Financial Liberalization, Crises and the Role of Capital Controls: The Malaysian Case

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Analysts have increasingly acknowledged the role of easily reversible capital flows in precipitating the 1997–98 crises in East Asia. They now generally accept that the national financial systems in the region did not adapt well to international financial liberalization (Jomo 1998). Financial liberalisation undoubtedly succeeded in temporarily generating massive net capital inflows into East Asia, unlike many other developing and transition economies, most of which experienced net outflows over the longer term. However, it also exacerbated systemic instability and reduced the scope for the government interventions responsible for the region's economic miracle. Foreign capital inflows adversely affected factor payment outflows, export and import propensities, and the terms of trade, and thus, the balance of payments. In particular, increased foreign capital inflows reduced foreign exchange constraints, allowing the financing of additional imports, but thereby also resulting in reducing current account surpluses, if not generating deficits. This created the conditions for the loss of investor confidence that resulted in the capital reversals from mid-1997.

The bank-based financial systems of most of the East Asian economies affected by the crises were especially vulnerable in the face of a sudden drop in the availability of short-term loans as international confidence in the region dropped suddenly from mid-1997. Available foreign exchange reserves were exposed as inadequate to meet financial obligations abroad, requiring governments to seek temporary credit facilities to meet such obligations incurred mainly by their private sectors. Data from the Bank of International Settlements show that banks were responsible for much of this short-term debt, though some of it did consist of trade credit and other short-term debt essential for ensuring liquidity in an economy. However, the rapid growth of short-term bank debt during stock market and property boom periods suggests that much short-term debt was due to factors other than trade credit expansion.

In Malaysia, the temporary capital controls on inflows the central bank introduced in early 1994 momentarily dampened the growth of such foreign stock market investments, but by 1996 and early 1997, a new investment frenzy was evident that involved not only domestic investors, but also banks lending for such investments. The sequence of developments and events that led up to the crisis was thus very different in Malaysia from the scenario elsewhere in the region. A

tightening of regulatory control was adopted with the Banking and Financial Institutions Act of 1989 in the wake of a serious banking crisis from the mid-1980s. From the beginning of the 1990s, there was an attempt to increase capital market activity in Malaysia, with a split between the stock exchanges of Singapore and Kuala Lumpur. The Malaysian authorities at that time staged "road shows" to try and lure foreign investors to invest in the Malaysian stock market. The efforts were successful, and during 1992 and 1993, a major influx of capital into Malaysia from international investors occurred. However, towards the end of 1993, there was a sharp reversal of capital flows out of the country resulting in a collapse of the stock market. In early 1994, the Malaysian finance minister at that time, Anwar Ibrahim, introduced capital controls on such financial inflows. These controls were subsequently lifted in the second half of 1994 due to lobbying by those with a strong interest in seeing a stock market boost.

As a result of these capital market-oriented policies, Malaysia's situation at the time of the crisis was different. Whereas the other three crisis-affected East Asian economies succeeded in attracting considerable, mainly short-term, US dollar bank loans into their more bank-based financed systems, Malaysia's vulnerability was mainly due to the volatility of international portfolio capital flows into its stock market. As a consequence, the nature of Malaysia's external liabilities at the beginning of the crisis was quite different from that of the other crisis-stricken East Asian economies. A greater proportion of Malaysia's external liabilities consisted of equity, rather than debt. Compared with Malaysia's exposure in the mid-1980s, many of the liabilities, including the debt, were private, rather than public. In addition, much of Malaysia's debt in the late 1990s was long-term, rather than short-term in nature, again in contrast to the other crisis-affected economies. Further, monetary policy and banking supervision had generally been much more prudent in Malaysia than in the other crisis countries. For example, Malaysian banks had not been allowed to borrow heavily from abroad to lend on the domestic market. Such practices involved currency and term mismatches, which increased the vulnerability of those countries' financial systems to foreign bankers' whims, and exerted pressure on the exchange rate pegs.

These differences have lent support to the claim that Malaysia was an innocent bystander who fell victim to regional contagion by being in the wrong part of the world at the wrong time. Such a benign view of portfolio investment inflows does not acknowledge that such inflows are even more easily reversible and volatile than bank loan inflows (Jomo 2001). Thus, Malaysia's experience actually suggests greater vulnerability because of its greater reliance on the capital

market. In mid-1994, those who stood to gain from a stock market bubble successfully lobbied for abandoning the early 1994 controls on portfolio capital inflows.

