CHAPTER 6

ANALYSIS ON THE POLICIES TO RESTORE THE MALAYSIAN ECONOMY

6.1 Evaluation Of The Malaysian Responses To The Crisis

Some of the policies adopted by the Malaysian government differed from some of the measures taken by other countries in the region. In some cases, some of the policies were seen to be rather controversial. There were also arguments and debates that some of the measures taken by the Malaysian government were the reverse of what would have been done by the IMF. Interesting enough, until today, Malaysia seems to be achieving economic recovery. As for the IMF, the organization claimed that it was not convinced by the selective capital controls that Malaysia had adopted. It also concluded that the selective capital controls were not the reason behind the Malaysian economic recovery.

This chapter attempts to evaluate the policies taken by the Malaysian government in its effort to combat the crisis.

5.2 Malaysian Recovery Approach Differed From The Strategy Suggested By IMF

IMF suggested that in order to come out of the crisis, it was essential that the Malaysian government should reduce the public sector expenditure. Apparently, that could have been the case of Indonesia and Thailand, but as for Malaysia, especially in the 1990s, the Malaysian government had strong views on privatisation and encouraged more participation from the private sectors to play greater role in the directions of the Malaysian economy.

The steps taken by the Malaysian government, through the years in the 1990s had resulted in massive participation from the private sector. That development led to the increase in the private sector debt tremendously. Foreign investors were the main source of financiers in many of the big projects undertaken by local private companies.

When the crisis hit the Malaysian economy and the Malaysian ringgit were suffering from tremendous depreciation, those companies were unable to pay their debts. To make things worse, the majority of the short term foreign investors began to pull out their investments in the attempt not to suffer any unfavourable returns to their investments as those companies that they were investing in began to show some signs that they might collapse. As a result, those companies were left helplessly as their funds dried out. Many projects were left abandoned. To list a few, Bakun, Kuala Lumpur monorail and Kuala Lumpur inner city projects were among those affected.

With the private sector suffering unbearably, it would be unwise to adopt the doctrine suggested by the IMF. That by far would have led the Malaysian economy to tumble, thus affecting all activities in the country and that would put the targeted Vision 2020 completely beyond reach as the future would be very gloomy indeed. Rationally, it was necessary for the Malaysian government to be bold and assume from the private sector the role of the engine of growth and increase its consumption and investment in order to expand the domestic economy.

During the crisis, the market witnessed that the interest rates were moving upwards. The scenario meant that borrowings were becoming more expensive. Banks started to be selective in giving loans. As the result of tightening the credit, there was liquidity problem in the market. In order for the companies to continue their activities and for domestic economy to expand it was highly essential that liquidity must also be restored in the market. Assistance from the government was needed. The issue of bailing out companies became controversial and was highly criticised by both foreign and local economy experts. They accused that some of the bailouts were not genuine as they were done in the interest to save companies that were owned or had connections with the government. Despite all the accusations, the government of Malaysia put on the brave face and stood by its stand that it was necessary to bail out those companies.

Unlike other countries that received the assistance from the IMF, Malaysia could afford expansionary fiscal and monetary policies. Malaysia managed to come up with some savings from the balance and surplus fiscal policy during the five years prior to the crises. That was based on several reasons:

1. Malaysia had adequate domestic private savings through a scheme called EPF (formed the compulsory savings) and insurance (formed voluntary savings).
2. Malaysia had low level of official borrowings. That eventually allowed the Malaysia government to seek for the international official financial assistance to finance some of its programmes for domestic expansions.
3. All banks were required to place some savings that formed the statutory reserves requirement with the BNM.

The government in all the cases mentioned above would be able to direct those organisations involved to mobilise the funds kept for investment in the manner that would best spur the economic activities.

6.3 Wrong Steps Taken During The Initial Stage Of The Crisis

Interesting enough, at the initial stage of the crisis, Malaysia was adopting a set of stabilization measures and financial reforms that were quite similar to those imposed by the IMF. The policy adopted comprised of tight monetary and fiscal policies accompanied by financial sector reforms. Unfortunately, the measures taken turned out to be rather ineffective in restoring both macroeconomic and financial sector stability. To make things worse, the measures resulted in rapid contraction to the GDP growth. The following paragraphs will illustrate the measures taken at the initial stage that turned out to be inappropriate and cause unintended effects to the Malaysian economy.

