On the Financial Policy Management of Capital Controls to Reduce Volatility of Capital Flows; Case Studies in Chile, Malaysia, and Vietnam in 1990s

PHAN NGOC MINH† and SHIGERU UCHIDA ‡

Abstract:

Historical evidence relevant both to political economics and macroeconomics in the financial crises throughout the 1980s and 1990s has showed how harmful large surges of private capital inflows, in particular short-term inflows, to developing countries may be. Accordingly, many developing countries have resorted to capital controls as a mean to curb the volatility of short-term capital movements, while continuing to enjoy the benefits of longer-term capital inflows. However, the effectiveness and the necessity of capital controls have been the subject of a wide controversy.

This article attempts to examine the use of capital controls in Chile, Malaysia and Vietnam in order to find conclusive evidence to support the general conclusion that the capital controls used in these countries have been effective in achieving the intended policies' objectives.

Keywords: Capital Controls, Volatility of Capital Movements, Effectiveness of Capital Controls

I INTRODUCTION

It has often been argued whether the definitive cause of financial and/or economic crises among Asian countries in latter half of '90s came out of the panic-stricken behavior of the capital management side, the less advanced status of national socio-economic fundamentals and infrastructure, or both. We have indeed more words from many economists to investigate this kind of rather complicated problem. The general perception is that the deeper integration of developing countries into the global economy, the heightened interest of foreign investors in these countries, and

† State Bank of Vietnam, M.A., Nagasaki University.
‡ Professor, Nagasaki University.
as a result, large capital inflows can bring considerable economic benefits to developing countries. However, this optimistic perception has to face with the fact that large surge of capital inflows, particularly of private short-term and potentially reversible capital, can also bring very harmful effects to the developing economies if they are not properly managed, as evidenced in the financial crises throughout the 1980s and 1990s. Griffith-Jones (1998) points out that in the Mexican Tequila crisis, especially in the East Asian crisis, the reversal of private capital flows has been really dramatic. As a consequence, afflicted countries experienced a severe reduction of absorption, as well as financial crises. In East Asian crisis economies, their GDP, which had been growing extremely rapidly for a very long period, fell dramatically. He claims that within present arrangements, the volatility and reversibility of some categories of capital flows and their very negative effects implies that the cost of these flows to countries’ development are seen as higher than their benefits, at least during important periods of time. As a result, controls over capital flows to alleviate their negative effects on developing economies have been back “in fashion” and adopted in several countries. However, these control measures have been opposed by IMF and some other international financial institutions as they argue that controls are not only ineffective in reducing the volatile movements of capital flows to developing countries, but also discourage long-term capital inflows which bring benefits to developing countries.\footnote{See, for example, Wade and Veneroso (1998), Argy (1994), Khor (1998), Stiglitz (1998), and Wessel and Davis (1998).}

Given this context, the objective of this study is to examine the effectiveness of capital controls in reducing volatility of capital flows and alleviating the negative effects resulted by this volatility. To do so, the study will involve three attempts. The first attempt deals with the question: Are capital controls an effective policy measure to cure the illness resulted by the large volatility of capital flows to developing countries? This attempt will encompass the discussion on the motivations for the use of capital controls and the debate on the effectiveness of capital controls. The main purpose of this attempt is to show that since there is a wide controversy on the necessity and the effectiveness of capital controls, it would, therefore, be difficult for us to get the right answer for the above-mentioned question if we just consider it from the theoretical perspective. Therefore, the study’s second attempt is to review the experience with capital controls of three developing countries, namely Chile, Malaysia, and Vietnam, in order to find conclusive evidence to
support conclusions on the role and effectiveness of capital controls. Before reviewing the countries’ experience, the study, as its third attempt, classifies the various types and characteristics of capital controls with the aim to offer the reader some helpful insights into the specific types of capital controls used in the three countries. With the relevant evidence found through reviewing the capital control measures used in the three countries’ cases, the study supports the general conclusion that capital controls could be an effective policy tool to reduce the volatility of capital flows, hence reduce harmful effects brought about by this volatility, and help governments gain more policy autonomy and room in dealing with economic woes resulted from financial crises.

II CAPITAL CONTROLS: AN EFFECTIVE MEASURE?

The financial crises in 1990s have renewed an old debate on the matter whether to use capital controls, especially in developing countries. Because the massive speculative attacks on local currencies of these countries and the sudden reversals of capital flows can cause great damages to the central bank’s foreign reserves and the financial and the real sectors of the economy, and because the deregulation of capital movements across the borders of the countries, which was an attempt to attract foreign capital to finance domestic investment and consumption, did allow foreign investors to move their capital out in 1997, and facilitate speculative attacks, Saxena and Wong (1999) state: “It was therefore straightforward to blame these currency speculators and question the wisdom of allowing capital movement in the first place”.

1. Motivations for the use of capital controls

Johnston and Tamirisa (1998) suggest that, while there is some overlap between the motivations for maintaining controls on capital movements, there are generally four different motivations, which are related to:

1.1 Balance of payments and macroeconomic policy management

Capital controls have often been used as one of the policy instruments for balance of payments and macroeconomic policy management. Capital controls are imposed in countries with weak balance of payments with the aim to prevent any

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2 The discussion in this section is a summary mainly of Johnston and Tamirisa (1998). Other authors are separately cited herein, if any.
possible capital outflow, preserve domestic savings for domestic uses. Capital controls are also used in an attempt to maintain or achieve a degree of monetary and exchange rate policy autonomy.

1.2 Market and institutional evolution

The use of capital controls is sometimes related to the premature development of domestic financial markets and institutions. In this regard, controls on inflows are aimed to protect infant industries and less developed financial markets. There are two different versions of the arguments that try to justify capital controls in forms of trade tariffs. One version states that, when protected by a tariff, infant industries will gain economies of scale and thus achieve a higher level of output in the domestic market. The second version notes that domestic industry will be able to lower its production costs thanks to learning by doing.

1.3 Prudential reasons

Johnston (1998) argues that capital controls can also play a role as prudential measures. Different types of risk, including transfer risk, sovereign risk, and country risk, involved in international transactions justify prudential regulations and requirements. In addition, different national jurisdictions, different supervisory and accounting standards, etc. could also justify the need of different and additional requirements for listing and trading of foreign assets in local financial markets.

