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Naysayers now admit capital controls do work

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CAPITAL controls are increasingly being accepted as a policy measure around the world. It features prominently in the recently concluded Singapore-US bilateral free trade agreement.

The agreement, Washington's first with an Asian country, allows the city state to "restrict short-term capital flows for at least six months during a financial crisis".

The free-trade agreement had been delayed due to Singapore's demand for the right to impose control.

Singapore wanted the provision, according to analysts, to cope with financial panics that can do untold damage and devastation to economies and nations.

"Singapore is a major financial centre, so obviously capital controls were a big sticking point" in the bilateral negotiations according to Rajeev Malik an economist with JP Morgan Chase in Singapore.

The inclusion of capital controls for a city state that prides itself with being "free" might seem odd.

But the Monetary Authority of Singapore (MAS), essentially its Central Bank, says "Singapore and the United States share a strong commitment to the free and unfettered flow of capital".

MAS maintains "The agreement provides for the free transfer of capital in both countries and enhances the protection and rights of US investors, while maintaining Singapore's freedom of action to take appropriate measures in the event of an economic crisis".

It adds that in an extreme balance of payments crisis that threatens to severely destabilise the economy, Singapore needs the flexibility to take all appropriate measures, including restrictions on capital flows.

The "special provisions" apply only to short-term capital account transactions, such as portfolio investments and inter-bank loans and placements.

They do not apply, according to MAS, to current payments and transfers such as debt servicing, profit repatriation and dividend payments as well as proceeds from the sale of foreign direct investments.

Thus, even in a crisis, while Singapore retains the flexibility to place temporary restrictions on potential short-term flows, current payments and direct investments will be fully protected.

Washington has worked out a similar arrangement with Chile. Observers point out that arrangements worked out with Singapore and Chile, which include provisions for capital controls, are likely to serve as a template for future US trade negotiations.

The mode of operations may differ from that adopted by Malaysia. But that is as it should be as the circumstances and the environment differ from one country to another and from one period to another. But the fact remains that the principle of "capital controls" has become a necessity.

The world's attitude towards capital controls has come full circle. The US-Singapore agreement recognises the concerns expressed by Southeast Asian nations stemming from the 1997 financial crisis.

Malaysia had pointed out the devastation short-term capital flows and their sudden reversal would cause to economies.

But no attention was paid to it then. Instead fund managers and investors with their herd mentality pulled out their investments from developing countries in a rush and sent currency rates and stock markets

to historic lows.

To protect its economy and citizens, Malaysia imposed capital controls. The leadership and its policy-makers, especially Prime Minister Datuk Seri Dr Mahathir Mohamad, were labelled "heretics" who did not understand economics and the workings of financial markets.

Multilateral institutions, the financial wizards, fund managers, analysts and developed nations including the US condemned it.

Kuala Lumpur was then accused of turning against the tide of liberalisation and globalisation.

Columnist David Roche in 1999 called Malaysia's policy measures "badly misjudged" and that "Malaysia's isolationist policies will hold it back as the rest of Asia recovers".

The Malaysian economy recovered faster, emerged stronger and more resilient and in a much better health than many others in the region including those who had "escaped" the 1997-1998 financial crisis.

Malaysia stuck to its policy in the face of severe criticism and even threats. The capital controls prevented the economy from sinking lower and into deeper trouble.

The policy measure that was designed to stop further deterioration of the economy proved to be useful.

With the results speaking for themselves even the most ardent critics have come round to admit that the policy worked.

Malaysia's approach and policies, including capital controls, are now being considered as an alternative solution to financial problems in other developing countries.

The IMF in its recent assessment of Malaysia acknowledged that the peg, which was part of the original selective capital controls imposed in 1998 as a "stability anchor".

As the largest shareholder of the IMF, Washington has considerable influence over the Bretton Woods Institution, it is likely that capital controls will not be as fiercely objected to as in 1998.

With the US having accepted the principle on the need for capital controls, Washington's move is expected to be translated into policy measures at the IMF and in its dealing with developing and emerging countries.

In fact, the IMF, which had once considered a proposal to make the free flow of capital part of its membership charter, now says that limits on financial flows make sense in some cases.

Malaysia's insistence on pursuing its home-grown policies designed to protect the country and citizens has paid off.

The conclusion is that developed countries alone do not have the monopoly of ideas and solutions. Developing countries too have the capacity and the capability of drawing up policies and solutions that work.