6.3.1 Untimely Merger Programme For Finance

BNM made an announcement in January 1998 that there was a need for the merger exercise to take place between finance companies. The reason was simply due to the fact that some of the weak financial companies may collapse as a result of financial difficulties (Daim 1998). This good intended programme to rationalize the finance companies to increase their resilience turned out to be untimely. The call for merger resulted in finance companies not being able to focus on giving loans for companies in need of help. As instructed by the Minister of Finance, the loan growth should achieve 8 per cent. The chaos led to liquidity problem in the market. Stliglitz (1999) argued that focus should be given on finding the right regulatory structure to manage the incentives and constraints that affect financial institutions' exposure to and ability to cope with risk.

6.3.2 Increase In The Interest Rate

The call made by BNM to increase the interest rate for the three months intervention rate from 8.7 per cent at the end of the 1997 to 11.0 per cent in the early February 1998 for the purpose of anticipating inflationary effect, caused hardship to companies, after all they were already in bad shape.

6.3.3 Tiering Of Commercial Banks

BNM came up with the idea of implementing the Two-tier Regulatory System whereby the banks that were categorized under the Tier 1 group will be able to exercise greater flexibility in their operations. That attracted many commercial banks to achieve the Tier 1 status. In order to do so, they had to increase their capital base. The only realistic way was by borrowing capital funds. Having borrowed the capital funds, they then lend it to other companies to make investments mostly in properties and shares. All of a sudden, rapid growth of loans were seen in the Malaysian economy. Not too long later due to financial difficulties, companies were unable to pay back to the banks. The number of NPLs was increasing.

6.3.4 Revision Of NPLs From 6 Months To 3 Months

The decision to call for reclassification of NPL period from 6 months to 3 months brought constant difficulties to financial institutions. Although the idea of the reclassification was intended to strengthen prudential supervision, the outcome was rather disappointing as financial institutions were facing with increased losses and their lending capabilities were weakened. To make things worse, they had difficulties in giving credits to business entities that really need money to survive.

6.3.5 Cut In Government Expenditure

The cut in the government expenditure by 18 per cent resulted in the deferment of several public sector projects. The measure taken affected and slowed down other economic activities in general.

6.3.6 Reduction In BNM Staff Affecting Bank Supervision

Prudent official regulatory is necessary to help maintain a balance between the competitive efficiency of markets and the requirements of a robust and efficient banking system (Chowdhury and Islam 1993; Park 1994). In 1994, BNM decided to reduce its staff strength. In some departments, the reduction reached to 50 per cent. It was so happened that the supervision department's strength was one of those that had experienced the 50 per cent cut to the number of its staff. As a result to this phenomenon, there was some reduction in the frequency of audits of commercial banks by BNM during the crisis, thus constraining the ability of BNM to monitor and supervise closely the activities undertaken by the commercial banks.

6.4 Malaysian Capital And Exchange Controls

When the government of Malaysia introduced the capital and exchange controls on the 1^{st}. September 1998, it attracted many opinions on how much impact it would give to ensure that the Malaysian economy was moving into the right direction towards recovery.

Interestingly, although the measures taken by the Malaysian government were seen to be rather radical, some form of exchange capital controls had been used before, amazingly by some of the world powerful economies such as Switzerland, Germany, France and Australia at one point or another. Even until today, countries like United States, Australia and France still impose requirements that money that are brought in or taken out should be rightly declared.

For those who were in favour of the selective capital controls, they claimed that the steps taken were successful since the economic decline had come to an end and positive signs were beginning to be seen. The stock market too was on its way back to recovery.

On the other hand, those who were not in favour of the implementation of capital and exchange controls argued that there were other external factors that were contributing to the economic recovery. Thus, they felt that it was vital that the contributions of those external factors to be acknowledged.

The capital and exchange controls came into enforcement approximately after one year and two months after the currency crisis had started. Interesting enough in that period, many incidents took place. All around the region, the economists felt that the volatility in the economies of the East Asia countries started to slow down. By the time the Prime Minister announced the selective capital controls, the move came around a little bit too late as the Malaysian economy was also ready on its early days towards recovery (Jomo 2000).

