18 CAPITAL CONTROL : AN EXPERIENCE OF INDONESIA, KOREA, INDIA , MALAYSIA AND THAILAND

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ABSTRACT

There is a substantial controversy about the role of capital controls. Prior to the Asian Crises in 1997 and recession in the western part of the world in 2008, the predominant view among economists was that controls on capital flows were generally bad. After the crises, there has been more disagreement about the role of capital controls. Of late even economist in IMF also agrees that some form of capital controls is good for the stability of the economy. In the transitional period capital controls may play a role in insulting the economy from volatile capital flows and provide a country time to strengthen initial conditions. In the post liberalization period transitional controls cannot be ruled out. Capital controls cannot be a substitute for sound macroeconomic policies, financial sector reform and effective prudential regulation and enforcement. The objective of this article is to highlights the experience of the Indonesia, Korea India ,Malaysia and Thailand regarding capital controls.

Keywords: Capital Controls, Crises, Capital Account Convertibility, Exchange rate policy.

INTRODUCTION

Today there is a substantial controversy about the role of capital controls. Prior to the Asian Crises in 1997 and recession in the western part of the world in 2008, the predominant view among economists was that controls on capital flows were generally bad. After the crises, there has been more disagreement about the role of capital controls. Many blamed capital mobility rather than national policies for the crises. During the 1997 crises and recently in 2008 recession, India and China were largely left untouched and some argued this was because they had substantial controls(one of the reason). Although there are certain others factors which left these two countries untouched from the recession of 2008, but the objective of this paper is not to discuss this issue.

Developing countries by large use a variety of controls to restrict and regulate the movement of capital. It is meaningful to segregate controls by the objective to which they can be assigned. Controls can be targeted to deal with balance of payments pressures and macroeconomic disturbances generated by volatile capital flows or can be designed to prevent flows from disrupting stabilization and structural reforms. Controls can be put into place to ensure that domestic saving is used to finance domestic investment and to limit foreign ownership of domestic factors of production and may also targeted to enhance the authorities ability to tax domestic financial activities and wealth[1].

OBJECTIVE AND METHODOLOGY

The objective of the paper is list down the experiences of major east Asian economics namely Indonesia, Korea India, Malaysia and Thailand regarding capital controls. More over how these capital controls measures helps them in liberalization of the capital account convertibility, sequencing of reforms, facing the Asian crises and thereafter.

The paper is descriptive in nature. It achieves the above mentioned objectives by comparing the capital controls measures adopted by the above mentioned economies.

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[1] Johnston and Tamirisa (1998) examine the structure and determinants of capital controls based on a crosssectional study of developing and transitional countries. They categorize capital controls by analytical purposes as being related to the balance of payments, macroeconomic management, market and institutional evolution, prudential and other factors. They find no robust relationship of capital controls with the balance of payments.

This paper is divided is into following sections. Section 2 lists out the various papers in which capital control is defined. Section 3 types of capital controls Section 4 articulate the lessons from the experiences of some countries namely Indonesia, Korea India, Malaysia and Thailand regarding capital controls and Section 5 finally concludes.

CAPITAL CONTROLS: PRUDENCE VS. CONTROL

The capital account liberalization experience primarily aims at liberalizing controls that hinder the international diversification of domestic savings in a portfolio of home assets and foreign assets and allows agents to reap the advantages of diversification of assets in the financial and real sector.

A working definition of capital account convertibility (CAC) is 'the freedom to convert local financial assets into foreign financial assets and vice versa at market determined rates of exchange. It is associated with changes of ownership in foreign/domestic financial assets and liabilities and embodies the creation and liquidation of claims on, or by the rest of the world. CAC can be, and is, coexistent with restrictions other than on external payments. It also does not preclude the imposition of monetary/fiscal measures relating to foreign exchange transactions which are of a prudential nature.[2]

As the definition indicates, capital account convertibility is compatible with prudential restrictions. Temporary measures to insulate an economy from macroeconomic disturbances caused by volatile capital flows are in accord with an open capital account.

It aims at allowing the country to reap the advantages of the inflow of foreign savings, information and technology. The benefits of capital mobility come with certain risks. These risks can be categorized into credit risk, interest risk and exchange rate risk and liquidity risk. There is the additional risk of herding and contagion in international financial markets. The ordering and degree of liberalization is a fine balance between removing the impediments in the way of efficient international financial intermediation as part of the overall reform process and introducing and maintaining prudential standards and the supervisory to contain the risks of international financial intermediation. This is especially relevant as the growing experience with financial market integration indicates that financial markets are imperfect and subject to information asymmetries[3].Theoretical literature does focus on capital market restrictions as welfare enhancing in an imperfect financial world[4].

