Business Management Quarterly Review

Institute of Business Excellence

UNIVERSITI TEKNOLOGI MARA

PORTFOLIO CAPITAL INVESTMENT IN MALAYSIA

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Abstract

The main objective of this paper is to highlight a conceptual understanding on the portfolio capital investment in Malaysia. It constitutes an overview of features, facts and figures over the financial account in the Malaysia balance of payment, Malaysia external trade, heightened exposure to mobile capital flows, total of portfolio capital inflow by country, total portfolio investment by country, the net inflow of portfolio capital investment in total and from four major countries and currency exchange rate of major portfolio capital investment by country. The findings of the paper show that the trends of portfolio capital investment are on uptrend after Asian crisis. Asian crisis had brought terrible effects to Malaysia especially during Asian crisis. The implication of this paper is to provide a platform for industry players and regulators to implement policies that maximize the benefits from foreign portfolio capital investment flows and minimize their potential risks. The paper aims to attract the global attention towards the issues of portfolio capital investment in Malaysia. The present trends of portfolio capital investment in Malaysia captured in this paper can tell all about its future challenges in the global investment perspective
Keywords: Portfolio Capital, Investment, Asian Crisis and Malaysia.

Introduction

The environment in which capital market activity takes place has become increasingly dynamic and competitive driven by a combination of factors including such advances in financial activity in many jurisdiction, the changing pattern of fundraising and investment. Technology has provided the information and communications infrastructure to facilitate cross-border and cross-asset financial transactions. Investors and issuers are seeking international pools of liquidity and capital. The Malaysian capital market has witnessed significant change and development over the last few decades significantly in terms of its market size, range of instruments and efficiency. This progress has enhanced its role in supporting economic growth and transformation. In particular, these developments were geared towards nurturing the capital market to fill the institutional gap in the financial system and complement the role of traditional leaders.

The capital market consists of markets in several asset classes, primarily the equity market, the private and public debt securities market and the market for financial derivatives. There are also markets in Islamic-based instruments as well as in hybrid of the “plain vanilla” instruments. Malaysia's experience with temporary controls on short-term capital flows is germane to the contemporary debate on how developing countries can manage integration with world financial markets. In 1994, Malaysia resorted to controls on inflows of short-term capital to re-establish monetary control amid rising inflationary pressures.

Several years later, during the Asian crisis, Malaysia restricted outflows of short-term portfolio capital and deinternationalized the use of its domestic currency, in a bid to contain speculation against the ringgit, stabilize short-term capital flows and regain monetary policy independence**.** How successful was Malaysia's strategy of using temporary controls to manage short-term capital flows? A consensus view on this issue has yet to be reached.

The literature on Malaysia's 1994 controls is scarce and largely limited to descriptive analyses, while the controversial role of capital controls in Malaysia's recovery from the Asian crisis has come under intense scrutiny in both academic and policy-making circles. The authorities consider that capital controls were a critical component of the policy response to the 1997-1998 crisis. By eliminating offshore trading of the ringgit, and thus curtailing the speculative pressures on the exchange rate, controls enabled them to ease monetary and fiscal policies, rehabilitate the banking and corporate sectors. However, analytically, it is difficult to differentiate the effects of capital controls from other contemporaneous factors. The costs or benefits of capital controls remain ambiguous. Malaysia had more favorable preconditions, it did not do appreciably better and the timing of controls coincided with the reversal of the yen appreciation, the end of the crisis elsewhere and Fed rate cuts that put an end to the crisis atmosphere in world markets.

However, because the costs are ambiguous, there is no evidence that the institution of capital controls or the failure to apply an explicit IMF program has yet resulted in any obvious detrimental effects. In accordance with imposing capital controls, Malaysia pegged the ringgit to the U.S. dollar at a rate that many analysts believed undervalued the domestic currency. The undervaluation made capital controls largely redundant; they became necessary neither for sustaining the exchange rate regime, despite an aggressive monetary and fiscal expansion, nor for engineering a recovery which was largely led by exports. Moreover, since they were imposed after a substantial amount of capital had already left Malaysia; the controls were also not tested by any significant pressures for capital outflows. The costs of the 1998 controls are also not obvious (Dornbusch, Rudiger (2001)).

Beyond the immediate but short-lived deterioration in credit ratings and spreads, it would seem far-fetched to attribute the post-crisis decline in foreign investment and activity in financial markets exclusively to capital controls. Moreover, the Malaysian authorities took steps to minimize the costs of controls and relaxing them shortly after introduction, so that in their strongest form capital controls were effectively in place for less than six months. Given the difficulty of disentangling the effects of the 1998 capital controls from other policies, it is not surprising that existing empirical studies tend to attribute Malaysia's successful recovery to these controls. Kaplan and Rodrik (2001), for example, find that Malaysia's recovery was faster and less painful when they compare Malaysia's performance in the year after the introduction of capital controls with Korea's and Thailand's performance in the year after the start of their IMF-supported programmes. We can see economic situation in Malaysia in September 1998, when the country introduced capital controls, was similar to that in those other crisis countries when they adopted IMF-supported programmes.

If September 1998 is used as a common reference point for analysis, Malaysia's performance appears to be on a par with that of the comparator countries. The current empirical literature treats Malaysian capital controls as a single, time-invariant policy instrument. This analytical simplification is helpful but it precludes exploring how the effects of Malaysia's capital controls depended on their design. The 1998 capital control package was an intricate array of regulatory changes that spanned various international financial transactions (i.e., portfolio and other capital investment, the international use of the ringgit, the operations of commercial banks, foreign exchange and stock market transactions) and evolved in a non-linear manner over time. Hence, capital controls allowed the Malaysian authorities to reduce interest rates, but these measures had only a limited effect because interest rates across the region had fallen by then. Probably we can create system of closer prudential regulation that would moderate capital inflows, deter speculative surges; include limits on foreign borrowing and a managed float of the currency with convertibility. To conclude, portfolio capital investment plays an important role in respect of the economic development of any country. Even though portfolio capital provides a number of important benefits to the country, but they also have, if not appropriately regulated which is very significant cost. Thus, appropriate policies and market friendly regulations that maximize the benefits and minimize the costs must be implemented.

This paper is therefore to provide on conceptual understanding of portfolio capital investment in Malaysia. The following sections will discuss on the definition of portfolio capital investment, benefits and costs of portfolio capital investment, effects of the global financial crisis on Malaysia, heightened exposure to mobile capital flows, trends of portfolio capital investment in Malaysia for the three sub periods crisis, sources of portfolio capital inflow in Malaysia (portfolio capital investment and currency exchange by country) and the future challenges. Finally, this research discusses on the conclusion.

Definition of Portfolio Capital Investment

Portfolio capital investment is where an entity / investor obtains or buys stocks, bonds and / other financial instruments that do not involve the management of assets which transactions also requires international transfer of funds. It covers the acquisition and disposal of equity and debt securities that cannot be classified under direct investment or reserve asset transactions. These securities are tradable in organized financial markets. Following the globalization, portfolio capital flows is also growing but tends to be more centered on developed markets. A distinction could theoretically be made between the ‘serious’ investors who plan to stay for some time (and might therefore be encouraged) and the short-term speculators looking for quick profits and are likely to exit when enough is made or at the first sign of trouble. In reality, such a distinction may sometimes be hard to make. In a panic situation, as we seen in Asia, any portfolio investor may acquire the herd instinct and quit fast leading to an overall large exodus of funds. In any case, proper management of foreign portfolio investment is vital to prevent manipulation and excessive speculation that would cause massive panic outflows which consequently adverse effects towards economy.

Benefits of Portfolio Capital Investment

The primary benefit conferred by portfolio capital flows on a host country is a reduction in its cost of capital. Prices in developing country stock markets typically have jumped higher upon opening to foreign investors indicating that removal of market segmentation has permitted domestic rate of return to fall. The cost of equity capital has also come down as a result of large capital inflows and associated increases in stock prices, in part driven by a perception of improved earnings prospects. Obviously, the portfolio capital flows are able to fill the gap existed in the domestic resource which make the economic to grow faster. The foreign portfolio capital investment contributes to the financing of domestic enterprises.

Another benefit is that the flows of portfolio capital actually promote investment and economic growth of the recipient countries. Capital flows to emerging market economies have eased the domestic savings constraints which in turn has increased investment, thereby boosting economic growth. To the extent that the real returns to marginal investor are lower in capital rich-countries than those in capital-scarce countries. Then, the movement of capital from developed economies to emerging market economies improves the efficiency of world resource allocation (Devlin, French-Davis and Griffith Jones, 1995).

The crucial factor determining portfolio risk for a given level of return is the correlation between the returns of the securities that make up that portfolio. *Ceteris Paribus*, low as opposed to high correlation between securities means lower portfolio risk (portfolio diversification). Risk-averse investors will always prefer less risk to more. Therefore, they will try to make use of the effect of diversification and select securities with low correlation. Since perfect negative correlation between different securities is rare, the lowest correlations possible will be chosen. This is where foreign securities come into play. Investors who compose their portfolio only on domestic securities restrict themselves to a smaller number of securities to choose from. Since they exclude the large set of foreign stocks, bonds and other securities, they limit the power of diversification a priori and forgo the possibility of further reducing portfolio risk by picking some foreign stocks that exhibit very low correlation with the domestic portfolio.

