CHAPTER 5: THE EFFECTS OF THE SELECTIVE CAPITAL CONTROLS IN RELATION TO THE FIXED EXCHANGE RATE AND EXPANSIONARY MACROECONOMIC POLICIES

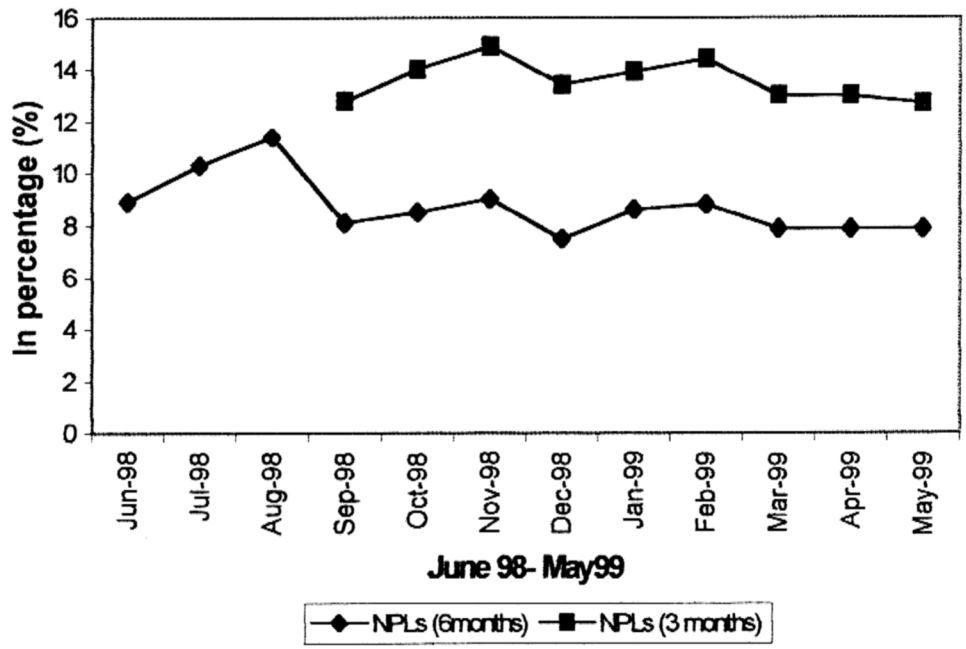
5.1 The Short Run Effects

To date, the selective capital controls and the fixed exchange rate regime have been in place for about one and a half years in the country since its implementation on the first and second of September 1998 respectively. Within this relatively short period, the above measures, coupled with the expansionary macroeconomic policies have effectively generated a number of positive signs and aided the economy to recover from the crisis.

