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WORLD BANK GROUP
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL FINANCE CORPORATION
INTERNATIONAL DEVELOPMENT ASSOCIATION
INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES
MULTILATERAL INVESTMENT GUARANTEE AGENCY

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Statement by the Hon. **DATO MUSTAPA MOHAMED**,
Governor of the Fund and the Bank for **MALAYSIA**,
at the Joint Annual Discussion

STATEMENT BY DATO' MUSTAPA MOHAMED
SECOND FINANCE MINISTER OF MALAYSIA

<u>ANNUAL MEETING OF THE IMF/WORLD BANK</u>

(Plenary Session)
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Ladies and Gentlemen,

1. More than a year has passed since the financial crisis unfolded in East Asia. Recent trends in global financial markets indicate that the international financial environment has further deteriorated. There is now a growing concern of the risk of a global financial meltdown. When it first unfolded, the Asian crisis was not recognised as a global problem requiring a global approach. While there is a general recognition of the risks in the global financial markets, the international consensus reached at these meetings for a rapid response to restore stability in the world financial system now needs to be translated into concrete outcomes. During last year's IMF/World Bank Annual meetings in Hong Kong, my Prime Minister had raised many of the issues that have been the focus of the discussions at this year's meetings. In particular, this relates to the need for the reform of the architecture of the international monetary system to deal with the mounting destabilising flows that are having a devastating effect on countries. These cautions are only receiving urgent attention after inflicting high costs to the global economy.

2. As we gather here in Washington, there is yet no clear sign of stability being restored. Indeed, this is the third time that we have gathered since the crisis. Several proposals have now been made to strengthen the architecture of the international monetary and financial system but the world's financial leaders need to act decisively to bring these proposals to yield positive constructive results.

3. In the region, we have witnessed the devastating effects of destabilising capital flows. Thailand, Korea, Indonesia, Malaysia, and other Asian economies have all fallen victims to the onslaught of speculative capital flows in search of higher returns. The crisis has spread to Russia and more recently to Latin America. The collapse of the mother of all hedge funds, the Long Term Capital Management Fund is a strong indication that no country is spared from the contagion effect of the present crisis. But for the fact that it could destroy the financial system of the very rich, the activities of the fund would have been overlooked. As it is, the possibilities of it causing havoc in the world's capital markets are finally receiving attention.

4. As more and more countries succumb to the contagion effects, the risk of a global financial meltdown has increased. The world economic situation has deteriorated considerably and the near-term outlook is more uncertain than ever. The IMF has revised global growth downward four times since December 1997. As we gather here today, the prospects do not look promising and the contagion effects show no sign of abating.

5. The experiences of the affected countries thus far clearly demonstrate that the traditional policy prescription has not produced results. In the case of Malaysia, the combination of high interest rates and tight fiscal policies further distressed economic activities and led to a contraction of the domestic economy. Nations have been impoverished by this approach, setting back decades of development and progress.

6. The international community's response to the crisis has been to call for reforms including improving transparency and governance. The argument is that lack of transparency and accountability makes it difficult for markets to function well. Various committees and working groups have been duly formed to study these issues as part of the move towards a modern architecture for the international monetary system. At this stage however, we need to chart the steps that need to be taken for the implementation to achieve this end.

7. Now after more than a year into the world's worst economic crisis, many prominent economists from the West have voiced concern on the approach that has been taken. There is a growing skepticism over the effectiveness and appropriateness of traditional ideas and orthodox policy prescriptions. There are also rising concerns on the destabilising activities of hedge funds and other institutional investors and the lack of regulation over their activities. Of course, the reasons for the shift in stance has not been so much concern over the plight of the impoverished millions in Asia as much as alarm over the increased risks of global contagion, deflation and loss of markets. Instead of reviving confidence, the IMF approach has inadvertently made a bad situation worse. The combination of sustained high interest rates and tight liquidity has led to a severe contraction in the real economy and a vast overhang of bad debt throughout Asia.

Ladies and Gentlemen,

8. The traditional prescriptions backfired because the severe economic contraction that was precipitated by massive capital outflows was exacerbated by contractionary monetary and fiscal policies. In such an environment, foreign creditors became increasingly concerned that debtor firms would default on their loans. In addition, the actual official foreign financing fell short of expectations. Banks also came under extreme stress and amidst concerns over the health of their balance sheets began to slow down disbursement of

new loans. Despite contractionary policies, flight to quality continued whilst regional currencies continued to depreciate.

9. The present framework of the global financial system was designed more than 50 years ago and is clearly inadequate to deal effectively with the risks and challenges of volatile capital flows. The framework, including the role and functions of the Bretton Woods institutions needs to be reviewed urgently to keep pace with changing times. Closer co-operation between the World Bank and the IMF is needed to further strengthen their capacity to respond to the growing demands for assistance in the three key areas of financial, corporate and social safety net programmes. As had been pointed out by several speakers, particular attention must be paid to the social dimensions of adjustment measures by strengthening social safety nets programmes and protecting budget allocations aimed at helping the poor.

