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Striking a balance in global financial system

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AMIDST a declining stock market which was reeling from a loss of over US\$140 billion (RM532 billion) and its currency that had been devalued by over 40 per cent, Prime Minister Datuk Seri Dr Mahathir Mohamad took the unprecedented step of imposing selective currency controls in Malaysia in September 1998.

The world media predicted doom and George Soros told the world that "the effect on the (Malaysian) economy would be disastrous".

In his book released a few weeks after Malaysia's introduction of capital controls, Soros stated that the move would "inflict considerable damage on foreign investors and speculators".

Soros was right in the last count: currency speculators lost substantially. The original terms of the selective controls were to restrict trading of the Malaysian ringgit abroad, a one year holding period for money invested in shares and was aimed at stopping the abuse of the liberalised monetary system that had yet to have an appropriate monitoring system in place.

The situation then was serious: having followed the International Monetary Fund advice (but not resorting to a IMF bailout), the economy shrank and the imposition of high interest rates brought businesses to almost a standstill.

The move to impose capital controls was a carefully deliberated but radical decision. The delay in implementing the decision resulted in a series of drops in Gross Domestic Product growth rates from - three per cent in the first quarter to 11 per cent in the third quarter of 1998, and would have been worse without the total reversal innovative packages to revitalise the economy.

By the first quarter of 1999, the economy began its slow move forward, GDP growth improved by over five per cent to 1.4 per cent in the first quarter and by the second quarter to +1.5 per cent. Business confidence overall has improved, and by year end it should show a GDP growth of +3 per cent or more.

The recovery of the economy was almost miraculous. Yet many critics doubted the official figures.

It has been argued by economists like Paul Krugman of the Massachusetts Institute of Technology and Jeffrey Sachs of Harvard that the Malaysian economy would have recovered anyway without the capital controls just as in Thailand, Indonesia and South Korea which received the International Monetary Fund bailout package.

But the difference is this: Malaysia's recovery was achieved without the bloodshed, riots and the destruction of property and lives which Indonesia, experienced, without surrendering vital equity in major corporations to foreign investors who bought it at a song due to the devalued currency of South Korea, and without the massive retrenchment of workers in Thailand and elsewhere.

The social cost and destruction to those economies outweigh the temporary relief it is now enjoying.

For it can be argued also that without some propping up by the IMF the country could not have stood on its own, and its recovery would have been subjected to the injected confidence and terms of the overseeing lender.

The capital controls has further been relaxed, and a standardised exit levy on profits of 10 per cent flat was introduced on Sept 22.

Compared to the United States which has a capital gains tax of 30 per cent for transaction gains within a 12-month period irrespective of repatriation or not, this is better for investors.

With a quick response mechanism in place, Malaysia has the capability to react to the realities of the challenging environment in the quest to find balance in our fluid world financial system.

At the Aug 27 seminar in Kuala Lumpur, Krugman exerted that it was time to lift capital controls or face the scorn of foreign investors.

Is the country ready to open its doors again to potential currency attacks as its reforms of the financial sector has yet to be completed, when the world financial "system" is still in a flux?

The emerging economies were in a process of transformation when the crisis struck. It is now recognised by IMF that the crisis in Asia was largely the result of a global crisis caused by the rush for liberalisation and deregulation in economies that have no monitoring systems in place.

After the substantial liberalisation of the capital account of the five Asian countries - South Korea, Indonesia, Malaysia and the Philippines around 1993 - some US\$220 billion in private capital flowed into the region during the three-year period between 1994 and 1996.

The reversal of flows in 1997 due to the sudden shift in confidence amounted to about US\$100 billion. None of the countries or the region could tolerate the sudden shift in market sentiment from euphoria to panic that caused the huge reversal of private capital flows.

It is the inherent instability of liberalised international capital markets that sudden reversals of market confidence caused periodic panic of differing magnitudes and duration.

Krugman acknowledged that "hedge funds and not crony capitalism played a significant role in the crisis".

And, the Report of the G7 Finance Ministers statement on capital flows supports the use of capital controls in situations like this:

"The use of controls on capital flows may be justified for a transitional period as countries strengthen the institutional and regulatory environment in their domestic systems...

"More comprehensive controls on inflows have been employed by some countries as a means to shield themselves from market pressures.

"Such steps may carry costs and should not in any case be used as a substitute for reform."

The Report does not share the view that a completely free-floating regime or a currency board is viable.

But "countries choosing fixed rates must be willing...to subordinate other policy goals to that of fixing the exchange rate" and that "arrangements institutionalising that policy can be useful to sustain a credible commitment to fixed rates".

The stance of G7 in regards to turbulent capital inflows is clear in its statement: "...to prevent turbulent capital inflows it should be justified when a country wants to keep capital inflows to a manageable level according to the stage of development of its financial sector..."

