October 15, 1998
No.5, 1998

IIMA
Institute for International Monetary Affairs
Newsletter

Malaysia's New Challenge

Hajime Shinohara
Managing Director, IIMA

Introduction

At the beginning of September 1998, Malaysia introduced exchange rate control measures and an accompanying fixed exchange rate regime. The following are some news analyses which appeared in their wake.

“The central bank hopes that this ［series of policy packages］ will halt the international speculation regarded as the cause of confusion in the foreign exchange and stock markets. Market players, however, point out that although such measures are sure to help stabilize the currency, they will also have the effect of discouraging the investment and lending from overseas which supported Asian economic growth.

Some question the extent to which such drastic regulations will have a positive effect on the country's economic recovery, and market players will continue to closely watch policy management by the Malaysian government"
－NHK News, September 2, 1998

“Malaysia allowed transaction of Malaysian companies' stock only on the Kuala Lumpur Stock Exchange from September 1, 1998. This is intended to prohibit speculation in Malaysian stocks on the Singapore over - the - counter market, which is deemed to be the main cause of the fall in stock prices. It has also been announced that transfers of capital overseas will require prior approval by the central bank. Last year's Asian crisis has raised calls in some quarters that an international framework for regulations should be considered, but no concrete measures have so far been taken. According to one local economist, this move by Malaysia 'can be said to be an expression of determination to take whatever steps are needed to protect its own markets.'

On the other hand, the strengthening of regulations could have the effect of slowing the flow of capital into such markets, which in turn will have the side effect of slowing economic recovery.

This is the basis of criticism by many market players that 'this means that the measures could have the effect of preventing further instability, but will also prohibit quick recovery of the markets.'"
－Kyodo News, September 1, 1998

These are only two examples, but media reports have tended to carry the same message that Malaysia has turned its back on the market economy and globalization, isolating it from the rest of the world. Malaysia, like many other South East Asian countries, has depended on investment from overseas to build its economy, and this flow of foreign capital has supported the rapid growth of recent years. The announced strengthening of controls and regulations will cut off international capital which requires markets that ensure freedom of action, meaning that it will effectively desert Malaysian markets, making it extremely difficult for the Malaysian economy to recover single‐handedly when the capital stops flowing in.This appears to summarize the most media reports.

The announcement of drastic measures coincided with political strife, as seen in the removal of Deputy Prime Minister Anwar Ibrahim and the resignation of central bank Governor Ahmad Don. These incidents have accumulated to paint a tense picture, which many reports have tried to convey. However, in this paper, political aspects have been set aside, focusing rather on economic policies alone.

The New Package

It is difficult to grasp a complete picture of the changes which have taken place, as those procedures related to control laws were announced without clarification of overall objectives. These can be best categorized into three groups:

● Extensively restricting international use of the ringgit. Transactions in non‐resident ringgit accounts will need prior approval, with the exception of some which are backed by real underlying transactions. The overseas ringgit balance will be eliminated, as it will contradict this rule.

● A one‐year holding rule will be applied to non‐residents' investment in Malaysian stocks, and over‐the‐counter transactions of Malaysian stocks on the Singapore Stock Exchange will, in effect, be terminated.

● Fixing of the exchange rate at 3.80 ringgit to one US dollar.

It should be pointed out that Malaysia has maintained relatively effective exchange controls over the years, and it can be said that this policy limited the damage caused by the first wave of the Asian monetary and financial crisis that began in Thailand last year. Malaysia has been able to avoid being used by the so‐called “free‐riding fund transactions"－interest rate arbitration which neglects foreign exchange risks－which take advantage of dollar‐pegged exchange rates, and its banks have not suffered from a run on foreign currencies－primarily US dollars－in overseas markets, as was the case in Korea.

There are two aspects which were considered the cause of speculative selling of the ringgit and fall in the stock market, which the latest strengthening of foreign exchange controls can said to have targeted.

First is the fact that there was a considerable amount of ringgit holdings by non‐residents

in overseas markets, partially as remnants of ringgit speculation in 1993／1994.Since this was in the course of devaluation－relative to other major currencies－of the US dollar, to which the ringgit was pegged, speculation was towards revaluation of the ringgit.

