MALAYSIA’S RESPONSE TO THE FINANCIAL CRISIS: RECONSIDERING THE VIABILITY OF UNORTHODOX POLICY

Malaysia enjoyed high rates of growth in the early 1990s. The economic crisis that struck Malaysia in 1997 caught the country by surprise. Amidst the economic turmoil that shook the other South-East Asian countries, Malaysia ventured to adopt an unorthodox policy response to the crisis, choosing to implement a policy package consisting of a pegged exchange rate and capital controls. This paper argues that the package, which went against orthodox policy prescriptions, did offer a limited measure of certainty to export-oriented businesses in so far as they were protected against currency fluctuations. This paper also argues that the unorthodox policy had its costs. These costs include the decrease in FDI, lowered competitiveness, possibly weaker financial institutions and a lack of transparency in decision-making.

The financial crisis in Malaysia came upon the country suddenly at a time when it was enjoying high rates of growth. It seemed at that time that the country was far from vulnerable to a crisis. The country’s economic fundamentals appeared to be strong, there was a spate of so-called ‘mega’ projects, and it seemed as if the nation would march into the twenty-first century with little difficulty. The Government’s plan of achieving developed country status by the year 2020 seemed plausible.

The crisis brought the Government, academics and policy makers back to the drawing board. Unlike other countries affected by the crisis, Malaysia did not seek IMF assistance. Instead, the Government initially introduced a set of policies that resembled the standard IMF package, with high interest rates and a contractionary stance. This proved to be futile. It only led to a deterioration of confidence. This was followed by a second package. The second package was unique in that it included exchange and capital controls. This package was dubbed as being ‘unorthodox’. Four years after their introduction, the unorthodox policies seem less unorthodox today than they did at that time.

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On one side of the debate there are the proponents of capital controls who unambiguously claim that the capital controls and the peg have been to the nation’s advantage. On the other hand there is the claim that the kind of economic discipline, corporate governance and structural changes that the IMF package would have demanded would have done Malaysia good. Specifically, one has to consider the validity of the controls against Malaysia’s policy commitments. One has also to consider Malaysia’s intention of seeking deeper integration into the global economy. In the light of such considerations the debate on controls takes a different angle.

This paper proceeds as follows. The first section discusses some of the sources of vulnerability in the economy in the years approaching the crisis. The second section discusses the salient effects of the crisis. Following Nealy (1999), who remarks that exchange controls and capital controls are distinct issues, the peg is evaluated in section three. Capital controls are discussed in section four. This is followed, in section five, by a discussion of the appropriateness of the controls and suggestions on the future course of action. The paper ends with an overview and conclusions.

I. THE PRELUDE TO THE CRISIS

Prior to the crisis of 1997, the Malaysian economy had been achieving an average growth rate of almost 9 per cent annually. Congruent with the impressive growth rate, a very low rate of unemployment was recorded. In 1996, the unemployment rate was 2.5 per cent. It is remarkable that in spite of the high growth rate, inflation was maintained at a modest level of 3.5 per cent per annum. The savings rate prior to the crisis was also high, standing at 38.5 per cent of GNP (gross national product).

Other indicators in the pre-crisis period were equally satisfactory. Foreign debt, for instance, was only US$ 45.2 billion or 42 per cent of GDP. Short-term debt is frequently cited as a source of risk and is less favoured than long-term debt. Yet, short-term debt amounted to only 31 per cent of total foreign debt, and, again, the short-term debt was more than adequately backed by foreign reserves. The central bank held foreign reserves amounting to 1.97 times the short-term debt. The banking sector, too, seemed to be on safe ground with a net non-performing loan ratio of a mere 2.2 per cent.

Beneath these apparently sound economic fundamentals all was not well. Ariff and Yap (2000) draw attention to the fact that total factor productivity (TFP) growth had been declining prior to 1997, indicating the loss of efficiency in the economy. This was further exacerbated by the high wage increases that exceeded productivity gains. Yap (1997) argues that the high growth rates in the years preceding the crisis were achieved primarily by capital stock accumulation. During this period increases in output fell short of increases in capital. It is during this period that the
country witnessed the inception of ‘mega projects’ involving considerable imported equipment.

A second source of concern was the rapid growth in bank loans to the property sector. Roughly between 1991 and 1996 there was a boom in property prices ranging annually from 10 to 17 per cent. Property developers sought bank loans using stocks and property as collateral. This exposed the economy to two forms of risk. First, there were signs of excess supply in the property market (Bank Negara Malaysia, 1998:21-22). Second, with the extremely high prices in the stock and property markets, banks were exposing themselves to risk in the event of a sudden fall in prices in these markets.

The rapid growth in bank loans to the property sector was symptomatic of the preference structure of banks in respect to extending loans. Banks preferred to make loans where high rates of return appeared to be assured, rather than to extend them for long-term investments. Banks more readily extended loans for consumption credit, real estate investments and share purchases rather than for manufacturing, agriculture or building and construction, or for technology-based investment projects with long gestation periods (Chin and Jomo, 2000).

The banking system exposed itself to risk both in terms of the sectors it favoured for loans and in terms of the collateral it accepted. In normal circumstances it would be acceptable to take property and stocks as collateral. With the build-up of the property bubble and the stock market boom, banks were opening the economy to financial fragility. This was fuelled by the extensive credit that the bank was granting to the private sector. Bank credit to the private sector rose rapidly from 1993 to mid-1997. The rate of growth of bank credit rose from roughly 85 per cent in 1993 to about 150 per cent in 1995. In mid-1997, the figure reached about 160 per cent.

The current account deficits (CAD) were a third source of concern. From 1990 to 1997, the economy experienced current account deficits every year without exception. The CAD was particularly high in 1991 (RM 11.3 billion), and in the years from 1994 to 1997. In 1994 the CAD was RM 14.6 billion, in 1995 it was RM 21.3 billion, and in 1997 the CAD amounted to RM 15.8 billion. The CAD was the result of increases in the investment rate. From 1995 to 1997 the ratio of investment to GDP was above 45 per cent.