10. In such times of crisis, large resources are required by Fund and Bank members to refinance their economies. In this regard, the World Bank must fulfill the role mandated to it. Given that sourcing funds from the market would be extremely costly, I urge the Bank to fulfill this financing role and provide the much needed assistance to preserve the socio-economic gains made by these countries and to restore investor confidence. I am concerned that inadequate financial support from the World Bank would undermine reform efforts and aggravate human suffering.

11. The belief that globalisation and liberalisation of markets and the unfettered workings of the market, especially the financial market, can only bring benefits is flawed. In the haste to liberalise, the downside risks have been downplayed. The Asian financial crisis has negated this claim as the speed of financial liberalisation and the huge amounts of capital flows have been proven as destabilising and disastrous. Unbridled capital flows, including speculative capital, have wrought havoc on economies that have relatively under-developed and thin capital markets. More rather than less, Government intervention may in fact be needed to ensure that there is effective financial regulation and corporate governance.

Ladies and Gentlemen,

Proposals for reform

12. At last year's Annual Meetings in Hong Kong, Malaysia called for changes in the way the international financial system operates, suggesting the need to formulate international parameters for currency trading as a first step towards a review of the entire system. Our suggestion was dismissed as an attempt at "denial" and "blaming others" for our own problems and weaknesses. The failure to recognise that the crisis is in fact due to both external and internal factors has delayed efforts to deal comprehensively with

all the issues that emerged from the crisis. More recently, as the crisis continued to engulf more countries, awareness is increasing of the need for the reform of the world financial system. We will risk a global meltdown if we continue with ad hoc and incremental measures. A complete overhaul of the international monetary system is required and required soon. Allow me at this juncture to propose that at a minimum, the reform of the system should include the following key elements:

13. **Firstly**, **increased transparency should not only be on the part of Governments, but also financial market players.** Currently, there is no regulatory authority to oversee the orderly functioning of the international capital markets, especially currency trading. The rationale for such an institution would be similar to that for a national regulatory authority that supervises the activities of domestic stock exchanges, commodity, and futures trading. The regulation of cross-border financial market transactions is not new. Work is already underway to address shortcomings in the international financial system so vividly highlighted by the Asian crisis. These include banking supervision which is being undertaken by the Basle Committee; the establishment of universal principles for securities regulation by the International Organisation of Securities Commissions (IOSCO); and the development of strong global prudential standards in the insurance industry by the International Association of Insurance Supervisors (IAIS). A Joint Forum on Financial Conglomerates has also been set up by the Basle Committee, IOSCO, and the IAIS to develop a set of principles for supervising internationally active financial groups.

14. **Secondly**, the establishment of a mechanism for making rating agencies accountable for their actions is needed, particularly when their ratings have a significant adverse impact on a country, more than had been warranted by economic fundamentals. In recent times, it has been shown that rating agencies have failed to make objective assessments, despite being provided with comprehensive information. None of the rating agencies predicted the outbreak of the regional financial crisis. Indeed, they were bullish on Asia's prospects. Subsequently, when the contagion effects of the crisis became more apparent, the rating agencies exacerbated the situation by continually downgrading the credit standing of the affected Asian economies. The downgrading were often based on inaccurate assessments of the country's economic and financial situation. This further undermined investor confidence, precipitating panic selling by investors.

15. **Next**, it is time we set up an **international lender of last resort.** In addition to the need to establish a global regulator of world capital markets, it is also important to provide temporary liquidity support to economies in crisis facing problems of massive capital flight and a liquidity crunch. There is a need for a lender of last resort for countries that are fundamentally sound and

financially solvent, but which require temporary liquidity support to weather a "run" on their economies.

16. **Finally,** there must be a review of the role of **International Financial Institutions (IFIs).** The role of the IMF, World Bank, and other International Financial Institutions must be reviewed to ensure that they remain relevant to the changing needs of their members. In particular, closer collaboration among the IFIs, notably the IMF, World Bank, and the BIS are essential to ensure that the world's financial system continues to function smoothly. We should also consider the establishment of a global system for the exchange of information among the IFIs, international regulatory bodies, and home-authorities. Such a system of global information sharing would provide important early warning signals of impending crisis and enable the affected countries and the international community to undertake appropriate policy responses.

17. We remain convinced that an international consensus on the reform of the international monetary system is the preferred option to address the present and future financial crisis. No country can do it alone. Efforts by countries such as Malaysia, Hong Kong, and Russia represent only short-term measures to cope with the immediate problem of volatile capital flows. A permanent, multilaterally agreed solution is required to strengthen the international financial system.