As a consequence, the Malaysian economy became hostage to international portfolio investors' confidence. Hence, when government leaders engaged in rhetoric and policy initiatives that upset such investors' confidence, Malaysia paid a heavy price when portfolio divestment accelerated. This exacerbated the 1997–8 portfolio capital flight from Malaysia, resulting in the stock market collapse by about four-fifths of its market capitalization in February 1997.

After the crisis broke in Thailand in early July 1997, capital withdrew from other economies in the region which were presumed to be similarly vulnerable. Thus, hard behaviour and contagion reflect prevailing market sentiment exacerbated by IMF recommended policy interventions. The exception was Malaysia, which tried to stem the cascading crisis through a number of ill-conceived policy initiatives. Initially, the Malaysian government spent about 9 billion Malaysian ringgit -- at that time worth about US$4 billion -- in two weeks to defend the ringgit. This endeavour was very expensive, and the Malaysian authorities consequently gave up as it seemed unending. Other countries in the region did not try to defend their currencies for as long, and therefore did not lose as much money in the process. However, from late 1997, after disagreements between Malaysian political leaders and lobbies, IMF-type policies briefly became more influential.

Thailand, Indonesia and South Korea had received International Monetary Fund (IMF) emergency credit and were subject to its contractionary conditionalities, which had aggravated the recession and crises in the region. Although the Fund continued its emphasis on strict monetary policy, it seemed more willing to abandon its earlier insistence on "fiscal discipline". By mid-1998, it allowed counter-cyclical (reflationary) fiscal policies by allowing debtor nations to run budget deficits — perhaps belatedly recognizing that most East Asian crisis economies had run budget surpluses for years.

In the last quarter of 1998, the regional turmoil came to an end as East Asian currencies strengthened and stabilized, partly as a result of the US Federal Reserve Bank's decision to lower interest rates. This effectively reversed capital flight from Asia to the US. Given that respite, Asian currencies stabilized and strengthened. From the last quarter of 1998, Thailand, Indonesia and South Korea posted positive growth rates. Malaysia, on the other hand, turned around in the

second quarter of 1999. However, matters changed soon. By the end of 1999 and into 2000, Malaysia's recovery was second only to South Korea's.

In Malaysia, fourteen months after the crises were sparked off by the floating of the Thai baht in July 1997, Prime Minister Mahathir Mohamad introduced several controversial currency and capital control measures. Malaysia's bold introduction of capital controls on 1–2 September 1998 elicited mixed reactions. Amidst the debate, both critics and advocates tended to exaggerate their case, with little regard for accuracy. Proponents of capital account liberalization generally opposed capital controls because they were viewed as a setback to the spreading capital account liberalization that had taken place over the previous two decades. They claimed that the measures undermined freer capital movements and capital market efficiency — reducing net flows from the capital rich to the capital poor, limiting access to cheaper funds, increasing financial volatility, aggravating inflation and lowering growth — besides encouraging reversal of the larger trends towards greater economic liberalization and globalization. Market fundamentalists loudly prophesied Malaysia's doom, little anticipating that Malaysia's recovery would be stronger than in Thailand or Indonesia, and second only to South Korea. Since then, the critics have reversed their opinion.

Neo-liberal critics referred to the fact that despite the administration's longstanding efforts to attract foreign direct investment, such flows had decreased after 1996. They claimed that this was due to the Malaysian authorities' reduced credibility, after various unorthodox interventions, culminating in the imposition of the September 1998 controls. However, this was not a purely Malaysian phenomenon. There is considerable evidence of a decline in FDI throughout Southeast Asia, including the countries that maintained open capital accounts. This was a period of reduced FDI flows, with the share going to Southeast Asia declining dramatically as China's share rose sharply.

Some more doctrinaire neo-liberals also disagreed with the IMF's interventionism, on the grounds that the Fund represents a super-state of sorts, and such intervention nonetheless undermined market forces. Meanwhile, counter-cyclical interventionists condemned the IMF's early pro-cyclicality. More generally, the Fund's own policy stance has also changed over time, and has often been shown to be doctrinaire, poorly informed, and heavily politically influenced, especially by western interests, led by the US.

