## *Chapter One*

### INTRODUCTION

Malaysia's economic development in the last forty years has been spectacular. Before the currency crisis of 1997 there were many favourable features of the Malaysia economy. Malaysia's GDP was growing at an average rate of 8% per annum for ten successive years (Mahathir, 2000). In 1996, the inflation rate was low around 3.8 per cent and unemployment was 2.5 per cent.

Malaysia has relatively low external debt of USD45.2billion or 42 per cent of GDP as at June 1997. The debt service ratio was 6.1 per cent of exports as at end 1996. The banking sector was healthy, with non-performing loans (NPL) at only 3.6 per cent of total loans as at June 1997. The nation's saving rate at 38.5 per cent in 1996 in one of the highest in the world. (NERP:1998)

With this robust growth and under stable economic and political climate, Malaysia is considered to be one of the most rapidly growing economies in the world, and is set to join the league of Newly Industrialising Countries (NIC). At the same time, Malaysia had announced its intention to work towards becoming a fully developed country by 2020, a vision propounded by its Prime Minister, Dr. Mahathir Mohamad.(see Mahathir:1991)

Unfortunately, Malaysia's progress towards industrialized-nation status was suddenly disrupted as a result of the regional currency crisis that started in the middle of 1997. Beginning with the speculative attack on the Thai bath on July 2, 1997, currency speculators shifted their attention to other regional currencies. In view of its regional proximity and close economic ties, the Malaysian economy was not spared when such a severe and prolonged currency crisis swept across these East Asian countries.

Within a few months, volatile short-term capital outflows resulting from currency speculation caused the depreciation of the ringgit and a decline in share prices. At the height of the crisis, on January 1998, the ringgit was RM4.88 to USD1.00 compared to the pre-crisis value of RM2.55 (BNM:1999), while stock prices declined sharply with the Kuala Lumpur Stock Exchange Composite Index (KLSECI) falling to a low of 262.7 points on September 1, 1998 from a high of 1,271.57 points in February 1997 (BNM:1999). Under such circumstances, a contraction of economic growth was expected.

When the second quarter GDP figures were announced in August 1998, it became evident that Malaysia was facing a recession for the first time in 13 years (BNM:1999). The real GDP growth for 1998 contracted by 6.8 per cent, more than the World Bank forecast of 5.1 per cent. (see Okposin et al 1999).

Initially, Malaysia adopted the IMF prescription of a contractionary fiscal and monetary policy to reinstate the economy. However, such policies which involved cutting back public spending with high interest rates and restriction on credit growth proved to be injurious to the economy. This was presented by serious cash flow problems faced by all sectors of the business community and individual. Their businesses were badly affected and debt repayments could not be made, which consequently increased non-performing loans of banks. To contain the severity of economic contraction, the government decided to adopt expansionary macroeconomic measures and ease monetary policy. (see Okposin et al 1999). It also rejected the concept of an IMF rescue package and shocked the international financial community when it announced the imposition of selective capital control policy on 1st September 1998.

When the Malaysian Government imposed selective capital control to safeguard its economy against currency manipulation and speculation, the advocates of the free market vilified the move as being counterproductive and asserted that such action would cause irreparable damage to the Malaysian economy.

Today, only about one and a half year after the imposition of selective capital control polices, most economic indicators show positive results, setting the Malaysian economy on the track to full recovery.(see Seventh Malaysia Plan. Mid-Term Review: 1999).

**Objectives**

The objectives of this paper are as follows :-

i) to discuss the causes of the Malaysian financial crisis

ii) to compare the performance of the Malaysian economy before the crisis, during the crisis and after the imposition of selective capital controls.

iii) to discuss the impact of selective capital controls on Malaysia's economic performance.

**Significance of the study**

The capital control policy adopted by Malaysia is a radical approach towards restoring its battered economy during the financial crisis of 1997. Such stance was taken by the Malaysian government to combat currency speculators from causing further damage to its economy as the earlier IMF-like prescription had failed. It may be an unpopular approach especially, to the advocates of the free market, nevertheless it provides an alternative solution for other countries to emulate in the event of facing such onslaught on their currency.

It is also hoped that this study will serve as a reference on the subject of selective capital controls and macroeconomic policies.

**Methodology**

**i) Data Collection**

Secondary data and materials were obtained from the following sources;

- Bank Negara Malaysia (BNM) Annual Reports, Monthly & Quarterly Buletin (various reports)
- Malaysia's Economic reports (various reports)
- The Sixth and Seventh Malaysia Plans
- Mid-term Review (Seventh Malaysia Plan)
- Textbooks
- Articles (newspaper, magazines, journals etc.)
- Internet Articles etc.