Furthermore, capital controls could help banks avoid maturity mismatching between their assets and liabilities by lengthening the maturity of liabilities of financial institutions, or preserve systemic stability by limiting excessive foreign exchange exposure of domestic institutions. They could therefore help protect the stability of the financial system (Johnston and Tamirisa (1999)).

1.4 Other reasons

Other factors that justify the use of capital controls include economic size (i.e., smaller countries have more incentives to open their capital account because of their having fewer opportunities for the diversification of investment than larger countries), and openness (i.e., more open economies tend to be more prone to external shocks and may introduce exchange and capital controls to mitigate such shocks); the general features of the regulatory system (e.g., in an economy with weakening public and corporate governance and reducing transparency, the need
of capital controls may arise); and social, sectoral, and strategic concerns, particularly as regards controls on inward direct investment (e.g., inflows of direct foreign investment to important or sensitive sectors may be controlled for security, national sovereignty and cultural reasons).

2. The debate on the effectiveness of capital controls

There has recently been a great deal of arguments and counter-arguments for the use of capital controls. Capital controls affect the economy in many aspects and may not bring about what have been expected by policy makers. The debate on this matter could be refined to focus on six major goals, at which capital controls are aimed as follows:

2.1 Reducing volatility of short-term capital

'Proponents of capital controls' argue that controls help limit volatility of short-term capital flows. So far, it has been convinced that volatility of short-term capital flows increases the vulnerability of emerging economies, which may eventually lead to financial crises, and, for this reason, they should be regulated. Reinhart and Smith (1997) examine the experiences of variety of developing countries that have restored to restrictions on capital flows in the 1990s and conclude that at least in the short run, policies (designed to curb short-term capital inflows) are often effective in either reducing the volume of capital inflows or affecting their composition (or both).

'Opponents of capital controls' argue that controls are ineffective, or not very effective in compared with other macroeconomic measures, in preventing short-term movements. In addition, imposing controls on short-term inflows could crowd out the long-term foreign investment for it is difficult to distinguish between short-term and long-term investment and also between direct and portfolio investment (Saxena and Wong(1999)).

2.2 Supporting the balance of payments

'Proponents of capital controls' argue that controls (on outflows) support the balance of payments by protecting the foreign exchange reserves by preventing outflows of domestic savings and capital flight (Saxena and Wong(1999)). Controls on outflows, argued by Reinhart and Smith (1997), are usually resorted to during balance of payments or financial crises, which are marked by large devalua-
tions of the exchange rate, a sharp change in official foreign reserves sparked by a change in expectation about the future exchange rate, steep declines in the stock market, increased volatility in financial variables, a higher risk of default, and in some cases, political instability.

‘Opponents of capital controls’ argue, because capital controls are ineffective in preventing outflows as people can circumvent the regulations through other transaction channels, and because controls can discourage inflows as they reduce the confidence of investors in the country, controls may therefore not necessarily protect the balance of payments (Saxena and Wong (1999)).

2.3 Limiting foreign ownership of domestic assets

‘Proponents of capital controls’ argue that controls limit foreign ownership of domestic factors of production to prevent either unwarranted depletion of a country’s natural resources or the emergence of a monopoly in a particular industry and protect infant industries and less developed financial markets. Equity and income distribution considerations are often cited as justifications for limiting ownership of domestic factors of production and real estate (Johnston and Tamirisa (1999), and Saxena and Wong (1999)).

‘Opponents of capital controls’ state that capital controls can, by limiting foreign ownership of specific domestic assets, discourage inflows of foreign direct investment, a valuable source of external finance because it bring not only capital but also new technology and trainings (Saxena and Wong (1999)).

2.4 Insulating domestic structural reform programs from foreign shocks

‘Proponents of capital controls’ argue that controls help in stabilization and structural reform programs. In the face of an early liberalization of capital account, there are two cases to consider:

In Case 1, if a stabilization and other structural reform plans are credible, they may result in stronger capital inflows because of high interest rates typically associated with a stabilization program and international and domestic investors’ reaction to the improved investment environment. Such inflows bring with them considerable benefits, but they may also bring various risks as we have discussed in Section 2 above.

In Case 2, if a stabilization program lacks credibility, and if there was uncertainty about the likely success of the reform program, a capital outflow could occur
if residents temporarily repatriate funds abroad to take advantage of the high real rates of interest; the liberalization of the capital account could lead to currency substitution and capital flight, which could trigger a balance of payments crisis, devaluation and inflation.

It is therefore argued that controls over free capital movements can help insulate domestic stabilization and structural reforms from dangers in these two cases (Saxena and Wong (1999)).

‘Opponents of capital controls’ feel that there are advantages in liberalizing the capital account simultaneously with domestic financial sector reforms. It is argued that capital account liberalization is often an attractive option for many developing countries because: (1) controls on capital outflows are believed not to be able to protect developing country’s balance of payments from capital outflows, and therefore, there is little to be lost by a program of liberalization; (2) capital account liberalization will help create a competitive and efficient financial system. The increase in net private capital inflows following the capital account liberalization will help to support balance of payments and smooth temporary shocks to income and consumption. In addition, an open capital account, with a threat for capital outflows, and of short-term capital flows in either direction, could have a disciplining effect, making the authorities careful in their macroeconomic management (Saxena and Wong (1999), and Johnston (1998)).

2.5 Providing short-term relief from speculative attacks

‘Proponents of capital controls’ argue that control program may provide the government with more time and room to move the fundamentals to a region where self-fulfilling speculative attacks are less likely.

‘The opponents’ hold the view that the possibility that controls might be introduced in the future can generate attacks where none would be observed otherwise (Saxena and Wong (1999)).

2.6 Lowering local interest rates

‘Proponents of capital controls’ argue that controls help encourage domestic investment by reducing the local interest rates without allowing capital outflows.

