Chapter 6: Restriction of capital flows in Malaysia

Exchange control is one of the direct controls enforced by governments to restrict or prevent inflow and/or outflow of capital. It is through exchange controls that capital controls are enforced in Malaysia. The objective of the control is to prevent external pressure on the exchange rate from falling/rising too much or too rapidly.

Although restrictions on exchange transactions were none in principle in Malaysia, it has, in recent years, been a favorite policy tool of BNM to manage the capital flows in and out of the country (Economic Forum, 1998). The authorities are apparently concerned with the destabilizing effects of the short-term capital flows that could occur in both directions: massive inflows and/or massive outflows.

6.1 Restrictions on short-term capital inflows in 1994-1995

Short-term capital, which comprises changes in the net external position of the banking institutions and the large corporations, have became significant since the end of 1980s. The period of capital outflows of RM4.5 billion in 1987-88 (Table 5) was coincided with the period of excess liquidity and low interest rates, and an expectation of weak exchange rate (BNM, 1994). However, this situation reversed from 1989 to 1993, with the net inflows of short-term capitals increased by almost ten-fold, from a mere RM1.6 billion in 1989 to RM13.9 billion in 1993.

Table 5: Private short-term capital flows, 1987-1994 (RM billion)

	1987	1988	1989	1993	1994
Private short-term capital[1]	-2.5	-2.0	1.6	13.9	-14.8

Source: BNM, Annual Report 1994, p128.

[1] Not including errors and omission.

Concerned over the potential economy overheating[15], the upward pressures on the exchange rate and an expanding current account deficit, the BNM placed a succession of restrictions on short-term capital inflows in the January and February of 1994. Table 6 below lists out the combination of monetary and administrative controls to mitigate the capital inflows.

Table 6: Policy responses to the short-term capital flows in 1994-1995

Measure	Date introduced	Date removed
1. Stepwise increase in statutory reserve requirement: 8.5% → 9.5% → 10.5% → 11.5% → 12.5%	 Jan 3, 1994 May 16, 1994 July 1, 1994 Feb 1,1994	
2. Redefinition of the eligible liabilities base of the banking institutions in order to capture all inflows of funds from abroad.	Jan 17, 1994	Jan 20, 1995
3. Establishment of a ceiling on the net external liabilities position of each banking institution, after deducting inflows which are trade-related or for genuine investments in Malaysia.	Jan 17, 1994	Jan 20, 1995
4. Prohibition of selling of short-term monetary instruments, such as Bank Negara bills, Treasury bills, Government securities (including Islamic securities), Cagamas bonds with remaining maturity of one year or less, BAs and negotiable instruments, to non-residents.	January 24, 1994	August 12, 1994
5. Requirement of the commercial banks to place with BNM the ringgit funds of foreign institutions held in non-interest-bearing vostro accounts.	Feb 2, 1994	

[15] This is manifested by increases in asset and consumer prices.

6. Requirement of ringgit funds placed by foreign banking institutions in the vostro accounts maintained with commercial banks in Malaysia to be transferred to a designated non-interest-bearing account maintained with BNM.	Feb 16, 1994	May 16, 1994
7. Prohibition of commercial banks' forward and nontrade-related swap transactions with foreign customers.	Feb 23, 1994	Aug 16, 1994

Source: Kuroyanagi and Hayakawa, 1997.

Many of these policies were repealed by August 1994, and most were gone by January 1995. The policies served to absorb RM10-12 billion in excess liquidity, but stock prices plummeted on the sudden stoppage of short-term capital inflows and the large-scale flight of short-term capitals, i.e. an outflow of RM14.8 billion in 1994 (Table 5).

On the other hand, BNM undertook a large-scale sterilization policy beginning in 1993. Sterilization involves issuing of debt securities (BNM certificates) to the banking sector in exchange for cash. As a result, BNM's foreign assets as of the end of December 1993 had surged by 34.4% over the quarter and by 62.6% over the year-end (Kuroyanagi and Hayakawa, 1997). This fact proves that the sterilization policy was the one undertaken quite instantly in order to respond to the inflows of funds from abroad. As a result, by the end of 1993, the net international reserves had risen to RM76.4 billion, up from RM47.2 billion in 1992, and reduced to RM68.2 billion in 1994 with the capital control measures.