Costs of Portfolio Capital Investment

Although portfolio capital investment has benefits, but there may be have some disadvantages of portfolio capital investment towards Malaysia. There are few costs of portfolio capital investment for Malaysia. Foreign capital flows may cause imbalances that threaten macroeconomic instability. This situation becomes likely if the absorptive capacity of the economy falls below the level of the capital inflows. Such a disparity arises because of policy arbitrage, where capital flows are attracted by the sound fundamentals of an economy causing financial markets to allocate too much or too little capital to some recipients or host country at a given moment (Guitian, 1998). Since capital account inflows entail financial transactions, they are also susceptible to market imperfections associated with asymmetric information and moral hazard. These microeconomic distortions normally result in an inappropriate assessment of rich-exposure and cause over-borrowing, making the financial system vulnerable to exogenous shocks. The problem becomes particularly acute when banks are the main intermediaries of capital flows. The situation is even more precarious in emerging markets where the risk-management practices of the private sector are underdeveloped, the capacity of regulators to supervise the financial sector are limited and the financial markets are thin. There is a potential increase in foreign ownership of domestic firms and the increase in systematic risk since failure of a financial intermediary in another country could have an impact on domestic markets. Portfolio capital flows might reduce effectiveness of monitoring and supervising financial intermediaries because of difficulties in assessing the financial status of firms that are active in many markets.

Effects of the Global Financial Crisis on Malaysia

A decade after the Asian crisis, Malaysia once again emerged as the one of the fastest growing regions 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).

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

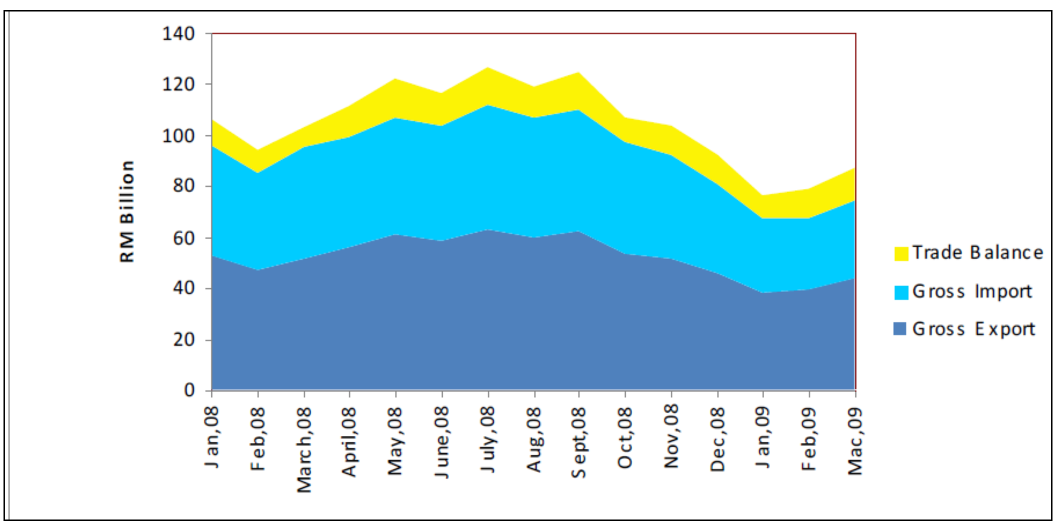
	2007	2008	2008Q1	2008Q2	2008Q3	2008Q4	2009Q1
Financial Account	-37.81	-123.90	26.45	-12.31	-61.48	-76.57	-29.76
Direct Investment	-9.14	-20.50	-2.98	2.91	-18.97	-4.36	3.19
Abroad	-38.22	-47.10	-6.33	-14.48	-19.5	6.43	0.435
In Malaysia	29.08	26.70	3.36	17.39	0.88	5.07	2.761
Portfolio Investment (net)	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

Source: Bank Negara Malaysia, Monthly Statistics Bulletin
*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.*

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 part of 2008. This situation 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 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, Park, Jha, Jongwanich, Hagiwara and Sumulong, 2008). Net capital flows began to decline in Malaysia by the second quarter of 2008 as shown in Table 1. Portfolio investment tuned 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. Portfolio investment continues 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 Malaysian 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.

Figure 1: Malaysia's External Trade

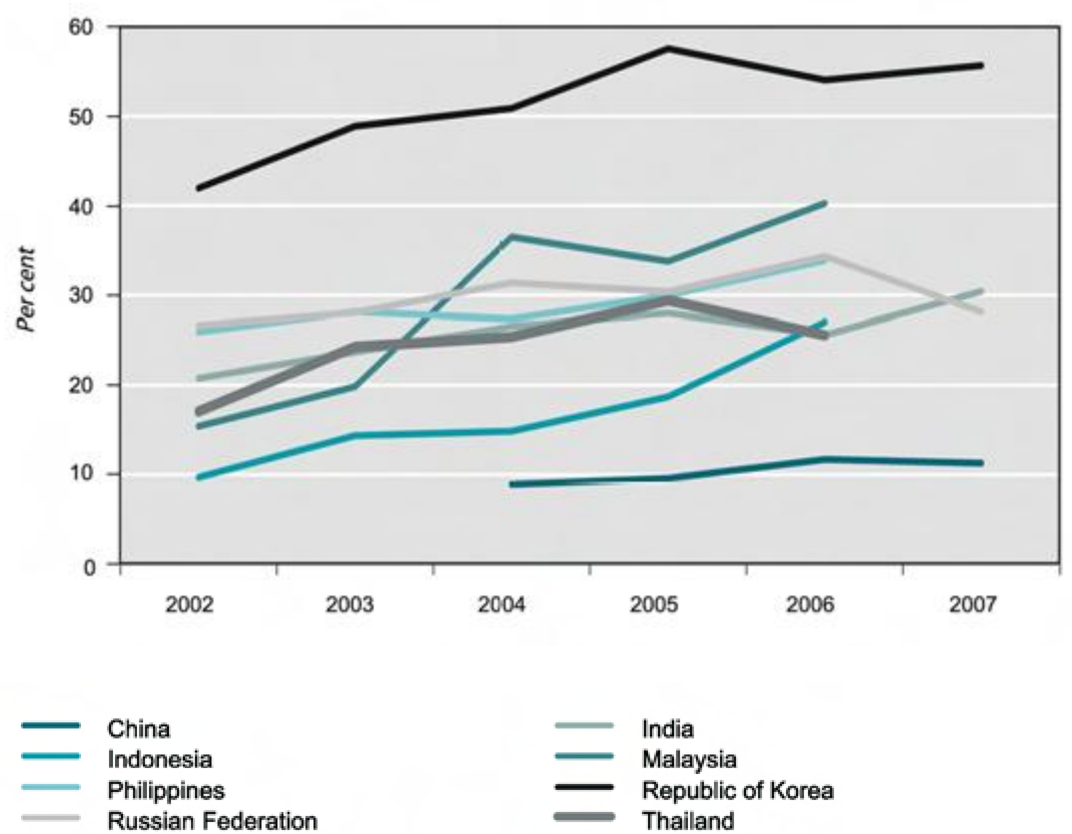


Source: BNM Monthly Statistics Bulletin

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. The trade sector was also badly hit in this global crisis. Data released by the Department of Statistics showed that Malaysia's exports which 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, it will also impact 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 1).

Heightened Exposure to Mobile Capital Flows

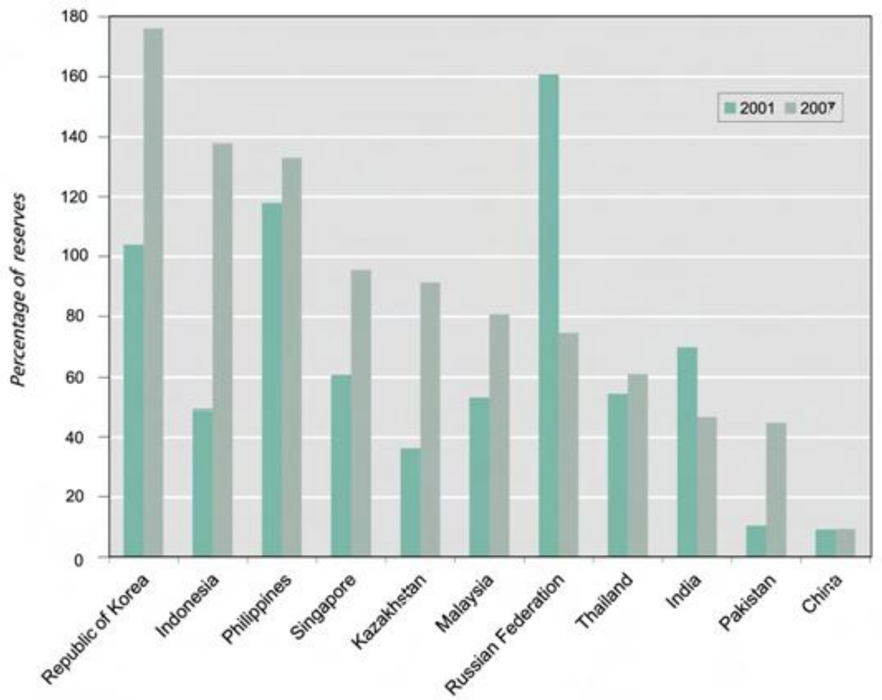
Figure 2: Stock of Foreign Portfolio Investment as Percentage of Total External Foreign Liabilities in Selected Developing ESCAP Economies, 2002-2007.



