

## ***Chapter Four***

### **THE RATIONALE FOR CAPITAL CONTROLS**

Since the outburst of the Asian currency crisis, the Chilean Model has often been cited as a success story for capital controls. (see Embong,A.R et. al.edit.2000:92-93) In the late 1980s and early 1990s, Chile was faced with increasing capital inflows. Inflows of foreign currencies increase the demand for domestic currency. Just like any other commodity, if demand exceeds supply, prices will go up. In the case of currency, it will appreciate and inflation will ensue. Appreciated currency also will ultimately have a negative effect on a country's competitive advantage in the international trade in terms of prices of export goods. In order to avoid inflation from setting-in, the Chilean government implemented capital controls in 1991. The capital controls were aimed at curbing the volatilities of short-term capital, which might upset the economy.

It is imperative for any country to have a stable economy for a variety of reasons. Unstable economy will drive away investors and have political as well as social implications. Furthermore, when the economy is stable, prices of goods and other commodities (including money) will not fluctuate erratically, and this will help to sustaining a country's export competitiveness.

Under the capital controls system, about 20-30 per cent of all external borrowing flowing into Chile had to be deposited with the central bank for one year without interest, and all capital flowing in had to stay for at least one year. This was designed to hinder short-term capital inflows, without hurting long-term investment. As a result, short- term external borrowing fell in Chile, and during the 1994-95 Mexican crisis, Chile was less affected than the other Latin American countries.(Embong A.R.2000:93)

In the case of Malaysia, as indicated earlier, during the initial stage of the crisis, Malaysia adopted a set of stabilisation measures and financial sector reforms, which were quite similar to the IMF's prescription for the other crisis-affected regional economies, though Malaysia itself was not under the IMF programme. The policy package was basically a combination of tight fiscal and monetary policy accompanied by financial sector reforms.

At the height of the crisis, it was discovered that the IMF prescriptions were counter-productive and ineffective in restoring both macroeconomics and financial sector stability. In fact, the macroeconomics and financial environment worsened causing serious difficulties to businesses and resulting in the rapid contraction in Malaysia's GDP growth.

The white paper on the status of Malaysian Economy produced by the economic Planning Unit of the Prime Minister's Department provided detailed measures taken during the initial stage which were inappropriate and brought about unintended effects to the Malaysian economy. The measures are as follows:

- 1) **Tearing of commercial banks.** The two-tier regulatory System was introduced by BNM to allow banks categorised under Tier 1 greater flexibility in their banking operations. The rapid development in loans prior to the crisis was partly associated with the policy of tearing commercial banks, which among others, was based on the value of capital. Many commercial banks borrowed to increase their capital base to qualify for the Tier -1 category. Having borrowed the capital funds, they had to lend these funds and this partly led to the rapid expansion in lending, particularly for property and shares.

- 2) **Curb on credit growth.** In the last quarter of 1997, BNM introduced measures to drastically reduce credit growth. Among them were the imposition of stringent limits on a credit plan to limit loan growth to 15 per cent by the end of 1998 and the tightening of rules on hire-purchase financing. These measures deprived even healthy corporation of investible funds and resulted in the cancellation of approved loans, causing severe liquidity problems.
- 3) **Untimely merger programme for finance companies.** BNM announced the merger programme for finance companies in January 1998. While intended to rationalise the finance companies to increase their resilience, this programme was untimely. In the midst of deepening problems in the financial sector arising from the crisis, BNM continued to embark on its credit, aggravating the liquidity problem as finance companies involved in such merger exercises stopped their lending operations temporarily to focus their efforts on the merger process.
- 4) **Increase in interest rate.** The BNM's policy to increase interest rate by raising its three-month intervention rate from 8.7 per cent at the end of 1997 to 11.0 per cent in early February 1998 was intended to address inflationary expectations, and raised the cost of loan able funds and debt service commitments. However, it caused further hardship to businesses, which were already adversely impacted by the slow-down in demand as a result of the crisis.
- 5) **Revision of NPLs from six to three months.** While intended to strengthen prudential supervision, the reclassification of NPLs as loans that have been in arrears for three months from six months previously, was untimely as it increases losses to financial institutions and weakened their lending capacity, particularly at a time when credit was most required by business entities.

