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Financial Policy and Management of Capital Flows: The Case of Malaysia

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NOTE

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Chapter 1

INTRODUCTION

THE management of capital flows and related issues such as the exchange rate and macroeconomic policies have become important to developing countries as they increasingly interact with the global economy, especially global finance. While finance has usually been seen as an important tool for economic development, in recent years it has also been an area of concern as the economies of many countries were destabilized because of problems or shocks originating from the financial sector.

This paper reviews the evolution of Malaysian financial policy, focusing especially on policies regarding various types of capital flows. Related issues such as management of the exchange rate and macroeconomic policies are also examined.

The paper describes the main features of the policies instituted by the Malaysian government in response to the financial crisis of 1997-99. An innovative mixture of policies relating to stabilizing the exchange rate, selective capital controls, counter-cyclical macroeconomic policies, and the revival of financial institutions and corporations was adopted. This set of policies was unorthodox as they were contrary to the usual policy mix that the International Monetary Fund (IMF) has been prescribing.

The paper then discusses changes in policies since the mid-1990s crisis. In recent years, there has been a liberalization of the capital account, with increasing freedom given for both inflows and outflows of funds. As at 2008, the economy is more financially liberalized than at 1997, on the eve of the crisis. As a result, the economy has become more vulnerable to sudden and significant shifts in capital. In particular, there have been large outflows of funds by domestic banks and residents in the past few years, adding to the more traditional outflows of profits by foreign firms. While these capital outflows have been covered by the large trade surpluses of recent years, they could contribute to weaknesses in the balance of payments should the trade surplus decline as a result of adverse conditions in the global economy, and if this is also accompanied by outflows of foreign portfolio capital. The volatility of foreign portfolio flows became rather extreme in 2008 with the onset of the global financial crisis, with massive outflows in the second and third quarters following large inflows in the first quarter. Mainly as a result of these huge outflows, the overall balance of payments slipped into deficit in the second half of 2008.

Chapter 2

THE 1997-99 CRISIS AND POLICY RESPONSE

a. The financial and economic crisis

IN 1997 several East Asian countries began to experience serious financial problems. They had received large inflows of capital, including bank loans (denominated in foreign currencies) and portfolio capital (especially foreign purchase of equity in the local stock exchanges). A significant part of the foreign loans was not channelled to activities that yielded revenue in foreign exchange, and thus a mismatch occurred, at least in the short term, so that pressures built up on foreign reserves. Sharp declines in the currencies triggered by speculative attacks started a chain of events leading to financial and economic crises.

Like other East Asian countries, Malaysia had a relatively open capital account. However, local companies were allowed to obtain foreign loans only with central bank permission, which would be given only if and to the extent that the loans were used for activities that would yield revenue in foreign exchange that could be used for loan servicing. This regulation prevented the country from having the scale of private-sector external debt that brought Indonesia, Thailand and South Korea to the brink of external debt default. Malaysia's debt situation remained manageable although there was a possibility of debt-servicing difficulty if the domestic currency, the ringgit (RM), depreciated even more sharply.

The ringgit, which had for years been stable at RM2.40-2.50 to the US dollar, depreciated and reached a low point of 4.88 on 7 January 1998. A major cause was speculation as the ringgit was subjected to short-selling by financial institutions. The currency depreciation increased the burden of external debt servicing. There was also a large reversal of foreign portfolio capital flows.

Although the country did not resort to an IMF loan, the government nevertheless undertook IMF-type policies in the first year of the crisis (mid-1997 to mid-1998). These included: allowing the currency to float with minimal intervention; maintaining an open capital account regime; increasing interest rates; a tight monetary policy; and a drastic reduction in government budget expenditure.

The orthodox policies led the economy into a sharp decline. The jump in interest rates raised the debt-servicing burden of local companies. The banking system was hit by an increase in non-performing loans and some banks came under stress. The stock market fell, and consumer demand declined. Real GDP growth turned from plus 7.3% in 1997 to minus 7.4% in 1998. Local savings were channelled abroad.

From mid-1998 the orthodox policies started to be reversed. Bank Negara Malaysia, the country's central bank, eased its monetary policy by reducing the statutory reserve requirement and by reducing the three-month intervention interest rate, whilst fiscal policy also became expansionary. In September 1998, measures were taken to fix the exchange rate and institute selective capital controls.

On 1 September 1998, measures were introduced which aimed at stabilizing the currency (through fixing of the exchange rate to the US dollar); preventing overseas speculation on the value of the local currency and local shares (by banning the overseas trade in these); and reducing capital outflows (through selective capital controls). This set of measures was a watershed as until then it had been almost taboo for economists, let alone governments, to even discuss capital controls.

b. The Malaysian counter-crisis strategy

The key elements of the Malaysian strategy included a full use of macroeconomic and financial policies, including capital controls, in order to stabilize the currency and facilitate a rapid recovery.

Monetary and fiscal policies

A major part of the policies was the reduction in interest rates. The central bank three-month intervention rate was reduced from 11% at end-July 1998 to 6% on 3 May 1999. After the introduction of capital controls, interest rates were reduced further throughout 1999, falling to some 3% in December, compared to 5% in Thailand, 6.7% in Korea and 13% in Indonesia.

The government also implemented an expansionary monetary and credit policy. During the initial phase of the crisis, credit flow had slowed to a trickle. The Malaysian alternative strategy was to increase liquidity in the system. The government reduced the statutory reserve requirement from 13.5% to 10% in February 1998 and 4% in October 1998. A target was set for the banks to increase their loans by 8% in 1999. The government also reverted to the original definition of non-performing loans as loans not serviced for six months (instead of the more stringent three-month criterion that had been introduced after the crisis broke out).

Finally, the government implemented an expansionary fiscal policy. The initial contractionary fiscal policy (a cut in government expenditure by 18% in December 1997) was reversed from 1998. As a percentage of GNP, the federal budget surplus of 0.8% in 1996 rose to 2.5% in 1997, then reversed into deficits of 1.8% in 1998, 3.2% in 1999 and 5.5% in 2001.

Financial and capital control measures

Stabilizing the currency: Stabilizing the exchange rate became the most important objective. The ringgit was fixed to the US dollar at RM3.80 to US$1. The central bank used this rate in its dealings with the commercial banks, which in turn used the same rate in their currency dealings with the public. The fixed exchange rate system allowed monetary and fiscal policies to be taken on their own merit without being constrained by fears of a fall in the value of the currency. It also reduced the opportunity for speculation. Explaining the introduction of the currency system, the then Prime Minister

Dr Mahathir Mohamad said the aim was to cut the link between the interest rate and the exchange rate so that, for example, interest rates could be reduced without speculators devaluing the currency, and companies could revive.

Measures to prevent overseas speculation and trade in the ringgit (i.e., de-internationalizing the currency): Measures were taken to reduce and eliminate the international trade in ringgit, and to repatriate back to the country a large amount of ringgit-denominated financial assets (such as cash and savings deposits) that were held abroad in overseas banks and other institutions. The measures mainly comprised the non-recognition or non-acceptance of such assets in the country after the expiry of a one-month period, i.e., local financial institutions were not allowed to accept the entry of such assets after the deadline. (Permission to repatriate after this deadline would however be given under certain conditions.)

This measure effectively put an end to the offshore trade in the ringgit and in assets denominated in ringgit (including the operation and holding of ringgit-denominated bank accounts abroad). Explaining the move to make the use of offshore ringgit invalid, the Prime Minister said normally it was offshore ringgit that was used by speculators to manipulate the currency. The speculators held the ringgit in foreign banks abroad and had corresponding amounts in banks in Malaysia.

Selective capital controls: Several measures were introduced on 1 September 1998 to regulate the outflow of funds. Measures aimed at foreigners and foreign-owned funds included the following:

- Non-residents holding shares in companies listed on the local stock exchange would have to retain the shares or the proceeds from the sale of the shares for a minimum period of one year from the purchase date. The objectives of this measure were to discourage speculative short-term trade in local shares, and to prevent capital outflow at least for one year.
- Domestic credit facilities to non-resident correspondent banks and non-resident stockbroking companies were no longer allowed (previously domestic credit up to RM5 million was allowed).

- Conditions were imposed on the operations and transfers of ringgit-denominated funds in external accounts, including those held by non-residents. Transfers between external accounts held by non-resident corporations and individuals residing outside Malaysia required prior approval for any amount (previously freely allowed). Transfers from external accounts to resident accounts would require approval after 30 September 1998. Sources of funding external accounts were limited to proceeds from sale of ringgit instruments and other assets in Malaysia, salaries, interest and dividend and sale of foreign currency.

Measures aimed at local residents included the following:

- Resident travellers were allowed to import ringgit notes up to RM1,000 only and any amount of foreign currencies, and to export up to RM1,000 and foreign currencies up to RM10,000 equivalent.
- Except for payments for imports of goods and services, residents were freely allowed to make payments to non-residents only up to RM10,000 or its equivalent in foreign currency (previously the limit was set at RM100,000).
- Investments in any form abroad by residents and payments under a guarantee for non-trade purposes required approval.
- The prescribed mode of payment for exports would be in foreign currency only (previously it was allowed to be in foreign currency or ringgit from an external account).
- Residents required prior approval to make payments to non-residents for purposes of investing abroad for amounts exceeding RM10,000 equivalent in foreign exchange.
- Residents were not allowed to obtain ringgit credit facilities from non-residents.

The capital controls were selective in that they covered movements of funds in the capital account. In the case of foreigners, they covered mainly some aspects of portfolio investment. In general, the ringgit was still to be freely (or at least easily) convertible to foreign currencies for trade (export receipts and import payments), inward foreign direct investment (FDI), and repatriation of FDI-related capital and dividends by non-residents. In the case of local residents, the capital controls covered a wider range of activities, and in fact the aim of preventing the flight of local-owned capital was to be just as important (if not more so) as the controls imposed on foreign-owned funds. However, there was no control on currency convertibility by local residents for purposes of trade. Convertibility up to a certain limit was also allowed for certain other purposes, such as the financing of children's education abroad. But convertibility for autonomous capital movements for several purposes not directly related to trade was to be prohibited or limited.

Some of the capital control measures were soon relaxed. With effect from 15 February 1999, the requirement that proceeds from the sale of ringgit assets be maintained by foreigners in the country for one year was replaced by an exit levy on assets owned by foreigners:

- For capital brought in before 15 February 1999, an exit levy was imposed on the principal at the following rates: 30% for maturity period of 7 months; 20% for 9 months; 10% for 12 months; and zero levy for capital exceeding the 12-month maturity period.
- For capital brought in after 15 February 1999, an exit levy was imposed on the profits at the following rates: 30% for maturity period of less than 12 months, and 10% for maturity period of more than 12 months.

There was further relaxation of the measures on 21 September 1999. Irrespective of the date of entry of the capital, an exit levy with a single rate of 10% was imposed on profits repatriated by foreigners. On 1 May 2001, this 10% exit levy was also abolished.

Stock market measures and closure of overseas trade in Malaysian securities: The Kuala Lumpur Stock Exchange (KLSE) established new measures from 1 September 1998. One major aim of the measures was to reduce possible capital leakage out of the country through the stock market. Among these measures were:

- Clearings in securities traded on the KLSE were to be undertaken only through the KLSE or a recognized stock exchange and through the KLSE trading system.
- New disclosure requirements were introduced, including that the beneficiary owners of shares must be identified in all dealings; and each Central Depository System account operated by a nominee must have only one beneficiary.
- Stockbroking companies could engage only in direct off-market dealings.
- All new issues of shares were to be made by crediting the securities into the Central Depository System accounts of securities holders.

The measures in effect caused the closure of existing secondary markets abroad that conducted trade in stocks of companies listed on the KLSE. The aim was to prevent speculation or manipulation of KLSE share prices and transactions from outside the country and to prevent the outflow of capital through the sale of Malaysian shares outside the country. The shares of 112 companies listed on the KLSE had been traded since 1990 in the Central Limit Order Book International (CLOB) based in Singapore, which was in effect an offshore market for Malaysian securities. The CLOB market was also linked to the ringgit offshore market as CLOB shares were used as collateral by currency traders dealing in ringgit. On 16 September 1998, the Stock Exchange of Singapore discontinued the trading of Malaysian shares on CLOB.

Government guarantee of depositors' funds and decision not to close financial institutions in trouble: There was a need to restore confidence and prevent a run on the banks. Measures were taken to restore public confidence through a government guarantee of deposits and a decision not to close down troubled institutions.

New vehicles to inject equity and take on non-performing loans in banks and restructure corporate debt: Several banks and companies had come under pressure and had to be recapitalized or have their loans restructured, or face insolvency. Three new agencies were created: Danaharta, an asset management company to manage non-performing loans; Danamodal, a special agency to recapitalize weak financial institutions; and the Corporate Debt Restructuring Committee (CDRC), a committee to restructure corporate debts. The institutions were successful in reducing the financial pressures on companies and banks.

c. Lessons from the Malaysian policy response

Financial openness had exposed the country to financial speculation, vulnerability to sudden or large movements of foreign capital, and volatile movements in the exchange rate. One major lesson was that under crisis conditions, it was not possible to maintain a stable exchange rate and to pursue expansionary macroeconomic policies while keeping an open capital account.

The Malaysian recovery strategy was an integrated package of various policies, all of which played vital functions. Lowering the interest rate was important for rescuing the micro-economy and reviving the real economy, but doing so would have brought down the ringgit's exchange rate to a level that could cause external debt-servicing difficulties. The interest rate had therefore to be decoupled from the exchange rate. A new policy instrument, i.e., fixing the exchange rate, was thus introduced. However, this alone would have been insufficient as speculation on the currency could still take place in ringgit offshore markets, and there was still the possibility of capital flight that could make maintenance of the exchange rate unsustainable. Thus, besides the fixing of the exchange rate to the dollar, the stabilization of the currency also required two additional policy instruments: (i) ending overseas speculation by banning the currency's trade abroad; and (ii) introducing selective capital controls to regulate the outflows and inflows of funds. Thus, starting from just one major policy goal (reviving the local companies and the local economy) and a single policy tool (interest rate reduction), we end up with several other policy tools and goals.

The economy recovered quite rapidly following the implementation of the strategy. Following the sharp 7.4% drop in 1998, the GDP grew in real terms by 6.1% in 1999 and 8.3% in 2000. The current account turned around from a RM15.8 billion deficit in 1997 to surpluses in the next three years (RM36.8 billion, RM47.9 billion and RM32.2 billion). The central bank's international reserves had fallen from US$27.7 billion at end-1996 to $21.7 billion at end-1997; it increased to $26.2 billion (1998) and $34.6 billion (2002). The country's external debt situation also improved. The debt was equivalent to 40% of GNP in 1996 and 64% in 1997, but declined to 51% in 2000 (Bank Negara Malaysia Annual Reports).

The policies Malaysia took on capital controls were adapted to its circumstances. The use of capital controls was selective. The current account remained open, with no restrictions on transactions related to trade or FDI. The controls were in the capital account, comprising a standstill on foreign portfolio capital and restrictions on capital outflows by residents.

The capital controls enabled the country to undertake Keynesian-style expansionary monetary and fiscal policies, which contrasted sharply with the policies normally imposed by the IMF on countries receiving its crisis loans.

Chapter 3

EVOLUTION OF THE CAPITAL ACCOUNT REGIME SINCE 1998

a. Introduction

SINCE the crisis measures of 1998, there has been a significant liberalization of the financial and capital markets in Malaysia. This process was guided by the Financial Sector Masterplan and the Capital Market Masterplan, both launched in 2001.

The Financial Sector Masterplan is a blueprint for the development of the financial sector, aimed at developing a competitive and dynamic domestic financial system that will be resilient to the challenges of the new and more globalized environment. It covers the banking and insurance sectors as well as Islamic banking. The recommendations were planned to be implemented in three phases – phase one (3 years) will enhance domestic capacity and capability, phase two (3 to 4 years) will introduce a more competitive environment, and phase 3 will move the financial sector towards greater international integration, allowing new players in the market.

In phase 1, focusing on capacity building, measures were planned to enhance the capability of financial institutions to be efficient and to promote stability. In phase two, there would be gradual deregulation of the financial market, with greater competition between the various financial institutions, while foreign banks would be able to compete more equally with local banks. Greater exposure in various financial markets and the use of hedging instruments would raise the standard of risk management. In the third phase, it was envisaged that the local financial institutions could be more deeply integrated into the global market, while new foreign competition would be introduced. The Masterplan also foresaw that the ability of domestic institutions to compete under a new liberalized environment in the second phase would determine the degree of further liberalization, to ensure that liberalization measures do not destabilize the financial system.

The Capital Market Masterplan is a blueprint aimed at making Malaysia an internationally competitive capital market. Phase 1 (2001-2003) reformed the corporate governance framework, and repositioned domestic intermediaries to consolidate liquidity and promote scale, and shift to a disclosure-based regime. Phase 2 (2004-2005) saw accelerated changes in the stockbroking industry and a liberalization process to broaden access to the Malaysian capital market, leading to the creation of investment banks and the entry of foreign stockbrokers and fund managers. The current Phase 3 (2006-2010) is focusing on regulatory issues and changes in market structures towards an internationally competitive capital market, involving a more deregulated framework (Ministry of Finance Malaysia 2007, p110).

In the 2005 Budget, the government announced several liberalization measures in the equity and derivatives markets, including allowing five major foreign stockbrokers to operate in Malaysia, allowing five leading global fund managers to participate in the Malaysian fund management industry, allowing 100% foreign ownership in futures broking companies and abolishing the limit on the number of foreign dealer representatives.

