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Malaysia and South Korea: A Decade after the Asian Financial Crisis

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Abstract

This paper undertakes a comparative analysis of the Malaysian and South Korean post-crisis policies over a ten-year period following the Asian crisis of 1997. The aim of this paper is to analyze the effectiveness of the policies and to obtain insight into the factors that generated simultaneous recovery, despite a different policy environment in both countries. South Korea implemented neo-liberal International Monetary Fund (IMF) policies, while Malaysia resorted to controversial capital controls. The ten year analysis demonstrates that an initial strong recovery to pre-crisis growth levels could not be maintained over the long-term. Moreover, improvements are still warranted in the field of corporate governance. Furthermore, the analysis shows that significant improvements have been made, with respect to the reduction of non-performing loans and the Human Development Index (HDI). In all, the outcomes indicate that a heterodox policy such as capital controls is by no means doomed from the start. This implies that future monetary and fiscal policy making in Asia should not blindly follow the Washington Consensus. Instead, each country should find its own rightful policy mix, possibly taking elements from the emerging Beijing Consensus. Indeed, China and other Asian countries appear to recover quicker from the current turmoil in the global economy. How South Korea and Malaysia will evolve from the current crisis remains to be seen.

Keywords: Crisis, Korea, IMF Policies, Malaysia, Capital Controls

Introduction

The Asian financial crisis started in July 1997 with the collapse of the Thai baht, and quickly spread to surrounding nations in the East Asian region. Particularly, it resulted in economic problems in Indonesia, Thailand, Malaysia and South Korea. These four countries had enjoyed strong economic growth for several decades (Cypher & Dietz, 1997). Nevertheless, the crisis had a severe impact on their economic performance and social and political situation. Political turmoil was particularly dramatic in Indonesia where President Suharto resigned after being in power for three decades (Schwarz, 2004: 308-366). In the following four years, explanations for the causes of the crisis generally focused on two broad topics: the first concerned external shocks, such as the depreciation of the US Dollar vis-à-vis the Japanese Yen between 1995 and 1997 and the speculation of currency traders and second, internal deficiencies such as excessive financial liberalization that led to a virtual absence of proper regulatory environments, extreme mobility of financial capital and risky activities of ever expanding conglomerates.[1]

According to the Asian Development Bank (ADB), 'The effect of the crisis has not yet been completely erased. Growth has settled on a lower trajectory. Comparing the period 2000-2006 with 1990-1996, growth has slipped by an average of 2.5% a year in the five countries that were most directly affected'.[2] However, the focus of this study is on the effects of the post-crisis policies in Malaysia and South Korea (hereafter Korea) until the beginning of 2007. In doing so, it provides a longer term analyses than Mahani et al.'s (2003) and Lee's (2003) work. Interestingly, these two countries undertook remarkably different policies in order to overcome the crisis. Malaysia resorted to controversial capital controls, while Korea accepted an International Monetary Fund (IMF) package and implemented structural adjustment policies, which mainly entailed the imposition of neo-liberal economic policies (Jomo, 2003: 180-215: IMF, 1999). It is surprising that both countries experienced quick recoveries while employing such different policies. In fact, of all countries hit by the crisis, Korea is seen as the one with the most impressive recovery, followed directly by Malaysia.

The aim of this paper is to analyze the effectiveness of Malaysian and Korean policies and how they were able to overcome the crisis and to obtain insights into the

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[1] See for example: Haggard 2000; Zhang 2000; Wade 1999; Whitt 1999

[2] ADB 2007: 46. The five countries commonly seen as most affected by the crisis are Korea, Thailand, Indonesia, Malaysia and the Philippines.

factors that generated this simultaneous recovery, despite a very different policy environment. The central question asks: were the initial observations regarding the recoveries in Korea and Malaysia overly optimistic when looking at the long-term consequences of the crisis? Additionally, we should also pay attention to the consequences of the current tensions in the global economy. Following the introduction, the paper is divided into four sections and then follows with concluding remarks. The first section introduces IMF policies and capital controls. The second section briefly discusses the reasons why two opposing policies resulted in strong recoveries in both Korea and Malaysia in the short-term. The third section forms the backbone of this paper and is concerned with an assessment of the effectiveness of the policies until the beginning of 2007 based on secondary sources: the literature and economic indicators of both real and financial markets. This section also pays attention to relevant post-crisis political economy trends. The fourth section addresses the remaining challenges and the current economic and financial turmoil associated with the consequences of the USA subprime crisis.

Table 1 Country Information and Key Economic Indicators (1996)

	Korea		**Malaysia**	
	1996	**2006**	**1996**	**2006**
Capital	Seoul		Kuala Lumpur	
Area	98 500 km^2		330 000 km^2	
Population (millions)	45.4	48.3	21.17	26.4 (estimated)
GDP, current prices ($ billions)[2]	558.031	888.267	100.852	150.923
GDP per capita ($) current prices[2]	12257.77	18391.68	4764.13	5718.43 (estimated)
GDP growth, %	7	5	10	5.9
Human Development Index[3]	0.835	0.912	0.755	0.805
External Debt as % of GNI	22.3	24.2	41.3	46.6 (2004)
Short-term debt as % of total debt	57.5	32.7	27.9	21.9
FDI net inflows	-2344.7	4588.3	5078.0	4624.2
Unemployment rate, %	2.0	3.5	2.5	3.4
Structure of output (% of GDP)				
Agriculture	5.3	3	11.3	8.4
Industry	37	35,9	42.2	49.8
Service	57.7	61,1	46.5	41.8
Trade balance ($ Millions)[4]	-15077.1	33437	3848.2	3155.6

Sources: ADB (2006); [2]IMF (2007); [3]UNDP various years; [4]IMF (2007b)

1. Introducing IMF Policies and Capital Controls

Within Asia, both Korea and Malaysia are comparatively well-developed countries. Korea managed to become a member of the Organization of Economic Co-operation and Development (OECD) in 1996 and Malaysia's socio-economic level has been considerably higher when compared with its neighboring countries Thailand and Indonesia. Within Southeast Asia, only Singapore and Brunei Darussalam have a higher standard of living. Table 1 gives a brief overview of the main socio-economic indicators in 1996 and 2006.