- 6) **Approach used to increase liquidity.** BNM opted to lend its own funds to the banking system at prevailing market rates to address the problem of tight liquidity in the financial system. This caused unnecessary losses to banks. BNM could have instead opted to reduce the statutory reserve ratio, which was at 13.5 per cent and thus make available funds at no cost to banks.
- 7) **Cut in government expenditure.** The federal government expenditure was reduced by 18 per cent resulting in deferment of several public sector projects. This exacerbated the slow-down in economic activities.  
(NERP, 1998)

The government therefore decided to change its course of action by relaxing the fiscal and monetary policies in mid-1998. It also continued to fine-tune its policies in order to strengthen economic and financial sector fundamentals and restore domestic and external balance. The initial strong conditions in both the real economy and financial sector have allowed Malaysia to exercise greater flexibility and provided excellent scope for designing pragmatic policy measures.

The National Economic Recovery Plan (NERP) was launched in July 1998 by the National Economic Action Council (NEAC) to chart out strategies and actions to stimulate the growth of the economy. It provides a comprehensive framework for economic recovery, including steps to counter the negative effects of the ringgit depreciation and stock market collapse.

The NERP has six objectives, 40 lines of action, and over 580 detailed recommendations. The objectives are namely, to stabilise the ringgit, restore market confidence, maintain financial stability, strengthen macroeconomic fundamentals, continue the socio-economic agenda and to restore sectors badly affected by the crisis. The NERP focuses the attention and effort of the whole nation to pursue a consistent line of action for recovery.

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The recommendations include wide-ranging proposals for economic stabilisation and structural reforms as well as address socio-economic priorities and sectors affected by the crisis. Top on the priority list are actions to restore stability in the currency and capital markets, as well as to strengthen financial markets and economic fundamentals.

The NERP also recommends the easing of fiscal and monetary policies as well as lowering the cost of capital to re-vitalise the economy. To date, its recommendations are at different stages of implementation by the relevant agencies, closely monitored by the NEAC, with the release of progress reports to the public periodically.

### **Stabilising the Ringgit and Exchange/Capital Controls**

With the deepening of the financial crisis, what had initially started as a crisis in the foreign exchange market and stock market, subsequently affected Malaysia's real economy. With the GDP contracting by 6.8 per cent during the first half of 1998, Malaysia had to act fast and decisively to protect its economy. Among the important moves was the action taken to strengthen the ringgit by reducing Malaysia's over-dependence on the US dollar. (Embong A.R and Judgen Randolph eds. 2000)

The trend of increasing ringgit outflows as opposed to other foreign currencies began in April 1998. The ringgit outflow was attracted by higher interest rates of 20 to 40 per cent offered by offshore centres while onshore rate was only about 11 per cent. The strong demand for offshore ringgit at a high cost and the build-up of offshore ringgit increased its vulnerability. In view of the openness of the Malaysian economy, this trend could cause crucial damage to the real economy and affect the country's ability to conduct appropriate monetary policy based on domestic conditions.

Having initially adopted IMF-style policies, Malaysia was able to identify her shortcomings based on first-hand experience. As a result of these developments, Malaysia announced the introduction of selective exchange/capital control measures on 1 September 1998 and switched to a fixed exchange rate system pegging the ringgit at RM3.80 to one US dollar. With this, the ringgit has a legal value only within the country.

Malaysia's exchange control was announced at almost the same time as Paul Krugman's proposal for foreign exchange controls. Krugman identified the problems with the IMF prescriptions based on his theoretical analysis, and it is extremely significant that both parties came to the same conclusion independently.

However, Malaysian selective capital control has been grossly misunderstood. It is important to note that under this system, only the following items are controlled

- Ringgit-denominated transactions among non-residents via a non-resident external account.
- Outflows of short-term capital by requiring such inflows to remain in the country for a minimum period of one year.
- Import and export of ringgits by travellers, both resident and non-resident; and
- Malaysian investments abroad which now require approval, as there are insufficient funds to be taken out. Capital may, however, be raised abroad, collateralised by foreign assets.

