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Influencing Capital Flows in Macro-economic Policies: The Malaysian Experience

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Coverage

1. • Views and rationale on use of exchange controls : A broad perspective
2. • Monetary Policy--Managing short-term flows in Malaysia
3. • Evaluation of short and long-term impact of capital flow management measures
4. • Critical success factors for controls on capital flows
5. • Conclusion

Views on controls to manage capital flows

1. **Generally adverse views in the past :** historically controls used mainly for BOP reasons and in economies with less developed financial sector

2. **More recent studies showed mixed views**
   - View controls on inflows to be more effective than outflows
   - Controls to restore monetary and financial stability beginning to be viewed more favourably

3. **IMF more receptive recently, but still cautious**
   - Main issue is difficulty to segregate impact of controls from other measures

4. **World Bank**
   - Effective as insurance against further "disturbances"
   - Minimal damage to integrity of market place
   - Modest benefits & costs

Evaluating effect of controls require full understanding of economic & financial structure, state of economy, objective, type, nature & magnitude of controls, causes of instability

Views on controls

Generally 3 situations:

- **Address balance of payments issues**, mainly through curbing outflows

- **Manage volatile capital flows**, mainly through controls on short-term inflows

- **Influence composition of capital inflows** – limit volume of short-term flows, convert short-term into longer-term flows.

The Malaysian experience

Since floating Ringgit Malaysia (RM) in 1973, exchange controls used as **prudential and development oriented policy instrument** to support growth and influence economic stability

Principles	**Objectives**
1. Export receipts repatriation	▪ Develop foreign exchange market
2. Approval for foreign borrowing by residents (including NRCC)	▪ Ensure barrowers meet external obligations and reduce strain on nation's reserves
3. Approval for large foreign remittance by residents	▪ Encourage use of nation's financial resources for productive purposes within country
4. Selective exchange controls are temporary, specific, mainly to complement other policies	▪ Mitigate adverse impact of volatile short-term flows without affecting trade flows and FDIs

Use of controls to manage capital flows in Malaysia

Only as a **short-term line of defense** to restore stability **<u>under extreme situations</u>**

<u>NEVER</u> substituted for **sound macroeconomic policy**

- ❑Used mainly to manage s-t flows when other measures prove inadequate
- ❑Controls imposed only during periods of strong BOP position, **not solution to bop problems**
- ❑As safeguard measures to reduce vulnerability to destabilising external shocks during periods of structural reforms
- ❑Applied on selective and temporary basis
- ❑When needed to allow monetary policy to be more effective to influence domestic conditions
- ❑Safeguard against imperfect markets : " hostile capital"

Controls to address volatile capital flows used on two occasions

1993-1994

- Large speculative inflows into RM – denominated assets
- Highly destabilizing on asset prices and ER
- Limited monetary instruments
- Complement use of interest rates to contain effects of inflows on exchange rates
- Restore monetary conditions to support growth & contain asset inflation

Asian Crisis 1997-1998

- Speculative attack on currency → herd mentality and contagion affects
- Destabilizing ER depreciation not reflective of economic fundamentals
- Interest rates increase not effective in containing speculation
- Financial & economic instability heightened risks of prolonged contraction