The rationalization and further concentration of the financial institutions was one of the results of implementing both the Masterplans. There was the industry-wide consolidation of domestic banks, through the merger of 54 banks and finance companies into nine domestic banking groups by 2006, the rationale being that this would enhance the operational efficiency and resilience of domestic banks, thus making them more capable of withstanding foreign competition (Latifah 2004). Also, 14 investment banks were formed from the integration of merchant banks, discount houses, stockbroking companies and universal brokers.

The past decade also saw the rapid growth of Islamic banking; Islamic banking subsidiaries were established and the Malaysia International Islamic Financial Centre was launched in 2006. The Islamic banking system is made up of independent full-fledged Islamic banks, Islamic banking subsidiaries and Islamic windows within the conventional banks. Total assets of the Islamic banking industry grew from RM17.9 billion in 1997 to RM43.5 billion in 2005 (Ooi 2006).

b. The exchange rate regime

The fixed exchange rate regime was retained from September 1998 to 2005. Throughout this period the rate US$1 to RM3.80 was also maintained. In that period there was often a debate on whether the "peg should be lifted". The government maintained that fixing the currency to the US dollar resulted in stability and predictability as well as preventing currency speculation, and thus kept to the system.

The Malaysian fixed exchange rate system was similar to the one in China, and had in fact been styled after the Chinese regime. On 21 July 2005 China moved from a fixed exchange system (in which the rate had been maintained since 1996 at US$1 to 8.2765 renminbi) to a more flexible peg linked to an undisclosed basket of currencies. The Bank of China announced a new level of 8.11 that could change by plus or minus 0.30% based on the renminbi's performance related to the basket of currencies, with the goal of having the currency float with increased flexibility (Bumiputra Commerce Economic Update 2005).

On the same day, shortly following the announcement by the Bank of China, Bank Negara Malaysia announced that the ringgit exchange rate would be allowed to operate in a "managed float, with its value determined by economic fundamentals." Bank Negara would "monitor the exchange rate against a currency basket to ensure the exchange rate remains close to its fair value", according to its statement (Bank Negara Malaysia 2005). The central bank explained that the stability of the ringgit exchange rate against the regional currencies would be increasingly important, and this stability could best be achieved by maintaining the value of the ringgit against a trade-weighted index of Malaysia's major trading partners.

Bank Negara did not disclose the currencies in the basket and their relative weights. The managed float implies the central bank would intervene to reduce currency fluctuations by buying ringgit in the foreign exchange market when it depreciates too rapidly and by selling ringgit when it appreciates too rapidly. According to the Bank, the two-way intervention operations are to smoothen exchange rate volatility and excessive exchange rate movements induced by large short-term capital flows. Nevertheless the Bank would allow the ringgit level to be determined by "economic fundamentals and market conditions." The Bank also stated that the shift to a managed float regime did not entail a change in the monetary policy framework, with monetary policy (using the interest rate as the signalling mechanism) still focused on domestic considerations. Interest rates would thus not be used to influence capital flows or the exchange rate (Bank Negara Malaysia *Annual Report 2005*, p99).

Since the de-pegging, the ringgit has moderately appreciated against the US dollar, from the pegged level of 3.80 in July 2005 to 3.6750 in June 2006, 3.5315 in December 2006, 3.4545 in June 2007 and 3.3065 in December 2007.

While the fixed exchange rate system has been altered to a managed float, Malaysia has continued to maintain the policy of non-internationalization of the ringgit, which had been introduced in 1998 when the trade in ringgit and the offshore ringgit deposits in overseas markets were closed, in order to prevent speculation.

c. Liberalization of foreign exchange rules and foreign investment

General

Financial liberalization since the 1990s financial crisis has taken place in the banking sector and the capital market. It has involved liberalization of rules in inflows and outflows of capital for both residents and non-residents.

Through the regulations in place in 1998, residents were restricted in opening foreign currency accounts, in investing in assets abroad, and in the amounts of funds they could take while travelling abroad. Non-residents were restricted from transferring their ringgit assets abroad, and faced restrictions in obtaining loans and in opening or maintaining ringgit accounts in the country.

Liberalization of these and other regulations took place in phases. The standstill on repatriation of portfolio funds by foreigners was relaxed within months and abolished within a few years of its introduction. Other rules on foreigners (including on obtaining loans locally, operating financial accounts and purchase of real estate) were also relaxed. Another major development was the removal of restrictions on residents, local companies and investment funds to invest abroad and relaxation of rules on borrowing in foreign currency.

Many of the measures to liberalize foreign exchange administration rules were taken in 2004 and 2005. In April 2004, many measures were announced, including relaxation of rules on maintaining foreign currency accounts of residents, increasing of ringgit credit facilities to non-residents and permission to domestic institutions (unit trust management companies, insurance companies, takaful operators and fund/asset managers) to undertake investments abroad. Rules on hedging (involving forward foreign exchange contracts) were also liberalized (Bank Negara Malaysia *Annual Report 2003*, pp89-91).

In April 2005, further major liberalization measures were announced. These included residents and non-residents being allowed to enter into forward foreign exchange contracts for certain purposes without prior permission, and further relaxation of rules on maintaining foreign currency accounts by residents. A major development was the relaxation of rules on investment abroad by residents (for example, residents with no domestic credit facilities are free to invest any amount abroad) while the limit that can be invested abroad by resident unit trust management companies and insurance companies was increased. Equally significant was the liberalization of rules on borrowing in foreign currency by residents. Up till then, the limit for residents to obtain foreign exchange credit facilities was RM5 million equivalent. This was raised to RM50 million for companies and RM10 million for individuals (Bank Negara Malaysia *Annual Report 2004*, pp98-100).

Several liberalization measures were also taken in parallel in the capital market. In September 2005, measures were announced by the Securities Commission aimed at allowing domestic investors to diversify their investments, including allowing investors to invest in foreign securities listed on foreign exchanges, allowing sophisticated investors (banks and universal brokers) to execute secondary trades of non-ringgit bonds without seeking permission, allowing the issuance of foreign-currency-denominated bonds to sophisticated investors, and offering of foreign shares in Malaysia (Bank Negara Malaysia *Annual Report 2005*, p207).

Further liberalization of rules in foreign exchange administration and in the capital market took place in 2006-08. A comparison of the main foreign-exchange-related regulations in Malaysia in September 1998 and in March 2008 affecting residents and non-residents, given below, shows the degree of liberalization that has taken place over the decade. Annex 1 provides more details.

The equity conditions for foreign direct investment have also been considerably liberalized, as described below and in Annex 2.

Foreign exchange rules relating to residents

Opening by residents of foreign currency accounts in Malaysian banks

Until a few years ago, it was not possible or difficult for residents to have foreign-currency-denominated accounts (FCA) in Malaysian banks. This has been liberalized. As at March 2008, residents are free to open FCA with onshore and offshore banks that are licensed to operate such accounts. There are, however, regulations and limits on the sourcing of these funds. Foreign currency funds coming from other residents and non-residents are allowed. Residents without domestic ringgit borrowing can also convert ringgit with banks and place in foreign currency accounts without limit, while there are limits for residents with domestic ringgit borrowing.

Capital transfers and investments abroad by residents

This is another area which has seen major liberalization. The 1998 regulation put a clamp on investment abroad by residents. Residents were required to seek prior approval from Bank Negara to remit funds in excess of RM10,000 for overseas investment.

The rules have been considerably relaxed. Malaysians are now permitted to invest in foreign currency assets abroad, within rather liberalized parameters. There are no limits to such investment by residents without domestic ringgit borrowing, using their own ringgit or foreign currency funds. Individuals with domestic ringgit borrowing can invest up to RM1 million equivalent per year (if from conversion of ringgit) or up to RM10 million if funded from foreign currency borrowing. Local companies can also invest abroad without limit if using own foreign currency funds or if using proceeds of listing through initial public offering, and up to RM50 million a year (if converting from ringgit) or RM100 million (if funded by foreign currency borrowing).

There has also been liberalization of rules for resident institutional investors. Unit trusts are allowed to invest in conventional foreign-currency-denominated funds, with a limit of 100% of net asset value; and for ringgit-denominated funds the limit is 100% of net asset value attributed to non-residents, 100% of NAV attributed to residents without domestic ringgit borrowing and 50% of NAV attributed to residents with domestic ringgit borrowing. There are similar limitations for fund management companies, insurers and takaful operators.

This liberalization of rules on capital outflows for local companies, individuals and institutional investors has had a very significant effect in facilitating large outflows in the past few years.

Foreign currency loans by residents

Prior to the 1997-99 financial crisis, a large part of the country’s external debt had been contracted by the public sector (government and public enterprises). Private sector external debt was also significant, but it was not in the same order as in Indonesia, South Korea or Thailand, in which there had been an explosive expansion of private sector debt denominated in foreign currency. One reason was that local companies were allowed to obtain foreign loans (beyond a certain maximum limit) only with central bank permission, which would be given only if and to the extent that the borrower could show that the loan would be used for activities that would yield revenue in foreign exchange that could be used for loan servicing. Partly as a result of this restriction, Malaysia's debt situation remained manageable, although the situation had become serious due to the sharp depreciation of the ringgit.

In September 1998, the strict limits on foreign currency loans by the private sector remained. Residents were allowed to obtain credit in foreign currency up to RM5 million equivalent; amounts beyond this required permission.

Since then, however, the external loan policy has been considerably liberalized. At present, individuals can take foreign currency loans up to the equivalent of RM10 million, while resident corporations (on an aggregate group basis) can take foreign currency loans up to RM100 million. Correspondingly, foreigners are allowed to provide foreign currency loans to residents up to the limit of RM10 million equivalent (for individuals) and RM100 million equivalent (for corporations). Beyond the limits, the resident is required to obtain prior permission from financial authorities.

Residents borrowing in ringgit from non-residents

In the September 1998 regulation, residents were not allowed to obtain credit facilities in ringgit from non-residents without Bank Negara approval. This regulation has remained.

Issuance of ringgit and foreign-currency-denominated securities by residents

There has also been liberalization in this area. At present, residents are free to issue ordinary shares, irredeemable preference shares and private debt securities registered in Malaysia to non-residents. Residents are also allowed to issue foreign-currency-denominated bonds as long as total foreign currency borrowing, including the bonds, does not exceed RM100 million equivalent. For ringgit-denominated bonds, residents are free to use for investment in foreign currency assets provided the issuer's total investment does not exceed RM50 million equivalent per year. For foreign-currency-denominated bonds, residents are free to use the proceeds onshore and offshore.

Currency rules for resident travellers

In September 1998, the currency regulation for travellers was tightened. Travellers were allowed to carry ringgit notes up to RM1,000 upon arrival or departure and to take out foreign currency the equivalent of only RM10,000. Present regulations are basically the same. Resident travellers can import or export ringgit notes up to RM1,000; import foreign currency notes and traveller's cheques without limit; and export foreign currency notes and traveller's cheques up to an equivalent of US$10,000.

Export and import of goods and services by residents

In September 1998, in relation to current account transactions, there were no restrictions regarding payment for import of goods and services (except that payment must be in foreign currency), but some regulations on export proceeds. All export proceeds were required to be repatriated back to Malaysia within six months of the date of export and had to be received in foreign currency and then sold for ringgit or retained in approved foreign currency accounts with onshore commercial banks.

Most of the 1998 rules on export proceeds still apply at present. The present regulations include that payment must be made in foreign currency, and that export proceeds be repatriated to Malaysia within six months from the date of export. Residents can retain export proceeds in foreign currency accounts and ringgit accounts in onshore banks. Permission is needed to retain export proceeds in foreign currency accounts with offshore banks.

Foreign exchange rules relating to non-residents

Foreign direct and portfolio investments by non-residents

In the September 1998 regulations, there was no restriction on the movement of foreign direct investment and income derived from it. There were, however, very significant controls on foreign portfolio capital. From 1 September 1998, non-residents were required to hold their principal sum for portfolio investment for at least 12 months in Malaysia.

This rule was progressively liberalized. From 15 February 1999, capital and profits of the portfolio investments were allowed to be repatriated, subject to a system of levy on repatriation of portfolio funds, with a higher levy rate the shorter the duration of the capital (e.g., 30% levy for 7-month maturity period, 10% levy for 12-month maturity period). On 21 September 1999 this was amended so that a single exit levy of 10% was imposed on profits repatriated. This levy was abolished on 1 May 2001.

There are now no restrictions on movements or payments for direct or portfolio foreign investment. Foreigners are free to bring in funds to invest in any ringgit assets including equities or bonds, and residents are free to issue ringgit securities (shares and private debt securities) to foreigners. Moreover, local investment by foreigners has been facilitated through making available to them loans up to RM10 million in ringgit to buy ringgit assets, and they can also borrow any amount for margin financing from resident stockbroking companies.

Investment in immovable properties

Non-residents can purchase residential and commercial properties in Malaysia, as long as they comply with the guidelines issued by the Foreign Investment Committee of Malaysia. FIC approval is not required for purchasing residential property exceeding RM250,000. (Details of the regulations on foreign ownership of immovable properties are in Annex 3.)

Lending in ringgit and foreign currency by non-residents to residents

The present regulations are that lending in ringgit to a resident by a non-resident requires prior permission of the Controller. However, non-residents are free to lend in foreign currency to a resident provided the resident borrower's total foreign currency borrowing does not exceed RM10 million equivalent in aggregate (for resident individuals) or RM100 million equivalent in aggregate (on a corporate group basis).

Borrowing by non-residents from residents

The September 1998 regulations had only one restriction on extension of credit facilities to non-residents in foreign currency (banks could extend these for all purposes, except for buying immovable property). However, there were several restrictions on credit facilities in ringgit. Banks may lend in ringgit up to RM200,000 for purposes other than to buy immovable property; non-residents could borrow from banks up to 60% of the purchase price or construction cost of a residential property in Malaysia for their own accommodation; and non-resident-controlled companies operating in Malaysia could get credit up to RM10 million from domestic sources and any amount of forward exchange contract and short-term trade financing; but of the total amount of credit from banks, at least 60% must be from Malaysian-owned banks.

These regulations have been significantly liberalized. The restriction to foreigners on borrowing in foreign currency from banks to purchase immovable property has been lifted. The maximum limit of RM200,000 in ringgit-denominated loans (except for immovable property) has also increased to RM10 million, while there is no limit for borrowing in ringgit for buying residential or commercial property.

Non-residents are free to borrow any amount of foreign currency from onshore banks, and can also obtain foreign currency borrowing from non-bank residents, with some conditions. They can also obtain ringgit borrowing from onshore banks and non-bank residents up to RM10 million for any purpose. There is no limit to their borrowing from licensed onshore banks and resident stockbroking companies for margin financing, or to purchase residential and commercial properties in Malaysia.

Issuance of ringgit and foreign-currency-denominated bonds/sukuk in Malaysia by non-residents

Multilateral development banks, multilateral financial institutions, foreign sovereign, foreign quasi-sovereign agencies and foreign multinational companies may issue ringgit or foreign-currency-denominated bonds/sukuk in Malaysia. Proceeds from the issuance of bonds/sukuk are allowed to be used onshore or offshore.

Opening of ringgit and foreign currency accounts in Malaysia by non-residents

In the September 1998 regulations, non-residents were freely allowed to open foreign currency accounts in commercial and merchant banks and there was no restriction on the flow of funds nor any levy on repatriation of these funds. There were, however, several restrictions on the external accounts (i.e., accounts in ringgit) of non-residents. The permitted sources of funds for such accounts were the sale of ringgit assets in Malaysia, income (salaries, interest, profits or dividends) and sales of foreign currency. The uses of funds in the external accounts were restricted to: (i) purchase of ringgit assets/placements of deposits; (ii) payment of administrative and statutory expenses in Malaysia; (iii) payment of goods and services for use in Malaysia; and (iv) granting of loans and advances to staff in Malaysia. Prior approval was required for transfer of funds between external accounts and for uses of funds other than permitted purposes. However, there were no restrictions on the operations of external accounts of non-residents working in Malaysia, or of embassies and international organizations.

There has been very significant deregulation on the ringgit accounts of non-residents. The restriction that these accounts can only be used for payments in Malaysia (and not abroad) has been lifted. The permitted domestic uses of funds in these accounts have also been extended to practically all uses with a few remaining restrictions.

Import and export of ringgit and foreign currency by non-resident travellers

In September 1998, the currency regulation for travellers was tightened. Foreign travellers were allowed to carry ringgit notes up to RM1,000 upon arrival or departure. A non-resident traveller could take out foreign currency only up to the amount brought into Malaysia. The present regulation is that non-resident travellers are allowed to import and export ringgit notes up to RM1,000; allowed to import foreign currency notes and traveller's cheques with no limit; and allowed to export foreign currency notes and traveller's cheques up to the amount brought into Malaysia or US$10,000, whichever is higher.

Policies and regulations on FDI

Malaysia has always been liberal in enabling the inflow of FDI, but through different periods it has had a differentiated policy with regard to different sectors. The most liberalized sector has been manufacturing. Agriculture has been dominated by local residents and domestic companies since the purchase by Malaysian public sector organizations of the plantation and mining companies from UK-based companies in the 1980s. The services sectors have been generally more dominated by local companies, although in a few areas (for example, insurance) there is majority foreign participation.

In terms of regulations, the Foreign Investment Committee determines the entry and terms of foreign direct investment in the country. The FIC's Guidelines on Acquisition of Interests, Mergers and Takeovers provide the general conditions. The latest version (effective 1 January 2008) still has equity conditions similar to those of previous years. The main equity condition is that companies are required to have at least 30% of their equity owned by Bumiputra (the ethnic group that forms the majority of the Malaysian population). Also, foreign equity in companies in sectors considered to involve national interests such as water and energy supply, broadcasting, defence and security is limited to 30%. There are, however, several exemptions from the guidelines, such as an acquisition of interest in a manufacturinjg company licensed by the Ministry of Trade and Industry. (More details on equity conditions for FDI are in Annex 2.)