Source: IMF, International Financial Statistics (CD-ROM) (Washington, D.C., 2008).
Note: Derived from international investment position (IIP) of the respective economies.

The spark that has led to immediate macroeconomic difficulties for some economies of the region has been once again exposure to short-term portfolio capital. The significant and growing share of foreign portfolio capital in external financial liabilities has been a significant feature of many major developing economies across the region including those most affected by recent equity and currency market declines (see figure 2). At a time of generalized international risk aversion, defending outflows of short-term portfolio capital to prevent excessive currency depreciation can reduce the amount of reserves available to cover external short-term debt repayments and current account deficits. This is an ongoing concern for many countries.

Figure 3: Stock of Foreign Portfolio Investments as a Percentage of Reserves for Selected Developing ESCAP Economies, 2001 and 2007.



Source: IMF, International Financial Statistics (CD-ROM) (Washington, D.C., 2008).
Notes: Financial investment comprised of portfolio and financial derivatives investments. Derived from the international investment position (IIP) of respective economies. Data for 2007 refer to 2007 or latest available.

An analysis of the stock of portfolio investment held by foreigners as a percentage of reserves (see figure 3) provides a snapshot of the possible vulnerabilities that currencies would face in the event of an outflow of short-term portfolio capital. The reserves cover for portfolio investments is seen to have decreased substantially across much of the region over the past decade with reserves insufficient to fully cover the stock of portfolio investment for the Republic of Korea, Indonesia and the Philippines.

At a time of unprecedented financial instability, in which flights to safety have low threshold triggers, or in which liquidity constraints for financial institutions can easily result in recalls for highly leveraged investors, reserves may easily come under strain in any bid to defend currency values. Such generalized outflows of foreign portfolio capital may be further compounded by a similar exit of capital initiated by domestic residents, to the extent that residents are free to make portfolio investments abroad. It is clear that access to a greater pool of reserves than is normally adequate assumes an even more important role in reassuring investors and can in turn serve to reduce the extent of net capital outflows.

Portfolio Capital Investment in Malaysia

History of Portfolio Capital Investment

Portfolio capital investment in Malaysia can be divided into three stages. There are before Asian crisis (1987-1996), during Asian crisis (1997-1998) and after Asian crisis (1999- 2007).

Portfolio Capital Investment before Asian Crisis

Between 1986-1990 and 1991-1995, investment as a percentage of GDP rose from less than 32% to almost 38% in South Korea, from 23% to 39% in Malaysia and from 33% to over 41% in Thailand as reported by United Nations Conference on Trade and Development (UNCTAD) in 1998. Malaysia's remarkable economic growth during the period 1987-1996 had been fuelled by foreign capital inflows. Foreign direct investment (FDI) notably from Japan and the United States, had helped push the average annual growth of the Gross Domestic Product (GDP) up to a dizzy height of about 8 percent. The foreign portfolio capital investment flows to Malaysia seems to be very volatile. In the period from 1992 to 1994, Malaysia witnessed a rapid inflow of short-term portfolio capital mainly motivated by the large interest rate differential, the expectations of ringgit depreciation, the bullish stock market and strong economic fundamentals (BNM, 1999). Realizing the dangers associated with the rapid build-up in short-term capital flows, Malaysia introduced several administrative measures in 1994 which were successful in dealing with the problem.

Real GDP registered strong growth of 8.8% per annum in 1988 to 1994, with strong growth of 8.8% per annum and strong inflows of foreign direct investments. However, short-term capital inflows also increased in importance during this period especially in 1993 to 1994. While average annual net inflow of total long-term private capital during the period 1990 to 1993 was about RM 9.5 billion a year identified short-term inflows, (mainly net increase in commercial banks liabilities) amounted to about RM 8 billion a year. The net inflow of identified short-term capital in 1992 (RM 12 billion) and 1993 (RM 13.9 billion) either exceeded or matched long-term capital inflows (BNM, 1999). Sterilization operations were undertaken by BNM to mop-up the excess liquidity. BNM issued Bank Negara Bills (BNBs) and raised the statutory reserve requirement (SRR). Despite the measures, inflow of short term capital continued to increase and the excess liquidity continued to remain large in January 1994. BNM introduced several exchange control measures in January and February

1994 to deal with the highly destabilizing speculative activity and to reassert control over monetary policy. These measures helped to stabilize the economy and reduced the contagion impact from the Mexican peso crisis in January 1995.

Portfolio Capital Investment during Asian Crisis

During the financial crisis in Asia, significant outflows of non-resident portfolio investments occurred since June 1997 which severely destabilized the financial market as well as adversely affected economic growth. In 1997, Malaysia registered a net portfolio capital outflow of RM 28.3 billion (10% of GDP). With the speculative attack on the ringgit and de facto devaluation of the Thai Baht, the depreciation of the ringgit reinforced the downward spiral of the Kuala Lumpur Stock Exchange Composite Index (KLCI). Malaysia had lower levels of foreign debt compared to Thailand, Indonesia and Korea because Bank Negara had limited short-term foreign borrowings. But the ensuing “loss of investor confidence” in East Asia caused easily reversible portfolio investment, so-called “hot money” to exit quickly from the region. Hence, the Malaysian financial system was no less vulnerable because of the far greater role of foreign investments in the relatively larger Kuala Lumpur stock market.

September 11 incident has dampened investors’ confidence in Malaysia. Should Malaysia run the risk of being perceived as a ‘high-risk’ country, despite evidence to the contrary, its position as one of the favorable investment hubs in the region may be eroded. The emergence of China as an economic powerhouse will hog the bulk of capital that flows into the Asean region. Its 1.3 billion populations provide a huge consumer market and a cheap labor force crucial for attracting FDI. In addition, its gradual financial market liberalization will further worsen the scenario. To deal with all these, an extremely tactful approach is needed. Although the sudden flight of foreign short-term capital was deemed to be one of the major causes of the 1997 crisis, but it cannot be dispensed with, as short-term capital flows still represent a vital input to fuel Malaysia’s future economic growth. Nevertheless, in the wake of Morgan Stanley Capital International’s free float weighting this year, shares free float in Malaysia worth only about 30% of paid-up capital has been relegated to the same rank as India, Pakistan and China. This pales in comparison with Singapore’s 40% and Hong Kong’s 50%.

Portfolio Capital Investment after Asian Crisis

With the rosy economic conditions, foreign portfolio investments had buoyed the Kuala Lumpur Stock Exchange (KLSE) composite index and market capitalization up to about 1,300 points and RM900 billion respectively. Foreign capital has shunned the Malaysian market after the 1997 Asian financial crisis. Actually, FDI had dropped sharply by 32% from RM8.3 billion in 1996 to RM5.6 billion in 2001. Meanwhile, foreign portfolio investments had fallen by 74% from RM144.9 billion in 1996 to RM37.6 billion in 2001. Without the active presence of foreign portfolio investments, the stock market capitalization had plunged to RM450 billion in 2001. This is a 50% drop from the pre-crisis level. It is worrisome because should foreign capital continue to shy away from the Malaysian market; the present incipient economic recovery is likely to be mild and slow. The export-led economic recovery will lose momentum if there is not enough foreign capital coming in this year.

Meanwhile, without a noticeable increase in foreign portfolio investments, it is unlikely that the stock market will climb back to its previous enviable heights. This will dampen in hope of reviving the listless economy with wealth effect. Domestic initiatives alone taken by the government in the midst of the crisis do not guarantee a fast revival of economic growth due to apparent weaknesses, both structural and non-structural. In early August 1997, Malaysia introduced a swap limit on the offer side for non-trade or services related transactions with non-residents. On 1 September, 1998, the Malaysian authorities decided to impose selective exchange controls to protect its economy from external vulnerabilities and restore financial stability. This was achieved through measures to cease the internationalization of the ringgit by eliminating the availability of ringgit in offshore markets. These measures were followed by fixing the ringgit exchange rate of RM 3.80 to 1 US dollar on 2 September 1998.

