CHAPTER 1 : INTRODUCTION

1.1 Introduction

In the aftermath of the Mexican crisis, and even more so after the recent East Asian currency crisis, many views have been expressed on the issue of financial liberalization and capital controls. Many analysts have argued that excessive financial liberalization is one of the main causes to the 1997 Asian crisis (Henderson, 1998).

In response to the currency crisis, some countries have re-imposed controls on their capital account and re-introduced regulations in their financial market, while others sought financial aid from the International Monetary Fund (IMF)(Haque, Mathieson and Sharma, 1997). UNCTAD (the United Nation Conference on Trade and Development) in its key proposals on preventing and dealing with future financial crises also concluded that governments of the affected countries should be allowed to make use of capital controls to insulate their economies from the effects of speculation and volatility (Khor, 1998). However, such measures (that is capital controls) are deemed inconsistent with the ideology of international agencies such as the IMF and the Group of 7 countries which insist on free capital flows as a pre-requisite for IMF-coordinated rescue loans (Khor, 1998)

Malaysia, which has been experiencing a positive Gross Domestic Product (GDP) growth rate of about 8% for the past decade was not spared from the contagion effect of the 1997 currency crisis which started from the devaluation of the Thai's baht in July 1997. In order to stabilize its economy, the Malaysian government has taken a bold and unconventional step by imposing selective capital controls and fixing the country's exchange rate at RM3.80 to one US dollar effective 1 September 1998 (Kwan, 1998, BNM, 1998).

With capital controls in place domestic interest rates need no longer be equal to world interest rates. Nor can households convert foreign assets to domestic assets to domestic money rapidly. The central bank will not sell or buy foreign exchange reserves for this purpose (Sachs & Larrain, 1993).

The implementation of these measures by Malaysia generated much interest as well as controversy not only among the academia, economists and policy-makers, but also the public, particularly the business community. Based on the Bank Negara Malaysia's (BNM) Monthly Statistical Bulletin- for December 1999, signs of improvement have been noted in the country's real Gross Domestic Product (GDP) since the above measures were undertaken. The real GDP has moved from -10.3% in the fourth quarter of 1998 to a positive of 10.6 in the fourth quarter of 1999 (Table 1).

Some have attributed this encouraging performance to the effectiveness of the selective capital controls imposed by the government while some have cast doubts as to whether the recent economic growth is real economic recovery and whether it would be sustainable. A comparison with its neighboring countries, for example, Thailand and South Korea, which were also affected by the recent financial crisis but did not implement capital controls and were able to achieve high GDP growth rates, seems to indicate that economic progress is possible without capital controls. From Table 1, it is noted that both Thailand and South Korea regained a positive real GDP growth rate in the first quarter of 1999. Thailand and South Korea achieved a positive GDP growth rate of 0.8% and 4.5% respectively in the first quarter of 1999, while Malaysia only achieved a positive GDP growth rate in the second quarter of 1999.

To date, the appropriateness and effectiveness of Malaysia's selective capital controls as a remedy for dealing with the currency crisis remains a controversial issue. It is therefore the purpose of this paper to study the effects of the above measures, particularly in relation to the country's monetary and fiscal policies, which are deemed important not only for the economic recovery from the crisis, but also for the economic development of Malaysia in the longer run.

Table 1: Real GDP and Inflation of Malaysia, Thailand and South Korea, 1997-1999

Quarter		Malaysia (% Annual Change)		Thailand (% Annual Change)		South Korea (% Annual Change)	
		Real GDP	Inflation	Real GDP	Inflation	Real GDP	Inflation
1997	Q1	8.6	3.2	1.1	4.5	5.7	4.5
	Q2	8.4	2.2	-1.6	4.4	6.4	4.0
	Q3	7.7	2.3	-2.0	7.0	6.1	4.2
	Q4	5.6	2.9	-4.4	7.7	3.9	6.6
1998	Q1	-3.1	5.1	-8.2	9.5	-3.6	9.0
	Q2	-5.2	6.2	-12.3	10.7	-7.2	7.5
	Q3	-10.9	5.5	-13.6	7.0	-7.1	6.9
	Q4	-10.3	5.3	-5.8	4.3	-5.3	4.0
1999	Q1	-1.3	3.0	0.8	1.6	4.5	0.5
	Q2	4.1	2.1	3.5	-1.9	9.9	0.6
	Q3	8.1	2.1	7.7	0.2	12.3	0.8
	Q4	10.6	2.5	N.A	0.7	N.A	1.4

