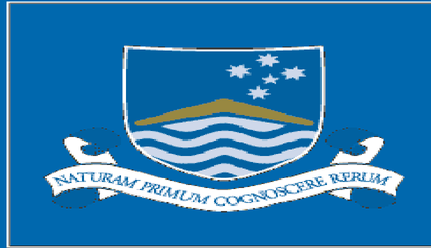

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The Malaysian Capital Controls: A Success Story?

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Purpose/Motivation

- Malaysia's radical crisis resolution strategy

  – controls on short term capital inflows + Keynesian the therapy

  – the first case of an emerging market economy temporarily reversing the course of capital account opening in a crisis context.

- Rapid/smooth recovery following the policy shift, but the economists are divided on whether this episode makes a case for using capital controls as a crisis resolution tool.

Three alternative views:

(1) Capital controls made no difference to the recovery process
(Fischer 2003; Dornbusch 2003, IMF 1999)

- a case of 'locking the stable door after the horse has bolted'
Capital had already left Malaysia, and the pressure for capital outflow from the region was coming to an end at the time

Malaysia's recovery was much the same as that of the other crisis-hit countries in the region

(2) Capital Controls have adversely affected long-term growth dynamism of the economy (even if they were instrumental in the recovery)

-discouraged new foreign investment, both FDI and portfolio investment

- control-based political patronage imposed undue economic costs

- provided an excuse to ignore/slowdown needed reforms.

(3) Capital controls were instrumental in achieving recovery, while minimizing potential economic disruption and related social cost.

- provided the leeway to implement expansionary monetary/fiscal policy

A systematic analysis of the Malaysian 'experiment' is important, given the new-found interest in temporary capital inflow controls as a crisis resolution measure

(see King 1999, Krugman 1999, Cooper 1999, Corden 2003,)

Structure

2. Capital account opening, capital inflows and signs of vulnerability
3. Onset of the crisis, policy muddling through and economic collapse
4. Policy U-turn: Capital-control based crisis resolution package
5. The recovery
6. Have capital controls worked?
7. Conclusions/inferences

2. Capital account opening, capital inflows and signs of vulnerability

Policy history

- long-standing commitment to maintaining an open foreign trade and foreign direct investment regime.
- until the mid-1980s, binding restrictions on short-tem ('mobile') capital flows.
- Significant capital opening since then.

But

Restrictions on foreign currency borrowing by residents and domestic currency borrowing by non-residents were never lifted.

For details see Athukorala (2002)

Capital inflows and signs of vulnerability

- Massive inflow of volatile capital (predominantly portfolio flows) in the early 1990s

  - Share of portfolio capital in total net capital inflows:

1987-89	1990	1991	1992	1993	1994	1995	1996	mid-1997
27	74	60	59	72	80	81	74	72

  - Reserve adequacy ration (RAR, foreign reserves as % of mobile capital)

1987-89	1990	1991	1992	1993	1994	1995	1996	mid-1997
162	158	171	149	124	94	80	72	56

  - RAR of other crisis-hit countries, Mid 1977:

Indonesia 71; Korea 18; Thailand 45; Philippines 64

Source Athukorala and Warr (2002)

Share market boom

- market capitalization to GDP ration in 1996 = 300%, the highest ever in any country
- market leaders were foreign investors

The close link between the Malaysian and Singapore stock and money markets – rapid internationalization of the ringgit.

Policy slippage that made share market boom a source of vulnerability :

- Poor corporate governance

  – equity market liberalization was not accompanied by attempts to redress weaknesses of corporate governance

- Massive domestic credit expansion with a heavy exposure of bank to share trading and the real estate sector

  Outstanding back credit to GDP ratio:

  1985-89 85%

  1994 120%

  mid-1997 160%

3 Onset of the crisis, policy muddling through and economic collapse

- Onset of the crisis – From early July 1997, massive selling pressure on the ringgit combined with share market collapse
- Policy muddling trough until August 1998

  (This was possible because of low foreign debt exposure)
- The economy was in a precarious state by the third quarter of 1998 (whereas economies in Thailand and Korea had become stabilized and begun to exhibit signs of recovery) .