For an adequate assessment of the post crisis period, a rather holistic approach seems to be appropriate that includes a thorough analysis of the political, economic and social environment. As concerns Korea, several authors have argued that foreign firms, foreign governments and the IMF should be included in the analysis, whereas domestic coalitions in Malaysia, particularly between the private and public sector have had considerable influence on economic development between 1998 and 2007. (Lee & Han, 2006; Hundt, 2005; Ritchie, 2005; Haggard, 2004; Jayasuriya, 2004). Following these arguments, this paper will take into account a variety of actors. Additionally, one should keep in mind that while general explanations for the crisis (as outlined in the introduction) might apply to both countries, looking at country specific pre-crisis issues might be of more use in explaining the outbreak of the crisis. For Korea, the poor regulation of the financial system, the weak supervision of the chaebol[3] and the large number of non performing loans (NPLs) are often cited as more immediate causes. In the case of Malaysia, there is the large current account deficit and excessive off-shore trading in the Malaysian Ringgit.

Moreover, it is important to remember that the crisis events in Korea and Malaysia did not unfold simultaneously. Kaplan & Rodrik (2001) assert that the pressure on the Korean financial markets was at it highest point in January 1998, yet only in August 1998 did pressure reach its peak in Malaysia. Another important difference is that when Malaysia implemented capital controls, Korea had already received nine months of IMF treatment. However, before delving further into a holistic approach by which to analyze the policies taken, a brief introduction of the background of IMF policies and capital controls are provided in the following two sections.

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[3] Chaebols are characteristic of the Korean economy and refer to large family-owned and controlled conglomerate enterprises (see Whitley 1999).

1.1 The IMF Package for Korea

Due to a sharp worsening of the economy, Korea requested IMF assistance on November 21, 1997. The IMF policy package for Korea included many different measures and conditionalities in order to overcome the crisis. The focus for this study will be on the main attributes of the package, which included a financing package, monetary policy, fiscal policy and financial sector and corporate sector reforms.

After Korea requested IMF assistance, a financial package was quickly agreed upon that promised a three year stand-by credit of about $21 billion. The package was the largest standby credit ever given to an IMF member country. Additional credits of several international banks and a group of industrialized countries resulted in a multilateral aid package of about $58 billion, also called the 'second line of defense.' However, this aid package was seen as underfinanced in that it was not able to restore confidence. Therefore, this first program was regarded as a failure (Emery, 2005; Freedman, 2002: 242).

A new program based on a rollover agreement was announced on December 24, 1997. This program was more successful as governments and central banks of a group of industrial countries agreed to rollover bank credit lines with Korea and extend maturities of their short term claims on Korean banks. According to the IMF, an increase in market confidence because of the rollover agreement contributed to a recovery of the won during 1998 (IMF 2003: 20). In the end, the IMF financing package would not be fully drawn upon and Korea was able to repay all outstanding debts ahead of schedule. Nevertheless, as seen later, the rollover was in the long-term insufficient for employment.

Parts of the package were concerned with specific monetary and fiscal policies. Since the main goal was to stabilize the foreign exchange market and counteract the inflationary effects of the depreciation of the won, a high interest rate was employed. Similar to this monetary policy, a tight fiscal policy was initially employed with high tax rates. It is widely recognized that pre-crisis regulation of the financial sector was generally poor, resulting in bad loans, insolvent institutions and a lack of transparency. Hence, a structural program that focused on the financial sector would therefore form an essential part of the IMF package. As such, several financial sector reforms were implemented immediately following the IMF program in December. First, the most troubled financial institutions were immediately closed. Second, there was an extension of the 'deposit insurance system' funded by government-guaranteed bonds in order to protect depositors and prevent bank runs' (Sen, 1999: 185). Third, the Korea Asset Management Company (KAMCO) became fully utilized in order to deal with the problem of non-performing loans (NPLs). Finally, weak but solvent institutions were required to submit a restructuring and recapitalization plan for approval (IMF, 2003: 108). With respect to corporate governance, several key reforms regarding auditing standards, employer-employee relations and privatization of state assets were designed. Measures were especially aimed at large chaebols, whose problems had played a large role in the start of the crisis.

1.2 Capital Controls for Malaysia

When the financial crisis spread through the Southeast Asian region, Malaysia's initial response entailed conservative IMF-like measures. Tight fiscal and monetary policies were implemented in order to slow credit growth, defend the Ringgit and limit interest rate hikes. Yet, in March 1998, signs of output slowdown made the government loosen its tight macroeconomic policies. This first macroeconomic policy package initiated by the government under then Deputy prime-minister Anwar Ibrahim failed to restore confidence and the crisis intensified. Several factors indicated the deteriorating state of the Malaysian economy. Due to these increasingly worsened conditions, the tight fiscal policy turned into an expansionary one with higher capital spending and tax reductions in August 1998. Yet, this shift was not enough and the Mahathir government turned to the controversial and widely debated exchange and capital controls.

The main objective of the exchange and capital controls implemented in September 1998 was to deter speculation against the Ringgit, gain monetary independence and limit capital flight (IMF, 2003; Yoon, 2005: 1317; Reinhart & Edison, 2001: 536). The following measures were most important in the policy package:

1. The Ringgit was pegged at RM 3.8 per US dollar.
2. Portfolio investors were restricted from withdrawing funds invested in Malaysia for at least a year.
3. Trading of the Ringgit outside of the country became prohibited in order to get rid of the offshore Ringgit market.
4. Fund transfers abroad became subject to approval.
5. International borrowing and lending in Ringgit, as well as trade settlements in Ringgit were prohibited.
6. Exports and imports of Ringgit banknotes were restricted (Meesok et al., 2001: 50; Jomo, 2003: 195).

The decision of Malaysia to resort to capital controls was welcomed negatively by the international financial markets. 'Rating agencies downgraded Malaysia, sovereign bond spreads increased relative to those of Korea and Thailand, and Malaysia was removed from major investment indices' (ibid: 13). This was mainly the result of uncertainty about the specific measures and potential influence on foreign direct investment. Although pre-crisis financial sector regulation and supervision was better established in Malaysia then in Korea, Malaysia also undertook centralized financial sector reforms. Compared to Korea, Malaysia had a better financial position with less NPLs, less foreign borrowing and a smaller proportion of debt of short-term maturity, thus, no bank closures occurred.

This section has taken a brief look at the policy responses in Korea and Malaysia. Two different measures were taken in order to overcome the crisis. The background of the countries and different factors that contributed to the crisis can explain why different policies were taken. In the case of Korea, poorly regulated financial and corporate systems and the large presence of NPLs caused Korea to have a large foreign debt problem (Yoon, 2005: 1316). In Malaysia, foreign debt was less of a problem, while local debt was high. This, in combination with pressures to protect local industries, as well as eliminating the offshore trading market, explains the use of capital controls. The next section will assess the short term effectiveness of both policies.

