

Financial Stability Through Exchange Controls:Malaysia's Experience

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I am pleased to be here tonight among distinguished guests and experts and I feel honoured to be asked to talk about Malaysia's own experience in maintaining financial stability through selective currency or exchange controls. Before I proceed with my talk, I would like to thank the organisers, the Asia Society for inviting me to speak at this occasion.

2. Since July 1997, Malaysia and a number of Southeast Asian economies together with Korea have been afflicted by such a severe financial crisis that it has destroyed the Asian tiger image of our countries. Nevertheless, we are now back on different levels of the recovery path after implementing stabilisation and structural adjustment measures. As is well known, Malaysia adopted a home-grown set of policies and strategies as enumerated in the National Economic Recovery Plan (NERP) that was launched in late July 1998.

3. Since independence Malaysia had managed its economy and finances relatively well. We did not depend on foreign aid nor did we borrow much from foreign sources, neither the Government nor the private sector. We therefore believed that we would not get into the kind of trouble that Thailand or the Latin American countries often suffer from.

4. Unfortunately the currency traders did not spare us. They only saw opportunities for making vast sums of money by deliberately devaluing our currency. Many believe that the finances of a country must be weak before the currency can be devalued. Actually whether the financial situation of a country is good or bad is quite irrelevant. Even corruption, nepotism or cronyism are not factors contributing to the devaluation of a currency. It should be remembered that the countries of Southeast Asia were growing at very high rates economically. Corruption, nepotism, cronyism and lack of transparency were all there all this while that the economies were achieving their so-called 'miracles' and becoming 'tigers' and 'dragons'. Their currencies fluctuate minimally and harmlessly, never affecting their economic performance.

5. The currencies only devalued rapidly when the currency traders started short-selling them. The traders were not in any danger of losing money because they never had and never bought the currencies. When they want to trade, all they do is to borrow the currency and sell it, so that the currency devalues. Then when the currency devalues further they would buy and deliver to their earlier buyer making a considerable amount of profit as they deal in very large sums of money. Their leveraged funds were unlimited and it was futile for Central Banks to buy all that the traders were selling. Central bankers who tried to defend their currencies invariably lose all their foreign exchange reserves and were landed with a lot of their own much devalued local currency.

6. Clearly the currency traders can attack any of the developing countries, especially those which are doing well like the so-called 'Asian Tigers'. It was not

their weakness which precipitated the attacks. Observers must notice that they never attack poor countries however weak their finances may be. It is not because they are being kind, but because there is no money to be made.

7. I am sure all of you know how currency trading is done but I have to relate the process because people talk of devaluation as if currencies have sensors and can detect when the Governments are corrupt, nepotistic etc. When they do they seemingly devalue themselves. You know they don' t. Some people do that and the people are the currency traders out to make fortunes for their rich investors.

8. Malaysia had some experience in currency trading but we confined ourselves to the currencies of rich countries. We speculated. We never had enough or could leverage enough in order to move the market in the direction we wanted. When Britain failed to join the European Monetary Union we lost almost two billion Ringgit. We got out but we learnt valuable lessons which stood us in good stead when our Ringgit was attacked by currency traders. We knew what they were doing and how they were doing it. We studied their activities closely and were finally able to frustrate them and save our currency.

9. Initially we thought of countering the currency traders impoverishment of our country and people by increasing the incomes of all our people. This involved putting more money into circulation. In effect it would be the classic approach of countering inflation by devaluing the currency - only it would be the other way round. But it would not stop the currency traders from devaluing the currency further or even revaluing it upwards. We could not be chasing the fluctuations in the currency values, as we cannot reduce the currency in circulation as easily as we would increase. We cannot print money and then destroy it. And so we rejected the idea.

10. But the currency traders were still devaluing our currency and impoverishing our people. We had to do something even if it was only palliative.

11. We set up what we named the National Economic Action Council with members from both the private and public sectors. The problems faced by both sectors as a result of the downturn were aired and discussed in order to find solutions. Briefings on the current economic situation in the country and among neighbours kept us posted as to what is going on and what possible solutions could be formulated.

12. An Executive Committee of seven pored over economic data daily and decided on actions to be taken to prevent the economy from collapsing and to rejuvenate it. Thus the unemployment rate was minimised, inflation kept low, sales of goods, motor- vehicles, houses, shops were stimulated, interest rates lowered and enough money made available to the banks; imports were reduced while exports were increased. We watched the balance of trade as it turned in our favour.

