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CRONYISM AND CAPITAL CONTROLS: EVIDENCE FROM MALAYSIA

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ABSTRACT

The initial impact of the Asian financial crisis in Malaysia reduced the expected value of government subsidies to politically favored firms. Of the estimated \$60 billion loss in market value for politically connected firms from July 1997 to August 1998, roughly 9% can be attributed to the fall in the value of their connections. Firing the Deputy Prime Minister and imposing capital controls in September 1998 primarily benefited firms with strong ties to Prime Minister Mahathir. Of the estimated \$5 billion gain in market value for Mahathir-connected firms during September 1998, approximately 32% was due to the increase in the value of their connections. The evidence suggests Malaysian capital controls provided a screen behind which favored firms could be supported.

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1. Introduction

Until the late 1970s, capital controls were widely used to prevent the free flow of finance. A cautious relaxation of such controls during the 1980s proved consistent with greater economic integration in Europe and strengthened the case for capital market opening more generally. By the time the IMF and World Bank encouraged a further wave of liberalization for "emerging markets" in the early 1990s, capital controls appeared to be finished as a serious policy tool for relatively open economies (Bhagwati 1998a). Today, however, capital controls are again being taken seriously. Malaysia reimposed capital controls in September 1998, China and Chile maintain effective capital account restrictions, and there is debate regarding the value of free capital flows in a number of crisis-prone countries, including Korea, Russia, and Turkey. Capital controls have also just begun to be mentioned as a possibility for Japan (Dornbusch 2001b).

There are two main views on the causes and effects of capital controls. The more established view emphasizes macroeconomics. If a country faces a severe external crisis, particularly one caused by pure panic, and if standard measures have failed, Krugman (1998) argues that imposing capital controls may be an effective way to stabilize the economy. More generally, Bhagwati (1998a and 1998b) and Rodrik (2000) oppose the conventional wisdom that free capital flows help countries benefit from trade liberalization, and argue instead that capital market liberalization invites speculative attacks. The recent performance of Malaysia has been interpreted as demonstrating that capital controls can have positive macroeconomic effects (Kaplan and Rodrik 2001), although this claim is controversial (Dornbusch 2001a).

While not denying the importance of macroeconomic issues, the second view puts greater emphasis on institutions (i.e., the rules, practices and organizations that govern an economy). Rajan and Zingales (1998) argue that capital controls are an essential part of the package of policies that allows "relationship-based" capitalism to function. In this system, informal relationships between politicians and banks channel lending towards approved firms, and this is easier to sustain when a country is relatively isolated from international capital flows. If capital controls are relaxed, as in some parts of Asia in the early 1990s, the result may be overborrowing and financial collapse (Rajan and Zingales

1998).[1] In this context, Rajan and Zingales (2001) suggest that reimposing capital controls may be attractive if it enables politicians to support the financing of particular firms (sometimes known as "cronyism"). At the same time, directed lending behind capital controls may store up problems in the form of bad loans and distorted incentives.[2]

Recent experience in Malaysia offers an opportunity to assess the extent to which capital controls are linked with cronyism. There are two testable implications at the firm level from the Rajan and Zingales view. Firms with stronger political connections should (1) suffer more when a macroeconomic shock reduces the government's ability to provide privileges and subsidies and (2) benefit more when the imposition of capital controls allows a higher level of subsidies.

Using data from Malaysia before and after the imposition of capital controls, this paper reports strong support for both hypotheses. In the initial phase of the crisis, from July 1997 to August 1998, of the estimated $60 billion loss in market value for politically connected firms, roughly 9% can be attributed to the fall in the expected value of their connections. With the imposition of capital controls in September 1998, of the estimated $5 billion gain in market value for firms connected to Prime Minister Mahathir, about 32% can be attributed to the increase in the value of their connections. For connected firms, the value of political connections was approximately 16% of their total market value at the end of September 1998.

Malaysia is an appealing case for several reasons. Researchers identified important relationships between politicians and firms before capital controls were imposed (Gomez and Jomo 1997). Politically connected firms may generally differ in unobservable ways relative to unconnected firms, but in the Malaysian data it is possible also to examine variation in performance within the set of politically connected firms.

[1] Theoretically, relaxing capital controls may lead to financial distress in at least three ways. First, local financial institutions may respond by taking on more risk. Second, local firms may borrow directly from international lenders who are either unable to assess risks appropriately or believe that there is an implicit sovereign guarantee. Third, after they lose their monopolies, local banks may be less willing to bail out firms that encounter problems, as in Petersen and Rajan (1995).

[2] Leading proponents of the macroeconomic perspective on capital controls are aware that institutional issues may be important as well. For example, Kaplan and Rodrik (2001) clearly state their concerns that capital controls may distort incentives and undermine future performance in Malaysia. However, their emphasis is on macroeconomic effects (i.e., for all firms), rather than the differential benefits for just some firms.

The connection of firms to individual politicians appears to have been based primarily on chance personal histories, i.e., who knew whom early in their careers. Therefore, because imposition of capital controls in September 1998 coincided with a major political realignment, with Prime Minister Mahathir Mohamad winning and Deputy Prime Minister Anwar Ibrahim losing, any "excess" gain for firms connected to the winner should provide a good measure of cronyism-with-capital controls.

In addition, throughout the Asian financial crisis that began in July 1997, Malaysia maintained a large and liquid stock market, so examining how stock prices varied across firms is a reasonable way to measure the effects of policy changes.[3] Anecdotal evidence suggests financial markets understood the crisis as threatening to politically favored firms and believed that the imposition of capital controls represented an opportunity for strong politicians to support some firms. The available information also indicates that these expectations have subsequently been met – for example, there have been numerous press reports of government support for well-connected firms after September 1998.

We find that firms' stock price performance in Malaysia is broadly supportive of the view that capital controls create a screen for cronyism. Firms with political connections had worse stock returns in the early phase of the Asian financial crisis, but once capital controls were imposed, these firms did better on average. One way to evaluate the size of this effect is to compare having a political connection with the consequences of being more indebted when the crisis hit. Malaysian firms with more debt suffered larger falls in stock price in the first phase of the crisis (through August 1998). Having political connections had a similar effect (in the sense of inducing a similar fall in stock price) to that of increasing a firm's debt-asset ratio by 50-60 percentage points, e.g., from the median of 23.3% to around 75% (roughly equivalent to a 3-standard deviation increase in the debt ratio). These results hold when we control for other measurable characteristics of the firms, such as debt, size, and sector. The results also hold when we control for whether a firm has the status of being "Bumiputera,"

[3] Analyzing stock prices has several advantages compared with looking at published financial statements. Financial statements appear only with a considerable lag and after many other events have taken place. Reported earnings do not always reflect actual performance, depending on

meaning that it is largely owned by Malays and qualifies for some official government support.

Consistent with the view that cronyism increases behind capital controls we find only firms previously connected to Prime Minister Mahathir experienced a disproportionate increase in stock price in September 1998. The stock market's reaction appears to have been confirmed by subsequent events – over the following year, Anwar-connected firms were either taken over by Mahathir-connected firms or their owners switched allegiance to Mahathir.

As a check on the plausibility of our results, we examine stock price variation within the group of Mahathir-connected firms, differentiating between those that previously had access to international capital markets and those that did not. All other things equal, if capital controls affect firms' access to funds and relationships with investors, we would expect a smaller increase in value for firms that had previously reduced their cost of capital by listing overseas. This is what we find in the data. Mahathir-connected firms with prior access to international capital markets experienced a small (and not statistically significant) increase in stock price following the imposition of capital controls. The main beneficiaries were Mahathir-connected firms that had not previously listed overseas.

The paper closest to our approach is Fisman (2001), who estimates the value of political connections in Indonesia, through looking at how stock prices moved when former President Suharto's health was reported to change. Fisman (2001) measures the direct effect of health shocks to a dictator, which is presumably quite specific to authoritarian systems, during a period of relative economic stability. The Malaysian experience lets us examine the interaction of cronyism and capital controls in a democracy. In addition, we are able to use variation between firms connected to winning and losing politicians. This helps ensure political connections rather than some other unobservable characteristics of firms drive our results.

Our paper is part of a growing literature that examines the performance of relatively privileged firms. Morck, Strangeland, and Yeung (2000) show that established,

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accounting practices. If there were any room for maneuver in an accounting system, we would expect politically well-connected firms to be more able to take advantage of it.

well-connected firms in Canada (as measured by family inheritance of control) are less efficient and had negative abnormal stock returns when the 1988 Canada-U.S. free trade agreement reduced barriers to foreign capital. La Porta, Lopez-de-Silanes and Zamarippa (2001) show that well-connected Mexican banks engaged in a considerable amount of irresponsible lending before the 1995 crisis, and this presumably contributed to the severity of the crisis when it came. To our knowledge, no previous papers have tried to measure the combined effects of cronyism and capital controls.

Our work is also related to the recent literature that shows important links between institutions and economic outcomes. Johnson, Boone, Breach and Friedman (2000) present evidence that the Asian financial crisis had more severe effects in countries with weaker institutions in general and weaker investor protection in particular (as measured by La Porta, Lopez-de-Silanes, Shleifer and Vishny 1997 and 1998). Mitton (2001) finds firm-level evidence that weaker corporate governance was associated with worse stock price performance in the Asian crisis, and Lemmon and Lins (2001) confirm these results using different definitions of governance and outcomes. More broadly, Morck, Yeung, and Yu (2000) argue that in countries with weak property rights protection, stock price movements are predominantly driven by political shocks.