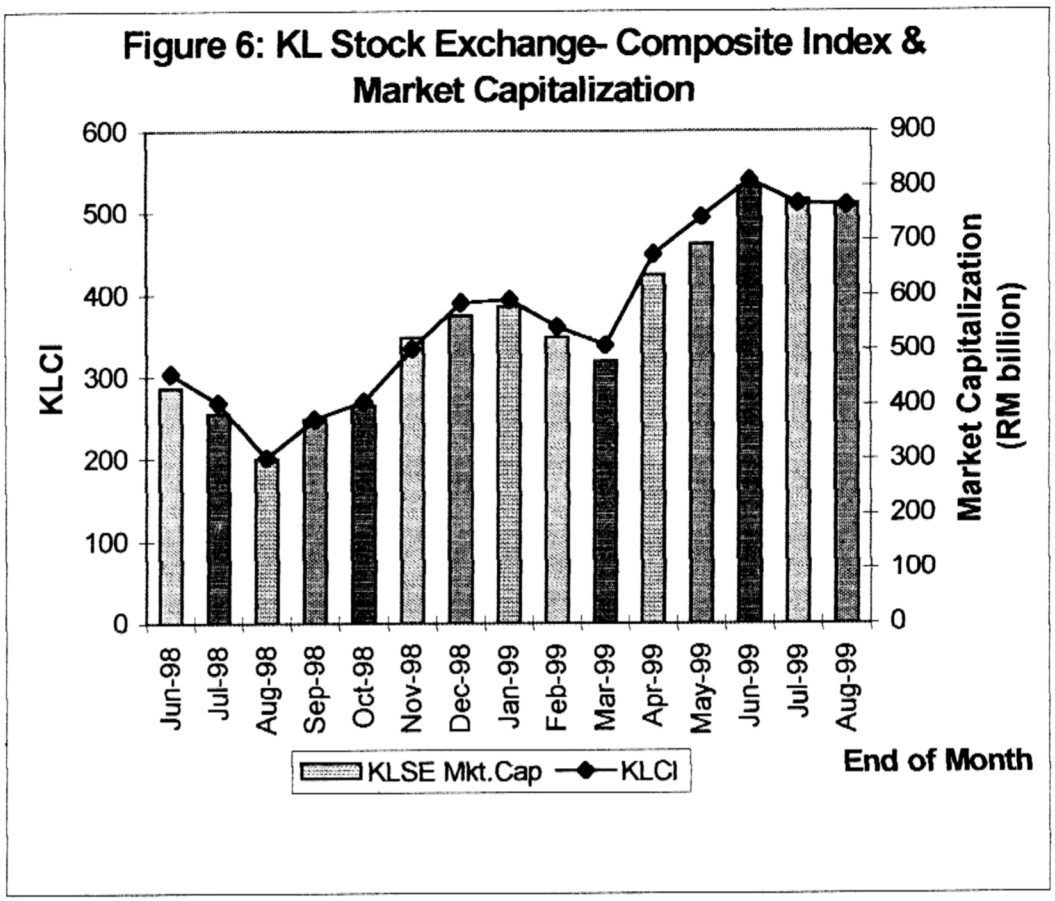
Most significantly, real GDP has rebounded back from a low of –10.9% in the third quarter of 1998 to 8.1% in the third quarter of 1999. The money supply M1, M2 and M3 increased almost by double in the third quarter of 1999 compared to the first quarter of the year (Table 30). The current account finally achieved a positive balance, that is, 13.7% and 16.9% of GNP in 1998 and 1999 respectively after suffering from a deficit for the past 8 consecutive years (Table 31). This improvement was largely attributed to the continuing strengthening of the trade surplus. The trade balance recorded a rising surplus of RM58,439 million and RM72,311 million for 1998 and 1999 respectively compared to 1997 trade deficit of –RM45 million. With the increase in the trade surplus, international reserves increased by 98.31% in 1999 (RM117,244 million) compared to 1997 (RM59,123 million) and it is estimated that it is sufficient to cover 5.9 months of retained imports. Importantly, inflation in 1999 fell from 5.4% in the fourth quarter of 1998 to 2.8% in 1999 (Table 30).

Besides, the total debt was lower at RM162.2 billion or 58% of GDP as at June 1999, due mainly to the decline in short-term debt. More importantly, the total short-term debt of the banks and the non-bank private sector amounted to RM29 billion. This is substantially lower than Bank Negara's reserves of RM118 billion while the Non-Performing Loans (NPLs) for both 3-months and 6 months have declined gradually (Figure 5). Overall, market confidence has been restored as evidenced by the rebound in stock market activity and the re-capitalization of the KLSE (Figure 6). The KLSE Composite Index rose by 152% from its low of 302.9 points at the end of August 1998 to 764.8 at the end of August 1999.

Figure 5 :Non-Performing Loans of Banking System



Sources : *"Malaysia on the Road to Recovery"- International Symposium On Currency Controls and Asian Monetary Co-operation, Sept 1999*



Sources : *"Malaysia on the Road to Recovery"- International Symposium On Currency Controls and Asian Monetary Co-operation, Sept 1999*

Table 30: Major Economic Indicators (2nd Quarter 1998 – 2000f)

	1998			1999				2000f
	2nd Qtr	3rd Qtr	4th Qtr	1st Qtr	2nd Qtr	3rd Qtr	Year P	
Output and Prices	**Annual Change In %**							
Real GDP	-5.2	-10.9	-10.3	-1.3	4.1	8.1	5.4	5.8
Agriculture	-6.9	-4.0	-4.8	-3.5	8.6	3.8	3.9	2.0
Mining	0.3	1.2	5.1	-2.3	-5.9	-3.0	-4.0	2.1
Manufacturing	-10.3	-18.9	-18.6	-1.1	10.8	19.5	13.5	10.0
Construction	-19.8	-28.0	-29.0	-16.6	-7.9	0.9	-5.6	5.0
Services	1.9	-3.7	-3.4	0.6	0.6	4.0	2.9	5.4
Consumer Price Index	5.7	5.7	5.4	4.0	2.7	2.3	2.8	3.2
Producer Price Index	13.9	13.9	3.9	-4.1	-5.0	-4.3	-3.3	1.0
Unemployment Rate	3.3	3.3	3.4	4.5	3.3	n.a.	n.a	n.a.
Monetary Aggregates	**Annual change in %**							
M1	-16.0	-17.0	-14.6	-3.8	14.4	20.9	33.6	n.a
M2	8.3	5.9	1.5	4.6	10.7	11.4	11.6	n.a
M3	7.3	4.0	2.7	3.9	7.7	8.2	8.2	n.a