Notes : *N.A – Not Available*

Sources : *Bank Negara – Monthly Statistical Bulletin, December 1999 and The Bank of Thailand website.*

1.2 Objectives Of The Study

More specifically, the objectives of this study are:

i) to understand the role that selective capital controls may have played in coping with the recent financial crisis

ii) to examine the effectiveness of the selective capital controls in relation to Malaysia's fiscal and monetary policies in dealing with the recent financial crisis and in facilitating the subsequent recovery.

iii) to evaluate the usefulness of capital controls as a policy instrument to induce and sustain short, medium or longer term economic growth of the country.

1.3 Scope Of The Study

The study begins with a review of the relevant literature on financial crisis, capital flows, capital controls and exchange rate policies. Thereon, it focuses on the root causes of the crisis particularly in the Malaysia context, and the Malaysian government's macroeconomic policies before and during the crisis. The understanding on these issues provides a background for further analysis on the rationale of imposing selective capital controls and the effectiveness of such measures in overcoming the crisis.

In this study, the theoretical approach for dealing with capital flows, namely the Mundell-Fleming model will be examined and used as the major guideline for the analysis. This theoretical framework will provide a general understanding on the significance of capital flows and exchange rate polices and their impact on expansionary fiscal and monetary polices.

Lastly, the effects of capital controls will be analyzed by studying the behaviour of some selected economic indicators before and after the imposition of capital controls.

1.4 Organization Of The Study

Chapter 1 sets out the introduction for the study and provides an overview on the research objectives, scope of the study, research methodology, limitations of the study and defines some relevant concepts pertaining to the study.

Chapter 2 reviews the relevant literature on the financial crisis, capital flows and capital controls, specifically the changing trends in the international financial flows, the influx of capital flows to the developing countries. The chapter will also review relevant literature on the driving forces, the behavior of different types of investment that is foreign direct investment and foreign portfolio investment; the significant and drawbacks of capital flows; the behavior of capital flows under different exchange rate system; the causes of capital flight and the management of capital flows. The relevant literature pertaining to exchange rates will not be neglected as capital controls are almost always implemented in conjunction with fixed exchange rates.

Chapter 3 studies the root causes of the crisis from the Malaysian perspectives.

Chapter 4 examines the Malaysian government macroeconomic policies (specifically on fiscal, monetary and exchange rate polices) before and during the crisis.

Chapter 5 studies the effectiveness of the selective capital controls in the short and medium or long(er) run. The short run effects of the selective capital controls will be determined by analyzing the selective economic indicators while the medium or long(er) effects (in terms of the sustainability of the economic growth) will be projected by using the Mundell-Fleming Model.

Chapter 6 concludes the findings of the study.

1.5 Research Methodology

The study makes extensive use of secondary macroeconomic data that is published by the Malaysian government and international agencies.

1.5.1 Sources of Data

The data for the study is obtained from various secondary sources such as economics and international finance textbooks, write-ups and articles from the economics and international finance journals, magazines, newspapers and the internet, survey statistics, working papers, discussion papers, symposium of international seminars or conference from relevant agencies such as International Monetary Funds (IMF), World Bank, United Nation Conference on Trade and Development (UNCTAD), the Organization for Economic Cooperation and Development (OECD), Bank Negara Malaysia, Ministry of Finance Malaysia, Annual Reports by Statistics Department and Bank Negara Malaysia and Economic Reports by Ministry of Finance.

1.5.2 Data Analysis

The research analysis will be based primarily on the economic theoretical framework that is the Mundell-Fleming Model, which is of great relevance to capital flows, exchange rates and fiscal and monetary polices.

1.6 Limitations Of The Study

Selective capital controls have been in place in Malaysia for only about one and a half years, that is, since 1 September 1998. According to Kwan, Vandenbrink and Chia (1998), the impact of capital inflows and policy responses to capital flows can be analyzed at three levels, that is, the long term, medium term and short term. Long term has been defined as the period when both price and quantity in the goods market adjust, while medium term is the period when quantity adjusts in the goods market with price remaining constant and short term is the time when the asset market but not the goods market adjust.

