Chapter 3

MALAYSIA'S ECONOMIC CONDITIONS BEFORE AND AFTER THE CONTROLS

3.1 INTRODUCTION

The depreciation of the Thai Bath in mid of 1997 caused a regional currency crisis that affected Malaysia. With a highly open economy that included the liberalization of capital movement, the crisis had led to a major contraction in the Malaysian economy, which later proved to be the worst in its history.

In this chapter, the study intends to discuss Malaysia' s economic conditions before and after the regime of selective capital and exchange controls was imposed. Thus, the organization of this chapter is as follows:

The section 3.2 highlights the framework of the selective capital and exchange controls in Malaysia, as published in Bank Negara Annual Report 1998.

In the section 3.3, the study will highlight in brief Malaysia's economic conditions prior to the start of the crisis. The objective of this section is simply to facilitate the discussion and to provide some background information on the state of the economy.

Section 3.4 will analyze the state of the economy prior to the introduction of the selective capital and exchange controls during the crisis. The aim of this section is to understand the impact of the recent crisis on the economy.

Section 3.5 discusses the condition of the economy after the controls were imposed would follow this. The goal of this section is to look at the impact of the regime on the economy.

Section 3.6 is devoted to discuss the effectiveness of the selective capital and exchange controls in achieving the intended objectives.

Finally, section 3.7 summarizes the chapter.

3.2 FEATURES OF THE SELECTIVE CAPITAL AND EXCHANGE CONTROLS

According to Bank Negara Malaysia Annual Report 1998, the design of the selective exchange controls was aimed at reducing the internalisation of the Ringgit. This was achieved by eliminating all accesses to the Ringgit, home and abroad, to currency speculators. This included the introduction of rules related to the use of external accounts by non-residents and currency settlement transactions. The regime was also aimed at stabilising short-term capital inflows by requiring, in the early part of its existence, inflows to remain in the country for a period of 12 months. These measures would be modified once the objectives were met and as such, on February 4 1999, the rule on the one-year holding period was modified and replaced by a market based exit levy.

The features of the exchange controls are as follow:

- selected Ringgit denominated transactions among non-residents effected via non-resident external accounts require approval
- short-term capital flows are required to remain in the country for one year. However, these funds are free to engage and managed in the Ringgit assets
- imports and exports of Ringgit by travellers, both residents and non-residents, are restricted for amounts not exceeding RM1,000

- Malaysian investment abroad exceeding the equivalent of RM10,000 require prior approval and
- Malaysians travelling abroad require approval to carry foreign currencies in excess of RM10,000 or equivalent.

There are no, however, controls on:

- current account transactions, (amendment in rules only require trade transactions, both in goods and services, to be settled in foreign currencies and no longer in domestic currency);
- repatriation of profits, dividends, interest, fees, commissions and rental income from portfolio investments and other form of Ringgit assets and
- foreign direct investment inflows and out flows.
- Foreign direct investment inflows and outflows, including income and capital gains are not subjected to any form of restriction.

In addition, the Ringgit has been fixed or pegged against the United States dollar at RM 3.80 to a dollar so as to provide a greater degree of certainty to the market participants to conduct trade and investment activities. For more elaborate details on the regime, the Bank Negara Malaysia's web page furnishes up to date information on the regime and its framework.

3.3 A BRIEF LOOK AT THE MALAYSIAN ECONOMY BEFORE THE CRISIS

It is widely acknowledge that prior to the recent East Asian crisis, Malaysia was dubbed as one of the miracle economies of this region due to its consistent achievements of high economic growth, averaging annually around 8.9 percent between 1988-1996. This highly successful track record was supported by an open and liberal trade regime, sound macroeconomic management to address any internal and external imbalances, a stable central government as well as long term policies to address any supply side rigidity (BNM, 1999a). Moreover, this period had also witnessed full employment and low inflation, with unemployment rate averaging about 2.7 percent and the inflation rate at 2.8 percent per year respectively.

This high economy growth was translated into improvements in private household as well as social income. For example, 88 percent of urban households and 72 percent of rural households had access to electricity and 92 percent and 65 percent had access to safe drinking water. In all about 88 percent of urban dwellers and 77 percent of their rural counterparts had health clinic within 9 km radius, with access to primary education standing at 100 percent and 94 percent respectively. Household income had also increased for the last 25 years. The percentage of household living under the poverty line fell to 8.9 percent in 1995 from 49.3 percent in 1970 (Mohamed Ariff et al., 1998a). In terms of poverty eradication, the level of poverty had declined from 17.3 percent to just about 6.8 percent in 1997 (BNM, 1999a). This remarkable achievement was achieved through various social programs implemented by the government such as the Amanah Ikhtiar Malaysia (AIM) project, which granted financial assistance to the poor.

These substantial economic and social gains were derived from a development strategy based on public sector expansion in the 70s and 80s, and was followed by private sector expansion in the mid 80s and 90s. This improvements was assisted by economic liberalization following the recession in the 1980s, and further consolidation by the government in the 90s, including trade liberalization, deregulation, public sector down-sizing, tax reforms and massive industrial and privatization plans. These measures were backed by prudent macroeconomic management, which had permitted FDI into export-oriented led industries that formed the major thrust of the country economic growth.

Nonetheless, while Malaysia had enjoyed the above successes, the economy was showing signs of weaknesses prior to the East Asian crisis. According to the Mohammed Ariff et al. (1998b) among the various weaknesses were an economy that was growing above its potential output, loss of efficiency in the economy, a current account deficit and large credit extensions to unproductive sectors like the stock market and the property sector.

The economy has been consistently growing above what was deemed as its potential growth path since 1991. This has created price pressure due to wage increases beyond productivity gains. Moreover, in order for an economy to improve its potential growth path in the long term, it has to improve its efficiency in utilizing inputs. It was quite worrisome that a significant amount of these inputs were imported, such as foreign labor.

The presence of misallocation of resources in the economy was also indicated by the trend growth of Total Factor Productivity (TFP) and the incremental capital output ratio (ICOR). The computation made by MIER showed that the TFP growth over the years showed a declining trend and in 1997, it was estimated negative (Mohamed Ariff et al., 1998b). Likewise, according to Ghani and Suri (1999) between 1987-1991, TFP was the chief contributor to economic growth averaging 60 percent. However, contribution of capital per worker, within the same period, was under 10 percent. More recently, between 1993-1997, the contribution of TFP fell well under 10 percent. In this period also, capital accumulation became the main driver of economic growth with an average of almost 60 percent. This findings confirmed earlier expectations that the character of Malaysia's economic growth in recent years has changed dramatically from being productivity driven to input driven. The rise in ICOR since 1995 has showed that the use of capital had become less efficient.

The current account deficits was also a source of concern as in 1996, net long-term capital inflows, which were used to finance part of the deficits, exceeded the current account deficits by only RM1.3 billion (Mohamed Ariff et al., 1998b). The investment boom period had seen a decline in efficiency in capital utilization and TFP growth rate. Moreover, the reliance on short-term capital flows to cover the current account deficits is not tenable as they are highly volatile.

Finally, the excessive loans growth to unproductive sectors had been rising at a fast rate. Between 1971-1997 for instance, lending by the commercial banks and finance companies in Malaysia grew at nearly 21 percent per annum in stark contrast to nominal GDP growth of only 12.5 percent per annum. During the period of 1995-1997, the baking sector accounted for 58 percent of net funds raised, compared to 15 percent from the equity market and 11 percent from the domestic debt market (Ghani and Suri, 1999). This highly dependence on the baking sector was due several major reasons. First, implicit government guarantees against private investments and project failures. An example of such investment is the Bakun Dam project in Sarawak, where the government has clear intention of ensuring that this project, undertaken by a private consortium, would be completed. Second, underdeveloped capital markets have created an over reliance on the banking sector and hence, permitting risky transactions and maturity mismatches to take place, which had contributed to the inefficient capital intermediation process. Third, several institutional and regulatory characteristics of the Malaysia banking sector were also responsible for this over dependence on the banking sector. For example, the introduction of the two-tier system in the banking sector in 1994 was clearly one of the reasons that forced some bank managements to borrow short-term in order to enhance their capital base. Instead of relying on no-debt sources to spur their capital base, these affected banks were forced to lend heavily in order to generate sufficient returns to service their short-term debts (Mohd Redzuan, 2000).

Furthermore, total loans growth grew at an average of 12.2 percent during 1992-94, and by 1997 it rose to a level close to 30 percent. By March of 1997, the central bank imposed quantitative restrictions on the amount of loans to 'less productive' sectors (property base and share markets) due to excessive loans extended by the banking system. Nonetheless, Ghani and Suri (1999) argued that these restrictions came just too late, as the guidelines were clearly not successful in slowing down the credit growth. Exemptions were also awarded to several types of loans such as those related to the construction of residential houses and development of infrastructure projects.

These worrisome trends apparently coincide with the East Asian crisis and may have in fact worsened the overall impact on Malaysia's economy.

3.4 THE MALAYSIAN ECONOMY BEFORE THE CONTROLS (PRIOR TO SEPTEMBER, 1998)

In this section, the discussion will look at the impact of the recent financial and currency crisis on the Malaysian economy, prior to the imposition of the selective capital and exchange controls, by analyzing the macroeconomic indicators as mentioned earlier in chapter one.

3.4.1 Gross Domestic Product (GDP)

The Real Gross Domestic Product (GDP) contracted by 7.5 percent in 1998, which was in response to the contraction in real domestic demand for goods and services as well as the sharp deceleration of growth of real external demand due to the financial crisis. (Ministry of Finance, 1998). The manufacturing sector had lower output during the year in view of the depressing state of the economy, sluggish sales order around the region due to the latest crisis and stiff competition from other competitors around the world. Moreover, the volatility and depreciation of the Ringgit led to higher import price of imported components and the high interest rates in the early period of the crisis led manufacturers not to maintain stocks due to poor demand and higher holding stocks and postponed some expansion plans.

In terms of domestic demand, the situation was not better than the above deteriorating condition. Aggregate domestic demand was recorded declining in 1998 for the first time since 1986 by 20.6 percent in current prices, reflecting the sharp contraction in the first three quarters of the year, against a growth of 9.7 percent in the preceding year. Moreover, total consumption spending also decline by 6.5 percent in nominal terms (BNM, 1999e). Some of the suggested reasons for the decline include the major correction in the value of the Ringgit and the slide in the stock market, and poor balance sheet performance by the private sectors, which later was translated into poor private demand and activities. Furthermore, the negative wealth effects due to the poor performance of the stock market, rising inflation rate, uncertain future in the labor market and significant consumption adjustments made by households, saving rather than spending, also contributed to the drop in private consumption. The cutback in private consumption was also apparent in the decline for expensive durable items such as cars, motorcycles and household refrigerators. For example, the demand for cars in May 1998 was registered at 8,373 units compared to 16,089 units in January of the same year (Ministry of Finance, 1998 & NEAC, 1998b).