4. Capital-control based crisis resolution strategy

Two policy options

- Entering into an IMF package ('obtaining a good housekeeping seal')
- Resorting to capital controls to combine fixed exchange rate with the Keynesian therapy

Malaysian government (or, rather, Dr Mahathir!) opted for the latter. (why?)

Capital control-based Policy Package

- Strong, but narrowly focused capital controls
- [Adjustable] Pegged exchange rate (RM 3.80 per US$)
- Expansionary fiscal and monetary policy
- Banking and corporate restructuring

<u>The role of capital controls</u>

- Supporting the exchange rate peg

  and
- Breaking the link between domestic and world interest rates.

5 Recovery

- Rapid/smooth recovery from about the first quarter of 1999
- The economy regained pre-crisis (1996) level of GDP by mid-2000
- Public expenditure led the recovery, but because broad based.
- Rapid export expansion (on the back of a boom in world electronics industry and favourable primary commodity prices (rubber and palm oil) played a pivotal role, but domestic-oriented industries and non-tradable sectors too played an important part in recovery.
- Turnaround of the economy was accompanied by a notable strengthening of the external payments position. By 2000 Malaysia's fiscal position remained perhaps the healthiest among the crisis-hit countries.

6 Have Capital Controls Worked?

The Malaysian economy did recover following the policy turnaround.

But <u>precedence</u> does not necessarily imply <u>causation</u>.

Two inferences based on comparison of Malaysian experience with that of the IMF-program countries:

- Capital had already left Malaysia and speculative pressure for capital outflow from the region was coming to an end at the time (controls were a ritualistic locking of the barn door after the horse has bolted)
- Not only Malaysia, but also the IMF program countries began to recover about the same time

Thus, capital controls did <u>not</u> make a ‘distinct’ contribution to the recovery

(Dornbusch 2003, Fischer 2003)

My inferences

‘Closing barn door’ analogy is wrong for two reasons:

The purpose of capital controls was to set the stage for monetary and fiscal expansion by preventing outflow of funds, both foreign-owned and local, in response to lowering of the domestic interest rate relative to world interest rates under expansionary macroeconomic policy

The potential threat of capital exodus was much greater in Malaysia than in other crisis countries because of the close financial links with Singapore.

- There is no evidence to suggest that Malaysia has lagged behind the IMF program countries in the recovery process is not consistent with facts.