Since the 1997-99 financial crisis, the trend of liberalization of the rules governing the inflow and establishment of FDI has continued, particularly in the services sector where the limits on foreign ownership were relaxed.

New entry into the banking sector is limited to an aggregate foreign shareholding of 30% in the existing Malaysian-controlled banks. This limit has remained in the past decade. While locally owned banks predominate in Malaysia, there is considerable foreign presence in the sector. There are 14 100% foreign-owned banks in the country. In 2000, foreigners accounted for 20% of total shareholders' funds of the banking sector. Foreign banks accounted for 25% of the banking sector's market share in terms of total assets and total deposits as at end-2000. At the same time, in the insurance sector, the foreign share of shareholders' funds was 40%.

In the financial services negotiations at the World Trade Organization (WTO) (the results of which were ratified in January 1999), Malaysia made several liberalization commitments, including to increase the foreign equity limit in insurance from 30% to 51% under certain conditions; to issue six new licences for life reinsurance; to allow 100% foreign equity in fund management companies; and to liberalize offshore investment banking, offshore insurance and offshore financial leasing.

In the financial services sector, despite recent liberalization, several types of restrictions remain. In commercial banking, a single foreign shareholder is limited to 20%, with total foreign shareholding limited to 30%, and any holding over 5% requires Bank Negara approval. In stockbroking and investment banking, foreign shareholding is limited to 49%. On the consumer finance side, foreign companies looking to set up these services in Malaysia cannot have majority control of a company established in Malaysia. In terms of cross-border trade in financial services, foreign mutual fund providers are restricted from entering Malaysia and selling their products, and international fund managers have to go through a local house (AMCHAM Malaysia 2006).

In recent years there has been liberalization in the rules governing foreign ownership in the Islamic banking sector. New licences were given to an international Islamic bank and a foreign takaful company (Bank Negara Malaysia 2007).

Equity ownership policy was also liberalized in other services. The foreign ownership limit was increased in telecommunications (from 30% to

61%), forwarding agencies (from 49% to 70%) and shipping agencies (from 49% to 70%). In the 2001 Budget, the government announced that foreign participation is also allowed at the management level in sectors such as energy, ports and the airline industry. Several local companies have been forming strategic alliances with foreign companies.

The policy of liberalization of the services sector has had a significant effect. Prior to the 1997 crisis, the share of foreign investment in total investment in services was only about 5%, but this rose to more than 50% in the few years after the crisis. In 1990-97, foreign investment in services accounted for 10% of all foreign investment; this share rose to 35% in 1998-2000, while manufacturing remained the dominant sector for foreign investment during the two periods.

Foreign equity participation requires the approval of the Foreign Investment Committee. As part of the liberalization process, the general regulation that the foreign equity share is restricted to 30% (and that foreign companies should include 30% ownership by Bumiputra) has given way in many sectors in recent years.

Currently, foreign companies are allowed to establish with 100% equity ownership in the manufacturing sector. In services, although there has been very significant relaxation, restrictions are retained in selected sectors. In broadcasting, foreign investment in terrestrial broadcast is prohibited, and there is a 30% limit on foreign investment in cable and satellite operations through licensing conditions. In telecommunications, foreign equity is restricted to 49% in a Malaysian telecom operator. In distributive trades, there is a set of 2004 Guidelines on Foreign Participation which requires manufacturing companies distributing products locally to have a separate marketing arm with 30% Bumiputra ownership (AMCHAM Malaysia 2006).

Chapter 4

RECENT DEVELOPMENTS RELATING TO CAPITAL FLOWS

a. General

SINCE the capital controls introduced in August/September 1998, Malaysia has gradually liberalized various forms of capital flows, both inflows and outflows, and for both residents and non-residents. While there has been progressive liberalization in the past decade, several types of controls still remain.

The following describes policies as well as developments relating to various types of capital flows: foreign direct investment; outflow of domestic investment abroad; loans; portfolio investment; and "other investments", particularly deposits abroad by banks.

b. Flows of direct investment

Outflow of Malaysian direct investment abroad

In September 1998, as a response to the financial crisis, Malaysian companies were prohibited from direct investment abroad, except with Bank Negara permission. This regulation was removed after a few years and after further liberalization the situation is even more liberal than in the pre-crisis period. As foreign reserves built up due to strong merchandise trade surpluses and a resumption of foreign capital inflows, the policy was reversed and Malaysian companies were encouraged to invest abroad. Capital outflows by Malaysian companies became a major method for reducing the pressures arising from capital inflows.

The trend of Malaysian direct investment abroad has become so pronounced that it increasingly offsets the flows of foreign direct investment into Malaysia, with 2006 and 2007 being landmark years. In 2006, direct investment abroad by Malaysian companies had reached RM22.1 billion, exactly the same level as FDI into Malaysia, and thus there was zero net flow of direct investment. In 2007, Malaysian investment abroad rose further to RM37.9 billion, which for the first time exceeded FDI inflow of RM29.1 billion, resulting in a deficit in net direct investment of RM8.8 billion.

The 2007 Malaysian investment abroad mainly reflected acquisition of large interests in existing businesses in other countries, for example in the gaming and resort sector, in shipping and telecommunications, oil exploration and extraction, and construction (Bank Negara Malaysia *Annual Report 2007*, p40).

Inflow of revenue and income from Malaysian direct investment abroad

Residents are at present free to repatriate and convert divestment proceeds or income from investment in foreign currency assets into ringgit as well as to retain the proceeds in foreign currency accounts. As the stock of Malaysian direct investment abroad has grown, the inflow of direct investment income has also increased in recent years. The inflow of income was in fact negative in 2000 and 2001, but increased steadily to RM14.7 billion in 2007.

Overview of inflows and outflows of direct investment and investment income

Table 1 gives an overview of the inflows and outflows of direct investment and income derived from direct investment for 1999-2007. FDI inflows have been fluctuating, with a level of RM14-15 billion in 1999-2000, followed by a sudden drop to RM2 billion in 2001, and rising to RM29 billion in 2007. However, due to the high stock of FDI accumulated through decades, the outflow of direct investment income has remained high and has steadily risen, from RM20 billion in 1999 to RM34 billion in 2007. In the 1999-2007 period, investment income outflows (totalling RM247 billion) more than offset FDI inflows (RM137 billion) by almost a factor of 2.

Table 1: Malaysia: Foreign Direct Investment and Investment Income Inflows and Outflows, 1999-2007 (RM billion)

	Inflow of FDI	Outflow of direct investment income	Outflow of direct investment	Inflow of direct investment income
1999	14.8	20.5	5.4	0.4
2000	14.4	27.5	7.7	-0.8
2001	2.1	22.5	1.0	-0.2
2002	12.2	23.3	7.2	0.7
2003	9.4	25.6	5.2	2.0
2004	17.6	29.5	7.8	4.3
2005	15.0	31.5	11.3	4.1
2006	22.2	32.7	22.1	11.9
2007	29.1	33.7	37.9	14.7
Total	136.8	246.8	105.6	37.1

Source: Bank Negara Malaysia, *Monthly Statistical Bulletin* (March 2008, Table 7.2)

On outflows of direct investment from Malaysia, there has been a sudden and dramatic jump in the most recent years. In the wake of the 1997-99 financial crisis, there was only a moderate level of investments by Malaysian businesses abroad, at an annual average of RM5-8 billion in 1999 to 2004. The outflow jumped in the next three years, reaching RM38 billion in 2007 when for the first time it exceeded inflow, by some RM9 billion. If this trend continues, Malaysia will be a net exporter of direct investment. The inflow of direct investment income also rose to RM15 billion in 2007, compared to RM1-4 billion in 2002-2005.

However, given the large stock of FDI in Malaysia, compared to the stock of Malaysian direct investment abroad, there was in this period a large net outflow of direct investment income of RM210 billion or an average of RM23 billion a year. Should the trend continue of large outflows of direct investment which even exceed the FDI inflows, while the significant outflows of direct investment income abroad continue (as can be expected), the country will be open to new vulnerabilities of significant net capital outflows on the direct investment account. For example, in 2007, there was a net direct investment outflow of RM9 billion and a net direct investment income outflow of RM19 billion, giving a total of RM28 billion net outflow on the direct investment account, equivalent to 4.5% of GNP, which is very significant. If direct investment outflow continues or rises at the level of 2006-2007, while outflow of investment income continues at its high level, the country will be especially vulnerable if the new FDI flow is for some reason reduced.

c. External loans and external debt

Outstanding debt and debt servicing

Table 2 shows the evolution of Malaysia's outstanding debt and debt servicing in 1996-2007. The external debt level in ringgit equivalent jumped from RM98 billion at end-1996 to RM170 billion a year later. This was due to the sharp depreciation of the ringgit in 1997. This caused great difficulties for the local corporations (both public enterprises and private companies) that had taken foreign currency loans, as the value of these loans in ringgit increased sharply, as did their debt-servicing obligations. Between 1996 and 1997, public enterprise medium- and long-term foreign debt rose from RM29 to RM52 billion, while private sector debt almost doubled from RM33 to RM60 billion, and total short-term external debt rose from RM26 to RM44 billion. Debt servicing also rose from RM15 to RM22 billion. As the depreciation continued into 1998, the situation became even more seri-

Table 2: Malaysia: Outstanding External Debt and Debt Servicing, at Yearend (RM billion)

	1996	1997	2000	2003	2004	2005	2006	2007
Medium- and long-term outstanding debt	72	126	143	153	157	151	143	133
Federal government	10	13	19	37	35	30	25	20
Non-financial public enterprises	29	52	60	60	62	56	51	42
Private sector	33	60	65	56	60	65	67	72
Short-term outstanding debt	26	44	18	34	44	47	43	54
Banking sector				23	35	39	29	42
Non-bank private sector				10	8	8	14	12
Total debt outstanding	98	170	161	187	201	198	185	187
Total debt servicing (including interest)	15	22	26	29	25	33	32	26
External debt service ratio[a] (%)	6.6	5.7	5.8	6.4	4.5	5.4	4.8	3.8

Source: Bank Negara Malaysia, *Monthly Statistical Bulletin* (March 2008, December 2007, July 1998)
Bank Negara Malaysia, *Annual Report* (various issues)
Ministry of Finance Malaysia, *Economic Report 2007/2008*

[a] Debt service as percentage of export of goods and services

ous. The fixing of the exchange rate in September 1998 avoided a worsening of the external debt situation.

After 1997, the level of outstanding external debt stabilized in absolute terms, and declined as a percentage of GDP. Total debt at end-2000 was RM161 billion or 45% of GDP, while at end-2007 the debt was RM187 billion (29% of GDP). During the last decade, the federal government's medium- and long-term debt rose rapidly from RM13 billion in 1997 to RM35-37 billion in 2003-2004, then declined to RM20 billion by end-2007. The medium- and long-term debt of the private sector was stable at RM60-65 billion from 1997 to 2005 and went up slightly to RM72 billion in 2007. The public enterprise debt rose to RM60 billion in 2000-2005, then dropped to RM42 billion in 2007.

However, the level of short-term debt rose sharply from RM18 billion in 2000 to RM54 billion in 2007. Much of the short-term debt is held by the banking sector, which has rapidly built up its debt from RM12 billion in 2001 to RM42 billion in 2007.

With the stabilizing of the outstanding debt level, the total debt-servicing level has also been relatively stable in absolute terms at around RM25-33 billion in 2000-2007. The external debt service ratio (repayment and interest as percentage of exports of goods and services) has also fallen from 6.6% in 1996 and 6.4% in 2003 to 3.8% in 2007.

External borrowing and loan repayment

Table 3 shows the flows in relation to external loans – gross borrowing, repayment, net borrowing and interest payment – for 2002-07.

For most years, there has been negative net borrowing in relation to medium- and long-term external loans as repayments and prepayments offset gross borrowings in 2003, 2005 and 2007. If interest payment (whose level was RM5-7 billion in each year) is also taken into account, there has been a significant negative flow in medium- and long-term loans. This has been mainly due to the federal government almost stopping gross borrowings from 2004 onwards. Non-financial public enterprises have continued to borrow, but their flow of repayment and prepayment has far exceeded

Table 3: Malaysia: External Borrowing and Debt Servicing, 2002-07 (RM billion)

	2002	2003	2004	2005	2006	2007
Medium- and long-term debt:						
Gross borrowing	23.9	22.2	27.1	29.2	28.6	23.8
Federal government	10.5	3.2	1.1	0.7	0.8	0.5
Non-financial public enterprises	3.7	5.1	11.5	6.4	10.9	1.7
Private sector	9.7	13.9	14.4	22.1	16.9	21.7
Repayment and prepayment	23.1	29.3	25.2	35.0	28.5	25.7
Federal government	2.4	6.9	1.0	4.2	3.9	4.8
Non-financial public enterprises	6.9	12.4	12.7	13.9	13.2	7.8
Private sector	13.7	10.0	11.5	16.9	11.5	13.1
Net borrowing	0.7	-7.1	1.9	-5.8	0.1	-1.9
Federal government	8.0	-3.7	0.1	-3.5	-3.1	-4.3
Non-financial public enterprises	-3.3	-7.3	-1.1	-7.5	-2.3	-6.1
Private sector	-4.0	3.9	2.9	5.2	5.4	8.6
Interest payment	6.3	6.2	5.4	6.1	6.6	5.0
Short-term debt:						
Net change	8.3	1.1	10.2	3.2	-4.2	11.7
Total external debt:						
Net change[a]	12.3	1.0	13.9	-2.9	-13.2	2.9
Total debt servicing	27.8	28.6	24.9	32.8	32.1	26.4

Source: Bank Negara Malaysia, *Annual Report* (various years)

[a] Net change in external debt may not equal net medium- and long-term borrowing plus change in short-term debt because of the treatment of prepayment of loans in the accounting.

their new borrowing. However, in the private sector, there has been an increasing level of gross borrowing which exceeds repayments, and the level of net borrowing reached RM8.6 billion in 2007.

In short-term borrowing, there has been a greater fluctuation in net flows. The net change in short-term debt fell from RM8 billion in 2002 to only RM1 billion in 2003, rose to RM10 billion in 2004, then dropped to RM3 billion in 2005 and a negative of 4.2 billion in 2006, only to recover to a positive flow of RM12 billion in 2007. Most of these sharp fluctuations are caused by changes in the outstanding short-term debt of the banking sector.

The change in the total external debt, which is a measure of the net capital flow on account of foreign loans (i.e., aggregate gross inflow of all foreign loans minus all repayments), has also been fluctuating, with some years having a high net inflow (RM12-14 billion in 2002, 2004) and others a high net outflow (of RM13 billion in 2006).

d. Volatility in portfolio flows

There has been very significant volatility in portfolio flows in the past decade. Due initially to the financial crisis and then to the discouragement of portfolio investment due to the selective capital controls, there were net outflows of portfolio investment from Malaysia until recently. In 1997, the order of the outflow was RM30 billion. The net outflow continued at RM3-10 billion a year during 1999-2002, before significant volatility set in, with a huge inflow in 2004 (RM32 billion), a reversal in 2005 (RM14 billion outflow) and strong net inflows of RM13 billion and RM18 billion in 2006 and 2007 (Table 4).

In 2008, the volatility became extreme. After a net inflow of RM21 billion in the first quarter, there were large outflows of RM24 billion in the second quarter and RM56.2 billion in the third quarter (Department of Statistics Malaysia, December 2008).

There has also been a continuous net outflow of income from portfolio investment, at annual levels of RM0.3-1.0 billion in 1999-2004, increasing to RM3 billion in 2006 and almost RM6 billion in 2007. As portfolio invest-

Table 4: Malaysia: Portfolio Investment and Income Flows, 1999-2007 (RM billion)

	Net Investment Flow	Net Income from Portfolio Investment
1999	-4.4	-0.6
2000	-9.4	-0.7
2001	-2.5	-0.3
2002	-6.5	-0.4
2003	4.2	-0.4
2004	32.3	-1.0
2005	-14.2	-1.6
2006	12.9	-3.0
2007	18.4	-5.8

Source: Bank Negara Malaysia, *Monthly Statistical Bulletin* (various issues)

ment made a major comeback in 2006-2007, the outflows of investment income have also increased correspondingly.