1993-1994:
Controls specifically targeted at s-t capital inflows

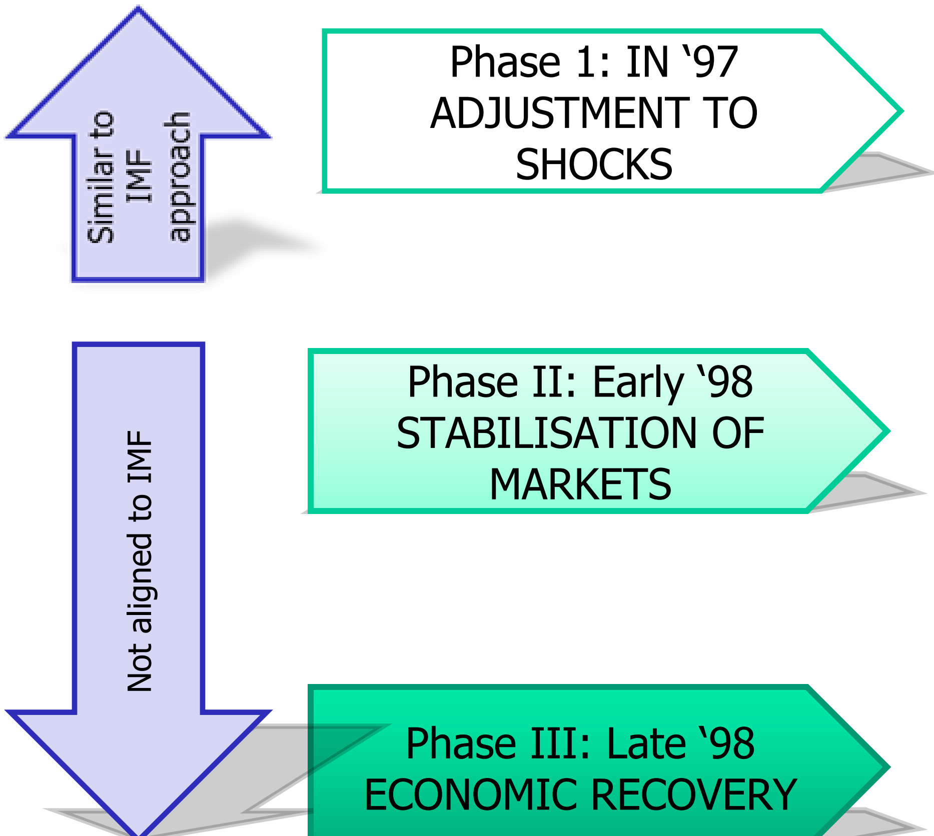
Objective:

- High interest attracting more inflows, but need to manage inflation

Measures:

- Eligible liabilities for computing SRR revised to include all inflows from abroad
- Limit on non-trade related outstanding net external liabilities of banking institutions
- Restrictions on sale of s-t monetary instruments to NR
- Require banks to place with CB the RM funds of foreign banking institutions held in non-interest bearing vostro accounts
- Commercial banks were not allowed to undertake non-trade related swaps and outright forward transactions on the bid side with foreign customers, excluding forwards for hedging purposes.
- SRR revised upwards 3 times to as high as 11-5% (from 8-5%)

1998 Controls introduced as part of a comprehensive macro-economic policy package



Tight monetary & fiscal policies
– To address inflation & current account deficit in BOP

Policy easing & bank restructuring
– With improved inflation & reversal to current account surplus, address collapse of aggregate demand

Eliminate instability & renewed currency speculation
– Controls, fixed ER, followed by aggressive policy easing & financial & economic structural reforms

Controls in 1998 aimed to achieve objective of monetary policy easing & facilitate restructuring

Principles

- **Target was specific**
  - Reduce destabilizing impact of offshore trade in ringgit
- **Measures were limited**
  - covered mainly portfolio flows
  - did NOT cover trade flows
  - did NOT cover FDI
- **Measures were temporary**
  - Removed once market stabilized

Measures

- Curb internationalization of ringgit – by reducing access to offshore RM for funding speculation
- Regulate short-term capital flows to reduce volatility in exchange rate.

Result: Monetary independence → effective interest rate and monetary policy to meet domestic requirements

Summary of Measures

Objective		Measure
1. Reduce RM volatility by curbing internationalization of ringgit	⇨	▪ Restriction on external account transactions ▪ Tighten rules on overseas investments ▪ Settlement of all trades in foreign currencies ▪ Restrict export and import of ringgit ▪ Limits on foreign currency notes held by Malaysian travelers ▪ Demonetize large currency notes ▪ Fixed exchange rate
2. Monitor gross flow of short-term RM assets	⇨	▪ Transactions in securities effected through authorized depositories
3. Reduce volatility in capital flows	⇨	▪ Investment in RM financial assets for a minimum of 1 year

Impact Assessment of Measures

1. No impact on residents, except when travel abroad	⇨	▪ Free to effect forex transactions, only fill statistical forms
2. No impact on long term investors	⇨	▪ Free to repatriate int., div. and profits and cap. Assets upon divestment ▪ Free to make payments/receipts in forex, only fill statistical forms
3. Impact only on Non residents, except when travel abroad	⇨	▪ Free to effect forex transactions, only fill statistical form
4. Malaysian traders cannot settle trade in RM	⇨	▪ Necessary because trade in RM provides RM overseas for speculation

