Managing the Impossible Trinity: The Case of Malaysia

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Abstract

This paper discusses how Malaysia manages the impossible trinity, the conjecture that a country cannot simultaneously maintain an open capital account, an exchange rate stability and monetary policy independence. Only two out of these three goals can be mutually consistent and policy makers have to decide which third goal to give up. The paper shows how Malaysia adopts an intermediate regime -- a regime that enables policy makers to manage all the three goals simultaneously. The impact of the global financial crisis on the Malaysian economy and the policy options for Malaysia to deal with the recent huge capital outflows are discussed in this paper. The willingness by Bank Negara Malaysia to allow a certain extent of exchange rate adjustments in the face of current global crisis reflects that Malaysia is not exempted from the impossible trinity.

Keywords: Impossible Trinity, Malaysia, Global Financial Crisis

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1. Introduction

In any open economy, policy makers are confronted with a trilemma, which is known as the "Impossible Trinity", demonstrated by Nobel Laureate Robert Mundell in the sixties during the times of fixed exchange rate regime. This paper examines how Malaysia manages this impossible trinity. The question of why an intermediate solution to this trilemma could work in Malaysia is analyzed in this paper.

Section 2 of this paper begins with a general discussion of the "Impossible Trinity" and its relevance to Malaysia. This is followed by Section 3 which describes the institutional structure of the exchange rate management, monetary policy and financial liberalization regimes in Malaysia. Section 4 explains two key channels through which the recent global financial crisis is transmitted to Malaysia, namely, the trade channel and the finance channel which led to a fall in the country's income. Section 5 examines what are the policy options available for Malaysia to handle such volume of capital outflows when the choice of objectives relative to the impossible trinity is not clear. Section 6 concludes this paper.

2. Impossible Trinity

The impossible trinity stipulates that economic policy makers are faced with a macroeconomic trilemma, that is, exchange rate stability, free capital mobility and monetary policy independence. This theorem asserts that under any macroeconomic circumstances, only two out of these three goals can be mutually consistent and policy makers have to decide which third goal to give up. The intuition is when a country has an open capital account and the exchange rate is pegped to some base currency, simple interest rate parity will pin down the domestic interest rate, forcing it to be equal to the interest rate of the base currency, if not, capital will flow until they do (Obstfeld et al., 2004).

Figure 1 illustrates the policy trilemma for open economies. The corners of the triangle show the policy goals just described. Any pair of goals is achievable but requires the third goal to be abandoned (Joshi, 2003). Specifically:

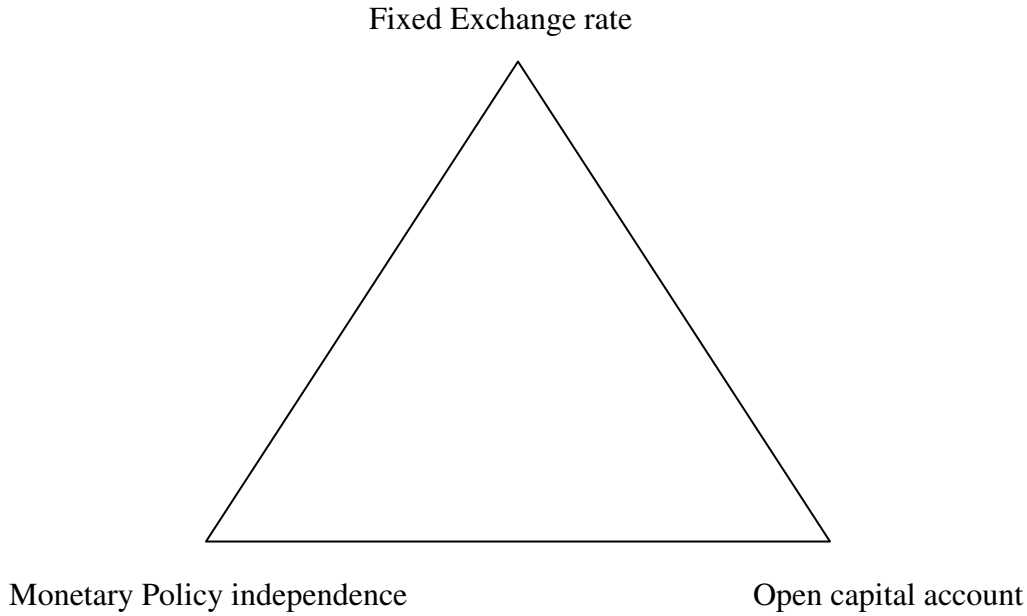
(i) Exchange rate stability and free capital mobility can be combined by adopting a permanently fixed exchange rate but has to surrender monetary independence.

(ii) Monetary independence and free capital mobility can be combined by adopting a floating exchange rate but has to surrender exchange rate stability.

(iii) Exchange rate stability and monetary independence can be combined but

has to surrender capital mobility. In other words, combine a fixed exchange rate and domestic monetary independence at the cost of a closed capital account.