The profile of categories of portfolio investment has changed. By far the most dominant type has been investment in shares and corporate securities, which up to 2003 was two-thirds or more of the total. Private debt securities became more prominent in 2004-2007. However, the most important rise has been in investment in money market instruments from 2004 onwards and especially in 2007, when receipts for this item shot up to RM117 billion, compared to RM217 billion receipts for shares and corporate securities, RM18 billion for Malaysian government securities, RM14 billion for private debt securities and RM13 billion for financial derivatives (Table 5).

e. "Other investments": Outflows of banking deposits abroad

One category of capital flows that has recently assumed significance is "other investment" in the financial account of the balance of payments. In recent years, there were massive capital outflows on this item. It comprises: (1) borrowing and lending of the public and private sectors, (2) placements of assets by the banking sector abroad and withdrawals of these assets from

Table 5: Malaysia: Portfolio Investment by Type, 1997-2007 (RM billion)

	1997	2000	2001	2002	2003	2004	2005	2006	2007
Shares and corporate securities[a]									
Receipts	113.3	44.6	24.1	38.2	52.4	75.9	71.1	95.8	216.6
Payments	139.5	51.6	26.7	39.3	44.1	60.5	73.8	92.2	209.3
Malaysian government securities									
Receipts	-	0.5	0.6	1.7	0.8	13.0	12.4	9.5	18.0
Payments	-	0.6	0.6	1.8	0.5	2.1	8.5	6.0	9.4
Foreign government securities									
Receipts	2.3	1.0	1.0	2.9	8.6	5.9	1.8	0.5	1.3
Payments	3.5	0.9	1.1	3.4	8.5	5.5	1.9	0.4	0.9
Private debt securities[b]									
Receipts	8.8	2.4	3.7	4.2	7.2	18.3	12.5	19.6	13.8
Payments	6.6	3.7	3.3	9.0	6.9	16.8	16.4	17.8	16.8
Money market instruments[c]									
Receipts	18.1	2.8	1.8	3.5	1.1	17.9	24.5	40.2	116.5
Payments	24.6	3.2	3.1	1.8	0.6	11.3	28.1	38.3	102.3
Financial derivatives[d]									
Receipts	6.4	3.2	6.5	3.9	6.0	4.2	4.9	7.0	12.6
Payments	6.3	3.3	5.1	4.1	4.5	4.2	5.3	6.9	14.5
Total									
Receipts	148.8	54.5	37.8	54.4	76.0	135.1	127.3	172.7	379.0
Payments	180.4	63.3	39.9	59.4	65.2	100.4	134.2	161.6	353
Net	-31.6	-8.8	-2.1	-5.0	10.8	34.7	-6.9	11.1	25.9

Source: Bank Negara Malaysia, *Monthly Statistical Bulletin* (March 2008)

[a] Include listed shares and bonds, unit trusts, warrants, and rights and options in respect of such shares

[b] Include bonds, debentures, notes, etc. with original maturity of over 1 year

[c] Money market or negotiable debt instruments with original maturity of up to 1 year; including Treasury bills, Bank Negara Bills, commercial and finance papers, bankers acceptances, negotiable instruments of deposit

[d] Linked to specific financial instruments or indicators or particular commodities that may be purchased or sold at a future date, e.g., options, futures, swaps

abroad, and (3) non-bank private sector transactions with unrelated counterparties, including trade credits, and the sector's placement of deposits with financial institutions abroad (Bank Negara Malaysia *Annual Report 2004*, p53; *Annual Report 2007*, p41).

The deficit in this item had been around RM20-27 billion annually in 2000 to 2005 and this increased further in 2006 and 2007 to RM40-50 billion annually. The most important component is the placement of assets abroad by Malaysian-based banks and companies, which has been enabled by the liberalization of the capital account in recent years. The banks' placement of assets abroad is the main component of the serious deficit in the private sector flows under "other investment".

The large and growing outflows due to these "other investments" have been the main factor reducing the surplus in the overall balance of payments. For example, in 2006, the current account surplus was 16.3% of GDP but the overall balance was only 4.4% of GDP mainly because of the net 8.5% outflow under "private other investment."

There are a number of factors explaining these massive bank outflows, which mainly reflect the shifting by commercial banks of their short-term deposits abroad. Firstly, the outflows tend to be higher when there is weak demand for domestic loans. This has been so especially since 2003, when loan growth was lower than deposit growth, and bank lending abroad increased. Secondly, and probably more significantly, the banks were probably led by the search for higher yield in their decision to place deposits abroad. There is a correlation between changes in interest rate differentials between the US (and other G7 countries) and Malaysia and changes in Malaysian bank lending abroad. Malaysian interest rates have been steady and low throughout the past decade, while interest rates in the US, UK and other countries were significantly higher, until the reduction in US rates in the past year (JPMorgan Chase Bank, Singapore 2008).

Chapter 5

OVERVIEW OF THE EVOLUTION OF CAPITAL FLOWS

IN the past decade and a half, Malaysia has experienced four phases of external financial flows in the current and capital account of the balance of payments. (See Tables 6, 7 and 8 for the balance of payments in the periods 1994-98, 1999-2003 and 2004-07 respectively, which give a consolidated view of the movements and net result of the various types of capital flows in recent years.)

In the period before the financial crisis (1994-96), the current account was in significant deficit. This was largely due to large deficits in the services account (RM17-19 billion in 1994-96) mainly as a result of high outflows of investment income that was earned by foreign companies through direct investments. The merchandise trade account was in surplus, but only to a small extent (in 1995 it was only RM0.1 billion, though in 1996 it was RM10 billion), and thus it was unable to cover the services deficit.

The current account deficits were to some extent offset by significant inflows of long-term capital, most of it in the private sector as FDI. The net inflow of long-term capital was RM12-17 billion in 1994-96. With the basic balance having small deficits in 1994-95 (RM3-5 billion) and a small surplus in 1996 (RM2 billion), the overall balance was dependent on the fluctuations in the flows of short-term capital as well as errors and omissions (which is widely thought to also comprise short-term flows). In 1994 there was a net outflow of RM8.5 billion in short-term capital, which turned into a net inflow of RM2.5 billion and RM10.3 billion in the next two years. The overall balance of payments was in deficit of RM8 billion and RM4 billion in 1994 and 1995, leading to declines in foreign reserves. In 1996, the eve of

Table 6: Malaysia: Balance of Payments, 1994-98 (RM billion)

	1994	1995	1996	1997	1998
Merchandise trade	4.5	0.1	10.0	10.3	69.2
Exports	148.5	179.5	193.4	217.7	281.7
Imports	144.0	179.4	183.3	207.5	212.5
Services	-17.0	-19.2	-18.4	-22.8	-22.2
Note: Investment income	-9.4	-10.3	-11.6	-14.6	-14.8
Balance on goods and services	-12.5	-19.1	-8.2	-12.5	47.0
Unrequited transfers	-2.2	-2.5	-2.9	-4.2	-9.6
Current account balance	-14.8	-21.6	-11.2	-16.7	37.4
Official long-term capital	0.9	6.1	0.7	4.6	2.1
Private long-term capital	10.8	10.5	12.8	14.5	8.5
Balance on long-term capital	11.7	16.6	13.5	19.0	10.6
Basic balance	-3.1	-5.0	2.3	2.4	48.0
Private short-term capital	-8.5	2.5	10.3	-12.9	-20.6
Errors and omissions	3.3	-1.9	-6.4	-0.4	12.9
Overall balance	-8.3	-4.4	6.2	-10.9	40.3
Bank Negara foreign reserves	68.2	63.8	70.0	59.1	99.4
Reserves as months of retained imports	5.5	4.1	4.4	3.4	5.7
Current account as % of GNP	-7.9	-10.2	-4.6	-6.3	14.0

Source: Bank Negara Malaysia, *Monthly Statistical Bulletin* (various issues)

the crisis, the net inflow of short-term capital was to some extent offset by outflow in errors and omissions. The overall balance was RM6 billion.

During this period, the balance of payments was fragile due mainly to the large services deficit which could not be covered because of the small merchandise trade surpluses, leading to significant current account deficits (equivalent to 5 to 10% of GNP), and very large fluctuations in short-term

Table 7: Malaysia: Balance

	1999			2000			
	+	-	Net	+	-	Net	
Goods	319.6	233.5	86.0	374.0	294.9	79.1	
Services	45.3	56.0	-10.7	53.0	63.6	-10.7	
Balance on goods and services	364.9	289.5	75.3	427.0	358.5	68.5	
Income	7.6	28.5	-20.9	7.6	36.5	-28.9	
Employee compensation	1.2	1.8	-0.6	1.3	2.3	-1.0	
Investment income	6.4	26.7	-20.3	6.2	34.2	-27.9	
Direct investment	0.4	20.5	-20.1	-0.8	27.3	-28.1	
Portfolio investment	0.3	0.9	-0.6	0.3	1.0	-0.7	
Other investment	5.7	5.3	0.4	6.8	5.9	0.9	
Current transfers	3.0	9.6	-6.6	2.9	10.2	-7.3	
Current account balance	375.5	327.6	47.9	437.4	405.2	32.3	
Capital account			0			0	
Financial account			-25.2			-23.8	
Direct investment			9.4			6.7	
Abroad			-5.4			-7.7	
In Malaysia			14.8			14.4	
Portfolio investment			-4.4			-9.4	
Other investment			-30.2			-21.1	
Official sector			6.7			3.9	
Private sector			-36.9			-25.1	
Balance on capital and financial accounts			-25.1			-23.8	
Errors and omissions			-4.9			-16.6	
Overall balance			17.8			-8.2	
Bank Negara foreign reserves			117.2			109.1	
Bank Negara reserves (US$)			30.9			28.7	

Source: Bank Negara Malaysia, *Monthly Statistical Bulletin* (various issues) of Payments, 1999-2003 (RM billion)

2001			2002			2003		
+	-	Net	+	-	Net	+	-	Net
334.3	264.5	69.9	358.5	286.4	72.1	398.0	300.2	97.8
55.0	63.3	-8.3	56.5	62.5	-6.0	49.9	65.2	-15.3
389.3	327.8	61.5	415.0	348.9	66.1	447.8	365.4	82.5
7.0	32.6	-25.6	8.1	33.2	-25.1	13.1	35.7	-22.5
1.4	2.4	-1.0	1.7	2.8	-1.2	2.2	3.2	-1.0
5.6	30.2	-24.8	6.5	30.4	-23.9	11.0	32.5	-21.6
-0.3	22.5	-22.8	0.7	23.3	-22.6	2.0	25.6	-23.6
0.2	0.5	-0.3	0.2	0.5	-0.4	0.3	0.7	-0.4
5.6	7.2	-1.6	5.6	6.6	-0.9	8.9	6.2	2.5
2.0	10.2	-8.2	2.5	13.1	-10.6	1.9	11.2	-9.3
398.3	370.6	27.7	425.7	395.2	30.5	462.9	412.3	50.6
		0			0			0
		-14.8			-11.9			-12.1
		1.1			4.9			4.2
		-1.1			-7.2			-5.2
		2.1			12.2			9.4
		-2.5			-6.5			4.2
		-13.4			-10.4			-20.5
		7.1			4.7			-11.2
		-20.5			-15.1			-9.3
		-14.8			-11.9			-12.1
		-8.4			-4.0			1.3
		4.5			14.6			39.8
		113.6			128.2			168.0
		29.9			33.7			44.2

Table 8: Malaysia: Balance of Payments, 2004-07 (RM billion)

Item	2004			2005			2006			2007		
	+	-	Net	+	-	Net	+	-	Net	+	-	Net
Goods	481.9	377.1	104.8	537.0	411.4	125.6	589.7	455.2	134.6	605.8	477.7	128.1
Services	65.0	73.2	-8.2	74.1	83.1	-9.0	80.0	87.0	-6.9	97.1	96.0	1.0
Balance on goods and services	546.9	540.4	96.6	611.1	44.5	116.6	669.8	542.1	127.6	702.9	573.8	129.1
Income	16.4	40.8	-24.4	20.3	44.3	-23.9	31.0	48.3	-17.6	38.8	52.5	-13.7
Employee compensation	3.0	4.0	-1.0	4.2	4.7	-0.5	5.0	5.3	-0.3	5.3	5.9	-0.5
Investment income	13.4	36.8	-23.4	16.1	39.5	-23.4	26.0	43.1	-17.0	33.4	46.6	-13.1
Direct investment	4.3	29.5	-25.2	4.1	31.5	-27.4	11.9	32.7	-20.8	14.7	33.7	-19.0
Portfolio investment	0.4	1.4	-1.1	0.4	2.0	-1.6	0.6	3.7	-3.0	0.6	6.3	-5.8
Other investment	8.7	5.9	2.8	11.6	6.0	5.6	13.5	6.7	6.8	18.1	6.6	11.6
Current transfers	1.6	16.5	-14.9	1.1	18.1	-17.0	1.1	18.0	-16.9	1.2	17.3	-16.1
Current account balance	565.0	507.7	57.3	632.6	556.9	75.7	701.9	608.5	93.4	742.9	643.5	99.3
Capital account			0			0			0			0.1
Financial account			19.3			-37.1			-43.5			-37.1
Direct investment			9.7			3.8			0			-8.8

Abroad			-7.8			-11.3			-22.2			-37.9
In Malaysia			17.6			15.0			22.2			29.1
Portfolio investment			33.1			-14.1			12.9			18.3
Other investment			-23.4			-26.6			-56.4			-46.7
Official sector			2.4			-3.2			-8.0			-5.8
Private sector			-25.8			-23.4			-48.4			-40.9
Balance on capital and financial accounts			19.3			-37.0			-43.5			-37.2
Errors and omissions			7.1			-25.1			-24.8			16.8
Overall balance			83.7			13.6			25.1			45.3
Bank Negara foreign reserves			251.7			265.2			290.4			335.7
Bank Negara reserves (US$)			62.2			70.2			82.5			101.3

Source: Bank Negara Malaysia, *Monthly Statistical Bulletin* (various issues) capital flows that swung from RM8.5 billion deficit in 1994 to RM10.3 billion surplus in 1996, the eve of the crisis. The fragility of the current account, coupled with an exchange policy that prioritized stability vis-à-vis the US dollar, made the economy vulnerable to currency-based speculation and to speculative currency attacks.

In the crisis period of 1997-99, there was a decline in the overall balance in 1997 due to large outflows of short-term capital, but a huge recovery in the overall balance in 1998 as the merchandise trade account went into massive surplus as export value jumped and import value remained stagnant, due to the large depreciation of the ringgit. The year 1997 was the low point for the balance of payments, with the current account in RM17 billion deficit (6.3% of GNP) and short-term capital outflows offsetting the traditional private long-term capital inflow. The year 1998 marked an important turnaround of the merchandise account to large surpluses, which in that year and future years would give the economy an important good standing to withstand not only the deficits in services but also the fluctuations in capital flows. In 1998, the current account turned around from a RM17 billion deficit the previous year to a RM37 billion surplus, and this offset the increased private short-term capital outflow of RM21 billion (due mainly to a repatriation of equities before the prohibition of such outflows at the end of August). Reserves strengthened by RM40 billion to RM99 billion. The recession, which caused the GDP to fall 7.4% in real terms in 1998, and the ringgit's depreciation, swung the balance of payments around. In 1999, the goods surplus remained very high (RM86 billion) and could offset the continued high services and investment income outflows and the large capital outflow in "other investment", so that the overall balance had an RM18 billion surplus.

In the period 2000-05, the real economy went into recovery, with growth of 8% in 2000, then a dip to 0.3% (mainly due to effects of the global slowdown which caused real exports to drop 7.5%) in 2001, and growth of 4-5% in 2002-03, 7% in 2004 and 5% in 2005. The overall balance of payments was in deficit by RM8 billion in 2000, then recovered to a small surplus in 2001 and to large surpluses of RM40 billion in 2003 and RM84 billion in 2004 before moderating to RM14 billion in 2005. The foreign reserves expanded from the crisis low point of RM59 billion (1997) to RM114 billion or US$30 billion (2001) and RM265 billion or US$70 billion (2005). The surpluses in the overall balance of payments were in all years underpinned by the continuing high surpluses in merchandise trade (RM70-80 billion annually in 2000-02, rising to RM105-125 billion in 2004-05). The services account was in deficit for all years, usually at the level of RM8-11 billion. Investment income had net outflows of RM22-28 billion annually, mainly due to repatriation of profits from FDI in Malaysia.

In the financial account, the main capital flow into the country was private FDI, at the gross level of RM14-15 billion in 1999 and 2000, then RM9-12 billion in 2002-03, rising to RM15-18 billion in 2004-05. During this period, there was a recovery of Malaysian direct investment abroad, after its being prohibited (except with permission) in August 1998. The level was about RM5-8 billion a year in 1999 to 2004 (except for a low level in 2001, and the rise to RM11 billion in 2005). Portfolio investment was in fact negative in 2000-02 (by RM3-9 billion) due partly to the effects of the capital controls imposed in 1998 and which were then liberalized from 1999. Portfolio investment flows became volatile after 2003, rising from a small net inflow of RM4 billion in 2003 to a huge inflow of RM33 billion in 2004 and a large net outflow of RM14 billion in 2005. This was probably accounted for by foreigners placing their funds (in 2004) in local equities and bonds to speculate on an anticipated appreciation of the ringgit as a de-pegging against the dollar was widely expected. However, after the small appreciation of the ringgit following the de-pegging in July 2005, there was a reversal of portfolio flows (Foong 2008). There was also volatility in net flows on account of external loans, most of the volatility being a result of net changes in short-term debt (see earlier section on external borrowing). This is reflected in the item “other investment.”

During this period, “other investment” (comprising loans; movements of bank funds to and from abroad; and non-bank private sector transactions with counterparties and placement of deposits abroad) built up significance as a financial account item. It was in deficit in all years in this period (of about RM20-30 billion for most years). Much of the outflows was due to the private sector, which had net outflows of RM37 billion in 1999, then around

RM20-26 billion a year in 2000 to 2005 (except for lower amounts in 2002-03). This item thus became a drain on the financial account. The increasing placement of assets abroad by Malaysian-based banks and companies has been enabled by the liberalization of the capital account in recent years.

In the period 2006-07, some interesting developments (some arising from the trends in the earlier period) took place.

- The surplus on the goods account continued to be high, increasing to RM135 billion in 2006 and RM128 billion in 2007. This continued to be important for underpinning the good overall performance of the balance of payments.
- The traditional deficit in the services account (involving travel, freight and insurance, education, etc.) declined in 2006 and then turned around to become a RM1 billion surplus in 2007. This strengthened the balance on goods and services.
- Although another traditionally high-deficit item, investment income, continued to be in deficit, the net deficit level declined significantly (from RM23 billion in 2005 to RM17 billion in 2006 to RM13 billion in 2007). While the gross outflow of profits from FDI in Malaysia continued at a high level and increased, there was an even greater increase in the investment income accruing to Malaysian direct investments abroad. By 2007, inflows of Malaysian investment income (RM15 billion) were able to significantly offset outflows of foreign-owned investment income (RM34 billion).
- Net portfolio income flows abroad became much more significant (RM3 billion in 2006 and RM6 billion in 2007) because of the rapid inflows of portfolio investment in these two years.
- Income from "other investment" (which includes interest paid and earned on loans) in the two years became significantly positive, due to earnings rapidly exceeding payments. This was mainly due to the increased earnings of the central bank from its expanded holdings of foreign reserves.
- Mainly as a result of the above, the current account surplus strengthened significantly to RM93 billion in 2006 and RM99 billion in 2007.