The Government also introduced a 12-month holding period on portfolio outflows to discourage the speculative forms of portfolio investments and to achieve greater stability in short term capital flows. The rule was modified in February 1999 to allow repatriation of principal capital and profits based on a graduated levy depending on the duration of investments. The new levy system was aimed at encouraging existing portfolio investors to take a longer term view of their investment in Malaysia and to attract new funds into the country, while at the same time discouraging destabilizing short term flows. In September 1999, the two tier levy system was further relaxed to a flat system. In year of 2001, following the achievement of its objective of restoring stability in the domestic financial markets, Malaysia's selective exchange control measures have been progressively relaxed. The final major relaxation was the removal of the levy system on portfolio investment in May 2001. Since then, there is complete free movement of funds for all foreign investment in Malaysia including the equity market.

Regulations on capital flows are liberal with policies aimed at monitoring the settlement of payments and receipts as well as encouraging the use of the country's saving for productive purposes. For monitoring and compiling balance of payments statistics, residents are required to complete statistical forms; Form P and Form R, for each payment and receipt respectively of more than RM50,000 vis-à-vis non-residents. Payments for overseas investment including extension of a loan to a non-resident continue to require prior approval if the amount exceeds the equivalent of RM10,000. Approval requirements for large inflows and outflows are mainly for prudential reasons to ensure financial stability. All regulations are applied uniformly to transactions with all countries except Israel, Serbia and Montenegro for which special restrictions apply. Exchange control regulations are also applied, where appropriate to prevent recourse to the Malaysian banking system for money laundering and financing of terrorist activities. Non-residents are freely allowed to move their funds in and out of the country for portfolio investment purposes. However, repatriation of funds arising from the sale of Ringgit assets, dividends, interest, commission and fees must be made in foreign currencies. In the year of 2007, Exchange Rate Regime applied which is the Managed floating system Exchange rate of the ringgit. It is determined based on a basket of currencies of Malaysia's major trading partners. In terms of Capital Flow Management Framework, Malaysia maintains liberal regime on cross-border transactions including capital flow, involving residents and non-residents. For Foreign currency borrowings by residents, will imposed a specified limit requires prior permission of Bank Negara Malaysia (BNM). Both residents and non-residents are free to remit abroad own funds. Non-residents are free to repatriate any amount of capital, profits and income earned in Malaysia.

Later, recent policy change. It is effective from April 2007. The foreign exchange administration rules were liberalized to provide greater flexibility to licensed onshore banks to undertake foreign currency business, to widen the investor base for ringgit assets and financial products and to increase business efficiency. Other policies which are implemented consist of:

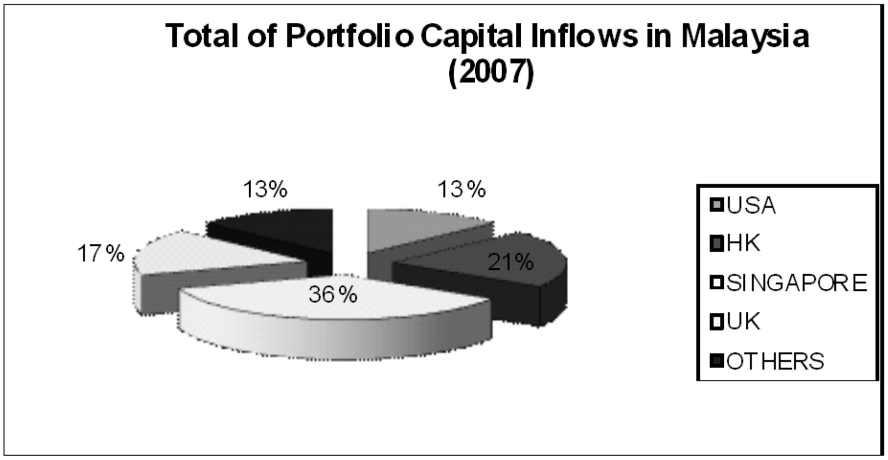
- Net position limit of licensed onshore banks was abolished.
- Limits imposed on licensed onshore banks for foreign currency accounts maintained by residents were abolished.
- Investment banks were allowed to undertake foreign currency business subject to a comprehensive supervisory review.
- Limit on the number of residential or commercial property loans obtained by non-residents was abolished.
- Licensed onshore banks were allowed to appoint overseas branches.
- Limit of foreign currency borrowing obtained by resident corporations was increased.
- Residents were allowed to open and maintain joint foreign currency accounts for any purposes.

Sources of Portfolio Capital Inflow in Malaysia

Figure 4 shows that only four countries such as Singapore, Hong Kong, United Kingdom and USA dominated more than 80% of the portfolio capital inflow to Malaysia in 2007. The largest portfolio investment since 1991 was from Singapore, which account for 36% of the total inflow. Other countries includes, among others, Australia, Belgium, Brunei, Japan, Germany, Canada, Luxembourg, Netherlands, China, Switzerland and Taiwan account only 13% of the total inflow during that period.

Table 2 is shown the portfolio capital inflow by country from 1997-2007. The largest portfolio investment since 1991 was from Singapore which account for 36% of the total inflow during that period. However, Singapore’s portfolio investment declined tremendously after the financial crisis which saw a declined by 70% in 1998. After the crisis, Singapore and other countries’ investment were trending downward and in 2000 onwards, Hong Kong replaced Singapore as the largest portfolio capital investor in Malaysia. In year 2002, Hong Kong’s portfolio inflow to Malaysia was 25% of the total inflows. Figure 5 shows total portfolio investment by country from year of 1991 until 2007. Total of portfolio capital investment in Malaysia kept on increasing from 1991 to 1994. There was an increased of RM 219,109 million during that period. However, there was a slightly decreased 55% in 1995. The amount of capital inflow dropped from RM 238,454 million in 1994 to RM 106,414. After 1995, total capital inflows were increased again until 1997. The rising trend was, however, halted in 1997 when the economy began to experience the adverse effects of the Asian crisis.

Figure 4: Total Portfolio Capital Inflow by Country, 2007



Source: Bank Negara Malaysia

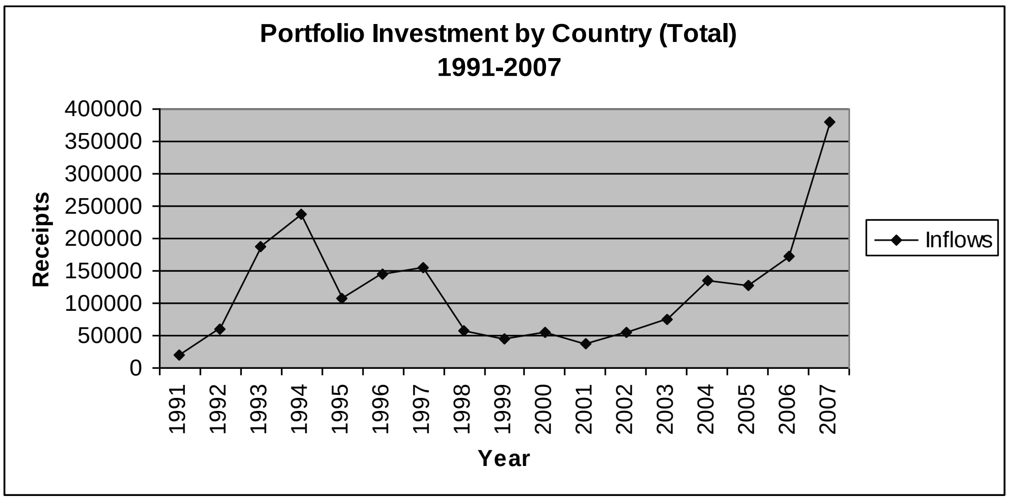
Table 2: Portfolio Capital Inflow by Country from 1991 to 2007 (RM million)

YEAR	USA	HONG KONG	SINGAPORE	UNITED KINGDOM	OTHERS	TOTAL
1991	995	4731	10359	2174	1086	19345
1992	4361	9853	31596	13471	1654	60935
1993	9135	31343	113307	26100	7894	187779
1994	35028	37267	114017	36004	16138	238454
1995	13778	24108	52155	12304	4069	106414
1996	8870	41699	70198	17653	6531	144951
1997	9878	42229	75373	20647	8033	156160
1998	5625	17477	22240	6866	4987	57195
1999	2870	8474	18157	5856	8449	43806
2000	4748	17125	16072	8161	8421	54527
2001	7352	8703	7530	7578	6646	37809
2002	7259	13721	11072	12085	10246	54383
2003	9172	20279	15192	19621	11749	76013
2004	20131	29901	34990	28943	21141	135106
2005	20117	25904	31738	27332	22227	127318
2006	30030	28537	31169	36946	45979	172661
2007	74201	65548	90111	71077	77988	378925
TOTAL	**263550**	**426899**	**745276**	**352818**	**263238**	**2051781**

Source: Bank Negara Malaysia

The Southeast Asian financial crisis that erupted in Thailand in July 1997 took investors by surprise. There was a decline in portfolio capital to Malaysia during 1998 to 2001. The amount of capital inflow decreased 63% from RM 156,160 million in 1997 to RM 57,195 million in 1998. Fortunately, the inflows of portfolio investment from United States, the United Kingdom, Hong Kong, Singapore and other countries turn into increase again since 2002 until 2007. In year 2005, Ringgit strengthened a percent against various major currencies and was expected to appreciate further. This situation had give confidence to foreign investors so that the total inflows increased 197.62% from 2005 to 2007.