Note: f- forecast
P – preliminary

Sources: Bank Negara Malaysia, Quarterly Bulletin, First-Third Quarters of 1999 (Vol.14, No1-3) and Annual Report 1999

Table 31: Balance of Payment, 1995-1999 (RM million)

Item (in net)	1995	1996	1997	1998	1999e
Merchandise balance (f.o.b)	**97**	**10088**	**10273**	**69008**	**83534**
Trade Account	**-9358**	**-254**	**-45**	**58439**	**72311**
Balance on Services	**-19229**	**-18371**	**-22748**	**-22338**	**-28943**
Freight and insurance	-9028	-8203	-9162	-8435	-9731
Other transportation	737	1725	1747	2268	2479
Travel and education	4143	4801	3252	3070	5568
Investment income	-10338	-11629	-14639	-14817	-18790
Government transactions	-23	-27	-150	-215	-46
Other services	-4720	-5038	-3796	-4209	-8422
Balance on goods and services	**-19132**	**-8283**	**-12475**	**46670**	**54591**
Unrequited transfers	-2515	-2943	-3345	-9876	-7210
Balance on current account	**-21647**	**-11226**	**-15820**	**36794**	**47381**
% of GNP	**-10.2**	**-4.6**	**-5.9**	**13.7**	**16.9**
Official short-term capital	6147	748	4645	2137	6692
Federal Government	-1633	-2179	-1683	1819	2923
Market loans	-1091	9675	-697	1111	3057
Project loans	-542	-1504	-986	708	-134
Non-financial public enterprises	7768	2844	6366	361	3850
Other assets and liabilities	12	83	-38	-43	-81
Private long term capital	**10464**	**12777**	**14450**	**8490**	**5025**
Balance on long term capital	16611	13525	19095	10627	11717
Basic Balance	**-5036**	**2299**	**3275**	**47421**	**59098**
Private short term capital	**2529**	**10317**	**-12913**	**-20633**	**-35958**
Errors and omissions	-1896	-6371	-1254	13513	-5321
Overall balance (surplus + / deficit -)	**-4403**	**6245**	**-10892**	**40301**	**17819**
Net Change in international reserves of BNM	**4403**	**-6245**	**10892**	**-40301**	**-17819**
Special Drawing Rights	-41	-37	-51	-315	464
IMF reserve position	-701	-15	117	-757	-789
Gold and foreign exchange	5145	-6193	10826	-39229	-17494
BNM international reserves, net	**63770**	**70015**	**59123**	**99424**	**117244**
(Reserves as months of retained imports)	**4.1**	**4.4**	**3.4**	**5.7**	**5.9**

Note: e.-Estimate

Sources: Department of Statistics and Bank Negara Malaysia, ,Annual Report 1999

If we were to dissect the economy or the components of the GDP further, that is, GDP=Y= C+I+G+ (X-IM)[10], it is clear that the economy is indeed gradually expanding, mainly driven by the lower interest rates, increase in money supply and stability in the currency exchange rate. Again, the presence of these motivators were the selective capital controls which de-linked interest rates from exchange rates; thus enabling the government to ease monetary policy to stimulate fiscal expansion which was deemed needed for economic growth.