Theory as well as practical experience points to the legitimacy of using capital controls of a prudential nature and stronger disclosure and prudential standards.

In the transitional period capital controls may play a role in insulting the economy from volatile capital flows and provide a country time to strengthen initial conditions and allow the authorities to use discretionary policies in the pursuit of this objective. Even in the post liberalization period transitional controls cannot be ruled out. For example, the OECD Code of Liberalization for Capital movements provide for transitional arrangements for retaining controls if a members economic and financial situation does not justify liberalization and also in order to contain adverse developments in the balance of payments[5].

Certain advanced economies have retained some selective control of capital movements in accordance with their domestic financial sector development and array of financial instruments, as well as sectoral and strategic considerations. Caution needs to be exercised with the use of controls. Although restrictions for managing macroeconomic disturbances are legitimate, the evidence based on country experiences in Ariyoshi, A. et al. (1999), and the survey of crises in Kaminsky, Lizondo, and Reinhart (1998) indicate that capital controls cannot be a substitute for sound macroeconomic policies. Moreover, a crisis can take place both with a closed or open capital account. Closing the economy does not necessarily mean, that

[2] Reserve Bank of India, (1997) Report of the Committee on Capital Account Convertibility, Mumbai, p.4.

[3] Eichengreen et al. (1999). for a discussion on asymmetries.

[4] Dooley, M. (1996). "A Survey of Controls over International Capital Transactions", IMF Staff Papers, vol. 43, no. 4, December.

[5] Quirk and Evans (1995) for the industrial experience with capital account liberalization. These authors discuss the effectiveness of controls designed to contain disturbances in the industrialized countries. They conclude that the effectiveness of actions following the 1992 ERM crisis seems likely to have been short-lived.

a country can escape disaster. Even stringent controls that were strictly administered did not always protect a country from a balance of payments or financial crisis.

The international experience with capital controls highlights that in the short run capital controls may under some conditions provide a brief respite to deal with disturbances or working out a transition phase but over the long run capital controls become ineffective, costly and even distortive. The existence of international arbitrage opportunities has rendered capital controls ineffective. Capital flight has been a feature of almost the entire developing world. Apart from the loss of capital through capital flight the existence of capital controls encourage financial market repression, and inefficiencies in the financial intermediation process. Black markets in foreign exchange, lack of ability to manage interest rate and exchange risk are only some of the problems. Essential institutional and structural reforms are postponed so that the costs of capital controls become prohibitive. They may even provide greater opportunities for corruption.

TYPES OF CAPITAL CONTROL

Broadly controls can broadly be grouped into two categories - direct or administrative

controls and indirect or market based controls. The former range from outright prohibition or discretionary approval procedures for cross-border transactions. The latter are price based instruments designed to effect price and sometimes both price and volume Administrative controls usually imply an outright prohibition on cross-border transactions. In many cases a discretionary approval procedure may be in place. Market based controls are designed to regulate the flow of liquidity through the price mechanism by making them more costly. The desired effect can be attempted through variety of measures. For instance, through implicit or explicit taxation, reserve requirements, interest rate ceilings, dual or multiple exchange rate systems or discrimination between transactions and investors.

(a) Direct or administrative capital controls restrict capital transactions and/or the associated payments and transfers of funds through outright prohibitions, explicit quantitative limits, or an approval procedure (which may be rule-based or discretionary). Administrative controls typically seek to directly affect the volume of the relevant cross-border financial transactions. A common characteristic of such controls is that they impose administrative obligations on the banking system to control flows.