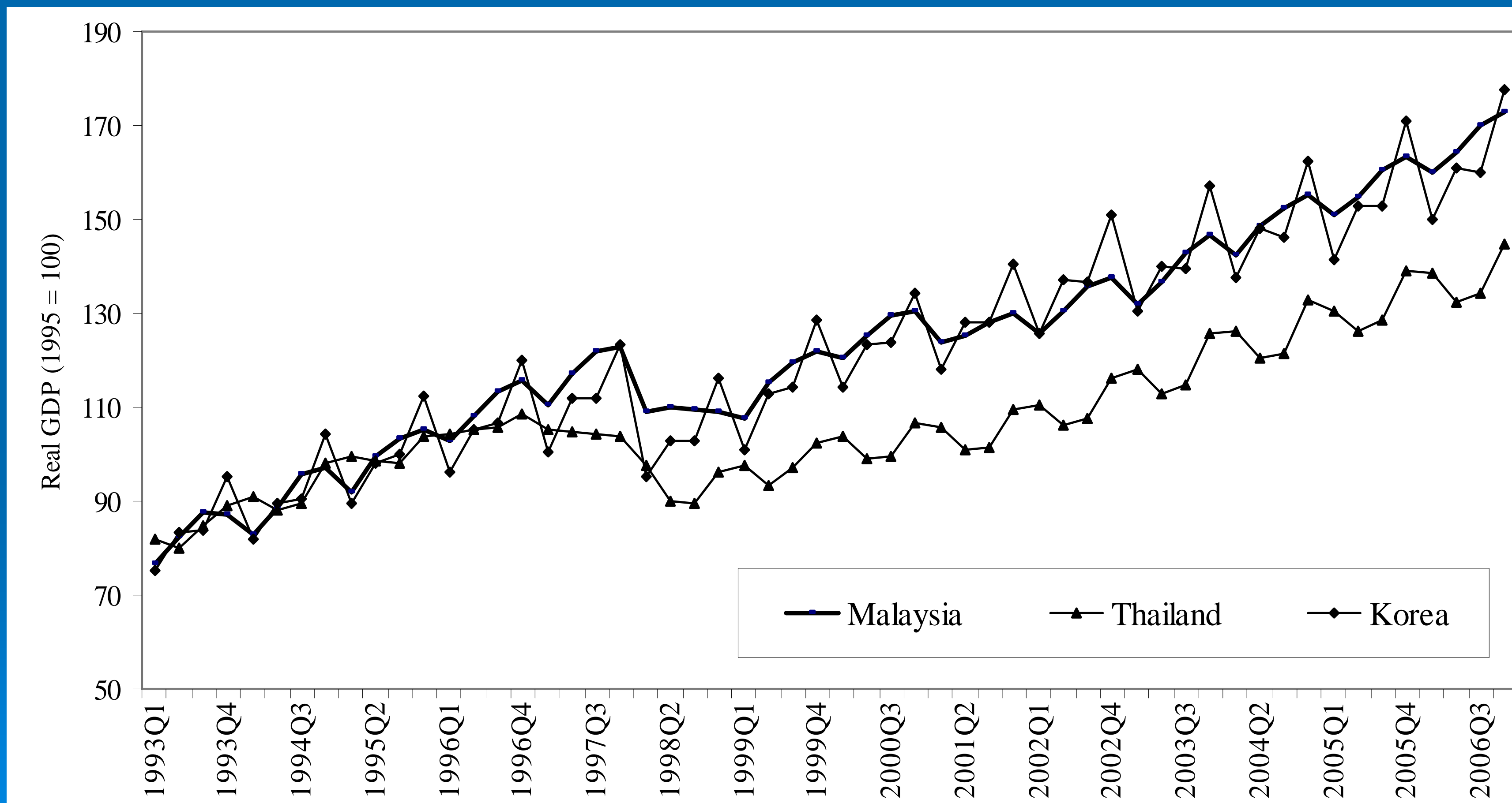
  (Table 2, Figure 1)

- Paper by Kaplan and Rodrik (2003)

  - provide econometric evidence in support of the hypothesis that Malaysia's economic recovery was superior to that of Thailand, Indonesia and Korea during the first twelve months following the implementation of capital controls.

- Their results are however sensitive to the particular counterfactual used in the comparison.

Figure 1: GDP in Malaysia, Korea and Thailand, 1993q1-2006q4



In any case,

There is little justification for posing the question as, 'whether Malaysia has recovered faster than the IMF-program countries'.