There are no controls on :

- Current account transactions (amendment to the rules only requires trade transactions, both for goods and services, to be settled in foreign currencies and no longer in domestic currency);
  - Repatriation of interest, dividends, fees, commissions and the rental income from portfolio investment and other forms of ringgit assets; and
  - FDI inflows and outflows, including income and capital gains.
- (Okposin et.al)

Malaysia's exchange controls are therefore selective, designed to achieve the specific objective of containing speculative capital. The measures implemented do not apply to FDI and are not intended to disrupt or dislocate genuine trade-related activities. (Okposin et al.) Overall, the Government has adopted a flexible approach in the implementation of the new exchange control rules and the situation is being closely monitored. Emphasis is placed on the efficiency of the implementation process as well as the dissemination of information on this exchange control rules to provide a greater understanding. The administrative machinery is in place to provide prompt responses to requests, thus minimising disruptions and inefficiencies.

It is worth noting that the main point of the Malaysian exercise was not to target short-term capital flows in the way that the Chilean model did. Rather, it is to create some breathing space to lower interest rates to promote economic recovery by gaining room to manoeuvre in domestic monetary policy. Krugman suggested that the Malaysian capital control must be a temporary measure to support economic reform and promote a recovery of the Malaysian real economy.

## **Lower Interest Rate**

The main objective of these exchange controls is for Malaysia to regain monetary independence, and to enable the country to introduce measures based solely on domestic conditions. Prior to the introduction of the selective exchange controls, the policies were essentially, reactive to external developments, which were beyond Malaysia's control.

For example, when the economy recorded a growth of -2.8 per cent during the first quarter of 1998, it was clear that the economy needed to lower interest rates to encourage economic activities.

The imposition of exchange control regulations enabled BNM to pursue policies more aggressively such as lowering interest rates, injecting greater liquidity into the banking system and enhancing the intermediation process to support economic recovery. The average base lending rate (BLR) of commercial banks was reduced from a peak of 12.27 per cent at the end of June 1998 to 8.04 per cent in November 1998, lower than the pre-crisis rate. The statutory reserve requirement (SRR) was reduced in stages from 13.5 per cent to four per cent.

The reduction in the SRR and interest rates resulted in greater liquidity in the banking system, making available more funds to borrowers at a reasonable rate. With the reduction of interest rates, the debt service burden of the corporate sector as well as households was reduced significantly. The total loans approved by the banking system increased at an average of RM7.8 billion per month between October and December 1998 compared with an average of RM4.3 billion per month between January and September 1998. For January 1999, a total of RM7.8 billion was approved.



The selective capital controls were tied up with a low interest rate and fixed exchange rate regime. Low interest rate alone would result in a free fall of the domestic currency. This can be explained using the interest rate parity relations and the purchasing power parity. Low interest rate will result in capital outflow, i.e. Ringgit will be taken out and reinvested in another country which offers a higher interest rate.

Ringgit in other country, then will be converted to foreign denominations resulting in the oversupply of Ringgit in the market with an increase in demand of foreign currency. Increase supply of Ringgit in the market will result in further depreciation of Ringgit. In order to stop the capital flight, selective capital controls was imposed.

This means that Ringgit cannot be taken out as easily and they will not be considered a legal tender outside Malaysia. In this case, all Ringgit outside Malaysia would re-enter the country and hence any further speculation and manipulation of the Ringgit would be hindered. The fixed exchange rate would facilitate international trade, as importers and exporters would not have to scramble for prices, as fluctuation in prices of goods and services due to an unstable currency had been eliminated.

The expansionary monetary and fixed exchange rate policy to increase domestic income and support economic growth adopted by Malaysia could be explained by the **Mundell-Flemming Model**.

The **interest rate parity** and **purchasing power parity** will also demonstrate the need for capital controls and fixed exchange rate policy to support a low interest rate regime and the effective controls of the prices of goods.

### **Theoretical Perspective**

As mentioned earlier, the IMF-like policy of cutting down credit growth and reducing government spending further exacerbated economic contraction. Unregulated capital movement was also jeopardizing the economy, making it vulnerable to market manipulation. By then, the adverse effects of free market and trade liberalization have begun to surface.

After going through a period of economic contraction in the third and fourth quarter of 1997, which put the economy into a recession in the first and second quarter of 1998; and the failure of the IMF recipe to reciprocate, Malaysian decided to introduce an expansionary fiscal and monetary policy, and pegged its currency.