(b) Indirect or market-based controls discourage capital movements and the associated transactions by making them more costly to undertake. Such controls may take various forms as following[6]:

1. **In dual (two-tier) or multiple exchange rate systems,** different exchange rates apply to different types of transactions. Two-tier foreign exchange markets have typically been established in situations in which the authorities have regarded high short-term interest rates as imposing an unacceptable burden on domestic residents, and have attempted to split the market for domestic currency by either requesting or instructing domestic financial institutions not to lend to those borrowers engaged in speculative activity. Foreign exchange transactions associated with trade flows, FDI, and usually equity investment are excluded from the restrictions. In essence, the two tier-market attempts to raise the cost to speculators of the domestic credit needed to establish a net short domestic currency position, while allowing non-speculative domestic credit demand to be satisfied at normal market rates. Two-tier systems can also accommodate excessive inflows and thus prevent an overshooting exchange rate for current account transactions. Such systems attempt to influence both the quantity and the price of capital transactions. Like administrative controls, they need to be enforced by compliance rules and thus imply administration of foreign exchange transactions of residents and domestic currency transactions of non-residents to separate current and capital transactions.

2. **Explicit taxation of cross-border flows** involves imposition of taxes or levies on external financial transactions, thus limiting their attractiveness, or on income resulting from the holding by residents of foreign financial assets or the holding by non-

[6] *Source:Ariyoshi et al. (1999) Country Experiences with the Use and Liberalisation of Capital Controls. IMF, advance copy.*

residents of domestic financial assets, thereby discouraging such investments by reducing their rate of return or raising their cost Tax rates can be differentiated to discourage certain transaction types or maturities. Such taxation could be considered a restriction on cross- border activities if it discriminates between domestic and external assets or between non-residents and residents.

3. **Indirect taxation of cross-border flows, in the form of non-interest bearing compulsory reserve/deposit requirements** (URR hereafter) has been one of the most frequently used market-based controls. Under such schemes, banks and non-banks dealing on their own account are required to deposit at zero interest with the central bank an amount of domestic or foreign currency equivalent to a proportion of the inflows or net positions in foreign currency. URRs may seek to limit capital outflows by making them more sensitive to domestic rates. For example, when there is downward pressure on the domestic currency, a 100 percent URR imposed on banks would double the interest income forgone by switching from domestic to foreign currency. URRs may also be used to limit capital inflows by reducing their effective return; and they may be differentiated to discourage particular types of transactions.

4. **Other indirect regulatory controls** have the characteristics of both price- and quantity-based measures and involve discrimination between different types of transactions or investors. Though they may influence the volume and nature of capital flows, domestic monetary control considerations or prudential concerns may at times motivate such regulations. Such controls include: provisions for the net external position of commercial banks, asymmetric open position limits that discriminate between long and short currency positions or between residents and non-residents; and certain credit rating requirements to borrow abroad. While not a regulatory control in the strict sense, reporting requirements for specific transactions have also been used to monitor and control capital movements (e.g., derivative transactions, non-trade related transactions with non-residents).

LESSONS FROM COUNTRY EXPERIENCE

INDONESIA

Background

In 1985, Indonesia initiated a reform program that was intended to reorient the economy away from its dependence on the oil sector and towards an internationally competitive industrial export sector that could help absorb the growing labour force. This objective required reform on a broad front, including the liberalization of direct investment flows to promote export diversification, maintenance of a competitive exchange rate, trade liberalization, improvements in monetary management and strengthening the financial sector.

Sequencing of reforms

Indonesia accepted Article VIII obligations to liberalize payments for current international transactions in 1988. On the capital account, Indonesia maintained selective controls on both capital inflows and outflows. The financial sector was reformed in phases from interest rate reform in the early 1980s to a greater emphasis on accounting standards and prudential regulation in 1995-96.

Exchange rate policy

The rupiah floated freely in a trading band of +/-8 percent (immediately before rupiah floated in July 1997 this band was widened to +/-12 percent). Indonesia's real effective exchange rate remained remarkably stable over the 1987-1997 period.

Capital controls

On the inflow side, selective controls were maintained on direct investment (domestic ownership requirements), portfolio investment (purchases of equity by foreigners was prohibited) and bank borrowing in foreign markets. While capital outflows by resident individuals were open in 1985, lending abroad by banks and financial institutions was prohibited (this prohibition was maintained in the 1985-1996 period).

Effectiveness of controls

Over the 1990s, Indonesia has imposed controls on both inflows and outflows. In 1990-91, in the context of

overheating economy and a stable real exchange rate, large inflows (mainly composed of commercial bank borrowing) were perceived to be excessive and a threat to macroeconomic management. The authorities re-imposed quantitative controls on offshore borrowing by banks and state enterprises and introduced stricter limits on the open foreign exchange positions of banks.