Figure 1: Impossible Trinity



This theorem sounds fairly straightforward. Policy makers are required to choose two out of the three favourable goals shown above. However, in reality, such simplification does not happen all the time. Some countries make unambiguous choices among these three objectives. For example, Hong Kong desires to achieve exchange rate stability and simultaneously a free capital mobility, has kept its currency fixed and given up monetary autonomy altogether. On the other hand, Japan uses monetary policy to affect its domestic economy, and at the same time, keep its capital market open, but had to let its currency float freely (Hannoun, 2007). But there are also some countries that manage all the three goals which cannot be simultaneously achieved (Obstfeld et al.(a), 2004). Some emerging market economies which have pursued capital account liberalization, manage the exchange rate movement, while concurrently retaining autonomy in the conduct of the monetary policy.

The impossible trinity asserts that only free floating and fixed exchange rates are sustainable regimes with increasing capital mobility. Intermediate exchange rate regimes, including adjustable pegs, crawling pegs, crawling bands and even a managed floating exchange rate are not sustainable and should be abandoned. This is described as the “two corners solution” or the “bipolar view” or the “hollowing out of the middle” (Eichengreen,1994).

However, some economists think that the bipolar view is unsound and that intermediate exchange rate regimes are often more appropriate than the bipolar view for many countries. Frankel (1999) commented that the impossible trinity has artificially restricted the menu of choice between fixed and floating exchange rates. In practice, authorities can opt for intermediate exchange rate regimes even with perfect capital mobility. Frankel wrote, "What then is the origin of the hypothesis of the disappearing intermediate regime (the "missing middle?")? …….this is not the same thing as saying one cannot have half-stability and half independence. There is nothing in existing theory that prevents a country from pursuing a managed float ……."(p.5, 1999). Frankel (1999) named this sort of selection as "intermediate regime" . In Hannoun's (2007) words, an intermediate regime is a regime that is somewhere between the clear cut choices relative to the trilemma. Hannoun wrote, "an intermediate solution has a certain appeal, i.e. there might be some kind of optimal weighting among the three objectives" (p.3, 2007). India and Malaysia are good examples of these intermediate regimes.

3. Malaysia – Economic Overview and Institution

3.1 An overview of the financial liberalization, exchange rate and monetary policy in Malaysia

Malaysia is a small open economy. It has a relative open trade sector and capital account. Liberalization of the trade account came before the liberalization of the capital account (Yusof, 1994). The total trade to GDP has increased from 89 percent in the 1970s to 230 per cent in 2008. Unlike other developing countries, liberalization of the capital account in Malaysia has been gradual and cautious. Prior to the onset of the Asian Financial Crisis, it has significant capital market liberalization. Capital controls were imposed selectively and temporarily in 1993-1994 and in 1998-2001. While the objective of the capital control in 1993-1994 was to slow down the inflow of short-term capital during good times, the 1998 controls were introduced to limit capital outflows of capital during the Asian currency crisis period (BNM,1999). During the Asian Currency Crisis of 1997, Malaysia's policy turnaround was to give up free capital mobility with a view to maintain a fixed exchange rate while using monetary expansion to stimulate domestic economy. Of course, the capital control policy created a controversy but it was recognized as a respectable option for the government to want an effective policy instrument to prevent further financial turbulence (Athkorula, 2001). Furthermore, Malaysia's capital account controls targeted only short-term capital flows and it used these controls for the shortest possible time (BNM,1999).

There were several exchange rate regimes in Malaysia since its independence in 1957. After obtaining independence in 1957, the Ringgit had been pegged to the Pound Sterling. Following the collapse of the Sterling era in 1972, the Ringgit was pegged to the US dollar before it was allowed to float in June 1973. However, in September 1975, Bank Negara Malaysia (BNM) adopted a new exchange rate regime whereby the value of the Ringgit was determined in terms of a basket of representatives of major currencies. This regime lasted until July 1997, when BNM gave up managed the exchange rate in the wake of the Asian financial crisis. The Ringgit was allowed to float and values were determined by the market. With the imposed exchange control in September 2, 1998, the Ringgit was pegged to the US dollar at US$1.00=RM3.80. In July 2005, the Ringgit was no longer pegged to the US dollar, but shifted to a managed float system. The objective of the managed float is to promote exchange rate stability against the currencies of Malaysia's major trading partners. However, BNM stresses that the exchange rate is "market determined" as cited in its report, "the value of Ringgit to be determined by economic fundamentals and market conditions" (BNM,2005). But they have also articulated other objectives that are incompatible with clean floating, such as ironing out excessive short-term volatility to prevent the exchange rate from becoming misaligned for a substantial period in order to ensure exchange rate stability(Ooi,2008). Exchange rate stability remains a key policy focus of BNM (Sukhdave, 2008).

Prior to the 1997 Asian Financial Crisis, the Malaysian Ringgit was an internationalized currency which was freely traded around the world. When Malaysia imposed capital and currency controls and fixed the value of the Ringgit at 3.8 to the US dollar, BNM decided not to trade the Ringgit internationally. A traveler who takes out more than RM10,000 out of the country needs to make a declaration to BNM. All payments/borrowings by residents to non-residents or non-residents to residents have to be in foreign currency, and not in the Ringgit. The policy of non-internationalisation of the Ringgit reduces the ability of offshore entities to speculate on the Ringgit as shorting the Ringgit is not permitted (Sukhdave, 2008). The fixed exchange rate was abandoned to a floating exchange rate in July 2005, but, BNM continues not to internationalize the Ringgit till today.

