nations can enhance their capacity for self-determination while accepting IMF assistance. However, this balancing act is not easy because IMF assistance is detailed, prescriptive and coercive. The IMF is no hands-off economic

⁸ Prema-Chandra Athukorala, *Crisis and Recovery in Malaysia: The Role of Capital Controls* (Cheltenham, UK: Edward Elgar, 2001) at 81.

⁹ Cited in Prema-Chandra Athukorala, *ibid.* at 74.

¹⁰ Ishak Shari, *supra* note 5 at 204.

¹¹ *Ibid.*

¹² Kevin Danaher, "Introduction" in Kevin Danaher, ed., *50 Years is Enough: The Case Against the World Bank and the International Monetary Fund* (Boston, Mass.: South End Press, 1994) at 4.

¹³ Chris Nyland, Wendy Smith, Russell Smyth and Marika Viczany, "Economic and Social Adjustment in Malaysia in the 'New' Business Era" in Chris Nyland, Wendy Smith, Russell Smyth and Marika Viczany, ed., *Malaysian Business in the New Era*, (Cheltenham, U.K.: Edward Elgar, 2003) at 1.

manager. Its officers sit cheek by jowl with domestic government policy makers and technocrats and, quite literally, call the shots—as was seen in the extraordinary extent and detail of the conditions imposed by the letters of intent in the cases of Indonesia, Korea and Thailand.¹⁴ Accordingly, IMF assistance usually translates into a degree of dependence that does not serve to enhance the capacity for self-determination.

For this and other reasons, developing nations like to retain control of their own economies. This is particularly so because of growing concerns that globalisation is serving to entrench a new form of colonialism. The Director of the Third World Network in Malaysia notes that “[e]conomically speaking, we are more dependent on the ex-colonial countries than we ever were. The World Bank and the IMF are playing the role that our ex-colonial masters used to play”.¹⁵

Whilst some of Malaysia's policies may have created uncertainty for a time, they also showed that Malaysia had the strength of leadership required to take the measures necessary to reform its economy and the administrative expertise to implement those measures. The perception of strength in government is important—a strong policymaker can do things a weak one cannot.¹⁶ Moodys viewed the Malaysian government's handling of the crisis as “exemplary in its firmness and competence and this itself reflected the underlying strengths of the Malaysian economy and its economic managers”.¹⁷

D. *The Avoidance of Moral Hazard*

A central tenet of IMF policies is that markets allocate resources best. However, the IMF is not consistent as it often does not allow markets to allocate losses in bad times. This engenders moral hazard. Moral hazard arises whenever a financial actor does not bear, or anticipate bearing, the full risk attached to its actions.¹⁸

Indonesia, Korea and Thailand were required to use the bail-out loans arranged by the IMF to repay the credits that were then due, i.e. the debts owed to short-term creditors. Systemically this was foolish because it encouraged the extension of short-term debt, the very type of debt that renders an economy more vulnerable to volatility. It also shielded the short-term creditors from the losses that would otherwise have ensued, and for which the high interest rates paid on short-term debts were compensation.¹⁹

This meant that in the following year, 1998, short-term creditors pumped massive amounts of credit into Russia to claim returns as high as 50% or 60% per annum on G.K.O.s (short-term Russian government bonds) while relying for the repayment of

¹⁴ See text accompanying note 133.

¹⁵ Khor cited in Kevin Danaher, *supra* note 12 at 4.

¹⁶ Gregor Irwin & David Vines, “International Policy Advice in the East Asian Crisis. A Critical Review of the Debate” in Dipak Dasgupta, Marc Uzan & Dominic Wilson, ed., *Capital Flows Without Crisis? Reconciling Capital Mobility and Economic Stability* (London: Routledge, 2001) 58–72.

¹⁷ Chris Nyland, Wendy Smith, Russell Smyth and Marika Viczany, *supra* note 13 at 2.

¹⁸ For a consideration of the moral hazard engendered by the IMF-organised bail-outs of Indonesia, Korea and Thailand in 1997 and the ways in which it contributed to Russia's economic meltdown in 1998, see Ross Buckley, *supra* note 5 at 431.

¹⁹ Jeffrey Sachs, *IMF is a Power Unto Itself*, 4 July 2003, online: Nouriel Roubini's Global Macroeconomic and Financial Policy Site <<http://www.stern.nyu.edu/globalmacro/AsiaCrisisSachsViewFT1297.html>>.

principal on an IMF arranged bail-out. In the words of Desmond Lachman,

Anybody who questions that Russia's fundamentals were worthy of investment ... wasn't operating in the markets at the time. ... Most [investors] who did take positions on Russia were doing this on the argument that Russia was too big to fail and that the G-7 nations would ... bail them out.²⁰

The proper operation of the market would have led to an earlier and more gradual withdrawal from investing in Russia but it was profoundly affected by the moral hazard of an anticipated bail-out.²¹ Russia's geo-political significance, in particular, meant investors were very confident that it would not be allowed to default on its financial obligations.²²

Such were the consequences of the IMF short-circuiting the market mechanism with its bail-outs of the Asian crisis countries. Malaysia's policies avoided this problem.

II. MALAYSIA'S POLICIES: DRIVEN BY POLITICS OR PRINCIPLE?

Malaysia's actions may have been motivated less by principle and more by political expediency and egocentricity on the part of Dr Mahathir Mohammed, its then Prime Minister. Certainly, Prime Minister Mahathir at times led the country in unprincipled ways.²³ The imprisonment of former Finance Minister Anwar Ibrahim undermined Malaysia's credibility as a country governed by principles.²⁴ Less serious, but no less bizarre, were Dr Mahathir's claims that Malaysia's problems were the result of the hostile manipulation of Jewish speculators.²⁵ Shari notes how Mahathir's contradictory statements "adversely affected investors' confidence and contributed to a further fall of the ringgit and the share prices at the KLSE".²⁶

Lawrence Spiedell argues against politicised approaches to economics, claiming that what is best for a country's people in the long run is a healthy economy, no matter how that is achieved.²⁷ Whilst a healthy economy is good for a country, the means by which it is achieved may exact a high social cost. In Malaysia's case, carefully constructed affirmative action policies to increase the participation of the *Bumiputra* population in business and finance may have been destroyed by adopting IMF policies. Equally the IMF often seemingly ignores the distributive impact of

²⁰ IMF Economic Forum, "Financial Markets: Coping with Turbulence", a forum at the IMF, Washington DC, December 1, 1998; online: International Monetary Fund Site <<http://www.imf.org/external/np/tr/1998/TR981201.HTM>>.