As compared to these views, most — though not all — heterodox economists endorsed the Malaysian challenge to contemporary orthodoxy for the opposite reasons. They emphasized that financial and capital account liberalization had exacerbated financial system vulnerability and macroeconomic volatility. More importantly, they pointed out that such measures created conditions for restoring the monetary policy autonomy considered necessary for fostering economic recovery.[1] The Malaysian experience does suggest that the orthodoxy's predictions of disaster (as, for example, by the late Nobel Laureate Merton Miller) were wildly off the mark, as plainly proven by later events. However, it is much more difficult to prove that the Malaysian controls were the resounding success claimed by its advocates and supporters.

Did Mahathir's September 1998 Controls Succeed?

The actual efficacy of Malaysia's measures is difficult to assess. Malaysia's recovery (6.1 per cent in 1999 and 8.3 per cent in 2000) was more modest than South Korea's (10.9 per cent in 1999 and 9.3 per cent in 2000). Since South Korea was also subject to an IMF bailout programme, one cannot attribute the different rates of recovery in 1999 to different monetary policy measures or IMF conditionalities. It seems likely that the relatively stronger recovery in Malaysia and South Korea, compared to the other crisis countries, can be attributed to stronger fiscal reflationary efforts, effective debt restructuring as well as increased electronics demand in anticipation of the year 2000.

Besides, after September 1998, Thai interest rates fell below Malaysian rates after being well above Malaysian rates for years (Jomo 2001: 206, Figure 7.1). This suggests that the US Fed's interest rate reduction did more to reduce interest rates in the East Asian region than did the September 1998 Malaysian initiatives. But it also points to an element of truth in the general observation that monetary policy is far less effective than fiscal measures in reflating the economy.

It also needs to be noted that the capital control measures were significantly revised in February 1999. The modifications represented attempts to mitigate some problematic consequences of the capital controls regime. As of 1 September 1999, the September 1998

[1] Many intermediate positions also emerged, e.g. the IMF's then first Deputy Managing Director Stanley Fischer endorsed Chilean-style controls on capital inflows, implying that the September 1998 Malaysian controls on outflows were far less acceptable, presumably because they involved controls on outflows, rather than inflows, besides undermining government credibility, and thus likely to generate more adverse consequences.

regime was fundamentally transformed, ending the original curbs on capital outflows. There have been no new curbs on inflows, but instead, strenuous efforts to encourage the return of capital inflows (including short-term capital) have been undertaken.

Did Malaysia's September 1998 selective capital control measures realise their objectives? The merits and drawbacks of the Malaysian government's capital controls regime in dealing with the regional currency and financial crisis will be debated for a long time to come as the data does not lend itself to clearly support any particular position. The diverse interpretations of the data enable proponents to claim that the economic decline and stock market slide halted soon after the onset of the controls, while opponents can counter that such reversals came earlier in the rest of the region.

Industrial output, especially in manufacturing, declined even faster after the introduction of capital controls in Malaysia until November 1998, and continued downward till January 1999 before turning around. Even after that, with the exception of a few sectors (notably electronics), industrial output recovery was not spectacular, except in comparison with the preceding deep recession. Meanwhile, unemployment rose, especially affecting those employed in construction and in financial services. Domestic investment proposals almost halved, while "green field" FDI seems to have declined by much less, though actual trends were obscured by quicker application processing, approval of previously rejected applications as well as some redefinitions of FDI measures (see Jomo 2001: Figure 7.2).

Further, as is now generally recognized, the one-year lock-in of foreign funds in the country came much too late to avert the crisis, or to help retain the bulk of foreign funds that had already fled. Instead, the funds "trapped" were those that had not already left in the preceding 14 months, inadvertently "punishing" those investors who had not already withdrawn funds from Malaysia.

It appears that the actual contribution of the capital controls to the strong economic recovery in Malaysia in 1999–2000 is ambiguous at best. It may even have slowed down the otherwise stronger recovery led by fiscal counter-cyclical measures and the extraordinary demand for electronics, thus explaining the weaker recovery in Malaysia compared to South Korea. In the longer term, many critics claim that the controversial controls adversely effected the recovery of foreign direct investment — which may have compelled the authorities to seek

more domestic sources of economic growth, though the evidence to support this argument is inadequate.