Figure 5: Total Portfolio Investment by Country from 1991 to 2007



Source: Bank Negara Malaysia

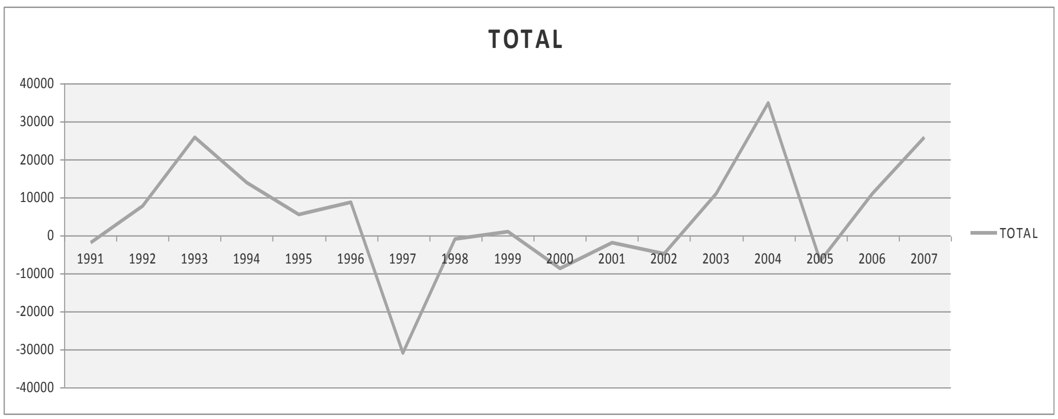
Portfolio Capital Investment from Four Major Countries

Malaysia's remarkable economic growth during the period 1991 up to 1996 had been fuelled by foreign capital inflows. Portfolio capital investment notably from Singapore, Hong Kong and the United States had helped push the economic growth. Unfortunately, these portfolio investments have shunned the Malaysian market after the 1997 Asian financial crisis. Foreign portfolio investments had fallen by 74% from RM144.9 billion in 1996 to RM37.6 billion in 2001.

The net investment flow had dropped sharply to outflow RM30.9 billion in the recession period (year 1997) from RM8.78 billion in 1996, the net inflow then start to rise a little above the break even until 1999. However, it shrinks back to negative figure in 2000 until 2002. Just after that, it looks right back on track where it start climbing back. Not surprisingly, without the active presence of foreign portfolio investments, the stock market capitalizations had plunged to RM450 billion in 2001. This is a 50% drop from the pre-crisis level. The net inflow of portfolio capital investment is shown as Figure 6.

Within the context of rapid changes in the global scene that pose unprecedented challenges, rejuvenating foreign capital inflows into Malaysia will likely be a Herculean task in the next decade. It is not clear to what extent the aftermath of September 11 incident has affected investors' confidence in Malaysia. The recent figures indicate that foreign capital has yet to come back to the Malaysian shore in a big way. This might probably imply that the policy instruments are not effective and efficacy enough to boost foreign investors' confidence. This is not surprising, as other crisis-hit countries have also been working hard to lure in foreign capital. This has led to an impression in foreign investors' opinion that there is no spectacular difference between Malaysia and its neighbouring countries in the region. Investors tend to look at the region as a whole rather than at individual countries

Figure 6: The Net Inflow of Portfolio Capital Investment 1991-2007



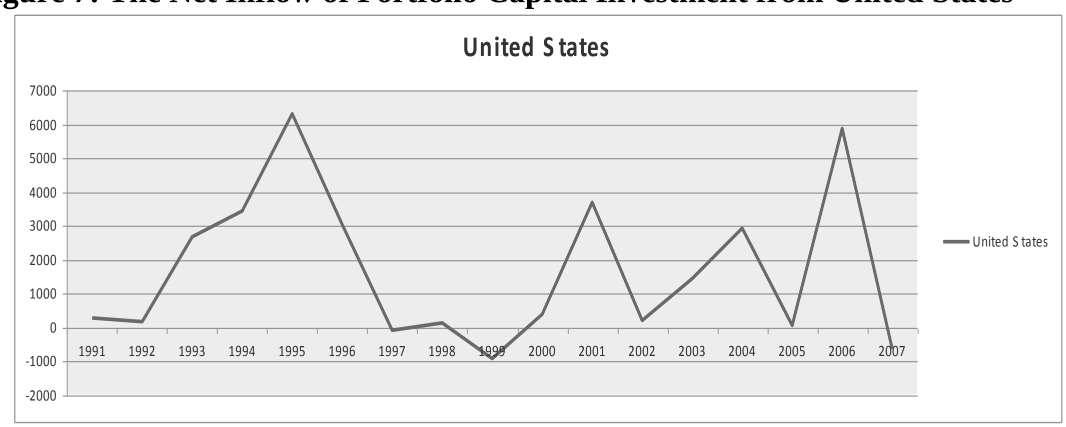
One issue of great concern is the perception that Malaysia's policy instruments might not be as competitive as the ones adopted by its neighbouring countries. The most recent example is the reduction of Singapore's corporate tax from 25.5% to 20%. This will likely tickle the fancy buds of many foreign investors in the region to shift their investments to the city state. It seems that there is nothing much that enables Malaysia to be advantageously competitive than others in attracting foreign investments. Some economists attribute this to the present less promising global economic environment although the thriving capital inflows, both long-term and short-term into China during the period suggest otherwise. A rekindling of foreign investor interest in Malaysia would require deep rethinking, restrategizing and repositioning of the whole economy. There is a pressing need to find out the root cause of the problem, so that a long-term solution can be worked out.

Foremost in this effort is the need to boost the supply of human capital that is vital for moving up the value chain of the manufacturing product cycle. A closely watched indicator, namely the number of research scientists and engineers per 10,000 labour forces, is only drifting at less than 10 in Malaysia compared to other newly industrialising economies where it hovers above 60.

If there is no immediate marked improvement in this front, the task of roping in new high-tech industries into Malaysia in the future will become increasingly difficult. As a result, Malaysia might end up competing directly with China on labour-intensive industries in the near future. Surely, this is not the right card to play. There will be no compelling reasons for the foreign investors to bring in additional capital if labour remains the main component of the production cost. It is imperative that the author fully explores other sources of foreign exchange earnings besides manufacturing exports. Tourism and education are presently the fast growing service industries that have yet to unleash their full growth potential. These two activities have contributed RM18 billion and RM6 billion respectively in terms of foreign exchange earnings. The aftermath of September 11 terrorist attacks in the United States has discouraged many well-to-do families in Islamic countries especially in the Middle East from visiting western countries or sending their children there for tertiary education. Malaysia should seize this golden opportunity by aggressively promoting its tourism spots and institutions of higher learning in these Islamic countries. There is a need to consistently boost the confidence of foreign investors in order to compete successfully for the world portfolio investments. There are no qualms about the present measures taken by the government such as speeding up corporate restructuring, enforcing stricter corporate governance and organising more international road shows which go a long way in convincing foreign fund institutions to knock on the door again.

What are still lacking is a significant presence of multinational corporations (MNCs) listed on the KLSE. In most cases, due to better corporate governance and transparency, the foreign portion on the total floated shares of these fundamentally sound MNCs is exceptionally high. However, to date, out of the 845 listed companies, less than 3% are foreign MNCs. Only when there is an increase in the listing of such MNCs in the local bourse, more foreign portfolio funds will be drawn into Malaysia. Thus, there is a need for the government to offer them additional attractive incentives such as special tax exemptions, subsidised underwriting fees and relaxation of listing conditions.

Figure 7: The Net Inflow of Portfolio Capital Investment from United States

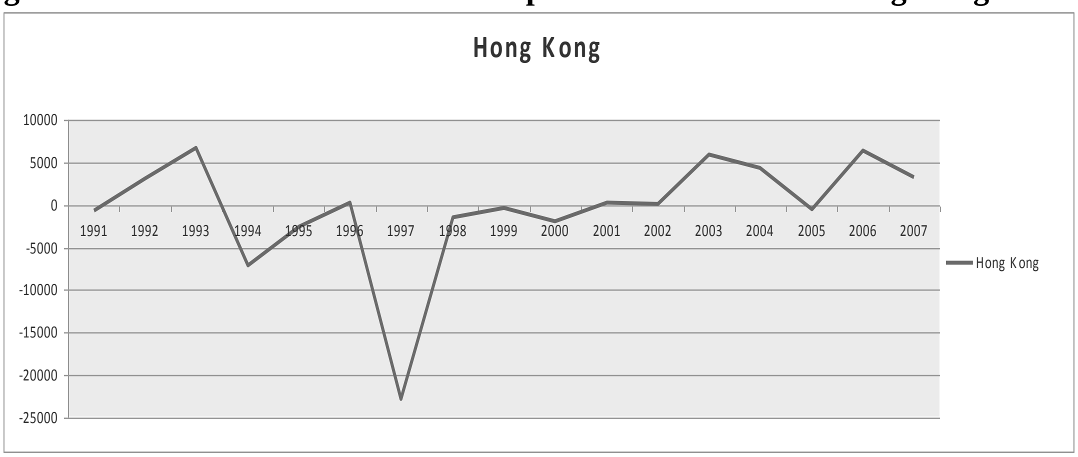


Admittedly, the existing measures of hogging a bigger inflow of foreign capital are necessary and useful, but might not be sufficient in the highly competitive world markets. More innovative strategies are badly needed to spark off the interest of portfolio capital investors in Malaysia. Vested with such sound macroeconomic fundamentals, there is little reason for Malaysia not to succeed in this endeavour. As what has been mentioned earlier are basically the overall figures of portfolio capital investment in Malaysia. Here are four major countries that are investing in Malaysia which are United States, Hong Kong, Singapore and United Kingdom.