The other factor is that even after the Singapore Stock Exchange and Kuala Lumpur Stock Exchange were separated in 1989, terminating mutual listing, sale of the company stocks of both countries continued as over - the - counter transactions.

It is quite clear what the recent control measures aim at and the objective of the recent control measures can be summarized by looking first to the regulation of ringgit balances held by non - residents, which is aimed at directly cutting the roots of foreign exchange speculation by non - residents. Where there is a forward and swap market with high fluidity and a large rate of turnover, speculative positions in foreign exchange can be created by heavily selling the targeted currency in forwards and swaps. However, when there is no such market, speculators will borrow the currency, sell it on the spot market (for example), and buying US dollars to be held as assets. The important thing here is to hold the currency that is expected to devalue as a "liability," and also hold the currency that is expected to re - value as an "asset." The ringgit balance overseas had been the resource that easily created this "liability" position. However, when use of ringgit holdings by non - residents is restricted to buying domestic assets such as stocks, bonds, and real estate, the overseas ringgit balance will disappear, as there will be no reason for them to exist except for such purchases. This will invariably halt speculators who maneuver to create speculative positions.

The second set of measures, related to the stock market, were applied because stock holdings by non - residents are part of portfolio investment and, because of the very nature of such funds, they tend to sell quickly when prices rise. This tendency is quite clear from Japan's past experience. Such capital overwhelms the markets when the home country does not want it, and is first to jump off the wagon when it is most needed. Malaysia underwent such an experience during the revaluation in 1993／1994 and again during the current devaluation. It was like being hit on both cheeks, and the harshness of these experiences has led to the current measures which will keep invested capital in the country for at least one year.

This measure could be criticized, as funds that were invested before the new regulations were announced will be covered by the same rules, and there are cases in which funds that were assumed to have freedom of movement are, so to speak, trapped.

The restrictions on sale and purchase of Malaysian stocks on the Singapore market is aimed at stopping the sale of stocks in a market where the government has no means of direct intervention, and especially want to avoid the creation of positions to sell on the futures market first. This can be understood as a measure to stop the downward spiral of stock prices and the ringgit.

The final point is the fixing of exchange rates. This policy was pursued in the belief that the government has enough foreign reserves to cope with operating transactions－even when taking account of seasonal fluctuations－on the basis of first eliminating speculative transactions in the currency internationally and then establishing standard settlement rules－as Japan previously had done－and concentrating foreign currencies in the hands of the central bank. This policy promises settlement of all current transactions at the fixed rate of one US dollar to 3.8 ringgits. This may be seen as an anachronism, but there is a significant effect that

tends to be overlooked: because of this policy, the voice of the markets will be completely shut out.

It is chilling to see how greatly Japan has been influenced by the easy and dogmatic thinking of the doctrine of market supremacy. Sad to say, the same belief in market supremacy has spread throughout Asia, and the financial crisis since last year has spread this to an unbelievable degree. There are those who explain the ups and downs on the foreign exchange market as if they are determined by a voice from heaven, and apply a completely different explanation from one day to the next, using the same reasoning for opposite results. One day the ringgit will rise because of the political stability in Malaysia and the next day will fall because of political instability. They brush aside any rationality by using the market as the answer to all questions. Such an attitude raises apprehensions in the mind of the public, which in turn causes further worsening of the economy, and hence a further fall of the currency. This chain of events occurs to a degree that is a cause for real concern. It is quite rational that at the time when exchange control measures are strengthened to ward off speculators, the exchange rate should be fixed simultaneously. Such an overall policy is very effective in providing a better understanding of objectives and eliminating anxieties.

Background of Recent Policy

The announcement by the Malaysian government last December of some emergency tightening policies, including a partial freeze on budget expenditures, was widely welcomed. This was because these policies were accepted as being very similar to the conditions the IMF would impose if Malaysia should request its support. In other words, Malaysia was seen as spontaneously imposing the IMF prescriptions.

