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Capital controls produce faster economic recovery

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COMPARED to the International Monetary Fund (IMF) programmes, Malaysian capital controls produced faster economic recovery, smaller declines in employment and real wages, and more rapid turnaround in the stock market.

This is the assessment and conclusion of Dani Rodrik and Ethan Kaplan of Harvard University. In their paper on "Did the Malaysian capital controls Work?" they consider how Malaysia did compared to South Korea and Thailand when these two countries were undergoing their IMF programmes. In their analysis they make allowances for changes in the external environment.

The approach taken by Rodrik and Kaplan is different from previous comparisons which asked how Malaysia did relative to South Korea and Thailand after September 1998 when Malaysia imposed selective capital controls.

In their analysis, the Harvard professors note that "some of the more pessimistic prognostications about the consequences of capital controls have not been borne out".

Malaysia and the Prime Minister Datuk Seri Dr Mahathir Mohamad were among others labelled as pariah, a heretic, cutting from the world and moving against the tide of liberalisation, moving towards isolationism and a move not conducive to building investor confidence.

Today the results speak for themselves. And as Rodrik and Kaplan point out there has been a change in the attitude towards Malaysia's measures.

"Early prognostications of impending doom were gradually replaced by more upbeat projections, as it became clear that Malaysia was recovering rather than sinking deeper into crisis".

They evaluate Malaysia's capital controls from four perspectives, namely financial, economic, political and the long term perspective.

From the financial perspective increased sophistication of financial markets, and in particular the spread of derivatives has led many observers to be skeptical of the Governments' ability to target specific types of balance of payments flows for restriction. In fact doubts were expressed that Malaysia's controls could have been effective in this sense.

"Such doubts seem to have been misplaced. The Government had no difficulty in sharply lowering domestic interest rates, and making the fixed exchange rate stick without the appearance of a black market premium for foreign currency," Rodrik and Kaplan point out. The stock market also did better and inflation was lower.

In addition an IMF report says there were "...no indications of circumvention through underinvoicing or overinvoicing of imports" while another IMF report concludes that controls were effective in eliminating the offshore ringgit market and choking off speculative activity against the ringgit despite the easing of monetary and fiscal policies".

Quoting from IMF's World Economic Outlook Rodrik and Kaplan show how views and opinions changed over time in favour of Malaysia's selective controls at the Bretton Woods institution:

* October 1998: "The introduction by Malaysia in early September of exchange and capital controls may also turn out to be an important setback not only to that country's recovery and potentially its future development, but also to other emerging market economies that have suffered from heightened investor fears of similar actions elsewhere."

* May 1999: "Despite stimulative monetary and fiscal policies introduced

last year, however, domestic demand is expected to strengthen only gradually..." and

* October 1999: "... a strong economic recovery is also now underway in response to fiscal and monetary stimulus and the pegging of the exchange rate at a competitive level".

The critics had said the timing of Malaysia's capital controls was also wrong. They argued that the economy had stabilised as had other countries. But Rodrik and Kaplan said this was not quite so adding that "the financial crisis was deepening in Malaysia in the summer of 1998".

For instance, they point out that unlike in South Korea and Thailand where interest rates had fallen to single digit, offshore ringgit deposits were paying rates in the range of 20 per cent to 40 per cent. The Harvard professors point out although domestic interest rates remained stable due to an interest rate ceiling of 2.5 percentage points over the base lending rate, the large onshore/offshore interest rate differential initiated massive capital flight and subsequent credit crunch.

But "Malaysia recovered from the Asian crisis swiftly after the imposition of capital controls". Critics argue that so have South Korea and Thailand, two countries that took the orthodox path. But as Rodrik and Kaplan point out the situation was different.

South Korea and Thailand, in return for financial assistance from the IMF and other multilateral institutions, had to adhere to very strict conditions and structural reforms, raise interest rates, tighten fiscal policy, open up their financial markets to foreigners and close troubled banks and financial institutions.

Malaysia on the other hand imposed selective capital controls and fixed the exchange rate of the ringgit to the US dollar and reduced interest rates.

The selective controls, among others, were aimed at stopping speculation against the ringgit. "Most of that speculation was coming from short selling of the ringgit in offshore (mainly Singaporean markets). These markets were offering high interest rates to attract ringgit deposits that in turn served to fund the shorting of the currency".

Opponents of capital controls argue that the measures "enlarge the scope for domestic political mischief". But Rodrik and Kaplan say, "In Malaysia's case, there is no indication of an increase in petty corruption - the controls were implemented transparently and with remarkable efficiency".

From a long term perspective they say in Malaysia's case there is concern about the impact on direct foreign investment (DFI) as these played an important role in the "successful economic development to date".

But "The Malaysian authorities were quite careful to target short-term speculative capital flows, insulating DFI... " Repatriation of profits and dividends from direct foreign investment were freely allowed.

The authorities also took pains not to affect current account transactions with foreign currency transactions for current account purposes were not restricted.

In conclusion: Malaysia's much maligned and criticised selective controls produced better results than the alternative on almost all dimensions.

On the real side, the economic recovery was faster, employment and real wages did not suffer as much. On the financial side, the stock market did better, interest rates fell more, and inflation was lower.