²¹ Timothy O'Brien, "When Economic Bombs Drop, Risk Models Fail" *The New York Times* (4 October 1998); "Splendid isolation no longer" (1998) 1246 I.F.R. 1.

²² "Many [investors] refused to believe the United States and the International Monetary Fund would allow Russia to collapse until it actually happened.": Jonathon Fuerbringer, "After Russian Lesson, Bond Prices Remain Stable in Latest Crisis" *The New York Times* (14 January 1999).

²³ Prema-Chandra Athukorala, *supra* note 8 at 63.

²⁴ International Monetary Fund, *Malaysia: From Crisis to Recovery* (Washington, D.C.: International Monetary Fund, 2001) at 13.

²⁵ Paul Krugman, *Capital Control Freaks: How Malaysia Got Away with Economic Heresy*, 4 July 2003, online: Slate <<http://slate.msn.com/id/35534>>.

²⁶ Ishak Shari, *supra* note 5 at 205.

²⁷ Cited in Hal S Scott & Philip A Wellons, *International Finance: Transactions, Policy, and Regulation*, 9th ed. (New York: Foundation Press, 2002) at 1278.

their policies. So that even if IMF policies would have delivered a more prosperous economy to Malaysia today (and as we shall see that is far from certain), it is highly likely that its policies would have delivered an even more unequal distribution of that wealth than is already the case in Malaysia.²⁸

Finally, in response to the argument that IMF intervention should be rejected to preserve a country's sovereign independence, it may be said that isolationist ideas of sovereignty no longer reflect the reality of international relations in a globalised world. Whilst policy independence may once have been integral to ideas of nationhood, it may no longer be. With the increase in the size and scope of the international bureaucracy, states are continually receiving policy advice from external parties. On the other hand, this advice is not usually mandatory. With the IMF, if a loan is accepted, its advice must also be accepted, and that advice is given by IMF officers sitting in the offices of the Ministry of Finance and the Treasury of the recipient country. This makes IMF involvement particularly invasive.

The truth, perhaps, is that from Dr Mahathir's perspective, populist political considerations pointed in the same direction as the considerations of principle canvassed above, and these factors worked together to shape the policies Malaysia pursued.

III. THE PRACTICAL RESULTS OF MALAYSIA'S POLICIES

The next question is whether Malaysia's decision not to request IMF assistance was correct in practice. We begin by considering Malaysia's policies in response to the crisis and how they affected Malaysia economically and socially. We then explore the arguments for and against Malaysia's policy approach during the crisis.

Malaysia's initial response to the crisis was referred to by many as an IMF package without the IMF.²⁹ At the time, in consultation with the IMF,³⁰ Finance Minister Anwar Ibrahim tightened fiscal policy and made sharp spending cuts.³¹ This policy was subsequently altered on an ad hoc basis, until Prime Minister Mahathir announced a complete change of policy with the introduction of the National Economic Recovery Program in July 1998.³² This decisive departure from IMF orthodoxy involved an increase in government spending to stimulate the economy, capital controls to allow the government more control over Malaysia's economy and to prevent the outflow of foreign capital that would have ensued, and a restructuring package for the financial sector.

After this policy turnaround Malaysia initially implemented a stabilisation process and then undertook the restructure of its financial system.³³ The stabilization process involved the establishment of Danaharta to purchase non-performing loans

²⁸ Ross Buckley, 'The Fatal Flaw in International Finance: The Rich Borrow and the Poor Repay', XIX No. 4 *World Policy Journal*, Winter 2002/3, 59.

²⁹ Seth Mydans, *Malaysia is ready to Inflict its own Economic Medicine*, 4 July 2003, online: New York Times <<http://www.nytimes.com/library/financial/121697malaysia-econ.html>>.

³⁰ *Ibid.* at 3.

³¹ International Monetary Fund, *supra* note 24 at 10.

³² Prema-Chandra Athukorala, *supra* note 8 at 66.

³³ Mahani Zainal Abidin, "Malaysia's Economy: Crisis and Recovery" in Mahani Zainal Abidin & Zakaria Haji Ahmad, eds., *The Financial Crisis in Malaysia: The Economic and Political Consequences* (Singapore: Institute of Southeast Asian Studies, 1999) 1 at 2.

(N.P.L.s), and of Danamodal to recapitalise financial institutions. The restructure phase involved the merger of financial institutions and the development of the local bond market.³⁴

Malaysia reduced the amount of N.P.L.s being carried by financial institutions, recapitalised these institutions and strengthened the system by closing and merging banks.³⁵ Like other crisis countries it also implemented 'a blanket deposit guarantee and liquidity support'.³⁶

Malaysia's two unique responses to the crisis were the introduction of capital controls and the pegging of the ringgit to the U.S. dollar.³⁷ Once these policies were introduced, the government was able to ease monetary policy, because it was no longer hampered by concerns about the impact on the exchange rate of capital outflows.³⁸

The capital controls blocked all avenues for the transfer of the ringgit outside Malaysia and stopped non-residents removing portfolio capital from Malaysia for a period of 12 months.³⁹ After 6 months had passed, the 12-month restriction was replaced with a variable exit levy applying to principal or profit from investments in Malaysian securities.⁴⁰

The ringgit was pegged to the U.S. dollar, at a rate of RM3.8 to US\$1, in an attempt to prevent speculation in the ringgit.⁴¹

It is widely acknowledged, even by the IMF with hindsight,⁴² that the introduction of the exchange controls and the currency peg was sound policy.⁴³ In the IMF's review of Malaysia's policies between 1997 and 2000 the changing public sentiment towards these policies is noted:

Market assessment turned more positive, however, as it became clear that Malaysia's macroeconomic policies were not out of line, that the undervalued pegged exchange rate was contributing to the rapid recovery of exports and output, and that financial sector reforms were being vigorously pursued.⁴⁴

Malaysia's response to the crisis also involved significant financial sector reform, which the IMF notes "led to substantial improvement in the sector's performance".⁴⁵ This approach has subsequently met with IMF approval:

The multiprong strategy involving Danaharta and Danamodal to acquire NPLs and recapitalize banks, as well as the Corporate Debt Restructuring Committee (CDRC)

³⁴ *Ibid.*

³⁵ *Ibid.* at 74.

³⁶ International Monetary Fund, *supra* note 24 at 74.

³⁷ *Ibid.* at 7.

³⁸ International Monetary Fund, *Malaysia: Recent Economic Developments* (Washington, D.C.: International Monetary Fund, 1999) at 16.

