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Malaysia's revival stylish, sustainable

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WEEKS before the Government announced the selective capital controls on September 1 last year, the media were already making speculations. Ideas were thrown around on how to arrest the worrying decline of the ringgit.

One was to create a currency board and another was to have a trading band on the ringgit.

This way, the currency would fluctuate between a fixed range of exchange rate which would eliminate any drastic decline.

When Prime Minister Datuk Seri Dr Mahathir Mohamad announced details of the selective capital controls this day last year, he shocked the International Monetary Fund (IMF), a great many foreign investors and fund managers, and not a few Malaysians.

After his attacks on currency speculators and hedge funds at the Hong Kong meeting of the IMF and World Bank, many were convinced that Dr Mahathir was desperately trying to save a sinking vessel.

Bank Negara Malaysia, as the custodian of the Malaysia currency looked at all the possibilities and decided on the selective controls.

First and foremost on the central bank's mind was how to control the currency as it was evident that the fluctuations were not entirely driven by market forces.

Hedge funds making profits by betting on currencies were part of the problem.

The immediate impact of fixing the ringgit's exchange rate and making it illegal to trade it offshore effectively curtailed any unwanted bets on the currency. What hedge funds needed - offshore ringgit - was no longer available.

The ringgit was fixed at 3.80 to the US dollar. This helped sort out a number of problems faced by businesses as well as the central bank.

For any central bank that guards a floating currency, there would always be an interest rate dilemma.

Under the floating exchange rate system, high interest rates were considered good for strengthening the external value of the ringgit but bad for the ailing domestic economy. One cannot target interest rates and exchange rates simultaneously. If the former is the target, the latter will have to be left free and vice versa. Hence the interest rate dilemma.

A straight forward solution was obvious. By disallowing the ringgit to float in the forex market, the monetary authorities no longer have to worry about the impact of interest rate policy on the exchange rate. Businesses which relied on imported input started to breathe easy with the fixed ringgit exchange rate. Inflated costs due to the ringgit's depreciation had prompted companies to pass on these increases back to the consumers.

"How do we do business when prices have to change every so often? Now, we know what our cost is and customers will be assured of a stable price," said Rafik Mohd Shah, the former finance director of Nestle (M) Bhd.

At the other end of the spectrum is exporters. A lower exchange rate at RM3.80 meant a more competitive pricing for their products. Despite this, other currencies in the region had also been devalued and this created a highly competitive scenario as exports from this region became cheaper. The selective controls also stipulated that the country's exports must be paid in foreign currency. This was done in order to address the

country's current account deficit of RM12.2 billion and RM14.2 billion posted in 1996 and 1997 respectively.

Malaysia managed to reverse it to a surplus position of RM36.1 billion in 1998. To kickstart the economy, the Government quickly addressed the soaring interest rate problem. Bank Negara cut the three-month intervention rate enabling the base lending rate to ease from 12.21 per cent in May last year to 6.81 per cent in August 1999.

The central bank also realised the banking system's need for liquidity and thus cut the statutory reserves requirement from a high of 13.5 per cent to four per cent currently.

This made it possible for banks to lend again to productive sectors that can help revive the economy.

Following the imposition of the controls, the stock market which plummeted to a 10-year low at 262.70 points on September 1 1998 rebounded to close at 389.08 points on September 15 1998.

However, it was still about 65 per cent lower than it was in June 1997, as was market capitalisation.

For the whole of 1998, the gross domestic product (GDP) contracted by 6.7 per cent, and the climb-back has been arduous, but signs of a turnaround started to emerge in the final months of the year.

As a result, in the first quarter of 1999, GDP contracted by a significantly lower 1.3 per cent, with the months of February and March recording positive growth.

Malaysia emerged from five straight quarters of contraction to post an impressive 4.1 per cent GDP growth for the second quarter for 1999.

Consumer confidence has returned and even Morgan Stanley capital International Inc has decided to put Malaysia back on its indices.

The anniversary of Malaysia's capital controls should not cause jitters. As with Merdeka celebrations the day before, it should be an occasion to celebrate as the nation has shown the world that there is an alternative to painful and punishing but yet not guaranteed to succeed prescriptions of the IMF.

While other crisis-hit countries in the region have also begun to experience signs of economic recovery, Malaysia's revival is certainly most stylish and most probably the most sustainable.

The rate of recovery in other countries will continue to depend on major external developments as well as the likelihood of another round of currency attack. It will be some years before they repay the debts owed the IMF and there is the sad fact that many local institutions and corporations had to be transferred to foreign ownership and custody as a result of the bail-out.

There is also anxiety on a possible devaluation of the yuan but a bigger concern to the crisis-hit economies in the region is the American economy. Its stock market is riding high on an unprecedented economic boom. Contrast that with having a massive current account deficit and it is also the world's biggest debtor nation.

Recently the Federal Reserve has put the brakes on the US economy by slightly raising interest rates. That move, however, failed to dampen Malaysia's recovery.

Even Harvard economist Paul Krugman, who was probably the first to advocate capital controls when it was clear that the IMF was failing miserably in its tasks to deal with the crisis, was awed by how the selective controls have worked and succeeded in insulating the Malaysian economy from external shocks.

Krugman has suggested, however, that Malaysia not wait too long before dismantling the controls as in the long run, the costs of keeping it would be high.

However, Dr Mahathir said Malaysia will only lift the controls when the international financial architecture is reformed. This time round, very few people would want to stake their reputation and go against this doctor's prescription.

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