Blanchard (1997) uses a model which relates fixed exchange rate, interest rates, and capital mobility to show that capital controls can help the central bank successfully manipulate interest rates without sacrificing its reserves, thereby en-
encouraging domestic investment. According to this model, if capital controls can discourage some of investors to shift to foreign assets in searching for higher return in response to the central bank’s attempt to lower local interest rates by money market operation, then the foreign exchange market intervention by the central bank to hold the exchange rate constant may be smaller than that without capital controls. And if capital controls truly prevent investors from moving into foreign assets at all, there may be no need at all for such an intervention. Thus, with imperfect capital mobility (or capital controls), a country has (some) freedom to manipulate the domestic interest rate while holding its exchange rate constant, predicts the model.3

'The opponents’ feel that capital controls are perceived as an additional risk factor by the investors. Hence, instead of reducing interest rates and limiting outflows, controls would require higher risk premia, and so would lead to higher interest rates to compensate for higher risk (Saxena and Wong (1999)).

III CLASSIFICATION OF CAPITAL CONTROLS

1. Types of controls

One of the few who systematically classify capital controls is Rajan (1998). According to him, capital controls can be broadly categorized into two: (1) controls on capital account transactions (capital controls); and (2) controls on forex transactions (exchange controls).

1.1 Capital controls

Fane (1998) defines capital controls as regulations or taxes that restrict the freedom of residents and non-residents to buy or sell any assets and liabilities in capital account. He separates capital flows into FDI, portfolio investment, and “other”, which comprises everything else, such as loans to residents from offshore bank. Other capital controls entail restrictions on real estate, emigration allowance limits and other forms of capital transfers.

3 By using this IS-LM model, we can analyze the effects of monetary policy under flexible exchange rate and see that, with imperfect capital mobility, a monetary expansion also leads to a lower domestic interest rate compared with foreign interest rate. (With perfect capital mobility, the domestic interest rate would be fixed at the world rate, and the monetary policy works entirely through its effects on exchange rate). For more discussion about IS-LM model with capital mobility, see for example, Hillier (1991), Blanchard (1997), and Dernburg (1989). As to structural reform problems in developing countries, see Uchida (1997) for instance.
1.2 Exchange controls

According to Fane (1998) and Rajan (1998), exchange controls restrict or tax the use by domestic residents of foreign exchange, or the use of domestic currency by non-residents. Exchange controls thus also encompass currency transactions taxes (such as the “Tobin tax”) and dual or multiple exchange rates. Exchange controls are usually seen as one particular tool in restraining capital flows (usually outflows). However they need not necessarily be a “subset” of capital controls. For instance, they may be used in the case of trade-related transactions.

2. Characteristics of controls

It is useful to consider the following four questions when evaluating controls on capital flows: (1) Are the controls selective or comprehensive? (2) Are the controls on outflows or on inflows? (3) Are the controls temporary or permanent (long-standing)? (4) Are the controls direct (or administrative) or indirect (or market-based)? (Rajan (1998); Ariyoshi et al. (2000))

2.1 Selective versus comprehensive controls

In practice, Rajan (1998) notes, there are various degrees of extensiveness of curbs on capital flows. At the highest level, this would involve virtual inconvertibility on the capital account, with accompanying controls on capital flows, i.e., comprehensive capital controls. It is more typical for a country to impose some form of exchange controls or selective controls on one or more areas of the capital account.

2.2 Controls on capital outflows versus inflows

Controls on capital outflows are aimed at slowing the speed of capital outflows (if not preventing them) when a country is faced with the possibility of a “sudden” and “destabilizing” withdrawal of capital during a time of uncertainty, and breaking the link between domestic and foreign interest rates. Thus, the afflicted economies could conceivably pursue expansionary monetary and credit policies as a means of “growing their way out of debt” without having to face the danger of capital flight (Rajan (1998)).

Controls on capital inflows serve a preventive function by precluding a surge in capital inflows during “boom” times, reducing the volume of capital inflows or affecting their composition (or both), so as to minimize the chances of an abrupt and sharp capital reversal (“bust”) in the future (Rajan (1998)).
2.3 Temporary versus permanent (long-standing) controls

Rajan (1998) argues that temporary controls are seen as a deterrent to “excessive” outflows or inflows during an “extraordinary” period. Thus, they may be used at a time when a country is faced of the danger of capital flight, so as to give policy-makers more room to make appropriate policy alterations. Or conversely, they may be imposed when an economy experiences unsustainably large capital inflows, due to rising confidence in growth prospects of the economy.

Permanent (long-standing) controls are imposed even during “normal” times. It is argued that even if all the necessary microeconomic distortions are revoked and macroeconomic policies are generally sound, it is possible that there may nonetheless exist certain inherent “market failures” that cause sub-optimal decisions to be made in a decentralized and free market economy. It may therefore be justified to institute capital restraints permanently, rather than temporarily (Rajan (1998)).

2.4 Direct (or administrative) versus indirect (or market-based) controls

Ariyoshi et al. (2000) define direct or administrative controls as outright prohibitions on, explicit quantitative limits or an (often discretionary) approval procedure for cross-border capital transactions and/or the associated payments and transfers of funds.

Indirect or market-based controls are aimed at discouraging capital movements and the associated transactions by making them more costly to undertake. Such controls may take various forms, including: dual or multiple exchange rate systems; explicit or implicit taxation of cross-border financial flows (e.g. Tobin tax); and other predominantly price-based measures. Depending on their specific type, market-based controls may affect either the price or both the price and volume of a given transaction.

IV CASE STUDIES: CHILE, MALAYSIA, AND VIETNAM

This chapter reviews the experience of three developing countries, namely Chile, Malaysia, and Vietnam, which used various types of capital controls. The review includes a brief introduction and background involved in the use of capital controls, observations on the types and objectives of capital controls, evaluations of their effectiveness, and the potential costs that may be associated with their use. The effectiveness of the capital controls used in the three countries is assessed on the
basis of their impact on capital flows and intended policy objectives such as change rate stability, providing greater monetary policy autonomy, or preserving domestic macro-economic and financial stability, the sensitivity of capital flows to domestic interest rates (if the controls are effective, capital flows would become less sensitive to domestic interest rates, which the authorities could then orient toward domestic economic objectives). Achievement of the six goals presented in the debate of the Section 2.2 will also be examined, where applicable.