³⁹ *Ibid.* at 23; and Ross Buckley, "The Role of Capital Controls in International Financial Crises", 11 *Bond L. Rev.* 231.

⁴⁰ *Ibid.* at 23.

⁴¹ *Ibid.*

⁴² Ariyoshi, Habermeier, *et al.*, "Country Experiences with the Use and Liberalization of Capital Controls" IMF Paper, January 2000, online: International Monetary Fund Site <<http://www.imf.org/external/pubs/ft/capcon/index.htm>> 29 February 2003.

⁴³ Ramon V. Navaratnam, *Malaysia's Economic Sustainability: Confronting New Challenges Amidst Global Realities*, 2002.

⁴⁴ International Monetary Fund, *supra* note 24 at 3.

⁴⁵ *Ibid.* at 71.

to facilitate debt workout by large borrowers, represents a credible plan to restructure Malaysia's financial sector.⁴⁶

Malaysia managed its economy fairly successfully without the IMF. Its expansionary fiscal policy prevented the economy from going into further recession. This policy stimulated the economy, which improved confidence. The expansionary fiscal policy and the improved confidence then combined to improve domestic demand.⁴⁷

The expansionary approach is not novel—Buirra goes so far as to say that “[a]ll theories would advise an expansionary fiscal stance at a time of recession”.⁴⁸ However, Malaysia was the first crisis country to implement expansionary fiscal policies. To be able to adopt these expansionary policies, Malaysia had to impose capital controls for otherwise the expansionary policies would have provoked an exodus of foreign capital that would have more than counteracted any stimulative effect the expansionary policies could have delivered.⁴⁹ While the impact of these capital controls is still contested by some, Navaratnam notes there has been widespread acknowledgment of the efficacy of Malaysia's controls.⁵⁰

Capital controls were first suggested as a possibility in this context by Krugman.⁵¹ He stressed that such controls (i) should only be temporary because of the way they distort the economy,⁵² (ii) should never be used to defend an over-valued currency and (iii) could provide a government with breathing space in order to undertake reforms during a crisis and must “serve as an aid to reform, not an alternative”.⁵³ Malaysia's use of controls met all of these principles. After three years the controls were all but gone.⁵⁴ Malaysia exercised monetary discipline and did not use the controls to inflate the currency or the economy or bail out companies.⁵⁵ It used the breathing space afforded by the controls provided to implement financial and corporate reforms.⁵⁶ The IMF notes that the “successful experience of the 1998 controls so far is largely

⁴⁶ International Monetary Fund, *Malaysia: Selected Issues* (Washington, D.C.: International Monetary Fund, 1999) at 62.

⁴⁷ Mohamed Ariff and Azidin Wan Abdul Kadir, *The Near-Term Outlook for the Malaysian Economy* (Singapore: Institute of Southeast Asian Studies, 2000) at 2.

⁴⁸ Ariel Buirra, *An Alternative Approach to Financial Crises* (Princeton, N.J.: International Finance Section, Dept. of Economics, Princeton University, 1999) at 5.

⁴⁹ Mahani Zainal Abidin, *supra* note 33 at 5. International Monetary Fund, *supra* note 24 at 13. Another way of saying the same thing is that controls “allow domestic policy makers to break the links between interest rates and exchange rates, so that interest rates can be lowered without incurring the costs of a currency devaluation”: Giancarlo Corsetti, Paolo Pesenti and Nouriel Roubini, *What Caused the Asian Currency and Financial Crisis? Part II: The Policy Debate* (Cambridge, M.A.: National Bureau of Economic Research, 1998) 24. See also Barry Eichengreen, *Toward a New Financial Architecture: A Practical Post-Asia Agenda* (Washington, D.C.: Institute for International Economics, 1999) at 56.

⁵⁰ Ramon V. Navaratnam, *Malaysia's Economic Sustainability: Confronting New Challenges Amidst Global Realities* (Malaysia: Pelanduk Publications, 2002) at 35.

⁵¹ Paul Krugman, “Saving Asia: Its Time to Get Radical” *Fortune Investor* (7 September 1998).

⁵² Paul Krugman, *An Open Letter to Prime Minister Mahathir*, 4 July 2003, online: Massachusetts Institute of Technology Site <<http://web.mit.edu/krugman/www/mahathir.html>>.

⁵³ *Ibid.*

⁵⁴ K.S. Nathan, *Economic Slowdown and Domestic Politics: Malaysia Boleh?* (Singapore: Institute of Southeast Asian Studies, 2001) at 4.

⁵⁵ Mahani Zainal Abidin, *supra* note 33 at 6.

⁵⁶ International Monetary Fund, *supra* note 24 at 54.

due to the appropriate macroeconomic policy mix that prevailed at that time”⁵⁷ and that the controls were effective because they “were wide ranging, effectively implemented, and generally supported by the business community”.⁵⁸

Whilst capital controls of the type implemented in Malaysia can be circumvented in various ways (notably through the settlement of commercial transactions, dividend payments, intra-firm transfers and mis-invoicing) there was limited circumvention in Malaysia because of the design and enforcement of the controls in that country.⁵⁹ The controls were designed to affect all channels for the movement of the ringgit offshore, whilst allowing current account transactions and foreign direct investment.⁶⁰ This selectivity minimised circumvention of the controls by leaving open certain options for investment in Malaysia through channels the Government did not consider problematic from the perspective of capital flows.

This is not to deny that there were some problems with the way in which Malaysia implemented its controls. Even Krugman, who had advocated the use of capital controls, argued that Malaysia had left them in place for longer than was necessary and that the Government appeared to be slackening the pace of financial reform under the cover of the protection afforded by the controls, rather than accelerating it.⁶¹ Krugman also had concerns that the lack of free speech in Malaysia would undermine the success of the controls, noting that “because currency controls are inherently subject to abuse, they have to be administered with the maximum possible fairness and objectivity”.⁶²

A. Pegging the Currency

The other decisive and unorthodox crisis policy of pegging the ringgit to the US dollar gave the government more control over its economic policy and prevented speculation in the ringgit.⁶³ The danger of a pegged exchange rate is that it may be, or become over time, overvalued. Malaysia avoided this danger.⁶⁴ In fact, the ringgit was undervalued, which boosted exports.⁶⁵ This undervaluing also served as “an incentive for retaining funds in the country”.⁶⁶ The peg reportedly “reduced uncertainty and made it easier for business to plan”.⁶⁷ As Navaratnam notes, there has been widespread acknowledgment of the efficacy of Malaysia’s currency peg.⁶⁸

⁵⁷ *Ibid.* at 63.

⁵⁸ International Monetary Fund, *supra* note 46 at 18.

