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CAPITAL CONTROLS

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Malaysian Prime Minister Mahathir Mohamad's 1 September 1998 announcement of capital controls was important in several regards. Whereas Thailand, South Korea and Indonesia had gone cap in hand — humiliatingly accepting conditions imposed by the International Monetary Fund (IMF) — in order to secure desperately needed credit, the Malaysian initiative reminded the world that there are alternatives to capital account liberalisation. The capital control measures were significantly revised in February 1999. As of 1 September 1999, yet another regime came into effect. These modifications recognise the negative impact of the capital controls regime, and represent attempts to mitigate it and to encourage the return of the often condemned short-term capital.

Unfortunately, there has been a tendency since for both sides in the debate over Malaysia's capital control measures to exaggerate their own cases, with little regard for what has actually happened. Market fundamentalists have loudly prophesied doom for Malaysia ever since, though the evidence does not support their often wild claims. Meanwhile, opponents of capital account liberalisation have gone to the other extreme with some wishful exaggeration about what the Malaysian measures actually imply and their consequences (one supporter has extolled its ostensibly virtuous consequences for labour with scant regard for Malaysian realities). Both sides often forget that capital controls are often necessary means to other policy objectives, rather than ends in and of themselves. One needs to be clear about these objectives. Will capital controls be used in the interests of workers, consumers or the national public interest? Or are they mainly being used to save the politically well-connected?

Capital Controls

There are many different types of capital control measures, with different consequences, often varying with circumstances as much as the nature of the instruments. Until capital account liberalisation from the eighties, most countries retained some such controls despite significant current account liberalisation in the post-war period. Most such measures can only be understood historically, in terms of their original purposes, and there are no ready-made packages available for interested governments.

Economists favouring capital account liberalisation have made three main arguments in favour of such a policy. It is argued that capital will tend to flow from capital-rich to capital-poor economies, or between economies with different savings rates, investment opportunities, risk profiles or even demographic patterns. Capital flows thus enable national economies to trade imports in the present for imports in the future, i.e. to engage in inter-temporal trade. Capital flows also allow national economies to offset pressures to reduce imports by borrowing from abroad or by selling assets to foreigners. Such imports and borrowings may be used to enhance national economic output capacity, i.e. a country's ability to increase production in the future. The foregoing arguments are similar to those for international trade liberalisation. Foreign direct investment is also expected to involve technology transfer, which should enhance industrial capabilities. Restrictions on capital flows are considered undesirable by advocates of capital account liberalisation because they prevent capital from being utilised where it is most demanded.

On the other hand, advocates of capital controls emphasise the adverse effects of free capital flows on national economic policy-making and implementation, or worse still, by undermining economic stability. Any policy intended to restrict or redirect capital account transactions can be considered a capital control. These would include taxes, price or quantity controls, including bans on trade in certain kinds of assets. Hence, there are many different kinds of capital controls, which may be introduced for various reasons. The effects of specific controls may change over time and could become quite different from what may have been intended. The major reasons advanced for the introduction of capital controls have included the following:

1. Achieve greater leeway for monetary policy, e.g. to reflate the economy.
2. Enhance macroeconomic stability by limiting potentially volatile capital inflows.
3. Secure exchange rate stability, e.g. protect a fixed exchange rate or peg.
4. Correct international payments imbalances, both deficits and surpluses.
5. Avoid inflation due to excessive inflows.
6. Avoid real currency appreciation due to monetary expansion.
7. Reduce financial instability by changing the composition of — or limiting — capital inflows.
8. Restrict foreign ownership of domestic assets, which might cause nationalistic resentment.
9. Ensure the domestic utilisation of national savings by restricting outflows.
10. Enable governments to allocate credit domestically without risking capital flight.
11. Enable domestic financial houses to attain scale economies in order to better compete internationally.
12. Facilitate revenue generation, particularly taxation of wealth and interest income; by allowing higher inflation, more revenue can be generated.

Capital controls may well be the most acceptable alternative to the destabilising effects of capital flows on inadequately regulated financial systems characteristic of developing economies. Effective regulation may be compromised by limited capabilities and experience, fewer personnel and other resources as well as politically or otherwise compromised regulatory capacity. When a country with a fixed exchange rate experiences a net capital outflow, it can either raise interest rates or devalue. But with a sudden large capital outflow, usually associated with easily reversible capital inflows, either option is likely to exert strong recessionary pressures due to higher interest rates or further capital flight. Monetary contraction may not only dampen economic activity with higher interest rates, but may also adversely affect the economy through the (invariably government-guaranteed) banking system, which may be exposed to foreign borrowings (Kaminsky and Reinhart 1999).