More importantly, the regime remains untested in terms of its contribution to economic recovery in the face of international currency volatility, as such instability abated throughout the region at around the same time following the US Fed's interest rate reduction. Although recovery of the Malaysian share market, which had declined more than other stock markets during the crisis, lagged behind the other (relatively smaller) markets in the region, it is not clear what should be made of this

If, indeed, Malaysia's capital controls stemmed from near-desperation following the seeming failure of earlier policy responses, as Mahathir said at a symposium on the first anniversary of the controls, then the timing was most fortunate. When introduced, the external environment was about to change significantly, while the economy had seen the outflow of the bulk of short-term capital, so that in a sense, the regime was never tested. If the turmoil of the preceding months had continued until the end of 1998 or longer, continued shifts and re-pegging would have been necessary, with deleterious effects.

Malaysian authorities set the peg at RM3.8 to the US dollar on 2 September 1998, after it had been trading in the range of RM4–4.2 per US dollar, in a bid to raise the value of the ringgit. From mid-September 1998, however, other regional currencies stabilized after the US Federal Reserve Bank lowered interest rates in the aftermath of the Russian and LTCM crises, strengthening the yen and other regional currencies. Thus, the ringgit became undervalued for about a year thereafter, which — by chance rather than by design — boosted Malaysian foreign exchange reserves from the trade surplus, largely due to import compression, as well as some exchange rate-sensitive exports. Malaysia's foreign exchange reserves depleted rapidly from July until November 1997, before improving in December, and especially after the imposition of capital controls in September 1998 (Jomo 2001: Figure 5.10). Thus, the ringgit undervaluation may have helped Malaysian economic recovery, but this was certainly not what the authorities intended when initially pegging the ringgit.

While the undervalued ringgit backed an export-led recovery strategy, this was not the intent as government efforts were focused on a domestic-led recovery strategy. The undervalued ringgit is said to have had a (unintended) "beggar-thy-neighbour" effect. Due to trade competition, the undervalued ringgit is said to have discouraged other regional currencies from

strengthening earlier for fear of becoming relatively uncompetitive relative to Malaysian production costs and exports. There were also fears that the weak Southeast Asian currencies might cause China's authorities to devalue the renminbi, which could have had the undesirable effect of triggering another round of "competitive devaluations", signalling danger for all.

Clearly, the ringgit peg brought a welcome respite to businessmen after more than a year of currency volatility. But as noted earlier, exchange rate volatility across the region abated shortly thereafter. Moreover, it is ironic that a presumably nationalistic attempt to defend monetary independence against currency traders should, in effect, hand over determination of the ringgit's value to the US Federal Reserve through the dollar peg. However, the greenback initially weakened due to lowered US interest rates. After strengthening from 1999, it again weakened after 2001, which created much less pressure for re-pegging or de-pegging against the US dollar to retain export competitiveness.

While interest rates were undoubtedly brought down by government decree in Malaysia, the desired effects were limited by banks' reluctance to increase liquidity. Interest rates were reduced dramatically across the region, in some cases, even more than in Malaysia, without others having to resort to capital controls. As noted earlier, while interest rates in Thailand were much higher than in Malaysia for over a year after the crisis began, they declined below Malaysian levels during September 1998. Perhaps more importantly, loan and money supply growth rates actually declined in the first few months after the new measures were introduced despite central bank threats to sack bank managers who failed to achieve the 8 per cent loan growth target rate for 1998. It became clear that credit expansion is a consequence of other factors besides capital controls and even low interest rates. Across the region, especially in South Korea and Thailand, counter-cyclical spending also grew, without resorting to capital controls.

The Malaysian authorities' mid-February 1999 measures effectively abandoned the main capital control measure introduced in September 1998, i.e. the one-year lock-in. While foreign investors were initially prohibited from withdrawing funds from Malaysia before September 1999, they were allowed to do so from mid-February 1999 after paying a scaled exit tax (lower taxes for longer term investment in Malaysia), in the hope that this would reduce the rush for the gates come September 1999.

The very low volume of actual capital outflows after the end of the lock-in on 1 September 1999 has been interpreted in different ways. One view was that since the stock market

had recovered and could be expected to continue rising, there was little reason to flee. A second view emphasized the role of the nominal exchange rate, which had been fixed against the US dollar at RM3.8. With the greenback perceived to be still strengthening, there was little exchange rate risk to discourage investors from holding ringgit. A third perspective held that the low rate of exit indicated that capital controls were probably unnecessary, having been introduced 14 months after the crisis began, i.e. after most of the capital flight had already taken place.