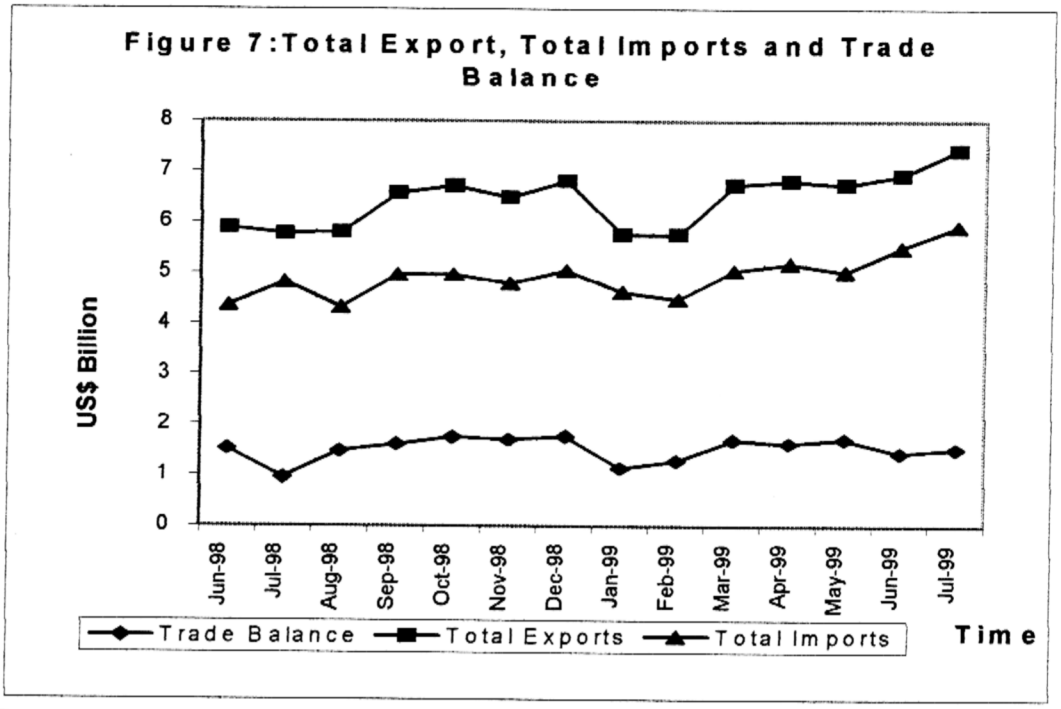
5.1.1 Exports and Imports (X-IM) -- Balance of Trade

In addition to the strong external demand (particularly for electronics goods), the increase in the country's exports could be largely attributed to the devaluation and the fixing of the ringgit at RM3.80 to the US dollar. The fixed exchange rate had made the ringgit more competitive vis-à-vis the currencies of the neighbouring countries'. After ringgit was devalued, imports became more expensive while exports became cheaper. Consequently, the depreciation of the ringgit led to a contraction of imports and / or an expansion of exports, which in turn resulted in a trade surplus and aided in building up the country's international reserves.

According to Bank Negara Malaysia, gross exports have increased for five consecutive quarters since the implementation of the selective capital controls. Imports of consumption goods registered a contraction of 32.7% in the last quarter of 1998 and the imports of intermediate and capital goods only picked up in March1999, reflecting the recovery in private investment activities in the second half of 1999. Nevertheless, export growth was stronger (12%) relative to import growth (9%) [Figure 7], contributing to a large current account surplus

[10] Y = Total output i.e. GDP, C= Consumption, G= Government Expenditure, I= Investment, X= Export, IM = Import , (X-IM) = Net Export

of RM47,381 million or 16.9 % of GNP in 1999 (Table 31) compared to the deficit of RM15,820 in 1997.



Sources : *"Malaysia on the Road to Recovery"- International Symposium On Currency Controls and Asian Monetary Co-operation, Sept 1999*

5.1.2 Government Expenditure (G)

The easing of fiscal policy, that is, the reduction in taxes and the increase in government expenditure led to an overall increase in consumers' disposable income, thereby putting upward pressure on aggregate demand. The increase in aggregate expenditure helped to stimulate economic growth.

As indicated in the 1999 Bank Negara Malaysia Annual Report, growth in real aggregate domestic demand (excluding stock) turned positive since the third quarter of 1999 due mainly to higher public sector expenditure and a revival in private sector consumption. Overall, aggregate domestic demand (excluding stocks) registered a positive

growth rate of 1.6% in real terms, a significant turnaround from the decline of 25.2% in real terms recorded in 1998. Whilst, the public or government consumption expenditure, which accounted for 23% of total consumption spending, increased significantly by 20.1% in 1999 (1998:-7.8%)[Table 32].

Table 32 : Aggregate Demand, Consumption and Investment

(% Annual Change of GDP)	1997	1998	1999p	2000f
Real Aggregate Domestic Demand	6.8	-25.2	1.6	7.3
Private Expenditure	6.5	-30.2	-3.5	8.3
Consumption	4.3	-10.8	2.5	9.5
Investment	9.4	-55.0	-19.0	4.5
Public Expenditure	8.1	-8.3	14.8	5.2
Consumption	7.6	-7.8	20.1	0.2
Investment	8.5	-8.7	10.1	10.0
Note: p.-Preliminary, f – Forecast				

Sources: Bank Negara Malaysia, ,Annual Report 1999

Worthy to note, the government development expenditure had increased markedly by 24.9% to RM22.6 billion in 1999 compared with RM18.1 billion in 1998 (Table 33). In terms of sectoral distribution, economic services remained the largest component of total development expenditure, although its share had declined to 40% compared to 51% in 1998 (Bank Negara Malaysia, 1999). Trade and industry, which included expenditure for the provision of infrastructure facilities, industrial research and development, development of small- and medium-scale industries and the promotion of tourism absorbed a sizeable share of the total expenditure, that is, 12.4% in 1999. This reflected the government's efforts to boost the economic activities via fiscal expansion.