⁵⁹ International Monetary Fund, *supra* note 24 at 54.

⁶⁰ *Ibid.*

⁶¹ Paul Krugman, *Malaysia’s Opportunity?*, 18 April 2004, online: The Unofficial Paul Krugman Archive <<http://www.pkarchive.org>>.

⁶² *Ibid.*

⁶³ International Monetary Fund, *supra* note 24 at 50.

⁶⁴ *Ibid.* at 13.

⁶⁵ *Ibid.*

⁶⁶ *Ibid.*

⁶⁷ International Monetary Fund, *supra* note 46 at 10.

⁶⁸ Ramon V Navaratnam, *Malaysia’s Economic Sustainability: Confronting New Challenges Amidst Global Realities* (Malaysia: Pelanduk Publications, 2002) at 35.

B. *The Social Effects of Malaysia's Policies*

Malaysia's policies had a far more benevolent impact on Malaysian society than did the IMF's policies in other crisis countries.⁶⁹ Pre-crisis economic policy in Malaysia involved extensive affirmative action to improve the position of the native Malays (*Bumiputras*).⁷⁰ The Malaysian government was experienced in using economic policy to support social policy, and did not forget this interrelationship during the crisis. As a result, the Malaysian government's policies did not affect the poor as harshly as IMF policies did in other crisis countries. In the words of one commentator, "the costs were not borne primarily by the poor and dispossessed, as occurred in some neighbouring states with great consequent social costs".⁷¹ And, as Athukorala noted, "the new policy measures enabled Malaysia to achieve recovery while minimizing social costs and economic disruptions associated with a more market-oriented path to reform".⁷²

C. *Comparative Economic Performance of Malaysia*

To compare Malaysia's rate of recovery with other crisis countries we can use the comparative gross domestic product (G.D.P.) growth rate as a rough indicator. The following table outlines G.D.P. changes for the main crisis countries before the crisis in 1995, and then as Asia was recovering from the crisis in 1999.

Year	Malaysia	Indonesia	Korea	Thailand
1995	9.8	8.2	8.9	8.9
1996	10.0	8.0	6.8	5.9
1997	7.5	4.5	5.0	-1.8
1998	-7.5	-13.2	-6.7	-10.4
1999	5.4	0.2	10.7	4.2

Source: CEIC Data Company Limited

This table shows Malaysia as second only to the Republic of Korea in its rate of recovery in 1999. It also shows that Malaysia's negative rate of growth in 1998 was significantly less than Indonesia's and Thailand's, and not much more than Korea's. Notably, Malaysia had the highest growth rates to begin with. The most comparable crisis country to Malaysia, considering its level of development and the maturity of its system, is Thailand.⁷³ The above table shows Malaysia recovered slightly quicker than Thailand.

⁶⁹ Chris Nyland, *supra* note 13 at 2.

⁷⁰ Dr Mahathir bin Mohamad, *The Way Forward* (London: Weidenfeld & Nicolson, 1998) at 85.

⁷¹ Chris Nyland, Wendy Smith, Russell Smyth and Marika Viczany, *supra* note 13 at 2.

⁷² Prema-Chandra Athukorala *supra* note 8 at 113.

⁷³ Prema-Chandra Athukorala, *supra* note 8 at 95.

Others agree with this assessment.⁷⁴ Merrill Lynch described Malaysia's recovery as "one of the most impressive ever".⁷⁵ Kaplan and Rodrik wrote that "compared to IMF programs, we find that the Malaysian policies provided faster economic recovery ... smaller declines in employment and real wages, and more rapid turn around in the stock market".⁷⁶ And in late 1999 the Economic Strategic Institute noted that "despite the bad press it gets as a result of Prime Minister Mahathir's critical comments about speculators, Malaysia is the best story in the region".⁷⁷

IV. REASONS FOR THE SUCCESS OF MALAYSIA'S POLICIES

There are a number of possible reasons for the success of Malaysia's policy response to the crisis. These include:

- Malaysia's experience as an economic policy maker.
- The appropriateness of capital controls as a response to a crisis of confidence.
- Malaysia's understanding of its own economy.

Each will be considered.

A. Malaysia's Experience as an Economic Manager

Given the high level of government involvement in its economy since independence, Malaysia is an experienced economic policy maker.⁷⁸ Malaysia had experience in imposing temporary capital controls in 1994 in response to speculative short-term capital inflows.⁷⁹ Salleh and Meyanthen note that in the three decades from 1960 "Malaysia achieved growth, equity and structural transformation in an ethnically diverse society".⁸⁰ It did so by focussing on social enrichment as the goal of economic growth, rather than on economic performance as an end in itself.⁸¹

B. Controls as a Response to a Financial Panic

One indisputable cause of the Asian crisis was a self-fulfilling panic by investors.⁸² In Alan Greenspan's words, the reaction of the markets to the problems in Asia was

⁷⁴ Mahani Zainal Abidin, *supra* note 33 at 1.

⁷⁵ Cited in Marika Viczany, Tan Sri, Ramon Navaratnam, Koi Nyen Wong & Tim Thornton, "Australia's Business Attitudes to Malaysia" in Chris Nyland, Wendy Smith, Russell Smyth & Marika Viczany, ed., *Malaysian Business in the New Era (Cheltenham: Edward Elgar, 2003)* 29.

⁷⁶ Ethan Kaplan and Dani Rodrik, *Did the Malaysian Capital Controls Work?*, 2 July 2003, online: National Bureau of Economic Research Site <<http://papers.nber.org/papers/W8142>>.

⁷⁷ Prema-Chandra Athukorala, *supra* note 8 at 93.

⁷⁸ Ismail Muhd Salleh & Saha Dhevan Meyanthen, *Malaysia: Growth, Equity and Structural Transformation* (Washington, D.C.: World Bank, 1993) at 1.

⁷⁹ Prema-Chandra Athukorala, "Capital Mobility, Crisis and Adjustment: Evidence and Insights from Malaysia" in Dipak Dasgupta, Marc Uzan & Dominic Wilson, ed., *Capital Flows Without Crisis? Reconciling Capital Mobility and Economic Stability* (London: Routledge, 2001) at 257.

⁸⁰ Ismail Muhd Salleh and Saha Dhevan Meyanthen, *Malaysia: Growth, Equity and Structural Transformation* (Washington, D.C.: World Bank, 1993) at ix.

⁸¹ *Ibid.* at 48.