- However, while the current account showed increased strength, the financial account fell into deeper deficits, due mainly to two factors: a rapid rise in Malaysian direct investments abroad, and very rapid expansion in the net outflows in “other investment”.
- Malaysian companies’ direct investments abroad rose to RM22 billion and RM38 billion in 2006 and 2007. This turned around the usual large surplus in direct investment to zero in 2006 and a large RM9 billion net outflow in 2007. The larger presence of Malaysian investments abroad was, however, also reflected in the higher inflow of earnings from these investments in the direct investment income item in the current account.
- In “other investment”, the huge deficits (RM56 billion in 2006 and RM47 billion in 2007) were only explained in small measure by the public sector’s net repayment of external debt. The main causes were the outflows of the banking sector, mainly placement of assets abroad amidst increased portfolio diversification by banks and ease of sourcing foreign exchange from the domestic market. The outflow was also caused by unwinding of inter-bank borrowings by banks. Outflows by the non-bank private sector were caused by trade credits extended by Malaysian exporters and placement of deposits with financial institutions abroad (Bank Negara Malaysia *Annual Report 2007*, p40; *Annual Report 2006*, p50).
- These two years also saw a significant return of portfolio investment into the country (RM13bil in 2006 rising to RM18 billion in 2007).
- After volatile swings in the “errors and omissions” item, the overall balance of payments was RM25 billion in 2006 and RM45 billion in 2007, causing the foreign reserves to increase to RM336 billion (or US$101 billion) at the end of 2007.

The bedrock on which the healthy overall balance rests at present is the very large surplus in the trade in goods account, and correspondingly in the current account. However, in the financial account, there is a significant extent of volatility, especially in portfolio investment and in “other investment”, while the increasing trend of overseas investment by Malaysian companies is also draining funds from the country.

Chapter 6

MANAGEMENT OF CAPITAL FLOWS AND THE EXCHANGE RATE

a. Managing the effects of capital flows

IN the last decade, the financial authorities were most concerned firstly about stopping excessive capital outflows (especially of portfolio capital) during the financial crisis, and then gradually restoring the system to its more usual liberalized state regarding freedom of foreign outflows (through relaxation and eventual elimination of controls on portfolio outflows). The capital controls had led to the plummeting of international portfolio investors' confidence in the equity market. Thus, even with the re-liberalization of capital flows, for most of the past decade Malaysia lost its previous status as a preferred venue for portfolio investment, with negative net portfolio investment outflows or only a small inflow for most years. In 2006 and 2007, however, there were significant portfolio inflows. In the second half of 2008, there were signs of large portfolio outflows as a result of the global financial turmoil.

By having such an open system of capital flows, the country is vulnerable to volatility. The magnitude of the challenge of managing short-term capital inflows is shown by the extreme rapidity in expansion and volatility of such flows since 2004. Bank Negara recognizes that the Malaysian financial system will face increased problems resulting from the current extremely uncertain and volatile global financial environment. Its *Annual Report 2008* acknowledges the challenges posed by volatility in international financial markets and in global exchange rates, and that such volatility will influence the direction of capital flows, which in turn will affect the domestic financial markets and overall financial system. The expectation has now become a reality.

In terms of policy choices, Bank Negara has, however, eschewed controls over short-term capital inflows, such as imposing a reserve requirement on short-term capital. Like almost all other countries in the region, it has chosen to allow free inflows of portfolio funds. This renders the country vulnerable to sudden shifts in investor behaviour and to large outflows. The Bank relies on monetary policy instruments to smoothen the effects of such flows on the interest rate, exchange rate and the volume of domestic liquidity. It also depends on strengthening domestic financial markets so as to absorb large and volatile capital flows (Bank Negara Malaysia *Annual Report 2007*, p87).

Thus, the Bank does not in effect regulate capital flows, choosing instead to have an open system which at present is even more liberal than before the 1990s financial crisis. What the Bank manages is the effects of the capital flows, making use of liquidity operations to influence money supply, interest rates and the exchange rate. The adequacy of such an approach will be seriously tested when there is high volatility and sudden large flows in the opposite direction, as is happening in 2008.

The liquidity operations of Bank Negara are used to reduce the effects of capital flows on the domestic financial system. The Bank undertakes contractionary activities by absorbing funds from the market when there is excess liquidity induced by inflows and expansionary activities by releasing funds when there are excessive outflows.

In the early 1990s, when there was massive inflow of funds, the Bank sterilized about RM16 billion (1992) and RM33 billion (1993). This was followed by four years of expansionary operations, especially in 1997 when the Bank released a net amount of almost RM30 billion in the market. This was reversed in 1998 and 1999 when almost RM40 billion and almost RM30 billion were sterilized, and in 2002 and 2003 when sterilization of RM10-20 billion a year was undertaken. In this period, liquidity operations were largely contractionary to sterilize inflows arising mainly from the large trade surplus and only to a lesser extent from portfolio inflows (Latifah 2004). In 2006 and 2007, there were large inflows of portfolio funds, mainly for purchase of shares on the Kuala Lumpur Stock Exchange, and this item was a major influence on liquidity operations. Meanwhile FDI inflows had been moderate until 2005, and then there were significant increases also in 2006 and 2007. Gross inflows of external loans were moderate and steady since 2002 and were mainly offset by repayments.

Thus, the management of excessive capital inflows was not a significant issue, until the most recent two to three years. In 2006, surplus liquidity in the economy increased, with the increased net inflow of direct and portfolio investment. Broad money (M3) increased in 2006 by RM82 billion or 12.3% (compared to RM50 billion or 8% in 2005). Bank Negara was involved in sterilization operations, which it said were aimed at offsetting the impact of the capital inflows on domestic liquidity and maintaining stable monetary conditions.

The total amount of surplus liquidity sterilized by the Bank's various market-based monetary policy instruments was RM164 billion on 31 December 2005, and this rose to RM208 billion in end-2006. Eighty percent of the surplus liquidity was sterilized through the conventional money market, and the remainder by operations in the Islamic money market (Bank Negara Malaysia *Annual Report 2006*, pp64, 99). The main instrument used by the Bank for sterilization was direct borrowing (accounting for 74% of the surplus liquidity sterilized). Under this flexible instrument, new borrowings may be conducted with a short turnaround time via competitive multiple-price auctions through the Fully Automated System for Tendering platform, and with maturities of the borrowings ranging from overnight to 6 months (the average maturity being 20-30 days). In the Islamic interbank money market, placements under the Al Wadiah Yad-Dhamanah principle are taken with the same flexibility.

The Bank also increased its use of another sterilization instrument, the repurchase transactions (repos). The increased use was facilitated by availability of collateral securities (mainly Malaysian Government Securities) from major institutional investors through the lending of securities. Another sterilization instrument, the Bank Negara Monetary Notes (BNMNs), was also introduced in December 2006. The notes replace the Bank Negara Bills and Bank Negara Negotiable Notes, and their role is to absorb excess liquidity. The notes are subject to a flexible limit in terms of the Bank's prevailing level of international reserves and may be issued in coupon-bearing or discount-to-face-value format with tenures up to three years. A total of RM6 billion of BNMNs were issued in 2006 (Bank Negara Malaysia *Annual Report 2006*, p100).

In 2007, in line with other countries in Asia, Malaysia received substantial capital inflows. Bank Negara itself listed the following as the challenges of liquidity management in the region for that year: (1) avoiding sudden and disruptive currency movements; (2) addressing potential adverse impact on central bank balance sheets; and (3) limiting the inflationary effects on the economy and financial system of the continued inflows.

In 2007, there was significant increase in volatility of capital flows. Volatility was especially prevalent in portfolio investment, with high growth in volume traded, in both inflows and outflows. Portfolio investment receipts in the year jumped to RM379 billion (more than double from RM173 billion a year before) while payments jumped to RM353 billion (from RM162 billion). Though there was a net inflow of portfolio funds during the year, there were also major periods of large outflows. The portfolio flows were subjected to global events especially the global equity correction in February, the global bonds sell-off in June and the subprime mortgage turmoil in August and September. The domestic money market was affected by the temporary reversal of capital flows arising from the pullback of portfolio funds during these periods. To offset the capital flow reversals, the Bank unwound existing outstanding sterilization operations to enable an orderly adjustment in the financial markets (Bank Negara Malaysia *Annual Report 2007*, pp85-86).

The Bank's swift response to the August-September heavy outflows was enabled by the short-term maturity structure of various monetary instruments. By the end of 2007, total surplus liquidity sterilized by the Bank was RM310 billion (a big rise from RM208 billion at end-2006) and the weighted average maturity of these borrowings was 39 days. The main instruments in use were uncollateralized direct borrowings and Shariah-compliant deposit placements (51% of surplus liquidity sterilized at end-2007), and BNMNs, whose value increased significantly from 2006, and accounted for 26% of the value of total instruments used.

b. Capital outflows as a means to lower the pressure of inflows

With large capital inflows exerting upward pressure on their currencies, the authorities in many Asian countries have liberalized capital outflows by easing up on restrictions. These measures had taken place since 2002 but accelerated in recent years in Korea, China, India, the Philippines and Thailand. According to McCauley (2008), these measures signal the authorities' comfort with their international liquidity position and their discomfort with adding to official reserve holdings.

Malaysia has also recently significantly liberalized capital outflows. With the central decision taken to operate financial policy within a liberalized capital account regime, Malaysia has had massive gross inflows from the current account (due to a high goods surplus) as well as high inflow of portfolio investment funds since 2006. It is questionable whether sterilization could absorb the massive gross inflows as there are limits to the market's capacity to purchase government debt. In recent years, Bank Negara coupled its liberalization of capital inflows with the liberalization of outflows. This helped to facilitate huge outflows by the domestic private sector in direct investments abroad especially since 2006. There were also massive outflows (since 2004 and accelerating further since 2006) of "other investment" of the private sector, mainly the placement of assets abroad by the banking system, but also increasingly through the non-bank private sector placing deposits with financial institutions abroad. There was (at least implicitly) an encouragement of such huge outflows in order to reduce the pressure of excessive liquidity caused by the massive inflows in 2006 and 2007.

While this policy of liberalized outflows has eased excess liquidity pressures, it also increases vulnerability in an increasingly volatile international environment. The continued global economic slowdown and financial volatility may lead on one hand to a reduced trade surplus and to short-term capital outflows. It would not be easy to institute a reversal of capital outflows by residents by policy shift as took place in 1998 because the volume of outflows in recent years is far greater than in the mid-1990s, and a large part of these are direct investments.

c. Managing the exchange rate and interest rates in a liberalized environment

A major objective of Bank Negara's liquidity operations has been to maintain interest rates within a certain target level. Writing in 2000, the Bank said its management of monetary policy was focused mainly on "managing liquidity flows to ensure stable liquidity conditions in the banking system so as to maintain interest rates at levels low enough to promote economic activity but sufficiently high to ensure positive real rates of return to depositors" (Bank Negara Malaysia *Annual Report 2000*, p70). Maintaining interest rates at low levels has been a central tenet of economic policy since the switch in policy in mid-1998 when the government changed course in the middle of the recession by boosting liquidity and lowering interest rates in an attempt to revive the economy and the corporate sector. Since 1999, interest rates have been kept remarkably low as well as steady. The banks' average base lending rate has remained at 6-7% from 2000 to 2007. The 1-month inter-bank rate has also been low and steady at a range of 2.9 to 3.6% in 2002 to 2007. The banks' fixed deposit rates have also remained steady at 3 to 3.5% from 2000 to 2007.

In the scheme of overall Malaysian economic policy, having a regime of a stable and low interest rate appears to be among the highest priorities, in order to make loans to consumers and businesses affordable, and thus facilitate economic growth. Since the inflation rate has been relatively low, Bank Negara could pursue this central policy while keeping interest rates at low levels.

Another central economic policy tenet is the stability of the exchange rate, and to maintain the rate at a level that is neither too low nor too high. That it not be too low was a matter of concern during the crisis years when the steep depreciation of the ringgit vis-à-vis the US dollar brought the country to the brink of difficulties in debt servicing. The fixing of the ringgit to the dollar at 3.80 stabilized the currency at this same level from September 1998 to July 2005. By the time the ringgit was on a managed float, the concern had shifted in the other direction, that the currency should not appreciate too significantly, as this would reduce export competitiveness. Since 2005, the maintenance of the ringgit within a range that would not have adverse effect on trade competitiveness has been a major (though discreet) objective of monetary policy and of liquidity operations.

In the thesis of the "impossible trinity" of policies, a country can have two but not all three of the following: openness to capital flows, stability of exchange rate and an independent monetary policy. During the financial crisis years 1998-2000, Malaysia had chosen to have selective capital controls, and was able to maintain the other two policies (including through fixing of the ringgit to the US dollar). From 2001 to 2005, the country re-instituted openness to capital flows but was still trying to also maintain the other two policies by having a stable exchange rate while keeping interest rates steady and low. In this it succeeded through the use of one instrument for the exchange rate (fixing the ringgit to the US dollar) and the use of monetary instruments (sterilization and its reverse) especially to smoothen out the effects of external capital flows. However, with the change to a managed float system in 2005, monetary instruments have also to be relied on to maintain the currency within a certain range. At the same time, Bank Negara took measures to improve surveillance and strengthen risk management of the banking system.[1]

The post-2005 period also coincided with increasing turbulence in the global financial system, with much greater volatility in the flows of funds into and out of the Asian region, including Malaysia. There was a greater use of monetary instruments to manage capital inflows and outflows in the much-liberalized regime, while keeping to the priority of low, stable interest rates, and allowing the ringgit to float in the framework of a basket of currencies,

1 An interesting explanation by a Bank Negara official on how Malaysia could effect monetary policy based on domestic policy objectives while being under a pegged exchange rate system, thus to some extent attaining the triple aims in the "impossible trinity", is provided in Latifah (2004).

Table 9: Malaysia: Overall Balance, Current and Financial Accounts, Balance of Payments, 1998-2007 (RM billion)

	Overall balance	Current account	Capital account, financial account, and errors and omissions
1998	40.3	37.4	2.9
1999	17.8	47.9	-30.1
2000	-8.2	32.3	-40.5
2001	4.5	27.7	-23.2
2002	14.6	30.5	-15.9
2003	39.8	50.6	-10.8
2004	83.7	57.3	26.4
2005	13.6	75.7	-62.1
2006	25.1	93.4	-68.3
2007	45.3	99.3	-54.0
Total	276.5	552.1	-275.6

Source: Bank Negara Malaysia, *Monthly Statistical Bulletin*; author's own calculations

Note: Overall balance in a year is equal to the change in Bank Negara's foreign exchange reserves.

when these reference currencies themselves were fluctuating with greater volatility. As the events of the most recent years indicate, there will be more challenges in operating in an open capital regime, especially in the midst of the global financial crisis.

d. Increasing buildup of foreign exchange reserves

Like many other Asian countries, Malaysia has also built up its foreign exchange reserves following the financial crisis. Bank Negara's foreign reserves fell from RM70 billion in 1996 to a low point of RM59 billion in

1997 (3.4 months of retained imports), then began recovering from there to RM99 billion in 1998, RM128 billion (US$34 billion) in 2002 and RM336 billion (US$101 billion) at end-2007.

The buildup in the reserves was wholly due to surpluses in the current account. In fact there were large net deficits on the capital and financial accounts and in "errors and omissions", which were then more than offset by the current account surpluses. From 1998 to 2007, the cumulative increase in the overall balance was RM276 billion, which is the amount by which the foreign reserves increased. This was made up of a cumulative surplus in the current account of RM552 billion, offset by a cumulative deficit of RM276 billion in the capital and financial accounts and errors and omissions (Table 9).

This also shows that the Malaysian economy needs to run current account surpluses if outflows on the capital account continue. Without large current account surpluses, there would be a negative overall balance which would be unsustainable as the foreign reserves could be drained within a number of years. The current account surplus in recent years comprised mainly the huge surplus on merchandise trade. A downturn in commodity export earnings coupled with a decline in demand for manufactured exports caused by a global recession could lead to a net reduction in foreign exchange reserves.

Several analysts have warned about the over-accumulation of foreign reserves, due to the high cost involved. Khor and Kit (2007) point to several Asian countries engaging in sterilized interventions to mop up excessive liquidity, and to the problem that if domestic interest rates are higher than foreign interest rates, the interest cost of servicing sterilization bonds will be higher than the returns on investments of the foreign reserves. These costs can become prohibitive and result in losses on the central banks' balance sheet. They can also suffer translation losses on their foreign exchange reserves should their currencies appreciate. Further sterilization may become difficult politically, forcing the central banks to resort to other measures, such as capital controls.

Writing in November 2007, Khor and Kit state that at that point, sterilization costs remained manageable for most Asian countries as the cost of servicing sterilization bonds appeared (until late 2007) to be fully offset by the interest income earned by the central banks' investment of foreign reserves. They warn that this may change if Asian central banks are forced to hike up interest rates sharply in response to a rise in inflation in Asia, or if there is a sharp cut in interest rates in the US. In June 2008, this scenario seems to be possible as the interest rates in the US have been sharply decreased in response to recessionary pressures and a credit crunch.

e. Strengthening the surveillance and risk management system

One significant plank of the Bank Negara approach to capital flows is to deregulate these flows and attempt to limit the adverse effects of a liberal capital regime by strengthening the capacity of the banking system to absorb the volatility and shocks that the Bank itself expects from such a liberal regime.