13. We implemented scores of schemes to minimise the effect of the Ringgit devaluation and the fall in share prices. We estimated we lost about 50 billion US

Dollars in terms of purchasing power of imports and 150 billion US Dollars in market capitalisation. We could not afford to have the currency devalued further and the stock market raided. We had to put a stop to the slide or we would have to turn to the IMF for loans and surrender our control over our economy.

14. Malaysia is a multiracial country where wealth is not evenly distributed. In 1969 we had race riots due to jealousies over economic wealth and political roles. We devised an affirmative action programme and shared the governing of the country with more of the opposition parties. We succeeded in reducing racial tensions and reduced politicking to the minimum so we could concentrate on economic development. Our strategy worked. The relations between the races improved so much that even the severe economic turmoil did not cause outbreaks of racial fights and quarrel.

15. The IMF wouldn't understand this. They would force their standard formulas to be implemented. Banks owned by different ethnic groups, a politically sensitive matter, would be closed. Credit would be tightened, interest rates increased and the NPL percentage would be increased by shortening the period of default. They would want to see companies bleeding to death to show how sincere the Government is in implementing their orders. Foreigners should be allowed to buy shares unrestricted after the short-sellers had reduced the share prices to one-tenth of their former market value. The banks should be sold to rich foreign banks again at fire-sale prices.

16. If the people suffer from unemployment and inflation then they should blame the Government for practising cronyism and nepotism in the past, for being corrupt and not transparent. They should overthrow the Government in order to create confidence for foreign investors to buy up the local businesses. And so on and so forth.

17. The financial turmoil had already undone most of the success of the affirmative action. The IMF in its usual uncaring way would worsen the situation further. And there would then be race riots and prolonged political instability. Then the foreign investors would not come in because they would all be flying to quality i.e. to Russia and Latin America where there is a lot to be made by undermining the economies of these nations.

18. Since the IMF is not an option for Malaysia, we had to think of something homegrown. The only way for the economy to recover was for the exchange rate of the Ringgit to be stabilized and the stock market to be protected from further attacks.

19. To stabilize the Ringgit it must be prevented from getting into the hands of the currency traders. The Ringgit has been made freely convertible for a long time. A lot of Ringgits were held by foreigners who could sell or lend without restriction. The attempt by the Government to prevent cash from being taken out of the country was naive. Electronic transfers of funds across borders and subsequent lending and sale made such restrictions useless.

20. Singapore is the biggest currency trading centre in Southeast Asia. The Singapore Government holds the Ringgit as part of its reserves. To increase the flow of Ringgits to Singapore where it was being lent to currency traders for short-selling, the Singapore banks offered very high interest rates. Malaysia could not raise interest rates as this would kill our businesses. And so large amounts of Ringgits flowed out of the country leaving Malaysian banks without money to lend to Malaysian businesses. With this both the banks and the businesses became moribund.

21. To stop the currency traders from borrowing Malaysian Ringgits and selling it down, the Government declared that Ringgits outside the country in whatever form i.e. Ringgits held in foreign accounts would not be allowed to be repatriated to Malaysia one month after the control was made official. This means that banks in Malaysia may not transfer funds belonging to non-residents in the account of foreign banks except to Malaysian entities during the first month of control. After that no transfers would be allowed at all. Effectively this made Ringgits held abroad totally worthless for purchases or for trade or exchange within or outside Malaysia.

22. And so currency traders found themselves unable to buy or borrow Ringgits in order to sell. Short-selling was stopped and only the Malaysian Government could determine the exchange rate of the Ringgit.

23. Many thought the Malaysian Government would push up the Ringgit to its former level. This would have made imports cheaper but it would also increase the cost of Malaysian exports. We would have become very uncompetitive against our neighbours. We chose an exchange rate that was neither too high nor too low.

24. Malaysia had sufficient reserves and a big trade surplus. We were able to earn enough foreign exchange to pay for our imports. We could make available enough foreign exchange to long-term investors wanting to take out their profits or even if they wanted to liquidate and take out their capital.

25. Short-term investors may take out their profits but may only take out their capital after one year.

26. Far from seeing an outflow of funds, the positive balance of trade resulted in foreign reserves growing rapidly. There was never a time when there was insufficient funds to pay for imports. The expected black market in foreign currency did not materialise. Instead the fixed exchange rate reduced the cost of doing business in Malaysia as hedging became unnecessary.