Capital controls may be used to limit capital flow volatility to achieve greater economic stability by checking outflows in the event of crisis or influencing the volume or composition of inflows. Sudden massive capital outflows — usually attributable to herd behaviour — are more likely to occur in developing countries for various reasons. The greater likelihood of asset price changes to cause further changes in the same direction increases the likelihood of greater volatility as well as boom-bust cycles. Discouraging capital inflows would reduce the quantity of capital that might take flight at short notice. But changing the composition of capital inflows — e.g. to favour foreign direct investments as opposed to more liquid portfolio investments — may well better reduce such instability.

Different types of capital controls may be distinguished by the types of asset transactions they affect as well as by the very nature of the control measure itself, e.g. tax, limit, or ban. Capital controls are not identical with exchange controls though the two are often closely related in practice. Exchange controls mainly involve monetary assets (currency and bank deposits), and may be used to control the current account of the balance of payments rather than the capital account. While exchange controls function as "a type of limited capital control, they are neither necessary to restrict capital movement nor are they necessarily intended to control capital account transactions" (Neely 1999: 21-2). Some of the major differences among the types of capital controls involve:

1. *Taxes versus quantitative* controls: Taxes rely on price or market mechanisms to deter certain types of flows. Such taxes may be on certain types of transactions or returns to foreign investment, or may even involve mandatory reserve requirements, which raise the cost of the flows concerned. Quantitative controls may involve quotas, authorisation requirements or even outright bans.
2. Controls on *inflows as opposed to outflows*: Limits on inflows may allow for higher interest rates, to check money supply and inflation. Checks on outflows allow lower interest rates and greater money supply than would otherwise be possible, and have often been used to postpone hard choices between devaluation and tighter monetary policy, as with Malaysia's September 1998 controls.
3. Controls on different types of inflows, especially in terms of *expected duration*: Governments may seek to encourage long-term inflows (e.g. foreign direct investment) while discouraging short-term (e.g. bank loans or money market instruments) or easily reversible (portfolio investments) inflows.

It is important to establish at the outset what particular controls seek to achieve. With the benefit of hindsight, it is crucial to determine to what they extent the measures actually achieve their declared objectives as well as their other consequences, intended or otherwise. For instance, it is important to know whether specific controls are meant to avert crisis or to assist recovery. In its *1998 Trade and Development Report*, the United Nations Conference on Trade and Development (UNCTAD) recommended capital controls as means to avoid financial crises. Almost as if endorsing the Malaysian measures, MIT Professor Paul Krugman recommended capital controls in his *Fortune* magazine column in early September 1998 to create a window of opportunity to facilitate economic recovery — which is a different objective, though some of the mechanisms or processes involved may not be altogether different.

A Previous Malaysian Experience

The September 1998 capital controls were not completely unprecedented. In fact, temporary capital controls had been introduced in early 1994 after an earlier experience of massive capital flight with the sudden reversal of massive net portfolio capital inflows in 1992-3. This earlier imposition of controls — while Anwar Ibrahim was already Finance Minister (from 1991) and soon after Ahmad Don became central bank governor — suggests that the two were not as opposed to such measures as they have been made out to be after Ahmad Don's (forced) resignation in August 1998 and Anwar Ibrahim's sacking on 2 September 1998. The 1994 measures sought to deter capital inflows by taxing them, unlike the 1998 measures that restricted capital outflows. If they had not been withdrawn so soon, it is quite likely that the magnitude of capital flight from mid-1997 would have been much less, and the 1997-98 crisis would have been less catastrophic.

The controls — introduced after the sudden collapse of the Malaysian stock market in early 1994 — were soon withdrawn after about half a year, without introducing a more permanent regime of market-based controls that could be flexibly adjusted in response to policy priorities and concerns. The central bank saw the problem as one of excess liquidity due to the massive inflow of short-term funds from abroad due to higher interest rates in Malaysia, the buoyant stock market and expectations of ringgit appreciation. Several monetary measures were introduced during early 1994, which were gradually phased out during the course of the year. The following measures sought to manage excess liquidity, especially to contain speculative inflows, restore stability in financial markets and control inflationary measures; for a fuller account, see BNM's *1994 Annual Report* (especially the Foreword, Boxes A to J and pp. 42-44):

- The eligible liabilities base for computing statutory reserve and liquidity requirements was redefined to include all fund inflows from abroad, thus raising the cost of foreign funds compared to domestic funds.

