

CAPITAL CONTROLS: A PRESCRIPTION FOR THE ASIAN CRISIS?

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Quickly Moving Capital

Hot money flows all over the world, causing massive currency depreciations in vulnerable economies and the disturbance of their financial markets. Some critics classify it a vicious by-product of greed capitalism. Others also argue that the current crisis in emerging markets is mainly due to the recent liberalization of international capital movements, allowing short-term capital to flow too freely.

For the past decade, the prevailing view among the world's economic policy makers, business leaders and most economists has been that capital should move freely around the world, to find the most profitable and productive investments. Until last year, the emerging market countries thrived under that arrangement, attracting huge amounts of foreign capital in the form of foreign investment, which accelerated the growth of their domestic economies.

But it now seems clear that relying on foreign capital has had its costs. Much of the inflow was in short-term investments and could flee as just quickly as it flowed in. When it did flow out, the result was to increase interest rates, devalue exchange rates and ultimately create financial crises and recessions.

The Lure of Capital Controls

On the other hand, some of the developing nations refused to adopt the free-flow of money orthodoxy of the 1990s, such as China,

Taiwan, India, and to a lesser degree, Chile, which stand out as the developing countries least affected the current crisis. Policy makers in the troubled economies could not help but notice this glaring fact.

On September 2, Malaysian Prime Minister Mahathir Mohamad announced that Malaysia would impose capital controls and no longer allow its currency to trade outside its borders. Malaysia's decision to impose capital controls flouts economic orthodoxy and directly contradicts the crisis prescriptions of the International Monetary Fund and the U.S. Treasury. Malaysia's central bank said the controls are designed to "regain monetary independence and insulate the Malaysian economy from any further distortion in global financial markets." If the capital controls show any signs at all that they are working, other Asian nations will be very tempted to follow Malaysia

World Bank chief economist Joseph Stiglitz has argued that controls should be considered, provided they can be designed to discourage short-term investments without disrupting foreign investment in factories and infrastructure. And Paul Krugman of MIT has said that the best alternative was to impose controls on currency trading to give troubled economies temporary relief from the pressure of the global economy so they can cure their problems.

Are They Good or Bad?

Capital controls come in various forms. Chile and Columbia have taxed short-term borrowing from abroad. Brazil once

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levied a 1% tax on foreign investment in its stock market to discourage short-term trading. Mexico, for a time, restricted the foreign-currency liabilities of its bank to 10% of their total loans. The Czech Republic levied a fee on all foreign exchange transactions.

In theory, capital controls allow a country to get interest rates down faster and further than they would be able to otherwise. Therefore, a government could stop worrying about setting interest rates at a level that will convince people to hold their domestic currency.

In addition, controls on inflows of foreign capital are getting a lot of serious attention because many experts blame Asia's crisis in part on hot money that flowed into the region and just as suddenly flowed out again. One way to protect against those dangerous swings is to make it harder for short-term capital to enter the economy in the first place; Chile, for example, hinders short-term inflows.

However, it is harder to make the case for broader capital controls that also restrict outflows. Latin American countries tried to restrict capital flows as they struggled with their own debt crisis in the 1980s. Even so, capital flight was a huge problem. The eventual repatriation of that capital in the 1990s played a big role in that region's recovery. The Philippines had severe capital flight problems in the 1980s despite capital controls. The controls were removed in 1992.

Furthermore, there is the question whether the costs and distortions generated by controls outweigh potential benefits. These costs include the possibility of retaliation by other countries, evasion, administrative costs, and the inability to quantify the needed tax on capital flow. And also, enforcing capital controls over extended periods can reveal itself as a hopeless task in a world of highly integrated capital markets.