2. Competing Views and Short-Term Effects of Policies

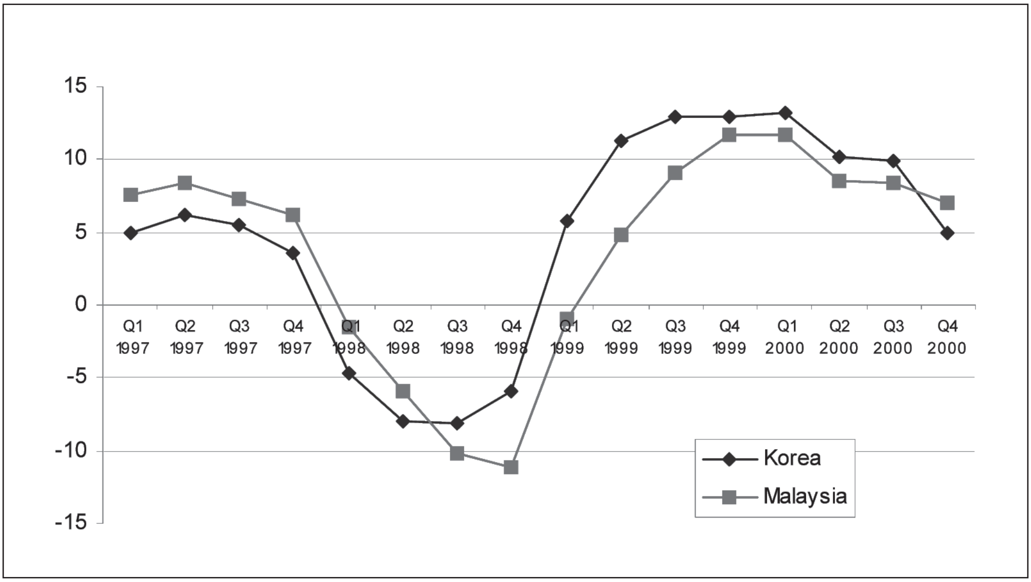
The IMF believes that their package was the main driver for rapid economic recovery and emphasize that such recovery could not have taken place without the IMF bailout and subsequent policy advice. This approach has met with considerable criticism from several prominent economists, which is directed to the fact that the underlying causes of the crisis were fundamentally different from previous economic crises. According to these economists, the crisis was not a result of wrongly managed government expenditures and weak budget and current account deficits, but was more a result of the heavily-indebted private sector. Thus, according to many economists expansionary policies would have been better alternatives (Sachs, 1998; Krugman, 1998; Koo & Kiser, 2001; Crotty & Lee, 2002). One of the main proponents of this view is ex vice-president and former chief economist of the World Bank, Joseph Stiglitz. When the IMF announced its policy package for the Asian countries in crisis, Stiglitz anticipated a recession and collapse of highly indebted firms as a result of the high interest rates under strict monetary policies. He states that 'every recession eventually ends. All the IMF did was to make East Asia's recessions deeper, longer and more difficult.' (Stiglitz, 2000). Additionally, the UN also put forward criticism on the implementation of strict fiscal and monetary measures in Korea, as current account deficits were moderate (UN 1998: 69). The IMF would also later give in to this view.

Other scholars are more positive toward IMF policies in Korea. For example, Lee and Han (2006) agree that the recession was exacerbated due to IMF prescriptions and that employment fell. However, in their opinion, this is merely a short term consequence. They agree with the IMF that in the long term IMF policies will have a strong positive effect since the policies resulted in structural reforms in the corporate and financial sectors (Lee & Han, 2006). This view is shared by *'The Economist'* that additionally praises the 'swift disposal of bad debts' (The Economist, 2002). To what extent this is right will be discussed in the next section. What is clear is that in the short-term IMF policies have resulted in massive unemployment and significant uprooting of the employment sector. Around middle 1998, unemployment in Korea had risen to about 8%, which was more than double the pre-crisis level. In absolute numbers, this entailed a rise in unemployed from 420,000 people to 1.41 million in only six months (Lee & Han, 2006: 307). Finally, criticisms arose on the issue of non-financial IMF reforms. It was said that the reforms were envisioned in order to give major shareholder governments within the IMF the opportunity to serve their national interests. For example, the United States was seen as the main protagonist in allowing increased participation of foreign companies in Korea (Wade, 1999).

While conservative IMF policies received criticism, the announcement of the implementation of capital controls in Malaysia was met with much more controversy. It was feared that the Malaysian economy would experience extreme slowdown, and perhaps would not be able to recover from such measures (Prestowitz, 1999). Nevertheless, after the implementation of capital controls in September 1998, a fast and strong recovery followed. The offshore trading ban 'halted capital flight, which allowed reductions in interest rates and business expansion' (Case 2005: 292). Yet, regarding the general economic recovery, there is also skepticism to attribute this directly to capital controls. Many stress the importance of other (international) factors that are responsible for the rapid recovery (Jomo, 2003; The Economist, 2002; Kawai & Takagi, 2003). According to Jomo and the Economist, recovery should be attributed to the presence of a considerably effective pre-crisis regulatory environment and expansionary policies (Jomo, 2003; The Economist, 2002).

However, there is opposition to these negative views as concerns the impact of capital controls. Several other scholars strongly believe that capital controls were the most important factor behind economic recovery (Meow Chung in Barlow, 2001; Furman and Stiglitz, 1998). Kaplan & Rodrik (2001) made a convincing case for capital controls in their insightful paper, *Did the Malaysian Capital Controls Work?* In contrast to other studies, their analysis is based on a time-shifted approach, meaning the usage of the starting dates of the implemented policies. They claim that while the other countries already benefited from the implementation of the IMF program, Malaysia's financial market pressure did not reach its highest point until September 1998. In addition, Malaysia implemented capital controls nine months after Korea received IMF treatment. Interestingly, the outcomes of the time-shifted difference approach favor Malaysia's capital controls in many aspects. However, Kaplan and Rodrick do take into account additional factors that contributed to this outcome such as expansionary policies which led to a revival of demand. In the sub-section below the time-shifted difference approach is applied in order to compare economic growth rates in order to analyze the severity of the crisis.