1. The Chilean case

1.1 Introduction and background

Chile witnessed a long history of controls on capital account flows and transactions that started in the 1930s and continued through the mid-1970s. Controls were gradually liberalized in the late 1970s and early 1980, but were tightened again in the aftermath of the Latin American debt crisis of the 1980s (Gallego, Hernandez and Hebbel (1999)). In 1989, the Chilean economy started overheating with GDP grew by over 10%, unemployment declined to less than 8% from 12% in 1985, inflation was on a strong upward trend (see Table 3.1.1). In response to overheating, monetary policy was tightened which, combined with a fall in world interest rates, an improvement of market sentiment toward Chile, and a generalized increased in the willingness to lend to emerging markets resulted in a surge of private capital inflows beginning in 1989. The most important dilemma faced by policy makers was that internal balance required interest rates higher than abroad - at a time in which Chile faced a decreasing country risk and expectations of currency revaluation - while external balance was inconsistent with the appreciation of the currency (Ariyoshi et al. (2000)).

In coping with this situation, Chile has adopted a policy mix which combined three available options for policymakers to: (1) allow the exchange rate to appreciate; (2) limit appreciation through sterilized intervention accompanied by tight fiscal policy to offset the costs associated with sterilization; and (3) reduce the volume of capital inflows by introducing controls on capital inflows and, at the same time, liberalize capital outflows. As a result, since 1991 Chile has levied long-standing and selective controls over capital flows, predominantly on inflows-an asymmetric Tobin tax, the one-year unremunerated reserve requirement (the URR) on foreign bor-

4 This is presented in the Blanchard’s model in Section 2.2
rowing and fixed income securities. The only control on outflows take the form of a one-year requirement before investment capital may be repatriated. This is meant to discourage the entry of short-term "speculative capital" (so-called "hot money") (Rajan (1998), Nadal De-Simone and Sorsa (1999)). At the same time, Chile also implemented supporting policies such as liberalization of capital outflows starting in the early 1990s, and further widening of the exchange rate band, as well as a strong fiscal policy (Ariyoshi et al. (2000)).

1.2 Objectives of the controls

The URR was expected to: (1) expand the autonomy of monetary policy while minimizing the effects on the exchange rate of the tight monetary policy aimed at keeping the interest rate differential required for reducing the excess of desired expenditure over output (put another way, to prevent excessive appreciation of the real exchange rate as a consequence of maintaining domestic interest rate higher than foreign interest rate); (2) moderate the buildup of speculative short-term liabilities without affecting long-term foreign investments (more specifically, to favor equity over debt and medium- and long-term capital inflows over short-term ones). This would in turn reduce the volatility of international capital flows into the country and subsequently could also reduce exchange rate volatility; and (3) impose prudential regulations on banks and institutional investors (Ariyoshi et al. (2000), Nadal-De Simone and Sorsa (1999), and Rajan (1998)).

1.3 Types of capital controls in Chile

According to Rajan (1998) and Gallego, Hernandez and Hebbel (1999), Chile has applied a range of controls on capital movements since 1991 as follows:

(1) Repatriation of profit of FDI is not regulated, but initial investment capital is required to be in country for one year. Maximum proportion of FDI that may be financed through debt is 50%.

(2) Issuance of American Deposit Receipts (ADRs) by Chilean companies is regulated. Only companies with risk classification of BBB (for non-financial companies) and BBB+ (for financial institutions) are permitted to issue ADRs. Minimum account requirement as of Nov 1995 was US $10 million.

(3) Portfolio inflows, such as foreign loans or bond issues, are subject to an unremunerated 10% reserve requirement (URR) deposited at the central bank for

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5 Reduce from 70% to 50% in mid 1996.
one year. The implicit cost of the URR falls with the maturity of the inflow, as the duration of the URR is fixed.

(4) Credit lines for trade financing operations also subject to the 10% reserve requirement.

In summary, Chile combined market-based controls (indirect taxation of inflows through an URR) with direct (minimum stay requirement for domestic corporations borrowing abroad and extensive reporting requirements on banks for all capital account transactions) predominantly on capital inflows. Between 1991 and 1997, the rate of the URR was raised and the coverage of the URR, initially imposed on all foreign loans (except for trade credits), was extended to those non-debt creating capital flows that became potential channels for short-term inflows, including FDI of a potentially speculative nature. In 1998, the URR was suspended with the objective of stimulating capital inflows and reducing pressures on the currency in response to more adverse conditions in world financial markets in the aftermath of the Asian crisis. Controls on capital outflows were relaxed during the 1990s, reducing the minimum stay period for foreign investment (from three to one year in 1995), increasing maximum share of foreign assets in total assets that commercial banks, pensions funds and mutual funds are allowed to hold, etc.

1.4 Supporting policies

Ariyoshi et al. (2000) identifies a number of concurrent and supporting policies, which supported the URR. First, macroeconomic policies, in particular fiscal policy, were greatly strengthened at the time the URR was introduced. The prudential framework for the financial system was enhanced. Surplus of the fiscal balance as a result of strengthened fiscal policy, in turn, helped offset the inflationary effects of sterilization and reserve accumulation, as well as the quasi-fiscal costs for the central bank of the policy of maintaining domestic interest rates higher than international rates.

Second, a flexible exchange rate regime was also introduced to allow for an orderly appreciation of the currency. Between 1992 and 1994, the currency was revalued gradually by 15% facilitated by a gradual widening of the exchange rate band from +/-3% in 1989 to +/-12.5% in 1997. Meanwhile, monetary policy

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6 Initially increased from 20 to 30% in May 1992. Subsequently reduced to 10% as of 26 June 1996 in response to a general slowdown in portfolio capital inflows to all emerging economies.
remained tight as evidenced by the upward trend of the differential of interest rates, in keeping with the adopted policy mix.

Third, prudential framework for the financial sector has developed over the years to establish high disclosures standards, stringent rules for loan classification and provisioning, strict limits on connected lending and on banks’ exposure to foreign exchange risks, prudential external borrowing. As a result of the prudential requirements, the banking system is sound as shown in the low level of non-performing loans, the compliance of all banks with the BIS capital adequacy ratio, etc.

1.5 Effectiveness of the URR

(1) External indebtedness: URR is expected to moderate capital inflows, therefore reducing the country’s overall indebtedness. In fact, the URR led to a fall in capital inflows, although this effect is of a transitory nature due to the URR loss of power. The evolution of the various components of capital inflows suggests that the impact of the URR in reducing specific inflows had only a short-term impact before economic agents found the circumventing channels to shift theirs transactions on the capital account to untaxed inflows (see Table 3.1.1, Figure 3.1.1, and Figure 3.1.2).