Based on the Manufacturing Production Index (MPI), which reflected the output of the manufacturing sector, during the first seven months of 1998, the index decline by 6.7 percent from a growth period of 13.3 percent in 1997. Specifically, the decline in the output of the domestic oriented industries was attributed to the significant cutbacks in the production of construction related industries such as non-metallic mineral and steel industries. The impact of the weaker Ringgit was also apparent in the PPI (Producer Price Index, 1989=100), which started to increase since October of 1997. In the first eight month of 1998, the PPI recorded double digits figures with the largest increase of 17 percent in the month July (BNM, 1999e).

Other statistics include the labor productivity or output per worker in the manufacturing sector, which declined by 2.9 percent during the first seven months of 1998. This decline was attributed to the slow down in sales and a decline in employment in the sector. Production of electrical and electronic machinery, apparatus and supplies as a group fell by 7.7 percent in 1998 due to weak demand from the affected Asia Pacific region as well as depressed global markets (BNM, 1999e).

In the agricultural sector, total value added for this sector including forestry, logging and fishery contracted by 4.5 percent. This sharp decline in value added was attributed to lower production of all major crops, with the exception of pepper in 1998 (Ministry of Finance, 1998 & 1999a). In all, an excess supply of rubber production that softened the price, labor shortages, unpredictable weather, poor demand and overseas producers, especially in Indonesia, selling off saw logs at cheap discounts caused this sector to experience a sharp contraction of an estimated 5.9 percent (Ministry of Finance, 1998). The mining sector, however, saw its value added increase by 0.8 percent in 1998 (BNM, 1999e) thus, reflecting an improvement in the tin industry and higher crude oil and gas production.

Finally, the construction sector was reported to experience a similar drop in demand and sales. Its value added dropped by 24.5 percent in 1998, in contrast to a growth of 9.5 percent in 1997 (BNM, 1999e). This severe contraction reflected significantly excess supply in the property market and lower construction projects. Moreover, construction activity was affected as large stock overhang, particularly in the high-end properties such as condominiums and non-residential property. The developers were also affected by high interest rates before and during the crisis and an erosion of wealth among the population. Buyers were more cautious in their selection in an anticipation of further fall in property prices.

Clearly, the poor performance in the GDP and subsequently in almost all relevant sectors was the impact of the recent financial and currency crisis. This slowdown was later translated into an economic contraction that saw Malaysia suffered its worst recession in history.

3.4.2 Prices and Employment

The first half of 1997 saw the inflation rate remained low due to consistent implementation of prudent macroeconomic policies, a liberal import regime and low inflation in most industrial countries. The CPI moderated in March of 1997 and reached its lowest point since 1985 at 2.1 percent in July. Nonetheless, the rate of inflation, measured by the Consumer Price Index (CPI, 1994=100) showed a rising trend in 1998, due to the impact of the currency crisis in the second half 1997. According to Bank Negara Malaysia Annual Report 1997, the CPI was on a downward trend since 1996, registering only a moderate 2.5 percent in growth rate in the second half of 1997, compared to a growth rate of 2.8 percent in the first half of the same year.

In fact, the CPI was only at 2.1 percent when the Ringgit crisis started in July of 1997. Accordingly, the impact of the Ringgit depreciation was not felt until the late of 1997 due to time lag in the calculation of the CPI and the PPI and changes in household consumption pattern, shifting from imported goods to domestically produced substitutes. As total production costs increased due to the depreciation of the Ringgit, producers were forced to absorb part of the costs in order to maintain their share of the market.

Thus, since January 1998, the increase in CPI was more apparent and by the first quarter of 1998, the impact of the Ringgit depreciation was becoming more apparent, with the CPI rising at an average growth rate of 4 percent compared to just 3 percent in the corresponding period in 1997 (BNM, 1998a). Likewise, the impact of the Ringgit crisis also affected the low income groups, especially the urban poor who saw the average CPI for January to August of 1998 increased at a rate of 6.0 percent for those earning below RM1,000 and 5.7 percent for the income group of RM1,500. This suggests a deterioration in their purchasing power and standard of living as higher prices of food and other essential items worsened the situation (Ministry of Finance, 1998).

The labor market remained tight albeit for much of 1997 with the unemployment rate increasing to 2.7 percent, slightly above than 2.6 percent registered in 1996. Nevertheless, the tight labor market had eased towards the end of 1997 due to some relaxation in the construction sector and certain selected services sub sectors due to deferment of projects and scaling down of non-essential developments as the economy was beginning to feel the effects of the Ringgit crisis (BNM, 1998d).

In 1998, the unemployment rate was recorded at 3.2 percent with total employment declining by 3 percent (BNM, 1998d and Ministry of Finance, 1999a). The decline was evidently in the construction sector followed by the manufacturing and agricultural sectors as slower production activities took place and firms downsized. There were about 85, 865 workers who loss their jobs as employers began to cut down on their cost of production. Nonetheless, the labor demand remained strong as the total number of job vacancies was at 74, 610 in the same year. Demand was apparent in certain industries such as selected manufacturing and non-manufacturing firms, according to The Business Expectation Survey pf Limited Companies, Second Half 1998 conducted by the Department of Statistics (BNM, 1999e).

3.4.3 Exports and Imports Performance

In the first seven months of 1998, Malaysia's total value of net exports in Ringgit term increased by an annual rate of 40.98 percent or RM162.7 million, as the significant depreciation of the Ringgit helped to improve export prices. However, since the Ringgit was highly volatile due to the currency crisis, a better estimation in US dollar terms saw the gross value of Malaysian exports declining by 7.8 percent to US$72.5 billion. Moreover, the decline in exports were largely due to weaker external demand from East Asia as well as lower export prices in US dollar due to stiff competition and excess supply, especially in the crude oil production (Ministry of Finance, 1998).

Manufactured exports showed a strong growth of 32.2 percent, followed by the agricultural commodities with an increase of 33 percent. The growth in export value in the manufactured goods could have been higher if not for the weak demand around the Asia Pacific region, excess production and stiff global competition from other producers. The electrical, electronic and machinery industries were the major contributors to manufactured exports, followed by chemical industry, textile and metallic manufacturers.

Exports of agricultural commodities meanwhile increased by 30.4 percent to RM30.2 billion reflecting a favorable increase in palm oil exports, which more than offset the loss in exports from other commodities such as saw logs, saw timber and cocoa. The favorable price for palm oil was due to the anticipated tight market supply in the world market as the Indonesian authority continued to ban the exports of the item. Moreover, as palm oil was quoted in Ringgit, the upward movement of the local currency against the US dollar also pushed the export price of this commodity.

With respect to imports, the conditions were quite reverse. Malaysia' s import of capital goods declined by 15.1 percent in Ringgit terms, a sign of significant contraction in private investment. This decline was also due to measures taken by the government, including requiring approvals for importing heavy machineries for construction and high import duty ranging from 5 percent to 10 percent, to limit the importation of capital good such as machinery from overseas as well as to encourage refurbishment of used machine within the country. For the first seven months of 1998, imports of capital goods had dropped by 6.8 percent to RM 23.3 billion as contraction in the import of motor vehicle for transport goods and mechanical handling equipment contributed to this figure (Ministry of Finance, 1998 & BNM, 1999d).

Overall, the impact of the recent financial and currency crisis on Malaysian exports and imports was mixed. After the currency crisis hit Malaysia, which led to a severe Ringgit devaluation, exports expansion took place. Total imports, however, fell due to the decline in Ringgit, as imported items were more expansive than before the crisis. The sharp drop in domestic demand for imported goods also led to a deterioration of imports to Malaysia. This in turn led to an increase in trade surplus, which recorded an unprecedented level of RM58.4 billion in 1998 and far exceeding the previous high of RM13.3 billion in 1987 and as a result, Malaysia's foreign exchange holding increased in 1998 to RM96.3 billion (BNM, 1999d).

3.4.4 Monetary Development

The conduct of monetary policy during the crisis can be divided into three major stages: the adjustment phase (start of crisis-early July 97- early January 98), the stabilization period (January 98-July 98) and the recovery phase (August 98 onwards). In this section, the discussion will center on the first two phases.

The Adjustment Period-Stabilization Period

The conduct of monetary policy during this period was clearly directed towards restoring economic stability in order to overcome disruptions caused by uncertainties in the foreign exchange and stock markets. The main goal of this approach was to address the tight liquidity distribution and to remove all distortions and inefficiencies related to the intermediation process, which have emerged within the financial system. This would then resulted in allowing the banking institutions to reduce their lending rates and ensure adequate financing to viable corporations and projects.

Overall during this period, the Ringgit, which was under tremendous speculative pressure, lost its value by 34 percent against the United States dollar. In the first two weeks of the crisis, the central bank actions to intervene in the foreign exchange market absorbed a significant amount of liquidity from the financial market, which later cause the interest rates on the interbank market to rise by as high as 40-50 percent for overnight money (BNM, 1999e). Growth in domestic loans also saw a significant drop as domestic banks became more cautious in their lending activities as there was fear that the financial crisis could lead to a rise in NPLs and poor financial performance. As a result, total loans extended by the banking system dropped from a high of 28.2 percent as at end June 97 to just about 23.4 percent at the end of January 98. The continuation of capital outflows due to higher offshore interest rates and the speculative activities on the Ringgit contributed to the worsening of the liquidity problems faced by the financial system as about RM11.3 billion worth of short-term funds were withdrew. The liquidity problem was also exacerbated by the actions of several weak financial institutions, which had increased their interest rates in order to attract fresh deposits. Monetary growth in the first and second quarters of 1998 also moderated with M3 contracting by 1.2 percent or RM4.9 billion and 13.7 percent respectively, reflecting a slowdown in lending activities In terms of the quality of assets, the net NPL ratio of the baking system increased from 7 percent at end of March 1998 to 8.9 percent at end-June (BNM, 1998a,b &d).

In response to the above problems, BNM had to resort to several monetary policy initiatives. First, effective from August 4, 1997 the central bank instructed all banking institutions to observe a US$2 billion limit on outstanding non-commercial related Ringgit offer swap transactions with non-residents (BNM, 1998d). This was intended to reduce domestic banks' exposure against currency traders and to curb the amount of Ringgit available to currency speculator in the offshore market. Besides that, it was the intention of the authorities to allow domestic interest rates to be more reflective of domestic economic conditions and hence, promote a conducive environment for investments. A credit plan was also drawn up by BNM in October 1997, which required banking institutions to submit their credit plans for the rest of 1997 and 1998 based on their business strategy and assessment. Lending to critical areas such as export-related manufacturing activities, production services, small and medium cost housing were given priority by BNM.