The effect of this can be seen in the fact that the ringgit actually rose fairly extensively, as compared to its lowest point. However, since the beginning of this year, the budget cuts and IMF - style high interest rate policy slowed the economy to an extensive degree, resulting in a drop in corporate profits. Last December the economic outlook for this year was 3.0% growth, but in reality the economy showed a drastic shrinkage, recording minus 2.8% for the first quarter and minus 6.8% for the second. For a country of the size of Malaysia, with such a heavy emphasis on the national budget, the downfall of the economy must be stopped by lowering of interest rates and using public financing.

It is well known that it is not possible to simultaneously achieve the following three objectives, even in a medium to small economic framework of a developing country such as Malaysia: foreign exchange rate stabilization through assurances given by policy maker, whether in the form of fixed exchange rates, dollar - pegging, or target exchange rates; liberalization of the financial markets, including capital transactions; pursuit of the independent monetary policy that Malaysia's economy requires.

If a government tries to pursue all these at once, it will invite a parade of “free - riders" from corporations and financial institutions—as was typically seen as the main cause of the crises in Mexico in 1994 - 95 and currently in Thailand—which ultimately results in a crash. The choice is for the governments to make.

One pattern was Hong Kong before the crisis. It had abandoned an independent monetary policy and had accepted the American interest rate framework. Another pattern is China, which placed emphasis on having an independent monetary policy and assurances of a stable exchange

rate, abandoning the liberalization of foreign exchange and capital transactions. Malaysia can be said to have made the Chinese choice this time, opting to stabilize domestic psychological insecurity by fixing the exchange rate, strengthen foreign exchange controls so as to pursue an looser monetary policy, and to stop capital transactions—especially short-term capital transactions—and the development of speculative positions.

It is reported that these basic policies were decided unanimously at the beginning of August, after the supreme strategic committee of five, including Prime Minister Mahathir, Deputy Premier Anwar, and former Minister of Finance Daim, met 26 times for intensive and thorough discussions. This fact leads to the belief that it is unlikely that the Prime Minister and Deputy Premier were split over economic policies, and that their conflict is purely political.

It seems that Malaysia waited until September to put new policies into effect because of the developing situation in Russia during August and the ensuing global credit crunch. Through the course of events, most of large and small investment trusts—including hedge funds which can be seen as speculation-oriented and without national identity—were hit to different degrees. This was true of those who were hit directly because of positions in Russia, as well as those who were hit by the stock downfall in Latin America. This meant that an extensive move to cut losses (which results in withdrawal of funds) and to recover the losses were about to be set in motion. It was about this time that in all developed countries the price of government bonds began to rise and the risk premium between government bonds and private bonds, and between local government bonds and stocks began to expand. This was evidence of another flight-to-quality, similar to those which occurred globally in 1974 and the mid-1980s.G7 policymakers have announced a policy to jointly lower interest rates, and that it is most important to closely monitor the movement of funds.

Malaysia must have felt helpless and threatened in the face of such tumultuous upheavals, the effects of which must have been felt even more harshly for being such a small country. The recently implemented policies are rational measures that had to be taken to place Malaysia outside the volatile movements of international capital to pursue independent fiscal and monetary policies which will put its economy back on the right track.

Outlook for the Future

It is correct to be optimistic that the policies recently taken by Malaysia will work smoothly, and that its economy will return to a normal course of development. There are a number of reasons behind this prediction.

One is that, as mentioned before, Malaysia has maintained a well organized foreign exchange and foreign currency control system. This means that Malaysia has not easily invited foreign currencies and funds, and so has not suffered from the sudden shortage of foreign currency which occurs from abrupt and simultaneous withdrawals. Needless to say, the recent policies have not affected trade-related and other current transactions. However, as there will effectively be no ringgit-denominated transactions in overseas markets, ringgit-denominated price-making and settlement with parent companies or other subsidiaries, in the case of foreign companies in Malaysia, are likely to be affected. Many foreign companies have been making direct investments under the highly organized control laws and foreign exchange laws up until now, however, and there is no reason to believe that the tightening of some aspects of such regulations will inhibit direct investments. It is even beneficial that foreign companies thinking about direct investment can be assured of a fixed exchange rate and that there will be no market