- Limits on non trade-related external liabilities of banking institutions were introduced; net external liabilities of the banking system declined from a peak of RM35.4 billion in early January 1994 to RM10.3 billion at the end of 1994.
- Sale of short-term monetary instruments was limited only to Malaysian residents to prevent foreigners from using such investments as substitutes for placements of deposits (this measure was lifted on 12 August 1994).
- Commercial banks were required to place ringgit funds of foreign banks in non-interest bearing vostro accounts.
- Commercial banks were not permitted to undertake non-trade-related swaps (including overnight swaps) and outright forward transactions on the bid side with foreign customers to prevent offshore parties from establishing speculative long forward ringgit positions while the ringgit was perceived to be undervalued (this measure was lifted from 16 August 1994).
- The statutory reserve requirements of all financial institutions were raised thrice during 1994 — by one percentage point each time — to absorb excess liquidity on a more permanent basis, absorbing an estimated RM4.8 billion from the banking system.

Mahathir's September 1998 Controls

Did Malaysia's September 1998 selective capital control measures succeed? The merits and demerits of the Malaysian government's regime of capital controls to deal with the regional currency and financial crisis will continue to be debated for a long time to come as the data does not lend itself to clearly supporting any particular position. Proponents can claim that the economic decline came to a stop soon after and the stock market slide turned around, while opponents can say that such reversals have been more pronounced in the rest of the region. As is now generally recognised, the one year lock-in of foreign funds in the country was too late to avert the crisis, or to lock in the bulk of foreign funds which had already fled the country. Instead, the funds 'trapped' were those which had not already left in the preceding 14 months, inadvertently 'punishing' the investors who had also shown greater commitment to Malaysia. This is also evidenced by the very low volume of outflow since the end of the lock-in on 1 September 1999.

It appears that, at best, its contribution to recovery was ambiguous, while at worst, it probably slowed it down and acted to diminish the likely recovery of foreign direct investment — which may yet have an impact on Malaysia's medium term competitiveness *vis-à-vis* its neighbours. Further, the regime remains untested in checking currency speculation, as such currency speculation abated shortly after its imposition for various reasons. Also, recovery of the Malaysian share market, which had declined much more than other stock markets during the crisis, has lagged behind the other (relatively smaller) markets in the region.

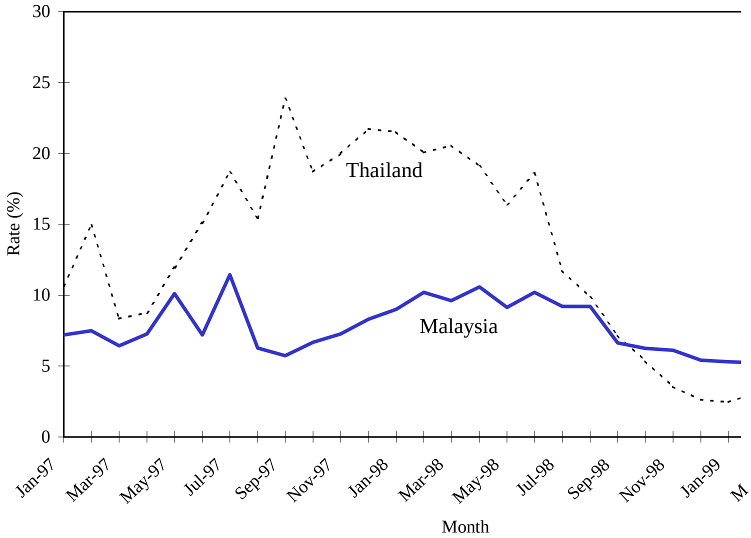
Malaysia was most fortunate in the timing of the imposition of capital controls if, indeed, as stated by Mahathir in his speech to the symposium on the first anniversary of the controls, it came about almost in desperation. At the time it was introduced, the external environment was about to change significantly, while the economy had seen the outflow of the bulk of short-term capital, so that in a very real sense, the regime was never tested. If the turmoil of the preceding months had continued until the end of 1998, or longer, continued shifts and re-pegging would have been necessary, with consequent deleterious effects.

Clearly, the ringgit peg brought a welcome respite to businessmen after over a year of currency volatility. However, exchange rate volatility across the region also effectively abated shortly thereafter due to other factors, and even the later Brazilian crisis did not renew such volatility. Moreover, it is ironic that an ostensibly nationalistic attempt to defend monetary independence against currency traders should, in effect, hand over determination of the ringgit's value to the US Federal Reserve. However, should the US dollar strengthen significantly against other currencies, Malaysia will probably have to re-peg to retain export competitiveness.

While interest rates were undoubtedly brought down by government decree in Malaysia, the desired effects were limited. Interest rates have come down dramatically across the region, in some cases, even more than in Malaysia, without others having to resort to capital controls. For example, while interest rates in Thailand were much higher than in Malaysia for over a year after the crisis began, they declined below Malaysian levels during September 1998 (see Figure 7.1). Perhaps more importantly, loan and money supply growth rates actually declined in the first few months after the new measures were introduced despite central bank threats to sack bank managers who failed to achieve the 8 per cent loan growth target rate for 1998. It has become clear that credit expansion will be a consequence of factors other than capital controls. Across the region, counter-cyclical spending has also grown, again without resorting to capital controls.