Indonesia imposed controls on capital outflows in response to the Asian crisis in July 1997. These controls took the form of restrictions on non-resident transactions in the forward market ($5 million per customer) and limiting the net open position of banks in the forward market ($5 million per bank). Crisis? Yes. Indonesia initially seemed poised to weather the 1997 Asian financial crisis given its smaller current account deficit and decision to widen the trading band of the rupiah. Widespread concerns about the soundness of the banking sector, however, renewed speculative pressure on the rupiah and after its forced float promptly collapsed in value. From an average rate of 2,342 against the US dollar in 1996 the rupiah traded at 10,013 in 1998.

Lessons

The Indonesian experience illustrates the problems created by large inflows into a poorly regulated and supervised financial system. These problems were related to the nature of the interaction between the political elite and financial industry, which obscured the functioning of this system from outside investors and allowed insiders to socialize the risks of their behaviour. Thus, there was little to sustain the confidence of outside investors when better-regulated systems in countries like Malaysia came under pressure. Indonesia also reflected the general problem of Asian countries in 1997: short-term, dollar-denominated debt far in excess of international reserves. According to the BIS, $34.2 billion of Indonesia's total private foreign debt of $55 billion – equivalent to 16% of GDP – was due to mature in less than one year. In the 1995 to mid-1997, Indonesian firms had doubled their exposure to take advantage of the spread between international and domestic interest rates. The government failed to curb or effectively monitor the inflow. Thus, the Indonesian experience points to fundamental structural in the pre-conditions for CAC as well as failures of regulation, monitoring and enforcement.

KOREA

Background

Throughout its period of rapid industrialisation from the 1960s to the late 1980s, the Korean economy was characterized by extensive government intervention. A key instrument of policy control was its use of the nationalized financial system to provide directed credits to certain industrial sectors, while monetary policy was pursued mainly through direct instruments, including ceilings on lending rates. While this served to mobilize large resources for industrial development, it also helped ensure that the development of the financial system lagged that of the real economy. Over the course of the late 1980s, Korea pursued a policy of gradually liberalizing the domestic financial system and the capital account, although this was accelerated under the Kim Young Sam administration in 1993.

Sequencing of reforms

In 1988, Korea accepted Article VIII obligations ensuring full convertibility for current account transactions. Liberalization of the capital account was gradual and selective and a comprehensive liberalization plan was not adopted until 1993. Korea's policy towards capital account transactions was guided by developments in the current account. In response to a significant current account surplus in 1986-89, authorities moved to curtail net capital inflows, whereas in the early 1990s as the current account weakened, they moved to encourage inflows. Policy thereafter was towards gradually liberalizing capital account transactions. Financial sector reform, including efforts to improve regulation and supervision, was pursued concurrently.

Exchange rate policy

As part of the reform process, Korea moved from pegging the won to a basket of currencies to the Market Average Exchange Rate (MAER) system in order to allow exchange rates to be determined more by market forces. The exchange rate is determined on the basis of the weighted average of interbank rates for the won-dollar spot transactions of the previous day. During each business day, the won rate against the dollar in the interbank market is allowed to fluctuate within margins of +/- 2.25 percent against the market average of the previous day.

Result of capital account liberalization

One key consequence of the increased access of Korean financial institutions to external financing was a rapid expansion of foreign debt, which nearly trebled from $44 billion in 1993 to $120 billion in September 1997. While this level of foreign debt accounted for only 25 percent of GDP in 1997, which was considerably lower than that of other comparable countries, a critical dimension was the maturity structure of the debt. The share of short-term debt rose from an already high 43.7 percent in 1993 to an extremely high 58.3 percent at the end of 1996. Newly-licensed merchant banks assumed a very large share of this short-term debt. Thus, although measures were undertaken in the 1990s to liberalise and strengthen the financial sector, persistent weaknesses of oversight and regulation remained which helped propel the country into crisis in late 1997.

Crisis?

Yes. Korea was hit by the Asian financial crisis of 1997. The sharp rise in the short-term debt to reserves ratio and concerns about the stability of the financial sector (especially the finance companies) encouraged continual pressure against the won. When the won was forced out of its trading band its value promptly collapsed. From an average of 804 won per US$ in 1996 the rate had depreciated to an average of 1401 won per US$ in 1998.