Table 33 : Federal Government Development Expenditure by Sector

	1998	1999p	1998	1999p
	RM million		% Share	
Defence and security	1380	3122	7.6	13.8
Economic services	9243	8970	51.1	39.7
Agriculture and rural development	960	1089	5.3	4.8
Trade and Industry	3227	2798	17.8	12.4
Transport	3062	2893	16.9	12.8
Public utilities	1968	1850	10.9	8.2
Other	26	340	0.2	1.5
Social Services	5783	6936	31.9	30.6
Education	2915	3865	16.1	17.1
Health	716	835	3.9	3.7
Housing	1030	1081	5.7	4.7
Other	1122	1155	6.2	5.1
General administration	1697	3587	9.4	15.9
Total	**18103**	**22615**	**100.0**	**100.0**
Note: p.-Preliminary				

Sources: Ministry of Finance, Bank Negara Malaysia, Annual Report 1999

5.1.3 Consumption (C) and Investment (I)

Lower interest rates, growth in money supply and the tax reductions not only increased individuals income levels that indirectly boosted the aggregate demand and consumption levels, but also enhanced the liquidity of the banking and financial sectors, which in turn made credit and loans more easily available for private investments.

From Table 32, it is noted that total private consumption had turned around to record a positive growth in 1999, that is, 2.5%, following a decline of 10.8% in 1998. Total private investment though still negative, had shown great improvement from the previous low of –55% in 1998. It stood at –19% in 1999. Various indicators that supported

the expansion of private consumption and investment were noted from the increase in (i) sales of commercial vehicles and passenger cars, (ii) loans disbursed and approved by the banking system for manufacturing, construction, consumption credit, wholesale, retail and (iii) improvement in stock market activities (Table 34 and 35).

Table 34 : Selected Private Investment Indicators (Annual change %)

	1995	1996	1997	1998	1999
Imports of capital goods (US$)	n.a.	-6.8	6.7	-40.5	-5.9
Sales of commercial vehicles	43.6	48.7	8.4	-76.1	50.8
Applications fr. manufacturing investment to MITI					
No. of projects	9.6	-16.8	-8.6	-14.5	2.9
Total Capital investment	10.3	56.7	-18.8	-44.7	-25.8
Foreign Capital Investment	11.8	32.9	-18.4	-12.2	-28.4
Local Capital Investment	8.9	79.8	-19.1	-68.2	-20.7
Approved manufacturing investment by MITI					
No. of Projects	3.2	-12.9	-2.9	11.2	-16.1
Total Capital Investment	-9.1	64.2	-24.6	2.1	-35.9
Foreign Capital Investment	-19.4	86.5	-32.7	13.9	-6.1
Local Capital Investment	1.0	46.7	-16.6	-7.4	-65.2
Loans disbursed by the banking system					
For manufacturing	n.a	n.a	n.a	-0.8	23.7
For construction	n.a	n.a	n.a	-31.6	19.7
Loans approved by the banking system					
For manufacturing	n.a.	n.a.	n.a	-68.4	35.4
For construction	n.a.	n.a	n.a	-77.7	39.3
Capital Expenditure by sector					
Manufacturing	16.0	-4.1	44.3	41.4	-44.6
Construction	72.9	-3.4	18.5	78.7	-80.2
Others (Services, etc)	39.1	-1.9	170.7	4.4	-44.4

n.a.- not available

Sources: *Department of Statistics, Malaysian Automotive Association (MAA), Ministry of International Trade and Industry (MITI), Bank Negara Malaysia, 1999*

Table 35 : Selected Private Consumption Indicators (Annual Change %)

