Chapter 5

SUMMARY, RECOMMENDATIONS AND CONCLUSION.

5.1 INTRODUCTION

This final chapter summarizes the work of this research paper and presents the implications of this study. Likewise, several recommendations are put forward for future consideration and research. This chapter is divided into three major sections. Section 5.2 is a summary of the findings of this research paper, consisting of the main arguments captured in chapters Three and Four. Section 5.3 is devoted to the presentation of policy recommendations. Finally, section 5.4 concludes the entire work.

5.2 SUMMARY

This section is divided into six subsections.

5.2.1. Weaknesses Within the Malaysian Economy

Even though Malaysia was dubbed as one of the miracle economies in East Asia, the recent financial and currency crisis has clearly exposed several fundamental weaknesses within the local economy.

1. The economy was growing above its potential output since 1991. This has created in price pressure due to wage increases beyond productivity gains.

2. The presence of misallocation of resources was also clearly visible, as the Total Factor Productivity (TFP) has shown a declining trend. The rise in the incremental capital output ratio (ICOR) also points toward the inefficient usage of capital.

3. The rise in current account deficits was also a cause of concern as the short-term capital flows were used to cover the saving investment gap was an unhealthy trend.

4. Excessive loans disbursements to unproductive sectors, shallow financial markets and the high dependence on the banking sector for funds led to the fragility of the financial institutions. These trends were clearly responsible for Malaysia's vulnerability to the recent crisis.

5.2.2 The Impact of the East Asian Crisis on Malaysia's Economy

The impact of the recent East Asian crisis can be seen via the various macroeconomic indicators presented in the discussion.

1. The real GDP had contracted by 7.5 percent in 1998 due to a contraction in domestic demand for goods and services as well as a sharp deceleration in external demands due to the recent crisis.

2. The inflation rate also showed a rising trend, indicating a deteriorating trend with respect to price levels. The impact of a depreciated Ringgit on the inflation rate was also translated into increased in prices of imported goods and services, thus causing imported inflation to rise.

3. With respect to the labor market, the employment rate rose as a result of slower production activities and firms restructuring. Employers were clearly eager to reduce their cost of production and laying off some workers temporarily was seen to be the best solution available.

4. Malaysia import performance rose significantly in Ringgit term as the sharp depreciation of the Ringgit helped to improve export prices. Nonetheless, in term of the US dollars, the gross value of Malaysia exports had actually declined as weaker external demand, over supply and stiff competition from foreign producers played a role in dampening Malaysia's exports. Imports of goods and services were also affected severely by the depreciation of the Ringgit as it made it more expensive to bring in foreign products. Government regulations to limit the importation of capital goods also affected import performance.

5. Fourth, the conduct of monetary policy was divided into three major phases namely the Adjustment phase, Stabilization phase and the Recovery phase. The conduct of monetary policy was aimed at restoring economic stability and viability in order to overcome the serious disruptions caused by external and domestic uncertainties, especially in the foreign exchange and stock markets. The reduction of the interest rates and SRR in several stages was clearly a direct intervention by BNM in order to help revive the economy. The introduction of a new liquidity framework had helped to reduce the cost of funds and as the crisis worsen, the setting up of several special funds aimed at helping the export sector and the small and medium sized companies was also implemented.

6. Malaysia's fiscal policy could also be divided into three major phases as mention above. In the early stage, a fiscal austerity drive was mooted in order to bring about a more rapid adjustment in the current account deficits and to reduce inflationary pressures due to the sharp depreciation of the Ringgit. Nonetheless, as the crisis worsened, further cutbacks in government spending were introduced including cuts in civil servant

allowances and deferment of non-essential government projects. However, it was later realized that the fiscal austerity approach was ineffective and had in fact led to more deterioration of the economy. As a response, the NERP and new fiscal stimulus were introduced in order to ensure the economy would be back on the recovery path. The setting up of Danamodal, Danaharta and the CDRC by BNM in conjunction with the NERP objectives helped ailing but viable companies from going bankrupt. The expansionary fiscal policy adopted by the government was evidently designed to support the economic recovery process by promoting economic activities, which had strong linkages with domestic producers.

7. The impact of the recent financial and currency crisis had also affected the hardcore poor, who did not have any stable employment or was earning below the poverty line, as mentioned in chapter Three. Essential socio economic agenda were also affected such as education and medical care. Moreover, as shares and property prices dropped, consumer consumption patterns were also affected as result of negative wealth effects and thus, worsening the situation.