6.4.1 Impacts Of The Capital And Exchange Controls

The capital controls would allow Malaysia to take bold monetary relaxation measures and expand its fiscal spending. Around the time the controls were introduced, money market interest rates were reduced by more than 2 per cent and the legal reserve cut by 4 per cent. Expansionary monetary policy was being accompanied by fiscal policy to stimulate domestic demand.

The budget proposal for the following fiscal year, announced in October, 1998, was expansionary and allowed fiscal deficits to rise from 3.6 per cent of GDP in fiscal 1998 to 6.1 per cent in 1999. Malaysia could not have decided to take those steps without exchange control measures to insulate its markets from foreign speculators. On the other hand, from a medium-term perspective, Malaysia was faced with some tough constraints on the balance of payments side since the fixed exchange rate eliminated foreign exchange markets as a means of adjusting international competitiveness. Unless the country takes steps to improve its export competitiveness (higher value-added products, suppression of price rises and labour costs, etc.), it would see its current account deteriorated.

In February 1999, Malaysia instituted a 'repatriation levy'. It was intended to spread out the shocks to the economy when the foreign investors pull out their funds as anticipated in September 1999, which was one year after the exchange control measures took effect. Under the provision, the longer investors refrain from repatriating their funds, the lower the rate at which they would be taxed. The announcement shook the stock market to some extent, but it was generally greeted positively by investors because it made the future more transparent.

The following paragraphs will analyze both the favourable and unfavourable arguments for the implementation of the capital and exchange controls.

6.4.2 Favourable Arguments On The Impacts Of The Capital And Exchange Controls

In mid 1997, Malaysian ringgit was considered slightly overvalued (Tan 1997). Among the features in the selective capital controls was that the Malaysian ringgit pegged to US dollar at the ratio of RM3.80 to USD1. The action led to the reduction in the volatility of the Malaysian currency. That move was important as it minimized the element of uncertainty. This eventually allowed the Malaysian businessmen and the government to strategize trading in the international market. There were lesser risks involved unless if there were drastic changes in the strength of the US dollar. If that were to be the case, then Malaysia might have favourable or adverse impact compared to the other currencies. Provided if the above scenario occurred, the government might have to remove the policy or perhaps re-pegged at a different ratio in order to retain export competitiveness.

As mentioned in the previous paragraph, by fixing the exchange rate at RM3.80 per USD1, some form of stability was achieved. That would promote for medium and long-term investment. Businesses became easier as uncertainty and transaction costs had been reduced. This can be supported by a report released on the amount of investments (domestic and foreign) being approved by MIDA (Malaysian Industrial Development Authority) had increased to RM 5,865 million for the month of September, 1998 alone.

Pegging at RM3.80 to a US Dollar had a favourable impact to the Malaysian economy although not in the way the Malaysian government originally intended it. The pegging was first introduced to protect the currency from fluctuating with great volatility. However, with favourable developments that took place in the mid-September 1998 when the US Federal Reserve Bank made a decision to lower the interest rates in the aftermath of the Russian and LTCM crises. As a result, the Japanese yen and other neighbouring countries' currencies started to slightly strengthen. By default, those developments boosted the Malaysian foreign exchange reserves.

By imposing controls, the government can insulate the domestic economy from the adverse external forces. Controls allow us to focus on the domestic economic management without having to align the measures with the outcome of external economies. Since external economy was beyond the Malaysian economic control, the best that can be done was to re-correct the domestic economy. Although what the government did was the opposite of what generally recommended the IMF, the latter does not seem to have brought the desired situation at the early stage in other Asian countries that have adopted its recovery policies. By most indicators, economic conditions have worsened under the weight of IMF rehabilitation measures. Exports have not risen in dollar terms in Thailand, South Korea and Indonesia as global overcapacity had depressed prices in the key Asian manufacturing industries such as electronic goods (Far Eastern Economic Review, October 1998).

Although many seemed to be sceptical of those drastic interventions, one can be sure that controls do provide a breathing space for our economy. It was reported that about RM11 billion of Malaysians' deposits parked abroad have returned home and that international reserves have gone up by some USD1 billion in just three weeks after the controls being introduced. Interest rates had been reduced significantly. Inter bank rates have fallen from an average of 10.2 per cent in August 1998 to 7.7 per cent in September 1998. Loans were growing at a faster rate. Businesses became less painful to do. The stock market had started to tick again. Car sales had picked up significantly from 5,000 units a month to 12,000 units (Ariff 1998).