⁸² Ross Buckley, *supra* note 5 at 431-454.

based on a “visceral engulfing fear”.⁸³ Jeffrey Sachs goes so far as to say that there was no reason for the financial panic except panic itself.⁸⁴ This panic took the form of “a self-fulfilling withdrawal of short-term loans”.⁸⁵ In the face of rapid capital outflows, unconventional tactics may be the only thing that can protect an economy.⁸⁶ Bhagwati expresses this sentiment memorably: “Markets may do something when you have done nothing wrong and you may have to do something wrong in order to convince the markets that you are doing something right”.⁸⁷

C. *Appropriateness of Home Grown Economic Policies*

Economic recovery is best achieved with policies that suit the condition of the economy in question.⁸⁸ One explanation for the success of Malaysia's policies is that it understood its own economy well, and was able to design a particularly appropriate set of policies for it. Similarly, because Malaysia implemented its own reform program, rather than having it imposed from the outside, the program seems to have been implemented more rigorously than were the reforms in IMF program countries. This claim is supported by the IMF: “Malaysia has moved ahead of other crisis countries in respect to formulation of prudential regulation, resolution of nonperforming loans, restoration of capital adequacy, and implementation of a bank consolidation program ...”.⁸⁹

V. CRITICISMS OF MALAYSIA'S POLICIES

Malaysia's policies in response to the crisis have been criticised on three grounds:

1. Malaysia's initial policy response was similar to that of the IMF.
2. Malaysia's subsequent policies did not bring about recovery much faster than in other crisis countries, yet Malaysia's economy was healthier than many others at the inception of the crisis.
3. The effectiveness of capital controls has been questioned, with some arguing that they made the situation worse and will have long-term negative side effects.

A. *Inappropriateness of Malaysia's Initial Policy Response*

As mentioned above, Malaysia's first response to the crisis was fiscal tightening along IMF lines. This was ineffective.⁹⁰ The IMF now acknowledges that these policies

⁸³ Cited in Paul Kelly, ‘IMF tightens the screws on Suharto’ *The Australian* (11 March 1998) 13.

⁸⁴ Cited in Jean Tirole, *Financial Crises, Liquidity, and the International Monetary System* (Princeton, N.J.: Princeton University Press, 2002) at 44.

⁸⁵ Sachs cited in *ibid.* at 44.

⁸⁶ Barry Eichengreen, *supra* note 49 at 56.

⁸⁷ Cited in Ariel Buira, *An Alternative Approach to Financial Crises* (Princeton, N.J.: International Finance Section, Dept. of Economics, Princeton University, 1999) at 10.

⁸⁸ Mahani Zainal Abidin, *supra* note 33 at 6.

⁸⁹ International Monetary Fund, *supra* note 24 at 15.

⁹⁰ Prema-Chandra Athukorala, *supra* note 80 at 263.

'proved to be insufficient to correct external imbalances and bring about needed economic adjustment'.⁹¹ The Malaysian government then took, on one view, a long time to put in place its counter-cyclical measures and introduce capital controls. However, Malaysia recognized the failure of these policies, and acted to change them, well before the IMF did in other crisis countries. It is unfair to hold Malaysia to a much higher standard than the IMF. It is also unfair to criticise Malaysia for initially responding with orthodox policies to the crisis, and only changing course once those policies had proven to be ineffectual. Indeed, such an approach would seem sensible and prudent: respond initially with those policies of which international capital will approve, and thus are most easily implemented, and only resort to less orthodox policies, the implementation of which will require the imposition of capital controls, when the orthodox approach is manifestly not working.

B. *With a Stronger Economy, Malaysia Recovered no Faster*

Given that Malaysia's economy was healthier than others at the beginning of the crisis, another criticism is that Malaysia should have recovered substantially more quickly than other crisis countries and it did not. The IMF notes that Malaysia's financial system was fairly strong before the crisis, which slowed down the impact of the crisis in Malaysia, giving it time to react and assess.⁹² More broadly, the IMF has stated that "Malaysia entered the 1997 economic crisis with generally stronger fundamentals than the other Asian crisis economies".⁹³

In broad terms, all the Asian crisis countries began to recover at much the same time.⁹⁴ In particular Korea and Thailand recovered in parallel with Malaysia.⁹⁵ The IMF discusses how the economic performance throughout the crisis countries was similar and notes that this makes it hard to determine the impact of Malaysia's policies.⁹⁶ The IMF claims Malaysia's policies seem to have made little difference because "countries that did not introduce these measures have been just as able to carry out accommodating monetary policy and maintain stable exchange rates".⁹⁷

However, on this point we agree with Athukorala when he argues that the judgement of Malaysia's success should be based on whether Malaysia recovered as fast as the IMF program countries, not whether it recovered faster.⁹⁸ This is particularly so because there are reasons other than rate of recovery that support Malaysia's decision to refuse IMF assistance, i.e. Malaysia recovered at least as quickly as other nations and avoided many of the negative consequences of IMF assistance, as is discussed below.

⁹¹ International Monetary Fund, *supra* note 24 at 1.

⁹² International Monetary Fund, *supra* note 46 at 71. International Monetary Fund, *supra* note 24 at 9.

⁹³ International Monetary Fund, *supra* note 46 at 6.

⁹⁴ Prema-Chandra Athukorala, *supra* note 8 at 95. International Monetary Fund, *supra* note 24 at 13.

⁹⁵ Ethan Kaplan and Dani Rodrik, *supra* note 77.

⁹⁶ International Monetary Fund, *supra* note 46 at 9.

⁹⁷ International Monetary Fund, *supra* note 24 at 8.

⁹⁸ Prema-Chandra Athukorala, *supra* note 8 at 97.

C. The Inappropriateness of Capital Controls

Further criticisms of Malaysia's policies relate either to the use of capital controls generally, or Malaysia's introduction of them specifically. Corsetti *et al.* note that imposing capital controls does not make "the financial system sound, well regulated and effectively supervised", which should be the aim of crisis policy.⁹⁹ In Malaysia, however, the controls were not used as an end in themselves. Substantive reforms were introduced under cover of those controls.

The IMF dislikes capital controls because "they distort international capital flows and are ultimately unenforceable".¹⁰⁰ We, however, do not believe that capital flows have their own perfect internal logic that should not be altered, as the IMF seems to believe. The market is manifestly not perfect.