Besides that, the statutory reserve requirement (SRR) was also reduced from 13.5 percent to 10 percent on 16 January 1998 and another reduction on July 1 to 8 percent. This led to a decline in money market interest rates and a corresponding reduction in the lending rates, which fell from 21.5 percent in early February of 1998 to about 16.3 percent by the end of that month (BNM, 1998a & b). This drastic reduction was a clear attempt by BNM to improve the distribution of liquidity that has already been previously injected, amounting to RM34 billion, into the banking system. Evidently, the central bank was trying to avoid the negative effects emanating from the financial crisis onto the real sectors of the economy.

Additionally, the high interest rate levels, which were maintained at the start of the crisis was later deemed as counter productive and reduced in mid August of 1997 by BNM as the effects, slowdown in loan growth and increasing burden on debt servicing, were detrimental to the financial institutions and the real economy. Nevertheless, as the crisis prolonged the threat of rising inflation, continuous outflows of funds and the collapsed of the Indonesian rupiah, which affected the Ringgit, in January of 1998 prompted the authorities to raise the interest rate once more to 11 percent (BNM, 1999e).

Other initiatives undertook by BNM during this adjustment period were also aimed at improving the tight liquidity problem and improving the efficiency of loan intermediation. In April of 1998, procedures were introduced to improve money market operations by making it more transparent and efficient. Under the new scheme, BNM would provide daily forecasts of cash flows for the financial system and details of BNM money market activities including government operations, opening balances in Day-1 current account as well as the surplus of SRR balances. Market participants were then able to use this service in order to make some assessment on the liquidity of the market.

A new framework for liquidity management was introduced to enable banking institutions to mange their liquidity positions with greater flexibility without compromising prudential standards. The calculation of base lending rate (BLR) of financial institutions was revised where the calculations were based on BNM's 3-month intervention rate. All financial institutions were required to readjust their BLR within a week from the date of change in the BNM's intervention rate and thus, leading to a faster transmission of changes in monetary policy. Effective May 1, 1998 the band of permissible daily variation in the average balances that were required to meet the SRR was also widened to +/- 2 percent of the prescribed SRR rate from the previous band of +/- 0.5 percent (BNM, 1998b). The widening of this band had in fact accorded banking institutions with more flexibility in managing their daily liquidity operations and helped to reduce the cost of funds, which were used in the computation of the BLR.

By August of 1998, the central bank had begun to ease monetary policy to complement fiscal policy in order to contain the contracting economy and promote economic recovery. Besides the reduction in the SRR in July, the 3-month intervention rate was also reduced in successive steps to 10 percent on August 10. This led to lower lending rates where the average lending rates of the commercial banks declined from 12.27 percent at end-June to 11.85 percent as at August 15 (BNM, 1998c).

The above mentioned measures had reduced the cost of borrowing and contributed to greater efficiency of the banking institutions since they were now provided with greater flexibility in their daily operations. The central bank was also given the task by the government in promoting and distributing a number of special funds, which were aimed at the export sector and small and medium sized enterprises. These funds were the Fund for Small and Medium Scale Industries, Export Credit Refinancing Facility, Special Scheme for Low and Medium Houses, Suppliers, Buyers and Overseas Investment Credit, Fund for Food, New Entrepreneurs Fund and Petty Traders and Hawkers Fund (BNM, 1999e).

3.4.5 Fiscal Policy

As a result of the financial crisis, fiscal policy played an important role in addressing Malaysia's economic weaknesses and was instrumental in restoring macroeconomic stability and recovery. Similar in discussion to the preceding section on monetary policy, the conduct of fiscal policy during the recent crisis can also be divided into three phases.

In the first phase or the fiscal austerity period, the government further tightened budgetary operations in order to bring about a more rapid downward adjustment in the current account deficits and to reduce inflationary pressures arising from the depreciation of the Ringgit. In the third quarter of 1997, the government introduced several policy measures to contain the depreciation of the Ringgit and the current account deficits. First, an immediate 2 percent cut across the board in government spending was implemented. Second, project deferments were initiated affecting mega projects such as the Bakun Dam project in Sarawak, the Kuala Lumpur Linear City, the Northern International Airport, and the Phase II of the Putrajaya Project. Third, purchases of foreign goods were also deferred, affecting all public sector agencies including the armed forces. The 1998 budget presented in October of 1997 also extended the deferment policy onto several others infrastuctural projects as the public sector begun its consolidation process in order to strengthen economic fundamentals against external developments. Overall, an estimated RM65.6 billion of the cost of projects were affected by this additional measure (Ministry of Finance, 1998; BNM, 1998d & 1999e).

As the pressure from the financial crisis mounted on the Federal revenue, a further cut in government expenditures was also announced in December 1997. The reduction across the board of 10 percent and 8 percent on a selective basis on both operating and development expenditure. This included cutbacks in civil service allowances, a freeze on optional retirement of civil servants, a reduction in overseas travel and deferment of non-critical projects not essential to economic development. However, the government cuts did not affect essential items such as poverty reduction, housing for the poor, health and education programs. The ensuing result showed that the total federal government expenditure had declined by 8.3 percent and consequently, by the first quarter of 1998, the overall position of the Federal government remained in surplus as lower expenditure due to the austerity drive enable the government to absorb the reduction in revenue collection. The current and capital account recorded larger surpluses of RM5.4 billion and RM4.2 billion respectively, reflecting contractionary budgetary position as part of the fiscal austerity to address the imbalances within the domestic economy (BNM, 1998a).

In 1998, Malaysia continued to experience difficulties emanating from the financial crisis. The fiscal austerity measures taken in the later part of 1997 seem to be unsustainable. The cutbacks had actually aggravated the decline in investors and consumer demand, thus introducing an unwarranted deflationary impact onto the local economy. Thus, on 24 March 1998, the government decided to reverse its earlier decision on fiscal austerity and reduced the targeted budget surplus to 0.5 percent of GNP. About RM 1 billion of additional fund was extended to socio-economic projects to protect the more vulnerable segment of the society. This marked the second phase in which a counter cyclical approach was adopted.

Thus, in July 1998 a fiscal stimulus amounting to about RM7 billion was announced along side with the National Economic Recovery Plan (NERP) (NEAC, 1998 a &b). The new fiscal stimulus were aimed at projects with strong linkages within the economy, low leakages in terms of imports, short gestation period and other expenditures to meet socio-economic objectives. In addition, the government expanded existing and set up new specialized funds, such as the Infrastructure Development Fund with an initial allocation of RM5 billion and was used to assist in the financing of infrastructure projects and projects involving large public facilities such as mass-transit rail transportation, ports, highways, water supply projects and waste disposal and sewerage projects, to ensure continued access to credit at reasonable cost for priority sectors. As part of the efforts to provide funding to companies undertaking infrastructure projects which require large capital outlay, the Government restructured *Bank*

Pembangunan Malaysia Berhad to form *Bank Pembangunan dan Infrastruktur Malaysia Berhad* with a paid-up capital of RM1 billion.

The NERP in the meantime was a set of six major policy objectives designed by the National Economic Action Council (NEAC), which was established in January 1998, and became the core principles in the economic recovery process. The objectives were namely, to stabilize the Ringgit, restore market confidence, maintain financial stability, strengthen macroeconomic fundamentals, continued the socio-economic agenda and to restore sectors badly affected by the crisis. The NERP focuses its attention and effort to pursue a consistent line of actions for recovery. The recommendations include actions to restore stability in the currency and capital markets, as well as to strengthen financial markets and economic fundamentals. The NERP also recommended the easing of fiscal and monetary policies as well as lowering the cost of capital to revitalize the economy (BNM, 1999e; NEAC, 1998a,b and Taing, 1998).

Besides that, three important bodies were also set up in response to the crisis. First, is an asset management company called Danaharta. Its objectives were to reduce the level of NPLs in the financial system in order to facilitate the intermediation process and to maximize the recovery value of the acquired assets. A second body, Danamodal, was established in August 1998 to recapitalize troubled banking institutions and to enhance their ability to generate new lending activities. Finally, the Corporate Debt Restructuring Committee (CDRC), which was supposed to restructure the debt of viable corporations in order to minimize losses to the creditors and shareholders, was also put in place by the government. These three bodies proved to be important players in the recovery process of the financial and private sectors.

The expansionary fiscal policy adopted by the government was clearly designed to support the economic recovery process by promoting economic activities, which had strong linkages in the economy and small amount of import requirements. In view of this, the total financing figures stood at about RM62 billion for 1998-1999, which included the funding of the recovery package, rebuilding the financial institutions and the NPLs, and infrastructure developments. According to the White Paper on the Status of the Malaysian Economy (NEAC, 1998b), which was presented by the Finance Minister to the Parliament and published in April 1999, the funds for the purchase of these non-performing assets would be raised through a combination of government contribution, borrowings from Government agencies and the issuance of bonds. A sum of RM15 billion was required by Danaharta to remove a significant proportion of the NPLs from the banking system, taking into account of the recent improvements in liquidity and lower interest rates. As of 31 December 1998, Danaharta acquired RM8.1 billion in gross value of NPLs and managed, on behalf of BNM, RM11.6 billion in gross value of NPLs. Included in the total amount of RM19.7 billion gross value of NPLs was an amount of approximately RM5 billion of NPLs acquired from offshore banks and development finance institutions. Excluding this amount, the NPLs acquired and managed represent approximately 22 per cent of the total NPLs in the banking system based on the 6-month classification at the end of December 1998. This also amounts to 4.8 per cent of total loan portfolio in the banking system.

3.4.6 Socio-Economy

Among those worst hit by the recent crisis was the hardcore poor, who did not have any stable employment or was earning well below the poverty line. The incidence of poverty has in fact increased since the beginning of the financial crisis. By 1998 for instance, the poverty rate had climbed to 7 percent. In contrast, in 1997 the rate was only 6.1 percent. The contraction in the domestic economy had also affected opportunities for employment as the number of reported vacancies between January-July 1998 stood at 46,202 job vacancies (64,463 job vacancies in 1997) compared to the number of job seekers of 34,514 persons (23,321 persons in 1997) in the same period. Furthermore, the unemployment rate rose to 3.2 percent in 1998 (Ministry of Finance, 1999a).

As the share prices and value of property dropped significantly, consumer consumption patterns were also affected due to the negative wealth effect. Businesses were less likely to be able to raise enough capital via the stock market as sentiments and the contracting economy continued to dampen the performance of the KLSE. The rise in interest rates also affected households as families were now forced to pay higher on their debt installments.

