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Forex moves will help expedite economic recovery

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MALAYSIA's foreign exchange policy measures will enhance its prospects for success of overall adjustment programme and will likely improve the country's sovereign credit profile, said US-based financial services group Salomon Smith Barney.

In an overview on Malaysia, the company said the policy initiatives should improve the Government's ability to bring forward the timing of economic recovery as they help reduce the damage to corporate Malaysia's collective balance sheet, which means lower non-performing loans and greater success of corporate debt restructuring.

Salomon referred to the new strategy as a "low sovereign debt strategy" and if successful, will reduce the overall need for external government borrowing by reducing the cost of bank bailout and restoring the economic conditions needed to attract and keep foreign private capital.

The report by Salomon summarises the new foreign exchange regulations introduced recently into four key features.

First, it includes fixing the ringgit exchange rate at RM3.8/US\$1.

Second, regulations were put in place to prohibit most types of offshore transactions in ringgit, especially offshore trading while all export and import transactions are to be conducted in foreign currencies, not ringgit.

Third, fund transfers abroad by Malaysian residents for import payments, foreign debt servicing, or transactions related to direct foreign investment in Malaysia remain free of any controls and are monitored for statistical purposes only. Other transfers by Malaysian residents are subject to statistical reporting by the central bank.

Fourth, ringgit assets acquired with funds from external accounts (set up in Malaysia by non-residents for the purchase of ringgit assets) must be held in Malaysia for a period of at least one year.

"The measures are a significant break with Malaysia's past policy of maintaining one of the world's most open foreign exchange regimes," it said.

But as the Prime Minister Datuk Seri Dr Mahathir Mohamad has clearly pointed out, the policy does not represent an abandonment of reforms or free markets, the report said.

Based on Salomon's assessment of the likely impact of the policy changes on the country's sovereign risk profile, it said the risk of failure is far lower than the risks associated with adherence to a high interest rate strategy.

However, external developments beyond Malaysia's control such as global liquidity conditions could upset the strategy.

Following the measures taken to stabilise the ringgit, Malaysia currently has a relatively strong external payments position which improves the chances of success for Dr Mahathir's "policy breakaway".

This includes a sizeable current account surplus which means Malaysia will have no need for net additional foreign capital inflows in 1998 and 1999, from a strict balance of payments perspective.

It will also result in short-term debt that is half the size of foreign exchange reserves, which means the country is not highly vulnerable to credit outflows over the short term.

These features, said Salomon, suggest that Malaysia can afford to lose access to equity portfolio flows for a period of time, a likely

consequence of the capital controls, provided that Malaysia can retain the confidence of foreign banks and to a lesser extent, bond investors.

Salomon said the success of the strategy hinges on convincing domestic and foreign investors that it will work and this can be done through "two lows and a moderate" - low inflation, low interest rates and moderate growth.

This two lows and a moderate are important to convince private creditors, bankers and bond buyers alike to open up their cheque books for the country, it said.

Describing Malaysia's international liquidity as being in a good shape now, the report said the country must be able to maintain that liquidity if recovery is to proceed as planned.

In this context, commercial banks and official creditors such as Asian Development Bank, the World Bank and friendly governments occupy the most critical role.

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