

Chapter 1: Introduction

1.1 Introduction

High capital mobility is characteristic of most freely open economies of the developed world. In the advanced industrial countries, most capital controls were eliminated in the 1980s, and investors can now freely convert domestic assets into foreign assets without significant administrative barriers (Sachs & Larrain, 1993).

In spite of that, the practice of capital controls remains in place in much of the developing world. 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).

Following the Asian currency crisis that has rocked Asian economies from July 1997, the issue of capital controls has regained much of its lost focus among the international community. It has generated much interest as well as controversy among the academia, economists and policy-makers. Despite the controversy, our country, Malaysia has decided to embark on the implementation of such measures. Towards this end, an assessment of the policy direction that is, on whether capital controls are appropriate and sustainable not only in the short-term, but over the medium and longer terms is useful to understand the likely path of economic development in Malaysia.

It is therefore the purpose of this study to analyze the effectiveness of the expansionary monetary and fiscal policies following the adoption of capital control measures using the framework of the basic Mundell-Fleming Model. An examination of the behavior of the economic indicators of the real economy for an empirical analysis of the policy impact is also made.

1.2 Scope of the study

The study begins with a review of the relevant literature on capital controls in the postwar period, the significance of capital mobility on economic performance and capital flows to developing countries. A brief history of Malaysia's financial openness from the mid-1980s to the present, and a review of macroeconomic policy management in Malaysia is then presented.

Finally, an analysis of the effectiveness of the expansionary monetary and fiscal policies following the adoption of exchange controls measures using the framework of the basic Mundell-Fleming Model is carried out. This study also extends to an examination of the behavior of economic indicators of the real economy for an empirical analysis of the policy impact.

1.3 Organization of the study

Chapter 1 sets out the introduction for the research project and also sets out the objectives, scope and limitations of the study.

Chapter 2 reviews the relevant literature on capital controls in the postwar period, the international capital market, the significance of capital mobility, and capital flows to developing countries in the 1990s.

Chapter 3 explains the research methodology used in the study.

Chapter 4 focuses on the financial openness of the Malaysian economy since the mid-1980s to the present. It first discusses the factors that led to economic liberalization, that preceded the liberalization of the financial and capital markets.

Chapter 5 provides an overview of macroeconomic policy management in Malaysia. The overview of macroeconomic policy management includes an overview of fiscal, monetary, and exchange rate policies.

Chapter 6 discusses the restriction of capital flows and exchange controls in Malaysia. The discussion is not restricted to the recent capital control measures but is stretched back to 1994-1995, when monetary and administrative measures have been taken to mitigate the impact of huge capital inflows into domestic economy.

Chapter 7 analyses the impact of expansionary fiscal and monetary policies using the Mundell-Fleming Model. A brief introduction to Mundell-Fleming Model is also made for general understanding. Chapter 8 focuses on the examination of available economic indicators in the balance of payments and the real economy for an empirical analysis of the policy impact. Chapter 9 sets out the conclusion for the study.