Section 2 reviews the nature of political connections in Malaysia. Section 3 explains our data and methodology in more detail. Section 4 reports descriptive statistics for connected and non-connected firms. Section 5 presents our main results and robustness checks. Section 6 reports the available direct evidence on what happened to firm subsidies after the imposition of capital controls. Section 7 concludes.

2. Political Favoritism in Malaysia[4]

Two forms of political favoritism exist in Malaysia today (Gomez and Jomo 1997). The first is the official status awarded to firms that are run by ethnic Malays. The second consists of much more informal ties that exist between leading politicians and firms that are run by both Malay and Chinese business people.

[4] Much of this information is taken from Gomez and Jomo (1997), whose research was completed before the Asian financial crisis broke out in July 1997.

Although ethnic Malays (known as Bumiputeras, literally "sons of the soil") account for some 60% of the population, business in Malaysia has historically been dominated by ethnic Chinese. With an eye toward correcting this imbalance, and partly in response to ethnic rioting in 1969, the government instituted the New Economic Policy (NEP) in 1970. Since that time Bumiputeras have been given, among other privileges, priority for government contracts, increased access to capital, opportunities to buy assets that are privatized, and other subsidies. The ruling coalition in Malaysia for the past 30 years has been the Barisan Nasional, which is dominated by the United Malays' National Organisation (UMNO). Dr. Mahathir Mohamad, president of UMNO and Prime Minister of Malaysia since 1981, has consistently promoted Bumiputera capitalism (Gomez and Jomo 1997).

The increased state intervention required for implementation of the NEP has opened the door to greater political involvement in the financing of firms in Malaysia.[5] As the government has more actively handed out favors to firms, businessmen have increasingly used personal connections to influence the allocation of those favors. During Mahathir's tenure as Prime Minister, three government officials, along with their associated protégés, concentrated the power to help business in Malaysia. The first is Mahathir himself. The second is Daim Zainuddin, who was finance minister early in Mahathir's term and who was brought back into government in 1998. He has been perhaps the most powerful person in corporate Malaysia and is generally considered to have been consistently close to Mahathir (at least until summer 2001). The third is Anwar Ibrahim, who, before his downfall in September 1998, was second in power to Mahathir and had numerous corporate connections. While Anwar was closely allied with Mahathir before the crisis, in 1998 he came to be regarded as a potential rival. Although other officials in Malaysia may have provided valuable connections for businessmen, Mahathir, Daim, and Anwar have clearly been the most dominant figures. This is illustrated in Appendix Table 1, which lists politically connected Malaysian companies

[5] For example, when Mahathir was minister for trade and industry in 1980 he helped set up the Heavy Industries Corporation of Malaysia (known as Hicom). Hicom subsequently invested in the auto industry, steel and cement. This kind of investment involved the government in picking which private sector firms received access to investment resources (Perkins and Woo 2000).

and to whom they were connected before the Asian financial crisis began in summer 1997.

Note that there is no evidence that the allocation of firms to Anwar rather than Mahathir was the result of anything other than chance personal relationships. Before the Asian financial crisis, affiliation to either politician was a close substitute, and we have found no evidence that being close to one was preferable to being close to the other. We therefore have no reason to believe that unobserved characteristics of these firms determined their political affiliations. Any systematic differences in the performance of those firms should therefore be due to the changing relative value of their political connections.

3. Data and Methodology

In this section we describe our sample of firms, define the crisis period, and describe the variables used and how they were constructed.

Sample

The sample consists of all Malaysian firms with at least a minimal amount of data in the Worldscope database as of October 1999. Although all firm characteristics are measured on a pre-crisis basis, we use this later version of the Worldscope database because Worldscope has substantially increased the number of firms that it covers over time.[6] The 424 firms in our sample are representative of the firms that are listed on the main board of the Kuala Lumpur Stock Exchange. Firms not represented in the sample include smaller unlisted Malaysian firms and multinationals with no local listing.

Crisis and Rebound Periods

Figure 1 shows an index of stock returns of Malaysian firms in Worldscope for 1990 to 1999, measured in both U.S. dollars and Malaysian ringgit. Lines on the chart delineate the “crisis period” as defined in this paper. The beginning of the crisis period corresponds to the devaluation of the Thai baht on July 2, 1997, a date generally considered to be the starting point of the Asian financial crisis. The end of the crisis period and start of the "rebound period" corresponds to the imposition of capital controls on September 2, 1998 when the stock index began a sustained upward trend.[7]

Other studies have focused on September 1998 as a key date in the Malaysian crisis. Kaplan and Rodrik (2001) explain the nature of Malaysian capital controls in detail, and assess how economic performance differed after September 1998. The most detailed account of Malaysia's economic crisis, Jomo (2001, chapter 7), also identifies the beginning of September 1998 as the critical turning point.

Political Connections

To identify which firms have political connections with government officials, we rely on the analysis of Gomez and Jomo (1997). We code as "politically connected" any firm which Gomez and Jomo (1997) identify as having officers or controlling shareholders with close relationships with key government officials – primarily Mahathir, Daim, and Anwar. Appendix Table 1 lists each firm identified as connected and the nature of the connection.

Using the analysis of Gomez and Jomo (1997) to identify connections has two limitations. First, these authors do not claim to have exhaustively identified every firm with political connections in Malaysia. This limitation is not too troublesome, because if they likely focussed on the subset of firms with the strongest connections or the subset of the largest firms with connections. Because larger firms generally had better stock price performance during the crisis, this would make it harder for us to find that (larger) connected firms performed worse during the crisis. The second limitation is that, while all connections identified by Gomez and Jomo (1997) are from before the crisis, some are identified from earlier in the 1990s, creating the possibility that a connection could have disappeared prior to the beginning of the crisis.[8] However, given the relative stability of

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[6] All the firms included in Worldscope prior to the crisis were still included in October 1999, so there is no sample selection bias due to firms dropping out of the data set.

[7] Capital controls were announced on September 1 and the ringgit-dollar rate was fixed in the early afternoon of September 2, 1998.

[8] In the second edition of their book, which was prepared in late 1997 and which appeared in 1998, Gomez and Jomo (1998) updated their list of political connections. We have used this revised list as a robustness check and find that it does not affect any of our main results. However, we prefer to use their pre-crisis list, as this was complete before there was any sign of economic trouble.

the government over this period, this limitation is also not too worrying. The variable we call “Politically Connected”, then, is a dummy variable that is set equal to one if the firm has a connection as listed in Appendix Table 1, and zero otherwise.

We use the same source, as reported in Appendix Table 1, to create another dummy variable called “Anwar Connected” which is set equal to one for politically connected firms whose connections depended primarily upon Anwar (based on the data presented in Appendix Table 1; 14 firms in total). We code a firm as “Mahathir Connected” if the connection in Appendix Table 1 is to Mahathir, Daim (Mahathir’s consistently close political ally), UMNO (the ruling party controlled by Mahathir), or to another politician. Note that some firms are associated with both camps and that a few firms are politically connected but the precise nature of the connection is not identified.[9]

Description of Other Variables

To measure firm performance we use dividend-inclusive monthly stock returns expressed in Malaysian ringgit. We do not calculate abnormal returns using historical betas because data limitations prevent calculation of pre-crisis betas for many of the firms in the sample.[10] Instead, we control for factors that could affect expected returns by including leverage, size, book-to-market ratios (Fama and French 1992), and industry in the regressions.

Firm size is measured as the logarithm of total firm assets.[11] As a measure of leverage we use the firm’s debt ratio, measured as the book value of total debt divided by total assets. We include dummy variables for 12 of 13 industries, where industries are defined broadly, as in Campbell (1996), and correspond with the firm’s primary SIC

[9] If a firm is indicated in Gomez and Jomo (1997) as being connected to both Anwar and Mahathir (a total of 5 firms), then it is coded as a 1 for Politically Connected, but as a 0 for Anwar Connected and as a 1 for Mahathir Connected. This seems the best way to identify those firms that a priori we would expect to suffer from Anwar's downfall.

[10] Even requiring a price history of just 24 months, we can calculate betas for only 65% of the firms in our sample. In this subsample, all of our key results are robust to including beta in the regressions.

[11] Because politically connected firms, on average, are larger than non-connected firms, we repeat our regressions using nonlinear measures of firm size to ensure that size effects do not drive our results. Our results are robust to including variables for total assets, total assets squared, and total assets cubed, as well as the logarithms of these measures, either separately or in combinations.

code. The book-to-market ratio is defined as the book value per share divided by the stock price. All of these variables are constructed using data from Worldscope, and they are measured using the last available information prior to the beginning of the crisis.

Return on assets is defined as net income (before interest and after taxes) divided by beginning-of-year total assets. Profit margin is defined as net income divided by net sales. The current ratio is defined as current assets divided by current liabilities, and the quick ratio is current assets minus inventory divided by current liabilities. Asset turnover is defined as net sales divided by total assets, and inventory turnover is cost of goods sold divided by inventory. Finally, we assume short-term debt is anything with maturity less than a year.

As a reasonable proxy for access to international capital markets, we look at where firms' stocks were traded before the Asian crisis started in summer 1997.[12] A significant number of Malay firms are traded in countries other than Malaysia, including Singapore (the so-called Central Limit Order Book, CLOB), the U.S. (either a direct listing or an ADR), London, and (in a few cases) Seoul or another foreign exchange. Other firms trade only on the Malaysian market. Of Mahathir-connected firms, 40% trade overseas and 60% trade only in Malaysia.

