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Risks and rewards of international capital flows: A study of Malaysia

Why has Malaysia been committed to maintaining financial openness over the past decade, despite experiencing potentially destabilising capital flows? A recent article shows that Malaysia has reversed its previously cautious position regarding international capital flows and is now locked into a position of international financial openness.** Notably, this commitment to financial openness comes at a time when capital controls are enjoying a renewed legitimacy, with even the International Monetary Fund revising its view of controls, now re-branded as “capital flow management measures”.

Malaysia's choice to maintain international financial openness has entailed a number of risks and trade-offs. The principal risks relate to the vulnerability created by financial openness, which can amplify both the booms associated with large inflows of capital and the potential bust when capital withdraws from a country. Several indicators suggest that Malaysia has increased its financial vulnerability, as evidenced by the increasing share of government debt held by foreign investors and signs of banking sector fragility. A commitment to financial openness also entails a well-known trade-off, often referred to as the “impossible trinity” or Mundell-Fleming thesis, which holds that a country can pursue only two out of the three conditions of monetary policy independence, exchange rate stability and international financial openness. In Malaysia's case, the country attempted to avoid this trade-off by large-scale sterilisation of excess capital inflows. Sterilisation, however, is costly and has some known perverse effects.

One finding of the research is that Malaysia's willingness to run the risks associated with financial openness can partly be traced to a paradoxical consequence of its earlier policy of imposing capital controls during the Asian financial crisis in 1998, a time when such controls were taboo in financial and policy circles. Once Malaysia's outspoken proponent of

capital controls, former Prime Minister Mahathir, stepped down from office in 2003, Malaysian officials appeared to engage in a process of ‘stigma management’ that involved rejecting the use of capital controls and committing to financial openness.

A commitment to financial openness has in turn altered the interests of some important Malaysian actors, especially financial industry banking groups, large firms and politically connected investment funds. As these sectors of the economy have become more internationalised, they have been able to capture many of the benefits of financial openness while the risks and costs are carried by the wider public. The now-notorious 1MDB scandal demonstrates an extreme version of this type of capture, as the offshore activities of this politically controlled investment fund directly funnelled benefits to a narrow group of beneficiaries. More broadly, the study shows that Malaysian business and political elites continue to be closely entwined. The Malaysian state sector holds significant stakes in nearly all large financial firms, and some firms have family links to the executive branch of Malaysian government. The author concludes that the alignment of political and business interests makes it more difficult for policy makers to regulate international capital flows as a means to promote financial stability.

**The full study results are available in an article authored by Natasha Hamilton-Hart: “Opting for Openness: Capital Mobility and Monetary Sterilisation in Malaysia” *Journal of Contemporary Asia*, Vol. 47 (2): 171-198.

