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Exchange Controls: The Path to Economic Recovery in Asia?

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EXCHANGE CONTROLS:
THE PATH TO ECONOMIC RECOVERY IN ASIA?

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Prepared by the economists of the Economic Analysis and Research Division, with the assistance of the Programs Departments and the Strategy and Policy Office.

Foreword

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INTRODUCTION

Exchange controls are regulations that attempt to preserve a country's international reserves by imposing limitations on the convertibility of the national currency or its movement across national frontiers. Exchange controls therefore represent an intermediate regime between total ban and total convertibility of the national currency. Mechanisms to effect exchange controls include restrictions on import financing, terms of payments (such as fixed payment delays for imports and exports), travel spending, and capital flows.

For poorer countries, historically the most important traditional objective of exchange controls has been to balance the current account. Exchange controls have also been used as instruments of commercial and industrial policy. For example, the government may subsidize certain types of investments by selling foreign exchange cheaply to selected industrial enterprises that the government is trying to promote, while selling foreign exchange for "luxury" consumption at a higher exchange rate.

Countries are often induced to move from convertibility to exchange controls when they develop strong creditor or debtor positions. But for some countries, defense of fixed exchange rate parities can lead to rapid depletion of international reserves, thereby inducing speculative activities. In the flexible exchange rate regime, where the financial markets are largely integrated, the scope for domestic policy maneuver in terms of prices and interest rates is limited. This can also lead to serious instability in the balance of payments. Imposing restrictions on currency convertibility appears to be one way for a besieged economy to preserve a degree of monetary autonomy.

Exchange controls were the rule rather than exception after the Second World War, but their use has declined over the past half century. The United Kingdom maintained comprehensive exchange controls until 1979. In the US, the interest equalization tax and in Germany, the Bondepost, have exchange control purposes.

There has been renewed interest in exchange control measures in developing Asia in the aftermath of the financial crisis, arising from the lack of success of IMF-type stabilization measures such as tight monetary and fiscal policies. While tight monetary and fiscal policies have not succeeded in restoring investor confidence or stabilizing currencies, they have prolonged economic downturns. These failures prompted Malaysia to adopt exchange controls.[1] Similar policies are now also being considered by other countries in the region as an alternative to the orthodox IMF polices.

EXCHANGE CONTROLS: MALAYSIA

Events Leading to Changes in Exchange Control Rules

With its strong economic fundamentals and long record of robust economic growth, Malaysia was expected to tide over the Asian financial crisis with minimum disruption. Unlike other Asian countries, Malaysia's external sector position was strong. But Malaysia's weak banking and financial institutions dragged the economy into the crisis. With a highly leveraged economy (loans of the banking system amounted to 168 percent of GNP in 1997, while external debt was 40 percent of GNP), Malaysia's rapid increase in interest rates in the first two quarters of 1998 prompted widespread defaults. Nonperforming loans of the banking system were officially estimated at 8.9 percent in end-June 1998, but now exceed 20 percent and are increasing. The market capitalization of the Kuala Lumpur Stock Exchange has shrunk dramatically over the last year.

In the aftermath of the regional economic crisis, the authorities adopted tight monetary policies. Bank Negara Malaysia's (BN) intervention rate (3-month interbank rate) climbed to 11 percent from the precrisis level of 7 percent. That led to a credit crunch which exacerbated the banking sector problems and led to a decline in real GDP by 2.8 percent and 6.8 percent in the first and second quarters of 1998, respectively. To arrest falling output, over the past few months, monetary policy has been gradually relaxed.

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1. Although so far, Malaysia has not required an IMF-led rescue package.

Key Features of New Exchange Control Rules

In early September 1998, the government announced sweeping changes in its exchange control rules. The salient features are:

(i) *Fixed Exchange Rate*. The central bank pegged the Malaysian ringgit (RM) exchange rate at 3.8 against the US dollar. After the onset of the regional economic crisis in July 1997, the RM had fluctuated in the range of 2.52-4.88 and immediately preceding the September changes, was trading at roughly 4.10 to a dollar.

(ii) *The RM Ceases to be Legal Tender outside Malaysia*. According to the government, the large quantity of the RM held offshore (unofficially estimated at $5-6.5 billion) is the major source of speculative trading. Therefore effective 1 October 1998, the RM held offshore would cease to be legal tender. Transfer of the RM held offshore to resident accounts in Malaysia after 30 September 1998 would require prior approval, and residents would no longer be allowed to obtain RM credit facilities from nonresident individuals.