Figure 7 is shown the net inflow of portfolio capital investment from United States. On the year 1995 are the prime portfolio transactions between Malaysia and US. It reaches RM6.295 billion and after that it starts dropping until 1997, where it appears that Malaysia is having some economic difficulties at that moment. It maintains at that point until 2000, where at that time the net inflow are climbing back up again. In the year 2001, the foreign portfolio investments reached RM7.4 billion while the net inflows rocketed to RM3.69 billion.

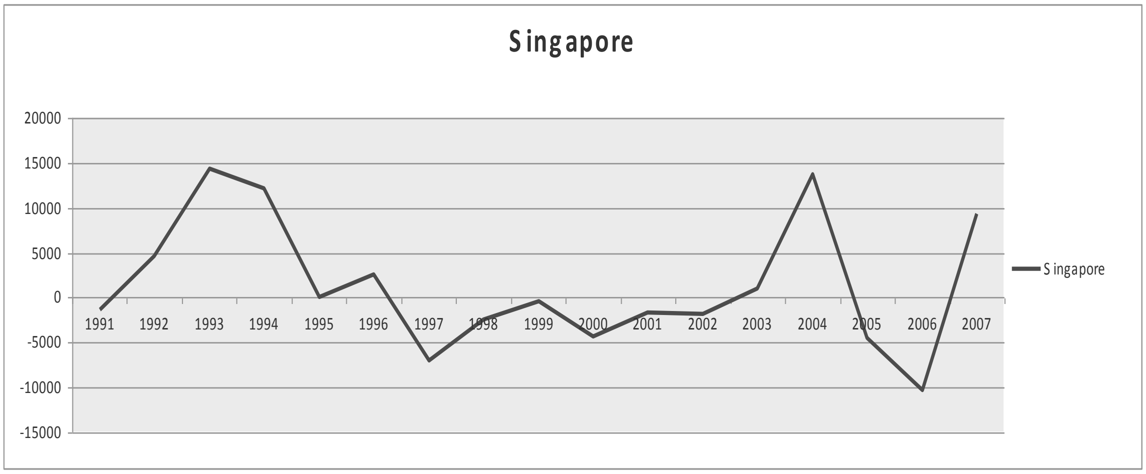
As being mentioned earlier on the September 11 issue, in 2002, the figures are dropping back again. It can't argue more that the declining in values is surely got something to do with the issue. All of these explanations are also quite similar to what is happening with other three countries. In Hong Kong, many of its investors are pulling out of Malaysia in 1997 due to the economic crisis.

Figure 8: The Net Inflow of Portfolio Capital Investment from Hong Kong



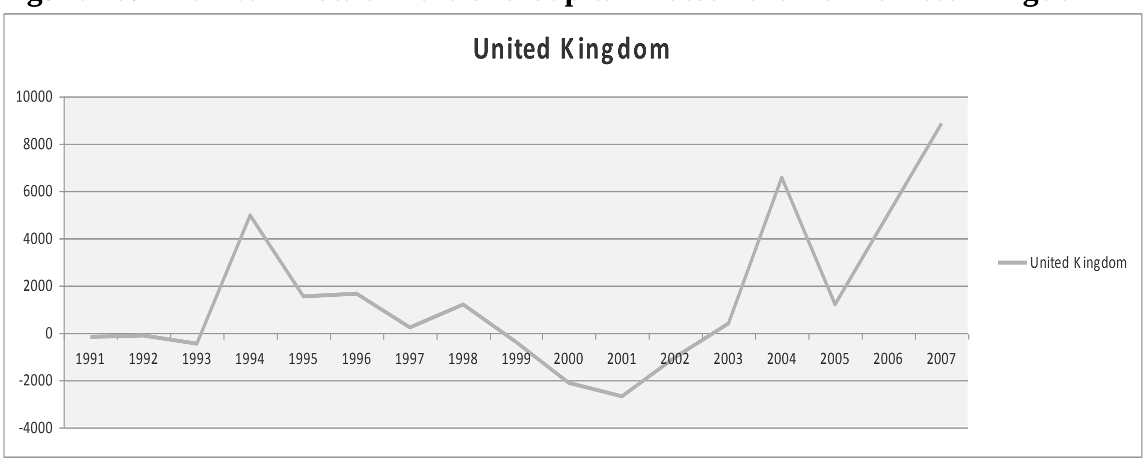
Even though, there are huge amounts being pulled out from Malaysia. The fact is in 1997, about RM42 billion are being invested here in Malaysia from Hong Kong and it is shown as Figure 8. It is quite a lot compared to UK which account for RM20.6 billion and US about RM9.88 billion. The fall out are influenced with RM64 billion that has been taken out from Malaysia in this particular year.

Figure 9: The Net Inflow of Portfolio Capital Investment from Singapore



The same goes to our neighbor which is Singapore, the trend are quite a bit similar. It's just that from the recession onwards, up to 2002, it appears that they still afraid to invest in Malaysia. It can be seen that the figures at that point in time are below break even. Figure 9 is shown the net inflow of portfolio capital investment from Singapore. It is also same as well as in United Kingdom. Based on the Figure 10, in 1997, unlike the previous three, the net inflows from UK are above par about RM238 millions. Apart from that, the foreign capital investments from UK in that particular year are amount RM20.6 billion. Figure 10 is shown the net inflow of portfolio capital investment from United Kingdom.

Figure 10: The Net Inflow of Portfolio Capital Investment from United Kingdom



However, not only because of the terrorist issue that arises on 2001, although know that they are US best ally; the amount starts to drop as early as 1999. The reason behind this is because of the issues on the millennium bug Y2K. Major investors need to pull out because of the needs to prepare for the "probable crisis". After the September 11 issues cool down, they start investing again in 2003.

Currency Exchange of Major Portfolio Capital Investment Country

In 2007, these four major countries which are United States, United Kingdom, Hong Kong and Singapore formed about 80% of the total foreign portfolio investment in Malaysia. Although way back in 1997 during recessions, these countries foreign investment are dominantly at 95% from Malaysia's overall portfolio investments. They are still regulars in Malaysia's market. If it is recall back just how much Hong Kong invested here in Malaysia in 1997, and actually it is the same as well as Singapore. Those two are the major investor during recession apart from United States and United Kingdom. However, nowadays given that a significant amount of overseas portfolio investment that flows to the local shores from Hong Kong and Singapore is reportedly originating from other countries. This suggests that foreign funds in the Malaysian capital market are predominantly from the United States and the United Kingdom.

The expected economic performance is a factor determines the actual inflows of foreign portfolio investment to Malaysia. It is found that the actual inflows of foreign portfolio investment mostly take place six months in advance of the announcement of the nominal GDP for a particular quarter. There is a long-run relationship between the expected economic performance and the actual inflows of foreign portfolio investment to Malaysia. In other words, the expected economic performance is a determining factor of the actual inflows of foreign portfolio investment to the country and such a relationship can be sustained over the long term. It is also found that there is a time lag of one to two quarters between the time the actual Malaysian economic performance is known and when foreign portfolio investment is brought into the country.

The actual inflows of foreign portfolio investment take place six to nine months in advance of the announcement of the nominal GDP for a particular quarter. For example, an expected increase of 1% in the nominal GDP of Malaysia in second quarter 2008 has a tendency to induce a hike of 2.5% in the inflows of foreign portfolio investment to Malaysia in first quarter 2008. Likewise, it would be 3.2% if the expected increase of 1% in the nominal GDP is for third quarter 2008. There is a strong herd instinct prevailing among foreign investors in the Malaysian capital market. In deciding whether or not to make portfolio investment in Malaysia, there is no clear sign that foreign exchange rate movement comes into the equation for international investors.

