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Reflections of a retiring Keynote Speaker[☆]

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1. Introduction

This year will mark my 10th and last appearance as Keynote Speaker for PACAP or PACAP/FMA into which the original organization has evolved. Ten years ago, Rosita Chang, Ghon Rhee and I shared the hope that the PACAP conferences and the associated *Pacific Capital Markets Basin Journal* would stimulate research on the Asian capital markets, an area we believed was being neglected by academic scholars not only in the U.S. but here on the ground, in East Asia itself. The program for this year's Conference, organized by Professor David Ding of the Nanyang Business School in Singapore, shows that our original aspirations have now been amply achieved. Pacific capital markets and institutions have emerged as a recognized and self-sustaining field of study in universities around the world. The time has come, therefore, for me to pass the torch to the next and younger generation of Keynote Speakers. That will also serve to relieve my old friend, Prof. Andrew Chen, of his annual chore of finding something new to say in his always flattering introductions.

1.1. Ten years of addresses: A very quick review of the highlights

A retiring Keynote Speaker may be tempted by the occasion to repeat highlights from his past speeches, like a retiring songwriter reviews his past hit tunes. I shall resist the temptation to review or to try to settle past scores, however, beyond

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noting merely from the titles of past addresses how much my own interests (and those of the profession) have shifted over the years. The Crash of 1987, for example, was the focus of my first Keynote Address in 1989 in Taipei. That Crash, which in its day spawned miles of press coverage plus countless articles and books, has by now been largely forgotten. Hardly a reference to the Crash can be found in any of the titles or abstracts of the papers at this Conference.

The so-called circuit breakers, the main regulatory response to the Crash, were the subject of my scorn in my second Keynote Address. These abominations, which caused so much mischief during the market drops in the U.S. in the summer and autumn of 1998 have now been shoved into the rubbish bin of history, for all practical purposes, although institutional investors had to drag the New York Stock Exchange and its claque of retail brokers kicking and screaming all the way. A number of East Asian stock markets, alas, are still adopting these by now thoroughly discredited circuit breakers. At least the Asian markets cannot claim any longer that they are merely following the American example.

The furious battles over stock index arbitrage in the U.S. and Japan were the subject of my third Keynote Address. Back then, many in both countries still believed that index arbitrage not only caused the Crash of 1987, but greatly increased the level of market volatility. These charges, however, could never withstand serious scrutiny and can be dismissed as little more than the natural reaction to denigrate their tormentors on the part of those losing in the competitive fray.

The bogeyman role that index arbitrage had come to play after the Crash of 1987 was eventually transferred to derivatives generally. They became for the financial press of the mid-1990s, the new alligators lurking in the weeds and threatening ever-present disasters. The calls for more regulation of derivatives, which were fortunately beaten off in the U.S. were the subject of my 5th and 6th Addresses. Derivatives, of course, are still a villain for much of the press, though they have had to share the limelight with hedge funds after the currency turmoils of 1997 and 1998.

My 7th and 8th Keynote Addresses were on the subject of futures markets, still an abiding interest of mine. The second of the two addresses was my insider's view of the negotiations to form a common clearinghouse between the Chicago Mercantile Exchange and the Chicago Board of Trade. I was serving at the time as Chairman of what the two exchanges called their Joint Strategic Initiatives Committee. In that capacity I informed those attending the 1997 PACAP Conference, held that year in Shanghai, that all the difficult obstacles standing in the way of common clearing, which I reviewed at length, had now been overcome and that a definitive agreement would soon be struck between the two exchanges. Alas, that was not to be. The deal fell apart at the last minute. So great was my chagrin that I asked Ghon Rhee not to publish my talk on common clearing in the Pacific Basic Review, and to substitute instead a paper I had prepared on the then erupting South East Asia financial crisis.

The following year, 1998, the PACAP Conference was scheduled for Kuala Lumpur in Malaysia. But for two reasons, I felt I could not in good conscience, participate. First, the government of Mahathir Mohamad had just thrown in jail, on what had all the signs of trumped up charges, the former Finance Minister of Malaysia, Anwar Ibrahim, who had served among other things as a PACAP Keynote Speaker 5 years earlier. That act of police-state barbarism was not something I wanted to be seen as condoning by serving as Keynote Speaker on Mahathir Mohamad's home turf.

But in addition to framing Anwar Ibrahim, the Mahathir government had also, at about the same time, abandoned the convertibility of its currency. The institution of currency controls by Malaysia, alone among the countries of the region, was not only bad policy for Malaysia in my view and a horrible example for the rest of Southeast Asia, but flew in the face of everything we in PACAP stood for. For 10 years, the economists on our program, and in our *Journal* (and in everybody else's *Journal* for that matter) had been illustrating and explaining the benefits to East Asia of free, competitive and profit-driven capital markets.

Malaysia's imposing of capital controls has aroused so much discussion over the past year that I propose to devote the rest of my last official PACAP/FMA Keynote Address to explaining why I so firmly believe that policy was a mistake; and what I believe are the better alternatives the countries of South East Asia have for best positioning themselves against currency devaluations.

