CAPITAL CONTROLS IN MALAYSIA

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On September 1st 1998, Malaysia became the first Asian country affected by the economic crisis to announce selective exchange and capital controls in an attempt to lay the ground for a recovery programme. Until recently, capital controls were a taboo subject. With its action, Malaysia broke the policy taboo. Only a week earlier, the American economist Paul Krugman had broken the intellectual taboo by advocating that Asian countries adopt exchange controls. The Malaysian moves involved fixing the local currency to the US dollar, stopping the overseas trade in ringgit currency and other ringgit assets, restricting the amount of currency and investments that residents can take abroad, and requiring a minimum one–year «stay period» for foreign portfolio funds. (The last measure has since been converted to an exit tax.) The measures were aimed at reducing the country's exposure to financial speculators and the global financial turmoil.

The Malaysian policy package included:

- The official fixing of the ringgit at 3.80 to the US dollar, thus removing or greatly reducing the role of market forces in determining the day–to–day level of the local currency (the ringgit's value in relation to currencies other than the dollar will still fluctuate according to their own rates against the dollar). This measure largely removes uncertainties regarding the future level of the ringgit.
- Measures relating to the local stock market, including the closure of secondary markets so that trade can be done only via the Kuala Lumpur Stock Exchange (this is to prevent speculation or manipulation from outside the country), and the requirement that non–residents purchasing local shares have to retain the shares or the proceeds from sale for a year from the purchase date (this is to reduce foreign speculative short–term trade in local shares). The one–year requirement has since been replaced by a graduated exit tax on the invested amount (for funds invested before the September 1998 controls) and a tax on profits and capital gains (for funds entering after February 15th 1999 and staying less than a year).
- Measures to reduce and eliminate the international trade in ringgit, by bringing back to the country ringgit–denominated financial assets such as cash and savings deposits via the non–recognition or non–acceptance of such assets in the country after a one–month dateline. (Permission will, however, be given under certain conditions.)
- Resident travellers are allowed to import ringgit notes up to RM1,000 only and any amount of foreign currencies, and to export only up to RM1,000 and foreign currencies only up to RM10,000 equivalent.
- Except for payments for imports of goods and services, residents are freely allowed to make payments to non–residents only up to RM10,000 or its equivalent in foreign currency (previously the limit was set at RM100,000).
  - Any form of investments abroad by residents and payments under a guarantee for non–trade purposes require approval. Prescribed manner of payment for exports will be in foreign currency only (previously it was allowed to be in foreign currency or ringgit from an External Account).
  - Domestic credit facilities to non–resident correspondent banks and non–resident stockbroking companies are no longer allowed (previously domestic credit up to RM5 million was allowed).
  - Residents require prior approval to make payments to non–residents for purposes of investing abroad for amounts exceeding RM10,000 equivalent in foreign exchange.
  - Residents are not allowed to obtain ringgit credit facilities from non–residents.
- Measures imposing conditions on the operations and transfers of funds in external accounts: transfers between external accounts require prior approval for any amount (previously freely allowed); transfers from external accounts to resident accounts will require approval**;** and sources of funding external

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accounts are limited to proceeds from sale of ringgit instruments and other assets in Malaysia, salaries, interest and dividend and sale of foreign currency.

In general, the ringgit is still freely convertible to foreign currencies for trade (export receipts and import payments), inward foreign direct investment, and repatriation of profit by non–residents. Convertibility up to a certain limit is also allowed for certain other purposes, such as financing children's education abroad. But convertibility for autonomous capital movements for several purposes not directly related to trade will be limited.

The rationale for the move was explained by the Malaysian Prime Minister Datuk Seri Dr Mahathir Mohamed as a last resort. «We had asked the international agencies to regulate currency trading but they did not care, so we ourselves have to regulate our own currency,» he said in a media interview in September 1998. «If the international community agrees to regulate currency trading and limit the range of currency fluctuations and enables countries to grow again, then we can return to the floating exchange rate system. But now we can see the damage this system has done throughout the world. It has destroyed the hard work of countries to cater to the interests of speculators as if their interests are so important that millions of people must suffer. This is regressive.»