Figure 1 Real GDP Growth (Percentage)



Source: IMF (2007c)

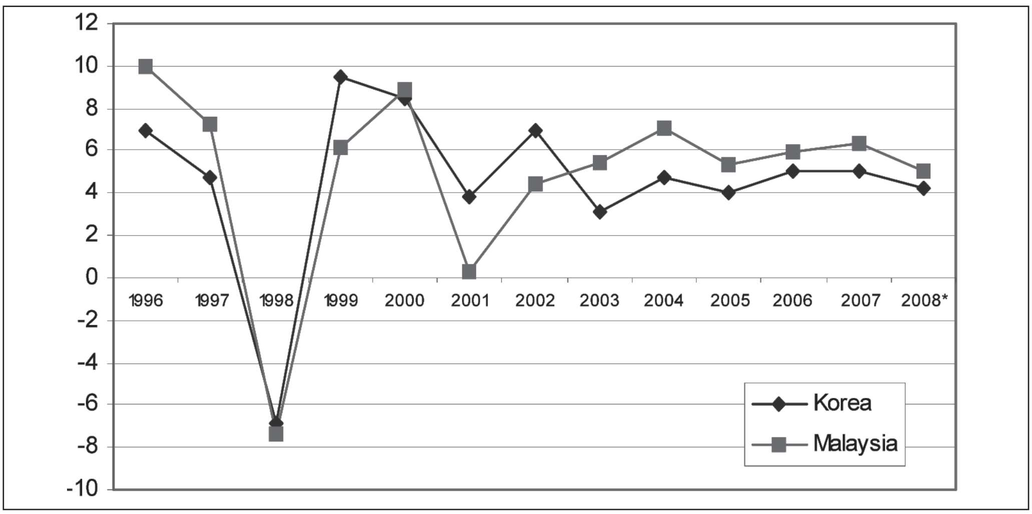
Figure 1 shows quarterly trends in the real GDP growth between 1997 and 2000. Three interesting observations can be inferred from this data. First, while Korea was already recovering from its recession, Malaysia experienced the largest output collapse. Second, Korea's recession, while less deep than Malaysia's, was more severe in duration. In fact, the IMF started to inject capital in Q4 of 1997, but GDP growth only started to recover one year later. Third, Malaysia experienced a deep output contraction, mainly *before* the implementation of capital controls; note that the controls were implemented in September 1998. This supports Kaplan & Rodrik's analysis wherein they establish that Malaysia experienced a significantly lower reduction in growth after the implementation of the measures (around 5 percentage points depending on a monthly or quarterly analysis).

Therefore, taking into account the time-shifted approach, it appears that Malaysia has done comparatively well. While Korea's output recovery in 1999 was more impressive than Malaysia's, it had suffered a lengthier output contraction in 1998 after the implementation of the IMF package. The recovery in Malaysia followed much quicker after the imposition of capital controls. In this respect, capital controls seem to have been less harmful than IMF policies that due to their initial tightness have severely impacted the growth of the Korean economy. What can be concluded here is that capital controls did not generate, as many anticipated, detrimental effects on the Malaysian economy.

3. Korea and Malaysia Ten Years After the Crisis: Analysis of Long -Term Consequences

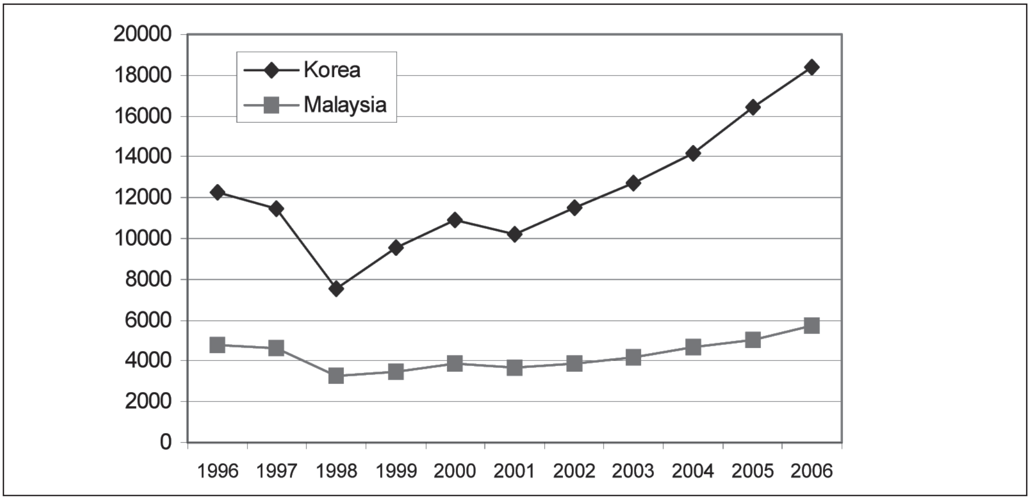
The previous parts of this paper pointed to the relatively successful and quick recovery of both countries' economies in the short term. In this sub-section, socio-economic indicators such as gross domestic product (GDP) growth, unemployment rate, foreign direct investment (FDI) and amount of NPLs will be assessed over a ten year period in order to get a better sense of the long term consequences of the crisis for Korea and Malaysia.

Figure 2 GDP Growth (Annual Change in Percentage)



Source: ADB (2008a) (*forecast)

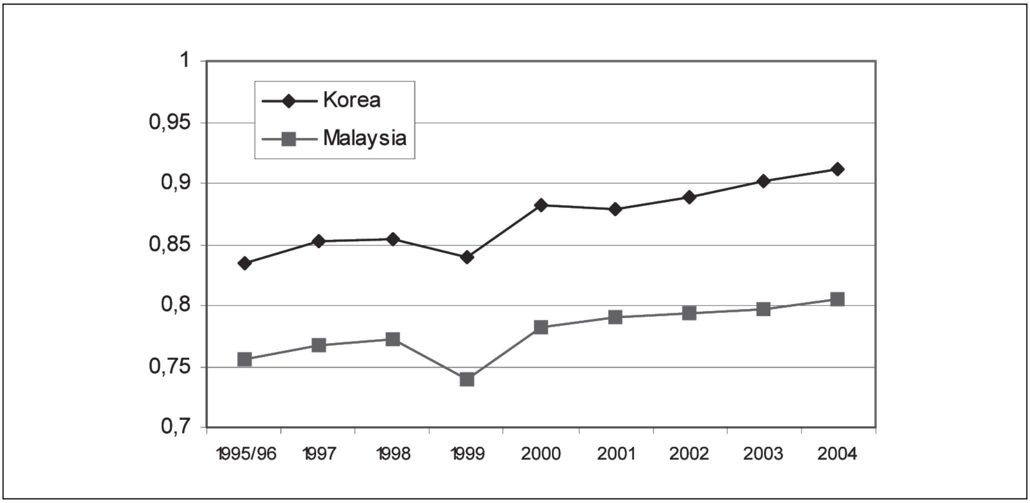
Figure 3 GDP per Capita (US$, in Current Prices)