6.1.1 Evaluation of the restrictions

The restrictive policies on capital inflows described above incited a debate as to their appropriateness. Kuroyanagi and Hayakawa (1997) cited the overall evaluation is that they were successful in the end. However, Economic Forum (1998) questions the effectiveness of sterilization in the long-run. It pointed out that the Bank Negara's stock of sterilization debt was gradually liquidated in 1994. Liquidating sterilization debt however creates high-powered money and artificially lowers interest rates. Such artificially-low interest rates had fueled credit expansions. And that this is so comes forth as somewhat ironic - the sterilization debt that was supposed to prevent credit creation in the first instance was now the cause of it! Whereas Roubini (1998) states that the controls on capital inflows had led to a real appreciation of the ringgit and hence caused a loss of Malaysia's export competitiveness.

6.2 Exchange controls from 1 September 1998

6.2.1 The exchange control measures

The Government of Malaysia has decided with effect from 1 September 1998 to implement a series of exchange controls to insulate and revive the Malaysian economy, following the economic contraction as a result of the Asian financial crisis.

The overriding objectives of these measures were to insulate the economy from the risks and vulnerabilities that could emerge from a deteriorating global financial markets as well as to gain monetary independence so that the real economy could be invigorated through domestic monetary policy, including that of interest rate.

As stated in the press statement (BNM, 1998a) dated 1 September 1998, the overriding objective of the new measures is to regain monetary independence, to insulate the Malaysian economy from the contagion effects of external developments, and to stabilize domestic prices that is conducive for economy recovery. The exchange controls effectively limit the trade of ringgit to within Malaysia, and thus seek the return of ringgit kept offshore. These measures are largely directed at containing speculation on the ringgit by eliminating the availability of offshore ringgit funds and at minimizing the impact of short-term capital flows on the domestic economy.

On 2 September 1998, BNM announced that ringgit is fixed at RM3.80 to the US dollar indefinitely. This marked the beginning of the return of a fixed exchange rate regime in Malaysia. Consequently, it allows the adoption of expansionary monetary and fiscal policies.

Given the Malaysia's openness to international trade, the selected exchange controls however, guarantee the general convertibility of current account (i.e. trade-related) transactions and free flows of FDI and repatriation of interest, profits and dividends and capital. BNM repeatedly reiterated its commitment that capital control measures will not disrupt real business activities. Indeed, there are no signs of shortage or rationing of foreign currency for trade transactions, as importers are able to obtain foreign currency freely for import payments. Nevertheless, the transaction cost is increased, as there will be more administrative red tapes.

As a result, the economy is effectively closed to 'unwanted' capital movements. The exchange controls effectively control and limit the movements of capitals. Of much focus is over the one-year holding period for securities by foreign investors, i.e. non-residents are not allowed to convert proceeds from the sale of securities into foreign currency before 1 September 1999. BNM's subsequent circular has clarified that the one-year holding period applies starting from either 1 September 1998 or date of purchase, whichever is the later date; and the securities include bills of exchange, private debt securities, Cagamas bonds, MGS, treasury bills, and share and warrants listed on the KLSE.

The main changes in the exchange control rules were as follows (Economic Report 1998/1999):

External Accounts : Approval is required for transfer of funds between External Accounts. Withdrawals of ringgit from External Accounts other than for permitted purposes, require approval.

Authorised Depositary: All purchases and sales of ringgit financial assets can only be transacted through authorised depositary institutions.

Trade Settlement: All settlements of exports and imports must be made in foreign currency.

Currency held by Travellers: With effect from 1 October, 1998, travellers are allowed to import or export ringgit currency of not more than RM1,000 per person. There are no limits on the import of foreign currencies by resident and non-resident travellers. The export of foreign currencies by resident travellers is permitted, up to a maximum of RM10,000 equivalent.

6.2.2 The public's response

The imposition of capital controls in Malaysia has gained support among the academics. Paul Krugman in his open letter to the Prime Minister Datuk Seri Dr. Mahathir Mohamed supported the measure but cautioned that capital controls should merely give a 'breathing room' for economy recovery. It should not postpone the effort of structural reforms in cleaning up the corporate sector and strengthening the banking sector. Others are critical about such a bold step as it goes against the direction of financial liberalization and distorts economic activities. Nevertheless, the general consensus is that capital controls should only be a temporary measure and be removed as soon as possible.

Malaysian businessmen in general, welcomed such measures as the easing of credit gives relief from the earlier credit crunch and the fixing of exchange rate ease operation planning, i.e. costs and revenues could be defined clearly. Such an impression is also confirmed by the preliminary result of a survey conducted by The Federation of Malaysian Manufacturers (FMM).

6.2.3 A policy U-turn

Following the implementation of the capital control measures from 1 September 1998, further measures to loosen the earlier fiscal and monetary restraints were introduced. This marked the regain of greater monetary and fiscal independence for a policy U-turn towards an expansionary one.

Chapter 7 discusses the measures of fiscal and monetary expansions and an analysis of policy impact of capital controls using the Mundell-Fleming model.