Interestingly, the inflows of portfolio investment from the United States, the United Kingdom, Hong Kong and Singapore had together surged significantly since early 2006. It is important to note that they all have started to show signs of weakening since the second half of 2007. This suggests that there is a strong herd instinct prevailing among foreign investors in the Malaysian capital market. This really poses a big risk to the local equity and bond markets, as any external economic shock may have a disastrous consequence for the whole capital market in the country. Contrary to common belief, there is no clear sign that the inflows of foreign portfolio investment to Malaysia have been driven by an expectation of an increasingly strong Malaysian Ringgit. The average quarterly growth of foreign portfolio investment from Singapore to Malaysia topped the list despite the fact that the Singapore Dollar was the only currency against which the Malaysian Ringgit depreciated during the third quarter 2005 to fourth quarter 2007 periods.

Figure 11 is shown the net inflow of portfolio capital investment from Singapore and the exchange rate of Singapore dollar.

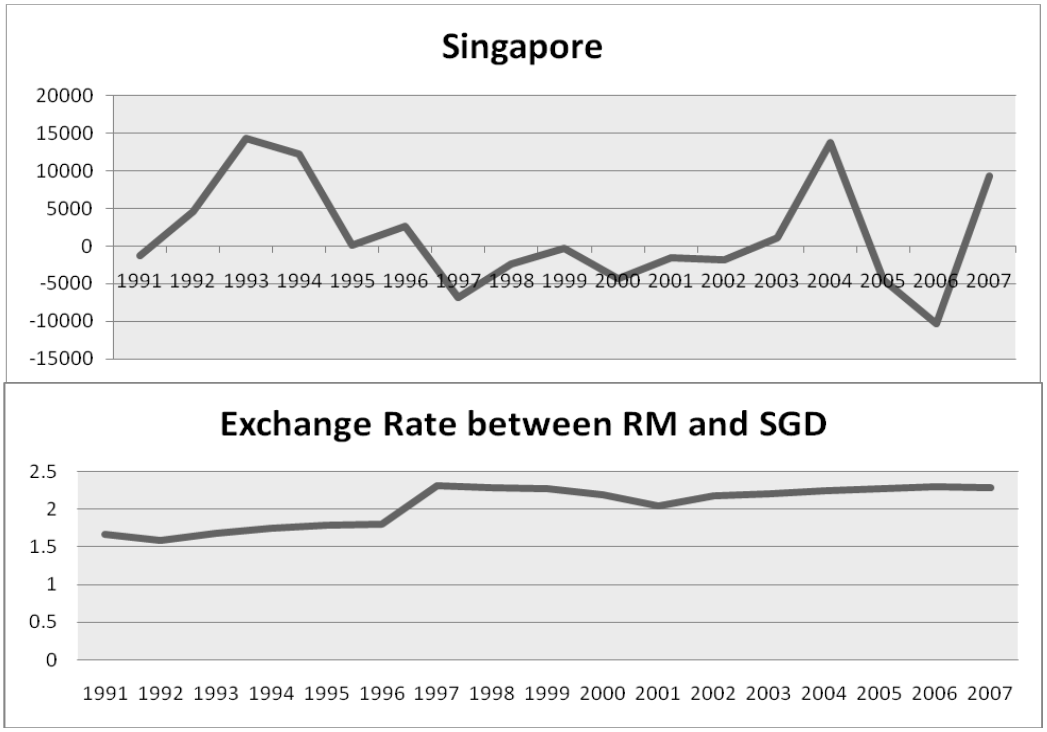
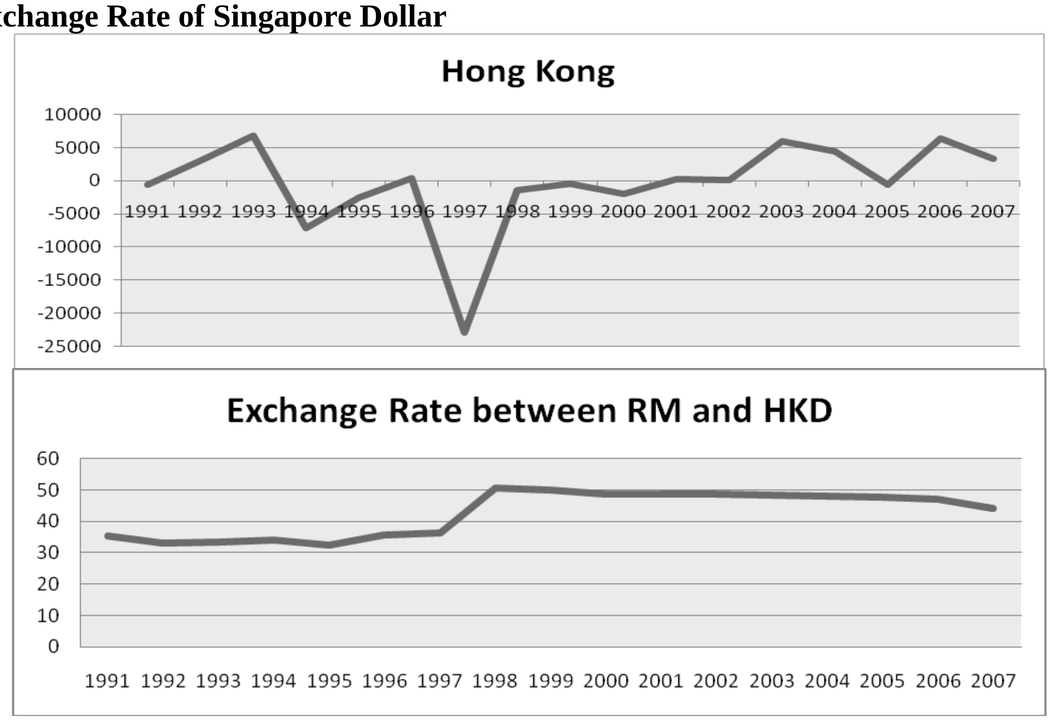


Figure 11: Net Inflow of Portfolio Capital Investment from Singapore and Exchange Rate of Singapore Dollar



On other cases, although the Malaysian Ringgit appreciated against the Pounds Sterling by only 1.3% during the same period, the inflows of foreign portfolio investment from the United Kingdom to Malaysia was significantly higher than that from Hong Kong to Malaysia.

Figure 12: Net Inflow of Portfolio Capital Investment from Hong Kong and Exchange Rate of Hong Kong Dollar

The Malaysian Ringgit appreciated against the Hong Kong Dollar by 12.7% during the two-and-a-half-year period. Based on the tables, for the foreign exchange movement between the Malaysian Ringgit (RM) and the US Dollar (USD), UK Pound Sterling (GBP), Hong Kong Dollar (HKD) and Singapore Dollar (SGD); it is noticed that sometimes the relationship between the exchange rate and the portfolio capital investments are negatively correlated, which can be referred to Figure 13 from 2005 until 2007.

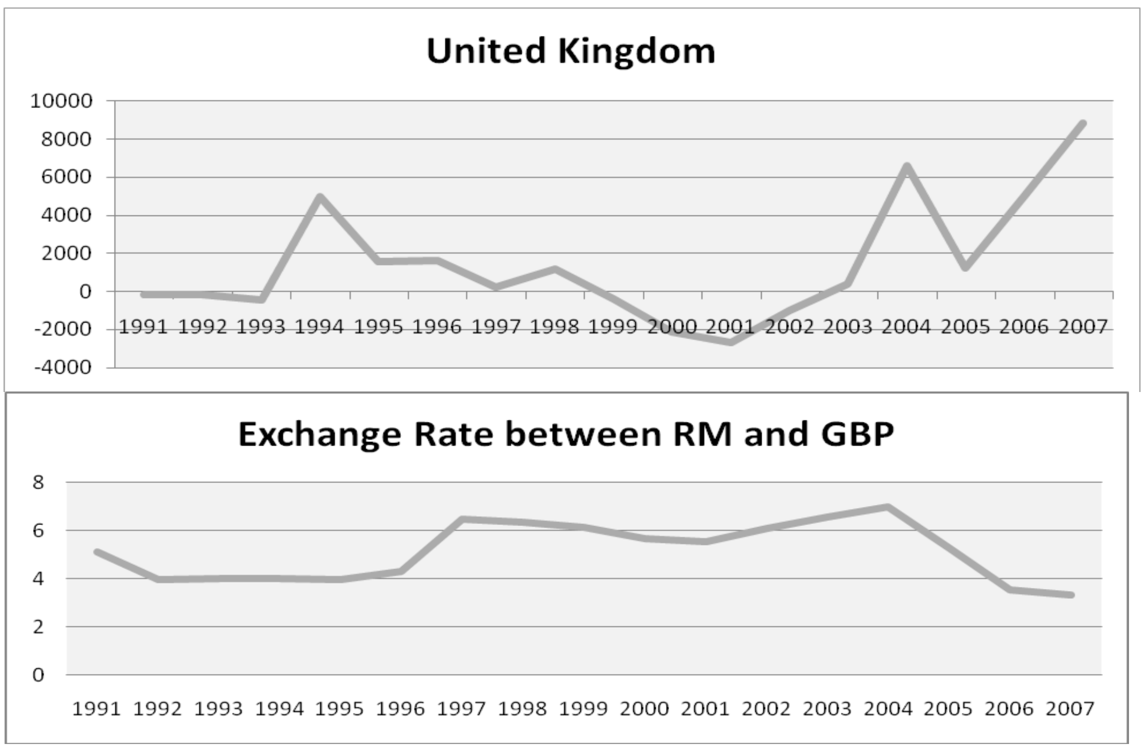


Figure 13: Net Inflow of Portfolio Capital Investment from United Kingdom and Exchange Rate of UK Pound Sterling

It is much clearer by referring to the portfolio investment from Figure 14. It's common that these investors investing in Malaysia to make profit. If somehow our currency appreciated against theirs, the amount that they are going to receive back in their country is much less than what they are expected.