The persistent CAD had been due to excessive investments in non-tradeables such as power generation and telecommunications. This has been criticized on two grounds (Jomo, 2001:163). First, by investing in industries that do not generate foreign exchange, the economy was potentially at risk of creating excess demand on its foreign reserves. Second, there was a problem of term mismatch in that the proportion of short-term foreign borrowings dominated total loans. For instance, in June 1996, short-term loans of under one year duration constituted almost 50 per cent of total loans that were lent to Malaysia by BIS (Bank for International Settlements)
reporting banks. The same was the case in December 1996. In June 1997, short-term loans of less than one year duration amounted to almost 70 per cent of total loans. The critical difficulty with the short-term loans was that they were used to finance medium to long-term projects.

Fourth, it is argued that the ringgit was possibly overvalued from 1995 onwards. This view is taken owing to the appreciation of the real exchange rate after 1995 although the economy was running large CADs (Ariff and Yap, 2000:310). High real exchange rates are not a problem per se, but they are a source of concern if the persistent appreciation is not supported by strong economic fundamentals. Athukorala (2001:41) remarks that “a real exchange rate that is higher than ever before and which continues to appreciate is suspicious, even when major reforms and access to capital markets justify some real appreciation.”

The real exchange rate for Malaysia actually began to appreciate after the middle of 1993. The exchange rate had appreciated by close to 20 per cent in 1997 as compared to 1993. Between 1995 and 1997 there were inflationary pressures in Malaysia, and the domestic inflation rate was higher than that experienced by Malaysia’s trading partners. That aside, the ringgit appreciated against the yen from 1994, leading to an increase in the nominal exchange rate. The result of both influences was a persistent rise in the real exchange rate.

II. THE CRISIS

Immediately following the sharp depreciation of the Thai currency, the exchange rate of the ringgit fell dramatically. In March 1997, the ringgit was valued at 2.48 against the United States dollar. Following the speculative attacks in July, the ringgit dropped to about 2.57. By the end of 1997 the exchange rate fell to 3.77. Bank Negara Malaysia (BNM) tried, unsuccessfully, to defend the ringgit in mid-1997. By January 1998 the ringgit had fallen to 4.88 against the United States dollar.

Along with the decline in the exchange rate, the stock market witnessed a drastic fall. The Kuala Lumpur Stock Exchange (KLSE) index in late January 1997 was at 1,216 points. The index declined unceremoniously to 594 points by the end of the year. The composite index touched 302 points in August 1998. From January to March 1997, the average daily turnover was RM 2-3 billion. In August 1998, the average daily turnover was RM 193 million. Similarly, the market capitalization of the KLSE was reduced by more than 20 per cent in August 1998 as compared to January 1997 when it was valued at RM 826 billion. The drastic collapse of the ringgit combined with the stock market crisis had their repercussions.

There was a mood of pessimism following the crisis. This was reflected in MIER’s (Malaysian Institute of Economic Research) Consumer Sentiments Index (CSI) and Business Conditions Index (BCI) (Ariff and others, 1998:15-16). The BCI was
58.7 points in the third quarter of 1997. In the fourth quarter of 1997, the BCI was 49.6 points. In the first quarter of 1998 the index stood at a stark 41.0 points, having declined by 17.7 points since the third quarter of 1997. The MIER Consumer Sentiments Index (CSI) in the third quarter of 1997 was about 120 points. In the fourth quarter of 1997 the index was at about 104 points and in the first quarter of 1998 it had reached 88.5 points.

The non-performing loan (NPL) ratio of financial institutions was adversely affected subsequent to the crisis. In 1991, NPLs as a percentage of total loans of the banking system were close to 16 per cent. However, this ratio dropped gradually to a little less than 15 per cent in 1992. In 1993, the corresponding figure was about 13 per cent. In 1995, the NPL ratio was about 5 per cent, and it reached its lowest level in 1996, at slightly more than 3 per cent. In 1997, NPLs as a percentage of total loans stood at 6 per cent, but in 1998 had risen to 14.7 per cent. By the end of 1999 the ratio was about 20 per cent.

The severity of the crisis was reflected most strikingly by the growth figures. The Malaysian economy had experienced high growth rates from 1988 to 1996, averaging a GDP growth rate of 8.8 per cent during this period. In 1996 the growth rate was 8.6 per cent. In 1997 it was 7.7 per cent, and the following year it was -6.7 per cent. 1997 witnessed a more modest growth rate in the manufacturing sector (10.4 per cent) as compared to the more exuberant rate in 1996 (18.2 per cent). In 1998, the sector saw a contraction of 13.7 per cent. The construction sector, too, was severely affected by the crisis. This sector registered a high growth rate in 1996 (16.2 per cent), which decreased in 1997 (10.6 per cent), only to decline even further in 1998 (-23.0 per cent). The finance, insurance and real estate sector was another victim of the crisis, which enjoyed a growth rate of 18.9 per cent in 1997, and a growth of – 4.3 per cent in 1998.

III. REVIEWING THE PEG

A little history

From its independence in 1957 to the middle of 1972, the ringgit was pegged against the pound sterling. In June 1972 when the pound sterling was floated, Malaysia chose to use the United States dollar as the intervention currency. Towards the later part of 1975, the ringgit was set against a basket of representative currencies, known only to the central bank. But there were strong links to the currencies of the United States and Singapore.