Prior to the mid 1990s, the monetary policy strategy had been based on targeting monetary aggregates. Monetary aggregates were closely linked to the ultimate objectives of the monetary policy. The large capital inflows in the early 1990s highlighted the problems associated with using monetary aggregates as policy targets (Latifah, 2002). Monetary aggregates became an unreliable indicator of price stability and BNM shifted its focus to interest rate targeting. In 2004, BNM executed its monetary policy responsibility by adjusting its policy interest rate – Overnight Policy Rate (OPR). OPR serves as the signal of the Bank's monetary policy stance. BNM does not use the exchange rate as a monetary policy tool; instead the Bank through its liquidity operations, steer the average overnight interbank rate so that it is very close to the OPR (BNM, 1999).

3.2 Managing the Impossible Trinity

During the Asian financial crisis, Malaysia was confronted with the problem of massive capital flight and a very large magnitude of depreciation of its currency. The immediate reaction was to adopt the International Monetary Fund 's (IMF) prescription of increasing interest rates to stem capital outflow. However, the move did not have the desired effect. As a consequence of the Impossible Trinity, Malaysia found that it was not possible to simultaneously control or manage the interest rate, the exchange rate and the flow of capital. The 1998's capital controls provided leeway for a monetary policy, stabilized exchange rates and enhanced macroeconomic stability. By imposing capital controls, a fixed exchange rate and making the Ringgit non-internationalisable in 1998, the government was able to handle the impossible trinity problem - it could now lower interest rates to stimulate the economy without having to worry about capital flight or currency volatility. In other words, Malaysia could conduct an independent monetary policy with the aid of capital controls and the nonconvertible value of the Ringgit.

Since the economy recovered in 1999, there has been a gradual removal of some of the 1998 exchange control measures, both inflows and outflows, and for both residents and non-residents. But the peg of the Ringgit to the US $ remained intact until July 2005. In fact, further major liberalization measures were announced after 2001. For example, the country re-instituted openness to capital flows by a further financial liberalization process guided by the Financial Sector Master plan and Capital Market Master plan, both launched in 2001. Exit levy on portfolio foreign investments were abolished in 2001; residents were allowed to open foreign currency denominated accounts with onshore and offshore banks in 2008. One major aspect of the financial liberalization policy during the post 97/98 crisis is the deregulation of capital outflows by residents as the main response to the surge in capital inflows in 2006 and 2007. This resulted in a big rise in direct investment outflows from Malaysia after 2006.

With the gradual removal of the 1998's capital control and an open capital account at a fixed exchange rate, Malaysia once again, faced a conflict between a monetary policy and an exchange rate policy. When the capital account was closed, BNM could conduct its monetary policy and exchange rate policy independently of each other. However, the two are longer independent with the opening up of the capital account. The conflict between domestic monetary policy and exchange rate policy arise when a country tries to keep its exchange rate fixed. Net inflows or out flows have to be absorbed by the central bank so that the exchange rate remains fixed. Reserves change in response to capital flows, hence, a country loses its sovereignty with respect to the use of monetary policy for macroeconomic management. Masih (2005) noted that since monetary policy was directed to keep the exchange rate fixed, an enormous burden was placed on the fiscal policy to achieve domestic objectives such as higher employment and higher income, hence, resulting in a persistent fiscal deficit since 1998. This is the dilemma faced by

Malaysia after gradually removing the capital controls while still pegging the Ringgit with the US$. It was only until 21st July 2005 that BNM announced the removal of the Ringgit peg in favor of a managed float regime. Malaysia has since then regained its monetary autonomy (Ariff, 2005).

The Ringgit is now under "managed float" against a basket of undisclosed currencies, with no fixed rate target. BNM has never revealed the composition of the basket or the weights given to the various currencies in the basket. All this is by no means new, in fact, the current system, is no different from the one Malaysia had before the Asian Financial Crisis, 1997/98. However, for this time around, there is no fixed rate target. Ariff (2005) noted that exchange rate targeting must be avoided. Ringgit was targeted at around RM2.50 per US dollar which led to the overvalue of the Ringgit, contributing to the 1997 currency crisis.

Since the removal of the Ringgit peg in 2005, the Ringgit has appreciated against the US$ by about 14%. The Ringgit moved from RM3.78/US$ in 2005 to RM3.30/US$ in 2007. The deputy governor of BNM, Dato'Ooi Sang Kuang stated in his paper, " no special measures have been introduced to deal with currency appreciation pressures over the past five years"(2008, p. 334). Nonetheless, like other developing countries, Malaysia prefers some exchange rate stability rather than complete flexibility (Sukhdave,2008).