Eichengreen criticises capital controls on the basis that they can involve the creation of burdensome bureaucracies.¹⁰¹ Even Krugman notes that capital controls should be short term and not used to avoid necessary reforms.¹⁰² It has also been noted that these controls can have an adverse impact on investor confidence.¹⁰³

Malaysia's use of its controls was so skilful that it avoided most of these problems. It is true, as the IMF has noted, that Malaysia's introduction of capital controls had some adverse effects almost immediately: '[r]ating agencies downgraded Malaysia, sovereign bond spreads increased relative to those of Korea and Thailand, and Malaysia was removed from major investment indices'.¹⁰⁴ However these adverse impacts arise from the market's dislike of capital controls, rather than intrinsically from the controls themselves.

It is also true that by the time Malaysia introduced capital controls in September 1998 a lot of the capital that investors wanted to get out of the country had already been removed.¹⁰⁵ This cushioned any effect, good or bad, that the controls otherwise would have had.¹⁰⁶

Another concern is that capital controls are bad for a country's welfare because they stand in the way of its financial integration with the rest of the world.¹⁰⁷ This integration is considered important because it allows a country to access international funding and diversify country risk.¹⁰⁸ Foreign investment is seen as a positive force that 'promotes the development of domestic financial markets', whilst foreign direct investment 'brings know-how to the domestic industry'.¹⁰⁹ As against these factors, capital controls also prevent a country's economy from being unduly affected by the roller coaster of investor sentiment, which may at times be more important than financial integration. In any event, there is no evidence that Malaysia's brief use

⁹⁹ Giancarlo Corsetti, Paolo Pesenti and Nouriel Roubini, *supra* note 49 at 25.

¹⁰⁰ Hal S. Scott & Philip A. Wellons, *supra* note 27 at 1379.

¹⁰¹ Barry Eichengreen, *supra* note 49 at 56.

¹⁰² Paul Krugman, *supra* note 52.

¹⁰³ Prema-Chandra Athukorala, *supra* note 8 at 2.

¹⁰⁴ International Monetary Fund, *supra* note 24 at 13.

¹⁰⁵ *Ibid.* at 9.

¹⁰⁶ *Ibid.* at 50.

¹⁰⁷ Jean Tirole, *Financial Crises, Liquidity, and the International Monetary System* (Princeton, N.J.: Princeton University Press, 2002) at 32.

¹⁰⁸ *Ibid.*

¹⁰⁹ *Ibid.*

of capital controls in the late 1990s has in any ongoing sense isolated it from the international financial community.

VI. ARGUMENTS IN FAVOUR OF THE IMF'S POLICIES

There are arguments in support of the IMF's policies during the Asian crisis. As mentioned above, whilst IMF program countries may not have coped with the crisis particularly well, this may be because they failed to implement the IMF's policies with sufficient enthusiasm. It can also be argued that the IMF has a legitimate interest in the protection of international creditors on the basis that this may be good for everyone who participates in the system. The conditionality of IMF loans may also be defensible if the conditions placed on loans are essential to bring about a recovery.

Recipient countries did not comply with many of the conditions the IMF placed on the provision of funds. Reforms were slow to proceed, perhaps because they had been forced on governments from the outside. As Corsetti *et al.* observed, 'governments failed to enforce even the most sensible components of such plans'.¹¹⁰ It is thus arguable that it was the slow and poor implementation of IMF's policies, rather than the policies themselves, that may have been solely to blame for worsening the crisis.

The implementation of reforms in Indonesia provides an example of such a lack of political will. Within days of signing the US\$40 billion accord with the IMF, "economic reforms seemed to disappear from the government's agenda".¹¹¹ In response to the claim that the IMF caused bank runs by insisting on the closure of ailing banks, it has been argued that "the IMF was not at fault if measures to prevent bank runs ... were not in place".¹¹²

Another argument in support of the IMF is that in protecting creditors the IMF was attempting to preserve the international financial system as a whole, which is reliant on the involvement of creditors, and to preserve the access of debtor governments to foreign capital.¹¹³ Others accept that while the protection of creditors involves moral hazard this is the least bad option available.¹¹⁴ The claim is made that to leave the apportionment of losses to the market "may have much more dramatic and distortionary consequences".¹¹⁵

Soros argues against criticising the IMF for imposing its typically extensive list of conditions, arguing that "[l]iquidity crises are inextricably interconnected with structural imbalances".¹¹⁶ Escape from the crisis may involve fixing the imbalances and thus domestic policy reform. But whilst reforms may be necessary, the reforms need not always be implemented when the crisis is in full swing.

¹¹⁰ Giancarlo Corsetti, Paolo Pesenti and Nouriel Roubini, *supra* note 49 at 23–24.

¹¹¹ David E. Sanger, "IMF Reports Plan Backfired, Worsening Indonesia Woes" *New York Times* (14 January 1998).

¹¹² Giancarlo Corsetti, Paolo Pesenti and Nouriel Roubini, *supra* note 49 at 20.

¹¹³ Max Corden, *The Asian Crisis: Is There a Way Out?* (Singapore: Institute of Southeast Asian Studies, 1999) at 44.

¹¹⁴ Giancarlo Corsetti, Paolo Pesenti and Nouriel Roubini, *supra* note 49 at 21.

¹¹⁵ *Ibid.*

¹¹⁶ George Soros, *supra* note 3 at 221.

Finally, in the IMF's defence, whilst its initial response may have worsened the crisis, when recessions occurred in IMF program countries in 1998 its policies became less restrictive and it allowed countries to operate with fiscal deficits.¹¹⁷

VII. CRITICISMS OF THE IMF'S POLICIES

Many commentators claim the IMF's policies worsened the crisis in some countries, and the IMF has admitted that its initial austerity policies were not appropriate to the economic conditions of crisis countries at the time.¹¹⁸ On the other hand, the IMF was dealing with countries where there was often a lack of political will to implement many of the IMF's reforms and this must have contributed to the failure of these policies to avert the crisis. Further, in the IMF's defence, it did change its policies further into the crisis when it became clear its earlier policies had not worked.

There are five principal criticisms of the IMF's response to the Asian economic crisis:

1. A complete initial misdiagnosis of the nature of the crisis.
2. Excessive conditions imposed by IMF programs, and inappropriate timing of the reforms mandated by those conditions.
3. Protection of the international financial system and foreign creditors.
4. Social costs of IMF policies.
5. Mishandling of market expectations.

A. *Misdiagnosis*

The IMF has been criticised for initially treating the wrong type of crisis in the Asian crisis countries.¹¹⁹ The IMF's initial policy prescriptions of fiscal austerity were designed to address a crisis of over-consumption, such as that which had gripped Latin America and Africa throughout the 1980s and into the early 1990s. The Asian economic crisis was a completely different sort of crisis.