To identify whether firms are ethnically favored, we use data from the Kuala Lumpur Stock Exchange *Annual Companies Handbook*. For each firm, the handbook identifies how much of its ownership falls into the following categories: Bumiputera, non-Bumiputera, foreign, or government. The *Handbook* does not provide an exhaustive listing of all firms, so we are able to identify the ethnicity of ownership for only 74% of the firms. To categorize firms as Bumiputera-controlled, we focus on a definition given by the Corporate Affairs Unit of Malaysia's Securities Commission (press release, 8/27/96) that states that a Bumiputera-controlled company is one in which 50% or more of the equity is held by Bumiputera shareholders or institutions.[13] We assume that

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Our results are also robust to using net sales instead of total assets in all of these specifications. In short, there is no evidence that size effects are driving our results.

[12] Reese and Weisbach (2001) show that non-U.S. firms that list in the U.S. do this in part to improve their access to equity capital.

[13] A secondary definition from the same source notes that a firm may qualify as "Bumiputera-controlled" if 35% of the equity is held by Bumiputeras and 51% or more of the officers of the

shareholdings by government agencies contribute toward this percentage. Thus, the "Ethnically Favored" variable is a dummy variable that is set equal to one if the Bumiputera shareholdings are above this threshold and zero otherwise.

4. Descriptive Statistics

Table 1 reports the basic descriptive data for these firms. The first row reports the number of firms in each category of our sample, breaking it down by politically connected versus non-connected and then by Mahathir connected versus Anwar connected. We also look at non-financial firms separately, as a robustness check.

The second row shows that politically connected firms had significantly worse returns from July 1997 to August 1998, although there was no significant difference between Mahathir- and Anwar-connected firms. The third row shows that politically connected firms had significantly better returns in September 1998, and that Mahathir-connected firms performed much better than Anwar-connected firms. The fourth row shows no significant differences between politically connected and unconnected firms in returns after September 1998. Anwar-connected firms outperformed Mahathir-connected firms over this later period, although as we explain below this is probably because most were forced into the Mahathir camp after September 1998.

The fifth row of Table 1 shows that, in terms of total assets, politically connected firms were significantly larger (about twice the size on average) compared with non-connected firms, although asset growth immediately before the crisis was not significantly greater in connected firms (row 6). There is no evidence that Mahathir-connected firms had more assets on average than Anwar-connected firms.

The seventh row of Table 1 suggests that politically connected firms were less profitable than non-connected firms (in terms of return on assets) before the crisis. We investigate the profitability of firms further in Table 2. Panel A of Table 2 shows that once we control for other firm characteristics, there is no evidence that politically connected firms had lower profitability before the crisis.[14] With return on assets (in the

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firm are Bumiputera. This definition is not useful for our purposes because the ethnicity of officers cannot always be inferred from their names.

[14] Using data through 1995, fewer firms and a different specification, Samad (n.d.) finds that politically connected firms have higher profitability but no difference in investment behavior.

last full year of financial results prior to July 1997) as the dependent variable, the dummy variable for being politically connected is consistently insignificant. The separate dummies for being Mahathir-connected and Anwar-connected are also not significant in a regression with profitability as the dependent variable (not reported here).

Table 1 reports very little other difference in the operational efficiency of favored and non-favored firms.[15] The ratios for profitability (profit margin in row 8), liquidity (current ratio and quick ratio), and asset utilization (asset turnover ratio and inventory turnover ratio) show no significant differences across the dimensions of political connections (in terms of t-tests of the means). The book-to-market ratio is one way to examine whether investors perceive there is expropriation of assets by managers or controlling shareholders. These ratios are not significantly different for any group of firms before the crisis. Overall, we find no evidence suggesting that favored firms performed differently during the crisis because they were better or worse run before the crisis.

Corporate Indebtedness

If politically connected firms had greater leverage prior to the crisis, then this could explain some or all of the performance differences. A firm with higher debt would naturally be expected to perform worse in a crisis both because of the effect of leverage on a firm's covariation with the market and also because the depreciation of the local currency will hurt a firm if any of its debt is denominated in foreign currency.[16] The data on leverage in Table 1 shows that firms with political connections had debt-asset ratios some eleven-percentage points higher, on average, than non-connected firms prior to the crisis. However, politically connected firms had less short-term debt and while total debt to assets before the crisis was rising faster in politically connected firms, the opposite was true for short-term debt. These differences are only rough measures, however, in that they do not account for differences in industry or other characteristics.

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[15] In related work, Pomerleano (1998) uses ratio analysis to study the East Asian crisis, but focuses on differences across countries rather than differences among firms within a country.
[16] In addition, if the government responds to the crisis by raising interest rates – as in Malaysia early in the crisis – this will raise the cost of servicing corporate debt.

Panel B of Table 2 presents the results of regressions intended to measure the effect of political favoritism on levels of debt more carefully. We estimate the following model:

$$\textit{Debt ratio} = a + b_1(\textit{Political Connections}) + b_2(\textit{Size}) + b_3(\textit{Profitability}) + b_4(\textit{Growth}) + b_5(\textit{Industry Dummies}) + e,$$

where the inclusion of size, profitability, and growth follows the lead of Lee, Lee, and Lee (2001).

Panel B of Table 2 confirms that politically connected firms had more debt before the crisis. For the full sample, using only industry controls, politically connected firms had debt ratios eleven percentage points higher (with the coefficient is significant at the 5% level). Restricting the sample to non-financial firms does not eliminate the effect of politically connections on indebtedness, although it does reduce significance to the 10% level (result not reported in the table).

Controlling for size, profitability, growth, and industry accounts for part of the difference in leverage between favored and non-favored firms. Specifically, larger firms had higher debt ratios (columns 5 and 6), as predicted by Titman and Wessels (1988), and more profitable firms had lower debt ratios (columns 5 and 6), as would be suggested by Myers (1977). Firms with higher growth had lower debt ratios (column 6). Only the coefficient on profitability is consistently significant at standard levels, however. After controlling for these factors, firms with political connections still had significantly higher debt ratios than those that were not connected, although the coefficient is halved (to 4.7). We control for levels of debt in all of our subsequent empirical analysis.

5. Results

This section presents our main results and robustness checks. To assess the impact of political connections on stock price performance during various periods we estimate the following model:

$$\textit{Stock Return} = a + b_1(\textit{Political Connection Variables}) + b_2(\textit{Size}) + b_3(\textit{Book-to-Market Ratio}) + b_4(\textit{Debt Ratio}) + b_5(\textit{Industry Dummies}) + e,$$

where the stock return is measured over the indicated period and the political connection variables change according to the specification.

We take two testable hypotheses directly from Rajan and Zingales, and we add a third as a plausibility check.

1) The stock price of politically connected firms should have fallen more in the early crisis period.
2) The stock price of politically connected firms should have risen more once capital controls were imposed. Within the set of politically connected firms, the benefits of capital controls should be concentrated in firms that were linked to Mahathir rather than Anwar in September 1998.
3) Within the set of firms linked to Mahathir, those with prior direct access to international capital markets should have gained less from capital controls than those that had always relied just on the Malaysian capital markets.

We examine the evidence for each of these hypotheses in turn.

The Early Crisis: July 1997-August 1998

Table 3 presents the results from these regressions for the period from July 1997 to August 1998.[17] In the first three specifications, the Politically Connected dummy variable is included. The coefficient on the Politically Connected dummy ranges from –5% to –9%, indicating that a political connection is associated with a greater stock price decline of 5% to 9%, on average, during the crisis period of July 1997 through August 1998. These coefficients are significant at the 1% level of confidence. The control variables for size and leverage are also significant in these regressions, with larger size being associated with higher returns during the crisis, and higher leverage with lower returns.

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[17] We use heteroskedasticity-robust standard errors. The significance of our results is not altered if we adjust the standard errors of the coefficients to account for clustering of observations among firms with the same connected entrepreneur. Additionally, multicollinearity does not seem to be a problem in the model, as the average variance inflation factor of the coefficients is about 1.5 with September 1998 returns or crisis-period returns as the dependent variable (with maximum variance inflation factors no greater than 2.8). Also, errors-in-variables regressions indicated that our results are not particularly sensitive to measurement error.

In the final specification we include separate dummies for being connected to Mahathir or Anwar. Both types of politically connected firms had worse stock price performance than did unconnected firms: Mahathir-connected firms had an 8.3% greater decline and Anwar-connected firms had a 6% larger fall. The difference in performance between Mahathir- and Anwar-connected firms is not significant in this time period.

Note that depending on the precise specification, as many as 6 of the 12 industry dummies are significant in our "crisis period" regressions. The agricultural sector does relatively well, presumably because the demand for agricultural products is less susceptible to downturns. The other sector dummies that are usually significant are industrial (i.e., manufacturing, which is positive), utilities (also positive), and service firms (also positive). Most important for our analysis, we find that including industry dummies does not weaken the coefficients on the political connection variables, in fact they usually increase in size and always remain significant.

In the first phase of the financial crisis, therefore, favoritism based on personal relationships had a strongly negative effect on the stock price performance of Malaysian firms. This is broadly consistent with the Rajan and Zingales (1998) view that firms with strong political connections may suffer more in a financial crisis, presumably because the expected value of subsidies declines. It is hard to know exactly what the Malaysian government was doing with regard to such subsidies in 1997-98, but Anwar’s policy was to follow tight budget discipline along the lines of a de facto IMF program (although Malaysia did not sign up for official IMF conditionality). There was also a certain amount of political rhetoric regarding the need to reduce “cronyism” (and various statements from both Anwar and Mahathir about who was or was not a “crony”). Our results indicate that the market interpreted the policies of July 1997 to August 1998 as squeezing politically connected firms.