In the meantime, the crisis has also severely constrained development and promotion in education. Expanded access to education has been curtailed because new school constructions under the Seventh Malaysia Plan were postponed temporarily during the crisis. Worst affected were children from poor families as they were unable to pay for their school fees. Other education programs such as professional upgrading programs for school teachers were also postponed. Overseas education was no longer economically viable as the weaker Ringgit meant higher cost. Government agencies such as MARA and Petronas, which regularly send Bumiputra students overseas in the past, had to reduce their number or ceased completely. Attention, however, was given to students majoring in critical areas such information technology, sciences and engineering. Health care was also affected by the recent financial crisis as the impact of the crisis was translated into higher cost for medical treatment and price of pharmaceuticals, including medicine and other essential drugs. Poor families and the unemployed had their ability to pay for medical care reduced, thus affecting their access to health facilities (NEAC, 1998a, World Bank, undated and Mohammed Ariff et al, 1998a).

3.4.7 Summary

The impact of the East Asian crisis was severe and had affected every sector of the economy and society. Even though vital policy measures were introduced and implemented, rather quickly, these policy actions were usually hampered by the adverse external and internal developments. As such, there was a serious need for a stable and predictable environment, where risks were minimized, in order for these policies to function effectively. Hence, after more than 14 months into the crisis Malaysia decided to introduce the Selective Capital and Exchange Controls on September 1, 1998.

3.5 THE MALAYSIAN ECONOMY AFTER THE CONTROLS

The introduction of the selective capital and exchange controls by the Malaysian's authorities shocked many unaware investors and traders as the about turn from a liberal stance against capital inflows towards a more defensive mode came as a surprise to many. The new system was a last resort in their effort to combat the financial crisis, to bring a sense of stability to the local economy and to shield it from the adverse developments in the capital market. More importantly, the controls were an opportunity for the Malaysia authorities to regain its monetary independence, via containing speculative money, and to stabilize short-term capital flows.

Moreover, the pegging of the Ringgit vis-à-vis, to the US dollar was also another turning point for the economy. It gave businesses and manufacturing a much needed reprieve from the fluctuations in the currency market. These two major objectives became the primary targets in the government attempt to emerge from the doldrums of the crisis. Even though capital controls were employed to restrict short-term capital outflows, it did not undermine currency exchange transactions, which involves cash, such as FDI & trade settlements (The Overseas Economic Cooperation Fund, 1999).

The length of time in wish the Malaysian authorities took, about 14 months, before the introduction of the regime strongly indicated that it was not an easy task. Thus, thrust of this chapter is to study the impact and effects of the selective capital and exchange controls and the pegging of the Ringgit on the Malaysian economy. A similar set of macroeconomic indicators will be use in order to facilitate the discussion. The style of analysis will also remain the same.

3.5.1 Gross Domestic Product (GDP)

The introduction of the selective capital and exchange controls and the implementation of several macroeconomics measures saw a gradual improvement in the domestic economy. Initial signs pointed in the direction of a steady recovery as the contraction in the economy has bottomed out in the third quarter of 1998. Based on BNM's Economic and Financial Developments Report for the Third Quarter of 1998, Malaysia's output growth in the quarter expanded by 2.3 percent compared to the second quarter, albeit the economy had actually contracted by 7.5% in that year.

This was visible in 1999 when the real GDP registered a moderate contraction of 1.3% in the first quarter before leaping to a positive growth of 4.1 percent in the second quarter of 1999 (Ministry of Finance, 1999). The economic recovery was confirmed when Malaysia posted a 10.6 percent growth in real GDP in the fourth quarter of 1999 and later producing a 5.4 percent GDP in contrast with a contraction of 7.5 percent in 1998 (BNM, 2000c). As of late, the GDP in the first quarter of 2000 was at 11.7 percent, which was a strong indication of increasing economic activities and private sector expenditures (BNM, 2000b).

On the supply side of the economy, evidences also indicated that the main impetus for economic recovery was the manufacturing sector, especially the export oriented industries such as the electronic and electrical products as favorable domestic and external conditions helped this sector to grow. In 1999, the value added in the manufacturing sector had increased at a rate of 13.5 percent, as expansion in output began to take place in February of that year (BNM, 2000c). The electronic sector still leads the export oriented industries with a strong output expansion of 21.2 percent in 1999 compared to –4.2 percent in 1998. Among the main reasons supporting this sharp improvement were due to the increase in demand from internet and e-commerce users, especially in the US, Europe and Japan, as well the recent Y2K bug fear that led to computer users upgrading their personal computers in order to avoid the problem. Output in other industries also increased. The electrical products industry saw an improvement in demand for consumer and office equipments from Asia and the US. Overall output expanded by 15.6 percent in 1999 against a background of –7.7 percent in the previous year. Furthermore, these two major industries accounted for 72 percent of the total exports in 1999, rising from 68 percent in 1998 (Metrowangsa, 2000a). Similarly, industrial output in off-estate processing, textiles and wearing apparel and wood and wood products also increased significantly, reflecting the impact stemming from the selective capital and exchange controls and other pro-growth policies. In particular, the Ringgit peg had helped domestic producers in their financial planning as the fluctuations in the exchange rate were eliminated (FMM, 2000).

The domestic-oriented industry also registered an improvement as a group by recording a significant turn around in performance. The recovery of this sector seems to suggest an increase in consumer demand for goods and public investment as the effects from the expansionary fiscal and easing monetary policies began to show results. Growth in this sector increased to 23.9 percent during the second half of 1999, compensating for the poor operation in the first half of the same year.

The construction sector finally turned around in the second half of 1999, with a smaller growth of 1.8 percent (Metrowangsa, 2000b). This slight improvement was still hampered by overhang from excess space of commercial buildings for office and retail and condominiums. The occupancy rate for office space in the Klang Valley for instance, was only 76.2 percent dropping from a high of 94.9 percent in 1997 and 79.8 percent in 1998 (BNM, 2000c). Nonetheless, large scale civil engineering works and projects largely due from government fiscal stimulus as well as construction of low and medium cost houses assisted this sector. The continued maintenance of low interest rates under the controls, attractive financing scheme for potential buyers, improved economic outlook and government led home ownership campaigns to boost demand in this sector had also helped the recovery.

Value added in the agriculture sector including forestry, logging and fishery had increased by 3.9 percent in 1999 against an estimation of 4.6 percent (BNM, 2000c & Ministry of Finance, 1999a). The significant improvement was largely due to the substantial increased in palm oil production, which has so far benefited from a weaker Ringgit, as manufacturers overcame several obstacles such as weather, low output per hectarage and low oil extraction rate. However, this was not enough to offset the deterioration in the production of rubber, cocoa and other agricultural products. On the whole, the agricultural, forestry and fishery sector only account for a small share of GDP in 1999 (BNM, 2000c).

The mining sector value added contracted by 4 percent in 1999 due to lower crude oil production, which was a major component of this sector. Other outputs, such as tin had registered a positive growth along with natural gas production (BNM, 2000c). Increased in demand for natural gas from industrial countries like Japan and the opening of new mining sites helped to boost production in these two sectors.

Albeit some of these industries were suffering from excess capacity, the situation should improve. A survey done by Malaysia Institute Economic Research showed that the rate on capacity utilization was 79 percent in the first quarter of 1999, 81 percent in the second quarter, 81.3 percent in the third and 84.8 in the final quarter (MIER, 2000). This clear suggest that as business confidence improves under the controls, the potential for further investment and higher capacity utilization in the manufacturing sector in the near future is there.

On the domestic demand conditions, consumer and investors confidence played a major role in reviving the economy. The government fiscal packages and loose monetary policies encouraged aggregate domestic demand to improve in 1999, as the private and public sectors began to pick up in the third quarter (BNM, 1999d). Apart from that, the improvement in the stock market performance seemed to help to generate positive wealth effects and could likely be a boost to domestic spending in the near future.

In nominal terms, total consumption expenditure increased in 1999 by 8.4 percent, in contrast to a deficit of 7.4 percent in 1998 and public consumption meanwhile, increased significantly by 20 percent in nominal terms as increased in expenditure and emoluments were the largest. Previously in 1998, private consumption was clearly weak as it declined by 7.5 percent, a strong signal that consumer and business confidence was poor. In an environment of lower interest rate, improve sentiment and performance in the stock market and greater confidence; private consumption expenditure did make an upturn to record a positive growth of 5.6 percent in nominal terms in 1999. Based on the information reported by the NEAC (1998a & b), total passenger car sales in 1999 rebounded to 255,878 units or 79.9 percent. The sharp increase in total loans disbursed for consumption credit and general commerce, RM17.1 billion and RM57.7 billion respectively, seems to suggest that Malaysia is experiencing a solid economic recovery.

In terms of public investment, the fiscal stimulus programs based on counter cyclical approach have resulted in an increase of 3.1 percent in nominal terms in 1999 and balance deficits of RM9.5 billion or 3.4 percent of gross national product (GNP) in 2000 (Metrowangsa, 2000b). Allocations for socio economic projects and selected infrastructure projects with high potential for domestic linkages and minimum import content were selected. This seems to suggest that public sector investment will remain as an important contributor to Malaysia economic recovery in the following years.

Private investment has been rather disappointing. In 1999, it decline further by RM33 billion from 1998's RM44 billion in nominal terms. Evidences seem to suggest that excess capacity is still apparent in many basic industries. Nonetheless, this trend is likely to improve in the near future as consumers and investors have begun to have a positive outlook of the economy. The move towards K-economy as highlighted in Bank Negara Malaysia Annual Report

1999 could spur new private investments as new technology driven industries emerge and demand for highly skilled labor increases.

3.5.2 Prices and Employment

Based on BNM Annual Report 1998, inflation seems to have stabilized in the third quarter of that year. It had been on the up trend since the fourth quarter of 1997 under the impact of the recent financial crisis and the depreciation of the Ringgit. In addition, the sharper contraction in the aggregate demand and the excess supply in the local economy helped to reduce inflationary pressures and contained the inflation rate from rising any higher. As Ringgit was fixed at RM 3.80 = US$1 for the last four months in 1998 and the domestic demand was recovering slowly, the inflation rate started to decrease. The CPI in December of 1998 was at 5.3 percent, compared to its peak of 6.2 percent in June. For the whole 1998, Malaysia posted 5.3 percent on the inflation scale (BNM, 1999e).

Overall, the relative stability of the Ringgit, excess capacity on the supply side of the economy and lower commodity prices led to a moderate price increase in 1999. The inflation rate was relatively subdued, rising at an annual rate of 2.8 percent, in contrast to an earlier estimate of 3.0 percent (BNM, 2000c). The marginal appreciation of the Ringgit against the US dollar since the imposition of the selective capital and exchange controls was also attributed to lower price levels as the excess supply of goods prevented producers from passing on the impact of this appreciation onto the consumers. The recovery of regional trade partners from the recent financial crisis, leading to lower inflation rates in their countries and the lower prices of agricultural commodities, where Malaysian producers are often the price taker rather than the price maker, helped to further eased the potential rise in prices and in general, the inflation rate. The pegging of the Ringgit had also reduced the potential for an increase in imported inflation, as imported goods were rather expensive than before the crisis.