Lessons

The Korean experience suggests the danger of liberalizing the capital account in the context of inadequate prudential regulation and an unreformed financial system. The failure to adequately monitor the activities of the finance companies was a serious gap in the regulatory regime that greatly increased the vulnerability of the country to sudden flow reversals. The precipitous dismantling of Korea's traditional system of coordinating long-term investment resulted in a poor allocation of these funds. This reflected as well a changing relationship between the state and the large chaebols (conglomerates) that dominate the economy, with the government no longer clearly as dominant a player in the new democratic dispensation. With the absence of state coordination and poor financial intermediation, funds flowed into low quality investments in sectors which already had serious problems with overcapacity. The Korean experience thus focuses on the appropriate preconditions for CAC (liberalization of the real sector), financial reform and improved regulation. It also points to the lessons of failed sequencing. Korea liberalised short-term flows first and as part of crisis management in 1997-98 liberalised long-term flows.

INDIA

Background

After the economic crisis of 1991, India embarked on a liberalization process that has begun to reverse decades of inward-looking and interventionist policies. Industrial licensing has been abolished and trade barriers have been reduced. Over the course of the 1990s, a cautious and gradual move towards more capital account openness was underway, although considerable obstacles to full convertibility are still present.

Sequencing of reforms

Signed Article VIII in August 1994, although some current account controls have been maintained that are consistent with these obligations. Capital account liberalization has proceeded at a gradual pace. The 1997 Tarapore Committee on Capital Account Convertibility recommended a cautious approach that seeks to establish the preconditions for liberalization on a sound footing. These include fiscal consolidation, an inflation target and, most importantly, the strengthening of the financial system. Consequently, more stable flows such as direct and portfolio investment have been liberalized first, followed by partial liberalizations of debt-creating flows, derivative transactions and capital outflows. Financial reform has continued concurrently.

Exchange rate policy

India has pursued a flexible exchange rate policy in the context of a managed float.

Capital controls

India maintains an extensive capital control regime, despite the liberalization of the past decade. Controls have been quantity-based rather than market-based and have been administratively enforced. They have been oriented towards limiting the country's external

debt, particularly acting to reduce excessive exposure to short-term foreign debt. Controls remain on the external exposure of pension funds and insurance companies and the external assets of banks are closely monitored.

Effectiveness of controls

India's controls have been largely effective in limiting measured capital flows and in shifting their composition towards long-term flows. Among other factors, such as the economy's limited trade and financial linkages with the global economy, controls insulated India from the 1997 Asian crisis. Indeed, long-standing and extensive capital controls have reduced the country's vulnerability to external crisis. It should be noted however, that the extensive controls of the 1970s and 1980s did not prevent India from experiencing high levels of external indebtedness and balance of payments crises in 1980 and 1991. There is evidence of evasion and avoidance of controls working through trade misinvoicing. Furthermore, controls carry significant administrative costs, burden legitimate transactions and create inefficiency.

Lessons

India's experience illustrates the gradual approach to capital account liberalization. CAC has proceeded gradually in the context of a broad reform agenda that encompasses trade, competition and industrial restructuring. Emphasis has been placed on the reform of the financial system as a pre-condition for capital account liberalization. The Report of the Committee on Banking Reform has set out the large-scale reform agenda that is required. India's experience also reveals the effectiveness of the present control regime in preventing, along with other factors, a build-up of short-term external liabilities that could increase the country's vulnerability to externally-generated crises. In contrast to the countries affected by the Asian crisis, India also limits banking assets held in real estate, foreign currency and equities. Thus, the balance sheets of Indian banks are not subject to the same degree of volatility. By effectively shifting the composition of inflows towards more stable, long-term flows, India can receive the benefits of capital account liberalization while limiting vulnerability while financial sector reforms proceed.

MALAYSIA

Background

In the early 1990s, Malaysia faced large inflows of foreign capital, comprising both short- and long-term capital. The significant increase in short-term inflows (which rose from 5.3 percent to 8.7 percent of GDP in 1993), induced mainly by a high interest rate differential and expectations of a ringgit appreciation, increased concerns regarding sustainability and stability. Domestic interest rates, however, remained high to restrain inflation. The high costs of sterilization and its maintenance of high interest rates, led authorities to implement controls on short-term capital inflows. In 1997, in the midst of a financial crisis, Malaysia implemented controls on capital outflows in order to limit downward pressure on the exchange rate and upward pressure on domestic interest rates that were exacerbating the contraction that was already under way and undermining the financial system. The controls also served to "buy time" for domestic adjustment and to insulate the economy from the international market turmoil. Initially, the authorities tried to break the link between onshore and offshore rates by setting limits on ringgit non-trade related swap transactions with non-residents, but these reinforced large interest differentials and induced greater outflows. Consequently, the authorities decided to impose direct exchange and capital control measures in September 1998. These sought to contain ringgit speculation and the outflow of capital by eliminating the offshore ringgit market.

