Comments on How Effective are Capital Controls? Evidence from Malaysia Prema-chandra Athukorala and Juthathip Jongwanich

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Thank you very much for the very interesting and informative paper on capital controls in Malaysia. I think the author has provided a very useful summary of the capital control regimes in Malaysia leading up to the financial crisis. The author has also done a very good job of compiling all the capital control measures and summarizing these in an index so that we can see the changes in the capital controls regime in Malaysia.

The main objective of the paper is to evaluate the effectiveness of capital control measures that were imposed in Malaysia in September 1998. The paper argued that it was successful in the sense that it provided the policy space to pursue an expansionary policy that would have not been possible without capital controls.

I suggest that the author elaborate more on the following issues:[1]

1. The capital control measure imposed in September 1998 came quite long after the crisis began in Malaysia. I suppose that it was imposed after substantial capital had left Malaysia. Were the capital controls effective in stopping further capital outflow, and was it too late since all the capital that wanted to leave had already left Malaysia? At the same time, over the period leading to September 1998, there was a substantial depreciation of the ringgit and, together with the imposition of the capital controls, the exchange rate was pegged at RM380 to the dollar from around RM250/$, so there was a substantial depreciation. With a much devalued currency, the incentive for further outflows has also been reduced so I think that is one thing that should be examined further.

2. I suggest that the author provide more elaborate discussion of Figure 1, which plots the interest rate trends for the Republic of Korea, Malaysia, and Thailand and shows that the trend is very similar for all three countries. All countries managed to reduce their respective interest rates during the period. However, the interest rate in Thailand, which did not impose any capital control, fell at the same rate as in Malaysia. It was unclear if the capital controls were needed.

[1]These issues were subsequently discussed and clarified in the final paper.

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One reason that the author suggests was that there is a close link between Malaysia and Singapore, and hence there is much greater potential for capital outflows from Malaysia. It was mentioned that around 40% of Malaysia's M1 is deposited in Singapore. However, if a substantial part of Malaysian currency is already in Singapore, how much further outflow could there be?

In the paper, the author also argued that capital controls allowed Malaysia to restructure its banks at a lower cost. In terms of the banking sector, Malaysia had better initial conditions than Thailand. Banks in Malaysia were in much greater shape and, hence, it is not surprising that bank restructuring costs were much less in Malaysia than in Thailand. Furthermore, Malaysia had much less short-term foreign borrowings compared to Thailand. I suggest that a comparison between Malaysia and Thailand be made in this regard.

For the interest of the forum today, it may be interesting to have more discussion on the capital controls on inflows that were introduced in 1996 in Malaysia. The paper suggested that this was a temporary short-term measure for relieving appreciation pressure on the Malaysian Ringgit. I think this is very interesting because this may have been the more effective capital measure in the sense that it is possible that it restricted Malaysian short-term borrowings in the period leading up to the Asian financial crisis, thus allowing it to enter the crisis with lower short-term borrowings than affected countries such as the Republic of Korea and Thailand.

Finally, I think it would be interesting to examine the long-term impact of capital controls. How would it affect long-term investor perception of the country?

On the econometrics, I think a 1-period lag structure, which was used in the paper, is insufficient to capture the impact of capital controls. The paper used quarterly data over a 10-year span or 40 observations. I am a bit concerned about the degrees of freedom in the VAR analysis.[2]

Another econometric issue is the use of the capital control index to evaluate how they were successful in affecting capital outflows. However, by definition these capital outflows have been affected by the capital controls. I would be surprised if it would be otherwise. If not then they may have used other channels of capital flow. One concern about measures of capital controls is that they can be easily evaded through other means of capital flight. Therefore if you limit capital flows in portfolio and bank borrowings, the official reported figure would obviously show that they have an impact but there may be other forms of capital flight occurring.

[2]The authors conducted robustness tests and discussed this in the final paper.