5.2.3. The Malaysian Economy After The Controls: Macroeconomic Indicators

Nevertheless, the introduction of the selective capital and exchange controls, including the Ringgit peg to the US dollar, had in fact helped the government's effort to revitalize the economy and could be seen via the recovery of the following selected macroeconomic indicators.

1. The real GDP had improved gradually in tandem with the recovery in the domestic economy. Malaysia's output growth recorded a strong positive

growth as the manufacturing sector, especially the export oriented industries such as electronics and electrical firms, played a vital role in bring out this result. The recovery in of the domestic oriented industries also pointed towards an increased in consumer demands for goods and public investment as the recovery measures implemented before and after the imposition of the controls began to show their positive effects onto the economy. This recovery was also assisted by the recovery in consumers and investors confidence in response to the measures implemented by the government.

2. The inflation rate seemed to have stabilized as the stability of the Ringgit peg, excess supply, lower demand for imported goods and lower commodity prices led to a moderate price increase in 1999. The completion of some companies restructuring programs and the winding up of others; lower costs of production and lower importation of capital and intermediate goods by the producers were also attributed to the containment of the inflation rate. On the labor market, the improvement in the economy meant a smaller number of workers were laid off. The rise in confidence as a result of higher expectation of an economic turn around and a better job market in the near future led to the rise in the employment index.

3. The improvement in the export markets has resulted in a rise in Malaysia's trade surplus. As the regional economies recovered, increased in external demand from foreign countries and a favorable exchange rate peg led to expansions in manufacturing and mineral activities. The economic recovery has led to an increased in importation of intermediate and consumption goods and as a consequence, giving an indication of a possible stronger recovery.

4. The modus operandi of the monetary policy after the imposition of the controls were targeted towards guaranteeing price stability and keeping the risks of the financial and currency crisis in checked. Once the controls and Ringgit peg were in placed, BNM was able to refocus its monetary policy to address domestic macroeconomic issues as the threat of Ringgit depreciation and external risks were severely curtailed. The availability of liquidity as a result of previous monetary easing measures helped to generate lending activities to domestic businesses. The disposal of NPLs by Danaharta and the successful recapitalization of domestic financial institutions further bolstered the economic recovery. The CDRC has to date solved several cases referred to it by local financial institutions and firms. The low interest rate environment has also helped the development and deepening of Malaysia's capital market as companies refinanced their activities via equity, bonds and other similar long term instruments. Overall, these favorable developments confirm earlier expectation that the economy is recovering from the recent crisis and thus, helped to improve market confidence.

5. Malaysia's fiscal policy position remained the same after the imposition of the controls and that is to ensure that counter cyclical measures worked in order to revitalize the economy and minimize the severity of the latest financial and currency crisis. Tight fiscal prudence to contain the overall budget deficits under manageable levels were practiced as fiscal stimulus helped to enhance consumers and investors confidence. Besides that, the funding of the fiscal deficits came from non-financial institutions and therefore, helped to avoid any crowding out of the private sector.

6. As the poor and hardcore poor were the most severely affected by the crisis, pre-emptive measures were also taken by the government to ensure their well being was taken care off. The government decided to rescind all budget cuts that affected social programs for the poor, while at the same time extended assistance to hawkers and petty traders. Several funds were also introduced to help the poor under the supervision of BNM. The economic stability enjoyed under the capital controls regime supported the government's efforts to combat the increasing socio economic problems due to the crisis. As the economy progressed, better employment prospect and improvement in the standard of living would also take place.

5.2.4. The Effectiveness of the selective Capital and Exchange Controls on Several Macroeconomic Indicators

The effectiveness of the controls could also be gauged by looking at several other related indicators.

1. The controls have definitely curtailed the Offshore Ringgit market and all speculative activities. The exchange controls had limited the internalization of the Ringgit and severely restricted its movements. Speculative activities were stopped as access to Ringgit funding was prohibited.

2. The controls and other macroeconomic also helped to bring about improvements in the KLSE's performance. However, it is still uncertain as to whether the stock market sharp turnaround would be sustainable in the long run.

3. The controls were not aimed at long-term capital flows such as FDI and official assistances as they were intended to stabilize the flows of private

short term capital flows. The introduction of capital controls and the one-year moratorium were credited for reducing the volatility of the short term capital flows and assisting the exchange controls. Nevertheless, this proposition seemed to be flawed, as the amount of short term foreign capital that remained in Malaysia after the controls were imposed seems to be small and therefore, rendering the controls ineffective.