The Effects of Capital Controls

If politically connected firms performed poorly during the first phase of the crisis because the connections themselves decreased in value, then the Rajan and Zingales view predicts that connected firms would rebound more than non-connected firms when capital controls were imposed.

In general, it could be difficult to differentiate a rebound based on political connections from a rebound based on operating characteristics of firms. But Malaysian political events allow for a cleaner test. September 1998 marked both the imposition of capital controls and also the downfall of the second-most-powerful political figure in Malaysia, Deputy Prime Minister (and Finance Minister) Anwar. Once considered Mahathir's certain successor, Anwar was fired on September 2, 1998, and then jailed on charges of corruption and sodomy on September 20, 1998. Clearly, over the course of September 1998, these events reduced the value of political connections for firms with strong ties to Anwar. To the extent that politically connected firms enjoyed a rebound in September due to the increased value of their connections, we would not expect the same increase in value to be enjoyed by Anwar-connected firms. As we argued above, the allocation of firms to Mahathir rather than Anwar before the crisis was essentially random, i.e., it did not make any difference in terms of access to resources and was the result of historical accident rather than some systematic unobserved characteristic of firms.

The first four columns of Table 4 present the results of regressions of stock returns for September 1998 on the same variables as in Table 3.[18] Politically connected firms as a whole enjoyed a rebound in September 1998. A higher return of some 18.3%, significant at the 1% level, can be attributed to political connections, falling only slightly to 16.3% when we also control for firm size and book-to-market ratio.

The fourth column shows that while there is a large and significant positive coefficient on being Mahathir-connected in this month (19.9%), the coefficient for the Anwar-connected dummy is insignificant and actually negative. This result suggests that the value of political connections themselves was an important determinant of the fortunes of Malaysian firms during the crisis.

[18] One econometric issue is that errors across firms may not be independent because returns are correlated in calendar time. As a diagnostic measure to address this issue, we run simulated regressions of the actual return data on a wide variety of randomly generated hypothetical variables. In 10,000 repetitions using September 1998 returns, we find that the coefficients on the hypothetical variables are significant at the 1% level in 1.07% of the repetitions, at the 5% level in 5.27% of the repetitions, and at the 10% level in 9.97% of the repetitions. (The corresponding percentages using crisis-period returns are 8.50%, 4.87%, and 9.61% respectively.) The lack of spuriously significant coefficients indicates that correlation of the errors is probably not a serious problem in this data.

The last two columns of Table 4 show that, in contrast, from October 1998 to September 2000, there was no differential stock price return across firms with various types of political connections. Other regressions on some key sub-periods of this later period (not reported in the tables) also showed no significant effect of political connections. The imposition of capital controls appears to have been an unusually powerful political and market event.

Variation within Mahathir-Connected Firms

If capital controls constrain financial flows across borders, we would expect to see smaller gains for Mahathir-connected firms having access to international capital markets compared with Mahathir-connected firms without such access. Table 5 repeats our basic regressions, breaking down Mahathir- and Anwar-connected firms according to whether or not they were foreign listed.

Column 4 of Table 5 shows that the only significant gains for politically connected firms in September 1998 were actually for Mahathir-connected firms that were not listed on foreign exchanges before the crisis. This subgroup rose 26.6% relative to independent firms. Foreign listed Mahathir-connected firms also rose relative to the base, but this increase was not significant. Neither of the Anwar subgroups differed significantly from the base group.

To assess these results, in columns 1 and 2 of Table 5 we present the same regressions for the eighteen months before the crisis (January 1996 to June 1997) and for the crisis period. In both cases the pattern is much more even across the subgroups of politically connected firms, i.e., being foreign listed does not appear to have been associated with significant differences in performance prior to September 1998. The coefficient on the interaction of Anwar-Connected and foreign listed is positive and significant in the last column, but this should be viewed in light of the fact that most Anwar firms were forced to switch allegiance to Mahathir in the year that followed the imposition of capital controls.

In addition, column 3 of Table 5 shows what happened in the market upturn of February 1998. In this month the market rose 38%, apparently just on improved expectations of the macroeconomy and not because of any political event or shift of power between Mahathir and Anwar. In this episode we see no significant difference in performance between any of the politically connected subgroups and the set of independent firms.

The evidence from Mahathir-connected firms is therefore consistent with the idea that capital controls affected Malaysian firms' access to foreign finance. Presumably all Mahathir-connected firms gained some subsidies or access to local capital when capital controls were imposed. But some also lost their previous access to international capital.

Economic Significance of Political Connections

Our estimated coefficients indicate that the "political connections" effect is large relative to one of the most important characteristics of firms – their leverage. From column 3 of Table 3, the coefficient on the debt ratio is -0.0015. Leverage (the debt ratio) is expressed in percentage points, i.e., for a firm with total debt to total assets (TD/TA) of 55%, the variable would be 55.0. So an increase in the debt ratio of 10 percentage points (e.g., from the median debt ratio of 23.3 to 33.3) would correspond to a lower crisis-period return of 1.5%. The coefficient on the Politically Connected dummy is -0.078 when we also control for debt, meaning that politically connected firms had a lower crisis period return of 7.8% compared to non-connected firms. Put together, this means that having political connections had a similar effect to increasing the debt ratio by 52.0 percentage points (e.g., from the median of 23.3% to around 75%). The standard deviation of TD/TA is 22.48, so having political connections is roughly equivalent to a 3-standard deviation increase in the debt ratio during the "crisis period".

For September 1998, the magnitude is similar. The coefficient of 0.0033 on the debt-asset ratio (from column 3 in Table 4) corresponds to a higher return of 0.33% for each percentage point increase in the debt ratio. So the higher return of 14.2% for politically connected firms is equivalent to the effect of increasing the debt ratio by 43 percentage points (e.g., from the median debt ratio of 23.3% to 66.3%). In sum, for both periods, the leverage effect is strong, but the political connections effect is arguably much stronger.

For an alternative measure of economic significance, we use our regression coefficients to estimate the impact of connections on the total market value of firms. We find that during the crisis period, roughly $5.7 billion of the market value lost by connected firms is attributable to their political connections. When capital controls were imposed in September 1998, although market valuations were then on a smaller scale, political connections accounted for an incremental gain of roughly $1.3 billion in market value for connected firms.[19]

By looking at the outcomes for Anwar- and Mahathir-connected firms separately in September 1998, we can obtain an estimate of the value of political connections as a percentage of total firm value after capital controls were imposed. If we assume that the events of September 1998 destroyed all remaining value of Anwar connections and restored the full value of Mahathir connections, then the loss due to Anwar connections added to the gain due to Mahathir connections should roughly equal the total percentage of firm value attributable to political connections. Our regression coefficients from column 4 of Table 4 show that Mahathir connections account for a 19.9% increase in firm value in September 1998, while Anwar connections are associated with a 5.1% decrease in firm value. In terms of (higher) valuations at the end of September 1998, these percentages would be about 12% and 4% respectively. Summed together, these estimates suggest that political connections accounted for about 16% of the total market value of connected firms after the events of September 1998. While only a rough estimate, this figure is within the 12% to 23% range estimated by Fisman (2001) for connected firms in Indonesia.

Robustness Checks

We have performed a number of tests in order to check the robustness of the central result that favored firms performed differently during the initial crisis and after the imposition of capital controls compared with non-favored firms. Our results do not appear to be dominated by outliers. All of our key results are robust to truncating the data at the 1st and 99th percentiles of observations on stock returns, firm size, or debt ratios.

[19] The estimates of the effects of political connections on market value are based on our estimated regression coefficients, monthly stock prices, and available data on the number of shares outstanding for each firm. Because the number of shares outstanding is not known for every

Table 6 repeats the regressions of Tables 4 and 5 just for financial firms (as identified by a primary SIC code in the range 6000 to 6999 in Worldscope). The results are quite similar. Politically connected financial firms suffered a larger stock price fall than the average from July 1997 to August 1998, although those with connections to Anwar did not do as badly. In September 1998, the stock price of financial firms with political connections surged, but Anwar-connected firms on average did no better than independent firms.[20] Again, when we break the politically connected firms into subgroups, it is only the Mahathir-connected firms that were not foreign listed that showed a significant improvement in stock price (57.8%) relative to independent firms. After October 1998 there was no significant difference in stock returns between Anwar-connected and other politically connected firms (not reported in the table).

Table 7 provides further robustness checks by adding control variables to our basic regressions. As discussed in Section 2, some Malaysian firms have advantages because they are officially ethnically favored. Note that the government publicly states its support for Bumiputera businesses and has implied that any direct measures to support firms were primarily designed to help Bumiputeras (Mahathir 2000).[21] Perkins and Woo (2000) also argue that the government helped Bumiputera firms after the imposition of capital controls. In Panel A of Table 7, we find that whether a firm is officially Ethnically Favored is not significant and including it does not have a large effect on our political connections coefficients (in fact, the Mahathir-connected coefficient increases slightly).

In Panel B of Table 7 we use the log of net sales as an alternative measure of firm size. Again the results are essentially unchanged. As mentioned previously, alternative firm size measures also had little effect on the results. Panel C presents the results of regressions with the sample restricted to firms included in the International Finance

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month and is missing for three of the connected firms, the estimated figures are not exact calculations, but reasonable estimates.