The Malaysian authorities' mid-February 1999 measures have effectively abandoned the main capital control measure introduced in September 1998,

Figure 7.1
Malaysia and Thailand: Average Inter-Bank Overnight Rates,
January 1997 – June 1999



i.e. the one-year lock-in. While foreign investors were prohibited from withdrawing funds from Malaysia before September 1999, they were allowed to withdraw from mid-February 1999 after paying a scaled exit tax (pay less for keeping longer in Malaysia), in the hope that this would reduce the rush for the gates come September 1999. Meanwhile, in an attempt to attract new capital inflows, new investors would only be liable for a less onerous tax on capital gains.

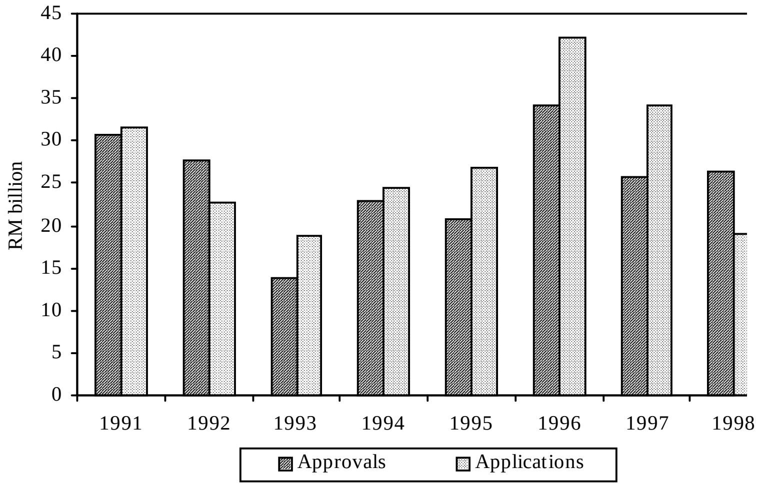
The new capital gains tax will hardly deter exit in the event of a panic as investors rush to get out to cut their losses. At best, however, it could serve to discourage some short-selling from abroad owing to the much higher capital gains tax rate on withdrawals within less than a year of 30 as opposed to 10 per cent. The differential exit capital gains tax rate may have discouraged short-selling from abroad, but did nothing to address other possible sources of vulnerability and will not deter capital flight in the event of financial panic. In September 1999, the capital gains tax rate was set at a uniform rate of 10 per cent, thus eliminating the only feature that might have deterred short-selling from abroad. Effectively, Malaysia is once again almost defenceless in the face of a similar sudden exodus of capital in future, though this may not be the most urgent problem at hand for the time being.

By setting the peg at RM3.8 to the US dollar on 2 September 1998, after it had been trading in the range of RM4-4.2 per US dollar, the Malaysian authorities were then seeking to raise the value of the ringgit. Since mid-September 1998, however, the other currencies in the region strengthened after the US Federal Reserve Bank lowered interest rates in the aftermath of the Russian and LTCM crises, strengthening the yen and other regional currencies. Thus, the ringgit became undervalued for about a year thereafter instead, which — by chance rather than by design — boosted Malaysian foreign exchange reserves from the trade surplus, largely due to import compression, as well as some exchange rate-sensitive exports. As Figure 5.10 shows, Malaysia's foreign exchange reserves depleted rapidly from July until November 1997, before improving in December, and especially after the imposition of capital controls in September 1998.

Thus, the ringgit under-valuation may have helped Malaysian economic recovery, but certainly not in the way the authorities intended when pegging the ringgit in September 1998. However, the US Federal Reserve reduced interest rates soon after, with the ringgit considered under-valued. While the undervalued ringgit would favour an export-led recovery strategy, this certainly was not the intent. (Meanwhile, however, government efforts continue to be focussed on a domestic-led recovery strategy.) The under-valued ringgit is said to have had a (unintended) 'beggar-thy-neighbour' effect. Due to trade competition, the under-valued ringgit is said to have discouraged other regional currencies from strengthening earlier for fear of becoming relatively uncompetitive with regards to Malaysian production costs and exports. This may even cause China's authorities to devalue the *renminbi*, which could have the undesirable effect of triggering off another round of 'competitive devaluations', with concomitant dangers for all.