Source: IMF (2007b)

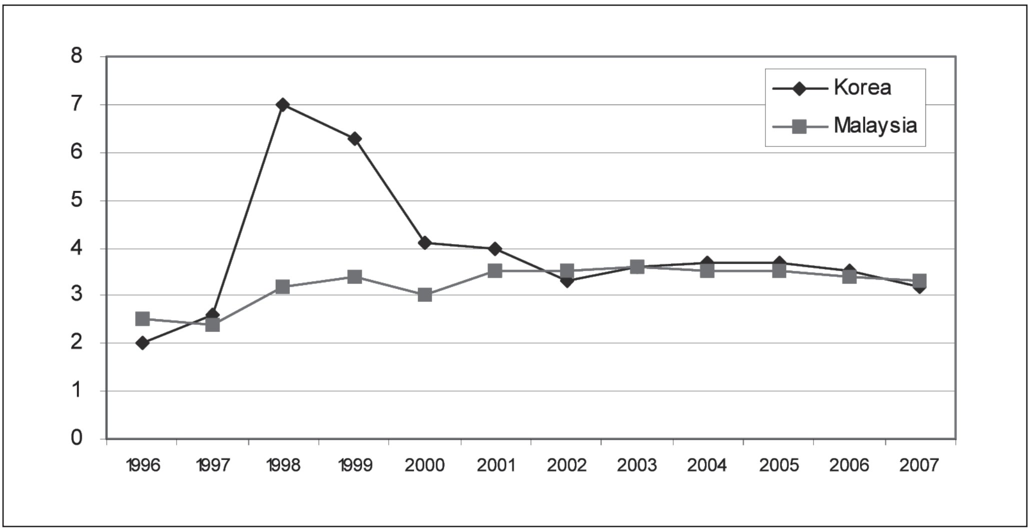
This analysis starts with GDP growth as presented in Figure 2. In 1999, the year directly following the crisis, Korea experienced an impressive growth rate of 9.5%. This growth rate was even higher than its pre-crisis rate of 7%. Malaysia's recovery was less impressive at around 6.1%, but Malaysia surpassed Korea in 2000. 2001 was a problematic year due to the end of the boom in information and communication technologies and the attacks on the World Trade Centre in New York, reflected by the dramatic fall of the NASDAQ between April 2000 and the end of 2001. After 2002, Malaysia showed consistently higher growth rates than Korea. It is possible that this was an effect of the tight fiscal and monetary policies employed in Korea; however, the ADB suggests that with Korea reaching the status of a developed country in the 1990s, it has also experienced structurally lower growth rates afterwards, following the path of many other developed countries (ADB, 2007). What should be noted is that both countries have not been able to attain pre-crisis growth levels. Figure 3 takes into account population. Compared with Figure 2, Korea has performed much better in this respect in that it experienced a sharper drop in GDP per capita during the crisis, yet it recovered quicker than Malaysia. Furthermore, Korea was also able to increase its GDP per capita during the period after the crisis. It is likely that the growth of population is largely responsible: between 2000 and 2005 the average annual population growth in Korea was 0.5%, but 2.2% in Malaysia. In addition, the World Bank suggests that Malaysia faces a 'middle-income trap', in which it struggles to shift from manufacturing to more advanced sectors, to create a highly skilled labor force and ultimately to attain higher income levels (World Bank 2007: 26). However, it is important to not only analyze GDP growth rates, but it is equally important to examine social indicators, which are provided below.

Figure 4 Human Development Index (0=worst, 1=best)



Source: UNDP various years

Figure 5 Unemployment Rate (Percentage)

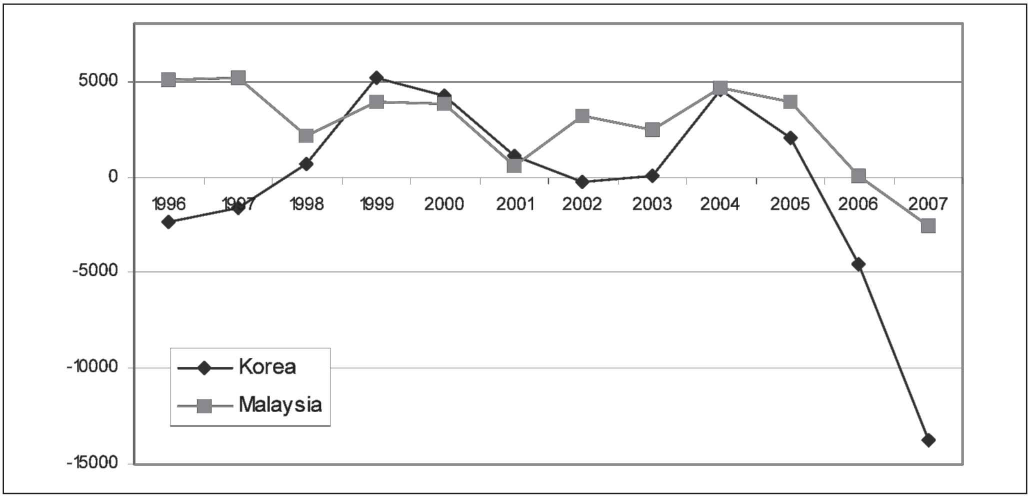


Source: ADB (2008c)

Figure 4 depicts the trends in the Human Development Index (HDI), a composite index developed by the United Nations Development Program (UNDP) and intellectually influenced by the Nobel Prize Laureate in Economics; Amartya Sen. The HDI is an index which combines the following indicators: life expectancy at birth, gross enrollment ratio in schools, literacy and GDP per capita (purchasing power parity) (UNDP, 2006). Both Malaysia and Korea have experienced steady improvements concerning HDI. While the crisis significantly affected the HDI score in the years immediate following the crisis, both countries were able to return to the pre-crisis HDI and increase their HDI score subsequently. Another relevant social indicator is the unemployment rate. Figure 5 seems to confirm that the crisis had a more severe impact in Korea. Within a time span of less than 2 years the unemployment rate in Korea more than tripled. In Malaysia the increase was less severe. Several factors might have influenced this difference. Due to tight fiscal and monetary policies, in combination with their already weak financial position, in Korea, many large companies went bankrupt. At the highpoint of the crisis as many as 100 companies went bankrupt in a day (Choi, 1999). Furthermore, tight policies resulted in less public expenditures, lower domestic consumption and investment. Therefore, it is no surprise that a good deal of lay-offs of workers took place during and after the crisis and that the era of lifelong employment came to a halt. This was in direct contrast to Malaysia, in which fewer companies had to cope with weak financial positions.