The PPI was also declining in late 1998 and in 1999, with the PPI recording 3.3 percent in the later. Among the factors that were attributed included lower import prices for commodity goods and lower cost of production as most producers have either completed their restructuring programs or simply wind up. This helped to contain the inflation rate from further rising. Prices were, in general, lower in all sub groups of the PPI with the exception of the beverages and tobacco sub group as the later were higher by 11.7 percent in the first nine months of 1999 compared to the same period in 1998 (MIER, 2000).

The third quarter of 1998 saw some signs of improvement in the labor market. The unemployment rate had remained stable at 3.3 percent, similar to that of the preceding quarter (BNM, 1998c). On a monthly basis (May-August), the number of workers laid off showed a downward inclination with the bulk of them in the manufacturing, services and construction sectors. A possible explanation for this situation could be due to the possible restructuring and consolidation processes, which were implemented by the management as the impact of the financial crisis began to lead to lower demand internally and externally, and the rising cost of production due to higher import contents.

The labor market for the whole 1999 improved even further, thus reflecting upbeat developments in the domestic economy and financial situations. The number of people who were laid off dropped from a peak of 26,238 workers in the third quarter of 1998 to about 11,454 persons in the first quarter in 1999 (BNM, 1999b). This downhill trend continued well into the fourth quarter of 1999 with just only 7,909 persons lost their jobs (2nd Quarter: 10,304, 3rd Quarter:

7,690) and the number of job vacancies remained strong throughout the year. With a total of 27, 461 job vacancies were registered in the fourth quarter compared to just 10, 304 jobs in the second quarter (BNM, 2000a). Moreover, the Malaysian Institute of Economic Research (MIER) in its Consumer Sentiment Index (CSI) survey predicted a higher expectation of a better job market in the first half 2000 and concluded that the employment outlook was expected to remain buoyant for the year 2000 (MIER, 2000). Indeed, the rise in the employment index, which stood at 127.9 points in the fourth quarter of 1999, from 119.5 points in the preceding quarter seems to support the preceding finding (BNM, 2000a).

3.5.3 Exports and Imports Performance

Reflecting an improvement in the domestic economy and export markets, Malaysia's trade surplus in 1999 expanded further to RM72.3 billion, exceeding the previous year figure of RM58.4 billion. The value of total trade increased by 10.8 percent to RM570 million or 203 percent of GNP (BNM, 2000c). Earlier, the trade account in the third quarter of 1998 recorded a surplus of RM16.6 billion, which allowed Malaysia to achieve a larger surplus of RM38.7 billion for the first nine months of 1998, surpassing the estimated surplus of RM 35 billion estimated by authorities for 1998 as a whole (BNM, 1998c). For the period between January to September 1999, the trade surplus amounted to RM52.3 billion, almost 40 percent higher than the level recorded in the same period in 1998, with the external sector continued to remained favorable as the US, Japan and Singapore were able to support exports not only from Malaysia but also from other crisis hit countries as well. The strong US economy in particular has been instrumental in providing stronger consumer demands for Malaysia products. At the same time, import growth also picked up, reflecting mainly the increase in inputs for the export sector and the steady recovery in domestic economy.

The growth in exports was due to higher volume emanating from production expansion in manufacturing and mineral activities. Exports of electronic and electrical goods expended by 30.4 percent and 8.8 percent respectively in 1999 (BNM, 2000c). The recovery of affected economies in this region such as Japan and Korea and increased in demand from other major industrial countries such as Europe and the US helped to boost manufacturing exports in 1999. Total exports, in terms of annual growth, of manufactured goods as reported in BNM Annual Report 1999 stood at 17.6 percent or US$71.5 billion with its earning exceeding previous export earnings recorded in the years before the crisis. If in 1998, higher exports were due to exchange rate valuation effects, where the Ringgit was pegged to the US dollar, as well as a marginal increase of 1.4 percent in export volume, 1999 saw higher export receipts mainly due from a stronger pick up in volume as export prices measured in US dollar term continued to decline moderately. This trend seems to suggest that the exchange rate valuation effects may have played a minor role in the increase of Malaysian exports in 1999. The pick up in volume indicates signs of an economic recovery, propelled by an increased in global demand for electronic and electrical goods, as the economy rebounded from its contraction in 1998.

As overseas sales improved, exports from this sector accounted for 84.6 percent of total gross exports in 1999. Clearly, the pegging of the Ringgit to the US dollar and the selective capital and exchange controls have also helped export-oriented producers in their financial planning and business operations, which then allowed them to maintain their competitiveness, due to the cheap Ringgit, in the global market (Metrowangsa, 2000a). Moreover, since its pegging the Ringgit has remained competitive compared to other regional currencies as they have started to strengthened against the US dollar. This has been translated into improved export competitiveness for Malaysian exports.

Nevertheless, contracting earning in the agricultural sector was due to lower revenues form palm oil and rubber. The former declined by 18.6 percent on account of lower export prices and only made 32.2 percent of total commodity exports in 1999 while the latter's earning also fell by 17.2 percent to RM 2.3 billion as weak external demand and over world supply dampened its performance (BNM, 2000c).

On the whole, the exports growth has accelerated signaling that the economy is undergoing a strong recovery process. This is also supported by an increased in gross imports, which increased by 9.1 percent in 1999. Imports of intermediate goods and consumption goods have also showed remarkable improvement since the imposition of capital and exchange controls as they expanded by 13.2 percent and 21.9 percent respectively (BNM, 2000c). As the economy began its recovery process, the expansion of the importation of intermediate and consumption goods gives a strong indication that the Malaysian economy is taking a stronger footing. It seems that the role of capital controls were rather minor in stimulating, as external developments played a larger role, although the Ringgit peg did benefit Malaysia's export manufacturers since it provided a cheaper Ringgit and zero foreign exchange risks.

3.5.4 Monetary Development

The formulation of monetary policy during the financial crisis had to contend with ensuring price stability and keeping the risks of financial stability in checked. Nonetheless, as the crisis unfolded, due recognition was given to ensure that BNM monetary policy was in line with government efforts to revitalize and reinvigorate the economy. Nevertheless, the risks of further financial instability as the crisis spread onto Russia and Latin America and continuous outflows of capital made it necessary to introduce the selective capital and exchange controls. The new measures were aimed at ensuring that Malaysia could regain its monetary independence and to insulate the local economy from further adverse effects and external developments. It was also the aim of the authorities to ensure that by introducing these new measures, economic and price stability was achieved. This is to promote economic recovery and restoring consumers and investors' confidence.

Once the controls were imposed, BNM was able to focus its monetary policy to address domestic macroeconomic issues. Interest rates were brought down in order to provide an environment that was conducive for businesses to recover and flourish. This regime was also accompanied by quick and distinctive restructuring, recapitalizing and rehabilitating programs aimed at the financial sector, especially the banking institutions. The stability enjoyed by BNM due to the introduction of capital controls have allowed it to pursue its monetary policy effectively and without fear of creating any imbalances to other sectors of the economy. Further elaborations on these measures are detailed in the following paragraphs.

Several other policy measures were also implemented in late 1998 in order to support the recovery process. Among those include the reduction of BNM intervention rate to eight percent on September 3 and to seven percent on November 9, lowering the SRR for financial institutions from eight percent to just six percent on September 1 and to four percent on 16th September, and the revision of the Base Lending Rate (BLR) framework so as to allow a faster transmission of changes in monetary policy to impact the interest rates. As interest rates came down, the average BLR of commercial banks and finance companies dropped sharply to just 8.89 percent and 10.54 percent respectively at end-September compared to 12.27 percent and 14.7 percent at end-June (BNM, 1999d). A cautious and gradual easing of monetary policy

These significant changes have actually helped to improve liquidity flows in the banking system, as well as to generate lending activities and also helped to ensure that viable businesses continued to receive financial assistance. In addition, in order to facilitate the economic recovery, financial institutions were instructed to achieve a minimum annual loan growth of eight percent (BNM 1999e).

The thrust of monetary policy was to create an environment to support economic recovery and to facilitate structural reforms and preserving price stability (BNM, 2000c). The conduct of monetary policy in the 1999 was similar to those implemented in the previous year. The easing of monetary policy since August 1998 has led to a considerable amount of liquidity in the financial market and became larger due to large inflows on both capital and current account of the balance of payments. Thus, the conduct of monetary policy in 1999 was largely influenced by the threat of renewed inflation, maintaining a positive real rate of return for depositors and intensification of structural reforms.

The central bank had decided to continue with its monetary easing by opting for a smooth and gradual easing of the interest rates. First, interest rates began to soften in the first quarter as further easing of liquidity in the interbank market took place. With strong trade surpluses and renewed short-term inflows, the banking system outstanding resource surplus increased from RM37 billion at the end of December 1998 to RM50.9 billion at end March 1999 (BNM, 1999b). In the absence of changes in the intervention rate and the SRR, the average BLR remained unchanged. Furthermore, as the inflation rate had moderated, the 3-month intervention rate was reduced twice to six percent on May 3, 1999. Thereafter, the intervention rate was further reduced by 50 basis point to 5.5 percent and remained for the rest of 1999. The decision to leave the intervention rate unchanged was due to the fact that the effective BLR had fallen to the historical low of 6.79 percent. Second, there were ample signs that showed the economic recovery was evident and would continue on a solid ground. Finally, progress in loan disbursements has also been impressive. The low interest rates and economic stability has encouraged total loans disbursement to increase by 1.3 percent at the end of March (BNM, 1999b).

In the second quarter of 1999, interest rates continued to decline as BNM reduced its intervention rate and thus, increasing surplus resources in the banking system. The intervention rate was slashed to another six percent amidst a moderating trend in expected inflation (BNM, 1999c). The consequent reduction in the average cost of funds, as interest rates were lowered, have provided banking institutions with greater flexibility in reducing lending rate and hence, stimulating lending activities. Loan approvals picked between June and December 1999, doubling the figures recorded in the first half of the year.