At that point., It would be naïve to think that using the policy influence of the orthodoxy, led by the IMF, the economic equilibrium would be achieved and normalized. Before situation got any worse, the Malaysian government intervened and imposed selective capital control measures. The purpose of taking this course of action has been discussed earlier.

Let us now look at how selective capital control policy with low interest rate regime and currency pegging can help to increase domestic income, and boost back the economy, putting it on a stronger footing.

### **Interest Parity**

The interest parity relationship results from profit seeking arbitrage activity, specifically covered interest arbitrage (Melvin. 1992.78). Let us examine how covered interest arbitrage works by going through an example. Here, we shall assume the followings:-

- $i_{RM}$  = interest rate in Malaysia
- $i_{\$}$  = interest rate in the United States
- $F$  = forward exchange rate (RM/USD)
- $E$  = spot exchange rate (RM/USD)

Where the interest rates and the forward rates are the same term to maturity (eg. 3 months or 1 year). Interest rate parity equation \* is given as follows:-

$$i_{\$} - i_{RM} = \frac{F - E}{E} \dots\dots\dots (1)$$

Using equation (1), we can plug in the known values for the interest rates and spot exchange rate and then solve for the forward rate. Assume  $i_{RM}$  = 4%,  $i_{\$}$  = 8%,  $E$  = 3.8.

Therefore,

$$\begin{aligned} 0.08 - 0.04 &= \frac{F - 3.8}{3.8} \\ (3.8) 0.04 &= F - 3.8 \\ F &= 3.8 + 0.152 \\ &= 3.952 \end{aligned}$$

This means that if Malaysia lowered its interest rates her forward exchange rate to USD would be 3.952. Hence, it would be difficult for Malaysia to adopt an independent monetary policy without capital controls.

\* to derive at the interest rate parity equation, please refer to International Money and Finance (third edition), Melvin.M.1992.(78-79).

**Purchasing Power Parity**

The relationship between the prices of goods and services and exchange rates is known as purchasing power parity (PPP). If E is the spot exchange rate (domestic currency units per foreign unit), P, the domestic price index, and P<sub>f</sub> the foreign price index, the absolute PPP relation is written as,

$$P/P_f = E \dots\dots\dots (2)$$

$$P = EP_f \dots\dots\dots (3)$$

Equation 3 is called the law of one price and indicates that goods sell for the same price worldwide. For instance, if a pair of shoes is sold for USD50 in the United States and £20 in the UK. If the \$/£ exchange rate is \$2.50 per pound, then  $P = EP_f = (2.50) (20) = \text{USD}50$ .

During the currency crisis, Malaysia wanted to stabilize the prices of goods while keeping inflation low. However, in a low interest rate regime and massive capital outflow, one would expect exchange rate, E to increase. Going by equation 3, the domestic price index, P will also increase significantly. Hence, the PPP also demonstrates the need to institute capital control measures in order to control severe increases in the prices of goods during the currency crisis that would result in stagflation and the worsening of the economy.

**Mundell Flemming Model**

By using the **Mundell Flemming Model**, (BP – IS – LM curve) we will examine why capital control is a pre-requisite in order to achieve an effective monetary policy in changing domestic income with fixed exchange rate. We shall also see how expansionary fiscal policy with fixed exchange rate can be effective in changing domestic income. Because of their irrelevancies, fiscal and monetary policy under floating exchange rates regime will be excluded in this discussion.

## Monetary Policy Under Fixed Exchange Rates

In deriving the Balance of payments (BP) curve, we assumed that higher interest rates in the domestic economy would attract foreign investors and decrease the capital account deficit. With fixed exchange rates, the domestic central bank is not free to conduct monetary policy independent of the rest of the world. If assets are perfect substitutes, then they must yield the same return to investors. With fixed exchange rates, this means that the domestic interest rate will equal the foreign interest rate.

If capital is perfectly mobile, then any deviation of the domestic interest rate from the foreign rate would cause investors to attempt to hold only the high return assets.

Clearly, in this case there is no room for central banks to conduct an independent monetary policy under fixed exchange rates.

Figure 10 illustrates this situation. With perfect asset substitutability, the BP curve is a horizontal line at the domestic interest rate  $i$ , which equals the foreign interest rate  $i_F$ . Any rate higher than  $i_F$  results in large (infinite) capital inflows, while any lower rate yields large capital outflows. Only at  $i_F$  is the balance-of-payments equilibrium obtained.