4. Malaysia's turbulent foreign exchange market showed signs of stability once the capital and exchange controls were imposed as the Ringgit peg stopped the erratic fluctuations in the exchange rate.

5. Malaysia's declining outstanding short term external debts remained unaffected by the controls as the declined was a result of other factors such as early repayments, sourcing funds domestically and higher external borrowing costs. This reduction presented the government with additional room to govern its fiscal deficits and made debt management manageable.

6. The introduction of an exit levy under the capital control regime was aimed at stabilizing the private short term capital flows. It was later fine tuned by the Ministry of Finance to meet the demand of foreign fund managers for easier calculations and to expedite administrative measures. International rating agencies and indices has welcomed this fine-tuning, which was deemed as a step towards a relaxation of the controls.

5.2.5. Weaknesses Within the Exit Levy Scheme

The exit levy scheme posed a few weaknesses.

1. Other forms of portfolio capital flows such as bank deposits, derivatives and property investments were less affected.

2. As mentioned earlier, the one-year moratorium may have come too late as most foreign funds had left the country and those that did remain may have written off their investments all together. The exit levy could also act as an implicit tax and consequently, discouraging potential short term capital flows in the near future.

3. Investors would also look for potential loopholes within the system, as the exit levy seems to affect mainly portfolio investment in the KLSE. Overall, it can be argued that the regime had been effective in certain areas albeit there were instances where the controls were ineffective. More importantly, the implementation of monetary and fiscal policies proved to be the essential part of the economic recovery process, as the regime could not work all by itself.

5.2.6 Issues Related to Exit Strategies and the Choice of an Exchange Rate Regime

With respect to exit strategies there are several important issues that must be address before Malaysia decides to abandon the selective capital and exchange controls regime.

1. The first issue is the selection of a new anchor for BNM. In this respect, it is possible that BNM will continue to maintain its pre-crisis anchor, which is

the interest rate. The adoption of the interest rates as a key anchor is not new as several central banks such as the Federal Reserves, Bank of Japan and the European Central Bank have all used the interest rates as their key anchor for their monetary policy.

2. The formulation of fiscal policy must entail transparency and prudence since a strong and discipline fiscal policy would be able to send the correct signals to economic agents on the government course of actions. It is important that Malaysia also recognizes the importance of saving its tax revenues in order to build up its international reserves and as an insurance against future crises.

3. The government has the responsibility to prepare the local populate and business community against the conversion towards a flexible exchange rate. Those who have benefited the most since the adoption of the Ringgit peg such as exporters and commodity producers would be the most vulnerable. Hence, a gradual move towards a more flexible exchange rate regime by expanding the exchange rate band would be welcome as it allows sufficient time for these groups to adjust.

4. The government must correct the attitude of some domestic producers who have become accustomed and comfortable with the Ringgit peg. This complacency has resulted a drop in producers' productivity and efficiency. Encouraging them to innovate and automate should be a viable long-term solution.

5. It is also important for Malaysia to exit at a time when the necessary adjustments and reforms in the financial institutions that emphasize

prudence, accountability and transparency on the part of the management have taken place. Moreover, access to foreign loans by domestic corporations should be limited to only those that qualify. This is to reduce the private sector exposure to external debts and hence, ensure that the debt level is within manageable limits. As for the offshore market, the current regulations should be maintained until further developments in reforming the international financial architecture and regional cooperation lead to positive results.

6. The latest crisis has also exposed weaknesses in local financial institutions management of risks. The borrowing of short-term debts to enhance the capital base of domestic banks led to maturity mismatches. In order to rectify this mistake, future capitalization should come from non-debt sources with long maturity period as this could any sudden withdrawals. The corporate sector should also take heed from the lessons learned during the recent crisis. The lack of reliable information, transparency, accountability and rent seeking activities were among the factors that resulted in weaknesses within the sector. Disallowing such factors to develop could help to avoid or reduce these weaknesses in the future.

7. Finally, increase regional cooperation on monitoring and surveillance among ASEAN members and other regional countries should be enhanced. This would create a stronger group capable of withstanding any potential speculative activity and at the same time reduces their vulnerability against volatile short-term capital flows. The proposed AMF should be pursued as it forms as a platform for financial assistance for regional countries.

8. In terms of Malaysia's choice of an exchange rate, the phrase 'Impossible Trinity' should be kept constantly in mind. For any country, maintaining an open capital market, a fixed exchange rate and monetary independence are rather impossible to accomplish. The range of potential exchange rate regime extents from a pure fixed exchange rate such as the currency board to a pure float. In general, there are two separate doctrines that address the issue of choosing the appropriate exchange rate.