The three important bodies that were set up under the NERP namely, Danaharta, Danamodal and the Corporate Debt Restructuring Committee (CDRC) also made progress. For example, Danaharta, as at March 15, 1999, has so far acquired a total RM15.1 billion worth of NPLs from the banking system. By the middle of last year, it has acquired a total sum of RM23.1 billion of NPLs, amounting to about 31.8 percent of the total NPLs in the banking system, completing its first mandate (Mahani, 1999). As at December 31, 1999 Danaharta has acquired a total of RM45.521 billion worth of NPLs from the banking institutions. It is expected to dispose its second batch of acquired NPLs by March 31, 2000, thus reducing the amount of outstanding NPLs in the banking system (Danaharta, 1999). The disposal of these NPLs would help to expedite economic recovery as these NPLs are put back to work. Moreover, it also helps to make the asset markets to become liquid, as the disposal would provide references prices to the market. With respect to Danamodal, a special purpose vehicle (SPV) used to recapitalize banking institutions, it has so far injected about RM7.59 billion into ten major banking institutions. Of that, five banking institutions have repaid their loans. Danamodal has also appointed nominees into the respective board of directors of the affected banking institutions in order to facilitate and accelerate changes required by it (Danamodal, 2000). The CDRC has succeeded in restructuring debts of 19 out of 68 cases, amounting to RM14.06 billion and another RM16.4 billion worth of debt remains to be resolve (CDRC, 2000). Although progress is slow, it is the intention of the CDRC to provide along term solution to all the affected companies. More importantly, an orderly solution should provide the financial and private sector a much needed boost as they can now concentrate on their core activities.

During last year, other form of financing such as private debt securities (PDS) and equities increased substantially as corporations took advantage of the low interest rates environment and the recovery of the local stock market to boost their capital and refinance their activities. More importantly, Malaysia corporate bond market would play a major role in the near future. Recently, BNM relaxed its approval procedures for corporate bond issues in order to spur fund raising activities in the bond market (Jagdev, 2000). The relaxation of the red tape was due to the fact that there was an urgent need to deepen Malaysia's financial sector and to develop its capital market, especially since well developed bond market can remove some credit risk from the banking sector. It is also an attempt by the central bank to persuade corporations from depending too much on loans and credit facilities from banking institutions. A bond issue could also allow a private firm to refinance its activities, as the interest rates associated with it is usually lower.

In general, these favorable developments clearly indicate that Malaysia's approach towards reviving its economy has been fruitful. This also indicates that without the economic stability enjoyed under the controls it would be quite difficult for BNM to conduct its monetary policy, as it no longer enjoys its monetary independence. In addition, improved market confidence and a healthy banking sector would depend critically on the conduct of monetary policy. New guidelines have been implemented in order to avoid a similar financial crisis in the future. For instance, there are now stringent guidelines governing the extension of credit and recapitalizing by controlling shareholders of a banking institution. It is hope that with the implementation of a master plan to develop the financial sector over the next ten years would lead to a more efficient, effective and stable financial system.

3.5.5 Fiscal Policy

The government tabled its fiscal 1999 budget bill in October of 1998. It stipulated that among others the government would adopt counter fiscal cyclical measures to revitalize the domestic economy and minimize the severity of the economic downturn arising from the regional financial crisis. The budget was aimed at ensuring economic recovery, strengthening the nation's resilience, competitiveness and restructuring the financial sector under the stability brought by capital controls. In general, the government was committed to maintain tight fiscal prudence and discipline so as to ensure that the overall deficits were under sustainable level. The fiscal stimulus via a budget deficit of 6.1 percent of GNP helped to enhance consumer and investors confidence, especially in the second half of 1999 (BNM, 2000c).

The expansionary budget was clearly evident in 1999 when the government continued its effort to accelerate the implementation of projects deemed necessary to minimize any shortfall in expenditure. Since Malaysia was shielded by the controls against negative external developments, this has helped the government to refocus its fiscal policies. Various measures were taken in order to ensure that the delay in the implementation of government projects would be overcome. This included extensive supervision, presenting monthly progress report and changes in the procedures for tenders and procurements. On the financing aspect, the government continued to rely on domestic sources to finance its budget deficits. This could be an attempt by the government to reduce the risks associated with exchange rate exposures, which could be detrimental to its fiscal policy. Besides that, the bulk of funding came from non-financial institutions such as the Employees Provident Fund (EPF) and via the issuance of government bonds. This was to avoid any crowding out of the private sector.

In the second quarter of 1999, the government recorded a small deficit of RM 386 million, in a way reflecting the faster disbursement of development outlays to support the recovery process as well as seasonally higher expenditure (BNM, 1999c). The fiscal deficit continued to widen in the fourth quarter. The total expenditure rose to RM 23.1 billion during the quarter as compared with 19.6 billion in the third quarter (BNM, 2000a). The significantly higher operating expenditure reflected the larger payments for emoluments, pensions, supplies and services, and debt servicing on the part of the government. The bulk of the development expenditure was channeled mainly to finance the economic and social programs currently underway to strengthen economic recovery.

Based on the recently tabled budget for the fiscal year of 2000, last year the government recovered a smaller overall deficit of RM 9.5 billion or 3.4 percent compared with a deficit of RM 16.1 billion or 6.1 percent of GNP estimated in the original 1999 budget (Daim, 2000). Likewise, the improved performance of the financial sector as well as government expenditures has positive impact on the social sector. For example, the average household income has increased from RM 2,392 in 1998 to RM 2,480 in 1990 in 1999 and the poverty level has also declined from 8.5 percent to 6.9 percent during the same period (Daim, 2000).

As for the rest of year 2000, the government will continue to use the controls to assist it in the implement of fiscal stimulus to strengthen as well as reinvigorate the economy. Nevertheless, the government will continue to emphasize greater efficiency and prudence in its financial management. The fiscal policy of the government would maintain most of objectives stipulated in the previous budget speeches. This include strategies to revitalize economic growth, strengthen the nation's competitiveness and resilience, transforming the services sector as an input to growth, strengthening thee agricultural sector, develop human resources and continuing the nation's social agenda and programs for environmental conservation (Daim, 2000).

3.5.6 Socio Economy

Among the main agenda of the NERP was to ensure the continuation of Malaysia's socio-economic agenda. It has tried to take pre-emptive measures by focusing on restoring economic growth by reviving domestic demand, preventing the erosion of gains in the social sectors and protecting the poor. Indeed, the financial crisis has severely affected the low-income groups who are among the most vulnerable in the society. The poverty level nonetheless, has decreased to just 6.9 percent in 1999, compared to 8.5 percent a year earlier (Ministry of Finance, 1998). This suggest that those who were affected by the recent crisis may have been able to secure employments or may have other alternative means in order to improve their living.

Moreover, in mid 1998 the government rescinded earlier budget cuts that affected assistance programs including the anti-hardcore poverty programs, rural and urban micro credit and 'fund for food'. Based on the 1999 budget, development expenditures for social programs were increased to 2.1 percent of GDP, from an average 1.6 percent during the pre-crisis years. Moreover, an allocation of RM200 million for the micro credit scheme was also introduced in order to assist hawkers and petty traders. The Amanah Ikhtiar Malaysia, which is responsible in providing small loans to the rural poor, was also given an additional grant of RM100 million (Ministry of Finance, 1999a).

The government has embarked on several policies initiatives, which were highlighted in the Budget 2000 recently. First, a sum of RM129 million will be spent on rural development programs such as providing clear drinking water to rural areas. A total of 1,000 projects were expected to be implemented in the year 2000, benefiting about 30,000 families. Rural facilities such health care will also received a sum of RM153.84 million in additional funding. This sum would be use to build village clinics and midwife centers among others. Second, a total sum of RM201 million has been allocated to Risda for its replanting programs, which is an important strategy in developing smallholders sector. A Smallholders Foundation Fund was also established to assist smallholders to carry out other supporting economic activities such as cash crops, food processing and livestock. Additional funds of RM4.3 billion were also extended to support the construction of low and medium cost houses, including the Housing Fund for Hardcore Poor, revolving Fund for Low-Cost Housing and Special Scheme for Low and Medium Cost Houses (Daim, 2000).

Since the economy is currently recovering from the recent financial crisis, it is possible that the level of poverty will decrease even further. The selective capital and exchange controls have allowed the government to response to the socio-economic problem in a stable and predictable environment. As the recovery process progresses, new job vacancies would become available to those who were retrenched and this would allow them to improve their standard of living. The construction of new low and medium cost houses should be able to attract larger demand from medium and lower income households as the current low interest rate environment should not pose any large financial burden on them.

3.5.7 Summary

The evidences presented in the preceding sections seem to suggest that the imposition of the selective capital and exchange controls has so far brought positive results to the Malaysian economy. Nevertheless, it is very unlikely that the regime was solely responsible for these positive results as a mixture of other macroeconomic policies such as monetary and fiscal policies was also responsible for these encouraging developments.

3.6 EFFECTIVENESS OF THE MALAYSIAN SELECTIVE CAPITAL AND EXCHANGE CONTROLS

In this section, the study will discuss the impact of the selective capital and exchange controls on the following areas: the offshore Ringgit market, speculative activities, the stock market, capital flows, and the foreign exchange market. The goal of this section is to highlight the effectiveness of these measures, which helped to bring about stability and recovery in the Malaysian economy.

3.6.1 Offshore Ringgit Market

One of the most important objectives of the controls was to regain monetary independence by limiting speculative activities in the Ringgit. Prior to September 1998, Malaysia had maintained a liberal approach towards the presence of an offshore Ringgit market. In fact, there was no restriction on the source of funds placed in the External Accounts as well as on the transfer of funds into in or out of it. Moreover, resident importers and exporters could settle their transactions in Ringgit, which relieved them of the need to hedge their exports proceeds and import payments. Nonetheless, as the burden of hedging these transactions had to be borne by a non-resident counter party, the offshore market began to grow. According to Lee (1998), the Ringgit was a stable currency in the early 1990s and later became a proxy for other less liquid regional currencies, despite BNM stiff resistance against the Ringgit internalization. The liquidity of the Ringgit resulted trading in it very easy but made domestic monetary policy difficult. Consequently, trading in Ringgit was driven gradually offshore, a result of a series of moves, which culminated in the imposition of negative interest rates on Ringgit held by foreigners. This led to the internalization of the Ringgit and an active Euro Ringgit market, based on

Ringgit deposited outside Malaysia. Moreover, the establishment of the Central Limit Order Book (CLOB) International in Singapore that facilitated trading in Malaysian shares offshore by the Stock Exchange of Singapore also contributed to the development of the offshore Ringgit market. Nonetheless, trading in CLOB was discontinued since September 16 1998 following the decision of the KLSE to improve transparency and not to recognize these transactions (BNM, 1999e).

As a consequence, the Malaysian authorities were clearly concerned about the existence of significant offshore Ringgit markets where much of the Ringgit denominated financial instruments like swaps and forward rate agreements were traded (Lee, 1998). Foreign exchange markets, mainly in Singapore, Hong Kong and London, were believed to be responsible in fueling speculative activities and capital outflows from the local scene. The BNM estimated that as at end-August 1998, the size of the offshore Ringgit market was somewhere in the region of RM9.1 billion based on the outstanding balance in the External Accounts maintained within the banking institution (BNM 1999e).