In Malaysia, better pre-crisis regulatory and supervisory policies, ensured a healthier business climate, which resulted in fewer lay-offs of workers (Jomo, 2003). However, an important factor that should be taken into account is a large presence of foreign workers (Menon in Barlow, 2001: 37-38). Data for the year 1993 estimated that 16% of the workforce consisted of these workers. The bulk of these workers were illegal and thus, not included in employment figures. When the crisis hit Malaysia, foreign workers were the first to lose their jobs, as their contracts were not renewed (Meesok et al., 2001: 7). In addition, the NEP might also explain the low unemployment figure during and after the crisis. The NEP, favoring redistribution to ethnic Malays, has been strongly inward-looking and protective of local markets which led to a limited negative impact of the crisis on local industries.

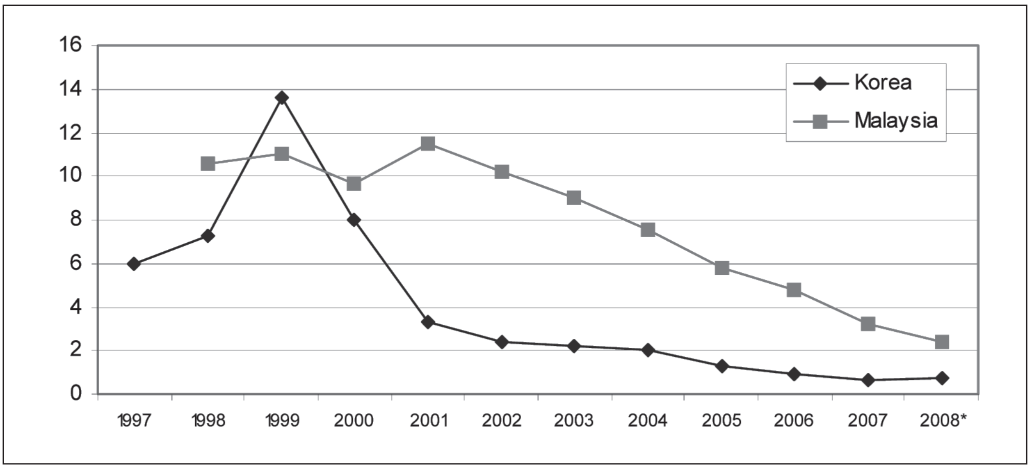
Figure 6 FDI Net Inflows (US$, Millions)



Source: ADB 2008c

While the capital controls were not aimed at limiting FDI inflows, many commentators mentioned that the controls would have a serious negative impact. As seen in Figure 6, this did not happen. FDI inflows recovered considerably in 1999. Both in Korea and Malaysia, net inflows fluctuated heavily in recent years. The evidence does not seem to indicate that capital controls had any clear long-term effects on FDI for Malaysia.

Figure 7 NPL of Commercial Banks (Percentage of Total Loans)



Source: World Bank (2007) : 63 and ADB (2008a) (*forecast)

The problem of NPLs is seen as one of the main contributors to the weaknesses of the financial sector. Unfortunately, pre-crisis information for NPLs for Malaysia could not be obtained. From Figure 7, it can be seen that both countries have significantly reduced NPLs as a percentage of total loans since 1999. In Korea, NPLs amounted to 0.9 percent of total loans in 2006 and Malaysia has also succeeded in reducing the amount, albeit relatively less impressive. The decrease in the ratio of NPLs can be attributed to the establishment of Asset Management Companies (AMCs) that were established after the crisis. While these AMCs have been successful, new build-ups of NPLs remain a serious concern for the banking sector (Yam, 2003).

Poor maturity structures of debt were a main problem in Korea. Indeed, the ratio of short-term debt/total debt was much too high. Fortunately, Korea was able to decrease its percentage of short-term debt of the total debt significantly after the crisis (ADB, 2006). The ratio increased in both countries in the last few years, but it is still remarkably lower than during the pre-crisis situation. Debt-to-equity ratios improved as well. The Korean ratio decreased from 161.28% in 2002 to 71.18% in 2006, and the Malaysian ratio decreased from 82.17% in 2002 to 54.11% in 2006 (ADB 2007: 57). Finally, the current account balance improved in both countries. Before the crisis, both countries had a current account deficit, and high surpluses were recorded after the crisis. However, in both countries these surpluses decreased after 2000, particularly in Korea. Trends in the balances seem to reflect changing international economic relations, such as the end of the high tech boom and increasing Korean imports rather than the effects of IMF policies and capital controls.

This sub-section compared Korea and Malaysia based on socio-economic indicators. The data in Figures 2 through 7 suggests that both Korea and Malaysia have been able to recuperate from the crisis quite convincingly. Korea has shown commitment to increase its efforts to eliminate NPLs and other financial flaws. However, the unemployment rate remains worrying. The ten year post-crisis rates have been consistently higher than pre-crisis rates. Fear of capital controls being harmful to Malaysia's foreign investment inflows seemed not to hold directly. Indeed, FDI decreased in both countries and is therefore difficult to attribute to capital controls per se. As concerns GDP growth, Malaysia's growth rates have been slightly higher, but population growth has been significantly higher than Korea's. Interestingly, neither IMF policies nor capital controls has seriously affected the HDI in the long-term. The 2006 scores for both countries are higher than the 1996 scores. As government actions or inactions have been of tremendous importance for the onset of the crisis, its development and recovery, the following section will examine more closely the current role of government; what changes have occurred regarding government attitudes and policies and how these issues influenced the post-crisis performance of both countries.

The Political Economy of Marginal Reforms

In Korea in late 1997, Kim Dae-Jung was elected president as the incumbent party of Kim Young Sam was voted out of government. The outcome of the 1997 elections can largely be attributed to the economic crisis. However, earlier resentment over favoritism and corruption already diminished the president's reputation before the crisis started (Freedman, 2002: 242). The new government of Kim Dae-Jung was burdened with the heavy task of overcoming the financial crisis. While the IMF is seen as the main organization behind the policy measures of the stringent neo-liberal reforms, some reforms had in fact already been implemented before the crisis. But, these reforms resulted in a lack of control of the chaebols, which eventually made the economy completely susceptible to the crisis (Crotty & Lee, 2002: 320). Furthermore, the idea that neo-liberal policies were imposed upon Korea is not entirely reflective of the situation. The reforms made, would probably have been implemented even if the crisis would not have taken place, albeit in a somewhat moderate fashion (Hundt, 2005: 244-248). Because Korea accepted these measures under IMF conditions, the government was able to blame at least part of the economic slowdown on the IMF intervention (Woo-Cumings, 2001: 363).