Industrial output, especially for manufacturing, declined even faster after the introduction of capital controls in Malaysia until November 1998, and continued downward in January 1999 before turning around. Except for a few sectors (notably electronics), industrial output recovery has not been spectacular since then, except in comparison with the deep recession in the year before. Meanwhile, unemployment has risen, especially affecting those employed in construction and financial services. Domestic investment proposals have almost halved, while 'green field' FDI seems to have declined by much less, though cynics claim the actual trends have been obscured by quicker processing of applications (see Figure 7.2).

Figure 7.2
Malaysia: Manufacturing Investment Applications and Approvals, 1991-1999



Monetary Stimulus for Stock Market Recovery

While the capital control measures may not have done much for the real economy, it is likely that associated measures have contributed to the stock market's recovery. Many foreign portfolio investors are now attracted to Malaysia by the very capital controls they may once have condemned soon after they were first introduced in September 1998. For them, Malaysia now offers a portfolio investment haven relatively sheltered from the volatility of global capital markets.

The ringgit peg against the greenback — ironically, tantamount to quasi-dollarisation of the currency — and the strict foreign exchange controls has also allowed the Malaysian authorities to pursue expansionary monetary policy while minimising its usual adverse consequences, e.g. price inflation. Despite significant increases in M1 money supply, price inflation has actually been brought down. The loose monetary policy has brought down the cost of credit, generating 'apparent profits and a sense of prosperity' (Shostak 2000), i.e. a wealth effect, which the authorities probably hope will generate a virtuous cycle leading to sustained recovery. As Figures 7.3a to 7.3c suggest, the Kuala Lumpur Stock Exchange Composite Index (KLCI) seems to have been responsive to changes in M1, rather than M2 or M3. However, Figures 7.4a and 7.4b does not suggest a very strong and consistent relationship.