Evaluation of Measures

1. On monetary sector	Effective	No financial repression, allowed indep. Monetary Policy
2. On stock market	Effective	Contribute to recovery, no adverse effect; initial adverse sentiments reversed later
3. On FDI	Neutral	Not important factor because segregate measures on short-term & long-term flows
4. On access to financing	Mixed	Did not impact access – bond over-subscribed Impact on pricing also due to other factors

On balance, positives outweigh initial adverse reactions

Positive

- Establish exchange rate stability
- Allowed the lowering of interest rates
- Facilitated timely reform of financial sector
- Restored domestic & foreign investor confidence
- Avoid social dislocation

Initial adverse reactions

- Removed from MSCI
- Foreign shareholdings in equity market declined
- Relatively less portfolio inflows

Details on evaluation of measures:
1. Controls allowed greater monetary autonomy

Domestic interest rates lowered aggressively after implementation of controls

- ❑ Controls contained speculative activities and allowed rapid interest rate cuts
- ❑ Confidence among residents, supported role of controls in granting monetary independence
- ❑ Resumption of private sector activity, orderly growth in consumption
- ❑ Elsewhere interest rate fluctuating, influenced by US rates
- ❑ Rapid cut in interest rates in Malaysia reduced the magnitude of monetary easing, relative to other regional economies

MP of other countries shadowed the US

Change in 3-month interbank rates during Apr 2000 – Mar 2004 (bps)

Malaysia	-34
US	-539
Thailand	-219
Philippines	-135
Korea	-325

Details on evaluation of measures:
2. Controls did not lead to or arise from financial repression

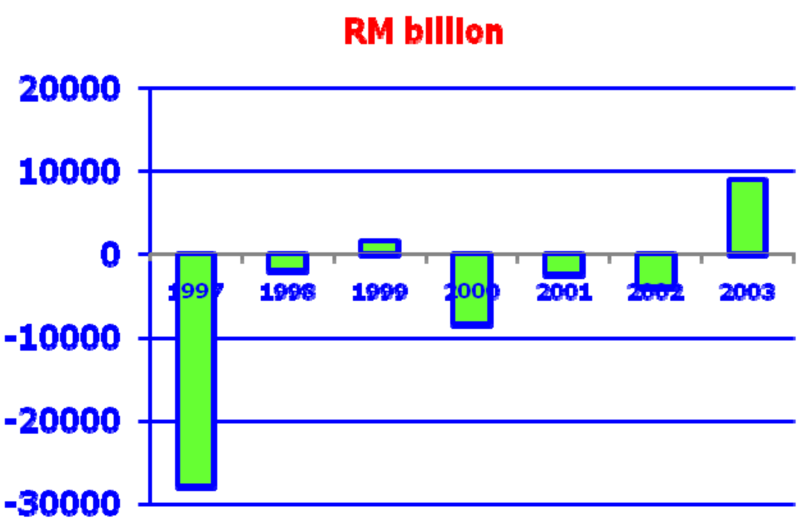
Key features of financial repression	In Malaysia, market forces determine pricing
1. Controlled retail rates	▪ Lower pricing of BLR in selective sectors ▪ Rate of decline in ALR> decline in policy rate
2. Negative real deposit rates	▪ Positive real rates a regular feature ▪ No disincentive to save, GNS among the highest in the world
3. Lending to Government at below market rates	▪ Open tender basis, bids at market rates, published results
4. Requirements imposed on banks' lending & investment	▪ Liquidity requirement abolished in 2001 ▪ SRR strictly a monetary tool ▪ Demand for Govt. papers exceeded supply
5. Central bank funding budget deficit	▪ Law prohibits funding of fiscal budget

Details on evaluation of measures:

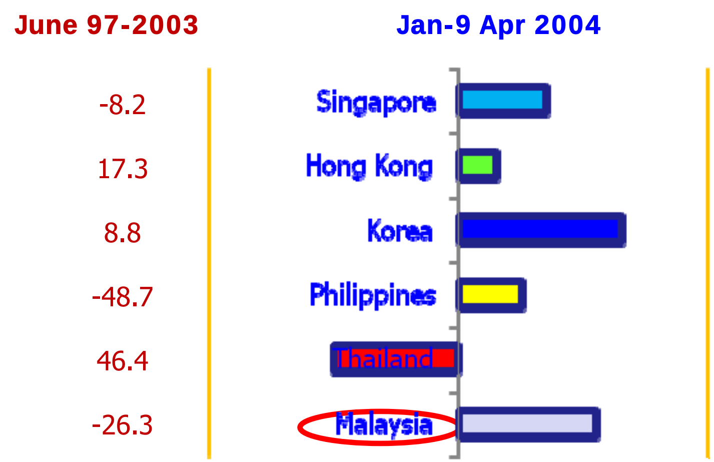
3. Foreign perception about investing in Malaysia improved over time