The neo-liberal reforms were in line with the general policy of the new Kim government that indicated that it would take a tougher stance on chaebol practices. This policy continued after 2002 when Mr. Roo Mhoo-Hyun became president. According to Hundt and Ahn & Lee (2005) this has led to an interesting paradox: the neo-liberal reforms did not weaken the influence of state elites, but instead increased their influence on economic policy making (Hundt, 2005: 242; Ahn & Lee, 2005). Chaebols were the main losers because foreign firms were increasingly allowed to start businesses in Korea. While the return of the state might be inconsistent with the main idea of neo-liberal reforms, it is a plausible outcome. In this respect, what should be kept in mind is that the return of the state resulted in more of a supervisory and regulatory role, rather than a traditional interventionist role. This is in accordance with the neo-liberal notion that the state has a supervisory role instead of the state being actively involved in the economy.

In the most recent presidential election which was held in December 2007, Lee Myung-bak of the Grand National Party won with a landslide victory, thereby returning the conservatives to parliament for the first time since they were voted out in 1997 at the height of the Asian financial crises. At the start of Lee Myung-bak's term, economic issues were at the top of his agenda and would only become more so as the consequences of the US sub-prime crisis spread over the globe, and into the strongly recovered Asian economies.

The Malaysian experience has been remarkably different and rather unstable. Although the same coalition has remained in power, headed by the United Malays National Organization (UMNO), it embarked on major policy changes. According to Case (2005), the following periods can be identified:

- Late 1999-beginning 2002: some neo-liberal reforms. When Malaysia's economy started to recover from the crisis in 1999, the Malaysian government under Mahathir was quick with abandoning the strictest regulations regarding capital controls. Yet, this seemed insufficient to the outside world as in the year 2000 FDI and export markets began to weaken, thus, capital controls were abandoned in 2000.
- Beginning in 2002 to late 2003: new state interventions. Neo-liberal reforms did not significantly improve foreign direct investments and as anti-reform UMNO politicians 'whose fortunes depended on patronage as well as their networks with local business elites' regained considerable power, the Federal Government revived support for 'local markets, especially agriculture, small business and services'.
- Late 2003 to the end of 2006: towards a pre-crisis equilibrium. Mr. Abdullah Badawi, who became UMNO's president and Malaysia's prime-minister in October 2003, tried to satisfy both foreign investors, domestic elites and the general population. For example, he turned to neo-liberal reforms in order to increase Malaysia's portfolio and FDI flows. Note that Figure 6 indeed shows substantial net FDI inflows between 2003 and 2005. On the other hand, he strongly supported a domestically oriented economy (notably the agricultural sector).

The initial strong political gains of Badawi were reversed during the 2008 parliamentary election in which UMNO experienced one of the worst setbacks in its history by losing its two-thirds majority in Parliament as well as control of five out of nine state assemblies. This setback was largely blamed on the failure of the UMNO to deal with rising inflation, crime and corruption (see the period 2002-2003 above) and increased ethnic tensions. As a consequence of the electoral blowout and discontent within his own party, Badawi stepped down in March 2009. His successor Dato' Seri Mohd. Najib bin Tun Haji Abdul Razak faces the task of protecting Malaysia from the current economic and financial woes originating from the subprime crisis.

Malaysia's overview of the political climate demonstrates, similarly to that of Korea, an interesting paradox. We have established in previous sections that capital controls have not been particularly harmful, yet it is important to recognize that they were not in place for a very long time and that some neo-liberal reforms have been implemented. It is interesting to compare the Korean paradox and the Malaysian shifts in government policies. Although neo-liberal policies were implemented in Korea, this did not result in a disappearance of the government from the political stage. While in the pre-crisis environment the government had a more interventionist role, after the crisis it has adopted a more regulatory role. In both countries, more prudent regulations have been implemented with regard to oversight of the financial market and corporations. In Malaysia, the state already possessed a strong regulatory position and state banking regulations were already in place before the crisis. In this respect, Malaysia was less vulnerable. Also the redistributive policies under the NEP entailed a strong influence of the state in the economy. What can be concluded here is that Korea's government is still present in the economy regardless of its liberalization policies. Conversely, the Malaysian government had to abandon capital controls and give in to some of the pressures of neo-liberalism.

4. Remaining Challenges and the Current Global Economic Turmoil

This section analyzes the future by combining remaining internal challenges and the effects of current international trends. What are the major challenges for the Korean and Malaysian economy and how does macroeconomic policy seek to mitigate current economic and financial threats?

Before the subprime crisis in the USA turned into a banking and global credit crisis, outlooks for the Korean and Malaysian economies were quite promising, albeit observers remained cautious. For example, despite the various reforms, corruption remained an endemic feature in both societies (Freedman, 2002; Case 2005; Hundt, 2005). Also, the post-crisis per capita growth, which was on average 2 percentage points less then the pre-crisis growth and structurally lower fixed investment rates implies a less than full recovery from the 1997 financial crisis (World Bank, 2007). The ADB attributes the lower rates in Korea to the usual process once a country reaches the status of a developed country, but could not find conclusive explanations for the Malaysian case. More worrying might be the FDI outflows (Figure 6) and growing income disparities in the two countries. Between 1997 and 2004, the Gini coefficient in Korea increased from 0.28 to 0.32 and between 1999 and 2004 from 0.42 to 0.44 in Malaysia (Economic Planning Unit, 2006: 333; ADB, 2000 & 2007). Furthermore, Table 2 shows that despite many efforts, the Bumiputeras have not increased their presence in entrepreneurial life. According to the World Bank, such trends can be harmful for growth as 'poor people without access to credit may be unable to exploit investment opportunities' (World Bank, 2007). Additionally, it can be a source for political and social unrest.

