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Pros and cons of exchange controls

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AS promised, Prime Minister Datuk Seri Dr Mahathir Mohamad did shock Malaysians and foreigners by announcing sweeping controls on the ringgit.

Currency controls include a ruling that makes the ringgit non-legal tender abroad, restrictions on the amount of cash in ringgit and foreign currencies that travellers can carry, new regulations on the purchase and sale of stocks in the local bourse, and making it compulsory for exporters to turn in their export earnings which will be denominated from now on only in foreign currencies.

All these are no doubt shocking but by no means surprising for those who have been reading the lips.

Apparently, Dr Mahathir by a single stroke of genius has delivered a serious blow to the currency speculators by bringing an immediate end to ringgit trading in the international market.

The ringgit will be no more than a piece of paper outside the country after Oct 1. This is a strategic manoeuvre to insulate the economy from the adverse effects of currency turmoil that threatens to take on global proportions. All this means that there will be currency exchange for economic transactions but no currency trading.

It may well be argued that tough times warrant tough measures, even if they flout economic orthodoxy. This is time for lateral, not linear thinking. As the saying goes "when the going gets tough, the tough get going". Be that as it may, there are pros and cons to almost everything. Nothing is costless.

The downside represents the price one must pay for the upside. It is important to count the costs and benefits before one can conclude if it is really worth the price one pays.

There are many positive things one can say about ringgit controls. First of all, it will protect the economy from the adverse external influences emanating from the forex market by stabilising the ringgit. Second, it will force ringgit parked abroad to be brought home before the end of September. Third, it will ease liquidity shortage in the banking system and keep interest rates low. Fourth, it will defuse inflationary pressures by keeping imported inflation at bay.

Fifth, it can make more domestic resources available for implementing the National Economic Recovery Plan, especially Danaharta and Danamodal which have been established to buy non-performing bank loans and to recapitalise the banking system, respectively.

Sixth, it can rev up the economy by removing the credit crunch that has had a debilitating effect.

Finally, it is likely to induce redundant foreign workers to return home, thereby creating jobs for retrenched Malaysian workers.

What is more, all these positive effects are likely to be felt almost immediately. The announcement by itself has produced some results, as shown by the firming up of the external value of the ringgit on the first day before the central bank fixed the exchange rate at RM3.80 to the US dollar.

The stock market has also rallied remarkably. The positive impact on the real sector of the economy may become manifest in the next few months, as offshore ringgit deposits return home.

The flip side is just as important. We must be wary of pitfalls. Recent measures may not bode well for the local bourse in the medium and long

term, as foreign portfolio investments are likely to shy away under the new regulation governing stock market transactions. The vision of making Kuala Lumpur a regional financial centre will remain a pipe-dream. It had better be, as it will mean sacrificing other more important socio-economic objectives for something in which we may not even have a potential advantage.

We may have to watch out for the adverse consequences of ringgit controls on the real sector of the economy which are likely to surface in the medium and long term. By the look of it, exchange controls and open economies are inherently incompatible. To be sure, exchange controls are not our intention, but the Malaysian version is somewhat different in that it is much less restrictive than controls in many other developing countries.

Exchange controls have worked effectively in countries with large domestic economies. We must not lose sight of the fact that Malaysia is a small open economy. Trade is the lifeblood and foreign direct investment the backbone of the Malaysian economy.

Although it is stated clearly that the policy shift will not affect the business operations of traders and investors in the sense that current account convertibility and free flows of foreign investment and repatriation of interest, profits and dividends are guaranteed, there is little doubt that exchange controls will make traders and investors somewhat uptight.

Currency controls mean new rigidity, while traders and investors prefer flexibility.

Since the ringgit will not be quoted any more in the forex market, Bank Negara has to fix the official exchange rate at which it will buy and sell ringgit at home. The ability of the central bank to defend this rate will depend critically on the supply and demand for foreign exchange at home. The supply of foreign exchange will come mainly from exports while the demand for foreign exchange will be for purposes of payments for imports and other remittances.

Any divergence between supply and demand can destabilise the exchange rate of the ringgit. In other words, there is no such thing as absolute certainty about the value of the ringgit vis-a-vis other currencies even under exchange control.

The central bank will have to adjust the exchange rate from time to time. Nonetheless, such adjustments are likely to be infrequent and marginal, nowhere near the kind of extreme volatility that we witnessed in recent times.

Stable exchange rates, without a doubt, are good for trade and investment, as it will eliminate one of the major sources of uncertainty and reduce transaction costs. However, in practice, it is extremely difficult to set a market-clearing exchange rate that would equate supply with demand. This would lead exporters to under-invoice and importers to over-invoice so that they can park some of their funds abroad.

Much would also depend on the competitiveness of our exports. If at the official exchange rate our exports are not competitive in the world market, the exporters will use different exchange rates for pricing purposes, while they are obliged to sell their export earnings to the central bank at the official rate, incurring a loss in the process. This risk is particularly serious when the competitors in the neighbourhood practise a floating exchange rate system.

There is no denying that a freely floating exchange rate is a wrong policy in a no-confidence situation. The market is by no means perfect. More often than not, it tends to overshoot especially when confidence is lacking. It is for this reason that the ringgit has remained grossly

under-valued in recent times. Fixing the exchange rate in such a way as to reflect the fundamentals is also unwise at a time when other currencies in the region are even more under-valued.

The danger is that we may be pricing ourselves out of the market. There is therefore a need to be cautious in fixing the exchange rate. Although it appears that the equilibrium rate for the ringgit is around RM3.20 to the dollar, it will be inappropriate to jump to this level at one go. We may have to crawl towards the equilibrium.

Experience elsewhere has shown that controls beget more controls. Businessmen are adept at circumventing controls. One way to beat exchange controls is to move goods instead of funds. Such practices may involve transfer pricing, under-invoicing and over-invoicing. All this has prompted some countries to impose trade controls as well. Needless to say, such trade controls would be detrimental to small open economies.

If experience in other countries is any indicator, exchange controls tend to spawn blackmarkets. While the central bank may readily provide exchange at the official rate to traders and manufacturers, foreign exchange for many other purposes is not easily available in a situation where demand exceeds supply, with fewer people selling than buying.

Exchange controls require an elaborate bureaucracy at the central bank. It is important to ensure that bureaucratic red tape is kept to a minimum. Manufacturers and exporters who need to import intermediate inputs need central bank approval for payments. Speed is critical especially for the electronics sector where goods fly in and fly out at short notice. Delays in central bank approvals can be fatal to such industries. We must also ensure that exchange controls do not increase transaction costs.

Exchange controls make enormous sense as an emergency measure that can achieve much in the short term, while its adverse effects are likely to be felt only in the medium and long term. It will therefore be in the interest of Malaysia to dismantle exchange controls after they have served their purpose.

Exchange controls, if allowed to outlive their usefulness, may do more harm than good for Malaysia, 15th largest trading nation in the world. We must ensure that insulation through exchange control does not lead to isolation by default. Selective capital controls to discourage volatile, speculative short-term capital flows may make better sense as a long-term measure.