Whilst this research may be conducted in time for understanding the rationale of capital controls and its short effects, it is deemed too early to make a comprehensive evaluation of its real medium and long run impact associated with expansionary fiscal and monetary polices. At present, the price of goods as indicated by the Consumer Price Index (CPI) is still in a rather initial stage. As reported in the Economic Report 1999/2000 (Ministry of Finance Malaysia 1999), the CPI increased by 3% during the first nine months of 1999 compared with an increase of 5.2% during the same period in 1998. For the whole of 1999, the CPI was expected to remain at 3% given that the monthly CPI has decelerated from as high as 6.2% in June 1998 to 2.1% in September 1999.

Besides that, there is also some concern over the economic data obtained, particularly those in the fourth quarter of 1998 and first quarter of 1999. These data may not really reflect the effect of capital controls as yet but more the effect of past policy measures.

The scope of this study is strictly confined to the Malaysian context, whereby no comparison will be made on the effectiveness of capital controls vis-à-vis that of the IMF rescue package to the other affected countries in the region. This limitation is very much due to the time constraints and difficulties in accessing the relevant data from other countries.

The studies of international finance and economics are always complex and dynamic. It is acknowledged that there are indeed many other economic variables, for example, inflation and external factors that also affect the real economy. The Mundell-Fleming model only serve as the basic guideline for the analysis, it is incomplete in the real economy sense.

1.7 Definition Of Concepts

This section highlights some of the common terms and concepts that will be used and discuss throughout the study.

Capital account or financial liberalization refers to the lifting of the restrictions or controls on the free flows of capital into and away from the country (IMF, 1995)

Capital account convertibility means that residents and nonresidents of a country can exchange the domestic currency for foreign currency when buying or selling assets. But convertibility does not rule out a range of capital restrictions, such as multiple exchange rates or other actions designed to influence capital transactions through price penalties or other means. (Cooper, 1999)

Capital control refers to those measures that directly restrict the quantity of foreign exchange made available for capital transactions. (Carse, 1995). On the other hand, Sach and Larrain (1993) defined it as limitation put on the movements of capital across national borders. They exist when domestic interest rates need no longer equal to foreign interest rates, nor can households convert domestic assets into foreign assets freely without significant administrative barriers.

Short term capital flows refer to capital movements with maturity of less than a year while ***Long term capital flows*** are capital movements with maturity of more than a year (BNM,1994)

International financial flows include a wide variety of transactions. The various categories include such items as bank lending of foreign currency, bank lending of domestic currency of foreigners, foreign bonds, domestic bonds, foreign and domestic equities, direct foreign investment, financial services such as banking and insurance, and various spot and forward currency transactions. These various transactions can be further subdivided on the basis of maturity into long-term or capital assets and short-term or money market asset. (Appleyard and Field, 1995)

Fixed or Pegged Exchange Rate Regime refers to a system that permits only very small, if any deviation from officially declared currency values (Appleyard and Field, 1995)

Flexible or Free Floating Exchange Rate Regime means that exchange rates that are completely free to vary, that is, the foreign exchange market is cleared at all times by changes in the exchange rate and not by any buying and selling of currencies by the monetary authorities (Appleyard and Field, 1995)

Managed Floating or Semi-Pegged Exchange Rate Regime is characterized by some interference with exchange rate movements, but the intervention is discretionary on the part of the monetary authorities. In other words, there are no announced guidelines or rules for intervention, no parity exchange rates or announced target rates. Rather, a country may intervene when its judges that are would be well served by doing so. (Appleyard and Field, 1995)

Foreign Direct Investment (FDI) refers to investment in which a resident of one country obtains a lasting interest in and have certain degree of influence over the management of a business enterprise in another country (Ranney, 1998)

Foreign Portfolio Investment (FPI) includes foreign purchase of domestic stocks, bonds, derivatives, and other securities in another countries. (Ranney, 1998)

Balance of Payment refers to statement, which summarizes a country's economic transactions with all other countries during a particular time period, usually a year. The statement indicates debits and credits in goods and services and investment income flows, unilateral transfers, long-term capital flows, short-term private capital flows, and short-term capital flows associated with activity by the country's monetary authorities. The statement is broadly divided into the current account and the capital account. A current account imbalance must be matched by an equal (but opposite sign) capital account imbalance. (Appleyard and Field, 1995)

Fiscal Policy refers to the deliberate use of government spending and taxes to influence the economy (Chrystal and Lipsey, 1998)

Monetary Policy involves using changes in interest rates, or the money supply, to influence the economy (Chrystal and Lipsey, 1998)