Table 2 Ownership of Share Capital (at Par Value) of Limited Companies (Percentage)

	1990	**1995**	**2000**	**2004**
Bumiputera*	19,3	20,6	18,9	18,9
Chinese	45,5	40,9	38,9	39
Indians	1	1,5	1,5	1,2
Others	34,2	37	40,7	40,9
Total	100	100	100	100

Source: Economic Planning Unit (2006: 336)

*Including trust agencies such as the State Economic Development Corporations

In light of the current credit crunch and global economic turmoil, the above factors are challenged even more and will have an impact on the economic situation in both countries. Yet, the most significant factor that will contribute to the economic slowdown in Korea and Malaysia seems to be the reliance on export driven growth by both countries. As the USA and large parts of Europe are in recession, demand from these countries will inevitably affect the exports of the export-led economies of Korea and Malaysia. For Korea, January 2009 exports fell by 32.8% compared to a year ago. (Lee, 2009). Malaysia's exports are also forecasted to drop significantly in 2009. Fortunately, as imports are projected to go down for both countries, the impact on the current account balance is expected to be limited.

However, overall, these drops in exports combined with a loss of consumer confidence will lead to strong economic decline. As such, forecasts for 2009 have already decreased significantly. While Korea experienced an economic growth rate of 4.2% in 2008 (ADB, 2008a: 30). it is expected to decrease with forecasts ranging from a growth rate of 3.0% or 2% (ibid; Economist, 2008). to an even more gloomy forecast as a – 4% growth rat. (IMF, 2008). Malaysia experienced a GDP growth of 5.0% in 2008 and this is expected to fall to numbers ranging from 3.5% to 3.2% (ADB, 2008a: 30; Economist, 2008).

Table 3 Reaction of the Korean and Malaysian Government to Global Economic Turmoil

	Korea	**Malaysia**
Deposit Guarentee	Guaranteed banks' external debt taken up from 20 Oct 08 to 30 Jun 09 for 3 years	Blanket guarantee on all deposits until Dec 2010, announced 16 Oct 08
Regulatory Forbearance	Announced plans to implement selective lifting of real estate regulations on 21 Oct 08	
Monetary Policy	Interest rate cuts FX swaps	Interest rate cuts capital provision to insurance insurance companies
Stock Market	Imposed temporary ban on short selling on 8 Oct 08.	Announced plans to infuse additional Rm 5 billion in a state agency to buy undervalued stocks
Fiscal Measures	Announced increased spending of KRW10 trillion for 2009 on 3 Nov 08, which includes infra expenditure, financial support for small and medium-sized business and tax cuts.	Announced a Rm 7 billion fiscal stimulus package on 04 Nov 08. Reduced subsidy on gas and diesel in Jun 08, followed by cuts in gas and diesel prices in Aug and Sep.

Source: ADB (2008a)

The eventual impact of the current crisis and subsequent recovery depend on a large part on the susceptibility of the economy and the policies enacted by the government to deal with the economic and financial turmoil. Table 3 summarizes important actions taken by the Korean and Malaysian governments as documented by the ADB. Malaysia and Korea have some common factors of concern yet there are also substantial differences.

Korea, as one of the few countries in the region, has a current account deficit and a large indebtedness of households and firms (Economist, 2008). This, coupled with the post-crisis problem to create employment indicates that trouble lies ahead. According to the Economist, inflation will decrease due to falling energy and food prices, which will allow even further cuts in interest rates (ibid). Moreover, contrary to the tight fiscal policies employed during the 1997 financial crisis, Korea moved quickly to announce a fiscal stimuli package and a bailout package for the

Korean banking system (Table 3). The combination of expansionary fiscal policies as well as the cheaper won (stimulating exports) are believed to be the main drivers behind Korea's economy (ibid). Malaysia will be hit by a lower foreign demand for its products, similar to Korea; especially since its exports make up over 100% of its GDP (ibid). One direct consequence of the economic slowdown is already visible on the labor market where foreign labor migrants are being laid off increasingly and sent back to their home countries. (Pradhan, 2009). As such, the direct impact on the Malaysian labor population might be limited, a phenomenon which was also observed following the 1997 downturn. Similar to Korea, fiscal stimuli, a stronger oversight on banking activity, as well as a depreciating ringgit are seen as the main buffers by which to keep excessive losses limited (Table 3).

5. Conclusion

This paper examined the economic developments of Korea and Malaysia in the ten years following the 1997 Asian economic crisis. Both countries were praised for their impressive recoveries in the immediate post-crisis period. The policies employed by these countries can be seen as the main contributors to their recoveries. However, the central question with which this paper is concerned is: Were the initial observations regarding the recoveries in Korea and Malaysia overly optimistic when examining the long-term consequences of the crisis?

What has been observed from the ten year analysis is that the initial strong recovery to pre-crisis growth levels could not be maintained over the long run. Initial positivism has been stemmed as evaluations have demonstrated some structural weaknesses in the economies. In both countries, GDP growth is significantly lower than before the crisis and post-crisis unemployment is higher. Furthermore, post-crisis fixed investment is much lower than the pre-crisis period, which could account for the lower growth rates. A major new challenge that might be a direct consequence of these weaknesses is the increasing gap between the rich and poor. Regarding the political and policy environment, both governments have made significant improvements concerning transparency, regulations and supervision of the economy, but unfortunately, corruption and nepotism remain recurrent features in both countries' political economies.

As stressed by (Mahani et al., 2003) this paper has also shown that a heterodox policy such as capital controls is by no means doomed from the start. The case of Malaysia demonstrates that neo-liberal policies, usually favored by the IMF, are *not always* necessary for processes of economic recovery. In fact, the IMF package for Korea turned out to be too tight with negative consequences for employment, domestic demand and ultimately output levels. This implies that future monetary policy making in Asia should not blindly follow the Washington Consensus. Instead, each country should find its own right policy mix, possibly taking elements from the emerging so-called Beijing Consensus (Ramo, 2004). As concerns economic development, this consensus fosters high quality growth without an ideological obsession with free markets, deregulation and liberalization. This provides opportunities for achieving pragmatic solutions to financial meltdowns. Indeed, China and other Asian countries appear to recover quicker from the current turmoil in the global economy (Economist, 2009). Future policy research should focus on the question as to how relatively small countries might learn from the Chinese variety of capitalism. Perhaps the Chinese way offers some elements that are suitable to implement in macroeconomic frameworks elsewhere.

Nevertheless, exciting times are ahead for South Korea and Malaysia. The previous section highlighted the challenges in order to maintain economic resilience. The extensive stimuli packages and swift action with regard to the financial markets indicate that both countries are committed to boosting domestic as well as foreign confidence. These measures are promising and provide hope that both Korea and Malaysia will withstand most of the turmoil and will regain their growth positions in 2010. Moreover, it should be stressed that a continuous emphasis on further implementation of sound regulatory policies in order to improve corporate governance and financial markets is of great importance in order to mitigate the consequences of the current crisis, overcome long-term internal challenges, and even more important, to avert future crises.

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