The government of Malaysia anticipated that there would be a huge outflow of funds once the one-year lock in period expired. In order to overcome such matter, another policy was introduced which gave the chance for the fund owners to withdraw their funds beginning from mid-February 1999. However that can only be done after they had paid a scaled exit tax i.e. the longer the funds were to be kept in Malaysia, the less would be the tax imposed. The exit tax introduced for capital gains was seen to be successful as it managed to discourage some short-term selling. Ruling imposed for any withdrawal made for a period of less that a year, a 30 per cent of capital gain tax would be imposed as opposed to 10 per cent when withdrawals were made after 1st September 1999.

6.4.3 Unfavourable Arguments On The Impact Of The Capital And Exchange Controls

Economists in the regions as well as those in other countries generally felt that just before the capital and exchange controls were introduced, the external environment i.e. volatility in the economies of other East Asia countries were slowing down. That positive effect was believed to spread all around the region as the countries in the region had strong economic and political relationships. Just like when the currency crisis first started, it was believed that once the turmoil 'infected' some of the countries in the region the 'sting' would then swept across the region. Therefore, when some parts of the countries in the region had managed to 'cure' themselves from the 'sting' the others would soon be feeling the same too.

The one-year lock in rule imposed on the foreign funds was believed to be too late to have large or significant impact on the economic recovery. When the rule was introduced, speculators and short-term investors by then had already pulled out their investments in Malaysia. The funds that did not leave the country were believed to be 'trapped' because they belonged to those who were committed in investing in Malaysia. Majority of those people were classified as long-term investors. This fact was backed by low volume of capital outflow since the barriers lifted on the 1st September 1999.

The issue on allowing fund owners to withdraw their funds after mid-February also did some damages to the credibility of the selective capital control. As been witnessed by the Malaysian economy, the capital gains tax did not discourage those foreign investors whose funds were 'trapped' to quickly withdraw their funds in order to avoid losses and faced with more uncertainties in coping up with the ad hoc policies that the Malaysian government was capable of doing. What the Malaysian government failed to anticipate was in times of financial panic, investors would react irrationally. Therefore, given that being the case, the new capital gains tax would do little in preventing foreign investors from pulling out their investments.

Rosenstein-Rodan (1961), Chenery and Strout (1966) argued that foreign capital inflows contributed to the economic growth. Empirical assessment of the role of foreign capital inflows in Malaysian economic development between 1966 and 1996 has sought to evaluate its impact on output growth (Jomo and Wong 1999). The implementation of capital and exchange controls were seen to be the cause for slow foreign inflow of direct investment after the crisis. The measures taken by Malaysia created uncertainty and frighten some foreign investors to invest in Malaysia. They believed that the Malaysian government was capable of changing rules and introducing drastic measures by giving short notices and therefore their interests may not be protected. As a result, the foreign investors felt that it was better for them to invest in a market that have stable policies and easily interpreted.

As been mentioned earlier, the external environment was about to change when the selective capital control was introduced. One aspect that was sometimes being over looked was the fact that such policies and measures came long time after the currency crisis had started. It was believed that billions of profits calculated in Malaysian ringgit had already left the country in the hands of currency speculators and foreign investors. In the first place, the tight selective capital control was introduced with the idea to prevent huge outflow of short-term funds. Given the fact that huge amount of Malaysian ringgit had already left the country, the success of the selective capital control had been questioned.

Interest rates were brought down by the government of Malaysia after being advised by the Bank Negara Malaysia and getting consent from the Ministry of Finance. It was done with an attempt to encourage more business activities to take place. For this purpose, Banks were forced to achieve the 8 per cent loan growth target rate for 1998. Unfortunately, loan and money supply declined in the first few months after the measure was introduced.

According to Reinhart (1998), who did a study on countries that have adopted measures designed to curb short-term capital inflows, they had found that most types of capital controls were only effective if policies were to be perceived as temporary measurement. Therefore that assurance of 'temporariness' was very crucial.

Bhagwati (1998) also said that some kind of control or like the Chilean model could work well in Asia but only after the crisis had been surmounted. He argued that control could be a good thing if they were being introduced precipitously as solutions to the crisis. Once a country being stormed by the crisis and lots of capital inflows have been reversed, he argued that there would be little gain from clamping down controls.