(iii) *Restrictions on External Accounts*. Debits and credits into the external accounts (RM accounts maintained in Malaysian banks by nonresidents), which had not been subjected to any restrictions, would henceforth be subject to the following controls: (a) payments for Malaysian exports can no longer be made in the RM from an external account; (b) funds in external accounts could only be used for purchasing the RM assets in Malaysia; and (c) sources of funding for external accounts would be limited to certain specified transactions as sale of foreign currency, salaries, dividends, etc., or as proceeds from sale of RM instruments, securities registered in Malaysia, or other assets in Malaysia.

(iv) *Payment Restrictions*. The RM would continue to be convertible for current transactions. However, residents travelling abroad can pay in foreign currency through their credit cards only up to a limit of RM10,000;[2] a resident traveler can carry a maximum of RM1,000 and foreign currency equivalent to RM10,000; and prior approval requirements are needed for payments by residents to nonresidents for investments abroad in excess of RM10,000.

Free flows of foreign direct investment (FDI) and repatriation of interest, profits and dividends, and capital would continue to be guaranteed.[3] However, proceeds from the sale of a RM security that a nonresident has not held for at least one year can no longer be converted into foreign currency,[4] and RM securities held by nonresidents must be transacted through the central depository system.

EXCHANGE CONTROLS: OTHER DEVELOPING COUNTRIES

People's Republic of China

Since 1994 the People's Republic of China (PRC) has had a fixed exchange rate of yuan 8.3 per US dollar. In December 1996, the government accepted the obligations of IMF's Article VIII, and made the yuan convertible on the current account.

The PRC government has been cautious in opening up capital account transactions. Within the capital account, policies toward FDI have been more liberal than other forms of capital flows. The caution exercised by the PRC policymakers in opening up the capital account has discouraged the buildup of short-term external liabilities, and has shielded the country from the contagion of the recent Asian currency crisis. Whatever short-term capital that has flowed into the country in recent years could not be taken out easily because of capital account restrictions. However, speculation that the PRC government may devalue the yuan has led to sporadic blackmarket premia on the dollar in recent months.

2. It is not clear if this restriction pertains to a single visit abroad or applies within a timeframe.

3. Malaysia has entered into Investment Protection and Guarantee Agreements with several countries.

4. For securities purchased or deposits placed before 1 September 1998, the one-year holding period starts from 1 September 1998. After 1 September 1998, the one-year period starts from the date of purchase/placement of deposit.

South Asia

South Asia has had extensive exchange controls till the late 1980s. In liberalizing exchange controls, the South Asian countries have focused more on the current account than on the capital account. The combination of ubiquitous exchange controls and investment regulations has led to widespread corruption and rent-seeking activities in South Asia. However, in recent years, South Asia has embarked on industrial and external reforms. By the mid-1990s, most South Asian countries had achieved IMF Article VIII status of full current account convertibility. Yet despite some liberalization, the capital account remains largely constricted.

Latin America

Advocates of capital controls cite the experience of some Latin American countries. Chile's capital controls get the most positive press while Brazil and Colombia receive more mixed reviews. Argentina imposes virtually no controls on the flow of capital, relying on its currency board arrangement to counteract shifts in investor sentiment. Supporters of the Chilean approach argue that well-designed controls stabilize short-term capital inflows without affecting long-run growth.

Along with many other emerging markets, Chile experienced an upsurge in private capital flows in the early 1990s. Chile's central bank sterilized the dollar inflows, the same strategy followed by Mexico, Thailand, and the Philippines (but not by Hong Kong, China and by Argentina). That meant contracting domestic credit to keep the money supply constant. But the resulting increase in domestic interest rates drew further inflows, and increased the capital account surplus. Colombia also responded with sterilized intervention. By late 1991, however, that strategy became too costly, and Colombia abandoned intervention and permitted the exchange rate to appreciate. Brazil, with its history of active capital controls and reputation for constantly tinkering with the rules, charges a 2 percent tax on financial (generally, nontrade-related) inflows and a 0.2 percent tax on outflows. Since adopting dollar-peso convertibility in 1991, Argentina imposes no restrictions on currency trading and makes no distinction between foreign and domestic investors.

SALIENT ISSUES IN EXCHANGE RATE MANAGEMENT

Fixed Exchange Rate with Exchange Controls: Pros and Cons

The economic consequences of fixed exchange rates for small open economies have been widely debated in the economics literature. The arguments that may have influenced the Malaysian authorities in switching to fixed exchange rates with exchange controls are that it allows an expansionary fiscal/monetary policy conducive to short-term economic revival; insulates the economy from large fluctuations in the trade sector owing to the volatility of the exchange rate; and eliminates the uncertainty inherent in a flexible exchange rate regime, which makes international transactions difficult. Indeed, much of the success in trade in Southeast Asian economies is attributed to the de facto fixity of currency values.