Meanwhile, in an attempt to attract new capital inflows, new investors were granted a less onerous capital gains tax. However, it is unlikely that a capital gains tax will deter exit in the event of a panic as investors rush to cut their losses. At best, it could discourage some kind of short-selling from abroad owing to the higher capital gains tax rate of 30 per cent as opposed to 10 per cent on withdrawals within less than a year. The differential may have discouraged some short-selling from abroad, but would not have deterred capital flight in the event of financial panic. In September 1999, the capital gains exit tax rate was set at a uniform rate of 10 per cent, thus eliminating the only feature of the February 1999 revised controls that might have deterred short-selling from abroad.

The desirability of some measures associated with the capital controls is also in doubt as evidence of favouritism or cronyism mounts, while the contribution of “rescued” interests to national economic recovery efforts is dubious (Wong, Jomo and Chin, 2005). Simon Johnson and Todd Mitton (2003) have shown that the market prices of stocks associated with Mahathir cronies rose disproportionately more after the introduction of the September 1998 capital controls. However, the evidence does not really allow one to conclude that the capital controls *per se* were solely or principally responsible for this outcome. As the Malaysian authorities had also undertaken several other important measures from mid-1998, one cannot conclusively attribute this effect on Mahathir crony stock prices to the capital control measures. The likely presumption of the persistence of cronyism would be enough to have such an effect. Furthermore, the popularity of crony stocks before the crisis — contrary to the neo-liberal presumption that minority investors have an aversion to such shares — suggests that portfolio investors understandably preferred such stocks, especially after the intense political conflict preceding the capital controls suggested that Anwar-connected stocks were doomed, while those linked to Mahathir would be the principal beneficiaries of government policy interventions.

Counter-cyclical fiscal spending had been re-introduced by then Finance Minister Anwar Ibrahim from around June 1998, possibly with an eye to the ruling party's annual general assembly at the end of that month. Around this time, the IMF had begun to reconsider its earlier policy conditionality and advice for the crisis-affected East Asian economies to avoid budgetary deficits. During this time too, the Malaysian authorities set up three important institutions to facilitate restoration of bank liquidity by taking over many large non-performing loans (Danaharta), bank re-capitalization (Danamodal) and corporate restructuring (Corporate Debt Restructuring Committee, or CDRC).

Some Policy Lessons

Malaysian Prime Minister Mahathir's September 1998 capital controls were correctly seen as a bold rejection of both market orthodoxy as well as the IMF's promotion of capital account liberalization. Where Thailand, South Korea and Indonesia had gone 'cap in hand' — accepting IMF imposed conditions to secure desperately needed credit — the Malaysian initiative reminded the world that there were alternatives to capital account liberalization. For many, enthusiastic support for the Malaysian controls and claims of its success are crucial in opposing market fundamentalism and IMF neo-liberalism, with some opponents of capital account liberalization exaggerating the actual benefits of the measures undertaken by Malaysia. For example, one supporter has extolled the virtuous consequences for labour resulting from capital control measures with scant regard for the Malaysian authorities' self-confessed intention of protecting big business interests, supposedly crucial for economic stability.

The coincidental timing of an article by Paul Krugman in *Fortune* magazine advocating capital controls reinforced the impression that the measures were intended to provide monetary policy independence to reflate the economy. However, as noted earlier, international monetary developments from August 1998 also facilitated the adoption of reflationary policies in the rest of the region. Although Malaysia missed out on most of the renewed capital flows to the region from the last quarter of 1998, it is not clear that such easily reversible capital inflows are all that desirable. The more serious problem was the credibility of government policies, which appeared to adversely affect the inflow of foreign direct investment (FDI) -- despite official protests to the contrary -- as well as risk premiums for Malaysian bonds.

The subsequently undervalued pegged ringgit also had negative implications for a broad recovery, which depended upon imported inputs into the very open economy. It is not clear that the peg gave a major boost to exports, as the official export figures suggest. The post-September 1998 regime has also not produced other desired effects as the export base remains narrow, with the most significant growth coming from electronics due to external demand increases before the year 2000, and with the increase in foreign reserves largely resulting from massive import compression.