[20] Anwar-connected financial firms that were foreign-listed did experience a significant increase in stock price, but there are only two such firms, so it is hard to interpret this result. For example, investors may have anticipated that a takeover by Mahathir-connected firms would benefit small shareholders.

[21] For example, on p. 20, Prime Minister Mahathir writes, "Recovery must be accompanied by the equitable distribution of the economic pie between *Bumiputeras* and *non-Bumiputeras*. Failure to do so could result in the kind of race riots that broke out in May 1969" (Mahathir 2000).

Corporation (IFC) Global Index only. The motivation for using this subsample is to address concerns that some Malaysian stocks in our base sample may not be very liquid, and thus we may be using uninformative stock prices. The IFC includes stocks in its Global Index only if they are among the largest and most liquid stocks in the country. In addition, the quality of data reported to Worldscope is often better for IFC Global Index firms. In the IFC Global Index subsample, the coefficients on the Politically Connected and Mahathir-connected dummies change slightly, but retain their significance and expected sign.

In regressions not reported here, we have also restricted the sample to non-financial firms only. That is, we have excluded all firms that have primary SIC in the range 6000 to 6999. The motivation for doing this is that financial data may not be entirely comparable between financial firms and non-financial firms. For this restricted sample, the coefficients on the Politically Connected dummy are significant for the crisis period and for September 1998, and the coefficient on Mahathir-connected remains positive and significant for September 1998. In other regressions not reported, we use data from Claessens, Djankov and Lang (2000) and verify that our results are robust to controlling for whether firms have a family group affiliation.

A potential alternative interpretation of our results is that politically connected firms may have done relatively well in September 1998 simply because the market rebounded in that month. Perhaps these firms would have done well in any market recovery irrespective of whether that upturn involved the imposition of capital controls? The data do not support this alternative interpretation. As mentioned previously, February 1998 was a strong upturn month in the middle of the "crisis period" (see Figure 1). In regressions with stock returns for this month only, the coefficient on the Politically Connected dummy is negative and insignificant, i.e., politically connected firms did not do well just because there was an upturn in the market. We have run similar regressions for returns in April 1999 and November 1998, the two other largest percentage jumps in the index through the end of 2000. In neither case are the political connection variables significant, or even close to being significant. (Results for these months are not reported in the tables to save space; they are available from the authors.) These findings support the hypothesis that in September 1998 the relatively good performance of well-connected firms was due to the political events of that month.

6. Support for Favored Firms after the Imposition of Capital Controls

What did the Malaysian government do once capital controls were imposed? Some general reflationary measures were taken, including cutting interest rates and making credit more readily available to consumers and firms (Kaplan and Rodrik 2001, Mahathir 2000, Chapter 8). Mahathir and Daim also encouraged banks to lend more, and announced bailouts for troubled firms (Perkins and Woo 2000). A new expansionary budget was introduced in October 1998 (Perkins and Woo 2000).

There also appears to have been both increased subsidies for some pro-Mahathir firms and punishments for firms that were allied with Anwar. The anecdotal evidence strongly supports the idea that the government used the economy's isolation from short-term capital flows to restore implicit subsidies for some favored firms. The precise distribution of subsidies is hard to measure, as they are usually not reported publicly. However, we can discern the three main forms of these subsidies from high profile incidents that have been reported in the international media.

First, the state-owned oil company, Petroliam Nasional Bhd. (known as Petronas), has been called upon to provide bailouts to particular distressed firms (Jayasankaran 1999a). In the most prominent case, Petronas injected cash into the national car company Perusahaan Otomobil Nasional (known as Proton) (Restall 2000a).[22] In mid-1998, Petronas also acquired the shipping assets of the Prime Minister's son, Mahathir Mirzan, who was facing financial difficulties (Lopez 2001).

Second, a number of companies have received advantageous deals directly from the government. In December 2000, the government bought back the 29% stake held by Tajudin Ramli in Malaysian Air System (MAS), the operator of Malaysian Airlines. The price was reported to be about twice the market price, effectively bailing out Mr. Tajudin

[22] Petronas is not the only government-controlled institution used to save firms. Khazanah Nasional Bhd., the powerful state-owned investment fund, has proved to be an alternative vehicle for providing financial support. For example, in 2000 it purchased shares in Renong's telecom unit (Jayasankaran 2000).

at the same time as putting MAS on a firmer financial footing.[23] There has also been serious discussion of the government buying back the assets of two unprofitable privatized light-rail projects in Kuala Lumpur. This would benefit primarily Renong Bhd., controlled by Halim Saad who is reported to be close to the ruling party (Prystay 2000).

Third, arguably the most significant changes have occurred within the banking system. The government has supervised a process of consolidation, including instructing 58 financial institutions to merge, creating 10 "superbanks". The final picture is not yet settled, but it is clear that bankers who were connected to Anwar are likely to do relatively badly and those with connections to Daim will do relatively better (Jayasankaran 1999b). At the same time, large companies, such as Renong and the Lion group, have been allowed to repeatedly roll over their debts (Dhume, Crispin, Jayasankaran and Larkin 2001).

All three forms of subsidies may benefit minority shareholders, for example because they put the supported firms on a stronger financial basis and reduce the incentives to transfer resources out of the firms (Johnson, Boone, Breach and Friedman 2000). In addition, however, the government has permitted companies to carry out actions that might otherwise be considered violations of laws protecting minority shareholders. The most prominent case involves Renong, which is financially distressed but has a "well-connected" chairman (Restall 2000b). In November 1997, a subsidiary of Renong, United Engineers Malaysia, received a waiver of stock market rules, in order to provide a bailout to its parent. The stock market fell sharply on this news, and some observers interpreted this reaction as indicating that the government would have difficulties if it provided further support to favored firms. However, in October 1998 after capital controls were in place, the government took over and paid off some of Renong's debts (Perkins and Woo 2000).[24] Again in late 2000, United Engineers

[23] Mr. Tajudin has a great deal of debt: $263bn personally and 900m ringgit borrowed by Naluri, the listed company in which Mr. Tajudin owns 44% and which in turn holds the stake in MAS (Asian Wall Street Journal weekly edition, July 31-August 6, 2000). There has been difficulty servicing these loans.

[24] Halim Saad, chairman of Renong, is quoted as saying "Yes, the government helped. But our creditors will get paid 100% with interest and with no haircuts. What's wrong with that?"(Jayasankaran 2000).

Malaysia agreed to purchase $1.8bn of problem assets from Renong. Shareholders have protested these actions.

While it is impossible to measure the size and nature of Malaysian subsidies precisely, the weight of anecdotal evidence supports the notion that well-connected firms received direct and indirect financial support from the government after the imposition of capital controls. This suggests that the market reaction to the imposition of capital controls in September 1998 was correct in anticipating that particular well-connected firms would receive greater subsidies.

In addition, we have checked the fate of all the firms in Appendix 1 that are listed as affiliated primarily to Anwar. As far as we can ascertain, all of these firms have either been taken over by pro-Mahathir management or the owners have switched allegiance to Mahathir. In many cases there have been asset transfers out of these firms and into firms more closely aligned with Mahathir. Again, it seems that the stock market in September 1998 correctly anticipated what would happen.

Assessment

Malaysia's macroeconomic performance after the imposition of capital controls was good. Growth was 4.7% in 1999, although there remains a controversy about whether it would have been higher or lower without capital controls (Kaplan and Rodrik 2001, Dornbusch 2001a). At the same time, there is clear evidence of some government support for favored firms, both directly and – more commonly – through various forms of indirect subsidies.

Weak institutions in Malaysia mean that the allocation of government favoritism is of first-order importance for firm-level outcomes. As a result, when hit by the initial Asian crisis, favored firms suffered large falls in expected subsidies. The imposition of capital controls, on the other hand, allowed the government to channel greater resources (and provide other advantages) to firms with strong political connections to the Prime Minister. The interaction of shocks and institutions therefore had a large impact on the distribution of outcomes at the firm level.

7. Conclusion

The evidence from Malaysia strongly supports the idea that firms with political connections were expected to lose subsidies in the first phase of the Asian crisis. Conversely, firms connected to the Prime Minister were expected to gain subsidies when capital controls were imposed in September 1998. The main beneficiaries of capital controls were apparently well-connected firms that did not previously have access to international capital markets.

The presence of political connections in East Asian economies does not mean that "cronyism" caused the crisis or even that "relationship-based capitalism" was necessarily a suboptimal system for these countries. While politically connected firms were hit harder during the crisis, the evidence presented here does not suggest that this was a punishment for past misdeeds and deficiencies. The evidence suggests rather that the crisis implied previously favored firms would lose valuable subsidies, and the imposition of capital controls indicated that these subsidies would be restored for some firms.

Our Malaysian results offer empirical evidence that is consistent with the general idea of Blanchard (2000), who argues that macroeconomic dynamics depend on institutional structures: "Institutions also matter for short-run fluctuations, with different mechanisms across countries" (p.1404). There is growing evidence that institutions matter for long-term growth (e.g., Acemoglu, Johnson and Robinson 2001.) A great remains to be done, however, to understand precisely how institutions affect short- and medium-run outcomes.

