Chapter 4

Impact of East Asia Economic crisis on Malaysia

Malaysia’s impressive record of sustained strong economic growth over the last ten years was halted in 1998 by the Asian economic crisis. The speed and severity of the contagion effects of the crisis, which started in Thailand following the devaluation of the Thai baht in July 1997, were unforeseen. Many countries in the region experienced extreme volatility and turbulence in their capital and financial markets. The effects of such capital and financial markets turmoil have impacted upon the real sectors of the economies of these countries, and adversely affected the level of output, employment, consumer sentiment and investor confidence.

In Malaysia, the ringgit depreciated and stock market fell sharply. Interest rates reached record high levels in 1998 before easing off after the country imposed selective capital controls and adopted a fixed exchange rate regime with the fixing of the ringgit at RM3.80 to the US Dollar in September 1998. The currency volatility, high interest rates and weak stock market had hurt many corporations and industries. The negative wealth effect from asset devaluation and raising unemployment contributed to a contraction in private consumption. The financial sector experienced slower deposit and loan growth and rising non-performing loans, due partly to falling property and equity market, despite prompt action taken by the respective Governments to restore stability in the currency and capital markets and to strengthen the financial markets. For the year 1998, the stockbroking industry of Malaysia suffered a major decline in business volume as a consequence of the economic turmoil and bearish market sentiments. The turnover of shares for the KLSE dropped substantially by about 74% as compared to the previous year. The KLSE Composite Index ended 1998 at 586 points, about 8 points lower than the previous year-end. Market capitalization also dropped marginally from RM376.0 billion to Rm374.5 billion. The Malaysian economy contracted by 6.7% in 1998. On quarterly basis, Malaysia’s real GDP contracted by 2.8% in the first quarter, -6.8% in the second quarter, -9.0% in the third quarter and -8.1% in the fourth quarter. (Public Bank Annual Report 1998)
Capital Control in Malaysia

Exchange control is one of the direct controls enforced by governments to restrict or prevent inflow and/or outflow of capital. It is through exchange controls that capital controls are enforced in Malaysia. The objective of exchange control is to prevent external pressure on the exchange rate from falling/raising too much or too rapidly.

Malaysia government has decided with effect from 1 September 1998 to implement a series of exchange controls to insulate and revive the Malaysian economy, following the economic contraction as a result of East Asian currency and financial crisis. Malaysia, therefore, designed the selective exchange control measures to specifically achieve the objective of reducing the internationalization of the ringgit. This was achieved by eliminating access to ringgit by speculators, both at home and abroad. This involved the introduction of rules retaining to the external account transactions of non-residents and currency of settlement of trade transactions, while general payments, including movements of funds relating to long-term investments and repatriation of profits, interest and dividends remained unaffected. The measures are also aimed at stabilizing short-term capital flows, by requiring inflows of capital to remain in the country for a period of 12 months. The measures are temporary and would be modified or removed when its objective have been achieved. In this regard, on 4 February 1999, the rule on the one-year holding of portfolio capital was modified to allow the foreign investors to repatriate the principal capital and profits subject to a graduated levy. (BNM , 1998)

The decision of government Malaysia to use exchange control had been widely criticized by proponents of the free market system on the ground that it leads to distortions and inefficiencies in some economies. The potential costs associated with controls on capital flows are lower real interest rates and capital flight, thereby contributing to higher rates of inflation and deterioration in the balance of payments position over the long term. It was important to consider when and under what circumstances such capital controls can
be applied, in what form they should take, the preconditions that would ensure it would yield the desired results and how it might be efficiently implemented.

Prior to the controls, Malaysia already had taken corrective measures which led to a significant improvement in the current account from a deficit of 5.4% of GNP in 1997 to a surplus of 13.7% of GNP in 1998, thus resulting in a strong build-up of reserves. Malaysia has generally not experienced significant capital outflows of the type and magnitude experienced by countries facing balance of payments and reserves constraints. In Malaysia, capital outflows have been in the form of prepayments of external loans by both the public and private sectors. (BNM, 1998)

To date, the build-up of external reserves has been significant. As at end-February 1999, international reserves stood at US$28.7 billion, an increase of US$8.5 billion from end-August 1998 level, adequate to finance 6.2 months of imports. This growth in reserves would provide greater overall confidence and place the government in a better position to cope with any bunching of short-term capital outflows that could occur on 1 September 1999. In addition, the short term debt is less than half the size of foreign exchange reserves, Malaysia is therefore, not vulnerable to credit outflows over the short term, and 60% of Malaysia’s external debt have remaining maturity that exceeds three years. Experience of countries has shown that countries with strong balance of payments position such as The People’s Republic of China and Taiwan have achieved a greater degree of success with capital controls. (BNM, 1998)

