Capital Controls: The Malaysian Experience and Economics

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I. Capital Controls: Economics

Capital controls have long been an instrument of economic policy, even in the industrialised countries before the 1980s. But – by analogy with free trade in goods – mainstream economic theory has since then generally shifted to a defence of unrestricted capital movements as beneficial over the long run.

The usual textbook arguments in favour of capital mobility, e.g. Caves, Frankel and Jones (2002), are embodied in three effects, which I would denote as:

- *efficiency* effect: investment can be financed more cheaply by borrowing from abroad than out of domestic saving alone;
- *diversification* effect: both domestic and foreign economic agents are able to better diversify away insurable risks, thus smoothing consumption;
- *competition* effect: international capital markets discipline domestic financial institutions and governments.

The financial crises of the 1990s have however confirmed that, in the real world, global financial markets do not operate as perfectly as assumed in theory. Therefore, *sequencing of the opening of the capital account* has more recently been recommended to developing and transition economies with only emerging markets, hence with weaker institutions and fundamentals. This sequencing usually favours:

- *FDI* over portfolio flows;
- *long*-run over short-run flows;
- *in*flows over outflows.

In essence, the motivation is that such countries should not introduce *capital account convertibility* – by opening the "financial account"[2] in the balance of payments – before domestic reforms have strengthened their financial sectors.

To describe capital controls, Jeffrey Frankel and other economists have often used *the highway analogy*. According to this latter metaphor:

- open financial markets are like highways: you get fast where you want;
- 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;

[1] Preliminary notes for a panellist comment at the joint British Council – University of Essex Seminar on *Capital Controls in Financial Crises: The Malaysian Experience*, Colchester, 24 April 2004. The usual disclaimer applies. Remarks and suggestions are welcome at mihailov@essex.ac.uk.
[2] The more precise notion now corresponding, according to IMF methodological guidelines, to the earlier term "capital account" still in use.

- capital controls are like speed bumps and posted speed limits when coming into a town, although not on the highway.

A reason to impose controls on all capital account transactions is sometimes related to *the "impossible trinity"* doctrine in economics: a country cannot have

- monetary independence,
- fixed exchange rate
- and capital mobility

at the same time. Hence, by relinquishing the third objective, domestic interest rates can be decoupled from foreign ones, simultaneously with maintaining a fixed exchange rate regime. It is well understood, of course, that such a strategy of insulation can be viable only temporarily in an interdependent world. Nevertheless, a number of (shorter-term but also long-run) issues related to capital controls are still controversial, both in theory and in policy applications.

Unfortunately, the state of the art in economics on the (short-run) implications of restricted capital mobility is at present fairly disappointing:

- there is no a well-accepted, coherent theory on (short-term) capital controls;
- there is, instead, a variety of opinions, resulting mostly from very specific
  - – analytical models, or
  - – empirical "case studies".

II. Capital Controls: The Malaysian Experience

Controversial remains, in particular, the interpretation of real-world experiences with capital controls, such as in the case of Malaysia at the turn of the century. What Malaysia imposed in September 1998 was, in fact, a rather comprehensive but *selective* (not full) and – more importantly – only *temporary* set of capital controls: indeed, its strictest ingredients have lasted less than a year.

The focus on Malaysia and its crisis management strategy in the late 1990s and early 2000s does not tell us much about the (longer-run) usefulness of capital controls either. Many economists would agree that

- even if capital controls might well have helped the country out of the crisis (in the short run),
- they have certainly not been the only factor acting in this direction, e.g. Korea and Thailand also came out of the East Asian crisis in more or less the same time as Malaysia although under alternative, IMF-supported policies.

Some observers do claim success of capital controls in the Malaysian case:

- but even these authors mostly restrict attention to the short-term, crisis management role of capital controls;
- moreover, the precise contribution of such a temporary policy measure is hard to isolate econometrically;
- and, after all, it is too early for any longer-term conclusion on the effects of these shortly employed and selective restrictions on capital (out)flows.

Athukorala (2001) concludes in a recent book that capital controls have been successful in Malaysia, "by providing policy makers with a viable setting for undertaking Keynesian reflationary policies without adverse backwash effects on FDI".

Kaplan and Rodrik (2001) also argue in an empirical paper that the Malaysian policy has been more successful than the alternative of IMF programmes as implemented in Korea, Thailand and Indonesia "in accomplishing an immediate reduction in interest rates, stabilising the currency and stemming financial panic".

- They hypothesise two channels through which this set of comprehensive yet selective and temporary capital controls "worked":
  - the standard Keynesian policy of demand reflation implemented through expansionary monetary and fiscal policies;
  - the removal of the uncertainty about the financial system and the exchange rate which had previously depressed confidence and business activity.
- Using an econometric technique known as "time-shifted difference in differences" to operationalise counterfactual analysis, they provide affirmative answers to three basic questions, which I quote below:
  - Were controls effective in segmenting financial markets, providing room for monetary and fiscal policies?
  - Did they allow a speedier recovery than would have been possible via the alternative IMF route?
  - Did they allow the leadership to do politically nasty things?

Thinking at the IMF, definitely intolerant to capital controls some five years ago, has also been shifting – largely due to the Malaysian challenge – to allowing more discretion in national policies, including the use of capital restrictions as temporary measures in times of crisis. Such evolution on policy recommendations has more or less been explicit in Prasad, Rogoff, Wei and Kose (2003). A rather perplexing conclusion from this same study concerns however the longer run: empirical evidence has been found that economic growth is enhanced by trade integration but not (necessarily) by financial integration…

III. Capital Controls: Further Research…

From the recent views on capital controls I sketched above it becomes clear that no consensus exists, in both theoretical and empirical work as well as in policy applications. I would admit that this lack of converging conclusions is due to a large extent to the complexity of the issue and the difficulty to separate the effect of capital controls itself from other effects, of economic, policy or institutional nature. It may also be the case that such effects are not the outcome of just capital controls broadly understood, but of the particular mix of their design and enforcement.

To sum up, although the long-run theoretical benefits of capital mobility seem obvious, conclusive evidence is hard to find in the data, especially in emerging markets. Economists are thus divided on the issue. Yet greater agreement now exists on sequencing first domestic financial liberalisation and then capital account opening. Reconsideration of the role of capital controls appears to be under way, even at the IMF. New research will be needed before we could say with more certainty what capital account policies developing economies should design, in general as well as during episodes of crisis prevention or management.

References

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