British Council – University of Essex Seminar
24 April 2004

Capital Controls: The Malaysian Experience and Economics

(Panellist Comment)

Alexander Mihailov
University of Essex

Plan of Talk

- Capital Controls: Economics
- Capital Controls: The Malaysian Experience
- Capital Controls: Lessons and Prospects

Capital Controls: Economics

- **why capital mobility**
  - efficiency: cheaper financing of investment
  - diversification: of insurable risks => consumption smoothing
  - competition: capital markets discipline governments
- **sequencing of the opening of the capital account**
  - productive use (+ technological spillover + job creation + export enhancement) matters: FDI over portfolio flows
  - time matters: long-run over short-run flows
  - direction matters: inflows over outflows
- **capital controls:** the state of the art is somewhat disappointing
  - no well-accepted coherent theory, notably on the short-run implications
  - results very specific to analytical models or case studies

Capital Controls: Metaphors

- **the highway analogy** (Jeffrey Frankel)
  - open financial markets are like highways: you get faster
  - but accidents occur, and tend to be bigger than before
  - which does not mean that highways are bad, simply:
    - drivers need to learn to drive carefully
    - society needs speed limits, and
    - cars need air bags
  - capital controls are like speed bumps and posted speed limits when coming into a town, although not on the highway
- **the impossible trinity:** one excuse to impose capital controls
  - monetary independence
  - fixed exchange rate regime
  - capital mobility

Capital Controls: The Malaysian Case

- **policy:** does not imply a clear conclusion
  - September 1998: capital controls introduced as
    - comprehensive, but
    - selective
  - temporary measure
    - crisis prevention role
    - the strictest ingredients lasted less than a year
- **economics/econometrics:** not a clear conclusion either
  - effect is difficult to isolate econometrically
  - success, whenever claimed, concerns the short run

Capital Controls: Malaysia in Research

- **Kaplan-Rodrik (2001):** time-shifted difference in differences
  - success relative to the IMF programme alternative
    - immediate reduction in interest rates
    - stabilising the currency
    - stemming financial panic
  - two channels
    - standard Keynesian policy: demand reflation through monetary-fiscal mix
    - removal of uncertainty on the financial system and the exchange rate
  - three affirmative answers
    1. Were controls effective in segmenting financial markets?
    2. Did they allow a speedier recovery relative to an IMF alternative?
    3. Did they allow the leadership to do politically nasty things?
- **Prasad-Rogoff-Wei-Kose (2003):** thinking at the IMF

Capital Controls: Looking Further

- **lessons:** more agreement on
  - sequencing of financial-sector reforms
    1. domestic financial liberalisation
    2. opening of the capital account
  - reconsideration on the role of capital controls under way
    - in policy-oriented research
    - even at the IMF
- **prospects:** more research on
  - the role of financial integration in economic growth and development
  - what capital account policies should developing countries design
    - in general
    - during episodes of crisis prevention or management