Another theory is that the exchange rate volatility tends to depress the portfolio investment. For example, as an investor, you must be aware that the amount you might be received in the future aren't constant, which reflected by this volatile exchange rate. Sometimes may be getting more and sometimes less. This may prevent the risk adverse investor not to invest here. That's why Malaysia had agreed terms to lock the exchange rate with US in the end of 90's.

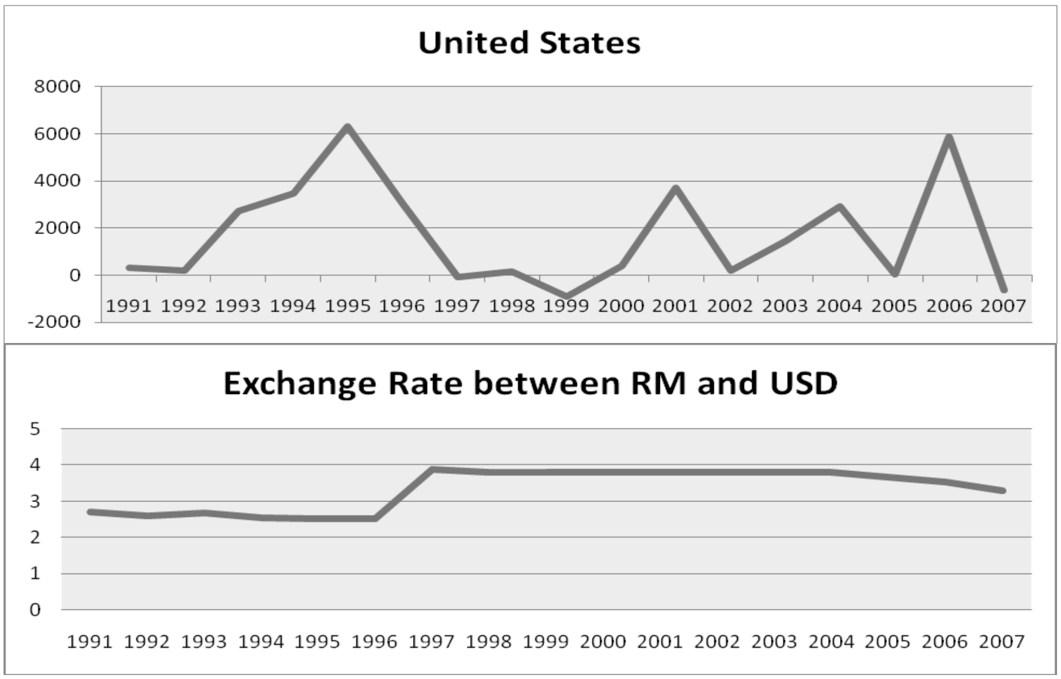


Figure 14: Net Inflow of Portfolio Capital Investment from United States and Exchange Rate of US Dollar

One more thing is if a country relies on foreign capital to maintain high levels of domestic absorption, it is natural for the real exchange rate to appreciate regardless of the exchange rate regime. The increased spending on traded goods will be accommodated through an increase in the trade deficit with no adverse impact on the exchange rate.

The Future Challenges

Malaysia must also prepare itself for the future challenges ahead to re-establish itself as one of the leading economies in the region. The future challenges in global investment perspective are due to the impact of the changing world economic situation on the Malaysian economy that is discernable in the various areas. First, the weak world demand for primary commodities, increasing oversupply and competition in the production of these traditional crops, the collapse of commodity prices, the fact of labor shortage and rising labor cost, which conspire against the traditional reliance on these sources of growth of national income. It is inevitable that with the long-term secular decline in the terms of trade against primary commodities, a shift of the economy towards industrialization has been called for.

Second, the decline in export receipts particularly from petroleum had affected government revenues and eventually the budget deficit. Government had undertaken an austerity drive since 1982 / 1983 to reduce the fiscal deficit by cutting back on development expenditure and by freezing posts, as well as initiating a policy of privatization in order to reduce government short-term and long-term obligations further. Besides that, because of the rising external debt to finance the current account deficit over the past five years, a policy has been adopted to cap new foreign borrowings to the level whereby the debt service ratio stays below 20%. However, this cutback in government expenditure has a deflationary impact towards the economy with unfavorable consequences on government-dependent private investment and unemployment.

Third, the general economic downturn which reflected the growth in the OECD countries and the contraction in world trade had affected Malaysian exports, profitability and private investments. However, some of the countries such as the Asian NICs have been able to increase their exports during this period of slower growth in world demand. The reason is that these countries had remained competitive and were helped by the appreciation of the Japanese yen. Therefore, there is the effective depreciation of their own currencies. The latter had also been the case with the Malaysian dollar and had made Malaysian manufactured exports competitive. Beyond these currency effects, however, Malaysian manufacturers are not as competitive in export markets because of cost inefficiencies and lower productivity.

Fourth, private investments other than those in the energy and the property sector had been sluggish. The need to stimulate private investments had been recognized. The government's response was to introduce greater liquidity and to deepen the financial system through lowering of interest rates and to make available funds through the New Investment Fund and other traditional means. The financial system, however, is still burdened by extensive a non-performing loan which tends to keep cost of funds at a high level. Greater efficiency of the financial system is therefore needed. The capital market especially the stock market is performing much better in recent times through higher market capitalization and injection of foreign portfolio funds. Further development of the Malaysian capital market including speeding up the corporatization of the securities and houses would seem necessary in order to gear the financial system to the task of economic recovery and restructuring.

Finally, direct foreign investments had also been affected by the economic slowdown and the fall-out from the series of "financial shocks" affecting the country. Together with the relaxation of the foreign investment codes, the signs of economic recovery, confidence, however, appears to have returned led initially by foreign portfolio capital and then by new longer term directs investment. The opportunities for joint ventures and other "new forms" of foreign investment are on the rise. The appreciation of the yen has also induced Japanese firms already operating in Malaysia to expand their facilities and others to consider relocating in Malaysia. This situation is also applies to the Asian NICs especially Hong Kong and Singapore.

The importance of the Asia-Pacific market and the emergence of an East Asian Industrial Belt extending from Japan through the Asian NICs and ASEAN have also been identified by scholars, planners and businessmen in the region. Being a highly open economy, Malaysia could not be insulated from the adverse impacts of the international environment. By the same token, favorable changes in the world economy, particularly in the development of new markets could be taken advantage of in the process of seeking a restructuring of the Malaysian economy in the long term. The danger lies with commodity prices improving and other signs of economic recovery pointing in the right direction, in the return of a sense of complacency. For then, the opportunity would have been lost to effect the required changes in the domestic front to face the challenges of the new international environment.

Thus, an important source of growth in Malaysia's future is derivable from more efficient use of resources, both labor and capital. This can be engendered in an environment of economic liberalization and competition. Furthermore, exporters have to consider the factor of competition not only in the context of rising protectionism overseas, but also entrepreneurs will have to improve productivity, reduce cost and make production more efficient. Establishing a more conducive regulatory environment for the private sector is also essential to prosper by facilitating robust investment activity and a more vibrant capital market in facing the future challenges ahead.

Conclusion

The trends of portfolio capital investment are on uptrend after Asian crisis. Asian crisis had brought terrible effects to Malaysia; there even had net outflow of portfolio capital investment during Asian crisis. However, the situation become well after Asian crisis which the portfolio capital investment is growing since year 2001 until 2007. The portfolio capital investment in year 2007 is the highest in almost 20 years ago. Portfolio capital investment plays an important role in aspect of the economic development. Even though portfolio capital provides a number of important benefits, but they also have, if not appropriately regulated, will brings a very significant costs. Thus, appropriate policies and market friendly regulations that maximize the benefits and minimize the costs must be implemented.

The successful domestic policies is vital in ensuring sustainable long-term portfolio capital investment and instruments that contribute to economic growth and discouraging the highly volatile types even if external conditions turn around (Helmy, 1997). There are four major sources of portfolio capital investment in Malaysia including Singapore, Hong Kong, United Kingdom and United States. They contributed almost 80% of total portfolio capital investment in Malaysia. It is good for Malaysia to have a good relationship with them while trying to diversify the sources of portfolio capital investment by encourage more investment in Malaysia. Government of Malaysia has to make sure the competitive advantages to attract portfolio capital investment are fundamentally unchanged time over time. Being Malaysia as a developing country, the portfolio capital investment is generally important in contributing to economy and liquidizes the markets.

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