![Figure 3.1.1 : Chile-Foregin investment flows/GDP, 1988-1999](image-url)

Source: Central Bank of Chile
On the Financial Policy Management of Capital Controls to Reduce Volatility of Capital Flows; Case Studies in Chile, Malaysia, and Vietnam in 1990s

Figure 3.1.2: Chile-URR tightenings (1991, 1995, 1996) and behaviour of affected gross inflows

![Graph showing URR tightenings and their effects on gross inflows]

Source: Central Bank of Chile, and Nadal De-Simone and Sorsa (1999).

Note: URR was tightened in 1991, 1995, and 1996 as marked by vertical lines

Table 3.1.1: Chile-Some key economic indicators, 1988-1999

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<td>GDP (billion of Chilean peso of 1986)</td>
<td>3,311</td>
<td>4,324</td>
<td>4,844</td>
<td>4,841</td>
<td>5,435</td>
<td>5,816</td>
<td>6,148</td>
<td>6,801</td>
<td>7,305</td>
<td>7,845</td>
<td>8,135</td>
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<tr>
<td>Real GDP growth rate (%)</td>
<td>7.3</td>
<td>10.6</td>
<td>8.7</td>
<td>8.0</td>
<td>12.3</td>
<td>7.0</td>
<td>6.7</td>
<td>10.6</td>
<td>7.4</td>
<td>7.4</td>
<td>3.9</td>
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<tr>
<td>Unemployment rate (%)</td>
<td>9.7</td>
<td>7.8</td>
<td>9.0</td>
<td>8.1</td>
<td>9.0</td>
<td>8.5</td>
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<td>9.2</td>
<td>9.0</td>
<td>8.6</td>
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Source: Central Bank of Chile and IMF's Country Information. Note: Figures are preliminary; 1/Percent per annum over monetary correction.

Figure 3.1.1 shows that despite the various tightenings of the URR, capital inflows to Chile exploded between 1995 and 1997 (dominantly by issuance of new capital abroad by Chilean residents). The fact that inflows to the region increased in general during this period may suggest that compared to external factors, the effects of the URR on capital inflows in Chile, it is argued, may either have been
small or short-lived.

Figure 3.1.2 indicates that when the URR was extended to ADRs in 1995, another exempt inflow (FDI) started to go faster; it is said to have become a major channel for portfolio inflows after the URR was extended to ADRs in 1995. (This led to further tightening of the URR in 1996 to exclude speculative investment from FDI.)

(2) Monetary independence: By giving a greater degree of monetary autonomy, and introducing a wedge between domestic and foreign interest rates, the URR provided more space for the use of monetary policy to accommodate different shocks in the case of Chile. In this regard, Ariyoshi et al. (2000) concluded "...The URR was somewhat effective in providing limited monetary policy autonomy to the authorities. It is particularly striking that Chile was able to maintain the interest and exchange rate mix in place since the mid-1980s despite episodes of strong capital inflows, and even to increase the differential between Chilean and foreign interest rates". Monetary policy continued to play a central role, supported by the URR, in limiting inflation (see Table 3.1.1 and Figure 3.1.3).

![Figure 3.1.3 : Chile-Inflation, 1985-2000](image)

(Average 12-month consumer price index, in percent)

Source: Central Bank of Chile.

(3) Exchange rate: URR was expected to lead-in the short run to a less appreciated exchange rate. In fact, contrary to the expectations of the policy makers, these controls failed to slow the strengthening of the Chile's currency. Furthermore, the URR does not affect in any way the long run level of the exchange rate. However,
Ariyoshi et al. (2000) argue that the URR slightly reduced the volatility of the exchange rate, with a 30% URR reducing the volatility of the real exchange rate by about 20%. They therefore suggest that the URR may have facilitated an orderly appreciation of the exchange rate (see Figure 3.1.4).

Figure 3.1.4: Chile-Observed market exchange rate, 1988-2000
[Index, 1988 = 100]

Source: Central Bank of Chile.

(4) *Increasing domestic interest rate:* Since 1991 evidence shows that Chile has been successful in maintaining domestic interest rates above international level (Table 3.1.1, and Figures 3.1.5). Others hold the view that although the URR may have played a role in this success; it had, however, a small and temporary effect on interest rate movements in Chile.

Figure 3.1.5: Chile-Differential of interest rate, 1990-2000

Source: Central Bank of Chile.
(5) Reducing short-term debt: Official data indicate that short-term debt as a proportion of total debt declined from 36% in 1990 to 10% in 1998 (Figure 3.1.6), which suggests that the URR contributed to lengthening the average maturity of Chile's external debt.

![Figure 4.1.6: Chile-Non-FDI flows in percent of total foreign investment flows, 1988-1999](image)

Source: Central Bank of Chile.

1.6 Conclusions

It is true that the control measures have been associated with such costs as quasi-fiscal losses (which is estimated around 0.5% of GDP per year), misallocation of resources (e.g., the URR discriminates against the short-term projects), and reducing investment and long-term growth; and since the URR was not universally applied to all foreign capital inflows, the control regulations tended to lose their effectiveness over time, as ways of circumventing them were developed channeling the inflows through exempted windows. Nevertheless, by reducing external indebtedness and change the composition of capital inflows toward longer-term maturities, the URR has addressed the concerns that economic agents, and in particular banks, would not be able to adequately control risks when faced with larger capital inflows, particularly of short-term nature. The URR has, therefore, allowed Chilean economy to attain better economic fundamentals than otherwise (Gallego, Hernandez and Hebel (1999)). It is contended that without the URR and other regulations, the size of net capital flows could have been larger and the same monetary policy could not have been applied (Ariyoshi et al. (2000)). Rajan (1998) concludes that (despite capital controls) Chile has enjoyed greater levels of FDI, both
relative to other Latin American economies and as a proportion of aggregate capital inflows into the respective countries (especially Mexico and Argentina, both of which have allowed for largely unfettered capital flows). As a result of capital controls, relatively lower levels of external indebtedness - which is a key criteria determining the potential vulnerability of an economy to a currency and financial crisis - and a sound financial system have been achieved, thereby the Chilean economy has been much less impacted by the Tequila crisis of 1994–95, than other Latin American economies.