In Malaysia, inflationary pressures from capital controls have been subdued due to several factors:

a. On the domestic front, weak domestic demand has more than offset the effects of the depreciation of the ringgit against the currencies of major trading partners. Excess capacity in product and labor markets contributed to lower inflation so that consumer prices rose by 5.3% in 1998, as against earlier expectations of 7-8%.

b. Generally, the low inflation environment and the strong expansion in income levels in the last decade have resulted in high savings and is expected to remain
high at about 40% of GNP. Consequently, the fiscal stimulus is being funded by non-inflationary domestic sources of financing, primarily through the issuance of bond and Malaysian Government Securities.

c. Malaysia also ranked favorably in terms of overall competitiveness. Malaysia has pursued an export-oriented industrialization strategy since the 1970s, which has exposed the economy to international competition. Malaysia’s economy is open with high foreign presence in the domestic industries, including financial services. Given the low inflation rate, the ringgit is also not overvalued when measured in terms of the real effective exchange rate.

It is important to recognize that Malaysia is not relying on controls to address macroeconomic imbalance in the economy. The approach adopted by Malaysia is to use such measure to complement other monetary and fiscal measures to bring about sound and balanced development of the country. Malaysia has shown commitments to undertake the necessary structural adjustment policies that are critical for strengthen economy fundamental and long-term growth with price stability. The facts show that the breathing space provided by the exchange control measures has been used effectively to undertake further macroeconomic policies and accelerate structural reform measures. The financial sector restructuring has been comprehensive. The achievement of restructuring program has exceeded the target set. In addition, the target dates for completion of acquisition of non-performing loans and re-capitalization of the financial institutions have been brought forward. Work on corporate debt restructuring to facilitate debt workouts on a voluntary basis has also been increased. Issue of corporate governance was being addressed as well.

The exchange control measures implemented on 1 September 1998, which included the requirement for portfolio capital to remain in Malaysia for a least 12 months, have contributed significantly to the stability of the economy. Accordingly, on 4 February 1999, the Government announced a new rule to replace the one year holding rule for portfolio capital. Under the new rule, the principle capital and profits will be allowed to
be repatriated subject to a graduated levy depending on when the funds were brought into Malaysia and the duration of investment.

The measures are aimed at encouraging existing portfolio investors to take a longer-term view of their investments in Malaysia, attract new funds into the country, while at the same time discourage destabilizing short-term flows. In addition, the rule was designed to allow a smoother outflow of funds, rather than a sudden and massive outflow upon the expiry of the one-year holding period. With respect to rules on external account transactions, Malaysia would remain cautious and lift the controls only when there are clear indications that the necessary safeguards are in place in the international financial environment to contain excessive speculative activities on currencies.

Initial indicators point to the success of the exchange control measures. The greater stability in the currency, stock markets and the financial system is contributing to some revival in consumer and investor confidence. The measures have been positively received by long-term investors. The measures have enabled an intensification of the ongoing reform. Malaysia has taken full advantage of the “breathing space” provided by these controls to further expedite economic and financial reforms.

On the international front, there has been an important shift in thinking on the broader issue of policy response to the financial crisis in general, and on the issue of exchange controls in particular. There is now increasing recognition that such controls are appropriate under specific circumstances, particularly when they are targeted at short-term destabilizing capital flows and when the controls complement, and are not a substitute for policy adjustments. (BNM, 1998).

The recovery from the 1998 recession is expected to be more gradual (growth of 1% in 1999). However, the structural adjustments and financial sector reforms would provide the foundation for sustainable growth and a stronger economy. Nevertheless, uncertainty and the threat of contagion and systemic risk remains, given recent developments on the international front. It is clear that, given the openness of the Malaysia economy, external
developments would continue to significantly influence the growth cycle of the domestic economy. In particular, given the more integrated nature of the world economy and the more hostile external environment, the policy responses in the 1998 recession have been more dynamic and unorthodox.

Just as Malaysia’s policy went into effect, the market panic against Asian economies began to subside, at least for the time being. Asian currency strengthen, interest rates came down, and things looked a little better. Was the call for capital controls alarmist? Was the IMF policy working after all? One might have thought so, but then came a clear demonstration that the world remains a very dangerous place for developing countries, and that the story is not over yet. (pg146, The return of depression economics, Paul Krugman)