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Yale Program on Financial Stability
Lessons Learned

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By Maryann Haggerty

Zeti Akhtar Aziz, a Malaysian economist, was governor of Bank Negara Malaysia, her nation's central bank, from 2000 to 2016; prior to that, she was acting governor and deputy governor. Dr. Zeti was a key leader in Malaysia's response to the Asian financial crisis of 1997-98, as well as the financial sector restructuring that followed. This "Lessons Learned" summary is based on a 2022 interview with Dr. Zeti. At the time of the interview, she was co-chair of the board of governors of the Asia School of Business in Kuala Lumpur, which is a partnership between Bank Negara and the MIT Sloan School of Management. Dr. Zeti is a member of the YPFS Advisory Board.

There are no one-size-fits-all solutions. Malaysia rejected the austere International Monetary Fund (IMF) approach to the 1997-98 Asian financial crisis, choosing currency controls instead. Despite criticism, its economy rebounded.

In mid-1997, a financial crisis that began in Thailand spread through the region, including Malaysia. This was generally regarded as a currency crisis.

At the time, Dr. Zeti was the chief economist at Bank Negara Malaysia, and an assistant governor covering the economic sector, monetary policy, reserve management, and money market and foreign exchange operations. She also had oversight of the foreign exchange administration. She said:

> The volatile capital flows started around May [1997], when the Thai baht, the Thai currency, was targeted as the market had assessed it to be overvalued. There were therefore continuous speculative attacks on the currency, which was subsequently felt throughout the region, including in Malaysia.
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> As liquidity tightened, following the outflows, our role [at the Bank] was to provide liquidity. The currency had also begun to depreciate in a discontinuous manner, meaning that there were abrupt changes in the trading range during that period of time. And so, intervention operations were also undertaken to stabilize the currency market.

Despite the currency crisis and a large pre-existing current account deficit, the Malaysian economy remained strong through much of the year. Growth slowed from about 9% annually—overheated in the eyes of some—to about 7%. By December, though, financial institutions were feeling stress. "This financial stress followed the depreciation of the currency and the collapse of the stock market, which fell by about 50% at that time," Dr. Zeti recalled.

As the months of the new year passed, Malaysia faced pressure, especially from the IMF, to manage the crisis by raising interest rates and taking other austerity measures. Thailand, Indonesia, and South Korea agreed to an IMF bailout program, but Malaysia did not.

Tensions built in the Malaysian financial and political systems. In August 1998, the governor and deputy governor of the Bank stepped down. Dr. Zeti was promoted to acting governor. "And at that point in time, I would describe Malaysia was about to breach its tipping point," she recalled. "By this time, the currency had depreciated by about 32%. … The currency had experienced wave after wave of depreciation. The stock market had also collapsed by about 70%."

Days after her appointment, she announced that the government was imposing a set of currency controls—an approach to the crisis far different from that in the rest of the region. The Malaysian ringgit was non-internationalized, which prevented trading in the currency in offshore currency centers that were a source of speculation. Currency was also made subject to a 12-month holding period, meaning if the currency was in the country, it would have to stay there for a year.

The Malaysian economy quickly bounced back, posting 6% growth in 1999. "Essentially it was a V-shaped recovery," Dr. Zeti said. The region's other countries also recovered, including those in the IMF program.

But, Malaysia's approach was condemned by many in the international financial markets. The main concern was that funds were trapped inside the country and counterparties were not sure, despite assurances from the government, that they would be able to take the money out of the country in 12 months. But Dr. Zeti strongly defends the controls as the right solution for her country at the time and afterward. In response to critics at one conference who said that Malaysia hadn't needed the controls to manage the crisis, she responded:

> I said, "Malaysia recovered at the lowest cost in the history of financial crises. The cost of the crisis was something like less than 5% of GDP. That includes the fiscal cost, the cost to labor dislocation, and other costs." It was very low compared to the cost that generations are still paying for in Korea, in Thailand, and in Indonesia. For them it was somewhere between 30 to 40% of GDP. So, I said, "Surely this mattered."

Don't wait for a crisis to assess your vulnerabilities.

In the mid-1990s, before the crisis, the Malaysian economy was hot, with GDP growth of 9-10% and credit growth of 20-30%. The current account deficit was "massive," Dr. Zeti said, at about 10% of GDP. She said:

> The argument made at that time was that Malaysia was receiving a significant inflow of foreign direct investment during this period that covered this deficit. The economy was viewed very positively. It was therefore highlighted that this deficit was being financed by long-term foreign direct investment and not short-term inflows.