turbulence due to speculation and consequent volatile exchange rate fluctuations. Adjustments will be made so that necessary funds can be borrowed domestically in the first instance, as in the past. It is also believed that if it is necessary to borrow capital investment funds or operating funds in foreign currencies, the central bank will allow it. So the only foreign funds that will be inconvenienced are investment funds—speculation-aimed and without national identity—that move around in a disorderly manner to build up speculative positions, and, when successful, run away with the gains. They will not be able to take advantage of Malaysian markets and fluctuations in the ringgit, and would probably feel quite frustrated. If this is perceived as Malaysia turning its back to global markets and becoming an economic hermit, I am sure it will happily bear such an accusation.

On the contrary, I believe that the set of policies taken by Malaysia is of positive and significant meaning. It has been understood that there should be some ways to regulate the international movement of short-term funds, which was one of the causes of the financial crisis that began in Thailand. There are many kinds of international short-term capital, such as those that are in the form of normal current transactions by banks, funds from institutional investors such as life insurance companies, pension funds, and speculative investment funds. Funds from different institutions can be regulated by the authorities by tightening the reins. This is one of the reasons for asking financial institutions to provide ever-greater amounts of information.

However, of funds whose aim is speculative operations, there is no openness or transparency of, for example, hedge funds. It is unrealistic to believe that there are ways to control their irresponsible, free-riding activities effectively. From the point of view of the victims, they have to put aside the damage that has already occurred and implement measures to avoid being victimized in the same way in the future. To accomplish this, it is necessary to regulate the inflow of foreign funds, especially short-term funds. This may be contrary in some ways to the doctrine of market supremacy of the market-liberalizing world, but such regulation should be permissible for certain countries, depending on their stage of development and size. Malaysia's experience may afford a good example to such countries.

Expectations of Japan

What is expected of Japan? First, as is repeatedly said, to put its economy back on the track of growth as fast as possible and to clean up the mess in its financial community. Next is to take steps to achieve a higher yen. The tendency of the past year has been that when the yen is sold, so are the other Asian currencies. It is necessary to stop this trend in order to give them room to put their houses in order. In addition to that, it must be remembered that the higher yen was the incentive for more direct investment by Japan in other Asian countries, which had supported their development. There is high demand for direct investment from the private sector and lending of necessary foreign currencies by Japan.

In addition to this, a long-term stable supply of funds from public institutions—including yen lending by the OECF and loans by Exim Bank—is also highly sought. Malaysia has decided not to depend on irresponsible foreign funds, which puts more weight on the long-term stable foreign funds.

It is time to consider providing the funds necessary to rebuild Malaysia's financial sector through bilateral cooperation. It is likely that there will be cynical objections to this suggestion,

comments that Japan has not even put its own financial house in order. However, such an extension of funds is possible without any additional fiscal or tax burden if Japan's foreign reserves are utilized. It is surprising that the currencies of Asian countries, with whom Japan has very close economic relations, and with whom, so to speak, Japan shares its destiny, are not included in the foreign reserve.

It is quite rational that the ringgit should be included in Japan's foreign reserve as a way of diversifying foreign reserve operations. This can be done by buying the newly - issued ringgit - denominated government bonds and paying for the purchase by selling some US government bonds. Again, there will be objections that this will cause unnecessary confusion in the US government bond market, but this operation is not only technically feasible, but US government bonds are now bought extensively in the United States. Prices will be favorable in the near future, providing exceptionally good timing, and thus this operation should be seriously considered.

©1997 Institute for International Monetary Affairs
All rights reserved. Except for brief quotations embodied in articles and reviews, no part of this publication may be reproduced in any form or by any means, including photocopy, without permission from the Institute for International Monetary Affairs.

Address: 2-2, Nihombashi Hongokucho 1-chome, Chuo-ku. Tokyo
103-0021, Japan
Telephone: 81-3-3245-6934, Facsimile: 81-3-3231-5422

e-mail: admiima@ppp.fastnet.ne.jp
URL: http://www.fastnet.ne.jp/iima/