Economic Viewpoint

BY ROBERT J. BARRO

MALAYSIA COULD DO WORSE THAN THIS ECONOMIC PLAN

DESPERATE: Capital controls, while not ideal, are preferable to the IMF's customary fix of intervention with high interest rates

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On my arrival in Malaysia last week, I had two quick impressions. The first came when I filled out a form requiring me to reveal my holdings of U.S. dollars. The capital controls represented by this requirement seemed inconsistent with a dynamic, market-oriented economy. The second was that I was amazed by the splendor and size of the newly opened airport, which seemed totally out of proportion to the volume of business going on at the time.

Both observations relate to the ongoing financial crisis. Malaysia's capital controls are a desperate response to the devaluation of the ringgit. The overly expensive airport epitomizes the pervasive excess of investment in infrastructure and buildings. The writing down of these projects, along with a scaling back of the country's long-term growth prospects, were major factors in the collapse of Malaysian stock prices and the onset of recession months ago.

Many economists are outraged by Malaysia's adoption of capital controls. Their reaction would be less harsh if not for the country's outstanding record of market-oriented policies. After all, it is easier to accept bad behavior from an established scoundrel than from one's friend or hero.

WESTERN ENEMIES. One element that makes it difficult to sympathize with Malaysia's policy change is the defense offered by the Prime Minister and now also finance minister, Mahathir Mohamad, who blames his nation's troubles on greedy speculators and Westerners with poor values. He also invites disdain because of the imprisonment and torture of his political rival and former finance minister, Anwar Ibrahim, who was opposed to capital controls.

But, counter to my initial instincts, there is some logic behind the capital controls. The Malaysian ringgit has been floating for some time, and one desirable consequence of this policy is that the central bank's reserves have been maintained. However, the volatility and downward trend of the exchange rate have been harmful to the economy. Hence, policymakers reasonably decided that some kind of fixing of the rate would be desirable. They also determined—I would say correctly—that the usual defense of the exchange rate with central-bank interventions that feature high interest rates would fail. As with Thailand in 1997 and Mexico in 1994 (and perhaps now with Brazil in 1999), this policy would probably lead to the loss of international reserves, which would culminate in any case in devaluation.

The basic problem is that central banks typically react to an attack on the domestic currency through a process called sterilized intervention. The central bank meets demands for foreign currency by selling its international reserves, mostly dollars, and uses the proceeds to buy the domestic currency, in this case ringgits. However, the bank does not allow the domestic money stock to fall. Instead, the bank buys domestic assets, such as government bonds, for ringgits, thereby injecting money back into the system.

CORRECT ACTIONS. This approach looks attractive because it does not expose the economy to the contractionary effect of a decline in the money stock. Unfortunately, these kinds of interventions usually do not end a run on a currency. In the end, the central bank tends to lose more and more reserves and is ultimately forced to devalue. The intervention would work a lot better if the central bank did not sterilize and allowed the money stock to decline.

The Malaysians are probably right that the usual policy sanctioned by the International Monetary Fund of sterilized intervention coupled with high interest rates would be worse than capital controls in the present environment. This is especially true if the controls are temporary. Capital controls may be superior to policies recommended by the IMF, but they are far from ideal. The best policy would entail a fixed exchange rate without capital controls, with the central bank intervening but not sterilizing.

One attraction of a currency board is that these kinds of interventions occur automatically when needed. Moreover, correct actions do not require any deep economic understanding by the board's administrators. However, a clever central bank can mimic the workings of a currency board. Given the widespread failure of standard operating procedures, this alternative kind of exchange-rate arrangement is worth a look in more countries. It would work especially well in Malaysia, which fortunately has sufficient international reserves of about $20 billion. That would more than cover the central bank's monetary liabilities. There's no reason Mahathir shouldn't give this a try.