2. The case against exchange controls

The case against foreign exchange controls is so well-known and has so often been made that I can be brief. For one thing, the controls just do not work. They cannot really stop capital outflows or prop the value of a currency above its free market level. Controls may *seem* to do so for a while, of course, but not for very long. The market is always one step ahead of the regulators.

Regulators, like generals, are always fighting the last war, while the market and its institutions are busily thinking up new ways around the old restrictions. Market participants have been doing that long before the term financial engineering was even coined. Many of the capital market institutions we take for granted today were created in fact precisely to thwart misguided government regulations. I need mention only the Eurodollar market, which owes its birth to the U.S. Federal Reserve System's Regulation Q, which put interest rate ceilings on U.S. domestic bank deposits, but not on deposits in overseas bank branches. Or the Eurobond market which arose in response to the imposition of interest-rate equalization taxes by the U.S. in the early 1960s. Or, above all, the world-wide market for swaps, now running into the trillions of dollars in notional terms. Swaps, in fact, were invented in the late 1960s precisely to get around the kind currency conversion restrictions that Malaysia was seeking to impose.

Financial innovations can thus fully be expected to undermine even the most efficient regulatory systems, like those of Great Britain in the post-World War II years. But financial innovations merely bend the law. Breaking the law is what East Asian countries have to contend with in imposing currency controls, and, of course, the inevitable corruption that invites. Individuals seeking to get their money out can and will avail themselves, of course, of the currency black markets, or free markets to use a less pejorative term, flourishing on every street corner. Those markets, incidentally, give a reading on the value of the currency far closer to its true value than that of the official rate (a good example of the price-discovery function of markets, though complicated a bit in this case by the widening of the spread to offset the inevitable dealer risks in illegal activities).

Only individuals, of course, can use the street markets. For businesses even of only modest size, however, the controls always bite harder. Classical currency controls require exporters to deposit with the central bank all their overseas foreign exchange earnings. The temptation to underreport those earnings by falsifying or hiding invoices is understandable; and if that means bribery, the potential gains are normally large enough to compensate for the risks.

The corrupting effects on the importing side are equally or even more corrosive than on the export side because they may have to involve officials of the central bank itself. An importer needing foreign exchange to pay its bills or an exporter needing foreign raw materials to keep its production lines running must somehow persuade the central bank officials, who have a monopoly over foreign exchange supplies under a control regime, that the proposed tapping of the foreign exchange reserves is indeed “appropriate” given the objectives of the controls. And they must persuade the relevant bureaucrats that any foreign exchange granted to them as approved users will not be covertly diverted to others. The term persuade, of course, has many meanings in this context, not all of them savory, needless to say.

The corruption that pervasive exchange controls inevitably entail should not be defended by libertarians as merely a way of nullifying government controls that never should have been enacted in the first place. Corruption is a most inefficient substitute for elimination. New distortions and new restrictions are often introduced as each new loophole in the existing controls is discovered and closed, at least, momentarily. Many years must often pass, alas, before the bureaucrats come to realize that the direct and indirect cost of maintaining their controls exceeds any likely benefits.

2.1. What could Malaysia have had in mind for its capital control scheme?

For countries like Malaysia, moreover, and much of East Asia as well, convertibility restrictions run the very real danger of inhibiting the inflow of foreign investment funds. Those foreign inflows supplement internal sources of savings and capital, not sufficient by themselves, to sustain rapid growth. Why then did Malaysia take those risks, I asked an old friend of mine, a distinguished

Malaysian economist who, for obvious reasons, prefers to remain anonymous? Certainly my old friend, who was a trained economist after all, could not have believed with Mahathir Mohamad that Malaysia's troubles in 1997 were due to the Jews in general, or George Soros in particular. Nor, did my friend try to fob me off with references to Chile. He knew that Chile's so-called capital controls differed fundamentally from those in Malaysia. Chile's controls, which have since been abandoned incidentally, sought to discourage foreigners from bringing money *into* Chile, not to keep them from taking money out.

Malaysia's policy, I teased him, reminded me of the lobster traps in New England, where I grew up. The trap entices lobsters to swim in; but once in, they cannot swim out. People are smarter than lobsters, however, I warned my friend. If you tell them they cannot get out, they will not swim in. You know that. What then could Malaysia possibly have had in mind?

2.2. *The Malaysian case for temporary capital controls*

My friend insisted that none of the previous and standard arguments against capital controls really applied to Malaysia whose controls were intended to be strictly temporary. A similar point had been made earlier by Paul Krugman who is sometimes regarded as the intellectual architect of the Malaysia action. The controls were seen merely as a sharp slap in the face to stop a panicky capital flight just as closing the doors temporarily of an otherwise solvent bank might serve to stop a panicky run by the bank's depositors.