The banking system had been hard hit by the financial crisis a decade ago. Thus the financial authorities are well acquainted with the dangers associated with an open financial system. Bank Negara took several measures since the crisis to strengthen surveillance and improve risk management. This was seen as crucial especially since it was preparing for a re-liberalization of policies regarding capital flows and later for the floating of the ringgit. The Bank recognized that the rapid growth in volume of financial transactions, increased complexity of financial markets and a more interconnected global economy had resulted in greater potential vulnerabilities and risks to the stability of the financial system. It sees its role as promoting a sound and efficient system that is able to withstand adverse economic cycles and shocks, thus preventing disruptions to the financial intermediation process.

The methods are seen as threefold: regulation and supervision of financial institutions; ensuring reliability of major payment and settlement systems; and developing efficient financial markets.

The Bank has promoted restructuring of financial institutions, better governance and risk management practices. It says this enabled the financial institutions to show the capacity to absorb the impact of volatility in the financial markets without disruptions to payment systems.

To contain cost increases, the Bank pursued a range of deregulatory measures, accompanied by a more rigorous supervisory oversight system. The Bank recognizes the risks of external liberalization but believes global integration brings new business opportunities including access for companies and consumers to competitive financial products and services. It says the benefits from liberalization must be commensurate with the increased risks of liberalization, and also that the preconditions are in place for the system to adjust to the changes.

Recognizing the greater risks from volatile capital flows to the domestic financial markets, the Bank instituted macro and micro stress testing of financial institutions. It found that to date the financial system can absorb the risks of capital flows. The Bank instituted surveillance processes to identify and manage risks in the system. The use of scenario analysis, stress testing and an early warning system are aimed at early identification of emerging threats to financial stability, and enabling better monitoring of complex inter-linkages from international capital flows, as well as fund flows between the financial sector, the corporate sector, financial markets and the macroeconomy.

Chapter 7

VULNERABILITY TO EXTERNAL SHOCKS

a. Vulnerability to global financial turmoil

THE vulnerability of developing countries to the volatility of financial markets is evident in the current global financial turmoil. Firstly, banks, firms or investors in some developing countries may suffer direct effects in terms of losses from investing in financial instruments or institutions involved in the subprime mortgage business. Secondly, the turmoil will affect the behaviour and operations of investors, whose decisions on where to direct or re-direct their funds in the new environment will affect the flow of funds either into or out of developing countries. Thirdly, effects on developing countries' real economy may also be transmitted through the trade channel.

Malaysia's open capital system as well as extremely high dependence on trade make the country vulnerable to potential shocks arising from the development of the global crisis.

Institutions and individual investors in the country have been directly affected by the subprime problem. There has been little analysis published on this. However, Bank Negara has provided an empirical estimate of the exposure of Malaysian financial institutions to the subprime market. According to the Bank, the subprime crisis has had a "minimal impact" on the operations, profitability and solvency of Malaysian financial institutions and on liquidity in the system. Direct and indirect exposures of Malaysian financial institutions in terms of holdings of securities linked to US subprime mortgages and lending to entities associated with the subprime mortgage business accounted for 0.3% of the banking system's capital base. The Bank does not provide a figure for the value of the exposure. However, since the banking system's capital base was RM104 billion in December 2007, the exposure can be said to be around RM300 million.

The Bank also reveals that the exposures were limited to the overseas operations of a few domestic banks. On aggregate, the banking system's exposure to foreign securities holdings accounted for less than 0.5% of total banking system assets. Since the banking system's assets in December 2007 were RM1,145 billion, the exposure to foreign securities was RM5.7 billion.

In the insurance industry, investments in subprime-related securities accounted for not more than 1% of total foreign assets in the investment-linked funds.

Though the exposure to the subprime business was not large, it should be noted that the recent liberalization of capital outflows (including the Bank Negara deregulation allowing individuals and companies to invest in foreign currency assets, and the September 2005 measures by the Securities Commission (i) allowing Malaysian investors to invest in foreign securities listed on recognized foreign exchanges, (ii) allowing banks and certain brokers to execute secondary trades of non-ringgit bonds without seeking the Commission's approval, and (iii) allowing foreign-currency-denominated bonds to be issued to banks and universal brokers) meant that Malaysian institutions are now able to purchase assets linked to the subprime business, or to other foreign assets or contracts (such as credit derivatives) that are now facing problems. If the liberalization had taken place earlier, or the outbreak of the subprime crisis had been delayed a few years, there could have been greater exposure and adverse effects.

One channel by which investors are exposed to risks is unit trusts and other investment vehicles. Unit trust management companies, fund management companies and insurers and takaful operators are now permitted to invest in foreign-currency-denominated funds. The unit trust industry has expanded rapidly. In May 2007 there were 39 unit trust management companies operating 435 unit trust funds with a net asset value of RM143 billion. Of these funds, 128 invest in foreign markets, with investment totalling RM10.8 billion. This growth in investment overseas was caused by liberalization measures allowing unit trust companies to invest in foreign funds, initially 10% of net asset value of resident funds in 2004, rising to 50% of NAV of funds in 2007 (Ministry of Finance Malaysia 2007, p115).

Many of the individual funds set up by fund management companies are open to members of the public and made available through commercial banks which act as agents. Several of the funds offered are linked to the performance of foreign stock markets, or individual companies or sets of companies. The following are two recent examples of such funds.

First is the Rebound FRNID, a structured product based on the shares of reference stocks of well-known banks (Citigroup, Merrill Lynch, UBS and Morgan Stanley) whose share values had taken a fall because of their links to the subprime business. The investor is asked to take a bet that the shares of these famous banks will rebound, and the brochure notes that Abu Dhabi Investment Authority, the Singapore Investment Corp. and China Investment Corp. have all taken stakes in the ailing banks. Funds are to be invested with maturities of 2, 3 or 5 years, with expected yields of 15, 23 and 45% respectively. Investors are guaranteed their capital back even if the funds do not perform to expectations. The fund was opened in January 2008. Despite the managers' expectations, the banks concerned have suffered even more serious financial difficulties since then, with their share values decreasing instead of increasing.

Second is the Kimchi Dynamic Fund (offered through Citibank), another "structured product" which links the fund's value to the values of stocks of four Korean companies (Posco steel company, Hyundai Motors, Daewoo Shipbuilding, LG Electronics). The individual investor will get a maximum 8% per annum return if the official closing prices of all the shares are equal to or above the "initial strike level" during the product tenure (30 months) and this is also subject to foreign exchange risk. The investor is taking a bet that all the four companies' stocks will perform. The capital is guaranteed if the investor holds the product to maturity.

Malaysia is also vulnerable to the effects of changing global economic conditions on its export commodity prices. The present global recessionary conditions have led to a sudden downward shift in prices and a reduction in export earnings. As a net oil exporter, the country has been hit by the dramatic fall in the oil price from a peak of US$140 a barrel in July to around

US$60 in early November 2008. Even more significant, as it affects the livelihoods of many rural households, has been the steep decline in the price of palm oil. Crude palm oil futures in Malaysia fell from an all-time high of RM4,500 per tonne in early March to about RM1,500 in early November 2008.

b. Effects of capital flows on asset prices

A major concern of both analysts and policy makers is the potential impact of large capital flows on domestic prices, in particular the potential of creating asset bubbles in the equity and property markets. For example, Khor and Kit (2007), in a review of the Asian economies 10 years after the financial crisis, warned of strong capital inflows translating into higher asset prices, with foreign buying driving stock markets in some Asian countries to record highs, until recently. Similarly, in the residential property markets there is some evidence of speculative activities and an asset bubble in some countries. A key risk is that asset prices could fall sharply in the event of a sudden reversal of foreign capital inflows. There is a reasonably strong correlation between foreign net purchases of Asian equities and stock price movements; and downside surprises in incoming economic data could trigger a broad-based re-pricing of Asian assets by foreign investors and spikes in risk premiums (Khor and Kit 2007, p18).

In Malaysia, the capital inflows in the most recent years have had moderate effects on domestic prices, particularly in the equity market. The moderate extent of the effects could be due to the fact that the portfolio capital flow was negative for most years since 1999. However, there was a major change to large net inflows in 2006 and 2007. This had an effect on the prices of stocks and the volume of trade in the Kuala Lumpur Stock Exchange. The KLSE Composite Index had been at a level of 800-900 from end-2003 to end-2005, then it rose to 1096 at end-2006 and 1445 at end-2007. The trading volume almost doubled from a daily average of 414 million units in 2005 to 803 million in 2006, and almost doubled again to 1,584 million in 2007. The average daily trading value also rose from RM720 million in 2005 to RM1,019 million in 2006 and RM2,346 million in 2007.

Table 10: Malaysia: Consumer, Housing and Equity Prices, 2000-08

	Consumer Price Index (annual % change)	House Price Index (annual % change)	KLSE Composite Index	KLSE Average daily trading volume (million units)	KLSE Average daily trading value (RM million)
2000	1.6	6.0	679	363	805
2001	1.4	1.2	696	204	224
2002	1.8	2.4	646	350	470
2003	1.2	4.2	794	456	748
2004	1.4	5.0	907	437	873
2005	3.1	2.3	900	414	720
2006	3.6	2.1	1096	803	1019
2007	2.0	4.8	1445	1584	2346
2008	3.0[a]		1206[b]		

Source: Bank Negara Malaysia, *Monthly Statistical Bulletin* (various issues); *Annual Report* (various issues)

[a] April 2008

[b] As on 20 June 2008

However, in line with the global equity sell-down, the KLSE also declined in the first half of 2008. The KLSE Composite Index had fallen to 1206 on 20 June 2008. (See Table 10.)

In the residential sector, there have been moderate increases in prices in recent years, and part of this is due to the rising cost of building materials. Due to ample liquidity and low interest rates, consumers had affordable access to housing loans. There has, however, been an overhang of unsold properties, and developers were cautious in launching new housing projects. The average price of houses as measured by the Malaysian House Price Index increased by about 4.2% in 2003, 5% in 2004, 2.3% in 2005 and 2.1% in 2006. The index however rose significantly by 4.8% in 2007. (See Table 10.) The highest rate of increase was in detached houses (7.5%) and in the Kuala Lumpur area (7.9%).

The 2007 acceleration of house price increases was contributed significantly by fund inflows and foreign purchase of real estate. In 2007, foreign purchase of residential properties significantly increased, facilitated by the liberalization of the Foreign Investment Committee guidelines on foreign purchases, exemption from Real Property Gains Tax and relaxation of the number of property-related loans that foreigners could obtain. Residential property transactions by foreigners increased by about 30% in the first half of 2007. Approvals of housing loans to foreigners also rose by 46% during the year. Some of the portfolio inflows in 2007 was directed to the property market, with increased foreign purchase of higher-end residential property in some prime locations, resulting in higher prices (Bank Negara Malaysia 2008).

Consumer prices have been affected mainly through the trade (rather than the finance) channel, by the rapid rise in the global prices of oil and food items in the past two years. The increase in the Consumer Price Index (CPI) was small at 1-2% in 2000-04, and rose moderately to 3.1% in 2005 and 3.6% in 2006, before falling to 2% in 2007. (See Table 10.) However, the overall figures hide significant increases in some key categories. In December 2007, overall prices were 7.1% higher than the 2005 index, while food and beverage prices were 9.4% higher and transport costs 13.9% higher. In the first half of 2008, prices shot up faster than for many years. The increase (on an annual basis) of the overall CPI rose from 2.3% in January to 3% in April. In June 2008, the government announced an increase in domestic petroleum prices of 40-50%. The inflation rate in June rose to 7.7%, and in July it climbed further to 8.5% (with transport costs 23% higher and food prices 11% higher). Inflation has climbed to the top of the list of economic problems. However, as mentioned, the rise in consumer prices is attributable to the trade channel, with capital inflows playing an insignificant role.

c. Balancing the benefits and risks of capital liberalization

The central bank, as shown in its reports, is aware of the risks of an open capital regime in a period of global market volatility, but believes the benefits (to growth, wealth creation and performance of the domestic financial markets) are worth the risks. It agrees that highly mobile capital inflows could fuel asset price bubbles with major adverse implications for financial stability. "As the fragility of the external environment remains an area of concern, any sudden reversals, especially that arising from higher risk aversion and the need to unwind investment positions to cover potential losses in other markets, may result in asset price corrections in the domestic financial and property markets." Also, the persistent surplus liquidity could induce imprudent behaviour in financial institutions such as a compromise in underwriting standards for lending facilities. Bank Negara believes it is its supervisory challenge to balance the tradeoffs between benefits of capital inflows and the associated risks (Bank Negara Malaysia 2008, p36).

Serious challenges lie ahead, as the country has only since 2005 experienced large volatile capital inflows, and also very significant outflows of direct investment and the placement of deposits overseas. The central bank's strategy of strengthening the surveillance and risk management system to withstand the effects of global volatility, and making increasing use of sterilization instruments, rather than limiting the flows of funds, may well be tested if the global financial turmoil develops further. In the second half of 2008, the inflows of portfolio capital changed direction suddenly to massive outflows, especially in the third quarter, thus emphasizing the risks of volatility.

d. Capacity to keep regulatory pace with new financial instruments

Another associated major challenge is the difficulty of keeping monitoring and regulatory pace with new financial instruments that market players are continually seeking to introduce. The securitization of loans through several investment products that led to the subprime mortgage crisis and its tremendous after-effects is only one example of new and exotic financial products that regulators and even market players themselves have found difficult to comprehend, let alone regulate effectively. With the current level of liberalization, Malaysian financial institutions, companies and individuals are already able to be exposed to these financial products and instruments that operate abroad. Financial institutions that operate locally are also increasingly offering new products in the market.

A key concern for financial markets is the growing problems associated with credit risk transfer products that have been increasing in value and in complexity, with associated increase in complex risks, which have also spread because of the global spread of these products. Among the products that triggered the subprime crisis are the credit default swaps that insure against defaults on companies' credit. The markets for these securities have grown from US$900 billion in 2000 to over US$45 trillion in mid-2008. Concern over the worrying trends in credit derivatives led to the Reserve Bank of India announcing in June 2008 it had postponed the issuance of final guidelines on introducing credit derivatives in India, stating that this was due to current circumstances in developed countries, in which the dimensions of the recent credit crisis had not been gauged. The Bank said the time was not opportune to introduce credit derivatives in India, mentioning the level of risk management systems and possible non-adherence to the regulatory guidelines on complex products such as credit derivatives in international financial markets (Reserve Bank of India 2008).

Interviews with senior officials in Malaysia involved in financial policies revealed their serious concern about the capacity to understand the workings of and to regulate new financial instruments, particularly credit derivatives, if they are introduced in the domestic market.

Chapter 8

SUMMARY AND RECOMMENDATIONS

THIS paper has examined the evolution of and changes in policies in Malaysia with respect to the management of capital flows, the exchange rate and related issues.

Malaysia had a relatively open financial system when the financial crisis struck in 1997. The relative openness contributed to the conditions for the crisis, especially the inflow of foreign portfolio investment, the internationalization of the currency, the overseas trade in the domestic stock market's counters, and the inadequate regulation of foreigners' borrowing of domestic assets (enabling currency speculation).

During the crisis period, Malaysia instituted many measures that reduced the speculation on the currency, stabilized the exchange rate, and stemmed the outflow of foreign-owned portfolio capital, as well as restricting capital outflow by residents.

Since the crisis, there has been the deregulation and liberalization of various categories of capital flows. Certain policies have been retained, especially the non-internationalization of the currency, aimed at preventing overseas or offshore speculation on the ringgit. However, the currency system itself has changed from having a fixed rate (in relation to the US dollar) to a managed float.

On capital flows, the restrictions on capital flows by foreigners have been largely lifted, on both the outflow and inflow aspects. Restrictions on foreigners for borrowing from local banks and residents in foreign or local currency have considerably eased, as have regulations on foreigners' purchase of property, and their operating bank accounts in foreign or local currency. The restrictions on outflow of portfolio capital and ringgit-denominated assets by foreigners have been totally lifted. The foreign exchange regulation system basically allows free inflow and outflow of foreign funds.

No less significant is the lifting or relaxation of restrictions on residents. There are no limits on locals using their own funds (i.e., non-borrowed funds) to invest in foreign currency assets, thus enabling the free flow of capital abroad. The strict rules on locals borrowing in foreign currency (the existence of which helped Malaysia avoid the excessive foreign borrowing that characterized the financial crises of Indonesia, Thailand and South Korea) have been relaxed so that a resident company can now borrow the equivalent of RM100 million without permission. Residents can now open foreign currency accounts in Malaysian banks or abroad. Although there are still restrictions, there are now more possibilities for Malaysian residents and companies to invest in unit trusts and other investment vehicles that have their investments abroad.

The financial authorities have estimated that the benefits of financial liberalization outweigh the risks and costs, and that the risks can be taken care of through stronger risk management techniques. Their approach to capital flows is basically to allow capital flows to be subjected to market forces, with less and less regulation, and to try to manage excesses when they occur, for example through sterilization of capital inflows. Among the main vulnerabilities recognized is that sudden reversals of foreign capital flows may cause asset price corrections in the financial and property markets (Bank Negara Malaysia 2008, p36).

The present liberalized system has exposed the country to greater risks of volatility and financial stress. The problems which the country is exposed to are in many respects different from the conditions that led to the 1997-99 crisis. Nevertheless they are potentially serious problems.

The 1997-99 crisis was triggered by speculative downward pressure on the ringgit and worsened by foreign portfolio capital outflows, which led to massive declines in stock market values. There was also substantial foreign debt, which made the country and the borrowing companies vulnerable to depreciation of the ringgit. Since then, Malaysia's foreign debt has become more manageable and its servicing more sustainable. However, the country's financial system and balance of payments are still vulnerable to external developments and shocks, although the present vulnerabilities may be different in character from those that led to the previous decade's financial crisis.