2. The Malaysian case

2.1 Introduction and background

Before the regional crisis, Malaysia had generally stronger fundamentals than other Asian crisis economies. It had very little foreign debt either by the government or the private sector (short-term debt accounted for only 25% of total debt, of which commercial banks accounted for 75% of total short-term debt and the debt service ratio (ratio of debt servicing to export of goods and services) was just 5.5% in 1997), good reserves (the net international reserves held by Bank Negara Malaysia reached RM81.5 billion as at end of September 1998. In US dollar terms, external reserves were US $26 billion, sufficient to finance 4 months and half of retained imports) (see Table 3.2.1). In first half 1997, before the regional crisis's outbreak, the Malaysian economy recorded a strong growth of 8.5%.

The full impact of the regional financial crisis was felt by Malaysia in 1998. After 12 successive years of strong growth averaging 7.8% per annum, real output declined by 6.7% in 1998. Macroeconomic management in early 1998, therefore, focused on reducing risks in the economy to ensure macroeconomic stability and promote a stronger financial system. Malaysia had adopted fiscal and monetary restraint to stabilize the financial market and contain inflationary pressures in order to strengthen macroeconomic stability and restoring investor confidence. While the measures were successful in containing inflation (which had been on an upward trend since the fourth quarter of 1997 but stabilized in the third quarter of 1998, with CPI stood at 5.7% - see Table 3.2.1), and restoring the balance of payments to a surplus position (at record level of RM38.7 billion for the first 9 months of 1998), the regional crisis induced a much sharper contraction in real output.

All the data and figures in this section are the excerpts of Bank Negara Malaysia Annual Report and Bank Negara Malaysia Quarterly Report in 1997, 1998, and 1999.
**Figure 3.2.1: Malaysia—Some key economic indicators, 1995-1999**

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<tr>
<td>GDP (millions of ringgit)</td>
<td>184,647</td>
<td>195,166</td>
<td>209,823</td>
<td>157,098</td>
<td>160,240</td>
</tr>
<tr>
<td>Real GDP growth rate (%)</td>
<td>9.8</td>
<td>10.0</td>
<td>7.5</td>
<td>-7.5</td>
<td>5.4</td>
</tr>
<tr>
<td>Unemployment rate (%)</td>
<td>3.1</td>
<td>2.5</td>
<td>2.4</td>
<td>3.2</td>
<td>3.0</td>
</tr>
<tr>
<td>Consumer price index change (%)</td>
<td>3.5</td>
<td>3.5</td>
<td>2.7</td>
<td>5.3</td>
<td>2.7</td>
</tr>
<tr>
<td>Average lending rate (commercial bank)</td>
<td>9.3</td>
<td>10.1</td>
<td>11.5</td>
<td>9.7</td>
<td>7.8</td>
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<tr>
<td>Balance of payments</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current account balance (% of GDP)</td>
<td>-9.7</td>
<td>-4.4</td>
<td>-5.6</td>
<td>12.9</td>
<td>15.8</td>
</tr>
<tr>
<td>Capital account balance (% of GDP)</td>
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<td>4.0</td>
<td>3.6</td>
<td>24.3</td>
<td>27.9</td>
</tr>
<tr>
<td>Net FDI (US $ billion)</td>
<td>6.6</td>
<td>5.4</td>
<td>6.8</td>
<td>2.7</td>
<td>3.1</td>
</tr>
<tr>
<td>Net short-term flows (US $ billion)</td>
<td>1.0</td>
<td>4.1</td>
<td>-4.6</td>
<td>-5.3</td>
<td>-9.5</td>
</tr>
<tr>
<td>Gross official reserves (US $ billion)</td>
<td>25.1</td>
<td>27.7</td>
<td>21.7</td>
<td>26.2</td>
<td>30.9</td>
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<tr>
<td>Equivalent to months of imports</td>
<td>4.2</td>
<td>4.6</td>
<td>3.5</td>
<td>5.8</td>
<td>6.1</td>
</tr>
<tr>
<td>Overall budget balance (% of GDP)</td>
<td>1.3</td>
<td>1.1</td>
<td>2.5</td>
<td>-1.5</td>
<td>-4.1</td>
</tr>
<tr>
<td>Total external debt (US $ billion, end of period)</td>
<td>33.4</td>
<td>38.7</td>
<td>43.8</td>
<td>42.6</td>
<td>42.0</td>
</tr>
<tr>
<td>Short-term debt (US $ billion)</td>
<td>6.4</td>
<td>9.9</td>
<td>11.1</td>
<td>8.5</td>
<td>6.0</td>
</tr>
<tr>
<td>Banking (US $ billion)</td>
<td>4.4</td>
<td>6.7</td>
<td>8.3</td>
<td>5.4</td>
<td>3.6</td>
</tr>
<tr>
<td>Non-banking private sector (US $ billion)</td>
<td>2.0</td>
<td>3.2</td>
<td>2.8</td>
<td>3.1</td>
<td>2.4</td>
</tr>
<tr>
<td>Debt-service ratio (% of exports)</td>
<td>6.5</td>
<td>6.8</td>
<td>5.5</td>
<td>6.4</td>
<td>5.2</td>
</tr>
<tr>
<td>Debt/GDP ratio (% of GDP)</td>
<td>37.6</td>
<td>38.4</td>
<td>43.8</td>
<td>58.8</td>
<td>53.4</td>
</tr>
<tr>
<td>Medium-and long-term debt</td>
<td>30.5</td>
<td>28.5</td>
<td>32.7</td>
<td>47.1</td>
<td>45.7</td>
</tr>
<tr>
<td>Short-term debt</td>
<td>7.2</td>
<td>9.9</td>
<td>11.1</td>
<td>11.7</td>
<td>7.6</td>
</tr>
</tbody>
</table>

Source: Bank Negara Malaysia and Ministry of Finance Malaysia.