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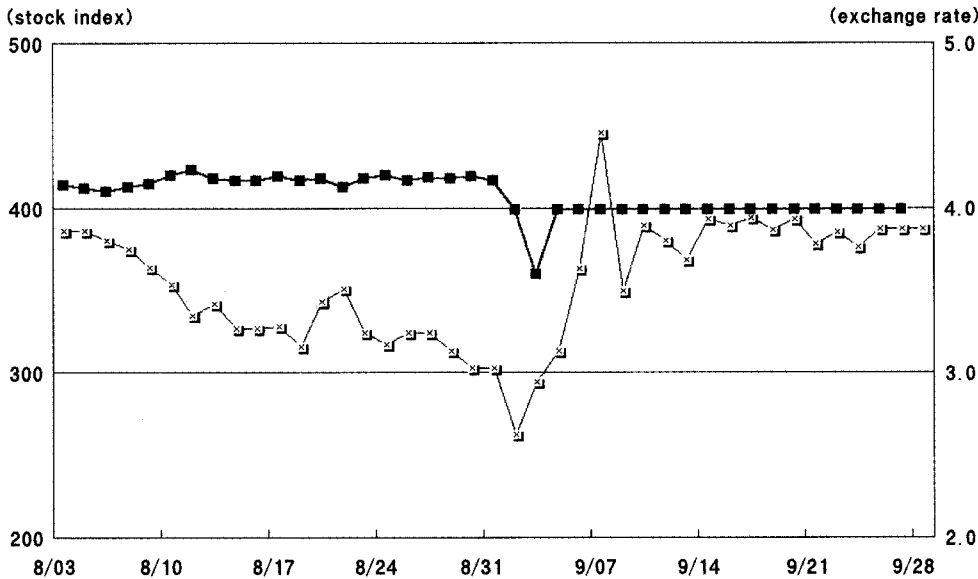
Malaysia

Malaysia has launched several measures to control the domestic money supply in the system:

- (1) Residents are no longer able to make payments to non-residents for amounts in excess of 10,000 Ringgit without prior approval.
- (2) Offshore domestic currency-denominated deposits have been given a month from 1 September to be remitted onshore. This pool of money has been estimated at between \$5.2 - 6.6 billion or almost 50% of M1.
- (3) Exporters no longer have the option of invoicing receipts in Ringgit. All export receipts must now be in foreign currencies. All U.S. dollar receipts by exporters must now be centralized at the central bank.
- (4) Non-residents selling domestic-denominated securities held for less than 1 year must keep the proceeds onshore for 1 year before repatriation. This is the single most damaging move for the equity market. The restrictions would mean funds facing redemption would no longer be able to liquidate their Malaysian portfolio at will. This could severely cut the weighting of the Malaysian markets among global investors.

However, the general convertibility of current account transactions will continue to be guaranteed, as will the free flow of FDI and repatriation of interest profits, dividends and capital.

〈Figure 1〉 Malaysia's Stock Index and Exchange Rate



Hong Kong

Several new measures aimed at deterring speculative activity have been implemented. The Hong Kong Futures Exchange announced the following measures in August:

- (1) A 50% hike in margin requirements for investors holding large positions of above 10,000 futures contracts.
- (2) The disclosure threshold for reporting of investor identities by brokers was lowered to 250 contracts from 500. Brokers must now immediately clarify the ultimate beneficiary of the account.

Clearly, the pace of market intervention seen in the second half of August, during which some \$15 billion worth of foreign reserves was

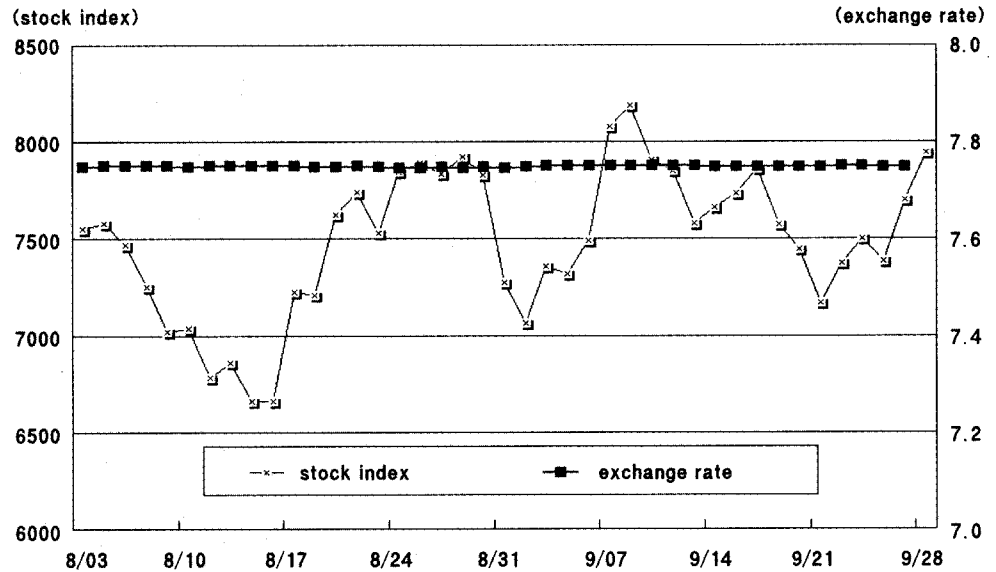
spent, is not sustainable. In line with this, as the protracted economic slump is getting worse, it is not entirely implausible that imposing some form of exchange control could be considered in order to uphold the peg. That could potentially undermine its longer-term role as a financial hub in Asia, but when times are desperate, extreme measures such as this may be less damaging from a policy-making viewpoint.