18. In the interim, what are the options available to developing countries like Malaysia? Malaysia like other affected economies have persevered since the crisis began one year ago to undertake macroeconomic adjustment policies and implement financial reforms to reduce the risks and vulnerabilities arising from external developments. These measures were aimed at achieving macroeconomic stability and increasing the resilience of the financial system. As the economy slows down, strains are increasingly being felt in the financial system.

Ladies and Gentlemen,

Malaysia's exchange control measures

19. In the past one year, Malaysia has suffered considerable loss in income and wealth, No country which has experienced a 40% depreciation in its exchange rate and a 65% decline in stock prices can withstand the dislocation in its economy and the social costs it entails. In an effort to ensure prospects for stability, Malaysia has introduced selective administrative controls to allow for orderly capital flows and insulate the domestic economy from such external risks. It is emphasised that the new controls are not a substitute for sound macroeconomic and financial policies. The measures will provide some breathing space to ensure that the ongoing structural adjustment measures

could continue uninhibited by external developments. The Government is in fact on course in its efforts to restructure the financial sector, in particular, the recapitalisation of the financial institutions. The measures are also aimed at preserving the gains that have been made in terms of strengthening of the balance of payments position and in terms of containing inflation to create a positive environment to support economic recovery.

20. These measures are by no means radical. The measures are not even unique. Indeed, a large number of both developed and developing countries have imposed capital controls. It was only by mid-1995 that all industrial countries removed exchange controls on both inflows and outflows of capital Countries such as Germany, Switzerland and the United States re-imposed capital controls when they faced difficulties in achieving domestic and external balance in the post-war years. Even as recently as 1992, Spain taxed certain short-term transactions and temporarily tightened controls on onward short-term capital movements, arising from the aftermath of market disturbances within the exchange rate mechanism (ERM) of the European Union. Capital controls played an important part in the defense of the Irish pound, the Portuguese escudo, and the Spanish peseta in the 1992 ERM crisis. And among the developing countries, Argentina, Chile, Mexico, Venezuela, and China have also used capital controls.

21. I would like to assure the international financial community that the imposition of these exchange control measures will not affect the business operations of traders and investors or the normal conduct of economic activity. We continue to guarantee general convertibility of current account transactions and the free flows of foreign direct investment, repatriation of interest, profits, dividends, and capital. Indeed, the changes are intended to contain the potential for speculation on the ringgit and preventing excessive cross-border flows of short-term capital.

22. As the changes in the exchange control rules are directed at containing speculation on the ringgit and at minimising the impact of short-term capital flows on the domestic economy, they will not affect the normal conduct of economic activity. More importantly, the measures continue to guarantee:

- The general convertibility of current account transactions;
- The free flows of foreign direct investment: and
- The free repatriation of interest, profits and dividends and commissions.

23. As the new rules were aimed at containing speculation on the ringgit, they will have no impact on non-residents who are Malaysian individuals with permanent resident status residing abroad, foreigners studying and working in Malaysia, embassies, high commissions, consulates, central banks international organisations and missions of foreign countries in Malaysia.

24. To reiterate, Malaysia is not closing its doors to the foreign investor community, much less to the international economy. Malaysia still maintains general current account convertibility and is not resorting to any rationing of foreign exchange. Beyond that, Malaysia has not changed its policy on foreign direct investment and repatriation of profits and dividends from foreign investment. We also wish to emphasise that we remain fully committed to making all external debt payments, in full and on time, and that foreign exchange is freely available for such payments. The Malaysian economy is a very open economy. Trade as a percent of GNP will remain high, exceeding 170%, foreign direct investment of more than 20% of total private investment and foreign market share in total assets of the banking system of about 30%.

25. The recent measures are aimed at creating stable domestic conditions to promote economic recovery with price stability. In the interim period, the measures will strengthen Malaysia's economic fundamentals in order that we can better manage the challenges of the globalised financial markets. Towards this end, Malaysia remains committed to pursuing structural adjustments in the economy in general, and the financial sector in particular. These adjustments are necessary and important to protect long-term investments in Malaysia. Reflective of the commitment to direct foreign investments, existing measures will continue to guarantee free flows of long-term capital.

26. These selective administrative controls were implemented to insulate Malaysian from adverse external developments. These measures will remain in place for as long as there is no regulatory framework for financial flows. In the absence of such a framework, it is unlikely that financial stability will be restored.

27. In conclusion, we hope that the international community will evaluate Malaysia’s measures fairly. Malaysia remains committed to the open market, trade-oriented that has served us so well for over thirty years. However, extraordinary circumstances have led us to implement these measures to insulate Malaysia from contagion developments in the global financial markets. The more fundamental issues of the global system, however, remain. A solution to these issues can only be achieved through the concerted efforts of the international community. These efforts would increase the prospects for a permanent solution to restore stability in the international financial system.