Another important factor that one has to bear in mind is that investors do not only take current interest differentials into account when they want to make investment but future interest differential is also a very important determinant. Again, this emphasises the adverse effect of not knowing when the measures are going to be lifted up. Although, the fixed exchange rates do ease businesses and help them planning ahead, other investment determining factors like business confidence may outweigh the gain from exchange rate stability.

Development in the region also saw that the interest rates had gone down at end of 1998. The fact that other countries in the region never use the capital control left a big doubt about the effectiveness of the selective capital control on interest rates. The argument here was that due to the contagion effect, Malaysia would had also experienced the reductions in the interest rates.

Exchange control and open economies are inherently incompatible. Exchange control may have worked effectively in countries with large domestic market but not for a small open economy like Malaysia where international trade constitutes 90% of her GDP (World Development Report 1992). By fixing the exchange rates, be it overvalue or undervalue, might affect volume of trade and reserves. It would be very difficult to get the accurate rate of exchange. BNM would definitely bound to have overvalued or undervalued the ringgit. If it had overvalued it means that our export would lose its competitiveness and import would become relatively cheaper. If that was the case, then Bank Negara Malaysia would have to run down its reserve to buy ringgit so as to maintain the official rate. On the other hand, if the Central Bank has undervalued the ringgit, imports would become relatively more expensive and our export would be more competitive. However, one has to remember that Malaysia's export has high import contents. Hence, either the ringgit being overvalued or undervalued, both would have adverse repercussion on the reserves and the volume of trade.

The important point here is that Malaysia might not be able to afford to have exchange control as long or medium term measure like what some other countries that had adopted exchange control policy since the degree of importance in the international trade differs amongst the countries. As mentioned. earlier, international trade is crucial to Malaysian economy that we cannot afford to set regulations that may deter the volume of trade.

While controls on inflow could be done successfully, controls on outflow is something more difficult to manage. Capital can still get out of a country through transfer pricing, under-invoicing or over-invoicing. Exporters underbill the foreign importers and instruct them to deposit the difference in a foreign bank account while importers overpay the foreign exporters with the difference deposited abroad. It is also easy to see that, like any other rationing system, exchange control generates a black market. That partial evasion by commodity traders gives rise to an undeclared supply of foreign currencies. On the other side of the market are potential users of foreign exchange, such as travellers who are denied an allocation by the control authority and are willing to pay a higher price than the official rate. Different accessibility to the supply of foreign currencies can also lead to corruption. An example of black market and corruption was a quote from the previous Philippines President Joseph Estrada when asked about Malaysia's currency controls. He said, "Each Asian member has to cope with its own circumstances. But our long experience of controls only led to corruption and the black market. We won't have them" (Asiaweek, Oct 23, 1998. Pg. 59)

Although pegging of Malaysian ringgit to US dollar at the ratio of RM3.80 to USD1, allowed Malaysian exports to look more attractive supposedly, inevitably that was not what had happened in the market. On a larger scope in the regional context, the development was carefully watched by other neighbouring countries. It was even suggested by economists that the neighbouring countries were discouraged to strengthen their own currencies much earlier for the fear that their exports would be less competitive in comparison to the Malaysian production costs and services. As a matter of fact, even China devalued its currency renminbi for the purpose of gaining export competitive. Other reasons would include:

1. Reduction in the investment for business expansion due to the element of economic uncertainties.
2. Reduction in some of the agriculture products in 1997 due to environmental (haze) and climatic (El Nino drought) factors.
3. Economic uncertainties had led to undermine the confidence level in the Malaysian market.
4. Long lag time needed for new investments to begin their productions.
5. Reduction in the some of the commodity prices.
6. Massive reduction in the foreign demand especially from the East Asian region.

6.5 Conclusion

The measures taken by Malaysia had certainly received lots of critics especially from the foreign currency speculators and IMF. What is important is that the measures introduced by the Malaysian government should not only cater for short-term remedy but it must take into account the long-term effect. Malaysia, being a young country, should analyze policies taken by other countries when dealing with economic crisis. There are many things that can be learnt from other countries experiences. However it is important for Malaysia to be alert that different crisis occurring to different countries may require different treatments.