There are costs to maintaining an undervalued ringgit, especially in the context of an economic upturn of what is still a very open economy. Undervaluation may help some exports in the short term, but it also makes imports of capital and intermediate goods more expensive, thus impeding recovery and capacity expansion in the medium term. (Before the crisis, imports were almost equivalent to GDP.) The trade surplus subsequently declined as import compression -- due to the undervalued ringgit -- declined. Coupled with an apparently stubborn negative services balance, a reduced current account surplus accompanied the economic upturn.

Contrary to official claims, the controls may also have had some negative effects on desired long-term FDI, e.g. among potential foreign investors who might mistrust a government for apparently reneging on an implicit commitment not to impose capital controls on outflows. However, there is no conclusive evidence to this effect. In fact, surveys by Japanese government agencies — notably the Japan External Trade Organization (JETRO) and Japan Bank for International Cooperation (JBIC) — suggest that such investors have been indifferent to or even appreciative of the controls. In any case, FDI throughout the world declined significantly from the late 1990s, with China receiving a significantly increased share of such investments.

The subsequent reduction of FDI cannot be conclusively attributed to the September 1998 measures. The authorities attributed the FDI decline to misperceptions, and spent inordinate energy and resources trying to rectify the situation. But confidence in the consistency and credibility of the Malaysian government's policy was probably eroded as were years of successful investment promotion, especially in the West. This was not helped by unnecessarily hostile and ill-informed official rhetoric, especially at the highest level.

The capital controls regime was thus probably counter-productive in terms of the overall consistency of government policy with some adverse long-term consequences. The problem was initially exacerbated by the Prime Minister's declared intention to retain the regime until the

international financial system was reformed as fundamental changes to the international financial architecture are unlikely to materialize in the foreseeable future. The Malaysian government should institute a permanent, but flexible, market-based regime of prudential controls to moderate capital inflows and deter speculative surges, both domestic and foreign, to avert future crises. This would include a managed float of the currency with convertibility, but no internationalization, minimally meaning, no offshore ringgit accounts, limits on off-shore foreign exchange accounts, and limits on foreign borrowings.

There is also an urgent need for much greater monetary co-operation in the region (Jomo, 2005). It is now clear that currency and financial crises have primarily regional effects. Thus far, the ASEAN + 3 (Japan, South Korea, China) has resulted in a complicated series of bilateral arrangements, public contingent on an IMF program been in place. In recent years, there has been a significant effort to multi-lateralize these arrangements and to increase the finance available, but progress has remained slow. Meanwhile, an Asian bond market has slowly emerged while several of the fastest-growing economies have accumulated huge foreign reserves to protect themselves in the event of future financial threats, often referred to as ‘self-insurance’.

In conclusion, it is relevant to point out that our critical evaluation of Malaysia’s unorthodox capital account management measures should not obscure their potential and desirability, especially when such problems cannot be avoided or overcome by other means. It is important to emphasize that such measures are consistent with the IMF’s Articles of Agreement. The window of opportunity offered by the capital controls regime in Malaysia was abused by certain powerfully-connected business interests, not only to secure publicly funded bail-outs, but to consolidate and extend their corporate domination, especially in the crucial financial sector. Capital controls have been part of a package focused on saving friends of the regime, usually at public expense. For example, besides involving public funds to ‘nationalize’ some of its assets, the government-authorized restructuring of the ruling party-linked Renong conglomerate will also cost the government, and hence the public, billions of ringgit in forgone toll and tax revenue. Also, non-performing loans (NPLs) of the thrice-bankrupted Bank Bumiputera and another bank — taken over by politically well-connected banking interests — have not been heavily discounted like other banks’ NPLs, although it had long abandoned its “social agenda” of helping the politically dominant Bumiputera community.

Other elements in the Malaysian government's economic strategy after the imposition of controls reinforce the impression that the capital control measures were probably motivated by political considerations as well as the desire to protect politically well-connected businesses. In sum, the Malaysian experiment with capital controls has been compromised by political bias, abuse by vested interests and inappropriate policy instruments. However, it would be a serious mistake to reject the desirability of judicious use of capital account management techniques or capital controls on account of the flawed Malaysian experience (Epstein, Grabel and Jomo, 2004).

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