Taiwan

Following the Hong Kong's government intervention in the domestic market, Taiwan unveiled three measures to boost its local bourse.

- (1) Stock margin buying ratio was raised to 60% from 50%. (2) Government agreed to co-

<Figure 2> Hong Kong's Stock Index and Exchange Rate



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ordinate with stock funds 6 months old to invest in wide and Over-the-Counter markets. (3) Parliament is to pass by the end of September a bill allowing share buybacks when prices fall sharply. In the foreign exchange market, the Central Bank of China in May imposed controls on both onshore and Non-Deliverable Forward (NDF) markets. Banks are required to report daily all NDF trades, and immediately for trade over \$5 million.

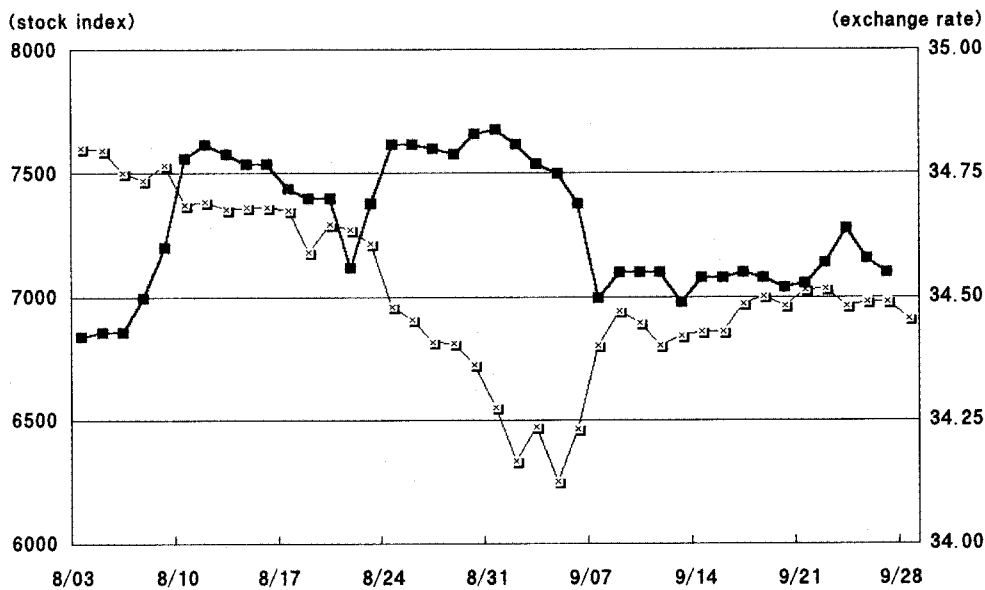
Will They Work?

It is unclear whether the recent capital controls of some Asian countries will be successful or not in the short term. The key for the success of them depends on whether these countries accomplish effective economic reform within the period of capital controls. If

they achieve this, then foreign capital will inflow into these economies gradually, because of the regained economic confidence. In addition, this might provide the foundation of the solution for Asian countries to get out of the currency crisis, and furthermore the reform of the global monetary system in future.

The current international environment is not favorable to the Korean economy. The Asian crisis has negatively affected the economies of Russia and Latin America. Developed countries, such as the U.S. and the E.U., are not safe from the financial turmoil of the emerging market economies. There is still the possible threat of another currency crisis breaking out in Korea. Should this happen, it is reasonable for policy makers to consider temporary capital controls to avoid a destructive economic meltdown in Korea. **VIP**

<Figure 3> Taiwan's Stock Index and Exchange Rate



<Figure 4> China's Stock Index and Exchange Rate