There are several downside risks arising from a combination of exchange controls and a fixed exchange rate regime. First, a blackmarket in the currency could speedily develop if the exchange rate fixed by the central bank is unrealistically pegged. An artificially appreciated exchange rate may also encourage capital flight through underinvoicing of exports and overinvoicing of imports. Second, if the nominal exchange rate is not adjusted from time to time, there may be an adverse impact on exports. Third, unofficial channels to export the local currency out of the domestic economy may develop to exploit arbitrage opportunities, should the domestic interest rates be dramatically lowered. Fourth, while the exchange control policy may lead to lower interest rates, this outcome is not an unmixed blessing. Lowering of domestic lending rates to revive the corporate sector may at the same time compress the margins currently available to domestic banks, thereby exacerbating the financial sector problems by reducing banks' profitability.

Currency Board: Pros and Cons

A currency board arrangement (CBA) is a fixed exchange rate (FER) system that allows full convertibility at the pegged rate. It, however, differs from conventional pegs in the nature of the restrictions it sets on changes to the level of the exchange rate and the sources of reserve money creation. In a CBA, changes in the exchange rate have to be accompanied by proportional changes in foreign reserves, which is not necessary in the FER system. Also, since CBAs cannot hold domestic assets, the monetary base is entirely determined by the holdings of foreign exchange reserves.

The CBA is attractive because of its administrative and operational simplicity; credibility of monetary and fiscal policies; and currency stability, interest rate convergence, and development of well-functioning financial intermediaries. Because of the low risk premium on interest rates, low exchange rate uncertainty, and orderly monetary conditions, long-run international trade and access to world capital markets are facilitated.

The weaknesses of the CBA are the mirror image of its strengths. The commitment to preserve the peg is an asset during times of currency crises, but is an obstacle during periods of real exchange rate misalignment. Correction of the misalignment typically results in a period of tight liquidity and high unemployment. The absence of borrowing privileges from the currency board authority can lead to a liquidity crunch. Downwardly rigid wages can bring about high unemployment in the economy.

Fixed Exchange Rate with Exchange Controls versus Currency Board

In contrast to a fixed exchange rate system with a central bank, the CBA does not acquire domestic assets, preventing it from financing fiscal policy, sterilizing reserve flows, or otherwise engaging in discretionary monetary policy. In a regime with restricted capital mobility and an adjustable peg, interest rate volatility is less and monetary policy more independent in comparison to a CBA.

In the adjustable peg regime, the authorities are required to make the difficult judgment of when and how to adjust the currency. If the market disagrees with their judgment on the size of the adjustment, further uncertainty is created. Even if the market goes along with the decision, there remains a question of whether the amount of the exchange adjustment will ultimately be adequate to correct the real exchange rate misalignment. Therefore, because devaluing or abandoning the CBA entails a substantial loss of credibility, exchange rate misalignments are a more serious problem for CBAs.

As a means of fighting inflation, CBAs can be more effective than FER arrangements when the monetary authorities' reputation has been weakened by a history of accommodative monetary policy, lax fiscal policy, and failed stabilization. By providing clear signals about the policy intentions of the authorities, CBAs facilitate an adjustment of expectations and promote wage and price discipline, thereby lessening potential inflation biases.

CBAs are less prone to policy reversals than conventional fixed pegs without capital controls. In a CBA, interest rates are expected to converge to levels in the reserve currency country and remain close to international levels. As a result, the long-run risk premium on interest rates is lowered and this promotes international trade and financial transactions. Cross-country evidence with CBAs suggests that there is a greater impetus for overall strengthening of policies, in comparison to fixed exchange rate systems.

As with conventional pegs, fixing the exchange rate in a CBA implies that the economy is more vulnerable to shocks or changes in the value of reserve currency in relation to the currencies of the other trading partners. For example, Hong Kong, China's inflation during the 1990s was partly a result of low nominal interest rates imported from the US, when in fact nominal rates should have been higher due to the asset price boom and economic expansion.

Strong macroeconomic policies are crucial for establishing and sustaining a CBA. A CBA's key function is to enhance policy credibility, but credibility cannot be maintained without fiscal discipline. In the case of Malaysia, the government in September 1997 started using expenditure policy to support the property and stock markets. Due to these actions, the government lost credibility on fiscal policy. These actions were in direct conflict with the Central Bank reform package limiting the risk-taking behavior of banks put in place in April 1997. As a result, both the government and the central bank had little credibility.