Figure 7.3a
Malaysia: KLCI and M1 Money Supply, 1990-1999

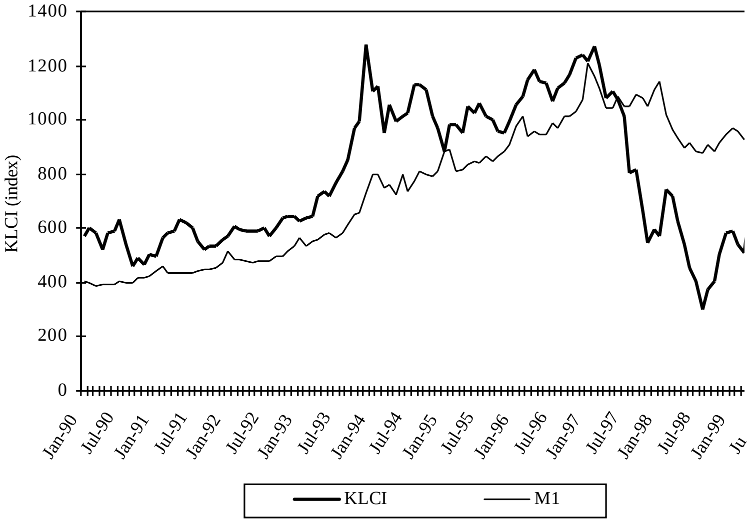


Figure 7.3b
Malaysia: KLCI and M2 Money Supply, 1990-1999

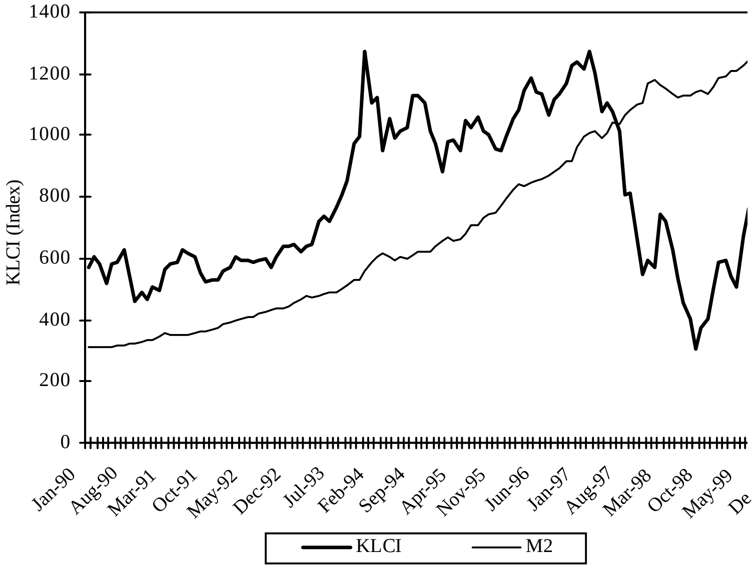


Figure 7.3c
Malaysia: KLCI and M3 Money Supply, 1990-1999

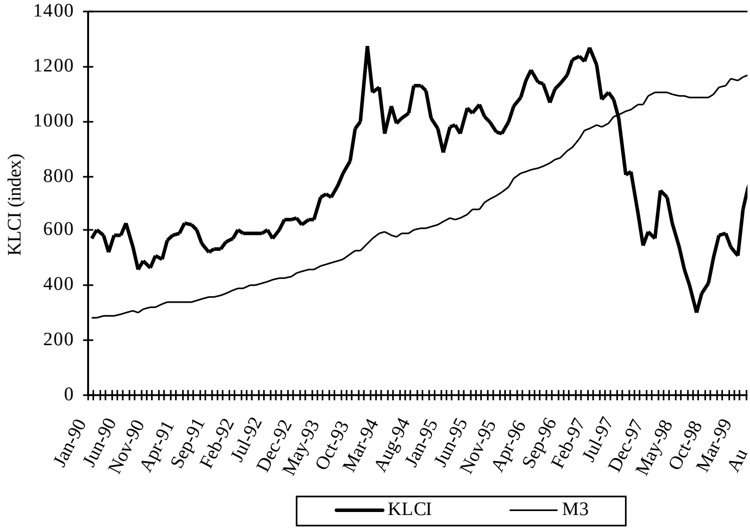


Figure 7.4a
Malaysia: Changes in KLCI and M1, 1990-1999

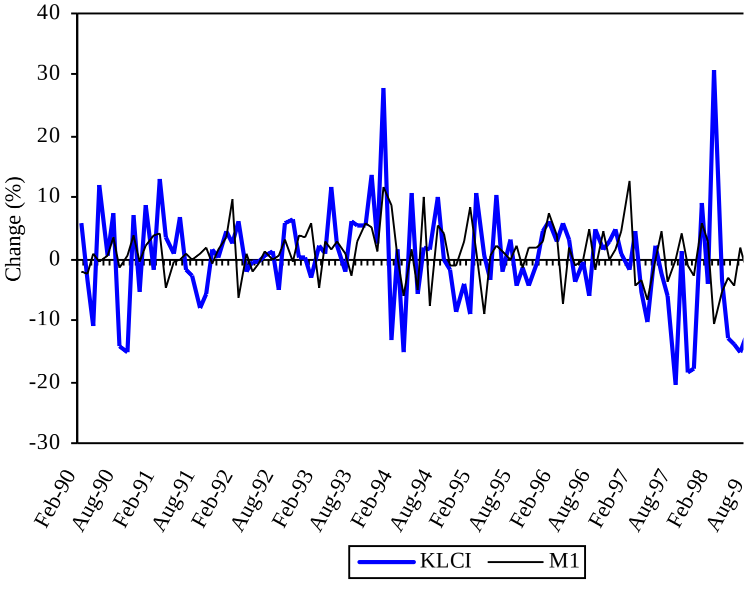


Figure 7.4b
Malaysia: Changes in KLCI and M2, 1990-1999

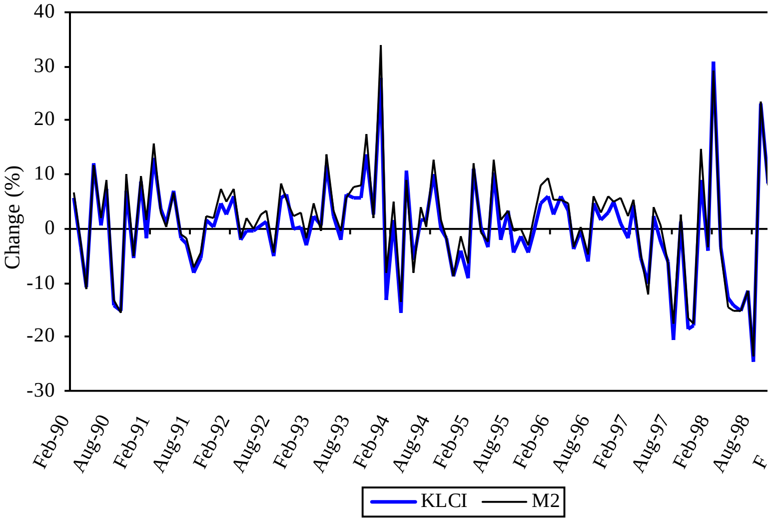
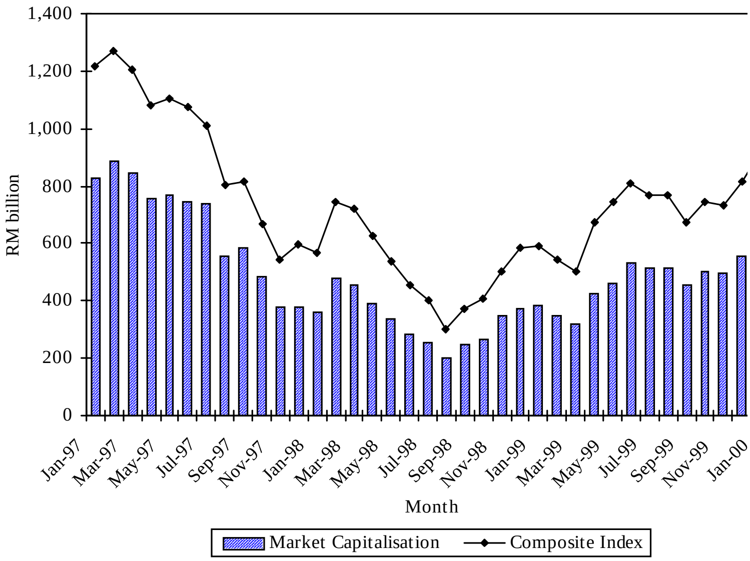