Explaining the move to make offshore use of the ringgit invalid, Mahathir said normally it was offshore ringgit that were used by speculators to manipulate the currency. The speculators hold the ringgit in foreign banks abroad and have corresponding amounts in banks in Malaysia.

Mahathir also said that with the introduction of exchange controls, it would be possible to cut the link between interest rate and the exchange rate. «We can reduce interest rates without speculators devaluing our currency. Our companies can revive. If our currency is revalued upwards, the companies can buy imports as they don't have to pay so much.»

He said the Malaysian measures were aimed at putting a spanner in the works of speculators, to take speculators out of currency trade. He added the period of highest economic growth was during the Bretton Woods fixed exchange system. But the free market system that followed the Bretton Woods system has failed because of abuses. «There are signs that people are now losing faith in this free market system, but some countries benefit from the abuses, their people make more money, so they don't see why the abuses should be curbed.»

BRIEF ANALYSIS OF THE MEASURES

The measures constitute a bold attempt to give the economy a reasonable chance to recover. By restricting the availability of ringgit in offshore markets and restricting the international trade in ringgit, the measures are aimed at greatly reducing the conditions and opportunities for speculators to make profits on fluctuations in the ringgit's value. The move to have the ringgit's rate fixed by the financial authorities, rather than by the market, has also restored greater financial stability by reducing the uncertain conditions under which businesses and consumers now have to operate.

Instead of fixing the exchange rate through a Currency Board system (where money supply and domestic interest rates are determined by the foreign reserves and inflows and outflows of funds), Malaysia has chosen the route of controlling the flows of ringgit and foreign exchange. The advantage of this approach is that it allows the government greater degrees of freedom to determine domestic policy, particularly in influencing domestic interest rates. The government can now reduce interest rates without being overly constrained by the reaction of the market and by fears of the ringgit falling. Since the introduction of the measures, interest rates have fallen by about five percentage points. This has eased the debt servicing burden of businesses and consumers (especially house buyers), and the financial position of banks.

The decision to make ringgit held abroad invalid after one month is meant to encourage an inflow of ringgit to return to the country. It has also dried up sources of ringgit held abroad that speculators borrow from to manipulate the ringgit, for example by «selling short.» No doubt some Malaysians who hold ringgit accounts abroad, or who travel frequently and who need to transfer funds abroad, may suffer some inconveniences. But these personal sacrifices can be taken as contributions to generating some conditions that are needed to get a serious recovery going.

The exchange control measures are a response to the basic causes of the crisis afflicting both the country and the region. The crisis began with funds being allowed to freely move in and out of the affected countries. Those countries had recently liberalised their financial systems, allowing locals and foreigners alike to freely convert foreign currency into local currency, and vice versa.

This currency convertibility was allowed not only to finance current transactions of trade and direct investment (which in the past had also been permitted), but also in the capital account, *ie,* for short–term flows such as investment in the stock markets, loans from and to abroad, and remittances to abroad by individuals and companies for savings or property purchases overseas. By introducing this «capital account convertibility», the countries exposed themselves to autonomous inflows and outflows of funds by foreigners and locals, subjecting their local currency to speculation as well as exchange–rate volatility.

The crisis was sparked by speculation and a stampede of foreign funds moving out, followed shortly by locals also sending their money abroad, whilst the local currencies fell sharply. Now that the countries are in deep recession, capital account convertibility is causing another equally vexing problem. It is preventing them from taking policies they need for recovery.

A major policy needed is to lower interest rates (to relieve consumers and companies from their heavy debt service burden) and increase spending (so that there is more demand for businesses and incomes for workers). Countries are constrained from this line of action, however, because speculators may again attack the local currency. Also, some residents may be tempted to send more of their savings abroad in search of higher interest rates. The possibility of funds exiting in an environment of free capital account convertibility of the local currency thus puts a damper on measures that are needed for recovery.