To maintain a CBA, a strong fiscal position can facilitate the accumulation of foreign reserves necessary for averting speculative attacks, which can be frequent because of the close integration of

CBAs with capital markets. In Malaysia, since fiscal discipline and government credibility in general were lacking, it is likely that a CBA's longevity would be suspect.

The success of a CBA also depends on the soundness of the banking system. If banks are unable to meet demands for deposit withdrawals, this would put pressure on the authorities to provide liquidity support to banks, which may undermine the CBA. In Malaysia, banks were heavily exposed to the property and equity markets, a fact which implies that they would not be able to sustain large deposit withdrawls. Therefore, because of a weak banking system and the ensuing high interest rates associated with a CBA, the CBA is likely to be unsustainable in Malaysia.

EXCHANGE CONTROLS: DESIRABILITY, EFFECTIVENESS, AND LESSONS FROM THE DEVELOPING WORLD

Current Account

The motivation behind controls on the current account is manifold such as building up foreign exchange reserves, directing import credits to favored industries, and curtailing outflows of foreign exchange remittances.

One of the most frequently used channels to evade exchange controls on the current account has been underinvoicing and overinvoicing of exports and import contracts. To shift funds abroad, an exporter (importer) would underinvoice (overinvoice) a foreign customer and then use these funds to invest in external assets.

Transfer pricing policies of multinational companies provide a similar means of evading exchange controls.[5] Prior to an anticipated exchange rate adjustment, changes in transfer prices and the leading and lagging of intracompany transfers provide a means of shifting funds in and out of the country.

5. Transfer pricing refers to the price of inputs bought from the parent company and the price of goods sold to the parent company by the local subsidiary.

Another trade-related channel for unrecorded capital flows has been the leads and lags in the settlement of commercial transactions or variations in the terms offered on short-term trade credits. Monitoring and enforcing restrictions on trade financing is difficult, but if successful can also eliminate the perceived advantage of capital controls, primarily shielding current account transactions from erratic exchange rate fluctuation.

Evidence from PRC and India suggests that the proper sequencing of current and capital account convertibility is crucial in reaping the benefits of global integration without exposing the economy to external shocks. In liberalizing exchange controls, PRC and India liberalized the current account, strengthened the financial sector and liberalized interest rates, then liberalized the capital account as the last stage. In this way, volatility of short-term capital flows and the possible balance of payments crisis were avoided, while reducing pressure on the currency.

Capital Account

The motivation behind the imposition of controls on the capital account is essentially threefold: to assert monetary autonomy; to avert a balance of payments crisis or unstable exchange rates arising from volatile short-term capital flows; and to ensure that domestic savings in developing countries are used to finance domestic investment rather than acquisition of foreign assets.

First, controls can provide some degree of monetary policy autonomy under a FER system. When government monetary and credit policies are consistent with the peg, the likelihood of a "self-fulfilling" balance of payments crisis is diminished. In the event that these government policies are inconsistent with the peg, exchange controls can prevent speculative attacks on foreign reserves in the short run. In the long run, reserve depletion can occur through the current account channels (since it is difficult to monitor underinvoicing and overinvoicing of export and import contracts).

Second, exchange controls may have only a limited effect in reducing the volatility of capital flows. Effective control of speculative capital requires control of current transactions, because capital transactions can be easily camouflaged as current transactions and vice versa. Forward foreign exchange operations, moreover, provide another means for evasion. It is difficult to monitor the magnitude and concentration of these transactions on a current basis as well.

Third, even if exchange controls limit the acquisition of foreign assets, these still might do little to increase or sustain the availability of savings for domestic capital formation. This is because domestic financial instruments carry relatively uncertain and low rates of return and residents cannot acquire foreign assets, they often respond either by reducing their overall level of savings or holding their savings as inflation hedges, such as in real estate or inventories.

Empirical evidence suggests that capital controls were effective in Chile and Colombia at least in the short run, either in reducing the volume of capital inflows/outflows and/or affecting their composition. The longer the controls persist, however, the greater the chances that they will be ineffective. The more integrated an economy becomes, and the greater the array of instruments, including derivatives, the easier it will be to circumvent controls.

ASSESSMENT AND CONSEQUENCES OF EXCHANGE CONTROLS IN MALAYSIA

The Malaysian government's efforts to stabilize the economy through a combination of monetary and fiscal policies have so far not yielded the desired results. Sustained high domestic interest rates, which were considered necessary to contain the pressure on the RM, appeared to accentuate the corporate sector distress that led to a worsening of the asset quality of the banking system, which was then constrained in its financial intermediation role. In this manner the problems of the banking and the corporate sector fed on each other and posed a monetary policy dilemma before the government. On the premise that economic fundamentals in Malaysia were basically sound, and perhaps persuaded by social and political considerations, the government recently adopted exchange control measures to insulate the domestic monetary policy from the external sector. These measures may assist the government in the near term in its efforts to revive the economy by using the stimulative influence of lower interest rates.