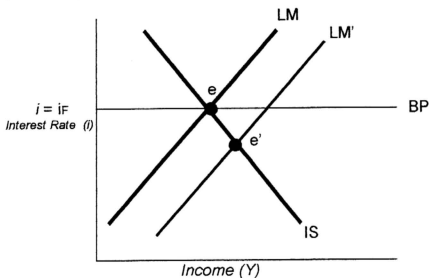


Figure 10: Monetary expansion with fixed exchange rates.

Suppose the central bank increases the money supply so that the LM curve shifts from LM to LM'. The IS-LM equilibrium is now shifted from  $e$  to  $e'$ . While  $e'$  results in equilibrium in the money and goods market, there will be a large capital outflow and large official settlements balance deficit.

This will pressure the domestic currency to depreciate on the foreign exchange market. To maintain the fixed exchange rate, the central bank must intervene and sell foreign exchange to buy domestic currency.

The foreign exchange market intervention will decrease the domestic money supply and shift the LM curve back to LM to restore the initial equilibrium at  $e$ . With perfect capital mobility, this would all happen instantaneously, so that no movement away from point  $e$  is ever observed. Any attempt to lower the money supply and shift the LM curve left would have just the reverse effect on the interest rate and intervention activity.

With less than perfect capital mobility, the central bank has some opportunity to vary the money supply. Still, the maintenance of the fixed exchange rate will require an ultimate reversal of policy in the face of a constant foreign interest rate. The process is essentially just drawn out over time rather than occurring instantly.

### **Fiscal Policy Under Fixed Exchange Rates**

A change in government spending or taxes will shift the IS curve. Suppose an expansionary fiscal policy is desired. Figure 11 illustrates the effects. With fixed exchange rates, perfect asset substitutability, and perfect capital mobility, the BP curve is a horizontal line at  $i = i_F$ . An increase in government spending shifts the IS curve right to IS'. The domestic equilibrium shifts from point  $e$  to  $e'$ , which would mean a higher interest rate and higher income.

Since point  $e'$  is above the BP curve, the official settlements balance of payments moves to a surplus because of a reduced capital account deficit associated with the higher domestic interest rate.

To stop the domestic currency from appreciating, the central bank must increase the money supply and buy foreign exchange with domestic money. The increase in the money supply shifts the LM curve right. When the money supply has increased enough to move the LM curve to  $LM'$  in Figure 14.6, equilibrium is restored at point  $e''$ . Point  $e''$  has the interest rate back at  $I = i_F$ , and yet income has increased.

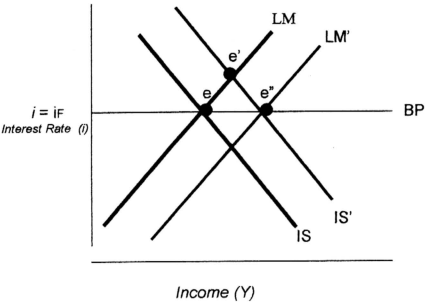


Figure 11 : Fiscal expansion with fixed exchange rates.

This result is a significant difference from the monetary policy expansion considered in the last section.

With fixed exchange rates and perfect capital mobility, monetary policy was seen to be ineffective in changing the level of income. This was because there was no room for independent monetary policy with a fixed exchange rate. In contrast, fiscal policy will have an effect on income and can be used to stimulate the domestic economy.

Mundell and Flemming assumes an open economy and perfect capital mobility, where with fixed exchange rates, a country cannot conduct an independent monetary policy to shift domestic income, whereas, fiscal policy is effective in changing domestic income under a fixed exchange rate policy.

Mundell and Flemming also demonstrated that, with floating exchange rates, monetary policy is effective in changing domestic income while fiscal policy changes tend to be offset by the balance of payments, so that crowding out occurs and income is unaffected. (Melvin 1992:229). Hence, from Mundell-Flemming model, adopting only expansionary monetary policy and fixed exchange rate regime cannot spur domestic income. That is the rationale for Malaysia to impose selective capital controls, so that it can adopt an independent (expansionary) monetary policy to increase domestic income, and at the same time rejuvenating the economic growth of the country.