As Ooi wrote:

"Bank Negara Malaysia recognizes the potential risks of currency exposure and has instituted several measures to manage and mitigate such risks. Currency exposures are monitored and foreign exchange gains or losses are revalued on a quarterly basis" (2008,p.335)

The managed float and policy of non-internationalization of the Ringgit are key factors that allow Bank Negara Malaysia to set an interest rate policy based on domestic considerations.[2]

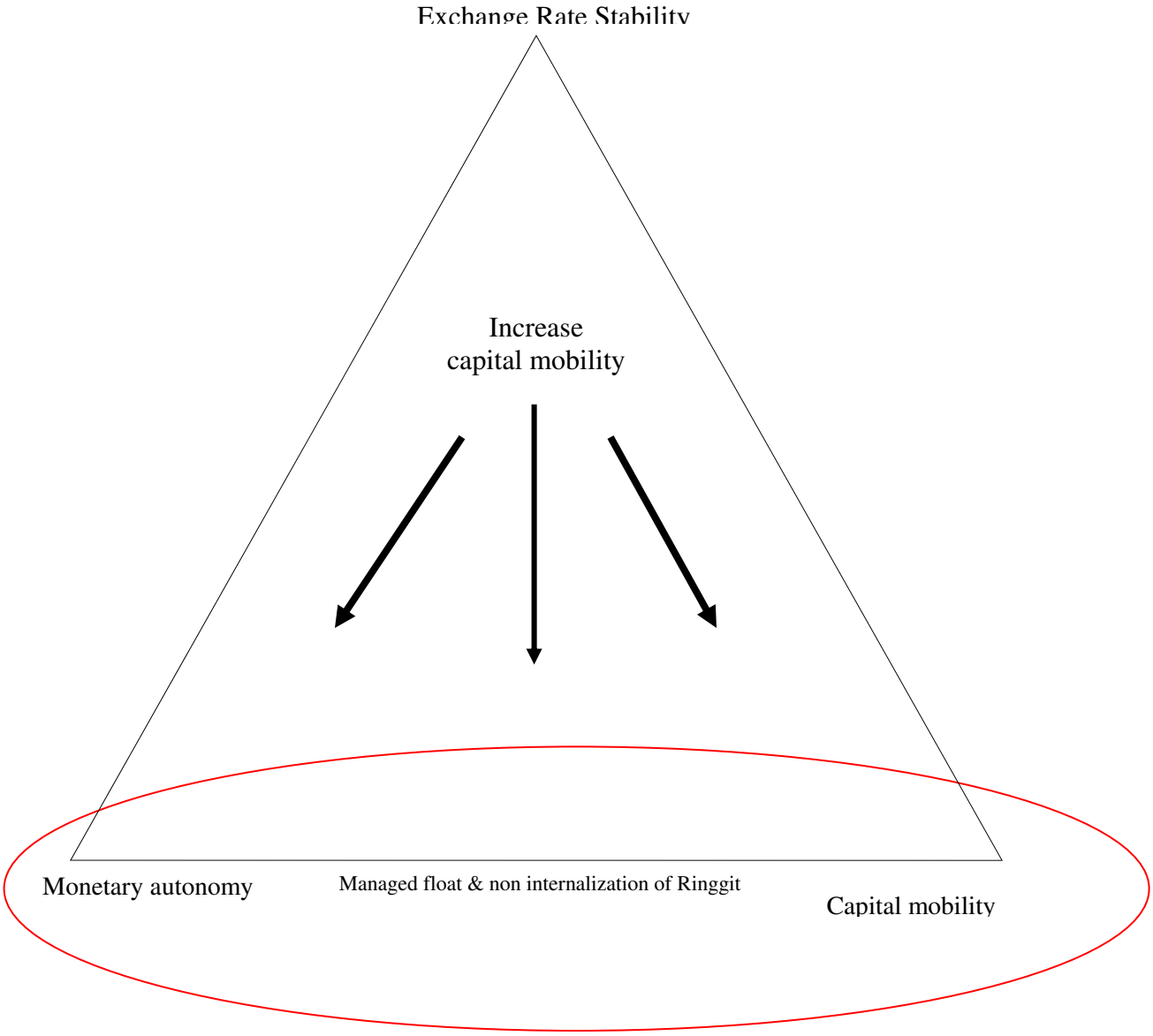
3.3 Intermediate solutions

An important lesson learnt from the impossible trinity theorem is that once an economy is fully committed to increasing capital mobility, it cannot both fix its exchange rate and pursue an independent monetary policy. Any attempt to do so will eventually run into inconsistencies that will force the country to abandon one of its objectives.

So how does Malaysia manage the three objectives? Does a managed float work in Malaysia? Could it be that Malaysia has found a successful combination of compromises on the three aspects of the trinity? A managed float, in particular, one targeting an

[2] BNM's Monetary Stability Web Site, http://www.bnm.gov.my/microsites/monetary/index.htm

undisclosed currency basket is a less rigid exchange rate objective than a fixed exchange rate. Hence, there is a first 'compromise'. Aside from this, in the case of Malaysia, currently, the managed float and the policy of non-internationalization of the Ringgit are key factors that allow BNM to set an interest rate policy based on domestic considerations[3]. Hence, Malaysia could conduct an independent monetary policy. Figure 2 is a simple schematic illustration of the intermediate regime in Malaysia. The liberalization of capital account has pushed Malaysia towards the lower part of the figure, the so-called "intermediate regime" by Frankel (1999).



[3] ibid

4. Effects of the Global Financial Crisis on Malaysia

A decade after the Asian crisis, Malaysia once again emerged as one of the fastest growing countries in Asia, expanding by an average of 6.5% in 2007. Large current account surplus, high accumulation of reserves, low external debts, and low inflation indicate that Malaysia is entering a new period of robust growth with stability. As the Asian region steamed along, Malaysia once again, encountered massive capital inflows and rapid currency appreciation in 2006 and 2007 (BNM,2007).