> But we did recognize at that time that this was an area of vulnerability and that it posed a risk to our economy and to our financial system. Macroprudential measures were thus aggressively implemented—although we were not clever enough to call it that. But essentially that was what were implemented. It included placing limits on lending to the property sector and the financing of activity in the stock market and so on. There were other limits that were imposed on the portfolio of the banking institutions aimed at reining in the excesses and risks to our financial system and to our economy.

That paid off when things went bad. Dr. Zeti said:

> The first lesson was the importance of determining and managing our areas of vulnerability. For us, it was our huge current account deficit, the rapid credit growth, and the rising domestic indebtedness. Policies were implemented during that time to address these issues and it produced results. So, when we entered into the crisis, it was at a much stronger position than the two years earlier, where we would have been in a similar position as in Thailand that had these risks during the time of the crisis.

Understand the nature of the crisis. In 1997-98, that meant understanding currency markets.

The Asian financial crisis began with the Thai baht. But currency markets are international, and contagion crosses borders. In 1997-98, the Malaysian ringgit came under repeated attacks from speculators in international markets, Dr. Zeti said. Fighting contagion requires knowing how those markets operate, she said, and what weapons a nation has in dealing with attacks on its currency. She explained:

> This crisis started as a currency crisis. It is therefore important to understand the foreign exchange market, the dynamics of this market, that it is prone to discontinuous adjustments, that it is prone to over-adjustment, and that it does not have self-equilibrating forces to return it to levels where it would reflect the underlying fundamentals of the economy.
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> In other words, during normal circumstances, when you are not in the crisis, the rates are expected to return to levels where it reflects the underlying economic fundamentals. During a crisis, however, it will tend to go further and further away from its equilibrium point. It is also important to understand the role of the major players in the market, including that of hedge funds—to understand how they take positions on currencies and so on. I personally spent a lot of time in the dealing room with the dealers, in particular at the ringgit desk. They engaged with the counterparties who would inform them that they had orders to sell off the currency at the various levels and at which rate. We could therefore see that they were dealing with hundreds of millions and therefore, we knew that the resources that they had far exceeded the resources that we had. We knew that we didn't have that kind of resources to defend our currency.

> And therefore, the lesson here is to understand the dynamics of the market, the different behaviors of the various players in the market such as that of investors and those such as hedge funds which produce different kinds of movements in the market. Sometimes it would be futile, absolutely futile to defend a currency. You would in no time deplete your reserves. And that is what brought a number of the countries to eventually come under an IMF program.

Guarding the ringgit from continued speculation was a primary goal of the 1998 currency controls, she said. It was a necessary step toward stabilizing the domestic economy and financial system.

A nation must determine its own objectives and communicate them.

At one point, the IMF wanted Malaysia to raise interest rates by 5 percentage points, Dr. Zeti said, and allow the currency exchange rate to adjust. "They said Malaysia had a relatively strong economy, and so, the exchange rate would adjust right back to where it would reflect the underlying fundamentals."

But Malaysia believed the currency markets were "irrational," she said, and would not reflect fundamentals. It rejected the IMF's ideas and did not raise rates. She recalled:

> Of course, when Malaysia did not adopt the IMF prescriptions—this was even before the controls were implemented—there was widespread condemnation. This was mainly for not raising rates. The IMF made interventions at various international meetings and issued press statements that Malaysia failed to raise interest rates and that this was causing our currency to depreciate and so on. The condemnation by the IMF and the international community was indeed very overwhelming for us. There was not much we could do but to present our case. But it wasn't listened to much. We nevertheless continued to pursue our own policies that we assessed to be in the best interest of our country. So that was our focus; we had very specific goals to achieve. They were three-fold: to restore stability in our financial markets, to repair our financial system, and to bring about an economic recovery.
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> Thus, we had three very specific objectives for our policies. There was therefore also an important role for communications. Since we didn't succeed in getting acceptance from the international community, we focused on our domestic community. And this was important because although Malaysia did have some domestic capital outflows, there was no large-scale domestic capital flight. The role of communications is a very important lesson. Information was provided on a daily basis to the financial industry, to the businesses, and to the public at large about our policies, the rationale for these policies, and our assessment of the impact of these policies.

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