	1995	1996	1997	1998	1999
Imports of consumption goods (US$)	n.a	5.4	-0.7	-32.9	21.3
Sales of passenger cars	49.5	22.8	12.3	-54.8	79.9
Prices of primary commodities					
Rubber	34.5	-11.1	-20.7	0.7	-14.4
Crude palm oil	14.7	-19.1	15.9	72.3	-38.5
Tax Collection					
Sales tax	17.9	12.4	12.7	-37.7	16.3
Services tax	23.2	21.1	19.8	-1.9	3.6
Loans disbursed by the banking system					
For consumption credit (excl. passenger cars)	n.a	n.a	n.a	-18.7	46.8
For wholesale, retail, restaurants and hotels	n.a	n.a	n.a	15.0	61.0
Stock market indicators					
Market capitalisation of KLSE	11.2	42.6	-53.4	-0.3	47.6
Kuala Lumpur composite Index	2.5	24.4	-52.0	-1.4	38.6

Note: n.a.- Not available

Sources: *Department of Statistics, Royal Customs and Excise Department, Palm Oil Registration and Licensing Authority (PORLA), Malaysian Rubber Exchange and Licensing Board (MRELB), Malaysian Automotive Association (MAA), Kuala Lumpur Stock Exchange (KLSE)*

It is therefore, no denying that the imposition of selective capital controls and the imposition of a fixed exchange rate regime coupled with expansionary macroeconomics policies are indeed appropriate and effective measures for stabilizing and reviving the economy in the short run.

5.2 Sustainability of the Economy Under The New Measures For the Medium or Longer Run - An Analysis from The Mundell-Fleming Model

The medium and long-term effects of the selective capital controls and fixed exchange rate regime together with expansionary

macroeconomics policies are still not very clear. Due to the lack of timely economic data, the medium or long term effect of the above measures will be projected based strictly on a theoretical model.

Theoretically and conventionally, expansionary macroeconomic policies are always adopted to boost aggregate demand and as a tool for closing the recessionary gap of an economy. However, according to the Mundell –Fleming model, the impact of changes in the fiscal and monetary policies (exogenous variables) on domestic output and interest rates (endogenous variables) hinges crucially on the assumption concerning the exchange rate system (Kwan,1998). In other words, the effects of fiscal and monetary policies in an economy of perfect or imperfect capital movements differ according to whether the adopted system of exchange rates is fixed or flexible.

5.2.1 Effects of An Expansionary Monetary Policy

The adoption of an expansionary monetary policy always comes with a lower interest rate and a growth in money supply. According to the Mundell-Fleming model, in the case of fixed exchange rate with perfect capital mobility, the slightest drop in domestic interest rates will lead to a large scale outflow of short-term capital. However, with imperfect capital mobility due to the presence of (selective) capital controls, the interest arbitrage activity would be blocked (Appleyard and Field,1995). The capital controls will entail a decline in the velocity of money circulation in the economy and thus provides autonomy to the government to pursue monetary policy, for example, to lower the interest rates under the fixed exchange rate regime. Lower interest rates coupled with the growth in money supply indirectly increases income, which in turn enhances the individuals' purchasing power, boosts aggregate demand, stimulates private consumption and investment, which eventually lead to short term economic growth.

This is exactly the short run effect of an expansionary monetary policy that is currently being experienced by Malaysia. This is also evident from the economic indicators discussed earlier. From Table 32, it is clear that private investment had improved from a –55% of GDP in 1998 to –19% of GDP in 1999, while private consumption had increased from a deficit 10.8 % of GDP in 1998 to 2.5% of GDP in 1999.

Despite these positive signs, it is important to note that, without an accompanying increase in supply, the increase in aggregate demand would bid up domestic prices, thus making exports relatively more expensive than imports. In other words, rising domestic prices would lead to a rise in total imports. In the long run, under the phenomenon where imports rise and exports remain unchanged, the trade balance will move into deficit. According to Bank Negara Malaysia 1999 Annual Report, the exports and imports growth rate in Malaysia were 12% and 9% respectively in 1999. Although the export growth (12%) was greater than the import growth (9%), it is deemed that a trade deficit may be possible if imports were to grow faster than exports in the long run, particularly, under the circumstances where the domestic demand increase while the domestic supply remain constant, which lead to an increase in domestic price. If there is a trade deficit in the future and capital controls were intact, then there would be a loss of foreign exchange reserves and a drop in the money supply. It is noted from Table 31, the imposition of selective capital controls in September 1998 had caused both the private long term and short-term capital flows to decline further, that is, private short term capital flows dropped from –RM20,633 million (1998) to –RM35,958 in 1999 while private long term capital flows fell from RM8,490 million in 1998 to RM5,025 million in 1999. Therefore, it is possible that, with the decline in capital inflows and an increase in the trade deficit, the foreign reserves will fall, thus reducing the money supply in the economy and leading to economy disequilibrium.

