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Krugman hopes our policy move will pay off

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KUALA LUMPUR, Wed. - US economist Paul Krugman who had written in favour of currency controls in a recent article in the Fortune magazine has sent an open letter to Datuk Seri Dr Mahathir Mohamad, saying he hoped Malaysia's "dramatic policy move" would pay off.

While expressing surprise at the move, he said he felt responsible for the policy turn as he had suggested temporary currency controls as part of the solution for Asia.

But the Prime Minister had said during a special television interview yesterday that the Government had studied the option for several months before adopting it.

Krugman said: "The imposition of currency controls is, of course, a risky step, with no guarantees of success. It is, as many people have pointed out, a stopgap measure."

"There is no shame in that: some gaps desperately need to be stopped.

"For the new policy to succeed, however, the freedom of action achieved by your willingness to defy orthodoxy must be well used, said Krugman who is professor of economics at the Massachusetts Institute of Technology.

He suggested four "guiding principles".

Firstly, he said the implementation of the controls should disrupt ordinary business as little as possible, adding that even conceptually sound policy could flounder if the rules were poorly conceived.

He pointed out the example of Malaysian travellers being restricted to carrying unreasonably small quantities of currency, a move which he said would need to be "fixed".

Secondly, he said currency controls always imposed serious distortions on the economy and thus, should only be regarded as temporary measures to win breathing room for an economic recovery, not as a permanent secession of Malaysia from the international capital market.

"It would be a good idea to state now a planned date for the removal of controls - at most three years from now, perhaps less - with the strong possibility of early parole as the economy recovers," he said.

Thirdly, he noted that experience had shown that currency controls did most damage when they were used to defend an over-valued currency, thereby evolving from a temporary defence against speculation into a permanent system of trade protection.

"Malaysia does not need a strong ringgit - on the contrary, it needs a highly competitive real exchange rate in order to increase exports," he said.

Krugman said lastly, the controls must serve as an aid to reform, not an alternative, as its purpose was to allow the adoption of more expansionary monetary and fiscal policies, and hence to promote a recovery of the real economy.

Recovery would reduce the problems of insolvency in the corporate sector and non-performing loans in the banking system.

But it would not eliminate these problems, and thus, the breathing room allowed by controls should be used to accelerate and not slow down, the pace of financial clean-up.

In conclusion, he gave a reminder that the point of the policy departure should be purely and simply to buy space for economic growth.

"It should not be used in an attempt to prove points about the soundness of the pre-crisis economy or about the wickedness of hedge funds or of

anything else.

"If Malaysia truly does succeed in achieving a recovery, that will be lesson enough for the rest of us," he said.

Commenting on the new exchange rule, the Asian Wall Street Journal today said the failure of the International Monetary Fund's orthodoxy to arrest the contagion sweeping through Asia had made ideas like capital controls intellectually respectable again.

"Policy makers in Asia can't help but notice that China and Taiwan both have capital controls and neither has succumbed to the region's control," said an article published in today's issue.

It said some economists have noted the short-term potential benefits of capital controls and said Malaysia's move "isn't necessarily a bad one" given the current circumstances.

"Compared with the alternative - a crushing recession - capital controls may look attractive if they allow Malaysia to bring down interest rates and get money flowing again in the economy."

However, it also said the benefits to be gained depended on the country's actions under the foreign-exchange shelter provided by capital controls.

It said in theory, capital controls would allow Malaysia to bring down interest rates "faster and further" than otherwise possible.

Lower interest rates was also the topic of an editorial in today's International Herald Tribune.

The editorial entitled "Time to Lower Interest Rates and Rein in the IMF" said all major central banks except Japan's must reduce interest rates and that the IMF must rethink its "rescue tactics".

(It said Japan suffered from more fundamental structural problems - a credit crunch - and required a more radical solution.)

"Specifically, it (IMF) must relax its fiscal austerity requirements - for instance, the mandate that governments cut spending - and recognise that it is time to put banking reform on hold because it denies the expansion of credit to borrowers at precisely the time they need it," wrote Stephen S. Roach who is chief economist and director of global economics for Morgan Stanley Dean Witter.

He said a world in crisis required people to "think the unthinkable", like reducing interest rates.

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