When the financial crisis began in the United States and Europe in 2007 and worsened in early 2008, there had been little effect on Malaysia and in other Asian countries. But then the financial crisis began to affect the developed countries' "real economy" of production and incomes in the second half of 2008, and this has been increasingly transmitted to Malaysia towards the end of 2008 and early 2009 (Khor, 2008). The real GDP growth for the 4th quarter of 2008 was only 0.1% year-to-year increase as compared to 4.7% growth in the 3rd quarter of the same year, and the real GDP growth was negative 6.2% in the first quarter of 2009.

There are two key channels through which the US financial crisis is transmitted to developing countries like Malaysia, namely, the finance channel and the trade channel (James et al, 2008).

Net capital flows began to decline in Malaysia by the second quarter of 2008 as shown in Table 1. Portfolio investment turned into net capital outflows since the second quarter of 2008. In total, portfolio investments recorded the largest net outflow of RM92.4 billion in 2008, compared to a positive net inflow of RM18.355 billion in 2007. Foreign direct investments into Malaysia plunged 95% from RM17.392 billion in the second quarter of 2008 to RM0.881billion in the third quarter. For the full year, foreign direct investments into Malaysia fell 9% in 2008.

One of the important scenarios of capital liberalization in post 1997 was the considerable liberalization of capital outflows in response to the strong capital inflows in 2006-2007 which built up reserves and pressure on the Ringgit. This reversed policy can be observed from the trend of Malaysia's direct investment abroad/outward. There has been a sudden and dramatic jump in direct investment outward after 2006. In 2006, direct investment abroad by Malaysian companies had reached RM22.2 billion, the same level as FDI into Malaysia. In 2007, Malaysian investment abroad had risen further to RM37.9 billion, which for the first time exceeded the FDI inflow of RM29.1 billion. In 2008, the outflow jumped to RM47 billion in 2008, again exceeded the FDI inflow of RM26.7 billion which resulted in a deficit of net FDI by RM20.5 billion.

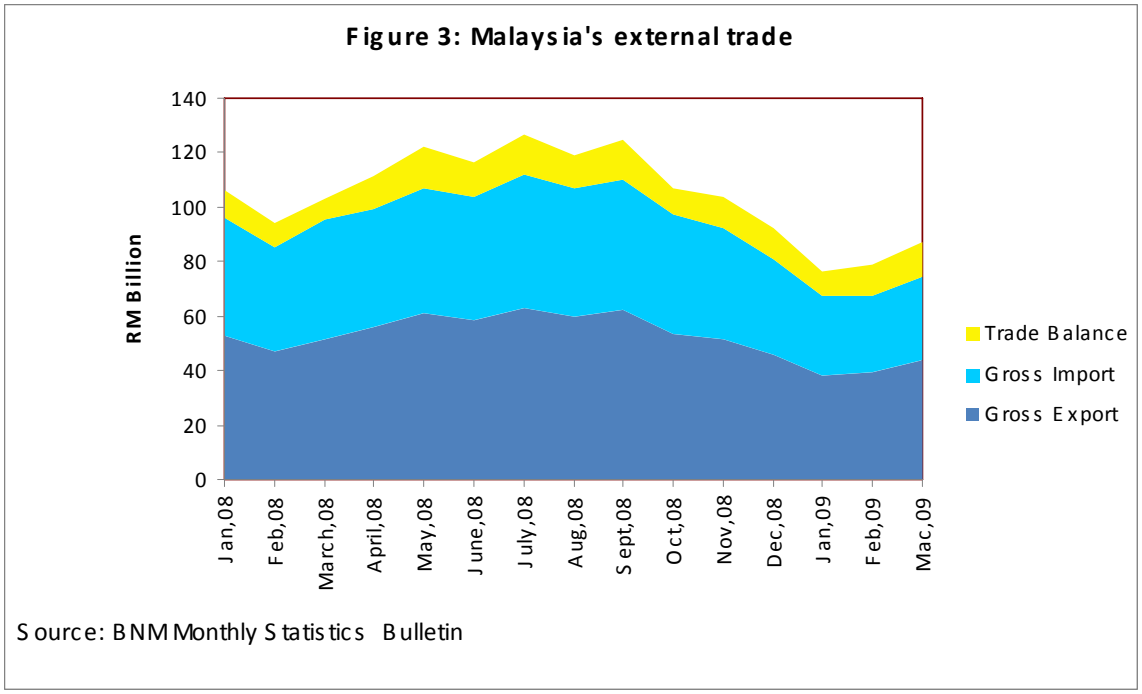
Table 1: Financial Account in the Malaysia Balance of Payment, 2007 to 1st quarter 2009