Figure 7.5
Kuala Lumpur Stock Exchange: Market Capitalisation and Composite Index



While this strategy has undoubtedly had some success in boosting the stock market since September 1998 (see Figure 7.5), it also exacerbates certain vulnerabilities. The stock market recovery is now more vulnerable than ever to a weakening of the money supply growth momentum. Since M1 cannot indefinitely race well ahead of other monetary growth indicators without exacerbating inflationary and other pressures, this money supply-led recovery strategy could well sow the seeds for the next bust when the central bank inevitably has to tighten monetary policy to stem growing inflationary expectations. Despite low interest rates (the three-month Kuala Lumpur inter-bank rate fell to 3.2 per cent at the end of December 1999 from the pre-controls post-crisis high of 11.05 per cent in April 1998), loan growth remains very low (barely above one per cent in 1999) despite considerable central bank pressure on the banks to increase lending; ominously, a higher proportion than ever before has been lent in recent months for share purchases, thus fuelling yet another share price bubble.

Thus, contrary to the claims of the Malaysian government, there is no clear evidence that the capital control measures have contributed decisively to economic recovery. All the other crisis-affected economies turned around during the first quarter of 1999, while Malaysia was the only one to do so in the second quarter of 1999, when some of the other countries registered even higher growth rates. (Hong Kong, the only other place with an even more tightly pegged currency, has been the worst laggard.) On the other hand, Malaysian capital controls have certainly not been the unmitigated disaster that many of its most vociferous and ideological opponents predicted.

There are now three remaining elements left of the controls introduced in September 1998, namely the ringgit peg, non-convertibility on the capital account and restricted convertibility on the current account, and the capital gains tax, though no longer with the higher rate on capital staying for less than a year.

With respect to the peg and convertibility, regional currency volatility has largely abated, and there is little risk in the near to medium-term of another round of sustained attack; hence, there is now little need to maintain the peg for this reason. In any case, it is unclear that the Malaysian peg would stand in the event of a sustained attack on neighbouring currencies, as evidenced by the need for Taiwan to devalue its currency in 1997. The evidence from Hong Kong, with its rigid peg, is far from encouraging — it's upturn has been the weakest in the region. Ironically, despite the regime's strong anti-Western rhetoric, the *status quo* leaves Malaysian exchange rate determination in the hands of the US Federal Reserve and, to a lesser extent, of the Japanese and European central banks.

Some Policy Lessons

Capital controls have not caused the recovery in Malaysia to be slower than in the other crisis countries. The 1998 collapse was less deep in Malaysia than in Thailand and Indonesia, while the recovery in Malaysia has been faster since early 1999, though of course, the pre-crisis problems in Malaysia were less serious to begin with. The Malaysian controls were intended to provide monetary policy independence to reflate the economy, though international developments from August 1998 also created new international monetary conditions that facilitated the adoption of reflationary policies in the rest of the region. While Malaysia missed out on most of the renewed capital flows to the region from the last quarter of 1998, it is not clear that such easily reversible capital inflows are all that desirable. The more serious problem has been the future credibility of government policies, which seems to have adversely affected foreign direct investments into the country (despite official protestations to the contrary) as well as risk premiums for Malaysian bonds.

The currently undervalued pegged ringgit has negative implications for a broad recovery, which depends upon imported inputs. It appears that the peg has not really given a major boost to exports, as the official export figures suggest. The regime has also not had other desired effects, as the export base remains narrow, with the most significant growth coming in electronics, i.e. due to fortuitous external demand, while the welcomed increase in the foreign reserves situation has largely resulted from massive import compression. There are costs to maintaining an under-valued ringgit, especially in the context of an economic upturn of what is still a very open economy. An undervalued ringgit may help some exports in the short term, but it also makes imports of capital and intermediate goods more expensive, thus impeding recovery and capacity expansion in the medium term. (Before the crisis, imports were equivalent to more than 90 per cent of GDP.) There are already some early indications of a declining trade surplus as the import compression due to the collapsed ringgit declines. This, together with an apparently stubborn negative services balance, will mean a shrinking current account surplus if the economic upturn continues.