Sequencing of reforms

Malaysia accepted Article VIII obligations in 1968. Malaysia has always had a relatively open capital account. Since the mid-1980s portfolio inflows have been free of restrictions, and bank's foreign borrowing and lending in foreign exchange has been free (except for net foreign exchange open position limits). Residents' foreign currency borrowing is subject to limits that require approval if they are to be exceeded. Before the crisis, cross-border activities in ringgit were also free. Financial sector reform has been accelerated in the wake of the crisis.

Exchange rate policy

Before the July 1997 crisis, Malaysia engaged in a

managed float of the ringgit. With the imposition of controls in September 1998, Malaysia pegged the ringgit to the US dollar.

Capital Controls

Inflow controls in 1994 were seen as temporary measures to restrain short-term inflows, particularly in the form of foreign borrowing by banks and ringgit deposits opened by bank and non-bank foreign customers. The measures included :

- Prohibitions on residents selling Malaysian money market securities to non-residents,
- Prohibitions on banks engaging in non-trade related bid-side swap or forward transactions with non-residents,
- Ceilings on banks' net liability positions (excluding trade and FDI flows) to curtail foreign borrowing to engage in non-trade and portfolio transactions,
- A requirement that banks place with the central bank the ringgit funds of foreign banks maintained in non-interest bearing accounts.

In addition to these measures also eased interest rate policy, curtailed sterilization measures and introduced increased prudential regulation to contain the excess liquidity in the banking system. The controls were largely lifted by the end of 1994.

The outflow controls imposed in September 1998 sought to eliminate channels through which speculative positions against the ringgit could be taken. The controls excluded FDI and current international transactions. The essential elements of the controls were:

- The closure of all channels for taking ringgit abroad
- Required the repatriation of ringgit held abroad to Malaysia
- Blocked repatriation of portfolio capital held by non-residents for 12 months
- Imposed restrictions on transfers of capital by residents

Further measures to close loopholes, such as amending the Companies Act to limit dividend payments, were also enacted. In February 1999, the one-year restriction on repatriation of portfolio capital was replaced by an exit levy that penalizes early withdrawal of funds. The levy applies to principal or profits of non-residents' portfolio investments, depending on whether the funds were brought in before or after February 15, 1999. The objective was to encourage investors to extend their investment horizons in Malaysia and to induce a smooth outflow of funds (rather than a sudden outflow when the holding period expired).

Effectiveness of controls

The 1994 controls on capital inflows were largely successful in achieving their objectives of containing short-term inflows and the monetary expansion and instilling stability in the foreign exchanges. Monetary aggregates significantly decelerated and the capital account surplus fell in response to a reversal in short-term inflows in the second half of 1994 (particularly new external liabilities of the banking system). Long-term flows such as FDI were unaffected. Some caution is required in interpreting the evidence, however, since authorities were simultaneously lowering the interest rate differential and ending sterilization operations which may also be expected to lower short-term flows.

The controls on outflows imposed in late 1998 were effective in eliminating the offshore ringgit market. The restrictions on the internationalization of the ringgit were essential in achieving this objective, especially the freezing of external ringgit accounts. The absence of speculative pressure on the ringgit, following the imposition of controls and the currency peg, in an environment of significantly relaxed monetary and fiscal policy is evidence of the controls' effectiveness. No parallel market has emerged and evasion and avoidance of controls through measures such as misinvoicing appear minimal. More studies are required to estimate the effectiveness of the controls.

Crisis?

