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A lot of hope and expectations riding on the 1998 Budget

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A LOT of hope and expectations are riding on the 1998 Budget. The last three months have been very eventful as the currency markets in Southeast Asia have been battered and the ringgit has depreciated by over 20 per cent since July.

The expectations are that the Budget would give some lift and glow to confidence, stir better sentiments on the ringgit and the stock market.

The immediate reaction of the market was rather disappointing as the ringgit dropped to RM3.28 to the US dollar on Monday Oct 20 and the Composite Index of the KLSE fell to 768 at the end of the trading day.

We will have to wait and see in the months following the Budget whether market sentiments and confidence will improve.

A few areas of pressing concern must be flagged. First, external events and developments are expected to have some influence on the ringgit and the economy.

We should keep our fingers crossed that our neighbours will set their houses in order too as there can be neighbourhood effects, as shown by the plunging baht from July onwards.

Thailand is in the midst of grappling with the intricacies of putting its house in order.

Political uncertainties are rearing its head once again. There seems to be some uncertainty too as to how effective and acceptable Thailand's financial restructuring plan will be.

Even at this stage it is clear that there are painful sacrifices that need to be made, if an economy is to have access to the IMF managed fund. Freedom to do what a country would like to do is the first to disappear.

Indonesia has decided on some form of technical assistance from the IMF but it still remains unclear whether it includes any financial assistance.

Secondly, are the efforts by the economies in the region to find ways to cope with the turbulence in the foreign currency markets adequate. There is the proposal to set up some sort of an Asian Stand-by Facility to assist economies which may be badly hit by attacks on their currencies.

Japanese support for a stand-by fund is welcome. Japan has sizeable interests in Southeast Asia and there is mutual interest in finding ways to cope with the turbulence in the currency markets. Of course the difficulties will come when the details of such a fund will have to be fleshed out.

What would be its guiding principles? Would it have conditionalities a la IMF too? What would be the size of the fund? How is the fund to be financed?

Any fund will have to be sizeable. Imagine if there are cries for help from a few more Thailands and the finance that would be needed to help the troubled economies. As for sources think again on the feasibility of imposing a tax on foreign exchange transactions or a "Tobin tax".

All that is needed is a very small rate of perhaps 0.5 per cent of the transaction.

Bank for International Settlements has estimated, the average daily foreign exchange transaction amounted to about US$1.2 trillion (RM3.8 trillion) and a small foreign exchange transaction tax would generate a very sizeable source of revenue for the stand-by facility fund.

There are, of course, all sorts of difficulties and roadblocks that can be put across the proposal but again a serious look or study should be made on the feasibility of such a tax.

Thirdly, the proposal by Prime Minister Datuk Seri Dr Mahathir Mohammad on ways to curb currency trading, for speculative purpose, it appears, has struck a guilty chord in the IMF and the World Bank. Countries in the South must stand up and be counted to show their support for such a move.

At the heart of the matter is the issue of making a distinction between the use of currency for speculative and non-speculative purposes. When does hedging turn into speculation?

The belief is that speculation serves no purpose, does not create real wealth, whereas using currency for trade and investment will add to wealth creation. It would seem best to drag out the skeleton of speculation rattling in from the financial closet and bring it out on the table. What else can be done about it?

Is speculation a necessary evil of market capitalism? Speculation probably appears to thrive in a liberalised regime, and fluctuating exchange rates which have created many of the risks that derivatives are designed to hedge. But the growth of derivatives has probably increased systemic risks.

Fourthly, what is really required is a re-assessment of the pros and cons of capital controls in the face of massive global flows into countries with undeveloped and thin capital markets and relatively weak financial system.

There is a need to go over the pros and cons of capital controls again. The offshot of the Washington consensus is that capital controls are undesirable and ineffective.

Central to the anti-controllers is their firm conviction that complete freedom for capital flows is crucial. All sorts of suggestions have been made for capital controls and different economies at different times have tried different ways of controlling capital flows.

The IMF has criticised capital controls and would frown on any serious move to reinstate capital controls for a long period. Alan Greenspan, in a recent report of the Asian Wall Street Journal, has joined the fray, lending his weight against any form of capital control and his sentiments on the munificence of freedom of capital movements border on the lyrical.

Milton Friedman, the prophet for unfettered capitalism, believes that speculation would be stabilising. Rational speculative bubbles' theory has lent credence to the concern that "speculators could be destabilising without losing money."

Rational speculative bubbles pushed prices up and up, increasingly divorced from the fundamentals. Speculative attacks can also take place under fixed rates or target zones.

The "second generation" models of speculative attacks have thrown up the phenomenon of multiple equilibria.

Fifthly, not much has been made of the downside risks of financial liberalisation because of the pandemonium and stampede over the claims that it can only bring bountiful presents for all who embrace the religion of liberalisation.

The pills prescribed by the proponents of financial liberalisation over headaches and migraines caused by liberalisation appear to be more the same i.e. keep on opening up as if there is nothing wrong with the prescription and only the victim is to be blamed after all.

Some countervailing views and critics of financial liberalisation, and these views should be circulated widely, have argued that the so-called wonderful benefits of financial liberalisation may not be completely true.

John Eatwell has marshalled the arguments against liberalisation. Savings were not really directed towards more productive investment and perversely for most of the 1980s resources were transferred out of the developing countries.

It is difficult to find evidence that there has been a lowering of costs to borrowers. Real long term interest rates were the highest in modern times. Derivatives mushroomed with liberalisation and systemic risks increased. Investment as shares of GDP fell over 1982-1991.

Discretionary policies by governments were severely curtailed. Is the behaviour of the currency market, as amply demonstrated recently, within the bounds of what can be expected from a free market or is it a manifestation of market wilderness, madness, greed and senseless aberration?

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