**ii) Time Frame**

In Malaysia, the first wave of the economic and financial storm was felt in July 1997. The selective capital control measures were adopted in September 1998 i.e. about one year after Malaysia was hit by the financial crisis. This study will examine Malaysia's economic performance over a five-year period starting from January 1995 till December 1999.

**iii) Economic Indicators**

In order to appreciate the trends and patterns, comparison of economic indicators is based on **quarterly** figures starting from 1995 till 1999.

The economic indicators to be examined will include the **GDP growth**, the **Balance of Payments**, the **Current Account** the **Balance of Trade**, the **Capital Account**, **Reserves**, the **Inflation Rate**, the KLSE **Composite Index** and the **Unemployment Rate**.

**Major sections**

This project paper is divided into six chapters. Chapter one is the introductory chapter, which provides the objective of the study, the methodology, the major sections of the project paper, the limitations of the study, the significance of the study as well as a brief background of the Malaysian economy. Chapter two presents an overview of the economic crisis, which includes a brief account of other East Asian countries affected by the currency crisis. Chapter three offers the likely causes of the economic crisis, while Chapter four deals with the rationale for capital control and provides a general outlook on the role of the International Monetary Fund. Chapter five discusses the findings of the various economic indicators before and after the imposition of selective capital controls.

Finally, chapter six, the concluding chapter deliberates on the policy implication of capital controls and their application vis-à-vis the Anglo-American model of free market and free flows of capital.

**Limitations of the study**

The scope of this study is confined to just the period between 1995-1999. This time period is relatively short but suffices to discuss the events surrounding the currency crisis before and after the imposition of selective capital controls. Future studies should include a longer time period to determine the policy implications of capital controls in the long run and their impact on the Malaysian economy.

**A brief background of the Malaysian economy**

Malaysia is a small open economy with a population of about 22.7 million. Since independence in 1957, it has made significant progress towards the diversification of its economy from one characterized by agricultural production and mining to one driven by manufacturing and services (see BNM. 2000:3).

At the same time, Malaysia has been going through a process of social and economic transformation to meet its social and economic agenda. The process became even more vigorous with the introduction and implementation of a twenty-year economic policy known as the **New Economic Policy** (NEP) in 1970. The ultimate goal of the NEP is National Unity with its two pronged objectives of eradication of poverty and restructuring of society.

Upon, the expiration of the NEP in 1990, the **National Development Plan** (NDP) was introduced. Apart from encompassing some characteristics of the NEP, the NDP includes an ambitious thirty-year project of transforming Malaysia into a fully industrialized nation by the year 2020. The Master Plan designed to enable Malaysia to join the league of developed countries, is also more popularly known as **Vision 2020**.

The pro-business stance of the Government and its commitment to the implementation of diverse economic plans and development policies has encouraged foreign direct investment and the private sector to be the main engine of growth especially in the last decade. (see BNM 2000 : 3). However, the liberalization of the financial market to meet the challenges of globalization has made the Malaysian economy vulnerable to both external and internal market forces, especially to currency speculation and manipulation.

As mentioned earlier, economically, Malaysia has evolved from a mere trading country dependant solely on its primary commodities to one that is aggressively embarking on manufactured goods, services and exporter of value added products.

The implementation of economic policy is being accomplished in a five-year roll over plan, which started with the First Malaya Plan and the just ended Seventh Malaysia Plan. Prior to independence, the Malaysian economy was based predominantly on the primary sector and on international trade (Lim, 1994).

In 1957, the primary sector, consisting of agriculture and mining was a major contributor to GDP as well as employment, generating 45.7 per cent and 61.3 per cent of GDP and total employment respectively (Fong, 1989).

The secondary sector, consisting of light manufacturing, building and construction, was a relatively small contributor to GDP and employment, amounting to 11.1 percent and 9.6 per cent respectively. The tertiary sector, which includes trade and services, on the other hand, contributed a significant 43.2 per cent to GDP in 1957. (Okposin S.B.)

The outstanding feature of the Malaysian economy during independence was the extreme reliance on trade. The average ratio of gross earnings to GDP over the period 1957 to 1960 was 0.447, making Malaysia, one of the most open economies in the world then (Okposin S.B.)

However, due to the high degree of trade dependence and a violent fluctuation of commodity prices, the Malaysian economy experienced great instability in its export earnings (Fong, 1989; Kamal & Zainal, 1989).