It noted that there might be some cases that "justify the reintroduction of controls on capital outflows as an exception", for example, in order to avoid a bailout by IMF loans.

The lesson that can be learnt from the crisis is not for governments to intervene heavily to defend an unsustainable exchange rate level.

Nor should there be large scale official financing provided for this purpose.

Our world is in search of an international financial system. After US President Richard M. Nixon's Aug 15, 1977 declaration of the non-

convertibility of the US dollar to gold, the fixed exchange rates established at Bretton Woods ended.

Today, of the 178 currencies listed, 23 are pegged to the US dollar, 14 pegged to the French franc and 38 currencies are pegged to another currency or a currency composite of their own choosing.

There are 31 countries whose currencies are "managed floating" and 37 that are classified as "independently floating".

The absence of a proper international regulatory mechanism led Soros to remark that "financial markets have recently acted more like a wrecking ball, knocking over one economy after another".

He said that "unquestioning faith in market forces blinds us to crucial instabilities that have chain-reacted to cause the critical situations we find ourselves in today - a situation which has the potential to get much, much worse".

The instances of the abuse due to flaws in the international financial system has led to fiascoes in derivatives trading, such as those narrated in Frank Partnoy's F.I.A.S.C.O. - blood in the water on Wall Street and Gregory Millman's The Vandals Crown on currency trading.

The herd mentality and rational calculations of Robert Merton and Myron Scholes the 1997 Nobel Laureates - misled the two eminent economists to err in their Long Term Capital Management - LTCM and had to be bailed out by a consortium of banks.

An even greater danger now confronts our world. Global capitalism is fast giving way to its transmutation - "Cyber Capitalism".

Cyber capitalism was first coined by Dr Eisuke Sakakibara, the special advisor to the Japanese Finance Minister who is popularly known to the world as Mr Yen - a reference to his role in the Japanese yen.

Sakakibara argues that "tremendous amount of information is being processed in real time in cyberspace", and "on the basis of the information, a huge amount of funds changes hands in an instant". This has given birth to cyber-capitalism.

Cyber capitalism as it is taking shape is likely to become an extremely unstable and risky system as it has no rules or pattern to conform to.

We are in a period of rapid changes and the transformation to cyber capitalism calls for a shift in paradigm. It is in this period of great uncertainty that Malaysia's capital controls need to stay in place while international institutions such as G7, IMF and regional groupings continue to look for solutions.

The lone voice crying to the world to wake up to this pending danger of collapse of the financial structure if global or cyber capitalism is left uncontrolled, is Dr Mahathir.

His voice now echoes in advanced text books in International Business authored by Czinkota, Ronkainen and Moffett (5th edition).

Students in MBA programmes worldwide are introduced to the international financial market with Dr Mahathir's famous statement "Currency trading is unnecessary, unproductive and immoral.....it should be illegal".

Dr Mahathir's fight for the freedom of emerging nations to develop without the fear of being undermined by the destructive force of erratic capital flows, is contained in his latest book A New Deal For Asia.

His fight has not been easy. Market fundamentalism has become so powerful that any political force that dares to resist it is branded illogical and naive.

The foreign media, some of which are owned by people who benefited from trading in currencies, turned the sharp edge on Malaysia and the Prime Minister with the accusation of political persecution of his former deputy instead.

It has been a most unequal fight. The media still refuses to acknowledge

the fact that hedge funds were the main cause of the Malaysian crisis. Nor are they willing to recognise that the capital controls has helped the nation to recover.

Nevertheless Dr Mahatir's call to the world has not been in vain. The G7 countries met and endorsed the view that the capital flows that tend to cause disruption, needs to be examined. Apec leaders endorsed the view to curb disruptive capital flows.

A new twist of events brought a benefactor of currency trading, Soros to join in the call "to rethink and reform the global capitalist system" for the "breakdown in the global financial system may be accompanied by a breakdown in international free trade".

The sword of currency trading cuts both ways: those who gain instantly can also be bankrupted instantly.

As Dr Sakakibara noted, we are living in a period of great transformation. In order to adapt to this great transformation, a shift in paradigm from "market fundamentalism...or a perception that governments and markets are substitutes...to a regime where national governments and regional and international organisations complemented and interact with markets seems in order".

We have overcome the immediate crisis but the root cause of the problem is still with us that is, the "inherent instability of cyber capitalism and serious convulsions associated with the transition".

Economies such as ours cannot afford another round of attack. Economics which in real life determines the fortunes or miseries of individuals, corporations, nations and regions, are too important to be left alone to international institutions, rating agencies, and economists however well intentioned or learned they may be.

We are living in exciting times. We are watching history as it happens, whether in conflict or in the shaping of world events. And as we watch events unveil, we have Dr Mahathir to thank for taking the cause almost single-handedly to right a serious flaw in the world financial system.