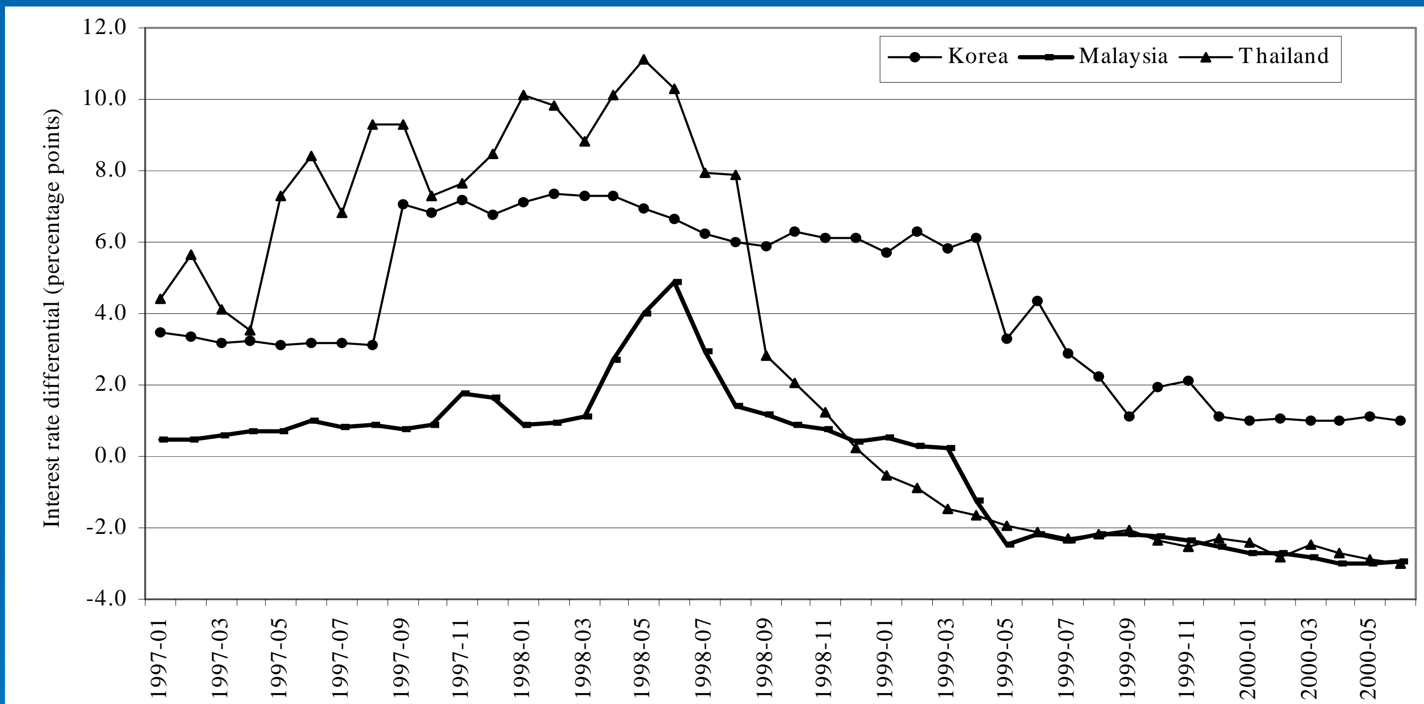
The real issue is whether the unorthodox policy choice was a viable alternative for the IMF route in achieving recovery

(Efficacy of a capital-control based policy package as a crisis resolution strategy, failing an early and gracious arrival of the IMF and/or socio-political resistance to going alone the IMF path)

Capital controls and policy autonomy

- Imposition of capital controls brought about a dramatic turnaround in the domestic- international interest rate differentials (Figure 2)

Figure 2: Differential Between Domestic and International Money Market Interest Rates in Malaysia, Korea and Thailand