The IMF's initial response to the Asian crisis involved tight credit, increased interest rates and fiscal tightening.¹²⁰ The IMF's high interest rate policy caused domestic deflation in IMF program countries.¹²¹ This policy may also have worsened the crisis by causing widespread bankruptcies.¹²² The IMF's policies caused a deepening recession in recipient countries and in most cases did not improve confidence but rather increased uncertainty.¹²³ At the time Buirra rightly observed that "the Fund's strategy discourages investment, compounds the recessionary impact of the reversal

¹¹⁷ Giancarlo Corsetti, Paolo Pesenti and Nouriel Roubini, *supra* note 49 at 18.

¹¹⁸ International Monetary Fund, "The IMF and Recent Capital Account Crises: Indonesia, Korea, Brazil" (IMF, 2003) at 49.

¹¹⁹ Robert Weissman, *supra* note 2 at 91; Gordon De Brouwer, *The IMF and East Asia: A Changing Regional Financial Architecture* (Canberra: Australia-Japan Research Centre, 2002) at 2.

¹²⁰ Ariel Buirra, *An Alternative Approach to Financial Crises* (Princeton, N.J.: International Finance Section, Dept. of Economics, Princeton University, 1999) at 7.

¹²¹ Max Corden, *supra* note 114 at 34.

¹²² Giancarlo Corsetti, Paolo Pesenti and Nouriel Roubini, *supra* note 49 at 16.

¹²³ Ariel Buirra, *supra* note 121 at 7.

in capital flows, and generally exacerbates the difficulties faced by firms, banks, and public finances".¹²⁴

Another of the failed IMF crisis responses was the attempt to induce a small depreciation in the exchange rate of crisis countries so as to promote exports, whilst tightening fiscal policy, in order to restore confidence.¹²⁵ Unexpectedly the currencies in the IMF program currencies fell rapidly—the Thai baht fell by 50 per cent; the Indonesian rupiah fell by 75 per cent and the Korean won fell by 40 per cent.¹²⁶ This in turn caused a downturn because the falling exchange rate increased the indebtedness of companies, leaving them unable to finance investment.

The IMF's assessment of Thailand's problems provides a good example of its failure to diagnose the crisis properly. The IMF initially thought that Thailand had "a conventional demand-management problem—excessively easy fiscal and monetary policy and a deteriorating current account—requiring a general policy tightening".¹²⁷ Instead De Brouwer describes Thailand as having "joint capital account and financial system crises" which required the opposite treatment to that which they were prescribed—supportive, not tight, fiscal policy.¹²⁸ The IMF's focus on fiscal contraction was counter intuitive because the affected countries all had long histories of good fiscal policy.¹²⁹

Exploring this misdiagnosis, Eichengreen discusses the problems with the IMF's requirements for fiscal austerity during the crisis:

It failed to anticipate the severity of the Asian downturn or see that the restrictive fiscal policies it recommended would themselves make that downturn worse ... the Fund's fiscal targets were too tight and ... larger deficits should have been encouraged.¹³⁰

These policies made the problems of banks and companies worse by making it harder to get credit, which in turn led to an increase in bad loans because loans could not be rolled over.¹³¹ To its credit, the IMF subsequently relaxed its tight fiscal policy and allowed crisis countries to go into deficit to fund projects to stimulate their economies.

B. *Excessive Conditionality*

Crisis countries that had IMF programs in place received IMF funds to support their recovery. This money always came with significant conditions attached. The IMF's initial conditions reflected the fund's policy that a prolonged crisis could be averted by increasing investor confidence in the crisis economies by undertaking major economic and financial sector reforms and reducing government spending to improve their balance of payments position.

¹²⁴ *Ibid.* at 20.

¹²⁵ Gregor Irwin & David Vines, *supra* note 16.

¹²⁶ *Ibid.* at 61.

¹²⁷ Gordon De Brouwer, *supra* note 120 at 3.

¹²⁸ *Ibid.*

¹²⁹ Max Corden, *supra* note 114 at 14; and LH Meyer, "Lessons from the Asian Crisis: A Central Banker's Perspective", Levy Economics Institute Working Paper No. 276, Aug. 1999.

¹³⁰ Barry Eichengreen, *supra* note 49 at 110.

¹³¹ Giancarlo Corsetti, Paolo Pesenti and Nouriel Roubini, *supra* note 49 at 10.

The number and scope of conditions placed on IMF crisis funding is one of the major problems with the fund's approach to crises. Whilst most crises are caused by underlying problems with a country's economic fundamentals, the time to deal with these issues is not whilst the crisis is at its worst.¹³² Crisis countries should have been allowed to focus on policies that would reduce the damage done by the crisis, rather than on long term policies aimed at preventing a crisis occurring again in the future. Corden also concludes that there were too many conditions on IMF relief, and that whilst the reforms were desirable it was not the time to implement them.¹³³

Not only the timing, but also the types of conditions imposed by the IMF on a number of crisis countries were inappropriate. Some of these conditions involved countries further opening their economies. Given that the crisis itself may have been caused by over reliance on short-term international financing, recommending a further opening of the economy to international financing at this particular point was unwise.¹³⁴ In this way, the IMF's policies simply gave program countries more of what had initially caused them problems.¹³⁵

The conditions imposed on Korea provide a good example of the wrongheadedness of IMF policies at the beginning of the crisis. The following conditions on Korea's IMF loan appear to have increased rather than decreased Korea's vulnerability to the vagaries of international capital flows. Korea was required to:

- review all remaining restrictions on corporate foreign borrowing, including short term borrowing;
- abolish restrictions on foreign ownership of land and real estate;
- permit equity investment in non-listed companies; and
- eliminate the aggregate ceiling on foreign investment in Korean equities.¹³⁶

C. Protection of the System and of Creditors

The IMF bail-outs of Indonesia, Korea and Thailand were extended upon the basis that the funds advanced would be used to repay debt then due, i.e. debt lent by short-term creditors. Foreign creditors were thus the main recipients of the money loaned to crisis countries. Critics have argued that IMF funds should have been used “not for rescuing foreign creditors—nor for financing capital flight—but for financing compensating fiscal expansion”.¹³⁷

The IMF solutions in Asian countries were unjust because they allowed investors to avoid the consequences of their actions, which creates moral hazard and places the burden of the consequences of those actions on people who had no power to control them. Vasquez puts this criticism succinctly—“Just as profits should not be

¹³² Gordon De Brouwer, *supra* note 120 at 3. Hak K. Pyo, “The Financial Crisis in Korea and its Aftermath: A Political Economic Perspective” in Dipak Dasgupta, Marc Uzan & Dominic Wilson, ed., *Capital Flows Without Crisis? Reconciling Capital Mobility and Economic Stability* (London: Routledge, 2001) 237 at 243.