Yes. Malaysia was hit by the 1997 Asian crisis which followed the Thai baht's devaluation. While Malaysia's fundamentals were relatively strong (high growth, low inflation, full employment, relatively strong financial system and, in contrast to Thailand and Indonesia, no massive build-up of short-term overseas debt), two vulnerabilities had been developing: a massive accumulation of outstanding domestic credit and a large

exposure of the banking system to the property sector and share trading. When the crisis erupted, the ratio of outstanding credit to GDP stood at 160%, up from an average level of 85% during 1985-1989. As much as 45% (and perhaps as high as 55%) of outstanding bank credit in 1996 was to the property and share trading sector. Thus, speculators reasoned that an interest rate defence of the ringgit was untenable and that the massive increase in credit was evidence of a decline in the quality of borrowers. After the baht's fall, the ringgit was placed under speculative pressure. Bank Negara relented and the currency depreciated rapidly. In contrast to Thailand and Indonesia which accepted IMF programs, Malaysia stood apart and instead implemented a capital control regime that would insulate it from market pressures while it sought to stimulate a recovery through more relaxed monetary and fiscal policy and reform the financial structure.

Lessons

The Malaysian experience with inflow controls in 1994 suggests that they can be affective when they are complemented by measures to reduce the interest rate differential and heighten prudential regulation. It also suggests that controls that are temporary in nature are also more effective in that they limit the increased porosity of controls that develops over time. The overall macroeconomic policy stance, particularly by maintaining a tight fiscal policy, also served to complement the inflow controls. While Malaysia had comparatively strong fundamentals when compared to other affected countries, the 1997 crisis revealed weaknesses generated by rapid credit expansion and the consequent deterioration of bank asset quality. The crisis led to a reassessment of the risks associated with regional banks and pressure soon escalated against the ringgit. The Malaysian experience suggests the importance of close central bank monitoring of the uses to which external funds are being directed and whether their properties are consistent with the type of inflows (for example, the excessive funding of non-tradeable sectors such as real estate with short-term inflows may signal greater vulnerability). Furthermore, improved bank surveillance and enforcement is required to rapidly ensure provisioning in banks with escalating non-performing loans.

THAILAND

Background

Like Malaysia, in the early 1990s Thailand experienced a large inflows foreign capital. A pegged exchange rate, an open capital account and large interest rate differentials induced large and often volatile short-term inflows. The establishment of the Bangkok International Banking Facility (BIBF) in 1993 along with incentives to borrow through it, accelerated short-term capital inflows. The size and volatility of inflows increased inflationary pressure and hindered monetary policy. In 1995, through monetary, prudential and market-based capital control measures, the authorities sought to deal with the large inflows. Continued strong inflows required an extension of the control program in 1996.

In 1997, Thailand was hit by substantial speculation against the baht in the wake of a deteriorating current account deficit and developing financial sector problems. These trends led to increasing questioning of the sustainability of the exchange rate peg. It was, correctly, assumed that the high interest rates required to sustain the peg were incompatible with the state of the economy and the stability of the banking system. To combat the speculative pressure, the authorities imposed capital controls in May 1997. The controls sought to close the channels for speculation against the baht.

Sequencing of reforms

Thailand accepted Article VII obligations in 1990. Thailand has always maintained a fairly open capital account, particularly with respect to capital inflows. The establishment of the BIBF in 1993 greatly increased the freedom to import short-term foreign capital into the country. While inflows were liberalized early in the reform effort (1985-1986 and 1990-1995) outflows were liberalized only gradually (1990-1992, 1994). Financial sector reform lagged this process of openness and was one of the key factors leading to the crisis.

Exchange rate policy

Thailand pegged the baht to a basket of currencies (primarily weighted towards the US dollar) since 1984. In the aftermath of the crisis, the control regime resulted in the creation of a two-tier currency market,

with separate exchange rates for investors who buy baht in domestic and overseas markets. Controls In conjunction with raising interest rates, increased sterilization of inflows and the prudential reduction of loan-deposit ratios in vulnerable banks, the authorities introduced more direct controls aimed at capital inflows in August 1995. These included:

- A symmetric open position limits for short and long positions
- A reporting requirement for banks on risk control measures in foreign exchange and derivatives trading
- A seven percent reserve requirement on non-resident baht accounts with less than one-year maturity and on finance companies' short-term foreign borrowing.

Restrictions were also placed on banks' non-priority lending in foreign exchange and on their foreign currency exposure. In 1996, with continued strong inflows, the authorities (a) extended the seven percent reserve requirement to non-resident baht borrowing with a maturity of less than one year and new offshore borrowing of maturities of less than one year by commercial and BIBF banks, (b) the minimum capital adequacy requirement for commercial banks was raised. In 1997, in the face of declining reserves and a costly interest rate defense of the baht, the Thai authorities sought to prevent speculation against the baht by adopting a set of capital controls. These included:

- Financial institutions were required to suspend transactions with non-residents that could lead to a build-up of baht positions in the offshore market.
- The prohibition on purchasing before maturity baht denominated bills of exchange and other debt instruments requiring payment in US dollars.
- Foreign equity investors were prohibited from repatriating funds in baht (but were free to repatriate funds in foreign currencies)
- Non-residents were required to use the onshore exchange rate to convert baht proceeds from sales of stocks.