One major aspect of the liberalization process has been the deregulation of capital outflows by residents. This has resulted in a dramatic increase in direct investment outflows from Malaysia, which in 2007 had risen to RM38 billion, exceeding direct investment inflow of RM29 billion. If the net outflow of direct investment income in 2007 is added to this net outflow of direct investment, there is a RM28 billion deficit on the direct investment account, or 4.5% of GNP, which is very significant indeed.

The liberalization of capital outflows could be aimed at giving Malaysian investors greater choice in investing their savings and in diversifying their investment portfolio, and enabling Malaysian companies to invest in projects abroad. Also, the authorities have implicitly encouraged the outflow of Malaysian capital as a measure to reduce the pressures of large foreign capital inflows in recent years. However, a continuous outflow of Malaysian capital at the present levels and a high outflow of profits from FDI have made the country highly dependent on FDI inflows. The deficit on the direct investment account can increase significantly if FDI inflow is reduced.

Another consequence of the liberalization of residents' capital outflows is the huge outflow of assets of the private sector (especially banks) placed abroad, which in 2006 was RM48 billion or 8.5% of GNP. The continuous and increasing draining of local investment capital and bank assets for investment abroad may be a symptom of the lack of investment opportunities within the country. Like in other Asian countries affected by the financial crisis a decade ago, investment in Malaysia has not recovered to pre-crisis levels in terms of ratio to GNP. The need to improve the investment climate and conditions aimed at greater domestic investment – making greater use of domestic financial resources rather than allowing these to flow abroad – is one of the lessons of the present situation.

The balance of payments has been in strong surplus in recent years. This is caused wholly by the huge surplus in the goods and services account. The other accounts (income, current transfers, and especially the financial account) are in deficit. The deficits on income and current transfers weigh down on the goods and services account, but the resulting current account has in recent years still been in strong surplus (RM99 billion in 2007). However, the financial account deficit (RM37 billion in 2007) is large and is the result mainly of the outflows of local direct investment and the placement of local bank assets abroad. As a result, the balance of payments surplus (RM45 billion in 2007) has been less than half of the current account surplus.

This situation contrasts with that of the pre-1997-crisis period, when the current account was in deep deficit, and the country was dependent on net inflows in the capital account. In recent years, the current account has been in high surplus, which covers the worsening deficit in the financial account.

So long as the conditions of trade remain good, this situation can be maintained. However, there are growing signs that the high trade surplus will be reduced in the near future. The high point in commodity prices (whose significant increases were responsible for the growth of the trade surplus) has ended. The prices of Malaysia's major export commodities, especially petroleum and palm oil, fell steeply between June and November 2008. The country's oil reserves are depleting and Malaysia is projected to be a net oil importer in a little after a decade. Moreover, manufacturing exports are expected to be hit by the global recessionary conditions.

A weakening trade surplus combined with continued high outflows on the financial account would cause the overall balance of payments to weaken and even move into deficit. This has already taken place in the second half of 2008. The country's foreign exchange reserves reached a peak of RM410.9 billion (US$126 billion) at end-June, then fell slightly to RM409.7 billion in July and RM400.3 billion in August, before plunging steeply to RM379.5 billion at end-September 2008.

The outflow of residents' capital through direct and other investments has in fact overshadowed the other major volatile capital flow – portfolio investment. In the years following the financial crisis, there was a net outflow of portfolio investment, but inflows picked up to high levels in 2006 and 2007. The return of foreign portfolio capital, together with the high trade surpluses, may have prompted the financial authorities to encourage or at least turn a blind eye to the large capital outflows by residents. However, from the second quarter of 2008 the flow of foreign portfolio capital reversed, with large outflows reported, contributing significantly to the overall balance of payments turning negative. There has been a huge turnaround in portfolio flows, emphasizing the volatility of this item: net portfolio investment was in surplus by RM21 billion in the first quarter of 2008, then there was a net outflow of RM24 billion in the second quarter, which increased to RM54.2 billion in the third quarter. This was the main reason for the overall balance of payments turning into a deficit position in the third quarter of 2008.

With these weaknesses and the growing global financial crisis and recession, the following policy measures should be considered.

The increasing deregulation and liberalization of the capital account regime should be urgently reviewed, as the volatility of many types of capital flows has heightened in the financial turmoil.

In particular, the strategy of allowing unfettered capital flows and dealing with the adverse consequences if and when they occur should be reconsidered. This approach facilitates large inflows of portfolio funds when international investors consider the domestic market an opportunity for profit, and builds the potential for sudden reversal and large outflows when perceptions change, as has recently happened in the second half of 2008. Moreover, the flows may be so large that sterilization can be used in relation to only a part of the inflows, while there are also limits to foreign exchange operations during periods of large outflows. Measures should be considered to avoid excessive capital inflows, and to discourage certain types of inflows, especially short-term speculative capital. This would reduce the danger of the development of domestic asset bubbles and the risks of sudden reversals with their negative consequences.

Regulation of foreign loans by domestic companies and financial institutions should be an important component in the treatment of inflows. The former regulation, that residents and domestic companies are allowed to obtain foreign currency loans only to the extent to which the projects and activities linked to the loans yield a return in foreign currency, should be re-introduced to avoid a situation where the country as a whole is over-exposed to external loans. Such excessive exposure is particularly problematic when the local currency is depreciating and foreign reserves are declining.

While unregulated inflows are associated with well-known risks, the deregulation of outflows has exposed Malaysia to new vulnerabilities, and measures to re-regulate these outflows should be considered, especially in the present period when foreign reserves are declining rapidly.

The huge outflows of investment capital by local companies are a strong sign that investment opportunities and conditions within the country for local investors are not attractive enough and should be improved as a matter of urgency, so as to reverse the decline in domestic investment ever since the financial crisis of a decade ago. Since the outflow of local direct investment funds is now so high, a reversal of the deregulation of this type of resident outflow should be considered, especially if the present trend of significant decline in foreign reserves continues.

A review should be made of the large and increasing placements of assets of resident banks deposited or invested abroad. The global financial turmoil could make these funds more vulnerable to losses. Information should be made known on the categories of the foreign assets in which the banks have invested, including whether and to what extent the local banks have been exposed to securities and loans whose values have deteriorated or which have become "toxic", and the foreign exchange gains or losses resulting from these investments. In view of the large capital outflows that have taken place since mid-2008, the banks in Malaysia should maintain their funds in the country instead of placing them abroad.

The deregulating of the types of foreign portfolio investment in which Malaysian investors are allowed to participate should also be reconsidered. In the Asian region, thousands of individual investors in Hong Kong and

Singapore suffered serious losses from having invested in investment products (offered by local banks) that were linked to the failed American investment bank Lehman Brothers. Malaysian investors have been investing in investment products linked to the value of stocks of foreign banks and companies whose values have fallen sharply. Individual investors have not been fully informed of the nature and extent of the risks involved. The liberalization in recent years of the use of unit trusts and other investment vehicles, including for placement of investments linked to capital movements abroad, should be reviewed.

The financial authorities should not introduce complex financial instruments such as credit derivatives and collateralized debt obligations in the domestic market, due to the high risks associated with them, as exposed in the global financial turmoil.

The Group of 20 Summit in Washington in November 2008 initiated a process of examining the need for stricter regulation of the range of financial markets, institutions and instruments, in order to avoid future financial crises. The dominant thinking among policy makers has changed in a very short time from the benefits of financial liberalization to the need for regulation. In Malaysia, a review of the policies linked to the liberalization strategy is thus also urgently required.

A possible barrier to a reconsideration of the liberal capital account policies is Malaysia's participation in multilateral and bilateral trade and investment agreements that require extremely liberal financial policies. At these negotiations, Malaysia should screen the proposals which have a potential effect on the country's policy space to make use of appropriate finance-related measures and instruments. At the World Trade Organization, developed countries are engaging with about 30 developing countries (including Malaysia) in plurilateral negotiations on various sectors, including financial services. The demand is that the developing countries bind in the WTO's General Agreement on Trade in Services (GATS) their present level of liberalization in terms of market access (commercial presence) and national treatment, and then also increase the commitment to the level and types of liberalization. Malaysia is also negotiating a free trade agreement

(FTA) with the United States which contains a special chapter on financial services as well as a general chapter on investment policies. The US is proposing that Malaysia commit to an open capital account regime, avoid regulation on inflows and outflows of capital, and liberalize financial services. The European Commission is negotiating an economic partnership agreement with Malaysia and other member countries of the Association of South East Asian Nations (ASEAN), and the EC is proposing similar provisions. Adoption of such provisions in bilateral FTAs would hinder the ability of the government to undertake many of the policy measures that can be used to manage capital flows and to formulate financial policy.

Table 11: Key Indicators of the Malaysian Economy, 2000-07

	2000	2001	2002	2003	2004	2005	2006	2007
Unemployment rate (%)	3.1	3.6	3.5	3.6	3.5	3.5	3.3	3.3
Per capita income (RM)	13,412	12,855	13,683	14,870	16,616	18,966	20,841	23,103
Per capita income (US$)	3,529	3,383	3,601	3,913	4,373	5,008	5,681	6,721
Real GDP (% change)	8.3	0.3	4.1	5.4	7.1	5.0	5.9	6.3
Gross saving (% of GNP)	39.5	34.9	34.4	36.5	37.3	36.5	38.2	37.8
Consumer prices (% change)	1.6	1.4	1.8	1.2	1.4	3.0	3.6	2.0
<u>Money supply</u>								
M1 (% change)	6.5	3.2	10.3	14.6	11.9	8.5	13.7	19.6
M3 (% change)	5.0	2.9	6.7	9.7	12.4	8.3	13.0	9.5
<u>Interest rates (end-year)</u>								
Overnight policy rate					2.7	3.0	3.5	3.5
Inter-bank rate (1 month)			2.87	2.99	2.86	2.84	3.54	3.56
Bank fixed deposit (3 months)	3.48	3.21	3.2	3.0	3.0	3.02	3.19	3.15
Bank base lending rate	6.78	6.39	6.39	6.0	5.98	6.20	6.72	6.72
<u>Federal government finance (RM billion)</u>								
Revenue	62	80	84	93	99	106	124	140
Operating expenditure	57	64	69	75	91	98	108	123
Net development expenditure	25	34	35	38	28	27	35	38
Overall balance	-19.7	-18	-20	-21	-19	-19	-19	-21
Balance as % of GDP	- 5.8	-5.5	-5.6	-5.3	-4.3	-3.6	-3.3	-3.2
Public sector net development expenditure	50	60	69	83	57	66	87	103
Public sector overall balance (% of GDP)	0.7	-0.3	-0.7	-4.9	4.1	1.4	-0.3	-2.6

Source: Bank Negara Malaysia, *Annual Report* (various years)

Annex 1

CHANGES IN MALAYSIA'S FOREIGN EXCHANGE REGULATIONS

IN 1998, the Malaysian government introduced several measures related to the country's foreign exchange as part of a strategy to contain the financial crisis and facilitate economic recovery. Since then, there have been changes in policies towards greater liberalization in capital inflows and outflows, and with regard to both foreigners and citizens. The following provides a comparison of the foreign exchange rules in 1998 and 2008, relating to residents and non-residents. The information is from the Bank Negara Annual Reports.

A. FOREIGN EXCHANGE RULES RELATING TO RESIDENTS

Opening by residents of foreign currency accounts in Malaysian banks

Until a few years ago, it was not possible or difficult for residents to have foreign-currency-denominated accounts (FCA) in Malaysian banks.

In the 1998 regulations, resident exporters were permitted to open foreign currency accounts to retain export proceeds in foreign currency up to strict overnight limits, depending on their export receipts. For example, those with average monthly export receipts exceeding US$20 million had an overnight limit of US$10 million, and those with US$5-10 million export receipts were limited to a US$3 million overnight limit. Resident companies could open foreign currency accounts to retain foreign currency receivables other than export proceeds up to only US$0.5 million (aggregate overnight limit) with commercial banks in Malaysia.

This has been liberalized. **As at March 2008,** residents are free to open FCA with onshore and offshore banks that are licensed to operate such accounts. There are, however, regulations and limits on the sourcing of these funds. The account can be credited with foreign currency funds coming from the following three sources: (1) other residents, for permitted purposes; (2) non-residents; (3) conversion of ringgit with licensed onshore banks, (i) without limit for residents without domestic ringgit borrowing, (ii) for residents with domestic ringgit borrowing, the limits for investment in foreign currency assets apply. Additional limits are granted for overseas education and employment purposes.

Capital transfers/investments abroad by residents

The 1998 regulation put a clamp on investment abroad by residents. Residents were required to seek prior approval from the Controller in Bank Negara to remit funds in excess of RM10,000 for overseas investment.

At present, there are no limits for residents without domestic ringgit borrowing who use their own ringgit or their own foreign currency funds to invest in foreign currency assets. However, if these conditions are not met, limits apply as follows:

- Resident individuals with domestic ringgit borrowing are allowed up to RM1 million equivalent in a calendar year if from conversion of ringgit, and up to RM10 million equivalent if funded using foreign currency borrowing.
- Resident corporations do not face limits to investing in foreign currency assets if funded from own foreign currency funds or from proceeds of listing through initial public offering on the local or foreign stock exchanges. But they have a limit of RM50 million equivalent per year if from conversion of ringgit, or RM100 million if funded using foreign currency borrowing.
- Resident institutional investors: (i) For unit trusts there is no limit if investing in Islamic funds; for investing in conventional foreign-currency-denominated funds, the limit is 100% of net asset value; and for ringgit-denominated funds, the limit is 100% of NAV attributed to non-

residents, 100% of NAV attributed to residents without domestic ringgit borrowing and 50% of NAV attributed to residents with domestic ringgit borrowing. (ii) There are similar limitations for fund management companies, insurers and takaful operators.

Divestment/income from investment in foreign currency assets by residents

At present, residents are free to repatriate and convert divestment proceeds or income from investment in foreign currency assets into ringgit. They are also free to retain the proceeds in foreign currency accounts.

Export and import of goods and services by residents

In September 1998, in relation to current account transactions, there were no restrictions regarding payment for import of goods and services (except that payment must be in foreign currency), but some regulations on export proceeds. All export proceeds were required to be repatriated back to Malaysia in accordance with the payment schedule in the sales contract, but which in any case should not exceed six months from the date of export. The export proceeds must be received in foreign currency and must be either sold for ringgit or retained in approved foreign currency accounts with onshore commercial banks.

Most of the 1998 rules on export proceeds still apply at present. **The present regulations** include:

- Payment must be made in foreign currency.
- Export proceeds must be repatriated to Malaysia in full within six months from date of export.
- Prior permission is required for residents to offset export proceeds against other payables to non-residents, or to receive the export proceeds exceeding six months from the export date.
- Residents can retain export proceeds in foreign currency accounts and ringgit accounts in onshore banks. Permission is needed to retain export proceeds in foreign currency accounts with offshore banks.

Borrowing in foreign currency by residents

In the September 1998 regulations, residents were allowed to obtain credit in foreign currency up to RM5 million equivalent; amounts beyond this required permission. There was no restriction for repayment of credit facilities in foreign currency if the credit was obtained in line with the exchange control rules.

This regulation has been liberalized, especially in the amounts that can be borrowed. **Present regulations** are that:

- Resident individuals can borrow in foreign currency up to the equivalent of RM10 million from licensed onshore banks and non-residents.
- Resident corporations can borrow in foreign currency up to the equivalent of RM100 million in aggregate on a corporate group basis from onshore banks, non-residents and through issuance of foreign-currency-denominated bonds onshore and offshore.
- A resident company can borrow from another resident company in the same corporate group the foreign currency proceeds from listing on foreign stock exchanges.
- Companies can obtain foreign currency trade financing facilities from onshore banks.

Residents borrowing in ringgit from non-residents

In the September 1998 regulation, residents were not allowed to obtain credit facilities in ringgit from non-residents without approval from the Bank Negara Controller.

This **regulation has remained.** At present, prior permission is still required for residents to obtain any amount of ringgit borrowing from non-residents.

Hedging by residents in current and capital account transactions

Present regulations on hedging are as follows:

- Current account: Residents are free to hedge with onshore banks the payments or receipts for the import or export of goods and services, based on firm underlying commitment or on anticipatory basis up to the actual amount paid in the last 12 months.

- Capital account: Residents are allowed to hedge with onshore banks based on committed capital inflows or outflows, and also hedge their existing holdings of foreign currency assets.

Issuance of ringgit and foreign-currency-denominated securities by residents

The **present regulations** are as follows:

- Issuance of securities to non-residents: (i) Residents are free to issue the following ringgit securities registered in Malaysia to non-residents: ordinary shares, including bonus and rights issues; irredeemable preference shares; and private debt securities. (ii) Prior permission is required for issuance of securities to non-residents other than as stated above.
- Issuance of ringgit-denominated bonds/sukuk: Residents are free to issue in Malaysia.
- Issuance of foreign-currency-denominated bonds/sukuk: Residents are allowed as long as total foreign currency borrowing, including the bonds/sukuk, does not exceed RM100 million equivalent.
- Utilization of bond proceeds: (i) For ringgit-denominated bonds/sukuk, residents are free to use proceeds onshore, and free to use for investment in foreign currency assets provided the issuer's total investment does not exceed RM50 million equivalent in aggregate per calendar year. (ii) For foreign-currency-denominated bonds/sukuk, residents are free to use proceeds onshore and offshore.

Currency rules for resident travellers

In September 1998, the currency regulation for travellers was tightened. Travellers were allowed to carry ringgit notes up to RM1,000 upon arrival or departure. A resident traveller was allowed to take out foreign currency notes, including traveller's cheques, up to RM10,000 equivalent. Resident travellers could bring in any amount of foreign currency.