While there is a need to continue to press ahead for international financial reform as well as for new regional monetary arrangements in the absence of adequate global reform, there is little to be gained by retaining the current regime of controls. Instead, if it succeeds in attracting short-term portfolio capital as the various amendments to the regime have sought to do, it would be largely ineffective in the event of another currency and financial panic.

The controls should be dismantled while ensuring an adequate and effective regulatory framework to reduce financial vulnerability and to moderate capital flow surges into and out of the country. Malaysia should not be completely defenceless against another round of speculative attacks. While Malaysia can afford to return to ringgit convertibility, this should be phased in with effective measures to ensure the non-internationalisation of the ringgit to reduce vulnerability to external currency speculation. This can include measures such as not permitting off-shore ringgit accounts as well as non-resident borrowing of ringgit.

Contrary to the official claim that the controls have had no adverse impacts, it appears to have had negative effects, among others, on desired long-term foreign direct investments. Even if this has been due to misperceptions, the authorities have nonetheless had to spend inordinate energy and resources trying to correct this misunderstanding. Confidence in the Malaysian government's policy consistency and credibility has been seriously undermined, as have been years of investment promotion efforts. This has not been helped by unnecessarily hostile and ill-informed official rhetoric.

The current regime is now counter-productive and will probably have adverse medium-term, indeed long-term, consequences if it is the intention, as declared by the Prime Minister, to retain the regime until such time as the international financial system is reformed. Hence, it would be desirable to phase out the existing measures in light of their ambiguous contribution to economic recovery and the adverse consequences of retaining the measures. While recognising the utility of portfolio inflows, there is increasing recognition of the need to have protection against rapid massive outflows. Part of that protection has to involve oversight of bank lending to avoid the creation of asset bubbles, which are then used to leverage other activity. Ultimately, however, there are no foolproof guarantees in an increasingly volatile globalised economy.

Since the desired reforms to the international financial architecture are unlikely to materialise in the foreseeable future, the Malaysian government should institute a permanent, but flexible, market-based regime of prudential controls to moderate capital inflows and deter speculative surges, both domestic and foreign, to avert future crises. This would include a managed float of the currency with convertibility, but no internationalisation, meaning, minimally, no off-shore ringgit accounts and limits on off-shore foreign exchange accounts, and limits on foreign borrowings. There is clearly an urgent need for some degree of monetary co-operation in the region. It is now clear that currency and financial crises have a primarily regional character. Hence, regional co-operation is a necessary first step towards the establishment of an East Asian monetary facility. Only responsible Malaysian relations with its neighbours will contribute to realising such regional co-operation.

The window of opportunity offered by the capital controls regime has been abused by certain powerfully-connected business interests, not only to secure publicly funded bail-outs at public expense, but even to consolidate and extend their corporate domination, especially in the crucial financial sector. Capital controls have been part of a package focussed on saving friends of the regime, usually at the public expense. While ostensibly not involving public funds, the government-sponsored 'restructuring' of the ruling party-linked Renong conglomerate will cost the government, and hence the public, billions of ringgit in foregone toll and tax revenue. Also, non-performing loans (NPLs) of the thrice-bankrupted Bank Bumiputra — to be taken over by politically well-connected banking interests — have not been heavily discounted like other banks' NPLs, although it has long abandoned its ostensible 'social agenda' of helping the politically dominant Bumiputera community.

Other elements in the Malaysian government's economic strategy since then reinforce the impression that the capital control measures were probably motivated by political considerations as well as the desire to protect politically well-connected businesses. For example, the Malaysian ringgit's exchange rate was pegged against the US dollar in the afternoon of 2 September 1998, hours before Deputy Prime Minister and Finance Minister Anwar Ibrahim was sacked, probably to pre-empt currency volatility and speculation after the firing. The Malaysian experiment with capital controls has been compromised by political crisis, vested interests and inappropriate policy instruments. Hence, it would be a serious mistake to reject capital controls on account of the flawed Malaysian experience.

Capital controls on outflows and other such efforts to prop up a currency already under attack may ultimately be ineffective and may actually unwittingly subsidise further speculative actions. Instead, measures to insulate the domestic banking system from short-term volatility through regulatory measures and capital controls on easily reversible short-term inflows as well as stricter prudential regulation and supervision may be far more effective and sustainable. International co-operation and co-ordination have often not only provided the best responses during crisis episodes, but have also been important for effective prudential and regulatory initiatives as well as to reduce 'policy arbitrage'.