The ringgit appreciated in the early 1980s in spite of declining commodity prices at that time. This was because of the countervailing effect of falling export prices coupled with the increased demand for ringgit owing to the establishment of heavy industry and infrastructure projects. The high oil prices at that time benefited Malaysia which was a net petroleum exporter.
In 1985, when the economy was beset with a downturn, the central bank resorted to a more flexible exchange rate regime. This was probably in view of the need to stimulate the sluggish economy. The exchange rate was, at that time, perceived as being overvalued. The more liberal approach to exchange rate policy was taken to correct the overvalued ringgit, as well as to stimulate exports. The ringgit witnessed a depreciation between 1985 and 1989.

The early 1990s saw high growth rates. There were substantial inflows of private capital during this period, leading to the appreciation of the ringgit. This period was characterized by current account deficits, and also by strong FDI and short-term capital inflows. In this period of high growth, there were substantial trade and current account deficits. Yet, the massive inflows of portfolio investments and FDI more than compensated for the trade and current account deficits, leading to the strengthening of the ringgit. The strengthening of the ringgit was not without its problems. As mentioned earlier, vulnerabilities were developing with regard to the exchange rate before the onset of the currency crisis.

The peg against the United States dollar that was announced after the crisis was not a novel policy measure in Malaysia’s economic history. Ariff (2001) points out that there were recurring episodes in the past when exchange controls were used. While resorting to a policy of exchange controls was not novel, that did not in any way diminish the severity of the crisis. Most striking at the time was the mood of uncertainty that prevailed. It must be remembered that Thailand was compelled seek to assistance from the International Monetary Fund (IMF), and Indonesia was rocked by social and political instability as a consequence of their respective crises.

**Did the peg help?**

In the aftermath of the crisis, the ringgit was on a downward spiral. There were quick changes to the ringgit, which raised the uncertainty associated with it. Against this background of sudden declines in value, and the uncertainty generated by rapid oscillations, the announcement of the peg was naturally welcome. The peg brought relief to businessmen because they now knew what to expect of the contracts that they had engaged in. Planning became an easier task for the manufacturing sector, because costing could be done with greater certainty.

There were added benefits to be gained with the ringgit being pegged to the United States dollar at 3.80. The weak ringgit was a boost for Malaysia’s export-oriented industries. Since Malaysia was dependent on foreign labour, the cost of foreign labour was now lower in United States dollar terms. Thus in the second half of 1999 there was substantial growth in the electronics subsector. Fortuitously, the global electronics industry was in a state of growth at that time. The competitive exchange rate and the low-cost structure enabled Malaysia to take advantage of the strong external demand in the electronics industry.
The primary commodities sector, too, stood to gain. Industries involved in plastics and rubber goods and in processed foods grew rapidly in this phase. There was a 19 per cent increase in palm oil output in the second quarter of 1999. This must be contrasted against the 8 per cent contraction in palm oil output in 1998. The agriculture sector (including fishing and forestry) experienced a positive growth rate in the second quarter of 1999 (8.4 per cent) after having had negative growth rates from the third quarter of 1997 and throughout 1998. As with the manufacturing sector, the low labour cost plus the competitive exchange rate helped the agriculture sector to perform well after exchange controls were imposed.

*The peg as solution*

Quite clearly, the peg had its role to play. The peg reduced uncertainties regarding the value of the currency; and it provided stability to the exchange rate. The peg was set at a competitive level. This improved competitiveness of some of the more export-oriented sectors. As we have seen, the possibly undervalued exchange rate coincided with changes in the external environment. The pegged ringgit was able to ride on the wave of improved demand in the international electronics industry and other agriculturally related industries. To this extent, the peg, rather than directly contributing to economic recovery on its own momentum, was a useful adjunct in helping to take advantage of certain external circumstances that were now more favourable.

The effectiveness of the peg is brought into question in view of the fact that exchange rate volatility across the region had receded soon after the peg was imposed (Jomo, 2001:205). Even the ensuing Brazilian crisis did not re invoke any exchange rate volatility. This raises the suspicion that the peg was introduced at a time when the worst of currency volatility had passed.

Maintaining an undervalued ringgit, it must be added, has its costs. For one, although an undervalued ringgit provides a boost for export-oriented goods, it makes imports of capital and intermediate goods more expensive (Jomo, 2001:213). This has deleterious effects for Malaysia’s medium and long-term capacity expansion and growth. At present Malaysia has a great deal of reliance on the electrical and electronics industry. The changing needs of this industry may make it inopportune to focus exchange rate policies for the exclusive advantage of the electronics industry. Malaysia’s diminishing comparative advantage in labour-intensive production reduces the desirability of locating assembly operations in this country. China’s accession to the World Trade Organization possibly makes China a more attractive destination for foreign direct investment. It is not immediately clear how the terrorist attacks of 11 September will impact on the electronics industry, but events preceding the attack pointed to a downturn in the global electronics market.
The Government realizes that Malaysia’s niche position in the global market has changed. Malaysia’s comparative advantage in cheap labour has now been usurped by other nations, notably by Indonesia in the case of agricultural production, and China in the case of manufactured goods. Malaysia cannot revert to agricultural production; neither can it continue to compete in industries that are based on labour-intensive assembly operations. The path ahead seems to lie in developing competencies in the information and communications technology sector. The Multimedia Super Corridor is a step in that direction. As Malaysia proceeds with its plans to be a knowledge-economy it will be necessary to import goods relevant to the development of the ICT industry. This can be problematic with an undervalued ringgit. Ariff (2001) expresses a similar concern since the movement to the knowledge-economy necessitates foreign workers who will find it unattractive to work in Malaysia if the ringgit continues to be weak. In fact, the broader prospect of development and growth in the long run is likely to be compromised if foreign direct investment is going to be discouraged. In all likelihood this will happen as firms find it expensive to import equipment and machinery. The Government has continued to stress that Malaysia is still the chosen destination for foreign investors. The evidence that the Government has marshalled in support of its claim is the increase in investment approvals. The actual volume of new investment projects that have been recently initiated would be more convincing evidence, but this information has not been forthcoming. Firms that have already installed their physical capital and have no immediate need to add to their stock of capital will benefit from the high level of exports encouraged by the peg. On the other hand, foreign investors who are planning to locate their manufacturing facilities within the country will be reluctant to do so under the weak ringgit.