¹³³ Max Corden, *supra* note 114 at 45.

¹³⁴ *Ibid.* at 49.

¹³⁵ *Ibid.* at 51.

¹³⁶ *Ibid.* at 50.

¹³⁷ *Ibid.* at 59.

socialized when times are good, neither should losses be socialized during difficult times".¹³⁸

This highlights the central hypocrisy of IMF policies. Whilst the Fund insists that the market is the best mechanism to allocate money and resources during good times, in bad times it refuses to leave the market to apportion losses.¹³⁹

A similar criticism is that many of the policies mandated by the IMF in crisis countries put the international banking system before those countries' citizens.¹⁴⁰ As Soros put it:

The net effect of this approach was to place the burden of adjustment mainly on the borrowing countries. They were required to service their debts to the limits of their capacity. The lenders did not get off scot-free, but their losses were much smaller than they would have been absent IMF intervention.¹⁴¹

If the IMF had not intervened to protect the creditors through bail-outs, it is likely the IMF program countries and their creditors would have negotiated other solutions.¹⁴² Creditors would have had enough incentive to accept a renegotiation of the debt, because otherwise they would have lost their entire loans.¹⁴³ This would have been preferable because it would have reduced the burden on crisis countries and forced financiers to accept responsibility for their bad investment decisions.

D. Mishandling of Market Expectations

Another criticism of the IMF's behaviour during the crisis is that the IMF made matters worse in crisis countries by overemphasising the supposed structural causes of the crisis.¹⁴⁴ Contrary to its intentions, the IMF's policies did not support confidence and recovery.¹⁴⁵ Corden sensibly suggests that it would have been "better to try to calm markets by emphasizing the positive features of these economies ..." instead of highlighting all the flaws.¹⁴⁶ A case in point is the IMF policy of encouraging bank closures in crisis countries. According to Sanger this IMF policy caused "a bank panic that helped set off financial market declines in much of Asia".¹⁴⁷

E. Social Costs of IMF Policies

In our view one of the most damning criticisms of the IMF is that it ignored the social consequences of its policies during the crisis. The IMF seems to have ignored the

¹³⁸ Ian Vasquez, *Why the IMF Should Not Intervene*, online: The Cato Institute Site <<http://www.cato.org/speeches/sp-iv22598.html>>; Ross Buckley, *supra* note 28.

¹³⁹ Interestingly Vasquez also claims that many of the conditions negotiated by the IMF would have been forced on crisis countries by the market if it had been left to do its job (Vasquez, *ibid.*). This suggests that if the IMF had stayed out of the crisis, countries would have undertaken the necessary reforms, and moral hazard would have been avoided.

¹⁴⁰ George Soros, *supra* note 3 at 222.

¹⁴¹ *Ibid.* at 269.

¹⁴² Ian Vasquez, *supra* note 139.

¹⁴³ *Ibid.*

¹⁴⁴ Max Corden, *supra* note 114 at 48.

¹⁴⁵ Gordon De Brouwer, *supra* note 120 at 2.

¹⁴⁶ Max Corden, *supra* note 114 at 48.

¹⁴⁷ David E. Sanger, *supra* note 112.

burdensome impact of its policies on the poor. The recession that occurred in IMF program countries had the worst effect on the poor. The very people who had not benefited from the preceding "miracle" in Asian countries bore the brunt of reduced public spending when things turned bad.¹⁴⁸ An example is seen in the aftermath of the financial crisis in Korea (an IMF program country) where there was an increase in the ratio of absolute poverty and greater inequality of income and wealth after the crisis.¹⁴⁹ Pyo notes that in Korea "the labour and capital income of the highest 10 per cent in 1998 increased by 8 per cent, while that of the other 90 per cent of income earners decreased sharply".¹⁵⁰

VIII. CONCLUSIONS

Malaysia's economic policies during the Asian crisis, on balance, delivered slightly better, and certainly no worse, economic results than those in countries under IMF programs.

It has been argued that Malaysia would have fared even better with IMF assistance, because unlike some other program countries Malaysia had the political will to undertake significant reforms. This willingness to undertake significant reforms may have resulted in a faster recovery for Malaysia than in fact occurred there. Unlike others in the region, Malaysia had a strong corporate regulatory and legal framework,¹⁵¹ which helped it to cope with problems caused by the crisis better than other crisis countries.¹⁵² This may have made it a much better candidate for IMF assistance.

However, this argument entirely ignores the fact that, in reforming its system, Malaysia was implementing home-grown policies, not those imposed by an external supranational institution. Policies developed abroad are rarely likely to be adopted and enforced with the enthusiasm and rigor of those developed at home. This is a simple fact of human nature. We all do more willingly what we choose to do, rather than what we are told to do.

What can be said with certainty is that Malaysia's policies during the crisis were better suited to its specific circumstances than those in other IMF program countries were suited to their circumstances. In particular, Malaysia has a history of economic affirmative action in relation to its *Bumiputra* population that was accommodated during the crisis. An IMF program in Malaysia was unlikely to accommodate these cultural issues.

Malaysia's policies were also preferable to those implemented in IMF program countries because they had a more benevolent impact on the poor. Fiscal austerity almost inevitably takes money from programs that benefit the poor. Malaysia's approach was more equitable. It did not punish the poor to repay capital that had principally benefited the rich when it had flowed into the country.

¹⁴⁸ Ian Vasquez, *supra* note 139.

¹⁴⁹ Hak K. Pyo, *supra* note 133 at 248.

¹⁵⁰ *Ibid.* at 248.

¹⁵¹ International Monetary Fund, *supra* note 46 at 85.

¹⁵² International Monetary Fund, *supra* note 24 at 7.

Malaysia's refusal to adopt IMF policies also allowed it to keep control of its own economic destiny. This was preferable because it meant Malaysia could act solely in its own best interests. Unlike the IMF, it was not responsible for protecting the international financial system as a whole.

Retaining control of economic policy also ensured that decision-making power in Malaysia remained with those who were elected to represent its citizens. This is desirable because it promotes democracy and because it prevents the country from being dominated by more powerful states and international organisations which may not act solely in its best interests.

So, whilst Malaysia's policies may not have made a large difference to its "bottom line" during the crisis, there are many important ways in which they were good for Malaysia. Given that Malaysia's policies certainly delivered no worse economic results than IMF policies elsewhere in the region, there can be no doubt that Malaysia's decision not to request IMF assistance and instead pursue its own path out of the Asian Economic Crisis was right for Malaysia.