Note: *Italic* figures are preliminary

(GDP contracted by 1.8%, 6.8% and 8.6% in 1st, 2nd and 3rd quarters of 1998 respectively). The continued instability in the international financial markets intensified in the early part of 1998 and spilled over into the domestic economy.\(^8\)

Potential vulnerabilities also existed from rapid credit expansion and deterioration in the asset quality of banks. As the onset of the crisis in mid-1997 revealed structural weaknesses in region's banking systems and resulted in a more general reassessment of regional lending risks, the ringgit came under significant depreciation pressure along with other regional currencies (Ariyoshi et al. (2000)). Much of this pressure occurred through currency trading in the offshore ringgit market. As agents took short positions in ringgit in the expectation of a depreciation, offshore ringgit interest rates increased relative to domestic interest rates and resulted in capital outflows, amounting to about RM24.6 billion in the 2nd and 3rd quarter of 1997. By the end of August, the ringgit had depreciated by more than 40% against the US dollar compared to June 1997 and the stock market had declined by 72% (Figure 3.2.1)

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\(^8\) The discussion in this section is drawn on *Bank Negara Malaysia Annual Report 1999.*
Given this adverse external environment, Malaysia imposed the *selective exchange* and *capital control* measures on 1 September 1998 to eliminate the internationalization of the ringgit and to stabilize the short-term capital flows.

### 2.2 Objectives of the exchange and capital controls in September 1998

The Malaysian move involved a series of *temporary, selective exchange and capital quantitative controls* predominantly on *outflows* to regulate the international trade in its local currency and regulate movements of foreign exchange aiming at: (1) regaining monetary autonomy, thus allowing Malaysia to pursue a low interest rate policy to stimulate growth in the recession-hit economy, without it having significant downward pressure on the currency; (2) by forcing the liquidation of external/offshore accounts, the intention is to preclude speculative attacks on the currency both onshore and offshore, as well as to stabilize the impact of short-term capital flows, without impacting FDI flows (Rajan (1998)).

### 2.3 Measures of exchange and capital controls

The policy package included:

1. The official fixing of the ringgit at 3.80 to the US dollar, thus removing or greatly reducing the role of market forces in determining the day-to-day level of the local currency (the ringgit’s value in relation to currencies other than the dollar will still fluctuate according to their own rates against the dollar). This measure largely removes uncertainties regarding the future level of the ringgit.

2. Measures related to the local stock market, including the measures to prevent speculation or manipulation from outside the country by closing secondary markets so that trade can be done only via the Kuala Lumpur Stock Exchange; and the measure to reduce foreign speculative short-term trade in local shares by requiring that non-residents purchasing local shares to retain the shares or the proceeds from sale for a year from the purchase deadline.

3. Measures to reduce and eliminate the international trade in ringgit by not recognizing or accepting ringgit-denominated financial assets such as cash and savings deposits outside the country after a one-month deadline.

4. Measures related to export (ringgit notes up to RM1,000 and foreign currencies only up to RM10,000 equivalent) and import (up to RM1,000 and any

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amount of foreign currencies) by resident travelers.

(5) Measures related to international payments and investment:
* Except for payments for imports of goods and services, residents are freely allowed to make payments to non-residents only up to RM10,000 or its equivalent in foreign currency (previously the limit was set at RM100,000).
* Approval is required for investments in any form abroad by residents and payments under a guarantee for non-trade purposes.

Figure 3.2.1 : Malaysia-Stock market index and exchange rate, 1997-1999

Source : Kuala Lumpur Stock Exchange and Bank Negara Malaysia.

* Prescribed manner of payment for exports will be in foreign currency only (previously it was allowed to be in foreign currency or ringgit from an External Account).
* Domestic credit facilities to non-resident correspondent banks and non-resident stock broking companies are no longer allowed (previously domestic credit up to RM5 million was allowed).
* Prior approval is required for residents to make payments to non-residents for purposes of investing abroad for amounts exceeding RM10,000 equivalent in foreign exchange.
* Residents are not allowed to obtain ringgit credit facilities from non-residents.

(6) Measures imposing conditions on the operations and transfers of funds in Ex-
ternal Accounts. Transfers between external accounts require prior approval for any amount (previously freely allowed); transfers from external accounts to resident accounts will require approval after 30 September 1998; sources of funding external accounts are limited to proceeds from sale of ringgit instruments and other assets in Malaysia, salaries, interest and dividend and sale of foreign currency.

In general, the ringgit is still to be freely (or at least easily) convertible to foreign currencies for trade (export receipts and import payments), inward foreign direct investment, and repatriation of profit by non-residents. Convertibility up to a certain limit is also allowed for certain other purposes, such as financing children's education abroad. But convertibility for autonomous capital movements for several purposes not directly related to trade will be limited.

2.4 Brief analysis of Malaysian exchange control measures

By restricting the availability of ringgit in offshore markets and restricting the international trade in ringgit, the authorities could reduce the conditions and opportunities for speculators to make profits out of fluctuations in the ringgit’s value. In addition, the ringgit’s rate fixed by the financial authorities, rather than by the market, will also help restore greater financial stability by reducing uncertainties in the markets.

Malaysia has opted not to introduce a currency board system to fix the exchange rate. Instead, it has chosen capital controls as these control measure allow the government greater degrees of freedom and much needed flexibility to determine domestic policy, particularly in influencing domestic interest rates. It can now reduce interest rates to enable the conditions for recovery, without being overly constrained by the reaction of the market and by fears of the ringgit falling. Capital controls could also reduce the conditions in which currency speculators can profitably operate (the decision to make offshore ringgit invalid after one month deadline will dry up the sources of offshore ringgit that speculators can borrow to manipulate the ringgit, for example by “selling short”), reduce the exit of funds and discourage the inflows of undesirable forms of short-term capital.

In summary, the Malaysian exchange control measures are a response to the basic causes of the crisis afflicting both the country and the region, beginning with funds being allowed to freely move in and out of the affected countries.

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10 The discussion in this section is drawn on Khor (1998). Other authors are separately cited, if any.
It is to be noted that Malaysia has not turned away from all forms of foreign capital. The controls are aimed specifically at short-term flows. They do not extend to FDI or the repatriation of interest, dividends and profits. Current account remains convertible; Malaysia remains committed to free trade.\(^\text{11}\)

2.5 Supporting measures

The exchange and capital controls were supported by additional measures to: (1) eliminate potential loopholes, such as law amendment to limit distribution of dividends; (2) strictly enforce and implement control measures by Bank Negara (e.g., commercial banks were required to ask for documentary evidence for the types of transactions they approve and to report to Bank Negara; the authorities closely monitored the activities of the commercial banks and at times exercised moral suasion to ensure enforcement of the regulations) (Ariyoshi et al. (2000)).