The controls sought to deny non-residents without genuine commercial or investment transactions access to domestic credit needed to create a net short domestic currency position, while exempting genuine business related to current account transactions, FDI flows and portfolio investments.

Effectiveness of controls

The 1995 measures contributed to a slowdown in economic activity and decelerated the pace of foreign borrowing but it was only with the extension of the measures in 1996 that total net flows fell and shifts in their composition were seen. The mix of measures designed to address large capital inflows seem to have attained their objectives:

- Net capital inflows were reduced
- Short-term net inflows declined as a percentage of total inflows between 1995 and 1996
- The maturity of BIBF loans increased
- The share of short-term debt in total debt declined
- Marginally reduced the growth of non-resident baht accounts

Two cautionary notes are required, however. First, isolating the effectiveness of the control regime from other factors (such as declining investor confidence) is difficult. Second, the true maturity of inflows is often weakly related to their maturities as measured in the balance of payments accounts. The controls did not prevent Thailand from experiencing the devastating experience of a reversal of inflows a year later and, as that crisis revealed, they did not prevent foreign funds from flooding non-tradable sectors with no capacity to generate foreign exchange. Only about half of bank's foreign currency loans were granted to foreign exchange generating sectors. The 1997 controls reduced trading in Thailand's swap market where investors buy and sell to hedge currency risks for investments in Thailand. They also temporarily halted speculative attacks on the baht by segmenting the onshore and offshore markets. However, controls did not prevent outflows through other channels, given the large spread between the onshore and offshore interest rates. Controls also could not prevent the devaluation of the baht in July 1997 that initiated the Asian crisis.

The 1997 controls provided only very brief respite for the Thai authorities. Circumvention was aided

by the narrow range of the controls, their inability to eliminate the offshore baht market (as Malaysia post-crisis controls eliminated the offshore ringgit market), and the continued deterioration of conditions in the financial sector and the macroeconomy. Thus, controls served to undermine investor confidence further and

discouraged capital inflows. In January 1998, as the economic environment improved, controls were removed and the baht appreciated along with riding stock market prices.

Crisis?

Thailand experienced weakening fundamentals during the course of 1997 and increasing speculative pressure against the baht. The combination of a fragile financial system, a pegged exchange rate and liberalized short-term inflows built-up large exposures to short-term foreign currency denominated debt that raised fundamental concerns of policy viability. The devaluation of the baht in July 1997 signalled the start of the Asian financial crisis.

Lessons

Thailand's experience with capital account liberalization highlights several important points. First, the reform of the financial sector and improvements in prudential regulation and enforcement lagged the implementation of greater capital account liberalization (especially the introduction of the BIBF in 1993).

Second, the liberalization of short-term inflows in the context of high domestic interest rates and a pegged exchange rate led to a substantial increase in short-term liabilities of banks and financial companies. Third, the use of controls in 1995-1996 may have precluded moves towards greater exchange rate flexibility and development of indirect monetary policy instruments. Fourth, the controls implemented before the currency crisis of July 1997 were ineffective in altering the basic constraints facing Thai policymakers: they failed to halt the speculative pressure against the baht and may have exacerbated negative perceptions of Thai policy. The experience demonstrates that, as in Brazil, controls cannot be a substitute for sound macroeconomic policies, financial sector reform and effective prudential regulation and enforcement.

CONCLUSION

Controls can be targeted to deal with balance of payments pressures and macroeconomic disturbances generated by volatile capital flows. The experiences of the countries listed in this paper shows that even though there are capital controls of different degree East Asian Crisis has effected these economics. The degree of crisis in turn is dependent on the soundness of macroeconomic fundamentals. Thus capital controls cannot be a substitute for sound macroeconomic policies, financial sector reform and effective prudential regulation and enforcement. There can't be any last voice whether capital controls are good or bad. It depends on the overall economic environment in which a country operates capital control is tools which policy makers and economist should utilize with great caution. The experience of some of the countries confirm this.

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