Malaysia hoped, my friend insisted, that closing the capital exit door momentarily might permit jumpstarting the Malaysia economy, as it were. Or to use economist lingo, might rescue Malaysia from a low-level equilibrium trap into which it had fallen. The panic had made the Malaysia banks, anxious to protect their own capital, fearful of extending credit to Malaysia businesses, even profitable ones with firm export orders in hand. The central bank, the presumed lender of last resort, hesitated to pour liquidity into the banking system. Massive monetary expansion would simply set off inflation, putting further pressure on the ringgit and possibly accelerating capital flight even further.

To see how temporary controls might help under those circumstances, think of it, my friend said, in quantity theory of money terms, M , V , P and T . Put aside V , the velocity of money, for the moment. If you can somehow increase M , the money supply, while keeping P , the price level, from rising (and the exchange value of the ringgit from falling), the result must be an increase in T , the level of economic activity. And once T has revived, and the economy gets moving again, the temporary controls can safely be lifted. That is what jumpstarting is all about, after all.

2.3. *Can it work? Did it work?*

Let it be conceded that, in principle, at least, such a jumpstart program *might* work. And, in Malaysia's favor, let it also be said that signs already exist of the

seriousness of Malaysia's intentions to end its capital controls in September 1999 as previously announced. Under the original controls of a year ago, U.S. mutual funds and other holders of Malaysian equities were required to wait a year before selling any shares and repatriating the proceeds. That absolute prohibition was later replaced by a penalty tax of 30%. Fortunately for the foreign mutual funds, however, the 30% penalty rate was applied not on current market value — where it would have constituted a substantial capital levy indeed — but on original book value. If you bought a stock at 10, say, that was now up to 50, your 30% penalty tax was thus only a far less ominous 6% of value. Many foreign mutual funds took advantage of this provision to sell their big winners and repatriate the proceeds — even, ironically, many fully indexed funds that we think of normally as the kind of long-term, buy-and-hold investors that Malaysia was hoping would stay. The 30% penalty tax has since been reduced to 20%, with a promise that it will be removed altogether in September and replaced with a simple capital gains tax on profits.

But while Malaysia official sources continue to insist that the remaining capital controls will indeed be allowed to expire in September as planned, and while Mahathir Mohamad himself keeps trumpeting the success of his plan, the fact is that the hoped-for sizeable and permanent increase in T has yet to materialize. The stock market may be up from its lows, and the economy itself may seem to have stabilized, but that is equally true for the rest of East Asia as well. The great crisis of 1997, like any other typhoon, finally seems to have blown itself out. What, then, did Malaysia's experiment with controls actually accomplish?

The most favorable answer for Malaysia is nothing. When the capital repatriation controls are finally removed in September — if indeed they *are* removed, temporary controls always seem to have a way of becoming permanent — any increase in M , the money supply, over the past year will have to show up somewhere. It cannot reasonably be expected to show up as a lower V , velocity of money. Measured velocity always falls, initially, if the controls suppress the outward signs of inflation. But velocity will quickly revert to its normal level when the controls are removed. To absorb the increase in M , with no increase in T , leaves only P , a rising price level, and, tied to it, a fall in the uncontrolled foreign exchange value of the ringgit.

If so, and still assuming that Malaysia does indeed restore convertibility, the country will be right back to where it would have been a year ago, if it had followed Thailand or Korea and let its currency float.

That is the good news, as the old joke has it: that the experiment with controls was at best useless. The bad news is that the episode was actually *harmful* to Malaysia and its citizens. Part of the cost to them will show up most obviously in the form of higher interest rates (and shorter maturities) on dollar borrowings. And, indeed, the press reports a recent sovereign bond issue by Malaysia at more than 300 basis points over U.S. Treasuries. Some of that premium may reflect the likely devaluation of the ringgit when trading is resumed, but some of it also is surely a risk premium. The creditors know that having abandoned convertibility

once, a country's commitment to free and unfettered exchange transactions can no longer be taken for granted.

However, higher interest rates are only the outwardly visible part of the costs. The cost of attracting outside equity funds to Malaysia has also surely risen, but, because equity funds carry no interest rate, a direct measure of the cost premium is not readily available.

3. Conclusion

The Malaysian flirtation with currency controls, thus, must be written off as a failure, and one whose costs will be borne by the Malaysian people for many years to come. But, did Malaysia really have a choice when faced with the prospect of massive capital flight back in mid-1997? Should it have allowed its exchange rate to float (that is, to sink) to the point where further devaluation became unlikely? Putting it in those terms will always, subtly tend to bias the choice toward intervention of one kind or another. But only because the choice set has been made too narrow and because important structural alternatives are thereby being neglected. I am referring of course to the institution of a currency board which permits any country to obtain the advantages of a fixed, devaluation-proof exchange rate *as long as it is willing to give up all discretionary monetary policy*. The examples of Hong Kong and Argentina show how much sense that policy makes in practice. It is still not too late for Malaysia and many of the other countries in East Asia to break with their past histories, to junk their central banks, which have caused them nothing but grief, after all, and move in a new direction. I am sure that will be a theme Keynote Speakers will be returning to again and again in future PACAP/FMA Conferences.