Malaysia's selective capital control model proved critics wrong

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By Patrick Smith

NORFOLK (Connecticut): You remember Sept 1, 1998, don't you? A year and a bit after the Asian financial crisis hit, that was the day Malaysia slapped selective capital controls on speculative funds invested in the local share market.

We ought to spend a moment or two contemplating that difficult time. Last week, Kuala Lumpur lifted the last of those controls. And to tell you the truth, I'm shocked.

I'm shocked that the Malaysian capital hasn't been reduced by now to a few thatched huts on stilts. I'm shocked that most Malaysians aren't living on rafts in the South China Sea.

You see, that's what the ideologues in Washington, along with most bankers and big thinkers at the brokerage houses, told me would happen when Prime Minister (Datuk Seri Dr) Mahathir Mohamad, everybody's favourite dart board, took such heretical steps as he did.

So where are they now? I think I actually heard a few pins drop after the May 3 announcement that the last of the controls were gone.

Where is, say, Credit Lyonnais Securities, which predicted that Malaysia would shortly become "an investment black hole"?

Even better, where is Fed chairman Alan Greenspan? He forecast, with plenty of that phony gravitas he likes to effect, "a sharp reduction in the availability of new foreign investment in the future".

Here's another good one, from the same speech: Malaysia and any other nation that tries such a stunt "will be mired at a sub-optimal standard of living and slow growth rate associated with out-of-date technologies".

This kind of thing was supposed to make knees knock in Southeast Asia's Finance Ministries, I suppose. And now what? Dead silence all around.

On the other side of the ledger, I wonder what they're thinking down at Salomon Smith Barney. Ten days after controls were imposed, SSB signed on to help dig Malaysia out of its banking problems.

"We are comfortable that Malaysia is a strong investment grade," co-chief executive Deryck Maughan said at the time. "We'll meet with more than 100 institutions in Europe and the US to tell the story."

It has been an interesting story, as it turns out.

It's just not the story one heard at the time. A fall-behind growth rate, scarce capital, a deflated stock market, pariah status among the foreign portfolio managers — all of this and more awaited Malaysians for having placed levies on short-term money leaving the country: 30 per cent on profits taken out within three months of arrival, 10 per cent on funds repatriated within a year.

What actually happened is different, of course.

As anticipated by those few who supported Malaysia's move — your correspondent among them, if I may add — Kuala Lumpur insulated itself from the deleterious impact of speculative capital flows, cut interest rates without wrecking the ringgit, and bought the time it needed to recapitalise the banking system.

The results are easily measured. By the second quarter of 1999, Malaysia was getting back on track. The current account then swung dramatically into surplus; gross domestic product grew by 6.7 per cent that year and 8.5 per cent in 2000.

Alan? Oh Alan? He must have gone out for fried rice take-away.

As to foreign exchange reserves, Kuala Lumpur reported on Tuesday that they inched up in April, to US$26.4 billion (RM100.32 billion) — not quite twice what they were when capital controls came in. Foreign debt as a proportion of GDP is now about 46 per cent, down from more than 60 per cent during the dark days of the crisis.

The three-month interbank rate is now 3.3 per cent — compared with a high of nearly nine per cent before the controls. Inflation is calm at about 1.5 per cent.

Not a bad performance, in all, especially when measured against those nations — Thailand, for instance — that bought into the neo-liberal orthodoxy.

Yes, the stock market is off by 13 per cent those Malaysian renegades.

Rating Agency Malaysia, a Kuala Lunpur forecaster, has lowered its 2001 GDP estimate from 6.2 per cent to 4.8 per cent.

Credit Lyonnais — still grousing after all these years — points out that the uptick in Malaysia's reserve position comes amid a longer-term downtrend. "Don't be fooled," it says in its *Morning Line* of May 9.

Fine, we won't be. None of this has anything to do with the negative effects of capital controls.

Malaysia, like South Korea, Taiwan, and its Southeast Asian neighbours, is wired into the high-tech cycle in the United States and is merely feeling the effects of weakness there.

And it must be counted a measure of Malaysia's confidence that it removed the controls under current circumstances.

What was actually behind all that shrill talk of doom among the foreigners? It was partly a reflection of poor memory, partly of poor understanding, and partly of the force with which the Washington consensus advanced an essentially ideological argument.

Ideology always rides in a bandwagon, and getting others to jump on is precisely the point of it.

To this day commentators fail to recall that Europe in the 1950s and 1960s — and most of Asia for a lot longer — thrived amid exchange control regimes of one kind or another. To this day they also seem to think controls are intended to trap other people's money in some underhand way.

It's just the opposite: Malaysia's intent was to keep hot money out, not in.

This leads to the final point. The fundamental issue between Malaysia and its critics was the validity of a model other than that touted by the consensus.

The US can't countenance controls on capital flows because, with a vast private sector financial deficit, it is ever more dependent on them — not least from Asia.

To put a complex matter too simply, Asians represent a different kind of capitalism. With high savings rates, they are more dependent on banks — and banking relationships, now known as ties between cronies.

They have no need for massive inflows of liquidity, they look to long-term investment, not short. And I might add here that Malaysia's long-term inflows rebounded even before the fateful year of 1998 was done. And the next two years showed steady increases.

Alan? Oh Alan? Probably not back from his rice run yet.

Malaysia belched in church when it imposed capital controls three years ago, and all the faithful gasped. Now they're silent, as churchgoers should be. Some people never learn — to think for themselves, that is. — Bloomberg

□ *The writer is a long-time correspondent in Asia for Bloomberg News and the author most recently of 'Japan: A Reinterpretation'. The opinions expressed are his own.*