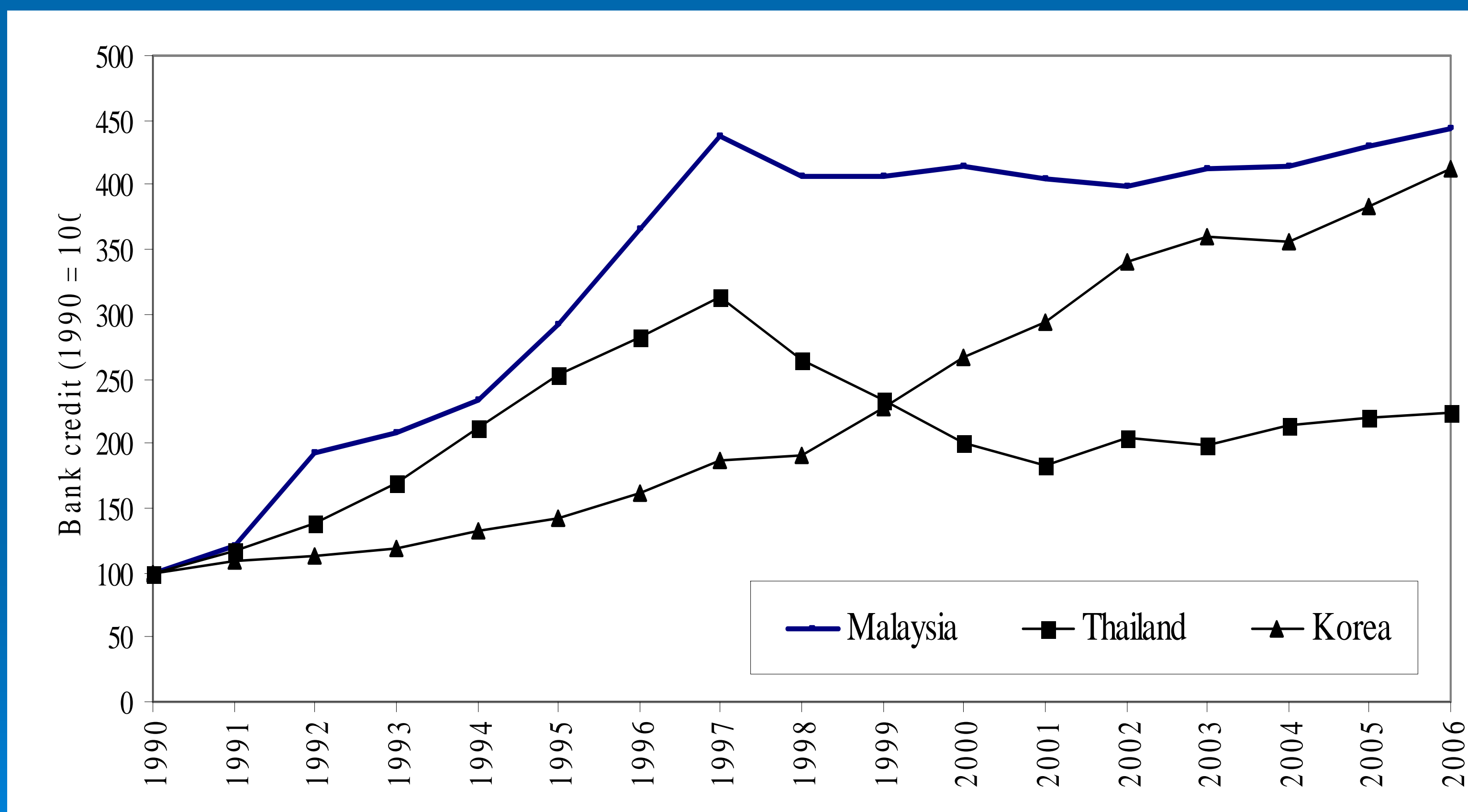


- The breathing space provided by capital controls, exchange rate stability and the resultant macroeconomic policy autonomy were instrumental in speedy implementation of banking and corporate restructuring.

- Unlike in Thailand, no contraction is real bank credit to the private sector (Figure 4)

- Banking restructuring in turn facilitated ‘broad based’ recovery.

Figure 4: Real Bank Credit to the Private Sector: Malaysia, Korea and Thailand, 1990-2006 (1990 =100)



Growth Implications

- No evidence to suggest that capital controls have had an adverse impact on FDI flows (evidence is inconclusive at best).

- No evidence to suggest that portfolio investors would shun Malaysia for ever as a punishment for its recalcitrant act.

- There is anecdotal evidence of ‘inappropriate’ rescue operations of banks and corporations, but one can argue that economic gains associated with speed recovery (and more importantly avoiding economic collapse) might have compensated for the alleged efficiency costs.

7 Concluding Remarks

The 'Malaysian experiment' has demonstrated that carefully designed temporary capital controls can provide policy makers with beathing space in crisis resolution through the standard Keynesian therapy

However, other countries should not treat Malaysia's radical policy choice as a 'ready-made' alternative to the conventional IMF recipe.

A number of factors specific to Malaysia may have conditioned the actual outcome — a well disciplined banking system, a competent central bank, strong leadership.

Capital controls are justified only as emergency measures. Capital account liberalisation is the ultimate destination in the process of gaining economic maturity through global integration.

But, some prudential regulation of foreign-currency denominated bank borrowing and of short term capital inflows are desirable until the domestic financial system gain maturity.

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