- ❑ Negative short-term effect on portfolio investment
- ❑ Confidence returned soon after
  - Reinstatement of MSE in MSCI Index in June 2000
  - S&P rating agency established equity research unit in Malaysia
  - Portfolio inflows returned soon after controls
  - MSE outperformed most other regional bourses in 2004

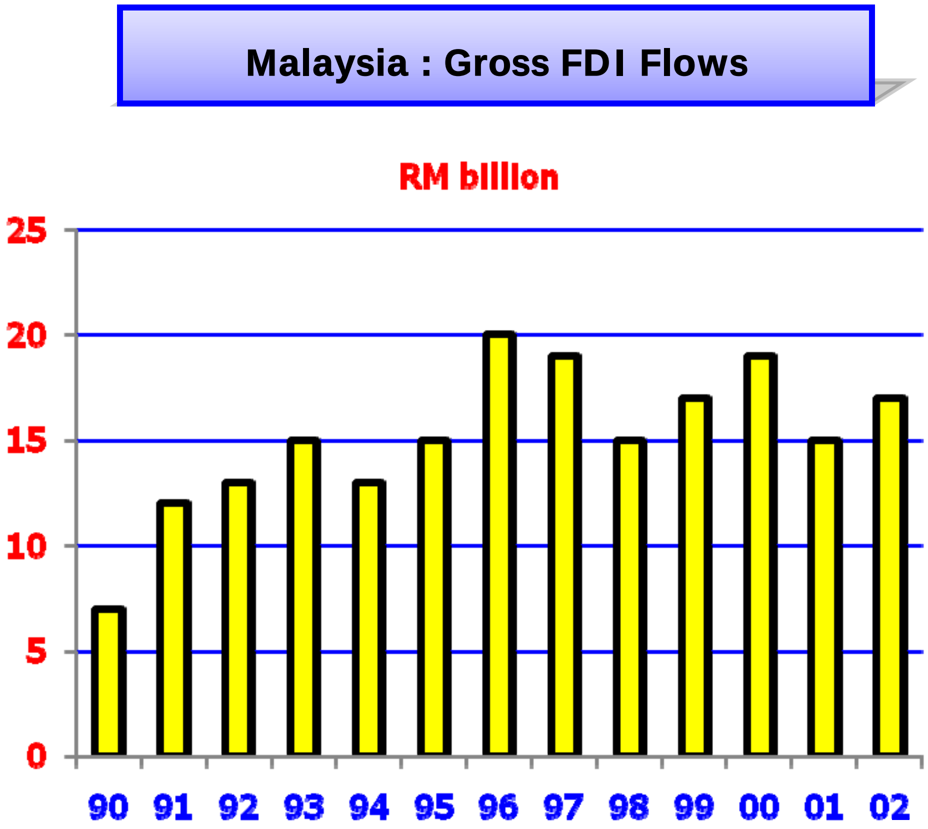
Portfolio Investment (RM b)