	2007	2008	2008Q1	2008Q2	2008Q3	2008Q4	2009Q1
Financial Account	-37.81	-123.90	26.45	-12.31	-61.48	-76.57	-29.76
Direct Investment	-9.14	-20.50	-2.98	2.91	-18.97	-4.36	3.19
Abroad	-38.22	-47.10	-6.33	-14.48	-19.5	6.43	0.435
In Malaysia	29.08	26.70	3.36	17.39	0.88	5.07	2.761
Portfolio Investment (net)	18.36	-92.40	21.07	-24.02	-56.18	-33.27	-12.15
Other Investment (net)	-46.92	-11.00	7.56	8.84	13.79	-41.19	-20.79
Official Sector	-5.79	-2.70	-0.71	1.61	-2.74	-0.86	-0.967
Private Sector	-41.14	-8.30	8.28	7.24	16.53	-40.34	-19.832

Note: * this category covers financial transactions in trade credits, long and short term loan and other transactions that are not recorded under direct investment, portfolio investment, and reserve assets.
Source: Bank Negara Malaysia, Monthly Statistics Bulletin

The trade sector was also badly hit in this global crisis. Data released by the Department of Statistics showed that Malaysia's export which is highly dependent on electronics and semiconductors, fell sharply since January 2009. Besides the fall in manufactured exports, there is also seen a sudden drop in the demand and prices of export commodities such as palm oil in Malaysia

While exports have declined, so has the import of intermediate goods associated with the exports. Imports in Malaysia have contracted by 32% to RM29.5 billion. The drop in exports has translated into a decline in imports as 70% of the country's imports are in the form of intermediate goods. Despite the decline in exports, Malaysia still maintains a trade surplus although these surpluses are smaller (see Figure 3).



5. Policy responses to the recent volatility in capital outflows

How does Malaysia manage such reverse flows of capital and at the same time, maintain its exchange rate stability and monetary autonomy?

Hannoun (2001) wrote that "if the choice of objectives relative to the impossible trinity is not clear, the policymaker has a wide range of policy options, but must make trade-offs …" There are several ways in which BNM may respond to the challenges posed by large capital outflows: 1) use of international reserves for crisis mitigation, 2) allow the exchange rate to depreciate, 3) Intervene to resist exchange rate depreciate, 4) restrict capital outflows.

5.1: International Reserves for crisis mitigation

The amount of foreign reserves accumulated by Asian countries in recent years is huge. Many Asian countries that have suffered from the Asian currency crisis in 1997/98 sharply increased their foreign reserves. Reserves accumulation accelerated after year 2000.

Asian countries began to accumulate huge reserves in the aftermath of the Asian Currency Crisis 1997. In 2006, among the top 10 reserves holding accumulating countries in the world, eight are Asian countries (Hashimoto, 2008).

Malaysia, like other Asian countries, built up huge reserves after the Asian Currency Crisis of 1997. In 1998, the foreign reserves were about RM99 Billion (USD26 Billion), but increased to RM317.44 (USD 91.6) in 2008. This huge amount of reserves accumulation occurred in the past few years. Table 2 provides insight of the reserves buildup after 1997 which was mainly financed by current account surplus rather than through capital inflows. This sort of reserves, known as "earned reserves" refers to national reserves built up by a country resulting from the trade or current account surplus (Martin, 2008). This sort of reserves is reliable and dependable and would be available when it is needed compared with reserves built through short term portfolio inflows or external borrowing.

It is clearly shown from Table 2 that prior to 1997, accumulated reserves was not high in Malaysia. Although Malaysia received high inflows of capital, it was offset with a deficit in the current account, leaving little balance for the change in reserves. But after 1997, the depreciation of the Ringgit enhanced the international competitiveness of Malaysia's exports. Strong current account surplus built up the national reserves to unprecedented levels despite a consecutive capital account deficit during this time period (except for a positive capital account balance recorded in 2004).

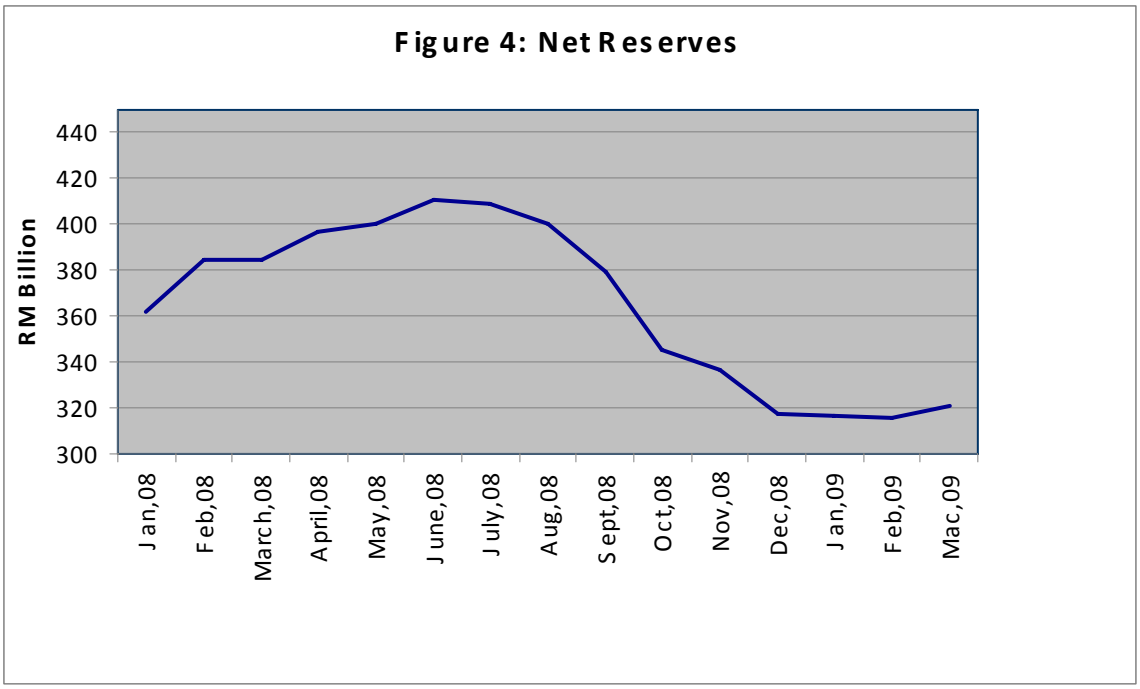
There are pros and cons in holding a large amount of reserves. The conventional view is that a large amount of reserves reflect strong economic fundamentals and is effective in preventing speculative pressures. On the other hand, the build up of reserves adds to quasi fiscal losses when the foreign interest rates earned are far lower than the interest paid on Malaysia's debts. In addition, a country incurs capital loss if its domestic currency appreciates.