It also hindered the local authorities capability to bring domestic interest rats down, as prolonged periods of high interest rates were detrimental to the economy and financial institutions. Albeit by August of 1998 the Ringgit had remained broadly stable as monetary policy was eased, the continuous uncertainty of the global financial market and the urgent need for a stable currency and economic environment deemed it necessary to introduced the selective capital and exchange controls.

The exchange controls prohibited the crediting of External Accounts among their holders and the credit line to non-resident banks and stockbrokers, required imports and exports to be settled in foreign currency and stringent restrictions on the movements of Ringgit notes, where currency notes in RM500 and RM1000 were later demonetized on July 1, 1999 (BNM, 1999h). Among these various measures, it is strongly believed that the restrictions on the internationalization of the Ringgit were the most important and instrumental. The freezing of the External Account transactions, in particular, which prevented funds from one to another and from being used to settle transactions or to lend to another non-resident, effectively eliminated any offshore Ringgit trading and the desire to hold Ringgit overseas. The above measures not only curtailed the availability of the local currency to any potential trader or speculator, but also confined the foreign exchange trading hours on Ringgit in Kuala Lumpur. In addition, banks in Malaysia were barred from providing any kind of credit line to cut of funding. As a result, offshore banks were unable to overdraw their External Accounts to fund their currency trading activities. Lastly, the reduction in the Ringgit activities related to trade has allowed for the settlement in foreign currencies, which eased the need to hedge in Ringgit (BNM, 1999e).

As a result of the imposition of these controls, BNM was able to regain its monetary independence and reduced the domestic interest rates without fear of further depreciation in the Ringgit.

3.6.2 Speculative Activities

One of the drawbacks with the current financial architecture is the opportunity to engage in speculative activity, especially in currency dealings. In the domestic market, currency transactions can arise from trade activities or position taking activities. Meanwhile, in an offshore Ringgit market currency traders, including banking and non-banking institutions such as hedge funds and portfolio funds, engaged in proprietary trading of foreign currencies. These two activities, position taking and proprietary trading, are speculative in nature and constitute as unstable capital flows or commonly known as 'hot money'. Once these currencies traders create either long or short positions on the Ringgit, banking institutions, which usually act as counter parties, would cover their positions as a matter of prudence by providing offer side swap. This offer side swap allows currency traders to speculate against the Ringgit via spot and forward markets and thereby exerting pressure on the exchange rate. The attack on the British pound sterling in the early 1990s, and the unraveling of the Thai Bath, Malaysia Ringgit and Indonesian rupiah in the middle of 1997 constitute as a statement of the monumental task of controlling or even curbing currency speculations.

The effectiveness of the controls has resulted in the thorough absence of any speculative activities or speculative activity or pressures on the local tender. As the offshore market for Ringgit trading has been eliminated completely, the supply of the Ringgit has depleted. This has resulted in traders and speculators being unable to trade in the Ringgit denominated contracts outside Malaysia (BNM, 2000c). Moreover, swap limits between Malaysian banks and their non-resident bank parties, which stood at an outstanding limit of US$2 million per bank group of vostro accounts, which were imposed on August 4 1997, were also totally prohibited (Ariyoshi et al., 2000). In short, speculative activities ceased to function as measures within the selective capital and exchange controls framework were implemented to curtail them totally.

3.6.3 The Stock Market

The initial buoyant Malaysian stock market vanished in the second half of 1997 after a resounding previous year. The Kuala Lumpur Stock Exchange (KLSE) experienced its sharpest correction ever, with both prices and value reduced by half. In the second half of 1997, the Kuala Lumpur Composite Index (KLCI) dropped by about 44.8 percent (Mohammed Ariff and Yanti, 1999). This was due to several well known reasons such as concerns over the speculative attacks on the Ringgit, the revised rating outlook on Malaysia by international rating agencies, continuous outflows of capital and restrictive measures related to share trading on the KLSE, which led to more questionable decisions than solutions. Overall, 1997 saw market capitalization of the stock exchange reduced by 53 percent or about RM376 million (or 135.6 percent of the nation's gross domestic product (GDP)), compared to RM807 million or 322.9 percent of GDP at the end of 1996 (BNM, 1998d & 1999e).

The bearish sentiment extended well into 1998 with the KLSE being influenced by the possibility of an economic contraction and unstable external development in Indonesia, Thailand and South Korea. As the contagion effect spread, investors' confidence was further eroded and caused large capital outflows to take place. As a result, on January 7 1998, the Ringgit had depreciated by as much as 20 percent.

The Kuala Lumpur Composite Index (KLCI) fluctuated erratically from 594.44 points at the end of 1997 to 719.52 by the end of March 1998. Nonetheless, the index dropped even deeper to about 261.33 points on September 1, 1998 and in the process eroded even further investors' wealth (BNM, 1999e). Following this unhealthy scenario, the introduction of selective capital and exchange controls, along with a Ringgit peg to the US dollar, and the implementation of several macroeconomic measures saw the KLCI recovered. For instance, in November of 1998, the KLCI had increased by almost 6.4 percent since end-August of the same year (BNM, 1998c). By the end of the fourth quarter of 1999, the KLCI ended at 812.33 points and total market capitalization stood at

RM522.7 billion, about 20.3 percent and 20.7 percent higher than the respective levels recorded in the previous quarter. On an annual basis, 1999 saw the KLSE rose by 38.6 percent and meanwhile, market capitalization had boosted by 47.6 percent likewise (BNM 2000a).

In this sense, it can be argued that the controls have helped to bring about a positive outcome to the KLSE's performance and helped improved households and businesses confidence. However, caution must be exercise when using the stock market indices as a measure of the health of the economy. Ironically, the stock market has been driven by investors' sentiments and as past experiences have showed, especially during the East Asian crisis, these sentiments do not always conform with the fundamentals of the domestic economy. Even though it is the intention of BNM to ensure that every deposit earns a positive real return, the fact that interest rates were no longer attractive, due to their lower yields, may have prompted depositors to invest their savings into the stock market. Ultimately, this phenomenon seems to be temporary. Since interest rates are bound to increase once the capital controls are removed, due to pressures from the exchange rate and capital flows, some risk adverse investors may decide to withdraw their investments and redeposit them into the banking system. In addition, the fact that foreign funds were trapped in Malaysia as a result of the one-year moratorium imposed by the government since the introduction of the capital controls may have also led to the remarkable performance of the stock market. Any withdrawal was subjected to an exit tax and this may have deterred foreign investors from withdrawing their funds. Nonetheless, although not perfect, the performance of the stock market can always act as a guide for the future prospect of the economy.

3.6.4 Capital Flows

The introduction of the selective capital controls was at first unwelcome by local and foreign investors as fears of capital flows drying up and because they reflect negatively on Malaysia's economic policy coherence and predictability. The removal of Malaysian shares from the Morgan Stanley Capital International (MSCI) index and the downgrading of Malaysia's sovereign ratings further eroded investors confidence and damage Malaysia's reputation directly. A one-year moratorium period on the capital outflows have also resulted in many fund managers such as Hill Samuel Asset Management of London to sideline Malaysian stock market due to their operating charters, which prevented them from investing in closed market economies.

However, the announcement made by MSCI to reinstate Malaysia into its indices by May 2000 could be seen as a positive sign that the international community has began to accept that these controls have actually worked and supports similar views echoed by the International Monetary Fund (IMF, 1999) and the World Bank (Bernama, 2000). Based on the Department of Statistics figures (1998 & 1999), between October to December of 1998, a positive but lower net long term capital inflows of RM10.6 billion was registered, down by 44.5 percent from the earlier level of RM19.1 billion. This reduction was attributed to the decline in private long-term capital of RM6.0 billion during the period. Nevertheless, net long-term capital inflow reverted to a positive trend of RM4.6 billion during the final quarter of 1998. This reversal was due to private long term capital which saw a net inflow of capital by RM2.3 billion during the final three months of 1998 and official long term capital inflows which registered an increase by RM0.1 billion to register at RM2.3 billion in the same quarter. This up trend continued into the first half of 1999 where the net long term capital inflow of RM6.0 billion in the second quarter of 1999 was almost fourfold the net inflow of RM1.6 billion recorded in the previous quarter. Private long-term capital inflows on the other hand observed an increased by RM1.3 billion to reach RM2.4 billion and official long-term capital inflows surged to RM3.6 billion in the same quarter. Although the capital controls were not aimed at long-term capital inflows such as foreign direct investment (FDI), the trend have remained modest the least. Nevertheless, the trend is expected to pick up in the near future as the economy has shown signs of recovery.

More importantly, the controls were also aimed at stabilizing private short-term capital flows by imposing a 12-month moratorium that blocked non-residents from repatriating their portfolio funds held in Malaysia and as an alternative, non-residents were allowed to invest in Ringgit denominated assets within the country. Even though foreign investors and international bodies heavily criticized this exercise, the suspension was credited for reducing the volatility in short term capital flows and assisting the exchange controls (BNM, 1999e). However, it has been argued that the moratorium had little effect, if any, on the flows of private short term capital that included portfolio investments as most of these funds had already left the country well before the imposition of the controls. This argument was based on the premise that prior to the introduction of the regime in September 1998, Malaysia's had been experiencing a net outflow of short term capital since the fourth quarter of 1997. The figures in the table provided below clearly shows that a substantial amount of these capital flows had been withdrawn from the nation.

Even with the in introduction of a new exit levy scheme in February of 1999, it did not stop these funds from leaving the country. These figures seem to support the argument that the introduction of capital controls did not stabilized these private short term capital flows as these funds had been drying up well before the controls were introduced.

Table 3

Private Short Term Capital Flows in 1998-1999 (in RM million)

Yr	1997	1998				1999		
Q	4	1	2	3	4	1	2	3
	2,874	-9,245	-4,563	-4,587	-2,238	-5,600	-2,090	-13,200

Source: Monthly Statistical Bulletin, BNM (1999f and 2000d).

The government also made a pledge that the moratorium would be temporary and modified once the pertinent objectives was met. The rule was later modified to allow investors to repatriate their principal capital and profits subject to a market based exit levies (See Table 4). The idea was to encourage portfolio investors to take a longer view of their investments in Malaysia and to attract new funds into the country, while at the same time discouraging destabilizing short term capital flows (BNM, 1999e). This modification was also meant to avoid any sudden massive outflow of funds upon the expiry of the one-year holding period in September 1999. Consequently, earlier fears of an immense outflow of funds following the expiration of the 12-month old holding period did not materialized. Not only was the outflows were low, at about US$50 million in the first three days of September 1999 (Ali, 1999) and US$1.8 billion between September-October 1999, but instead some of them have decided to return and invest in Malaysia (BNM, 1999e). Moreover, in the first three weeks of November of 1999, Malaysia had recorded a net inflow of portfolio capital and more significantly, FDI continued to record encouraging inflows. A similar trend could also be witnessed in the fourth quarter of the same year, thus a strong indication that the relaxation of the one-year holding rule did not lead to higher outflows of short-term capital. The net outflows of portfolio investment moderated to just about RM3.2 billion compared to RM5.2 billion in the previous quarter. In addition, between January to 23 February 2000, Malaysia has received a net inflow of RM6.9 billion (BNM, 2000a). Based on a Summary Report of Flows of Funds Through External Accounts/Special External Accounts published by the NEAC (2000), as of March 1, 2000 the figure stood at almost RM3.4 billion.