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Table 1
Summary statistics and ratio analysis

	All Worldscope firms							Non-Financial Firms Only			
	All	Politically Connected	Non-Connected	(p-value)	Mahathir Connected	Anwar Connected	(p-value)	All	Politically Connected	Non-Connected	(p-value)
Number of Firms	424	67	357		53	14		312	50	262	
RETURNS											
July 1997 to August 1998	-78.5%	-83.0%	-77.7%	(0.010)	-83.4%	-81.3%	(0.529)	-78.1%	-82.1%	-77.3%	(0.065)
September 1998	39.7%	53.2%	37.1%	(0.000)	61.7%	31.3%	(0.021)	38.7%	50.5%	36.1%	(0.007)
October 1998 to Sept. 2000	81.9%	83.5%	81.7%	(0.897)	69.8%	132.2%	(0.036)	81.6%	94.8%	79.1%	(0.348)
SIZE AND GROWTH											
Total Assets ($000)	986,606	1,845,217	820,423	(0.012)	1,799,914	2,013,485	(0.816)	599,554	1,299,733	465,535	(0.000)
Total Asset Growth (1-year)	50.3%	67.3%	46.8%	(0.301)	81.7%	20.3%	(0.376)	42.3%	39.3%	42.9%	(0.834)
PROFITABILITY											
Return on Assets	4.0%	-1.2%	4.9%	(0.041)	-3.0%	5.2%	(0.604)	3.7%	-2.7%	4.9%	(0.062)
Profit Margin	7.1%	9.7%	6.6%	(0.868)	8.9%	12.3%	(0.681)	1.6%	8.2%	0.3%	(0.746)
LIQUIDITY											
Current Ratio	1.77	1.53	1.82	(0.432)	1.52	1.61	(0.846)	1.69	1.54	1.72	(0.516)
Quick Ratio	1.26	1.20	1.27	(0.791)	1.27	0.93	(0.423)	1.26	1.21	1.27	(0.807)
ASSET UTILIZATION											
Asset Turnover Ratio	0.55	0.47	0.56	(0.147)	0.44	0.55	(0.421)	0.65	0.56	0.66	(0.170)
Inventory Turnover Ratio	9.43	12.70	8.82	(0.101)	14.79	5.47	(0.195)	9.50	12.71	8.91	(0.116)
LEVERAGE											
Total Debt/Total Assets (TD/TA)	23.7%	33.7%	21.9%	(0.000)	36.0%	24.6%	(0.298)	26.1%	36.9%	24.0%	(0.000)
Short-Term Debt/Total Debt (STD/TD)	61.8%	57.1%	62.8%	(0.216)	56.8%	58.5%	(0.869)	61.7%	59.3%	62.2%	(0.573)
Increase in TD/TA	2.7%	6.3%	2.0%	(0.062)	8.4%	-70.0%	(0.334)	3.2%	7.7%	2.3%	(0.046)
Increase in STD/TD	-2.2%	-7.7%	-1.1%	(0.088)	-7.6%	-7.9%	(0.975)	-1.9%	-8.9%	-0.5%	(0.062)
OTHER											
Book/Market Ratio	0.45	0.47	0.45	(0.568)	0.50	0.36	(0.105)	0.42	0.45	0.42	(0.450)
Percent Foreign Listed	26.9%	41.8%	24.1%	(0.003)	41.5%	42.9%	(0.928)	26.0%	44.0%	22.5%	(0.002)
Percent Ethnically Favored	26.4%	22.6%	27.2%	(0.495)	27.9%	0.0%	(0.058)	26.4%	29.2%	25.8%	(0.642)

The table presents summary statistics of Malaysian firms in the Worldscope database. The numbers reported are simple averages except as noted. Listed p-values are from t-tests of differences of means, except for last two rows, which are tests of proportions. "Politically connected" refers to a firm with identifiable political connections from Gomez and Jomo (1997). "Ethnically favored" refers to a firm controlled by Bumiputeras (primarily indigenous Malays). A financial firm is defined as one with primary SIC in the range 6000-6999. Financial figures are based on the last reported financial statements prior to July 1997. All figures are simple averages and based on pre-crisis data unless noted otherwise. Data points are missing for some items, thus the number of observations included for each average may vary. In particular, ethnic favoritism percentages are based on 74% of the firms in the full sample.

Table 2
Political connections and pre-crisis firm characteristics

	Panel A: Profitability			Panel B: Leverage		
	Industry controls only	Add control for size	Add control for growth	Industry controls only	Add controls for size and profitability	Add control for growth
	Dependent variable is pre-crisis return on assets			*Dependent variable is pre-crisis debt ratio*		
Politically Connected	-7.260	-8.820	-8.960	11.087 **	4.651 **	4.677 **
	[-1.00]	[-1.05]	[-0.98]	[2.26]	[1.96]	[2.01]
Firm Size		3.605	3.850		3.353 *	2.758
		[1.21]	[1.22]		[1.91]	[1.51]
Profitability					-0.636 ***	-0.630 ***
					[-22.69]	[-23.87]
Firm Growth			0.839			-0.129
			[0.90]			[-0.17]
Industry Dummies	Included	Included	Included	Included	Included	Included
Number of Observations	407	407	359	424	405	358
R-squared	0.031	0.038	0.040	0.108	0.503	0.528

The table reports coefficient estimates from regressions of firm characteristics on a political connections indicator. All Malaysian firms with available data in the Worldscope database are included. Profitability is return on assets, defined as net income divided by total assets (expressed in whole percentages) and measured in the last full year of financial results before July 1997. Leverage is defined as total debt over total assets (expressed in whole percentages) measured at the end of the last full year of financial results before July 1997. Firm size is the log of total assets; growth is the one-year growth rate in total assets (both measured pre-July 1997). "Politically Connected" means firm has an identifiable connection with key government officials from Gomez and Jomo (1997). Industry dummies are included for 12 of 13 industries as defined in Campbell (1996). Also estimated but not reported is a constant term. The number of observations varies in each specification due to missing data on net income and total asset growth. Numbers in brackets are heteroskedasticity-robust t-statistics. Asterisks denote levels of significance: *** means significant at the 1% level, ** is the 5% level, and * is the 10% level.

Table 3
Political connections and crisis-period stock returns

	Political connections, without controls	Political connections, with controls, no leverage	Political connections, with controls, incl. leverage	Mahathir and Anwar connections
	Dependent variable is stock return from July 1997 to August 1998			
Politically Connected	-0.053 ***	-0.092 ***	-0.078 ***	
	[-3.32]	[-4.56]	[-3.90]	
Mahathir Connected				-0.083 ***
				[-3.65]
Anwar Connected				-0.060 **
				[-2.14]
Firm Size		0.070 ***	0.077 ***	0.076 ***
		[4.82]	[5.25]	[5.24]
Book/Market Ratio		-0.010	-0.032	-0.031
		[-0.30]	[-0.98]	[-0.94]
Debt Ratio			-0.0015 **	-0.0015 **
			[-2.27]	[-2.24]
Industry Dummies	No	Included	Included	Included
Number of Observations	424	424	424	424
R-squared	0.016	0.198	0.238	0.239

The table reports coefficient estimates from regressions of stock returns on political connection variables and control variables over the Asian crisis period of July 1997 to August 1998. All Malaysian firms with available data in the Worldscope database are included. Numbers in brackets are heteroskedasticity-robust t-statistics. Asterisks denote levels of significance: *** means significant at the 1% level, ** is the 5% level, and * is the 10% level. "Politically Connected" means the firm has an identifiable connection with key government officials from Gomez and Jomo (1997). "Mahathir Connected" and "Anwar Connected" indicate the source of the political connection as in Gomez and Jomo (1997) . Firm size is measured as the log of total assets; the debt ratio is measured as total debt over total assets. Industry dummies are included for 12 of 13 industries as defined in Campbell (1996), with the industry corresponding to the primary SIC code of each firm. Also estimated but not reported is a constant term.

Table 4
Stock returns following imposition of capital controls

	September 1998				Oct. 1998 to Sept. 2000	
	Political connections, without controls	Political connections, with controls, no leverage	Political connections, with controls, incl. leverage	Mahathir and Anwar connections	Political connections	Mahathir and Anwar connections
	Dependent variable is stock return in period indicated					
Politically Connected	0.183 ***	0.163 ***	0.142 **		0.054	
	[3.22]	[2.83]	[2.52]		[0.37]	
Mahathir Connected				0.199 ***		-0.036
				[3.04]		[-0.23]
Anwar Connected				-0.051		0.353
				[-0.62]		[1.21]
Firm Size		-0.008	-0.022	-0.020	0.058	0.054
		[-0.23]	[-0.65]	[-0.60]	[0.63]	[0.60]
Book/Market Ratio		0.095	0.113	0.099	-0.148	-0.124
		[1.26]	[1.54]	[1.34]	[-0.84]	[-0.70]
Debt Ratio			0.0033 ***	0.0032 ***	-0.0027	-0.0025
			[3.69]	[3.50]	[-1.07]	[-0.99]
Industry Dummies	No	Included	Included	Included	Included	Included
Number of Observations	413	413	413	413	407	407
R-squared	0.039	0.106	0.134	0.148	0.051	0.054

The table reports coefficient estimates from regressions of stock returns on political connection variables and control variables during the period following the imposition of capital controls. All Malaysian firms with available data in the Worldscope database are included. Numbers in brackets are heteroskedasticity-robust t-statistics. Asterisks denote levels of significance: *** means significant at the 1% level, ** is the 5% level, and * is the 10% level. "Politically Connected" means firm has an identifiable connection with key government officials from Gomez and Jomo (1997). "Mahathir Connected" and "Anwar Connected" indicate the source of the political connection as in Gomez and Jomo (1997). Firm size is measured as the log of total assets; the debt ratio is measured as total debt over total assets. Industry dummies included for 12 of 13 industries as defined in Campbell (1996), with industry corresponding to the primary SIC code of each firm. Also estimated but not reported is a constant term.