Generally, in the early years after independence the Malaysian economy was characterized by the exports of primary products, mainly tin and rubber, resource-based industries, a high degree of inequality, high unemployment and high population growth.

Unlike the status of the Malaysian economy in the 1950s, the 1960s to 1980s witnessed an economy heavily dependent on manufacturing. The process of manufacturing has evolved with two fundamental strategies. First, the import substitution phase which was actively pursued in the First Malaysia Plan and second, the export strategy which has been implemented since the Second Malaysia Plan. (Okposin S.B.)

With the adoption of the First and Second Industrial Master Plan in 1985 and 1996 respectively, the manufacturing sector and the focus on cluster-based (cluster is an agglomeration of interlinked or related activities comprising industries, suppliers, critical business services, requisite infrastructure and institution) development provided the guiding principles for industrial development in the 1990s. (Okposin S.B.). Between 1991 and 1997, real GDP grew by 8.9 per cent per annum.

Though Malaysia has reservation about trade liberalization and the fairness of the free market enterprise, it has geared itself towards that eventuality. This is evidenced with its active role in international and regional organizations like APEC, ASEAN, AFTA and the WTO.

Since Independence, Malaysia has endured several political, social as well as economic crises. In terms of economy, Malaysia has experienced five major phases of economic crises, namely the `early commodity crisis' between 1956 and 1972, the first oil crisis of 1973-74, the second commodity/oil crisis of 1980-81, the third commodity/electronic crisis of 1985-86, and the currency and financial crisis of 1997-98. (see Okposin, S.B and Cheng M.Y; 2000).

Though each crisis was given special attention and received a specific prescription, the currency crisis of 1997 was the most phenomenal as it almost crippled the economies of a region once described as the Asian economic `miracle'.

Malaysia was not spared from the contagion effect, which first started with the devaluation of the Thai Baht in July 1997. What started as a currency crisis soon evolved into a full blown financial and economic crisis affecting Thailand, Indonesia, Malaysia and South Korea; and to some extend the Philippines, Taiwan, Hong Kong and Singapore.

However, the worst hit among these countries were Thailand, Indonesia, Malaysia and South Korea. While still grappling to find the right antidote, Malaysia spurned the advice of the IMF, the US and many economists; and adopted selective capital controls to stabilize its country's currency and protect it from excessive speculation and manipulation. At the same time, the selective capital controls is also meant to spur economic recovery and economic growth. Thailand, Korea and Indonesia by contrast, kept their economies open, liberalized their political sectors and took the I.M.F. medicine. (Thomas L. Friedman, NYT, Aug 24, 1999).

This paper will attempt to show that under unstable economic environment, **selective capital controls** is a viable option, and that it provides a flexibility to facilitate the implementation of appropriate fiscal and monetary policies to accelerate economic growth and recovery.

By using the **interest parity** and **purchasing power parity** arguments as well as **Mundell-Flemming model**, this paper will also demonstrate that expansionary fiscal and monetary policy with fixed exchange rate regime to stimulate economic growth in unrestrained capital activity can only be implemented effectively with the imposition of capital controls. Further elaboration on the rationale for capital controls will be discussed in chapter four.

## *Chapter Two*

### OVERVIEW OF THE ECONOMIC CRISIS

The financial turmoil that undermined the Malaysian economy in July 1997 was unparalleled and by no means expected especially when two months earlier, both the World Bank and the International Monetary Fund had applauded Malaysia for its excellent economic performance (see Mahathir, 2000). Starting with the devaluation of the Thai baht, the contagion effect then swept across other East Asian forcing their economies into a recession. Malaysia, which had recorded robust economic growth of about eight percent successively for the last ten years, suddenly was dealt a near fatal blow never before experienced in the country's entire financial and economic history.

The entire nation was taken aback while the people became restless as they witnessed the dismantling of the economy and financial system from the impact of the currency crisis. After a few months of intense currency speculation and volatile short-term capital outflow from Malaysia, the ringgit depreciated and the share prices in the Kuala Lumpur Stock Exchange (KLSE) declined sharply. When the Malaysian Government emulated the IMF prescriptions of tight monetary policy of high interest rates and restricted credit growth, the domestic business environment and the banking sector went into disarray.

The business sector was badly bruised. There was little liquidity due to the tight credit policy imposed by Bank Negara Malaysia then. With the high cost of borrowing at that time, many businesses were deemed uncompetitive, while the number of non-performing loans was alarmingly high as result of its reclassification from six months to three months. Ominously, many companies were forced to close down their operations, while those surviving waited in distress and apprehension. At the height of crisis about 87,000 employees lost their jobs.