IV. REVIEWING THE CAPITAL CONTROLS

The capital controls package

Under the pressure of the crisis, and with the failure of the first phase of crisis management, the Government had to re-think how it wanted to resolve the ‘impossible trinity’ of national economic policy. The policy maker cannot and does not have the comfort of choosing autonomy on three fronts, i.e. monetary autonomy, capital mobility and exchange rate stability. The United States and Japanese economies opt for monetary autonomy and capital mobility, relinquishing the choice of exchange rate stability. Pursuing this scenario would have required seeking IMF assistance, something the leadership of the country wanted to avoid. It was not advisable to pursue a fixed exchange rate and capital mobility, because that would have implied forgoing the central bank’s control over the supply of money. This left the Government with little choice but to adopt a scenario where monetary autonomy and exchange rate stability were to be retained, but at the cost of capital mobility.
The decision to impose capital controls was defensible at that juncture. Proponents of the capital controls package argued that short-term capital inflows needed to be restrained since their flows were subject to quick reversal. It was also argued that the trading of shares of Malaysian companies in Singapore contributed to the exchange rate and share price fluctuations. The total value of Malaysian shares traded in the central limit order book (CLOB) was supposed to amount to US$ 4.2 billion. Not only was this huge amount considered to be a destabilising figure, the fact that CLOB engaged in the short selling of Malaysian shares, when that was banned in Malaysia, was considered to be an undermining influence.

The capital controls that were introduced were directed at the following targets:

1. Controlling transactions with non-residents when such transactions were denominated in ringgit
2. Restricting the outflow of short-term capital
3. Restricting the carriage of ringgit by travellers
4. Restricting the export of foreign currency by Malaysian nationals
5. Controls on outflow of Malaysian investment abroad

Malaysia was careful not to jeopardize its position on open trade and investment. In consonance with this policy, there were no restrictions on FDI (in/out)flows. Neither were there any restrictions on repatriation of income earned by non-residents from FDI based in Malaysia.

Clearly, one objective of the capital controls was directed at putting a stop to speculative trading overseas in ringgit. The capital controls were also designed to discourage short-term portfolio investors from selling their shares on Malaysian companies. The outflow of short-term capital was an important target. To this end, the central bank instituted a one-year period (until 30 August 1998) until which time income from foreign portfolio investment as well as the principal amount was not to be repatriated. Malaysian nationals were also discouraged from investing abroad (since there was a cap of RM 10,000 on outflows). Overseas travel by Malaysians was discouraged owing to the limit of RM 1,000 that Malaysian travellers could carry on their person.

With time these controls were rolled back. The central bank had initially contemplated the idea of imposing regulatory procedures on the repatriation of capital and profits by foreign investors. Protests from this community (Zefferys, 1999) put a quick stop to these controls, leading to their removal by the central bank. In February 1999 the first significant act of rescinding the controls took place when the original 12-month restriction on the holding of portfolio investment gave way to a two-set repatriation levy depending on when the funds had entered the country and for how long they were held within the country. Under this scheme funds were subject to a two-tier levy: a levy of 30 per cent on profit made and repatriated within
a year, and a 10 per cent levy for profit made and repatriated after one year. In August 1999 this was revised to a 10 per cent levy for funds entering the country after 15 February. Another step was taken towards relaxing the capital controls when, in February 2000, the KLSE and the Singapore Stock Exchange agreed that funds, which had earlier been caught by the closure of CLOB, could enter the KLSE for trading.

The Government has announced that capital controls are a temporary measure. That announcement seems to underline Malaysia’s intention of integrating itself with the rest of the world. The ease with which the central bank has rolled back the capital controls is indicative of this stance. Indeed, the IMF in its Article IV consultations with the Government had noted the slide back in the controls. The IMF had encouraged further relaxation of the remaining controls. Nevertheless, there is little doubt that the central bank has been reluctant to announce the schedule that it intends to pursue. No indication has been offered as to the sequence of events or the timeframe within which the central bank intends to remove the remaining controls.

**Did the capital controls help?**

The objective of capital controls, in the immediate period following 1 September 1998, was to take a grip on the economy and to reverse the downward trend in activity that came to follow the introduction of IMF-type policies. The first task in that respect was to insulate the Malaysian economy from the effects of capital outflows and from the short-selling of the ringgit in offshore markets. As mentioned earlier, the capital controls, in effect, made offshore trading in the ringgit illegal. All ringgit assets held abroad had to be repatriated, or be deemed worthless. The stipulation that foreigners could not repatriate investments for a one-year period served to lock in funds that might otherwise have been withdrawn by foreign investors (who might have been frightened by these drastic measures). In this respect, capital controls worked.

It appears as if capital controls were effective in controlling the offshore trading in ringgit. More specifically, the capital controls were effective in putting a stop to the short selling that was going on in Singapore. This had its value since RM 25-30 billion was in Singapore at the time (Jomo, 2001:xviii). The controls were also effective in restraining the volume of interbank spot and swap transactions in the Kuala Lumpur foreign market. The transactions, which reached an all-time high of about RM 1,300 billion in 1997 and close to RM 900 billion in 1998, dropped to about RM 300 in the years to follow, i.e. in 1999 and 2000. Reportedly, most of the transactions were for trade and investment purposes (Tamirisa, 2001). The equity market probably benefited from the controls. The KLSE index did exceptionally well against regional bourses from September 1998 till the end of 1999. The controls helped draw ringgit funds into the domestic equity market while restricting capital
outflows and restoring market confidence. Retail buyers took great interest in trading in the KLSE. They could not invest overseas and found deposit interest rates in banks unattractive.

