

Chapter 1

AN INTRODUCTION

1.1 BACKGROUND

The recent financial turmoil that hit the East Asian region has begun to subside. This has allowed the affected countries to begin their long recovery process and to analyze and rectify their very own shortcomings. Clearly, the speed and pace of recovery are significantly apparent in East Asia with economic growth exceeding earlier expectation. The pickup seems to be strongest in Korea where the Gross Domestic Product (GDP) increased by 10.5 percent in 1999 and Malaysia with 5.4 percent (IMF, 2000).

The financial crises in Europe (summers of 1992 and 1993), followed by Mexico (end of 1994), Russia (summer 1998) and recently Brazil (January, 1999) have showed us the shortcomings of the global financial architecture in avoiding such incidents. Affected countries were forced to initiate several policy responses and among them were to seek for financial assistance from the International Monetary Fund (IMF), reduction in foreign borrowings via painful reversal of current account deficits, repairing the balance sheets of financial and non-financial institutions, adopting and implementing painful economic reforms and adjustments, and introducing capital controls.

In Malaysia, policymakers realized that some measures of action had to be taken since there was an urgent need to restore the economy so that it did not suffer from severe downward spiral and contraction. Thus, Malaysia decision to introduce selective capital and exchange controls was basically to insulate the economy from external volatile economic forces and to provide an environment

of stability, which macroeconomics policies cannot deliver under difficult circumstances, and to facilitate the ongoing economic and financial reforms. It was the desire of the authorities to limit downward pressure on the Ringgit, to stop continuous decline in foreign reserves and to allow them to buy time that was necessary for later macroeconomic adjustments.

The organization of this chapter is as follows. In section 1.2 the objectives of this study are presented. Section 1.3 discusses on the data, methodology and organization of this study. Section 1.4 takes a look at the implications of the study. And section 1.5 summarizes the chapter.

1.2 OBJECTIVES OF THE STUDY

The first objective of this study is to record Malaysia's experience during the East Asian crisis and to facilitate further economic research in this area.

The second goal of this study is to analyze the impact of the East Asian crisis and the imposition capital and exchange controls on the several macroeconomic indicators and other economic representations such as the offshore Ringgit market, speculative activities, trade, capital flows, stock markets, wealth, domestic prices and welfare.

Third, the study intends to discuss exit strategies, which Malaysia must consider and adopt should it decides to exit from the current fixed exchange rate regime and capital controls.

1.3 DATA, METHODOLOGY AND ORGANIZATION

This study will derive its data on the Malaysian economy from Bank Negara Malaysia's annual reports, Economic Reports by the Ministry of Finance, the

National Economic Action Council's web page (for the latest macroeconomic data) and other relevant sources. It uses the following macroeconomic indicators:

- a) Annual GDP,
- b) Unemployment, inflation and price level figures,
- c) Fiscal and monetary policies,
- d) Exports and Imports Performance
- e) Socio Economic indicators.

The period of discussion would cover the fiscal year of 1997 to the first quarter of 2000. Specifically:

Period 1: covers the entire of 1997 until 31 August 1998

Period 2: covers the time frame from September 1 of 1998 up to first quarter, 2000.

The outline and focus of this research paper are as follow. The first chapter contains an outline of the research paper, basically focusing on the design of the research paper, which includes the introduction, study objectives, methodology, scope and summary.

In chapter two, the focus is on literature review. It will cover the followings:

- a) East Asian Crisis – the main causes
- b) Significance of capital flows – global capital flows and consequences
- c) Capital controls – an introduction and effectiveness
- d) Exit strategies – preconditions for an exit and the general considerations for adopting a currency regime
- e) Conclusion

The third chapter deals with the impact of the East Asian crisis on the Malaysian economy before and after capital controls were imposed. It attempts to discuss the impact of the regime on the macroeconomic indicators and other economic features such as offshore Ringgit market, speculative activities, the stock market, capital flows and the outstanding short-term external debts. This discussion is then extended to include an analysis on the exit levy and its effects on capital flows and the stock market due to the relaxation of the 12 months moratorium.

The fourth chapter of this study discusses the exit strategies that Malaysia has to consider and could adopt should it decide to depart from the fixed exchange rate system and capital controls. It also takes a look, in brief, at the general considerations for adopting an exchange rate regime by a less developing country.

The summary, policy recommendations and conclusion of the study are available in the final chapter.

1.4 IMPLICATIONS OF THE STUDY

The findings and discussion of this research may be useful for policy considerations and for stimulating further research in this area.

1. This study highlights Malaysia's economic weaknesses and vulnerability to speculative attacks and irrational market behaviors. Thus, there is an urgent need to rectify these weaknesses as soon as possible before Malaysia decides to lift the regime.

2. It must be stressed that Malaysia economic weaknesses were also due to its faults. As such, stricter and prudent regulations must be implemented and observed in order to regulate our financial and private sectors. A good example would be that of Taiwan, which had passed a law prohibiting speculative activities within its stock market.

3. The recent imposition of capital controls does carry its own merits and to simply ignore the contributions and successes on its part is simply inappropriate.

4. There must be some concerted and concentrated efforts by the regional policymakers and central bankers, in order to protect this region from any similar crisis in the future.

1.5 SUMMARY

This chapter highlights the objectives, focus and organization of the study. Its main purpose is to put the research paper in proper perspective in order to facilitate the discussion. Moreover, it also highlights rather briefly the impact of the recent financial and currency crisis to its readers and lessons that could be learned.