Therefore, one logical move would be for the affected countries to partly re–impose some control over the convertibility of the local currency. This could reduce the conditions in which currency speculators can profitably operate, reduce the exit of funds and discourage the inflows of undesirable forms of short–term capital.

Many observers point to China and India as examples of countries that have not been subjected to volatile capital flows and currency instability because they do not allow full convertibility of their currencies. **The lesson is that developing countries that want to shield themselves from externally–generated financial crises should retain (or regain) some controls over the convertibility of their currency.**

The option of reintroducing some capital controls has till recently not been openly discussed, however, because it is considered a «taboo» subject. The prevailing ideology held and spread by the International Monetary Fund (IMF) and the Group of Seven rich countries is that countries should liberalise their capital account, and that countries that have done so will suffer damage if they re–impose controls.

Policy–makers in the affected countries are worried that even to discuss the advantages of capital control means black–listing by the IMF, the rich countries and financial speculators. By keeping silent, their countries will continue to be subjected to the views and interests of «market players», suffer the consequences of a relatively high interest rate policy, and be prevented from speedy recovery.

OVERCOMING ACADEMIC TABOO

On the academic level, the taboo against capital controls was broken in August 1998 when the Massachusetts Institute of Technology (MIT) economist Paul Krugman advocated that Asian governments should re–impose capital controls as the only way out of their crisis. In his *Fortune* article, entitled «Saving Asia: it's time to get RADICAL», Krugman agrees with the IMF critics that high interest rates imposed by the IMF would cause even healthy banks and companies to collapse. Thus, there is a strong case for countries to keep interest rates low and try to keep their real economies growing. However, says Krugman, the problem is that the original objection to interest rate reductions still stands, that the region's currencies could again go into free fall if the interest rate is not high enough.

Krugman said there is a way out, «but it is a solution so unfashionable, so stigmatised, that hardly anyone has dared to suggest it. The unsayable words are *exchange controls*.» Exchange controls, he adds, used to be the standard response of countries with balance of payments crises. «Exporters were required to sell their foreign–currency earnings to the government at a fixed exchange rate; that currency would in turn be sold at the same rate for approved payments to foreigners, basically for imports and debt service. Whilst some countries tried to make other foreign–exchange transactions illegal, other countries allowed a parallel market. Either way, once the system was in place, a country didn't have to worry that cutting interest rates would cause the currency to plunge. Maybe the parallel exchange rate would sink, but that wouldn't affect the prices of imports or the balance sheets of companies and banks.»

Asking why China has not been so badly hit as its neighbours, Krugman answers that China «has been able to cut, not raise, interest rates in this crisis, despite maintaining a fixed exchange rate; and the reason it is able to do that is that it has an inconvertible currency, that is to say, exchange controls. Those controls are often evaded, and they are a source of lots of corruption, but they still give China a degree of policy leeway that the rest of Asia desperately wishes it had.

As more economists like Krugman speak up, capital controls are being recognised as a respectable option for governments wanting an effective policy instrument to prevent further financial turbulence. After the announcement of the Malaysian measures, Krugman published an open letter to the Malaysian Prime Minister stating that he fervently hoped the dramatic policy move pays off. He warned, however, that these controls are risky with no guarantee for success. He gave four guidelines: that the controls should aim at minimal disruption of business; that they be temporary; that the currency should not be pegged at too high a level; and that they serve to aid reforms and not be an alternative.

UNCTAD'S ADVOCACY OF USING CAPITAL CONTROLS

The need for developing counties to make use of capital controls to prevent and manage financial crises has also been stressed by UNCTAD.[2] In fact, UNCTAD has been the international agency that has consistently been warning about the dangers of financial liberalisation and the risks posed by a policy of allowing freedom for the inflows and outflows of funds.