A more cautious view should be taken for the medium and the long term. It is hoped that the temporary reprieve expected to be provided by the exchange control measures will be utilized by the government to address, rather than ignore, the macroeconomic and structural weaknesses of the economy. Issues requiring immediate attention of the government include: (i) large buildup of risk in the banking institutions owing to their preponderance (or conversely, underreliance on the debt securities market) in intermediation of investible funds; (ii) large exposure of the banking institutions to the property sector; (iii) overwhelmingly short-term nature of the domestic debt of the corporate sector (estimated to be about 70 percent of the total debt); (iv) large explicit and implicit exposure of the government in private infrastructure projects; and (v) weak domestic linkages of the export sector. Backtracking on financial sector reforms (there are already some indications of rollback of the reforms), and in particular scaling back the prudential standards for the banks, would jeopardize prospects for generating sustained economic growth in the medium and long term.

Exports have been the driving force for the spectacular growth performance of the Malaysian economy. An overvalued real effective exchange rate would erode the competitive strength of exports and exacerbate the pressure on the current account. The exchange controls, while providing short-term relief on the negative pressures on the current account deficit and on the international reserve position, do not provide long-term solutions to these issues. In fact, if exchange controls are not removed in time, external capital inflows will suffer significantly. The experience of countries with exchange controls suggests that a plethora of rules to implement such controls and to plug leakage soon require a huge administrative infrastructure, which may not necessarily be readily available in Malaysia. Without such an apparatus, exchange controls may offer ripe ground for rent-seeking and pervasive corruption. Finally, in the case of Malaysia, which is now embroiled in a political imbroglio, whether this experiment with exchange controls succeeds or not will depend to a large extent on how the political dilemma is resolved, as political issues impinge in significant ways on investor confidence.

CONCLUSION

The experience of developing Asia and Latin America suggests that exchange controls are neither desirable nor effective long-term instruments for macroeconomic stability and economic growth. They are not desirable from a global perspective because they create market fragmentation. On an individual country level, they create additional distortions in the economic system, which may reduce economic growth.

Exchange controls that are misaligned with the macroeconomic fundamentals of the economy can lead to widespread arbitrage, rent-seeking, and eventual evasion of the controls. The evidence from Latin America and developing Asia suggests that in spite of significant exchange controls, there were substantial linkages between domestic and external markets that rendered exchange controls largely ineffective. As many international financial transactions are difficult for the governments to monitor and hence to enforce the regulations, the incidence of evasion of exchange controls has been widespread. This lack of effectiveness in enforcing exchange controls has in the past resulted in underinvoicing and overinvoicing of exports and imports, diversion of domestic savings for consumption or unproductive speculative investments, and widespread illegal activities such as laundering funds, as the differences between domestic and foreign returns to capital widen.

Despite the ineffectiveness of exchange controls as a long-term instrument of macroeconomic stability, they may be effective as a short-term measure in ensuring economic stability. Given that exchange controls act as a brake on unfettered expenditure on imports and the unhindered movement of capital across borders, they can help to constrict the total value of imports and the outflow of capital, thereby avoiding an impending balance of payments crisis.

In the aftermath of the Asian financial crisis, policymakers are considering other possible alternatives to IMF-type policies. An alternative to exchange controls for ensuring macroeconomic stability and reviving growth, which has often figured prominently in recent policy discussions, is a CBA. Under a CBA, monetary and fiscal policy autonomy is circumscribed. CBAs are suitable for countries with a track record of credible and independent central banks, solvent financial institutions with minimal exposure to speculative investment activities, and the ability to adjust wages and other factor prices in response to real exchange rate misalignments.

In Malaysia, given the somewhat low credibility of the central bank and the government at this time, the high exposure of banks to the property and equity markets, and downwardly rigid wages, a CBA is neither feasible nor sustainable. A fixed exchange rate system with exchange controls could be a more viable alternative in response to external shocks, but only as a short-term measure. Over the longer term, the best bet for revival of the country's economic prosperity and restoration of macroeconomic stability lies in energizing the reform process, which encompasses strengthening the financial institutions and liberalizing the economy, including dismantling exchange controls and adopting a more market-based exchange rate system. In short, the key to Malaysia's long-term economic prosperity is in more comprehensive reform, including that of the banking and corporate sectors, and return to fuller integration with the global trading and financial system. This is an important lesson applicable not only to Malaysia but also to other countries in Asia that are besieged by the economic crisis.

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