According to BNM 3rd Quarter Economic Report, 1999, the stability accorded by the selective capital and exchange controls regime, including the pegging of the Ringgit to the US dollar, have continued to facilitate business transactions and thereby contributed significantly in improving consumer and business confidence. In this regard, the Ringgit peg to the US dollar has helped to reduce foreign exchange risks by eliminating currency volatility and also helped domestic producers in their financial planning. This view was reverberated by Paul Low, vice president of the Federation of Malaysian Manufacturers, who supported the continuation the Ringgit peg, which has helped the manufacturing sector competitive globally during the recent crisis (FMM, 2000).

In short, with far better economic fundamentals than neighboring countries, the authorities were able to make certain that the capital and exchange controls would not in any way hinder the inflows of funds. Moreover, the controls have not only brought back stability but also ensured that the atmosphere was conducive for businesses to flourish. Nonetheless, continuous claims that credited the controls for stabilizing private short term capital flows seem to be hollow as most of the funds had already left before the controls were imposed.

3.6.5 Foreign Exchange Market

Based on BNM (1999e) estimates, between June 1997 to December 1998, the Ringgit continued to be influenced by the turbulent external developments as it had depreciated by as much as 33.6 percent against the US dollar in comparison to the Indonesian rupiah (70 percent), Thai bath (29.4 percent), Korean won (25.5 percent) and the Philippine peso (32.8 percent). The sharp depreciation of the Indonesian rupiah on January 7 1998 made matters worse as the Ringgit was closed at its lowest (US$1=RM4.88). Furthermore, from June to August 1998, the Ringgit continued on its downward spiral due to the contraction in the domestic economy, increasing speculative activities and the depreciation of the Japanese yen. Even though the government tried to reduce the impact of the Ringgit depreciation, evidently it efforts were hindered by the vulnerability of the Ringgit in the offshore market.

By August 1998, the Ringgit remained weak as currency traders tried to entice the Hong Kong Monetary Authority into abandoning its currency peg with the US dollar and the possibility of China devaluing its currency. Thus, on September 1, 1998 the Ringgit was pegged to the US dollar at a rate of US$1=RM3.80. As a consequence, stability immediately returned to the foreign exchange market and this has helped to improve market confidence. The adoption of a Ringgit peg to the US dollar could be seen as a tactical move since 85 percent of Malaysia's trade is settle in the US dollar (BNM, 2000c). It also has helped to reintroduce predictability in the manufacturing investment and pricing options.

3.6.6 Outstanding Short Term External Debts

The capital controls regime did not affect the total outstanding amount of short term external debts, which have declined by 29 percent to RM22,8 billion (US$6 billion) at the end of 1999 (compared to the end 1997 level of RM 43,257 billion (US$11, 106 billion) (BNM, 1999e and 2000c). The decline was rather due to the following reasons. First, there was ample liquidity within the banking system capable to cater the demand for loans by domestic borrowers. Second, the higher external borrowing costs due to the weaker Ringgit, monetary tightening in the industrial nations such as the U.S. as well as the absence of borrowing by local financial institutions, in particular the banks, to cover their forward exchange rate transactions as the Ringgit peg eliminated the need for traders to hedge. Third, the sharp contraction in domestic demand and imports after crisis had struck had severely reduced the need for trade financing and finally, the early repayments of foreign loans by the government had also helped to reduce the total outstanding amount of short term external debt. These factors helped to reduced the ratio of short term external debts to total debt to just 14 percent from 20 percent in 1998 (BNM, 2000c). The reduction of these short term external debts has also permitted the government more room to maneuver in its fiscal deficit and made the debt management more manageable. It also showed that it is important for the government to improve on the debt maturity profile, avoiding lumping of repayments and maintaining them at a moderate level while concentrating on long term external debts.

3.6.7 The Exit Levy System

The implementation of the selective capital and exchange controls had also required portfolio funds to remain within the country for 12 months. The purpose of this additional measure was to stabilize short-term capital inflows since these funds were prone to panic and a cause for concern to the authorities. Nevertheless, the exit levy on profits from portfolio investments had exempted among others dividends, interest earned, FDI flows and proceeds related to current international transactions. Moreover, certain investments in growth and technology shares listed on the MESDAQ, and principal and profits earned via Designated External Accounts for trading on the KLOFFE or COMMEX were also excluded (BNM, 1999g).

On September 1 1999, the government replaced the 12-month holding period with a new system of exit levies on February 4, 1999, taking effect from Feb 15, 1999. The system consists of two major parts namely (i) for funds bought in before 15 February 1999, the repatriation of the principal capital was subject to a decreasing scale of exit levies (ii) and for funds bought on or after February 15, 1999 only the repatriation of the profits would be taxed based on certain conditions and exit levy rates (BNM, 1999e). The Ministry of Finance in its press release dated February 4, 1999 informed the general public that funds that were brought into Malaysia on or after February 15, 1999 would be placed in Special External Accounts (SEA) to distinguish these finds from the existing External Accounts. On September 21, 1999 the government announced that a flat 10 percent levy on repatriation of profits on portfolio investments would replace the two-tier levy system (BNM, 1999i).

The levy was later fine tuned by the Ministry of Finance at the request of foreign fund managers particular the unit trust managers who had appealed to the government that the previous two tier levy system has created some computational problems. In light of this problem, BNM made two important changes namely (i) with immediate effect, a flat ten percent levy on repatriation of profits on portfolio investment to replace the old system was implemented and (ii) the merger of the Special External Accounts and existing External Accounts into a single account (Ministry of Finance, 1999b). The move not only solves the above problems but also helped to expedite administrative matters and made the system more efficient. In addition, the above modification has also prompted rating agencies such Morgan Stanley to announce plans to re-include Malaysian equities in its emerging market index, although Malaysia would have to wait until May 31, 2000 for it to materialize.

In addition, contrary to earlier expectations there was no exodus of portfolio funds from Malaysia once the one-year holding period expired. The total amount of net outflow of funds from External Accounts was US$1.4 billion in September of and US$0.4 billion in the following October 1999 compared to private sector estimates of fund outflows range between US$5 billion to US$8 billion (BNM, 2000c). In fact, in the first two months of this year, about US$1.8 billion worth of portfolio funds have been reinvested into the country (Hasni, 2000).

However, the exit levy system poses several drawbacks. First, other forms of portfolio capital flows, which included non-residents investments in short term instruments, bank deposits, bonds, derivatives and properly investment will be less affected; as interest payments comprised a larger share of the return on such ventures. This may simply suggest that the profit levy may only entail limited protection from volatile flows and the fact that the moratorium came too late as most portfolio funds had already withdrew from Malaysia well before September, 1998 seems to questioned such move when in fact there was little capital left behind.

Second, the design of the exit levies implied that the levy has the potential to discourage both short-term inflows and outflows (Ariyoshi et al., 2000). The exit levy could act as an implicit tax, which could discourage potential portfolio inflows. Another drawback of the exit levy is that it would only affect mainly on portfolio equity investment in the KLSE since certain exemptions were made before hand, a point mentioned earlier. Hence, the potential of a leakage within the system is possible as investors try to find alternative loopholes by manipulating the system. This could in the end lead to stricter rules governing the control in the future as the authorities try to compensate for earlier deficiencies.

In general, the introduction of market based exit levies and its subsequent revision could be viewed as a step towards a relaxation of the controls as investors were now allowed to liquidate some or even all of their portfolio positions. Moreover, this relaxation could help the KLSE to be reinstated into other international indices other than the MSCI indices. Albeit the tax poses as a bureaucratic obstacle to foreign investors, most of these investors have already taken this into account. The potential for the KLSE to move upward is bright given the fact that it is still below the 1997 pre-crisis high of 1217.57 points. In fact, the resolution of the CLOB issue should have a positive impact on the performance of the KLSE and allay any skepticism about investing in Malaysia.

3.7 SUMMARY

Based on the above set of arguments, one could concluded that the imposition of selective capital and exchange controls has brought financial stability and more significantly helped the economy in its recovery process. Based on the selective macroeconomic indicators, the capital controls regime and together with the Ringgit peg have helped to assist the authorities in their attempt to revitalize the economy. For example, the controls have allowed BNM to maintain a low interest rates environment and thus, permitting commerce operations to prosper. In the meantime, the Ringgit peg has also allowed domestic manufacturers to enjoy competitive advantage over their overseas rivals due to the lower value of the Ringgit. The peg has also helped domestic producers, who depended on imported items or were export oriented, in their financial planning as it has eliminated any form of foreign exchange risks. And although critics have pointed out that other affected countries in the region have recovered without the help of a similar regime, one important counter argument prevails. The selective capital and exchange controls have played an important role in assisting Malaysia's economic recovery process. Even though the regime was mixed with other monetary and fiscal policies, the economic stability and certainty endowed by the regime are something that Malaysia could not do without. Moreover, the affected countries had different sets of agenda for their economy and as such were bound by the different characteristics that they inherited. This in fact led them to adopt different strategies for combating the recent financial crisis. Malaysia is no exception.

Table 4: Exit Tax Rates

Form of Funds	Time Frame	Rate (%)
a) Foreign funds in Malaysia prior to Feb 15, 1999.		
Capital (excluding FDI)	Repatriated within 7 months	30.00
	Repatriated between 7-9 months	20.00
	Repatriated between 9-12 months	10.00
	Repatriated after 12 months	No Levy
b) Foreign funds in Malaysia on or after Feb 15, 1999.		
Profits (excluding principal amount)	Realized and repatriated within 12 months	30.00
	Realized and repatriated after 12 months	10.00
	Realized after 12 months, and repatriated after 12 months	10.00
	Realized during 12 months, but repatriated after 12 months	10.00
	Contra profits repatriated after 12 months of realization	10.00

Investment in Properties, including principal capital and profits.	No Levy
c) Effective September 21, 1999, a flat 10% levy on repatriation of profits on portfolio investment would replace the two-tier system.	

Sources: BNM Annual Report 1999 and Mohammed Ariff and Abu Bakar (1999).