UNCTAD's *Trade and Development Report 1998* makes a central point that **to protect themselves against international financial instability, developing countries need to have capital controls, since these constitute a proven technique for dealing with volatile capital flows**. The report comes to this conclusion after surveying several other measures (such as more disclosure of information and greater banking regulation) that have been proposed by the industrial countries and the International Monetary Fund. The agency finds these proposals to have merit but inadequate to deal with the present and future crises. It therefore stresses that developing countries should be allowed to introduce capital controls, as these are «an indispensable part of their

2 United Nations Conference on Trade and Development.

armoury of measures for the purpose of protection against international financial instability.»

The Report notes that good economic fundamentals, effective financial regulation and good corporate governance are needed to avoid financial crises, but by themselves they are not sufficient. **Experience shows that to avoid these crises, a key role is played by capital controls and other measures that influence external borrowing, lending and asset holding.** Control on capital flows are imposed for two reasons: firstly, as part of macroeconomic management (to reinforce or substitute for monetary and fiscal measures) and secondly to attain long–term national development goals (such as ensuring residents' capital is locally invested or that certain types of activities are reserved for residents).

Contrary to the belief that capital controls are rare, taboo or practised only by a few countries that are somehow «anti–market», the reality is that these measures have been very widely used. UNCTAD notes that they have been a «pervasive feature» of the last few decades. In early post–war years, capital controls for macroeconomic reasons were generally imposed on outflows of funds as part of policies dealing with balance of payments difficulties and to avoid or reduce devaluations.

Rich and poor countries alike also used controls on capital inflows for longer–term development reasons. When freer capital movements were allowed from the 1960s onwards, large capital inflows posed problems for rich countries such as Germany, Holland and Switzerland. They imposed controls such as limits on non–residents' purchase of local debt securities and on bank deposits of non–residents.

More recently, some developing countries facing problems due to large capital inflows also resorted to capital controls. For example, when faced with a surge of short–term capital inflows, Malaysia in January 1994 imposed several: banks were subjected to a ceiling on their external liabilities not related to trade or investment; residents were barred from selling short–term monetary instruments to non–residents; banks had to deposit at no interest in the central bank moneys in ringgit accounts owned by foreign banks; and banks were restricted in outright forward and swap transactions they could engage in with foreigners. These measures were gradually removed from 1995 onwards.

When Chile was faced with large capital inflows in the early 1990s, it took measures to slow short–term inflows and even to encourage certain types of outflows. The main step was that foreign loans entering Chile were subjected to a reserve requirement of 20% (later raised to 30%). In other words, a certain percentage of each loan had to be deposited at the central bank for a year, without being paid any interest. Also to prevent excessive inflows, Brazil in mid–1994 imposed controls such as an increase in the tax paid by Brazilian firms on bonds issued abroad, a tax on foreigners' investment in the stock market, and an increase in tax on foreign purchases of domestic fixed–income investments. When the Czech Republic faced large inflows in 1994/95, it imposed a tax of 0.25% on foreign–exchange transactions with banks and limits on (and the need for official approval for) short–term borrowing abroad by banks and other firms. Besides the specific cases above, the UNCTAD Report also lists examples of capital controls on inflows as well as outflows.

Controls on inflows of foreign direct investment and portfolio equity investment may take the form of licensing, ceilings on foreign equity participation in local firms, official permission for international equity issues, differential regulations applying to local and foreign firms regarding establishment and permissible operations and various kinds of two–tier markets. Some of these controls can also be imposed on capital inflows associated with debt securities, including bonds. Such inflows can be subject to special taxes or be limited to transactions carried out through a two–tier market. Ceilings (as low as zero) may apply to non–residents' holdings of debt issues of firms and government; or foreigners may need approval to buy such issues. Foreigners can also be excluded from auctions for government bonds and paper.