Table 2: Changes in Reserves, Current Account Balance, Capital Account Balance, Errors & Omissions, 1990 – 2008 (RM Billion)

Year	Accumulated Foreign Reserves	Change in reserves	Current Account Balance	Capital Account Balance	Errors & Omissions
1990	27.025	5.365	-2.483	4.829	3.019
1991	30.452	3.427	-11.644	15.466	-0.395
1992	47.195	16.744	-5.622	22.285	0.081
1993	76.435	29.239	-7.926	22.795	9.370
1994	68.172	-8.262	-14.77	3.175	3.333
1995	63.769	-4.403	-21.647	19.140	-1.896
1996	70.014	6.245	-11.226	11.642	-6.371
1997	59.122	-10.892	-16.697	6.182	-0.377
1998	99.424	40.301	37.394	-10.00	12.913
1999	117.243	17.819	47.895	-25.152	-4.924
2000	109.066	-8.176	32.252	-23.848	-16.580
2001	113.585	4.518	27.687	-14.791	-8.378
2002	128.181	14.595	30.494	-11.941	-3.958
2003	167.962	39.781	50.624	-12.146	1.302
2004	251.689	83.728	57.302	19.347	7.709
2005	265.240	13.550	78.367	-36.991	-27.825
2006	290.396	25.158	93.504	-43.488	-24.857
2007	335.694	45.296	100.410	-37.805	-17.309
2008	317.445	-18.250	129.935	-123.011	-25.174

Source: Bank Negara Monthly Statistics Bulletin

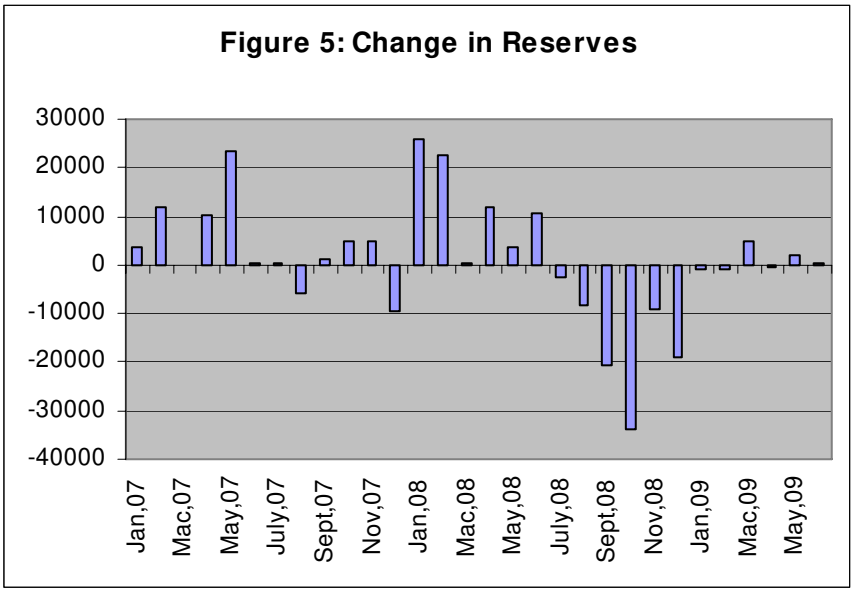
The strong international reserves position helps Malaysia weather the storm of capital flight and currency depreciation at the height of the global financial meltdown in late 2008 and early 2009. The reversal of the portfolio capital flows due to the repatriation activities by international foreign financial institutions following the deepening of the global financial crisis led to a decline in reserves in the second half of 2008.



5.2: Intervene to resist exchange rate depreciate

Of course, we cannot rule out that one of the policy options for BNM is to intervene to resist exchange rate depreciation. This is a justified policy response under exceptional circumstances. Intervention (by selling foreign exchange) offers a means to resist exchange rate depreciation. But to avoid undermining domestic price stability, intervention needs to be sterilized. Sterilization can be costly and the cost can increase with the exhaust of the stock of reserves. Sukhdave (2008) points out three main factors in determining the successful intervention operations. Firstly, the availability of good information about the nature of capital flows and market conditions. BNM has several internal reporting systems to monitor capital account transactions, hence, facilitating its exchange rate management. Secondly, the central bank must hold sufficient reserves to ensure successful intervention. Thirdly, a central bank must have enough instruments to manage the impact of its intervention operation on domestic liquidity conditions.