Table 5
Capital controls and the interaction of political connections and foreign listings

	Before crisis: Jan 1996 to June 1997	Crisis period: July 1997 to Aug 1998	Early market upturn: Feb 1998	Capital controls imposed: Sept 1998	Later period: Oct 1998 to Sept 2000
	Dependent variable is stock return in period indicated				
Mahathir Connected*Foreign Listed	-0.159 *	-0.089 ***	0.017	0.101	-0.152
	[-1.95]	[-2.89]	[0.19]	[1.29]	[-0.84]
Mahathir Connected*Not Foreign Listed	-0.026	-0.080 ***	-0.082	0.266 ***	0.044
	[-0.28]	[-3.01]	[-0.98]	[3.05]	[0.21]
Anwar Connected*Foreign Listed	0.082	-0.131 ***	0.152	0.013	0.802 *
	[0.64]	[-3.20]	[1.01]	[0.10]	[1.86]
Anwar Connected*Not Foreign Listed	0.688	-0.005	-0.101	-0.099	0.009
	[1.08]	[-0.23]	[-0.94]	[-0.99]	[0.03]
Firm Size	0.066	0.077 ***	-0.045	-0.019	0.053
	[1.19]	[5.27]	[-1.09]	[-0.56]	[0.58]
Book/Market Ratio	-0.074	-0.030	-0.040	0.102	-0.125
	[-0.51]	[-0.91]	[-0.47]	[1.39]	[-0.70]
Debt Ratio	-0.0013	-0.0015 **	0.0000	0.0032 ***	-0.0025
	[-1.62]	[-2.26]	[-0.01]	[3.42]	[-0.99]
Industry Dummies	Included	Included	Included	Included	Included
Number of Observations	375	424	422	413	407
R-squared	0.052	0.244	0.025	0.155	0.060

The table reports coefficient estimates from regressions of stock returns on political connection variables interacted with foreign trading status and control variables. Stock return periods are as noted in each column. All Malaysian firms with available data in the Worldscope database are included. Numbers in brackets are heteroskedasticity-robust t-statistics. Asterisks denote levels of significance: *** means significant at the 1% level, ** is the 5% level, and * is the 10% level. "Politically Connected" means firm has an identifiable connection with key government officials from Gomez and Jomo (1997). "Mahathir Connected" and "Anwar Connected" indicate the source of the political connection as in Gomez and Jomo (1997). "Foreign Listed" indicates that the firm's stock is traded in a foreign market in addition to Malaysia. Firm size is measured as the log of total assets; the debt ratio is measured as total debt over total assets. Industry dummies included for 12 of 13 industries as defined in Campbell (1996), with industry corresponding to the primary SIC code of each firm. Also estimated but not reported is a constant term.

Table 6
Political connections and stock returns of financial firms

	Crisis period: July 1997 to August 1998			Capital controls imposed: September 1998		
	Dependent variable is stock return in period indicated					
Politically Connected	-0.071 ***			0.296 ***		
	[-3.59]			[2.99]		
Mahathir Connected		-0.082 ***			0.405 ***	
		[-3.72]			[3.34]	
Anwar Connected		-0.044			0.037	
		[-1.49]			[0.35]	
Mahathir Connected*Foreign Listed			-0.067 **			0.081
			[-2.26]			[0.87]
Mahathir Connected*Not Foreign Listed			-0.089 ***			0.578 ***
			[-3.33]			[4.06]
Anwar Connected*Foreign Listed			-0.101 ***			0.192 **
			[-7.02]			[2.32]
Anwar Connected*Not Foreign Listed			-0.001			-0.096
			[-0.03]			[-0.69]
Firm Size	0.011	0.010	0.007	-0.029	-0.021	-0.003
	[0.71]	[0.65]	[0.41]	[-0.67]	[-0.50]	[-0.06]
Debt Ratio	-0.0010	-0.0009	-0.0007	0.0017	0.0008	-0.0005
	[-1.48]	[-1.33]	[-1.07]	[0.86]	[0.46]	[-0.30]
Number of Observations	112	112	112	111	111	111
R-squared	0.061	0.064	0.071	0.111	0.150	0.208

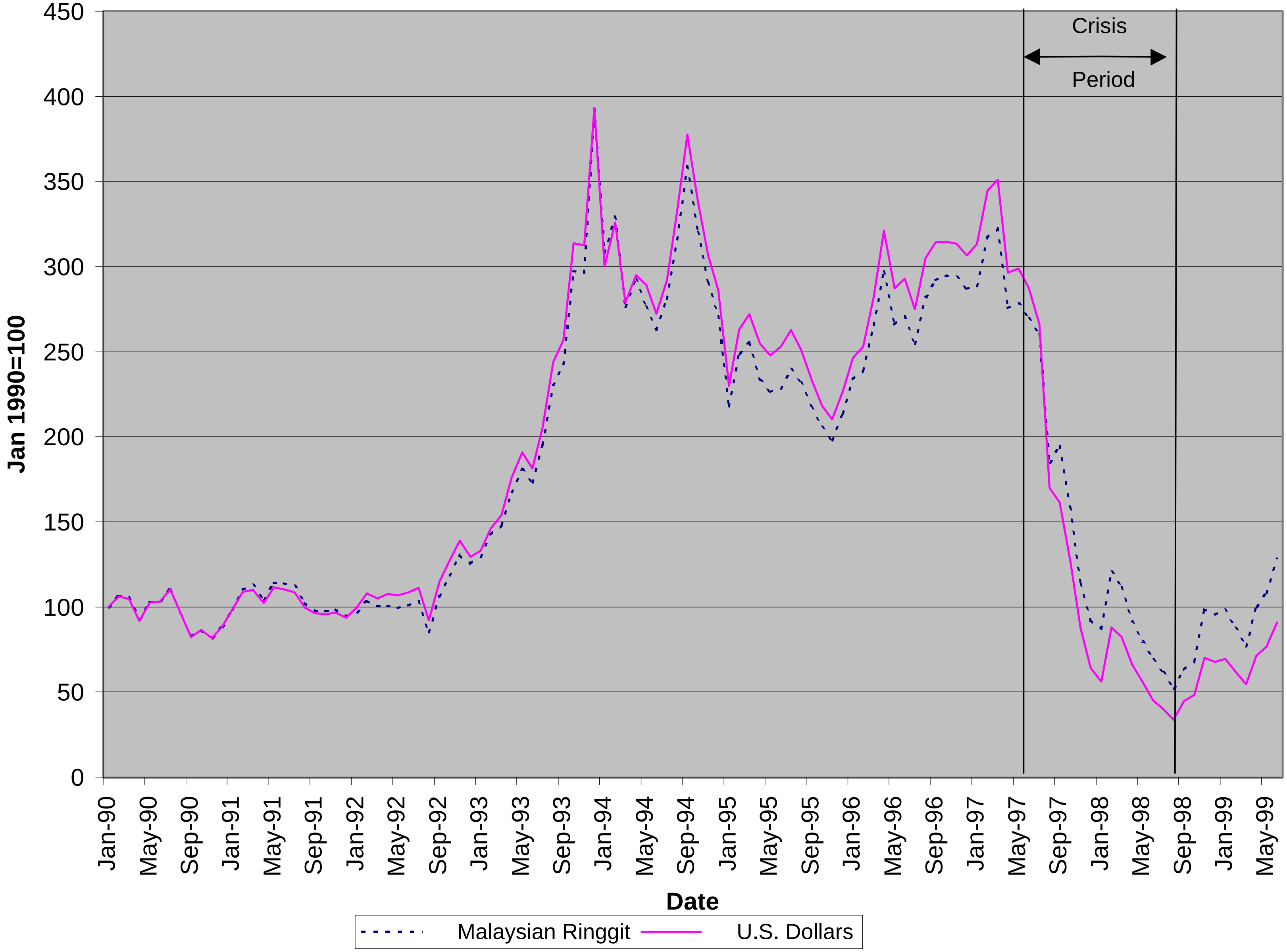
The table reports coefficient estimates from regressions of stock returns on political connection variables and control variables. Stock return periods are as noted in each column. All Malaysian financial firms (primary SIC between 6000 and 6999) with available data in the Worldscope database are included. Numbers in brackets are heteroskedasticity-robust t-statistics. Asterisks denote levels of significance: *** means significant at the 1% level, ** is the 5% level, and * is the 10% level. "Politically Connected" means firm has an identifiable connection with key government officials from Gomez and Jomo (1997). "Mahathir Connected" and "Anwar Connected" indicate the source of the political connection as in Gomez and Jomo (1997). "Foreign Listed" indicates that the firm's stock is traded in a foreign market in addition to Malaysia. Firm size is measured as the log of total assets; the debt ratio is measured as total debt over total assets. Also estimated but not reported is a constant term.