The immediate response to capital controls was not particularly favourable. International rating agencies such as Standard and Poor and Moody’s downgraded Malaysia’s credit and sovereign debt ratings. The sovereign bond spread also widened. There are less sympathetic views on the effectiveness of capital controls. Lim (1999) is of the opinion “that capital controls in Malaysia were neither necessary nor sufficient for economic recovery.” She argues that since Malaysia had stronger macroeconomic fundamentals and financial institutions before the crisis, it should have out-performed the other crisis-hit Asian countries in its recovery, but that was not the case, suggesting that capital controls may have been responsible. Krugman (1999), though he had considered capital controls as a tool for crisis management even before they were officially announced, reminds us that other countries that did not use capital controls recovered, too. Not only was recovery not a unique concomitant of capital controls, Malaysia’s recovery occurred at a time when market panic had ebbed.

Kaplan and Rodrik (2001) take a different position on the effectiveness of capital controls. They do not subscribe to the view that the financial crisis was tapering off, and that a recovery was in sight anyway. Instead, they hold that pressures on the ringgit were still high, and the prospect of a financial panic, which could worsen economic conditions, was still real. On the basis of their findings, they assert that the capital controls were relatively effective in so far as they reduced interest rates, stabilized the ringgit and contained panic. The Government successfully restored confidence in the banking system and this was reflected in renewed market confidence. However, Kaplan and Rodrik (2001) add that the capital controls might have been more effective if they had been imposed much earlier.

Effective as the capital controls may have been for the economy as a whole, there is some debate as to the manner in which it benefited individual firms. Johnson and Mitton (2001) test for the effects of capital controls on benefits to firms. They hypothesize that the controls could either affect all firms with equal impact, or if there was a differential in the impact it would be distinguishable on the basis of sector of activity or financial profile. Alternatively, the benefits from capital controls would be felt more strongly on firms that had stronger political connections. The evidence from their investigation strongly suggests that firms that had the support of prominent politicians gained more from the capital controls. As can be expected, politically connected firms suffered more than non-connected firms during the crisis. Amidst macroeconomic turmoil, and when subsidies may not be readily forthcoming, investors’ confidence in politically connected firms diminishes, leading to their poorer performance.

There is no doubt that cronyism did not cause the financial crisis. It would be mistaken to claim that cronyism was serious enough to effect the reversal of capital
and to cause such damage to the economy. When Johnson and Mitton (2001) make the empirically substantiated claim that capital controls were a veneer that allowed the Government to bail out cronies, they are not attempting to trace a line of causality. Instead, their conclusions are a warning of how the controls can be used to promote inefficiencies and distort market signals. Jomo (2001:215) expresses this view succinctly when he asserts that, “(c)apital controls have been part of a package focused on saving friends of the regime, usually at the public’s expense.” The adverse effects of cronyism were felt starkly after the crisis since the high growth during the booms years (1987-1995) masked the inefficiencies of political favouritism (Rasiah, 2001).

**Capital controls as solution**

There is some evidence of the effectiveness of capital controls (Kaplan and Rodrik, 2001; Athukorala, 2001; Zainal-Abidin, 2000; Yap, 1999). There seem to be reasonable arguments that suggest that capital controls did have a positive role to play. This was done, broadly, by restoring confidence, restricting speculation on the ringgit and reducing interest rates. The controls provided space for the conduct of monetary policies (Yap, 1999), and for restructuring the banking system. Obviously, the controls and the fixed exchange rate saved Malaysia the need to incur debts to the IMF or such other international institutions. This is not to say that the capital controls were without their limitations.

In the first place, the timing of the controls seems suspect. The controls were introduced after the worst was over, and this is definitely so as far as the outflow of portfolio funds is concerned. The bulk of portfolio flows had left the country by the end of 1997. It is estimated that outflows during 1997-1998 amounted to about US$ 10.4 billion. To that extent the impact of the controls was limited.

Secondly, the international rating agencies downgraded Malaysia in their rankings. This was a severe blow for the equities market in Malaysia. It was not until the more stringent aspects of the controls were relaxed that Malaysia’s standing in the indices of these agencies was upgraded. Malaysia’s reinstatement in these indices led to an improvement in market sentiment. This, coupled with a recovery in the regional economies, and the return of the Barisan Nasional in the 1999 general elections, resulted in a renewed interest in the equity market. Thirdly, the proposed controls that the central bank intended to impose on the repatriation of incomes of foreign investment houses met with instant protest, and the central bank responded in an accommodating fashion.

Clearly, the Government has not been able to impose the controls with the severity that was intended. It has had to ease the controls not too long after their introduction. In its Article IV consultation with Malaysia (IMF, 2000) several IMF Directors recommended that the remaining controls be lifted. This by itself does not constitute pressure to do so, but it is indicative of the opinion held in the international
community. Opinions do matter, and changes to the controls policy have been made in response to sections of the international community.

It is unclear whether or not capital controls have affected FDI. It was not the intention of the capital controls to affect long-term investments, and FDI certainly falls in that category. The flow of FDI into Malaysia does appear to be slow. The net FDI in Malaysia in 1996 was US$ 3.5 billion, and rose to US$ 3.9 billion in 1997. It has since dropped drastically. It was US$ 1.9 billion in 1998 and 1999, and registered another drop in 2000 to US$ 1.5 billion. FDI as a percentage of GDP has also dropped remarkably. It stood at 3.5 per cent in 1996 and fell to an estimated 1.7 per cent in 2000.

If capital controls are not responsible for the recent episodes of declining FDI, then it is possible that Japan’s weak economy could have affected the flow of FDI into Malaysia. It is equally possible that China’s liberalization programmes and its accession into the World Trade Organization have made China a more attractive venue for investment, leading to a detour of flows that might have otherwise found their destination in Malaysia. It must be pointed out that Thailand’s FDI in any particular year within the 1998-2000 period exceeds that in 1996-1997. Malaysia is performing better than the Philippines and Indonesia in attracting FDIs, but definitely not as well as Thailand.