In other words, the monetary expansion will be gradually reduced, that is, the money supply will be reduced by the worsening trade deficit over time or in the long run. In order to achieve economy equilibrium, the money supply will contract further until the trade balance is no longer in deficit. Of importance to take note is, when the money supply is reduced, it will lower the purchasing power of the consumers and thereon lead to a progressive reduction in private consumption and investment, which will eventually cause a decline in aggregate demand and lead to a recessionary gap.

Therefore, it is clear that under the new measure, that is, fixed exchange rate regime with selective capital controls and expansionary monetary policy, the economic growth will be unsustainable in the long run. The positive real GDP growth rate achieved (8.1% in the third quarter of 1999) since the implementation of these measures in early September 1998 might only be a short-term effect. The analysis has indicated that this positive short-term effect on income, output, and economic growth is extinguished over time.

5.2.2 Effects of An Expansionary Fiscal Policy

Fiscal expansion is always associated with an increase in government spending or a decrease in autonomous taxes (Chrystal and Lipsey, 1997). Based on the Mundell-Fleming model, under a fixed exchange rate system with imperfect capital mobility (due to the imposition of capital controls), an increase in government spending or a decrease in autonomous taxes will cause an upward shift in the interest rates and income. Interest rates increase particularly if the government were to borrow to finance the fiscal expansion, where the government will have compete with the firms who borrow in the capital market, thus leading to an increase in interest rates. On the other hand, higher income resulted under the expansionary fiscal policy as reduction in taxes

would indirectly increase the consumers' disposable income, hence increase theirs purchasing power. Besides, when the government increase their spending under the fiscal expansion, they actually creating more job opportunities for the people and hence increase the consumers income. Higher incomes help in boosting the aggregate demand and stimulating the economy. This is evident from the improvement in aggregate domestic demand, private consumption and investment and real GDP growth rate (See Table 30 in page 89 and Table 32 in page 93). Aggregate domestic demand improved from a low of –25.2% of GDP in 1998 to 1.6% of GDP in 1999 while private consumption increased from –10.8% of GDP in 1998 to 2.5% of GDP in 1999. The real GDP growth rate increased by almost double since the first quarter of 1999 to the third quarter of 1999, that is, growing from –1.3% in first quarter of 1999 to 4.1% in the second quarter of 1999 and 8.1% in the third quarter of 1999.

However, what is worrisome is, higher income does not only aid in creating domestic demand but it also creates demand for imports and thus the need for foreign exchange. In addition to the higher income, the raise of imports could also be caused by the revival of infrastructure and other major projects in the country under the government fiscal expansion. Over time, when imports rise and exports stagnate, a trade deficit will occur. The trade deficit will then provoke a decline in money supply, which would eventually lead to a balance of payment deficit (Copeland, 1994). This phenomenon will be very much similar to the earlier discussion in section 5.2.1., that is, despite the higher export growth rate (12%) than the import growth rate (9%), a trade deficit may be possible if imports grew faster than exports in the long run.

With a trade deficit and limited short-term capital inflows under selective capital controls, as evident in Table 31 (see page 90), where both the private long term and short term capital flows have declined

from RM8,490 and –RM20,633 respectively in 1998 to RM5,025 and negative RM35,958 respectively in 1999. Of importance to take note is, with the exchange rate fixed, the government must provide the necessary foreign exchange to meet the deficit and to maintain the value of the domestic currency. When the reserves is used to finance the trade deficit, the money supply declines. The money supply will continue to decline until the domestic interest rates have risen sufficiently to bring about a decline in private consumption and/or investment which exactly offsets the increase in government spending. In other words, the money supply will continue to decline until the levels of income and the interest rate have reached its initial level, that is consistent with the balance of payment equilibrium (Appleyard and Field, 1995).

In addition, the government attempts in fiscal expansion may also lead to a budge deficit over time, that is the government spending is greater than its raising from the tax revenue. According to Bank Negara Malaysia (1999), the government consolidated revenue collection is projected to decline by 12.0% to RM61.8 billion in 1999 (1998: RM70.3 billion) and the Federal Government overall account is expected to register a deficit of RM16.6 billion, or 6 percent of gross national product (GNP) in 1999. Worthy to note is, this fiscal deficit will be financed from borrowings from both the domestic (for example, the EPF, Socso and Tabung Haji) and international markets (such as World Bank and Japan) [BNM, 1999]. In the long run, the consequences of the government borrowings to finance the fiscal deficit would be (i) it forced the government to raise taxes and thereby reduced the business sectors' profits and the consumers' income (ii) it caused an upward shift in the interest rates, especially when coupled with the decrease in money supply due to trade deficit. Under this circumstance, it would lead to a reduction in private consumption and investment and aggregate demand, thus slowing down the economic growth.

