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Taking a closer look at capital controls

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AFTER announcing that the economy had a worse-than-expected contraction in the second quarter of 1998, the Government reached for what used to be one of the most popular weapons in the economic armoury - selective capital controls.

The measures bar foreigners from repatriating their Malaysian funds for a one-year period after investment.

This made many foreign funds which have been accused of causing the collapse of the local bourse by their short-term exit and entry, unhappy, and call for a lifting of the ruling.

Since then, the selected controls have been modified and relaxed to make them more market friendly through the introduction of an exit levy on short term foreign portfolio capital outflows.

The imposition of capital controls was designed to forcibly break the link between domestic interest rates and exchange rates so that monetary policy can be set without the external discipline of the exchange rates.

In other words, international trade is unaffected by the controls and foreign investors in the country are free to repatriate dividends and equity arising from their direct investment here.

Economists have never had the same confidence with respect to the merits of capital account liberalisation that they have with respect to the freeing of trade.

Some even argued that capital account liberalisation was an important cause of the Asian financial crisis.

Yet, as the crisis has clearly shown, relying on foreign money has its costs.

Countries employing controls, including China, India and Taiwan, appeared to fare better than those which had more open capital accounts (Hong Kong and Indonesia) or had liberalised recently (Thailand and South Korea).

The positive effects of the capital controls are felt almost immediately.

Although foreign financial experts and international media still condemn capital controls, others now say that temporary controls on short-term capital flows might give countries a "window of opportunity" to deal with economic turmoil.

In a written interview with the Nanyang Siang Pau Chinese daily recently, First Finance Minister and Special Functions Minister Tun Daim Zainuddin said that the selective controls had not driven away genuine foreign investors as they had nothing to fear.

Net inflows continued even with the current 10 per cent levy cap imposed on the principal sum of funds held in the country since Sept 1, 1998.

Today, the country is in a sound financial position. The macroeconomic situation has improved.

The stock market has improved considerably since the imposition of the controls, from a low of 262 points on Sept 1, 1998 to about 700 points at present.

The recovery in the stock market, however, will enhance household wealth, which may induce consumption.

Loan approvals and disbursement are up sharply, the non-performing loans problem has been contained, banks are recapitalised and corporate debt restructuring is making good progress.

Exports, which have been declining in US dollar terms since the beginning of the crisis, started to rise since September 1998.

The latest May industrial production index surged 5.4 per cent year-on-year to 154.0 compared with 146.1 in May 1998, reflecting increased exports and domestic consumption.

The Malaysian Institute of Economic Research business conditions index and index of consumer sentiments indicate the return of confidence.

The indices, respectively increased sharply to 60.3 and 101.6 points in the second quarter of this year from 42.3 and 79.1 points in second quarter of 1998.

Sales of motor vehicles rose to 19,106 units in March, which is 160 per cent higher than a year ago.

Retrenchment of workers has moderated. The number of retrenchments declined to 5,362 in March. The unemployment rate for 1998 is estimated at 3.9 per cent.

While capital controls have brought stability and restored confidence at home in the immediate term, their medium and long-term effects are likely to be somewhat unfavourable.

Although these controls are aimed primarily at volatile short-term capital and not targeted at long-term flows (for example foreign direct investment), it must be noted that it is difficult to distinguish between short- and long-term flows.

Standard balance of payments classifications - direct investment, portfolio flows, short-term flows, etc - are not neatly categorised in terms of their volatility and liquidity.

As argued by Reinhart and Smith (1997), even if a set of controls is effective in limiting "short-term" foreign financing, if incentives are not adequate enough, even flows that are perceived by policy makers to be "long-term" may in fact be considerably liquid. In fact, the very presence of capital controls would be discouraging to capital flows as a whole, regardless of their "targets".

In addition, critics have pointed out that the controls may hamper economic recovery by adversely affecting foreign direct investments in the country.

Investor confidence will be dampened since other markets in the region do not impose control requirements.

It was feared that long-term overall investment activity might be affected as well.

While some concerns have been expressed about a possible outflow of funds from Malaysia come Sept 1, when a moratorium on profit repatriation by foreign fund managers is lifted, Prime Minister Datuk Seri Dr Mahathir Mohamad has explicitly said the country has enough reserves to cushion any outflow of funds on that date.

Besides, he does not expect an exodus of foreign capital.

In fact, the latest National Economic Action Council report on net portfolio cumulative inflows shows that as of June 30, such inflows (since March) totalled RM3.879 billion.

While most market participants and observers agree that Malaysia's capital controls are legitimate, fund managers and analysts worry about their long-term implications if kept for too long.

The introduction of the exit levy, replacing the one-year holding period for portfolio investments, has raised questions on whether the country is able to attract the much-needed fresh capital inflows.

Despite the increasingly sanguine outlook on Malaysia, some fund managers said they remained cautious as the capital controls presented technical problems and difficulties in making investment valuations with the exit levy in place.

As a result, they cannot be sure they will be able to get their earnings and investments out.

This clearly shows capital controls come at a price.

The downgrading of Malaysia's sovereign ratings and the removal of Malaysian stocks from the Morgan Stanley Capital International indices are indications of international investors' concerns.

However, with the removal of the lock-up period and the imposition of a commonly-used capital gain tax, it is decided that Malaysia will be reinstated to the MSCI indices.

Due to these positive indicators on the larger aspects of the economy, the Government looks at capital controls as a smaller price to pay than subjecting the country to the vagaries of the open, unregulated international system.

In fact, the controls have apparently succeeded in bringing about the recovery of the Malaysian economy.

This will ensure that foreign funds continue to come in, instead of leaving the country on Sept 1.

It would thus seem unlikely that Malaysia will move further to remove its controls at least until it sees the effects of its lifting of the one-year rule.

Daim made the Government's position quite clear.

"The Government does not intend to remove the controls at this stage of development as it feels comfortable with the current pace of economic recovery."