Performance of stock market



Details on evaluation of measures:
4. FDI recovered, changing patterns emerged

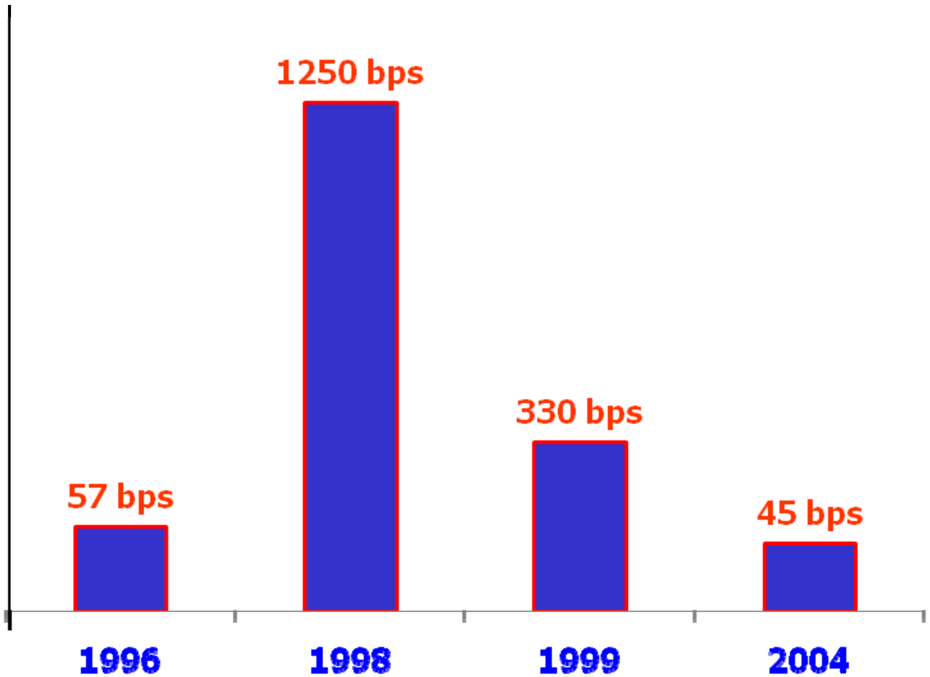


- ❑ Careful design of controls to exclude FDI flows mitigated short-term impact on FDIs
- ❑ Gross flows sustained, increasingly into high value-added services and knowledge-based activities
- ❑ Flow after 1998 in the line with structural changes in economy
- ❑ No FDI re-location post-controls

Details on evaluation of measures:
5. Continued access to external financing

- Temporary setback when controls were imposed, no access problems, but spreads rose significantly
- Spreads narrowed to below pre-crisis levels quite quickly, upgrades by rating agencies

Spread of Malaysian Offshore Bonds over US Tbills



Sovereign ratings by rating agencies

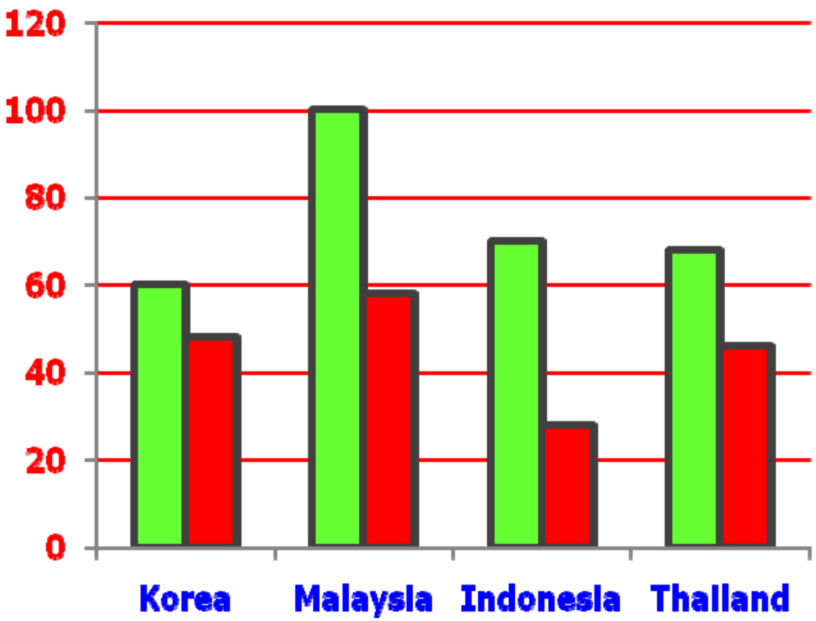
	Foreign Currency Long-term Debt, 2004			
	MOODY's	**S&P**	**Fitch**	**R&I**
Malaysia	Baa1 positive	A- stable	BBB+ positive	A- stable
Korea	A3 negative	A- stable	A stable	A- stable
Thailand	Baa1 stable	BBB positiv e	BBB positive	BBB+ stable
Philippines	Ba2 negative	BB stable	BB stable	BBB- stable

Details on evaluation of measures:

6. Provide window of opportunity to accelerate structural reforms

- ❑ Malaysia ahead on financial restructuring & voluntary corporate workouts

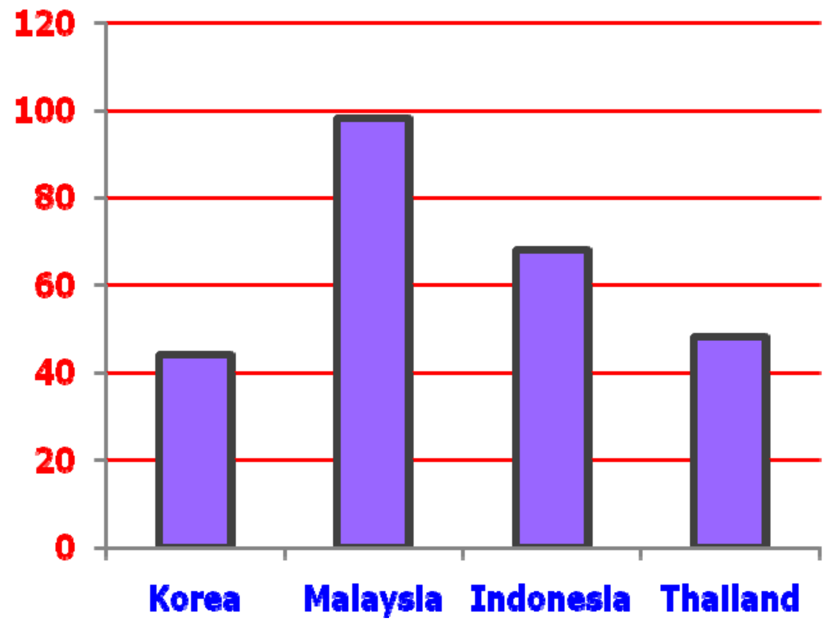
Progress of Financial Restructuring by AMC



% of assets resolved by AMC

Recovery rate of assets resolved by AMC

% of restructured corporate debt



Lessons: 1. Why 1998 controls worked for Malaysia

1. Structural adjustment in place prior to controls
   - finance company mergers
   - AMC (Danaharta) to handle NPLs
   - SPV (Danamodal) to address recap. With rationalisation of FI's
   - corp. debt restructuring

2. Without controls, external disruptions to progress of structural changes

3. Greater monetary independence---flexibility to stimulate domestic economic activity to protect employment

Lessons : 2. Critical success factors

- Controls focused on objectives

- A temporary measure

- Not a substitute for sound macroeconomic policy

- Strong fundamentals must already exist
  - No BOP problems
  - Reserves at satisfactory level
  - Low reliance on external funding

- Pragmatic & well designed implementation policies
  - Controls are specific and well targeted
  - Able to distinguish between long and short-term flows
  - Good governance and efficient administrative machinery – do not raise cost of business

Lesson 3: Implementation Process Matters

Policy Group

- Review regulations
- Assess requests
- Recommend action
- Ensure consistency in action, of all groups

Travel Approval Group

- Design the travel forms
- Special approval counter at KL branch

Communication Group

- Answer queries
- Direct interface with public, provide advice or resolve individual issues.

Consultations
•Domestic
•International

- Connect with domestic/international experts
- Feedback from business community
- Reports to NEAC

Approval mechanism

- Recommendation form
- Policy group approved by AG & Advisor

Internet Transmit Regulating Changes

- Use internet platform to disseminate policy & regulation changes.

- ***Daily Roundtable sessions chaired by Governor***
- ***All groups meet everyday at 4-5 pm to review events of the day, discuss issues & decide on specific actions.***

After 1998

- Controls removed before target date when objectives were achieved
- Resumed progressive liberalization of financial sector
- Implemented more market-based monetary & financial policy framework → liberalization aligned to financial sector master plan targets (banking sector + capital markets)
- Further liberalization of controls to:
  - Reduce regulatory cost to banking system
  - Improve efficiency
  - Flexibility to banking system to manage risks
  - Deepen capital market
  - Reduce transaction costs
- Liberalization an on-going exercise to benefit economy and with safeguards to ensure financial stability
- Improved monitoring system on flows – more use of cash bop data, securities settlement data, regional consultations.

Conclusion

- An option for small developing economies to protect against excessive destabilising capital flows in a less perfect global market
- An option to manage excessive speculative activities
- An option under extreme conditions where delayed actions could incur greater adjustment cost & social dislocation
- Effective when controls restore stability in financial markets
- Benefits sustainable over time when periods of stability used to accelerate financial & economic restructuring
- Controls are temporary & removed when targets are met.
- Going forward, a good data base on capital flows essential, leverage on technology platforms for real–time data

Thank you

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