9. Under the first doctrine, the choice of an exchange rate should be made in line with the domestic economic fundamentals and characteristics. This includes the type of shocks that a particular country is exposed to, the optimality of an exchange to economic conditions, the openness of a country to international trade and capital, nominal wage rigidity and the degree of financial deepness, whether a country has a well developed capital market or not.

10. The second doctrine focuses on the choice between credibility and flexibility. The general consensus seems to agree that the more rigid an exchange rate is the more credibility it has. However, this type of exchange rate regime is more crises prone. As an alternative, countries that adopted a more flexible exchange rate regime seemed to have far better results. These countries were less affected by the latest financial and currency crisis.

5.3 Recommendations

The following recommendations are put forward for further consideration and research. The idea of this section is to encourage future in depth studies on the long-run impact of the controls on the Malaysian economy. This is very important, as country experiences with capital and exchange controls have indicated signs of ineffectiveness in the long run.

1. The selective capital and exchange controls regime, which were introduced in 1998, was part of a right mixture of monetary and fiscal policies that helped to ensure the Malaysian economy would recover from the latest crisis. The regime could be credited for the economic stability, which was important for the successful implementation of the recovery policies. However, its performance in the long-term remains to be seen. Past experiences with capital and exchange controls have evidently showed that as time went by, the cost of maintaining the regime tend to increase as businesses and investors tried to evade it and took advantage of its loopholes. Thus, it would be beneficial to Malaysia if it could exit from the current regime when the world economy is stable. Nevertheless, Malaysia must also be willing to re-impose the regime in the future. The Malaysian government could use this as a warning to ward off any potential currency speculator. Since the current regime has a strong credibility due to the government efforts to ensure its success, the threat of a re-imposition could be deemed as real. However, frequent usage of the controls is ill advice as it could easily tarnish Malaysia's image and credibility.

2. Due diligence must prevail in all aspect of the economy. Ensuring that Malaysia's past mistakes are not repeated should be among the top agenda in formulating future policies. Good governance that includes transparency, responsibility and accountability should be the aim of the present government. This would in the send the correct market signal to economic agents on the government course of actions. The private sector has a similar role to play. Besides the three major values stipulated

previously, avoiding moral hazard behaviors and risky investment ventures are among the necessary conditions to avoid a repeat of the recent crisis. There must be also a change in the values, mindsets and attitudes within the corporate sector. This reform would then create a pool of well trained independent company directors who are well alert, intelligent and committed to a better corporate governance environment and who are also willing to make changes for the better. Shareholders and investors should demand these values and reforms as they bear the brunt should their investments become sour.

3. As mentioned in chapter four, the lack of experienced central bank officials, in terms of numbers, to enforce the laws and regulations pertaining to matters related to the financial sector may have led to a rise in risky and moral hazard behaviors. A possible solution is to enlarge the size of manpower within the central bank, as this would at least allow a wider scope and faster enforcement.

4. To tap on the potential of an increase cooperation among regional neighbors should be among Malaysia's top agenda, especially in issues related to the economy and trade. Continuous surveillance and monitoring of private short-term capital flows or 'hot money' should be maintained. The setting up of AMF and increased regional cooperation must be pursued since their existence would be a strong deterrent to any currency speculator.

5. Adopting a more flexible exchange rate would be in Malaysia's best economic interest, as it would force domestic borrowers and producers to hedge their foreign currency exposures. This would avoid complacency on

their part and could lead to a deeper capital market as demand for financial instruments would increase. It would also lead to a more efficient and productive manufacturing and export sectors since resources are allocated more efficiently under the regime. Hence, it would be better for the Malaysian authorities to re-float the Ringgit within a certain trading band. However, the appropriate policy mixtures associated with the exchange rate and bandwidth are subjected for further research.

5.4 CONCLUSION

The East Asian crisis has exposed several of Malaysia's weaknesses to eternal shocks. The lessons learned from this crisis should be a testament to the volatility in the international capital market and the need to defend and shield one self from the risks connected to it. Since reforms within the international financial architecture are hard to come by, Malaysia and in general, other emerging market economies have to rely on their own initiatives in order to accomplish this goal. It is strongly hope that this latest crisis would make Malaysia wiser as it enters the 21st century. The prospect of further liberalization in trade and capital would pose, as a major challenge to any policymaker and hopefully, Malaysia would avoid repeating its past mistakes in the future. The policy recommendations in the preceding sections are not comprehensive since there are other issues that were not covered by this research paper. Nevertheless, if the authorities