Therefore, the imposition of selective capital controls and fixed exchange rates, which lead to imperfect capital mobility in the domestic financial market, coupled with the expansionary fiscal policies would have a powerful influence over GDP in short run only. Their long-run effect would be a crowding out of private spending and consumption and net exports, which eventually lead to a trade deficit and contraction in the balance of payment.

CHAPTER 6: CONCLUSIONS

From the analysis thus far, it is no doubt that selective capital controls and fixed exchange rate are appropriate and effective instruments for dealing with the currency crisis. In a relatively short period, the Malaysian economy has been revived and preliminary economic growth has been achieved as evidenced by the improvement in the real GDP growth rate for the past one-year.

However, it is important to note that the success and effectiveness of selective capital controls should not be viewed in isolation. In conjunction with the imposition of selective capital controls, the Malaysian government has also employed a number of policies, that is, a fixed exchange rate and expansionary fiscal and monetary policies to revive the economy. "Besides, the relatively favorable economic fundamentals of Malaysia at the outset, the authorities' efforts to disseminate information to increase the transparency of the controls, and their efforts to accelerate and strengthen the financial sector via bank mergers and reform, the general return of confidence in the region, also seem to have played an important contributory role in this respect" (IMF,1999). Overall, it is the total package that works.

At this juncture, it is still too early to judge whether the measures will have long-run adverse effects on investor sentiment. Some opponents had argued that the recovery of the Malaysian economy was built on a fragile base of enhanced liquidity and robust exports to the US (particularly electronic goods) (Banerjee, 1998). It is deemed that overall Malaysia's economy still lacks that crucial engine of growth for the medium to long term. The earlier analysis, using the Mundell-Fleming model have shown that the sustainability of the economy (in terms of continuous positive GDP growth, ability to maintain sufficient foreign reserves and current account surplus) under such package

(that is, fixed exchange rate with imperfect capital mobility and expansionary macroeconomic policies) is highly questionable.

Economic and International theories aside, the experiences of China and India seem to suggest that the long-standing and extensive controls on capital transactions may have had some role in reducing the vulnerability of these countries to the effects of the recent regional crisis. However, other factors may have played a role as well in reducing their financial vulnerability. These include for both countries; a strong external position with ample foreign exchange reserves; larger sizes of the domestic markets; relatively weak trade and financial linkage with the rest of the world development (Ariyoshi, Habermeier, Laurens, Robe, Canales, and Kirilenko, 1999).

Previous research conducted by IMF suggested that (i) to be effective, the control must be comprehensive, strongly enforced, and accompanied by necessary reforms and policy adjustments; (ii) controls do not provide lasting protection in the face of sufficient incentive for circumvention, in particular attractive return differentials in the offshore markets and strong market expectations of exchange rate depreciation; (iii) control does not only prevent the trade–related hedging transactions, but more worrisome, it has also discouraged legitimate transactions, including FDI (this is evident where the private long tem capital flows in Malaysia dropped from RM8,490 million in 1998 to RM5,025 million in 1999). In addition, capital control may raise the cost of accessing international capital markets.

Being a small, open and highly export-oriented country, capital mobility is indeed important for Malaysia. Earlier analysis has suggested that the sustained economic growth lies in the ability of the government to maintain sufficient level of international reserves, which hinges heavily not only in the growth of exports, but also on the return of the foreign investment and free flow of capital. Although capital mobility has

caused vulnerabilities to the country, the significant and benefits brought by capital flows should not be neglected. The rapid growth in the country for the past decade and prior to the crisis was highly attributed to the mobility of capital flows, which induced large foreign investment into the country and stimulated the economic growth. Capital Control that aimed at short-term flow would implicitly and indirectly put grit in the wheels of long-term flows and cautioned the short-term actions of a long-term investor (Tan, 1999). As a result, it jeopardized the total capital flows, inclusive both long and short term flows to the country (Carse,1995 and Khor,1998).

At present, ways have not yet been found at a global level to eliminate the cross-border transmission of financial shocks and crises due to global financial integration and capital movements (Khor, 1998). In order to deal with the capital flows and increasing risks brought by globalization and financial liberalization, perhaps, what should be done is prevention. For instance, strengthen the economic fundamental and reform the banking and financial institutions to better prepare and shield Malaysia from the currency attack and financial shock. In addition, periodic review on the government polices are deemed necessary to allow government to adjust their policies promptly to the market changes.