Tamirisa (2001) suggests that capital controls could affect the flow of FDI into Malaysia, though indirectly. She observes that investors are concerned about the risk of investing in the country. Capital controls raise transactions costs because transfers between external accounts need to go through the regulatory process. This involves delays (the cost of time) and administrative costs (again, the cost of time, and labour costs). There is also a higher risk that foreign investors have to tolerate given the more limited opportunities for hedging. In the presence of capital controls, the cost of transactions for foreign investors increases, making Malaysia a less attractive destination for FDI.

There is evidence to support the view that capital controls are a barrier to exports into developing and transition economies, but not to industrial countries (Tamirisa, 1998). While in the short term this might be useful for a country that wishes to build up its foreign reserves, it is doubtful how helpful such a situation might be for a developing country in the long run. For a small open economy like Malaysia, it is important to remove policy instruments that hinder trade. Other problems that have been known to develop when capital controls are in place are the development of methods to circumvent the capital controls, such as transfer pricing and incorrect invoicing. From the information that is available, Malaysia is not affected by these attendant problems.

In the short term, capital controls have their role to play, as they have in Malaysia. It has been argued that short-term capital controls can promote capital inflows (Cordella, 1998). That has not happened in the Malaysian case. Nevertheless,
capital controls have, perhaps, played their role in reducing risks, removing the pressure on the ringgit, and have served prudential objectives. In the long term, however, capital controls can protect weak financial institutions, encourage rent seeking among local financial institutions, discourage FDI and hinder the expansion of trade. Policy makers must keep an eye on the long term implications of capital controls on the Malaysian economy.

V. IS THERE SPACE FOR UNORTHODOXY STILL?

The Malaysian economy has largely recovered from the 1997 crisis. Malaysia may not have returned to its pre-crisis dynamism, but that is not because the recovery process has not occurred. A complex of factors has prevented this return to pre-crisis levels of growth and consumer spending, predominant among which is the slowdown in the growth rates of the United States economy and that of Japan. Allowing that unorthodox policies have, indeed, accomplished some of the important tasks that were assigned to them, we need to consider if the programme of exchange and capital controls has to be retained.

In selecting the most appropriate exchange rate regime, three factors have to be given precedence: (a) the suitability of the regime in terms of its superiority in insulating the economy against speculative attacks, (b) the dependence of the economy on exports, and (c) long run considerations. The onset of the crisis in the face of the strong economic fundamentals at the time, notwithstanding the fact that there were some sources of vulnerability, suggests that contagion is a matter against which the country has to safeguard itself. While it is necessary to exercise caution and be able to contain currency fluctuations, it is no less necessary to realize that Malaysia is a country that depends on its exports and its export-oriented industries; as such, the country must continue to be attractive to FDI. All this apart, the national aspiration to integrate itself within the process of globalization has to be taken into account.

Academic fashions have influenced the preference of exchange rate regimes. Yet, the underlying dilemma remains: nations would like to simultaneously achieve exchange rate stability, full financial integration and monetary autonomy; but in pursuing two of these objectives, the third objective has to be abandoned (see, for example, Lamberte, 1999). Another version of this dilemma is expressed as the “inconsistent quartet” (Miller and Zhang, 1998). In this scheme, the four policy options available are: (1) free trade, (2) free capital movements, (3) independent monetary policy, and (4) fixed exchange rate. The United States and Japan have foregone a fixed exchange rate as a solution to the inconsistent quartet problem, whereas China’s answer has been to opt for partially free trade and to limit capital mobility. Thailand, from this perspective, attracts attention, because it tried to achieve all four policy options. It attempted to run an independent monetary policy along with liberalized capital and current accounts and, at the same time, hold on to the peg
against the United States dollar. This resulted in high interest rates that drew massive capital inflows. The capital inflows led to a loss of domestic monetary control, ultimately precipitating a financial crisis. The case of Thailand brings out in high relief the inconsistency of incompatible policy options. It shows the reason why the choice of an appropriate exchange rate regime demands careful thought and why we should review the options that are available.

Why the peg must be discarded

The crisis required a semblance of stability to restore confidence. The peg against the United States dollar did that. The fixed exchange rate regime was useful because it reduced transactions costs and the risks associated with exchange rate volatility. Besides, the fluctuating exchange rate disrupted the market for tradeable goods and services, something that Malaysia could ill afford.

It is a different proposal if one is to suggest that the peg be retained. One of the problems with sustaining a peg is that monetary authorities need to have sufficient foreign reserves to defend the ringgit. Immediately, this is not an issue of concern, but in June 2001 there was some anxiety about the declining volume of foreign reserves. Under such circumstances, since parameters change with time, the movements in international reserves start to act as a signal that can generate concern about the performance of the economy. As a consequence this can induce negative expectations of the central bank’s ability to sustain the peg. It is conceivable that the formation of pessimistic expectations, when foreign reserves fall, can generate a round of panic.

Another difficulty with the peg, as it now stands, is that it is fixed against a single currency. The exchange rate in an open economy encapsulates information about the state of the market for tradeable goods and services. By tying the ringgit to the United States dollar, investors will have to use less direct means to determine the state of the market for tradeables. Investors will have to judge through comparison how close the ringgit is to its equilibrium value. The fixed peg reduces the informational content of the exchange rate. This makes it difficult to assess the extent of convergence between the pegged value of the ringgit and its long-term equilibrium rate. From a long term perspective, for a country such as Malaysia, which intends to participate actively in the process of globalization and hopes to be the global hub of the ICT revolution, this could act as a constraint.