UNCTAD also lists other controls commonly used to restrict external borrowings from banks. They include: a special reserve requirement concerning liabilities to non–residents; forbidding banks to pay interest on deposits of non–residents or even requiring a commission on such deposits; taxing foreign borrowing (to eliminate the margin between local and foreign interest rates); and requiring firms to deposit cash at the central bank amounting to a proportion of their external borrowing.

As for controls on capital outflows, they can include controls over outward transactions for direct and portfolio equity investment by residents as well as foreigners. Restrictions on repatriation of capital by foreigners can include specifying a period before such repatriation is allowed, and regulations that phase the repatriation according to the availability of foreign exchange or to the need to maintain an orderly market for the country's currency. Residents may be restricted as to their holdings of foreign stocks, either directly or through limits on the permissible portfolios of the country's investment funds. Two–tier exchange rates may also be used to restrict residents' foreign investment by requiring that capital transactions be undertaken through a market in which a less favourable rate prevails, compared to the rate for current transactions. Some of these techniques are also used for purchases of debt securities issued abroad and for other forms of lending abroad. Bank deposits abroad by residents can also be restricted by law.

UNCTAD says recent financial crises and frequent use of capital controls by countries to contain the effects of swings in capital flows point to the case for continuing to give governments the autonomy to control transactions. It questions recent moves in the IMF to restrict the autonomy or freedom of countries to control flows.

Ways have not yet been found at a global level to eliminate the cross–border transmission of financial shocks and crises due to global financial integration and capital movements. Thus, concludes UNCTAD, for the foreseeable future, countries must be allowed the flexibility to introduce capital control measures, instead of new obligations being imposed on these countries to further liberalise capital movements through them.

CONCLUSION

Given an international environment of big financial players with huge blocs of money for speculation and investment, financially small countries are now subjected to great volatility and financial and economic danger. For instance, the LTCM affair revealed that a hedge fund with USD 4–5 billion equity could manage to raise so much credit that the banks had USD 200 billion exposure to it. Few governments can withstand a determined bid by a few big hedge funds to speculate on their currencies and financial markets. And besides the hedge funds, there are other gigantic investment funds (such as mutual and pension funds) as well as investment banks, commercial banks, insurance companies etc.

The almost total freedom given to international investors and speculators has wreaked financial and now economic and social chaos. The time has now come to regulate these big players. But there are serious doubts whether there is the political will to act, as the financial institutions and those that own and manage them are very powerful and it is in the vested interest of politicians and their parties to cater to these powerful institutions.

Developing countries need to protect themselves from the free flow of funds. Capital controls are thus a necessary part of economic instruments that must be an option. In these days of financial turbulence, they may even be a necessary option. This does not mean that capital controls by themselves are a panacea or «magic bullet». They should be accompanied, *eg*, by an international mechanism for debt standstill to help seriously indebted countries.

Moreover, there are weaknesses and loopholes in capital controls, such as leakages through transfer pricing mechanisms, false invoicing, possible black markets, etc. Also, capital controls should not merely be a shield for a country to protect itself from having to carry out changes and reforms made necessary by the financial crisis, or reforms that are structurally needed for the longer run.

The success of efforts to revive a financially viable economy will also depend greatly on the effectiveness, efficiency and fairness (in burden sharing) of recapitalisation, restructuring and reforms in the financial institutions and corporations. It will also depend on the right mix of monetary and fiscal policies that can spur recovery without causing greater financial or economic burdens on ordinary citizens, especially the poor. In other words, capital controls are a necessary but not sufficient condition to protect a country from unresolvable crisis and to enable conditions for recovery. They have to be accompanied by other measures.

The fact that there are weaknesses in capital controls, and that other measures are also needed, does not make capital controls a wrong or evil policy option, as some opponents of capital controls appear to portray them. Total freedom for capital flows is a principle championed by the big financial players and institutions that stand to gain from extreme financial liberalisation. Capital controls to limit such freedom are needed from an objective point of view and from the viewpoint of ordinary citizens who need to be protected from predatory speculation and from economic chaos.