Present regulations are basically the same. Resident travellers:

- Can import or export ringgit notes up to RM1,000.
- Can import foreign currency notes and traveller's cheques without limit.
- Can export foreign currency notes and traveller's cheques up to an equivalent of US$10,000.
- Can apply to Bank Negara to exceed the permitted limits, and response is given in one day.

B. FOREIGN EXCHANGE RULES RELATING TO NON-RESIDENTS

Foreign direct and portfolio investments by non-residents

In the **September 1998 regulations**, there was no restriction on the movement of foreign direct investment, and foreign investors were allowed to repatriate capital, profits and dividends freely.

There were, however, very significant controls on foreign portfolio capital. From 1 September 1998, non-residents were required to hold their principal sum for portfolio investment for at least 12 months in Malaysia.

This rule was progressively liberalized. From 15 February 1999, capital and profits of the portfolio investments were allowed to be repatriated, subject to a system of levy on repatriation of portfolio funds, with a higher levy rate the shorter the duration of the capital (e.g., 30% levy for 7-month maturity period, 10% levy for 12-month maturity period). On 21 September 1999 this was amended so that a single exit levy of 10% was imposed on profits repatriated. This levy was abolished on 1 May 2001.

There are now no restrictions on movements or payments for direct or portfolio foreign investment. The **present regulations** include:

- Non-residents can purchase any ringgit assets including ringgit-denominated bonds issued by non-residents in Malaysia.
- Ringgit for settlement of the investment can be sourced from: (1) non-resident's own external accounts (i.e., ringgit accounts maintained with licensed onshore banks by or for non-residents); (2) sale of foreign currency on spot or forward basis, with licensed onshore banks or over-

seas branches appointed by licensed onshore banks; or (3) onshore borrowing.

- Non-residents are free to borrow any amount in foreign currency from licensed onshore banks.
- Non-residents are allowed to borrow in ringgit up to RM10 million in aggregate from licensed onshore banks for any purpose in Malaysia, including financing the purchase of ringgit assets.
- Non-residents are allowed to borrow any amount for margin financing from resident stockbroking companies.
- Non-residents are free to repatriate funds from divestment of ringgit assets or profits/dividends arising from the investments. Repatriation, however, must be made in foreign currency.
- Non-residents are free to hedge the exposure arising from investment in ringgit assets made on or after 1 April 2005 with licensed onshore banks or overseas branches appointed by licensed onshore banks.

Investment in immovable properties by non-residents

The **present regulations** are that non-residents:

- Are free to purchase residential and commercial properties in Malaysia, as long as they comply with the guidelines issued by the Foreign Investment Committee of Malaysia. FIC approval is not required for non-residents purchasing residential property exceeding RM250,000.
- Can borrow any amount to finance or refinance the purchase of residential and commercial properties in Malaysia, except for purchase of land only.

Lending in ringgit and foreign currency by non-residents to residents

The **present regulations** are:

- Ringgit lending: Lending in ringgit to a resident by a non-resident requires prior permission of the Controller.
- Foreign currency lending: Non-residents are free to lend in foreign currency to a resident provided the resident borrower's total foreign currency borrowing does not exceed RM10 million equivalent in ag-

gregate (for resident individuals) or RM100 million equivalent in aggregate (on a corporate group basis).
- The onus is on the resident borrower to obtain the prior permission of the Controller for borrowing exceeding the limits.

Borrowing by non-residents from residents

The **September 1998 regulations** had a number of restrictions on extension of credit facilities to non-residents in foreign currency and especially in ringgit.

Regarding credit facilities in foreign currency, commercial banks were free to extend these facilities to non-residents for all purposes, except financing the acquisition or development of immovable property in Malaysia.

On credit facilities in ringgit to non-residents: (i) banks may extend credit facilities in ringgit up to the aggregate of RM200,000 for purposes other than to finance the acquisition or development of immovable property in Malaysia; (ii) banks and other non-bank residents could extend facilities to non-residents who were working in Malaysia to finance up to 60% of the purchase price or construction cost of a residential property in Malaysia for their own accommodation; (iii) resident stockbroking companies were allowed to extend margin financing facilities to non-resident clients to purchase shares listed on the KLSE; (iv) non-resident-controlled companies operating in Malaysia could get credit up to RM10 million from domestic sources; they could obtain any amount of forward exchange contract and short-term trade financing, but of the total amount of credit from banks, at least 60% must be from Malaysian-owned banks.

These **regulations have been significantly liberalized.** The restriction to foreigners on borrowing in foreign currency from banks to purchase immovable property has been lifted. The maximum limit of RM200,000 in ringgit-denominated loans (except for immovable property) has also increased to RM10 million, while there is no limit for borrowing in ringgit for buying residential or commercial property. The present regulations are as follows:

- Foreign currency borrowing from banks: Non-residents are free to borrow any amount of foreign currency from licensed onshore banks.

- Foreign currency borrowing from non-bank residents: Non-residents are free to obtain foreign currency borrowing from a non-bank resident as follows: (1) No limit to borrow from a resident with no domestic ringgit borrowing, or a resident, with or without domestic ringgit borrowing, using own foreign currency funds maintained onshore or offshore. (2) For borrowing from a resident with domestic ringgit borrowing, the limit is for conversion of ringgit up to RM1 million per calendar year (for individual resident) and RM50 million per year on a corporate group basis (for resident corporations).
- Ringgit borrowing from banks and non-bank residents: Non-residents are free to obtain ringgit borrowing from licensed onshore banks and non-bank residents as follows:
  — Up to RM10 million in aggregate for borrowing by non-residents other than stockbroking companies and correspondent banks from licensed onshore banks for any purpose in Malaysia.
  — No limit for: (i) borrowing by non-resident stockbroking companies and custodian banks from licensed onshore banks for settlement of ringgit securities on Bursa Malaysia and RENTAS due to inadvertent delays on the receipt of funds; (ii) borrowing by non-residents (other than stockbroking companies and correspondent banks) from licensed onshore banks and resident stockbroking companies for margin financing; (iii) borrowing from licensed onshore banks or non-bank residents to finance or refinance the purchase of residential and commercial properties in Malaysia.
  — Borrowing from non-bank residents up to RM10,000 in aggregate.
  — Borrowing from resident insurance companies, up to the cash surrender value of the insurance policies purchased by the non-residents.

Issuance of ringgit and foreign-currency-denominated bonds/sukuk in Malaysia by non-residents

The following are the **present regulations**:

- Issuance of ringgit or foreign-currency-denominated bonds/sukuk: Multilateral development banks, multilateral financial institutions, foreign sovereign, foreign quasi-sovereign agencies and foreign multinational companies may issue ringgit or foreign-currency-denominated bonds/sukuk in Malaysia.
- Utilization of bond/sukuk proceeds: (i) Proceeds from the issuance of bonds/sukuk are allowed to be used onshore or offshore. (ii) Ringgit-denominated bond/sukuk proceeds to be used offshore have to be converted into foreign currency with licensed onshore banks.
- Hedging: (i) Issuers are free to hedge exchange rate and interest/profit rate exposure arising from the issuance of ringgit-denominated bonds/sukuk and any subsequent interest/profit and coupon payments with licensed onshore banks. (ii) Non-resident investors of the bonds/sukuk are also free to hedge exchange rate and interest/profit rate exposure with licensed onshore banks.

Hedging by non-residents

The **present regulation** is that with respect to hedging of ringgit assets, non-residents are free to hedge with licensed onshore banks, exchange rate and interest rate exposures arising from investments in ringgit assets purchased on or after 1 April 2005 as well as ringgit-denominated bonds/sukuk issued in Malaysia by non-residents.

Opening of ringgit and foreign currency accounts in Malaysia by non-residents

In the **September 1998 regulations**, non-residents were freely allowed to open foreign currency accounts in commercial and merchant banks. There were no restrictions on inflow and outflow of funds in these accounts and no levy on repatriation of these funds.

There were, however, several restrictions on the external accounts (i.e., accounts in ringgit) of non-residents. Banks could open such external accounts, with the permitted sources of funds from: (i) sale of ringgit instruments, securities registered in Malaysia or other assets in Malaysia; (ii) salaries, wages, rental, commissions, interest, profits or dividends; and (iii) sales of foreign currency.

The uses of funds in the external accounts were restricted to: (i) purchase of ringgit assets/placements of deposits; (ii) payment of administrative and statutory expenses in Malaysia; (iii) payment of goods and services for use in Malaysia; and (iv) granting of loans and advances to staff in Malaysia.

Prior approval was required for transfer of funds between external accounts and for uses of funds other than the permitted purposes. However, there were no restrictions on the operations of external accounts of non-residents working in Malaysia, embassies, consulates, high commissions, supranational or international organizations in Malaysia.

There has been very significant deregulation on the ringgit accounts of non-residents. The restriction that these accounts can only be used for payments in Malaysia (and not abroad) has been lifted. The domestic uses of funds in these accounts have also been extended to practically all uses with a few remaining restrictions.

The **present regulations** are as follows:

- Opening of ringgit and foreign currency accounts: Non-residents are free to open foreign currency and ringgit accounts with licensed onshore banks.
- Repatriation/utilization of funds from the ringgit accounts (known also as external accounts):
  - (i) Non-residents are free to convert with licensed onshore banks for repatriation abroad.
  - (ii) Non-residents are free to pay a resident for any purpose, except for the following: payment for the import of goods and services; lending in ringgit to residents other than as permitted by the Controller; and payment on behalf of a third party.

(iii) Non-residents are free to pay to another non-resident's external account for settlement of purchase of ringgit assets from the non-resident.

- Repatriation/utilization of funds from foreign currency accounts: Non-residents are: (i) free to repatriate; and (ii) free to pay a resident for any purpose including for settlement of goods and services.

Import and export of ringgit and foreign currency by non-resident travellers

In **September 1998**, the currency regulation for travellers was tightened. Foreign travellers were allowed to carry ringgit notes up to RM1,000 upon arrival or departure. A non-resident traveller was allowed to take out foreign currency notes, including traveller's cheques, up to the amount brought into Malaysia. Non-resident travellers could bring in any amount of foreign currency.

The **present regulation** is that non-resident travellers are:

- Allowed to import and export ringgit notes up to RM1,000.
- Allowed to import foreign currency notes and traveller's cheques with no limit.
- Allowed to export foreign currency notes and traveller's cheques up to the amount brought into Malaysia or US$10,000, whichever is higher.
- To declare in the immigration Arrival/Departure Card for foreign currency notes and travellers' cheques exceeding US$10,000.
- Applications can be made to exceed the limits for import and export of ringgit and foreign currency, with a response to be given in a day.

Annex 2

EQUITY REGULATIONS RELATING TO FOREIGN DIRECT INVESTMENT

IN terms of regulations, the Foreign Investment Committee determines the entry and terms of foreign direct investment in the country. The FIC's Guidelines on Acquisition of Interests, Mergers and Takeovers provide the general conditions. The latest version (effective 1 January 2008) still has equity conditions similar to those of previous years. The main equity conditions are that:

- Companies which do not have any Bumiputra equity or have less than 30% Bumiputra equity are required to have or to increase the Bumiputrra equity to at least 30%; the remaining equity shareholding can be held by local interest, foreign interest or by both. Companies with Bumiputra equity shareholding of 30-51% have to maintain at least 30% Bumiputra equity at all times; and companies which already have Bumiputra equity shareholding of 51% or more will be required to maintain at least 51% Bumiputra equity at all times.
- The requirement of at least 30% Bumiputra equity participation will be applied uniformly except if expressly stated otherwise by the government.
- For companies whose activities involve national interests such as water and energy supply, broadcasting, defence and security and any activities which are of national interest, the participation of foreign interests is limited to 30%. In certain circumstances, the government may also impose other conditions such as the issuance of the "golden share".

There are, however, many exemptions from the guidelines. The guidelines shall not apply in the following situations: any acquisition of interest by federal ministries and federal or state government departments; federal or state privatization projects; any acquisition of interest in a manufacturing company licensed by the Ministry of International Trade and Industry (MITI) as well as manufacturing companies which are exempted from obtaining a manufacturing licence; any acquisition of interest in Multimedia Super Corridor (MSC) status companies; any acquisition of interest in a local company which operates in the approved area in the Iskandar Regional Development and in any regional development corridor, and any acquisition of interest in a company which has obtained endorsement from the Malaysia International Islamic Financial Centre (MIFC); and any acquisition of interest in companies that have been granted the status of International Procurement Centre, Operational Headquarters, Representative Office, Regional Office and Labuan offshore company or other special status by the Ministry of Finance, MITI and other ministries.

Annex 3

REGULATIONS ON FOREIGN PURCHASE OF REAL ESTATE

THE present regulations are that non-residents:

- Are free to purchase residential and commercial properties in Malaysia, as long as they comply with the guidelines issued by the Foreign Investment Committee of Malaysia. FIC approval is not required for non-residents purchasing residential property exceeding RM250,000.
- Can borrow any amount to finance or refinance the purchase of residential and commercial properties in Malaysia, except for purchase of land only.

According to the FIC Guidelines on Acquisition of Property by Foreign Interests (effective 1 January 2008):

Residential property: Foreign interests are allowed to purchase residential property exceeding RM250,000 and FIC approval is not required for such property.

For non-residential properties, foreign interests are not allowed to acquire such properties that are valued at RM150,000 or below. FIC approval is also required for properties above that level.

Commercial property: Foreign interests can acquire commercial property valued at less than RM10 million without having to incorporate a local company, subject to the condition that the property is only for own use.

Agricultural land: Foreign interests are only allowed to acquire agricultural land valued at more than RM250,000 or which is at least 5 acres, subject to the conditions for acquisition. Acquisition of agricultural land by foreign interests is only allowed for the following purposes: to carry out agricultural activities on a commercial scale using modern or high technology; to carry out agro-tourism projects; or to carry out agricultural or agro-based industrial activities for the production of goods for export. However, for this purpose relaxation on equity condition may be considered.

Industrial land: Foreign interests are allowed to acquire industrial land without any price limit and must be registered under a locally incorporated company and will be subjected to the conditions for acquisition and the conditions for foreclosure.

Hostel purpose: A local company owned by a foreign interest is allowed to acquire property valued at more than RM60,000 per unit to be occupied as a hostel for the company's employees.

Acquisition of contiguous properties: Foreign interests are allowed to acquire two or more contiguous properties with a total value of RM10 million and above and will be subjected to the conditions for acquisition.

Acquisition of entire building or project: Acquisition of an entire building or an entire property development project valued at RM10 million and above must be registered under a locally incorporated company and will be subjected to the conditions for acquisition.

Redevelopment of property: Foreign interests are allowed to acquire land or land with building for redevelopment on a commercial basis. If this acquisition is not meant for own use, it has to be registered under a locally incorporated company and will be subjected to the conditions for acquisition.

Transfer of property: Transfer of property to a foreigner based on love and affection is allowed only among immediate family members.

There are a number of **specific restrictions on foreign ownership** of property. Foreign interests are not allowed to acquire residential units under the category of low and medium low cost; properties built on Malay reserve land; properties allocated to Bumiputra in any property development project; stalls and service workshops; agricultural land developed on the basis of the homestead concept; and properties gazetted under the National Heritage Act 2005.

Conditions for acquisition of property by local and foreign interests comprise the conditions on equity, share capital, property development and employment.

Exemptions from following the guidelines are given to Multimedia Super Corridor (MSC) status companies, which can acquire any property in the MSC area provided it is for operational activities and residence for their employees; any acquisition of property by companies operating in the approved area in the Iskandar Regional Development and in any regional development corridor by companies that have been granted the status by the local authority; any acquisition of property by companies which have obtained endorsement from the Malaysia International Islamic Financial Centre (MIFC) provided the property is used by the company for international Islamic financial operations and the acquisition of the property is through a Shariah-compliant Islamic financial payment scheme; and acquisition of industrial property by manufacturing companies licensed by the Ministry of International Trade and Industry as well as any manufacturing company which is exempted from obtaining a manufacturing licence for own manufacturing operation.

The **equity conditions are the same as for FDI:** companies which do not have any Bumiputra equity or have less than 30% Bumiputra equity are required to have or to increase the Bumiputra equity to at least 30%, and the remaining equity shareholding can be held by local interest, foreign interest or by both; companies with Bumiputra equity shareholding of 30-51% are required to maintain at least 30% Bumiputra equity; and companies which already have Bumiputra equity shareholding of 51% or more will be required to maintain at least 51% Bumiputra equity.

The requirement of at least 30% Bumiputra equity participation will be applied uniformly except if expressly stated otherwise by the government; and for companies which activities involve national interests such as water and energy supply, broadcasting, defence and security and any activity which is of national interest, the participation of foreign interests is limited to 30%. In certain circumstances, the government may impose other conditions such as issuance of the "golden share".

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FINANCIAL POLICY AND MANAGEMENT OF CAPITAL FLOWS: THE CASE OF MALAYSIA

This paper looks at how financial policy in Malaysia has evolved over the years with regard to management of capital flows into and out of the country, the exchange rate and related macroeconomic policies.

To deal with the financial crisis which struck East Asia in 1997-99, the Malaysian government had adopted an innovative set of policies that included selective capital controls, exchange rate stabilization and counter-cyclical macroeconomic policy measures. This unorthodox strategy proved to be a success, as attested to by Malaysia's relatively rapid recovery from the crisis.

Since then, the Malaysian capital account regime has been progressively liberalized. The country has largely shifted from a policy of regulating capital flows to one of managing their effects on the domestic economy through such measures as monetary policy operations, buildup of foreign exchange reserves and surveillance and risk management in the financial sector.

However, as this paper cautions, the resulting increased capital mobility has rendered the economy vulnerable to sudden, damaging swings in the direction and magnitude of financial flows – a very real threat especially in the current period of global financial turmoil. In light of these risks, the author calls for a rethink of financial policy liberalization in Malaysia with a view to better shielding the economy from the effects of dangerously volatile capital flows.

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