As mentioned earlier, long-term development could be adversely impacted with Malaysia’s undervalued ringgit. While export competitiveness will benefit from an undervalued ringgit, development will not. An undervalued ringgit will discourage the import of technology and intermediate goods necessary for the ICT revolution. Skilled expatriate workers will not find it sufficiently attractive to work in Malaysia in view of the cheap ringgit (Ariff, 2001). An undervalued ringgit may contribute towards posting moderate levels of growth in the short term, but this will be deceiving if a concurrent increase in productivity is absent.
Under conditions of an undervalued ringgit, there is little pressure to revise the peg. An overvalued ringgit will be more problematic. If exports increase in excess of imports it might lead to an overvaluation of the ringgit. Again, if FDI reaches pre-crisis levels, this could set the scenario for an overvaluation of the ringgit. Such circumstances will demand a re-peg. This will then raise transaction costs since decisions will have to be re-evaluated and prices re-configured. Improvements in FDI inflows and a massive increase in exports do not seem imminent and may be further away than expected with the uncertainties that besiege the United States and the slowdown in the Japanese economy.

Further, Athukorala (2001:104) points out that as Malaysia proceeds with its economic recovery there will be increases in the rate of inflation and increases in the base-money stock. A higher level of inflation and expansion in base-money will make it increasingly difficult for the country to maintain its fixed exchange rate. This argument, in addition to some of the preceding arguments, indicates that the fixed exchange rate may not be a feasible alternative in the long run. Although the central bank may have sufficient reserves, when the fixed exchange rate is under pressure, there will be other political expediencies, which will reduce the Government’s will in maintaining the exchange rate (Obstfeld and Rogoff, 1995). Indeed the Government cannot be expected to defend the exchange rate to the exclusion of other monetary and financial variables.

**Why capital controls must be discarded**

Capital mobility has its appeal (see Hartwell, 2001 for an ideological version). It allows capital to seek its best possible use and reward. The international mobility of capital allows investors the benefit of a deeper reserve of savings; it allows them greater investment opportunities; and it allows investors to diversify their portfolios. Capital mobility provides an avenue for households whose domestic economies presently have low incomes to borrow. This smooths consumption and reduces the deleterious effects of a possible downswing. Cost increases or a bout of pessimism in a domestic economy need not necessarily result in funds being tied down domestically when conditions are unsatisfactory. Instead the funds can be loaned abroad to receive higher rates of return.

There are arguments against the free flow of capital. Primary among them is the concern regarding vulnerability to external shocks. Stiglitz (1999) expresses this best when he makes the following observation: “Volatile markets are an inescapable reality. Developing countries need to manage them. They will have to consider policies that help stabilize the economy.” As a possible solution he suggests that Chilean-style policies could put a limit on capital flows. The other strong objection to the free movement of capital arises from concerns regarding distortions due to informational constraints such as moral hazard, adverse selection and herding (Bhagwati, 1998; Cooper, 1998).
In any case, the capital controls that were imposed in Malaysia, by restoring confidence, were instrumental in stabilizing the economy. It cannot be conclusively established that the controls were beneficial to the economy since they were imposed after the worst had passed (Tamirisa, 2001; Jomo, 2001). Nevertheless, the controls did not imply serious costs, aside from those flowing from the initial disfavour exhibited by international rating agencies.

The long-term advisability of capital controls is a more contentious issue. Capital controls may have contributed towards eroding investors’ confidence in Malaysia, thus influencing the poor show in FDI inflows. Of relevance is the possibility that the capital controls may have the effect of reminding speculators that there is every possibility of the controls being re-introduced at some time in the future. The previous experience, if memory holds, will induce learning and will act as a deterrent. On the other hand, the capital controls can convey the message of unpredictability in economic policies.

Capital controls afford an opportunity for “buying time” (Laurens and Cardoso, 1998). The period during which the controls are under enforcement should give a country time to undertake structural reforms. But if the controls are kept in place for a prolonged period of time, there will be less urgency to design and institute the necessary reforms. This will initiate a weakening of credibility and further discourage FDI. The presence of these controls will create a false sense of security and complacency among policy makers (Edwards, 1999).

Finally, with the lifting of capital controls the Government will have to be more responsive to good corporate governance. Rodrik (2001:13) states that “among all the arguments in favour of international capital mobility perhaps the most appealing one is that such mobility serves a useful disciplining function on government policy.” Marginal efforts, at best, have been undertaken in the direction of establishing corporate restructuring. Ideally, companies that were fragile at the time of the crisis and were bailed-out by the Government should have been restructured. At the micro-level, when companies are bailed out, they are encouraged to form expectations that they can depend on being bailed out in the event of another crisis. This acts as an inducement to pursue risky actions and behaviour.

What needs to be done

The Malaysian economic agenda is based on the market mechanism coupled with substantial Government intervention. The Government has long envisaged a development process that is linked to globalization. The quest to be a part of the process of globalization implies greater integration into international markets. Globalization promises great gains that come with free trade in goods and services. Most parties are in agreement on this score. There is disagreement when it comes to free trade in capital. The enthusiasts say that stopping trade in capital is as meaningless
as restricting trade in goods and services, and that free trade in capital works in much the same way as it does for goods (Anjaria, 1998). The detractors say that trading in capital is riddled with complications such as inadequate information (Bhagwati, 1998), contagion (Edwards, 2000), and sudden stops.

As we have seen there are disadvantages to the fixed peg and capital controls. The Government cannot afford to bear the disadvantages of controls if it is seriously committed to gaining competitiveness and high growth in the movement towards globalization. In other words, it is doubtful if the Government can maintain the peg and capital controls over the long run without incurring substantial costs. The alternative is to insulate the economy and pursue lower rates of growth. If that is not the preferred choice then there is little option but to move towards greater flexibility in a manner that minimizes the associated risks.