Table 7
Robustness checks

	A: Control for Ethnicity		B: Alternative Firm Size Measure		C: IFC Firms Only	
	Crisis period: July 1997 to Aug 1998	Capital controls: Sept 1998	Crisis period: July 1997 to Aug 1998	Capital controls: Sept 1998	Crisis period: July 1997 to Aug 1998	Capital controls: Sept 1998
	Dependent variable is stock return in period indicated					
Mahathir Connected	-0.071 ***	0.2129 ***	-0.079 ***	0.2202 ***	-0.066 **	0.1951 *
	[-2.96]	[2.78]	[-3.52]	[3.39]	[-2.55]	[1.97]
Anwar Connected	-0.019	-0.153	-0.057 **	-0.030	-0.061 *	-0.151
	[-0.72]	[-1.49]	[-2.06]	[-0.37]	[-1.72]	[-1.40]
Ethnically Favored	0.014	-0.004				
	[0.95]	[-0.10]				
Firm Size	0.059 ***	0.013	0.026 ***	-0.023 **	0.111 ***	-0.133 **
	[3.69]	[0.33]	[4.56]	[-2.14]	[5.56]	[-2.24]
Book/Market Ratio	0.022	0.067	0.015	0.081	-0.124 ***	0.192
	[0.64]	[0.67]	[0.49]	[1.24]	[-2.72]	[1.20]
Debt Ratio	-0.0025 **	0.0034 ***	-0.0014 **	0.0037 ***	-0.0008	0.0028
	[-6.60]	[3.09]	[-2.11]	[3.94]	[-1.33]	[1.56]
Industry Dummies	Included	Included	Included	Included	Included	Included
Number of Observations	318	308	408	397	156	149
Adjusted R-squared	0.311	0.164	0.256	0.171	0.420	0.321

The table reports coefficient estimates from regressions of stock returns on political connection variables and control variables during the periods indicated. All Malaysian firms with available data in the Worldscope database are included, except in Panel C where only firms included in International Finance Corporation indexes are included. Numbers in brackets are heteroskedasticity-robust t-statistics. Asterisks denote levels of significance: *** means significant at the 1% level, ** is the 5% level, and * is the 10% level. "Ethnically Favored" indicates that the firm is controlled by Bumiputera (primarily ethnic Malay) interests. Number of observations is smaller in Panel A because ethnicity is not identifiable for all firms. "Mahathir Connected" and "Anwar Connected" indicate the source of the political connections of Malaysian firms as in Gomez and Jomo (1997). Firm size is measured as the log of total assets, except in Panel B where it is measured as the log of net sales (sales data is missing for 16 firms). The debt ratio is measured as total debt over total assets. Industry dummies included for 12 of 13 industries as defined in Campbell (1996), with industry corresponding to the primary SIC code of each firm. Also estimated but not reported is a constant term.

Figure 1
Index of Malaysian stocks, 1990-1999
Equal-weighted indices of firms in Worldscope database



Appendix Table 1
Politically connected Malaysian firms

COMPANY NAME	Primary Connected Major Shareholder/Director	Primary Political Connection
ADVANCE SYNERGY BHD	Ahmad Sebi Abu Bakar	Daim, Anwar
ANTAH HOLDINGS BHD	Negeri Sembilan royalty	Mahathir
AOKAM PERDANA BHD	Samsudin Abu Hassan	Daim
ARAB MALAYSIAN CORPORATION BHD	Azman Hashim	UMNO
AUSTRAL AMALGAMATED BHD	Samsudin Abu Hassan	Daim
BAN HIN LEE BANK BHD	Quek Leng Chan	Anwar
BANDAR RAYA DEVELOPMENTS BHD	MCA	MCA
BERJAYA GROUP BHD	Vincent Tan Chee Yioun	Daim
BERJAYA SPORTS TOTO BHD	Vincent Tan Chee Yioun	Daim
COLD STORAGE (MALAYSIA) BHD	Basir Ismail, Samsudin Abu Hassan	Daim
CONSTRUCTION AND SUPPLIES HOUSE	Joseph Ambrose Lee, Abdul Mulok Awang Damit	Daim
CYCLE & CARRIAGE BINTANG BHD	Basir Ismail	Daim
DAMANSARA REALTY BHD	Koperasi Usaha Bersatu Bhd	UMNO
DATUK KERAMAT HOLDINGS BHD	Koperasi Usaha Bersatu Bhd	UMNO
DIVERSIFIED RESOURCES BHD	Yahya Ahmad, Nasaruddin Jalil	Anwar, Mahathir
EKRAN BHD	Ting Pek Khiing	Daim, Mahathir, Abdul Taib Mahmud
FABER GROUP BHD	UMNO	UMNO
GADEK (MALAYSIA) BHD	Yahya Ahmad, Nasaruddin Jalil	Anwar, Mahathir
GEORGE TOWN HOLDINGS BHD	Tunku Abdullah	Mahathir
GOLDEN PLUS HOLDINGS BHD	Ishak Ismail, Mohamed Sarit Haji Yusoh	Anwar
GRANITE INDUSTRIES BHD	Samsudin Abu Hassan	Daim
HICOM HOLDINGS BHD	Yahya Ahmad	Anwar, Mahathir
HO HUP CONSTRUCTION COMPANY BHD	Halim Saad	Daim
HONG LEONG BANK BHD	Quek Leng Chan	Anwar
HONG LEONG CREDIT BHD	Quek Leng Chan	Anwar
HONG LEONG INDUSTRIES BHD	Quek Leng Chan	Anwar
HONG LEONG PROPERTIES BHD	Quek Leng Chan	Anwar
HUME INDUSTRIES (MALAYSIA) BHD	Quek Leng Chan	Anwar
IDRIS HYDRAULIC (MALAYSIA) BHD	Ishak Ismail	Anwar
KAMUNTING CORPORATION BHD	T.K. Lim	Daim
KFC HOLDINGS (MALAYSIA) BHD	Ishak Ismail	Anwar
KINTA KELLAS PUBLIC LIMITED CO	Halim Saad	Daim
KRETAM HOLDINGS BHD	UMNO Youth, Wan Azmi Wan Hamzah	Daim
KUMPULAN FIMA BHD	Basir Ismail	Daim
LAND & GENERAL BHD	Wan Azmi Wan Hamzah	Daim
LANDMARKS BHD	Samsudin Abu Hassan	Daim

(Continued on next page)

Appendix Table 1 (Continued)
Politically connected Malaysian firms

COMPANY NAME	Primary Connected Major Shareholder/Director	Primary Political Connection
MAGNUM CORPORATION BHD	T.K. Lim	Daim
MALAKOFF BHD	Malaysian Resources	UMNO
MALAYSIAN AIRLINE SYSTEM BHD	Tajudin Ramli	Daim
MALAYSIAN RESOURCES CORPORATION	Wan Azmi Wan Hamzah	UMNO, Anwar
METROPLEX BHD	Dick Chan	Unspecified
MULTI-PURPOSE HOLDINGS BHD	T.K. Lim	Daim
MYCOM BHD	Mohd Tamrin Abdul Ghafar	Ghafar Baba
NANYANG PRESS (MALAYA) BHD	Quek Leng Chan	Anwar
NEW STRAITS TIMES PRESS (MALAYSIA)	Unspecified	Anwar
O.Y.L. INDUSTRIES BHD	Quek Leng Chan	Anwar
PACIFIC CHEMICALS BHD	Ting Pek Khiing, Robert Tan	Daim, Mahathir, Abdul Taib Mahmud
PENGKALEN HOLDINGS BHD	Joseph Ambrose Lee, Abdul Mulok Awang Damit	Daim
PRIME UTILITIES BHD	Ahmad Sebi Abu Bakar	Daim, Anwar
PROMET BHD	Ibrahim Mohamed	Mahathir
R.J. REYNOLDS BHD	Wan Azmi Wan Hazmah	Daim
RASHID HUSSAIN BHD	Wan Azmi Wan Hamzah	Daim
RENONG BHD	Halim Saad	Daim
SAPURA TELECOMMUNICATIONS BHD	Unspecified	Mahathir
SETRON (MALAYSIA) BHD	Penang Bumiputera Foundation, Kamaruddin Jaafar	Anwar
SISTEM TELEVISYEN MALAYSIA BHD	UMNO Companies	UMNO
STAR PUBLICATIONS (MALAYSIA) BHD	Vincent Tan Chee Yioun	Daim
TAIPING CONSOLIDATED BHD	Vincent Tan Chee Yioun	Daim
TANJONG PUBLIC LIMITED COMPANY	T. Ananda Krishnan	Mahathir
TECHNOLOGY RESOURCES INDUSTRIES	Tajudin Ramli	Daim
TIME ENGINEERING BHD	Halim Saad	Daim
TONGKAH HOLDINGS BHD	Mokhzani Mahathir	Mahathir
UNIPHOENIX CORPORATION BHD	Ibrahim Mohamed	Mahathir
UNIPHONE TELECOMMUNICATIONS BHD	Shamsuddin bin Abdul Kadir	Mahathir
UNITED ENGINEERS (MALAYSIA) BHD	Halim Saad	Daim
UNITED MERCHANT GROUP BHD	Ahmad Sebi Abu Bakar	Daim, Anwar
UNITED PLANTATIONS BHD	Basir Ismail	Daim
UTUSAN MELAYU (MALAYSIA) BHD	UMNO	UMNO
WEMBLEY INDUSTRIES HOLDINGS BHD	Ishak Ismail	Anwar
YTL CEMENT BHD	Yeoh Tiong Lay	Unspecified
YTL CORPORATION BHD	Yeoh Tiong Lay	Unspecified
YTL POWER INTERNATIONAL BHD	Yeoh Tiong Lay	Unspecified

The table lists Malaysian firms in the Worldscope database which have an identifiable connection with high ranking political figures. The information is compiled from Gomez and Jomo (1997). Under "Primary Political Connection" Mahathir refers to Mahathir Mohamad, Daim refers to Daim Zainuddin, and Anwar refers to Anwar Ibrahim. "UMNO" refers to the United Malays' National Organisation, an ethnically based political party that dominates the government's ruling coalition.