Chapter 4: Financial openness in Malaysia since mid-1980s

4.1 Financial liberalization

A country's growth potential and its financial market structure play an important role in attracting private capital flows (Chen and Khan, 1997). Correspondingly, an efficient financial market can enhance the efficient mobilization and allocation of resources for economic transformation and development (BNM, 1996) through its intermediation process.

Malaysia has for a long time maintained a relatively open capital account with liberal exchange controls (BNM, 1997) although restrictions on trade in goods is said to be greater, particularly in the highly protected automotive industry. Steps toward financial liberalization can be traced back to 1978 when interest rates were liberalized.

It is, however, pointed out by some economists that financial liberalization contributes to volatility in the financial markets. Sachs (1997) argues that the financial liberalization allows private banks a much greater latitude to borrow from abroad and thus produces large capital inflows that must be reversed eventually (Jomo, 1998). In fact, Kamsinsky and Reinhart (1996, p8) came to the conclusion that: "In 18 out of the 26 banking crises studied here the financial sector had been liberalized during the preceding 5 years, or usually less. This suggests that the twin crises[12] may have their common origins in the deregulation of the financial system..." The IMF also claimed that their position has long been that capital-account liberalization should proceed in an orderly way: countries should lift controls on outflows only gradually as the balance of payments strengthens; liberalization of inflows should start at the long end and move to the short end only as banking and financial systems are strengthened.

[12] Twin crises here refer to banking crisis and balance of payments crisis.

4.2 Economic liberalization

In the face of growing fiscal and balance of payment difficulties (the so-called twin-deficit crisis in the mid-1980s), exacerbated by the recession (1985-86), the Government made the choice to accelerate economic liberalization in Malaysia in the mid-eighties. Such liberalization policies include various efforts at deregulation and legal reforms to attract foreign investors through the raising of Industrial Coordination Act, 1975 exemption levels and the introduction of the Promotion of Investment Act, 1986 with various investment incentives; reduced Government spending, reduced taxes, especially in the interest of businesses; deployed more public resources to support private investment; encouraged private enterprises, including privatization; and sought to encourage greater public-private sector collaboration (Salleh and Rani, 1991).

Thus, Malaysia undertook to attract foreign capital, particularly FDI which was necessary to generate jobs and incomes in the post 1985-86 recession era (Sivalingam, 1997). Access to domestic market is made available to capital flows with the further liberalization of exchange control regulations and trade and capital accounts, especially relaxation of investment regulation and foreign ownership for export-oriented investments.

4.3 The financial market

In terms of the regulatory and the supervisory framework of financial intermediaries, various measures for the liberalization and the deregulation of financial markets have been instituted in Malaysia. By 1978, the Malaysian commercial banks' lending rates (except loans to preferred sectors, i.e. Bumiputras, agriculture, small and medium industries) and deposit rates had been deregulated under some administrative guidance. Although it took until 1991 for a complete interest rate liberalization, it was faster than that of other Asean countries (Kawai, 1992; BNM, 1997).

After recovery from the recession in the late-1986, efforts were stepped up to enhance both the breadth and the depth of the money market. These efforts include the introduction of the principal dealer system, the issuance of Malaysian Government Securities, and the lifting of the limits on interbank transactions in 1992. As a result, the size of money market has increased tremendously, from an average annual transaction volume of RM118 billion in 1980s to RM597 billion in 1990-96 (BNM, 1997).

More recently, the Two-Tier Regulatory System was introduced in December 1994 to encourage consolidation of the banking sector to enable local banks to compete in an increasingly liberalized and globalised banking environment. This was seen to indicate a further liberalization in the domestic financial markets.

4.4 The capital market

Following the consolidation in the public sector, the Government has deliberately promoting the development of the capital market in the 1990s. These efforts include institutional development such as the establishment of Securities Commission in 1993 to strengthen and streamline the regulatory framework (BNM, 1994) in the Kuala Lumpur Stock Exchange (KLSE); the establishment of national mortgage corporation (Cagamas) to spearhead the development of the bond market; and the establishments of the two rating agencies, namely Rating Agency Malaysia and Malaysian Rating Agency Corporation to promote private debt securities.

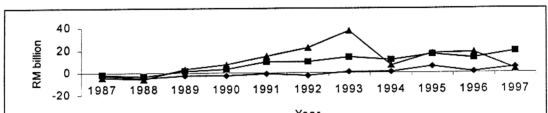
The scope of the capital market was further enhanced by the government's privatization projects. For example, the two major utility companies, namely Telekom and Tenaga, had offered foreign investors to participate in the initial public offering by way of tender. This had contributed to a greater awareness and interest among foreign investors in the KLSE.

Moreover, with the announcement of a package of incentives to attract foreign fund managers in Malaysia in June 1995, the intention of the Malaysian Government to further liberalize the capital market for foreign financial institution was confirmed (Chin with Jomo, 1996). These selective policies together with a very liberal and open economy were important pull factors attracting capital flows (both FDI and portfolio investment) during the 1990s.

Steps were also taken to enlarge the supply of domestic funds in the capital market through liberalization of guidelines of selected institutional investors like Employee Provident Fund (EPF), Takaful fund, and Amanah Saham Nasional. For example, the EPF's participation in the capital market was increased from 10% of the total net investible funds at the end of 1990 to 35% at the end of 1996.

Figure 3 below shows the trend of capital flows in Malaysia since the mid-1980s.

Figure 3: Trend of capital flows in Malaysia, 1987-1997 (RM billion)



Despite its financial liberalization, Malaysia's trade liberalization has been slower than the former due to the Government sponsored and promoted heavy industry drive in import substitution industries (James, 1998). Thus, one has to take note on what Mckinnon (1991) and others have cautioned against such a sequencing of reforms as it may encourage the financing of investments in inefficient.

industries, i.e. opening of capital account and financial market prior to trade liberalization is likely to result in distorted investment allocation.