27. Reviving the share market was more complex. Government had disallowed short-selling as soon as attacks were mounted against the KLSE. It soon became clear that share prices were still being pushed down the way the currency was being devalued. Some people were short-selling obviously, some very smart people with an agenda that went beyond just profits.

28. When Malaysia decided that the Singapore Stock Exchange should not trade in Malaysian shares, the Singapore Government created an over-the-counter market in Malaysian shares operated by a stock-exchange called the "Central Limit Order Book". The Malaysian Government never recognised this market. As far as Malaysia is concerned it was illegal. Appeals to the Singapore Government to close down CLOB went unheeded.

29. The unfortunate thing is that transactions through the CLOB affected share prices on the KLSE. Whereas short-selling could be stopped in Malaysia, it was free to be done in Singapore. Share prices dropped so much as a result that holders of shares could not meet margin calls. Loans were defaulted and the companies already in trouble because of the devaluation, high interest rates and shortage of funds in the banking system were deprived of funds completely. They were all rapidly collapsing. And the banks were also in distress.

30. CLOB was able to avoid registering changes in the ownership of shares following trading by having all shares registered in the name of nominee companies. Thus while the transactions did not change the ownerships of shares on the KLSE, the prices paid affected share prices on the Malaysian index. Short-selling through CLOB soon wiped out two-thirds of market capitalisation, bringing the Composite Index down from 800 plus to 262 on September 1st 1998.

31. To stop CLOB, registration through nominee companies was disallowed. Owners of shares had to register directly with the KLSE and trade in these shares were stopped until the status of these shares could be determined.

32. Almost immediately the share prices on the KLSE picked up. The Composite Index gained rapidly until at one time it registered an increase of almost 200 percent over the lowest figure in September 1998. The companies and their Malaysian share holders were relieved of unpaid loans as there was no more margin calls. The collaterals matched the loans again.

33. Making the Ringgit worthless outside Malaysia and stopping it from being brought back into the country one month after controls were imposed resulted in a massive inflow of the Ringgit. There was now sufficient funds in the banks for the interest rates to be lowered drastically without the money flowing out to Singapore. Cheaper loans were thus made available to the companies and for hire-purchases. Sales of motor- vehicles and landed property picked up immediately.

34. When the Government was implementing the IMF policy without the IMF, an attempt was made to have a surplus budget by cutting back on Government expenditure by 21 percent. Since 80 percent of Government expenditure is on emoluments, cutting back by 21 percent meant no development expenditure. The result was a severe contraction in the construction industry, a vital sector which contributed much to the GDP. The building material industry also suffered very badly. Trying to achieve a surplus as advised by the IMF was a most unwise thing to do. It could not help economic recovery. It merely worsened the

situation.

35. When controls were implemented the Government decided on a deficit budget and restarted all the development projects. Almost instantly the construction industry revived and helped the economy to grow.

36. The controls were imposed in the last month of the 3rd quarter of 1998. It was too late to stop the GDP contraction of - 6.3 percent in the last quarter. The first quarter of 1999 saw a much smaller contraction of - 1.3 percent. The second quarter saw a growth of 4.1 percent.

37. When we imposed controls we were vilified and condemned by practically the whole world. We were told our economy would be shattered as a black market in foreign currency would undermine our controls. We were called pariahs, idiots with no understanding of economics and finance.

38. Now the comments are kinder. Even our most virulent critics have admitted that we have succeeded in overcoming our economic problems, that we are growing again. Some even project better growth than we do.

39. But now we are being advised to lift controls as we are now stable. We are not about to do so, not unless the world curbs the currency traders and design an international financial structure that is less liable to abuse by the avaricious.

40. I am trained as a medical doctor. I not only have to cure my patients but also to advise them not to expose themselves to a recurrence of the disease if possible.

41. The currency traders, the highly leveraged funds and the possibility of their attacking us is still there. We will not lift our selective controls until the threat is removed.

42. We are doing quite well and we are not doing any harm to anyone other than the currency manipulators. We only wish the world to know that there are many ways to skin a cat. The idea that there is only one way to tackle an economic problem is erroneous. So please leave us and our selective controls alone. What people think of us is not important to us. People have never thought well of us at any time. What is important to us is that we do well for our country and our people.

43. Thank you for listening to this tedious narration.