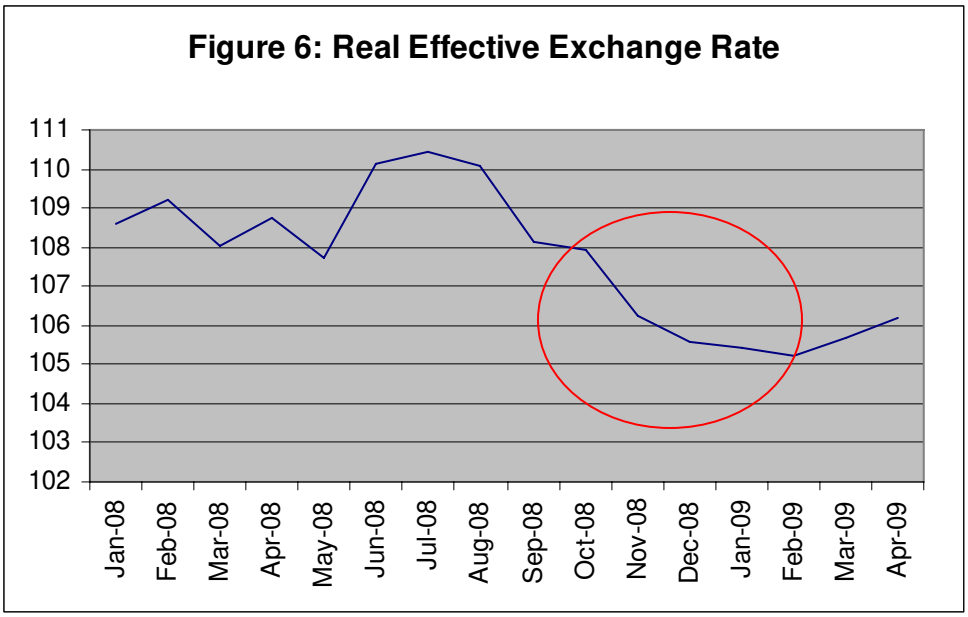
Data on market interventions are not publicly available. Nonetheless, the direction of intervention can be inferred from the change in official exchange reserves. Figure 5 shows unprecedented large scale selling of foreign reserves from July,2008 till February 2009 as capital outflows intensified during this period.



5.3: Allow the exchange rate to depreciate

The preferred policy option for countries confronted with large capital outflows is to allow the exchange rate to depreciate. In principle, the flexibility of the exchange rate is a major adjustment mechanism for global trade and financial flows (Hannoun,2007). Currency should depreciate for countries that experience current account deficit and gross capital outflows. This will help to reduce future balance of payment deficits. Furthermore, a country can move away from reserve accumulation when exchange rates allow to adjust its value in the market. Figure 6 shows the real effective exchange rate (REER) of the Ringgit after January 2008. Figure 6 shows a downward trend of the REER since September 2008 following the tumble of the global stock market due to the collapse of Lehman Brothers in the US.

Unlike during the Asian Currency Crisis, the decline in the value of the Ringgit has nothing to do with the fundamentals of the economy, rather it is due to declining demand in exports and capital outflows. The depreciation in the Ringgit may help to improve the export performance of the country, hence, limiting the negative impacts from the global recession.



5.4: Impose restrictions on capital outflows

If the balance of payment deteriorates, one of the policy responses is to temporarily restrict capital outflows. Capital controls can be an option, but it has to be a policy option of the last resort. Malaysia imposed such controls to stem the outflow of capital during the Asian currency crisis. Although the effectiveness of such controls remains a debate till today, these controls will enable Malaysian policy makers to buy time for the country to recover from the crisis. However, there are costs involved once capital control is introduced. Once a country resorts to control on capital, especially on capital outflows, investors will think that they might be introduced again in the future, which could deter further productive capital inflows.

6. Conclusion

Malaysia recovered from the Asian Currency Crisis and has made reasonably good progress since 1999. With the gradual removal of the 1998's capital control and an open capital account at a fixed exchange rate, the country found that it was subjected to the "impossible trinity", i.e. surrendering monetary autonomy at the expense of exchange rate stability and capital mobility. It was only in July 2005 that Malaysia responded to this trilemma by adopting a managed float exchange rate with non internationalization of the Ringgit. This enabled policymakers to balance exchange rate stability with monetary autonomy at the opening up of the capital account.

But to manage all the three choices require intervention in the market and intervention has its costs. With increased financial integration, the trilemma is forcing most Asian countries to accept a somewhat less exchange rate stability or less monetary autonomy. This has become increasingly apparent in the case of Malaysia. In fact, the willingness by the BNM to allow a certain extent of exchange rate adjustment in the face of current global crisis reflects that Malaysia is not exempted from the impossible trinity. Perhaps the best choice to practise in future is to liberalize capital flows, maintain price stability and let the exchange rate float.

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