The peg and capital controls are complementary mechanisms. Controls on the outflow of capital ensure that the peg will not be subject to destabilizing attacks. Moving in the direction of flexibility will mean abandoning the peg and the capital controls. In reality, the Government has been lifting the capital controls. The IMF in its Article IV discussions with Malaysia has suggested that the controls be lifted in line with the act of instituting a more flexible exchange rate.

It is hard to say if the Government has thought about the notion of preparing a transition strategy from the existing situation. There does not seem to have been any publicly declared announcement on this. Although any discussion of a transition strategy will require far more detailed analysis than this paper will allow, the strategy will at least involve some of the following elements:

1. Choice of exchange rate regime: Malaysia could choose between a super-fix or a clean float. Super-fixes will not be politically acceptable, especially dollarization. Besides, moving out of a super-fix is a protracted and costly affair. However, it is hazardous to launch immediately into a clean float regime. In the interim period it would be practical to revise the peg in small increments towards what is felt to be the equilibrium level (Ariff, 2001). The Government will have to deliberate on the timing of the exit from the peg. This will have to be done when the ringgit is relatively strong. Meanwhile the supporting legal and institutional structures should be reformed.

2. Strengthening the banking system: Banks play an important role in the financial system. From previous experience, it should be learnt that banks can expose the country to risk if they make excessive loans to speculative sectors using collateral from equally speculative assets. This calls for firmer policies and guidelines on credit extension, prudential supervision and stringent accounting and disclosure requirements. There should be fewer restrictions on the
participation of foreign banks in Malaysia. The presence of foreign banks will provide more access to capital overseas, provide a benchmark on best practices and discourage the bailing out of banks (Mishkin, 2001).

3. Developing capital markets: Concerted efforts should be made to develop the bond market in Malaysia. Bond markets have their advantages in so far as they offer an alternative source of financing aside from bank finance, they reduce the monopolistic and rent-seeking character of banks, are likely to reduce short-term and foreign debt, and, once developed, will serve as a conduit for the functioning of monetary policy (Yoshitomi and Shirai, 2000). It is also necessary to develop a market for derivatives. Derivative instruments can help reduce the volatility and risks associated with currencies and commodities prices and also reduce unhedged foreign debt.

4. Market-based discipline: Political patronage must not be extended to banks or other companies. The Government should desist from intervening in the corporate performance of firms. The active participation of the Government in corporations encourages moral hazard, promotes risk-taking behaviour and discourages efficiency. A more market-based discipline will promote caution among firms and make them more accountable to investors. This will weed out the uncompetitive firms and save financial institutions from the risk of having to support non-viable firms that are politically connected. The Government should muster the political will to encourage good corporate governance and eliminate firms that are considered too-politically-connected to fail. This is best done well after the crisis has ended.

5. Sequencing liberalization: Malaysia has to adopt a pro-active policy towards liberalization. One option is for the Government to respond to external pressures, when they build up, for the opening up of markets, particularly capital markets. A more prudent approach will be to plan a strategy ahead of exigencies. The necessary legal systems, business and accounting practices and safeguards have to be instituted before full liberalization takes place, if we are to avoid the crisis that could follow an unprepared opening of our financial systems (Eichengreen and others, 1999).
VI. SUMMARY AND CONCLUSION

Despite Malaysia’s good fundamentals in the years preceding the crisis, the ringgit was subject to speculative attack and the economy succumbed to a crisis. The view that Malaysia was, as it were, an innocent bystander that fell victim to the effects of contagion is, however, not entirely tenable. There were sources of vulnerability that were developing within the economy that made the economy more susceptible than it otherwise might have been.

The first phase of policy measures that were implemented to curb the crisis were IMF-inspired, although IMF had no hand in designing or implementing them. They were unsuccessful and perhaps assisted in propelling a downward spiral. The second phase of measures ran counter to the standard IMF recipe for recovery. Essentially, they consisted of fixing the ringgit against the United States dollar at RM 3.80 and a programme of capital controls.

Now that it has been more than four years since the controls were imposed and with the recovery of the economy, it is worthwhile to consider whether there is still need for the controls. A discussion of the controls reveals that the controls may have distortionary effects and lead to inefficiencies if their use is continued. More problematic is the issue of development, since the controls may have the unintended effect of hindering rather than promoting it.

At its core the problem is: how can Malaysia reap the promised benefits of globalization and financial liberalization without being subject to the immense risks that can come with the opening of markets and the free flow of capital? One option is to insulate the economy from the vagaries of the market, to the extent possible. The other option is to be committed to global competitiveness and to participate within the global markets while minimizing the risks involved. Given Malaysia’s policy announcements and initiatives, the latter seems to be the more appropriate choice. If it is the case, then it would be sensible to put in place the necessary institutions and safeguards and to prepare for the new economic order.

In accordance with this thinking it is suggested that a strategy be planned and enunciated. This strategy should clearly indicate the time frame for the withdrawal of the controls. It is suggested that there be an interim policy with regard to the exchange rate regime, simply because Malaysia does not possess the resilience and the structural and institutional foundations for a flexible exchange rate policy and financial liberalization. Nevertheless, it should be Malaysia’s goal to head in that direction. Policy makers should work towards preparing the economy for the eventual aim of liberalization.

The Government was courageous in implementing ‘unorthodox’ measures, irrespective of whether it was undertaken in a moment of desperation or through calculated risk. That is no longer the question now. The issue at hand is the fact that the economy is on the road to recovery and the unorthodox measures that served well
will cease to do so as time progresses. The Government’s role becomes more important because it has to draw on its political will, push aside short-term considerations and pave the way for future development. In doing this it has to eliminate the generation of moral hazard that owes its origins to Government intervention in business and banking. The Government has the responsibility of encouraging market-based discipline. Finally, the Government has the complex and challenging task of developing bond and capital markets, markets that are in their infancy in most developing economies.
REFERENCES