2.6 Effectiveness of, and benefits associated with, Malaysian control measures

Evidence suggests that with the imposition of the control measures Malaysia has effectively obtained the followings:\(^\text{12}\)

(1) \textit{Recovery of stock market and consumer confidence:} KLSE index reached over 590 at the beginning of first quarter of 1999, compared with 303 at the beginning of September 1998 - the time the control measures were imposed (see Figure 3.2.1). Moody’s upgrade of Malaysia’s Baa3 sovereign rating outlook from stable to positive is in line with its strengthening economic recovery and resilient external balances. More than $370 million had flowed into Malaysia from the time the controls were imposed to the first quarter of 1999. And government tested the US bond market in the first quarter of 1999, the issue was oversubscribed by three times. Sales of cars and houses have picked up. In second quarter of 1999, GDP rose by 4.1% after 5 successive quarters of recession.

\(^{11}\) Malaysia loosened controls in February 1999 by introducing market-based measures, a graduated levy or exit tax on foreign investments in Malaysian stocks, replacing the rule that required foreign investors to retain capital and profits in the country for one year. Foreign investors are now able to take their money out if they are willing to pay a levy of up to 30%. The aim of new relaxation was to be explained as to encourage portfolio investors to take a longer-term view of investment, to discourage short-term flows, and to allow a smoother outflow of funds, rather than a sudden and massive outflow upon the expiry of the one-year holding period.

\(^{12}\) All the data in this section are the excerpts of \textit{Bank Negara Malaysia Annual Report} and \textit{Bank Negara Malaysia Quarterly Report} in 1998 and 1999, and “Capital controls a right move, says Dr Mahathir”, Bank Negara Malaysia’s Press Release, August 1999.
(2) *Elimination of the offshore ringgit market:* According to Bank Negara, available evidence suggests that the controls have so far been effective in achieving the objective of eliminating the offshore ringgit market. In particular, the freezing of the external accounts, which prevented ringgit funds from being transferred from one account to the other and from being used to settle transactions or lend to other non-residents effectively eliminated offshore ringgit trading and constrained non-residents’ access to ringgit funds.\(^\text{13}\) The 12-month requirement for repatriation of portfolio capital, as well as the restrictions imposed on residents’ outward investments, seemed helpful in containing the potential outflows (Ariyoshi et al. (2000)).

(3) *Absence of speculative pressures on the ringgit:* Evidence also suggests that despite a significant relaxation of monetary and fiscal policies, there has been no sign of speculative pressures on ringgit since the introduction of control measures and the pegging of ringgit. Controls’ effectiveness is also found in the absence of black market, few efforts to evade controls, and no indications of circumvention through under-invoicing of exports or over-invoicing of imports (Ariyoshi et al. (2000)).

(4) *Strengthened balance of payments:* Balance of payments, which has almost been in deficit for many years, was reversed and huge surplus achieved in the trade balance. This enabled the reserves to increase from US $ 20 billion to US $ 30 billion in the space of six months. The government’s reserves of foreign currencies rose by about 4.8% in the early 1999.

(5) *Lower inflation, lower interest rates, and as a result, lower non-performing loans:* Inflation is on a downward trend, down continually from 5.7% to 5.2% and 2.3% in 2nd, 3rd quarters of 1998 and 3rd quarter of 1999 respectively. Interest rates fell by about 4 to 5% from the peak of 12.27% at end June 1998 to 8.04% at end-1998 and 5.5% in August 1999 (see more in Table 3.2.1 and Figure 3.2.2). The reduction in interest rates that accompanied the controls are believed to have helped to contain the increase in non-performing loans of the banking system, paving the way for Malaysia to clean up the bad loans and accelerate bank and corporate sector restructuring.

2.7 Conclusions

Like the Chilean control measures, the Malaysian controls have also been associated with some costs, including: (1) some inconveniences suffered by some

\(^{13}\) *Bank Negara Annual Report, 1998.*
Malaysians who hold ringgit accounts abroad, or who travel frequently and who need to transfer funds abroad; (2) the interrupt access to foreign sources of investment finance, and short-term investments in the stock market were subject to some tolerable conditions; (3) controls require a burdensome administrative bureaucracy for all parties involved; (4) initial dampening of investor confidence given context that for a very successful economy like Malaysia, the imposition of currency controls might be viewed by foreign investors as casting doubt on the openness of the country to the rest of the world; and (5) initial cautious attitude toward new investment in Malaysia adopted by foreign direct investors because of considerable initial uncertainty about the coverage and impact of the measures.\textsuperscript{14}

\textbf{Figure 3.2.2: Malaysia-Balance of payments, inflation international reserves, and selected interest rate, 1995-1998}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure3.2.2.png}
\caption{Malaysia-Balance of payments, inflation international reserves, and selected interest rate, 1995-1998}
\end{figure}

\begin{itemize}
\item Overall balance of payments (net)
\item International reserves (net)
\item Inflation
\item Interest rate (Discount rate on Treasury bills (3 months))
\end{itemize}

Source: Bank Negara Malaysia.

However, the positive indicators on the larger aspects of the economy suggest that the controls have been effective in realizing their intended objective of \textit{reducing the ringgit's internationalization} and helping to contain capital outflows by eliminating

\textsuperscript{14} For more information, see \textit{Bank Negara Annual Report 1998}, Khor (1998), and Ariyoshi et al. (2000).
the offshore ringgit market and by restricting the outflows of capital by residents and nonresidents. The Malaysian government looks at capital controls as a smaller price to pay than subjecting the country to the vagaries of the open, unregulated international system (Khor (1998)).

Also, on the one hand, the World Bank concluded "There was no adverse effect on FDI...There may even have been a slight upsurge at some point". And: "...The capital controls did not have the adverse effects said by people 'who wished Malaysia so ill' when the controls were imposed". On the other hand, the IMF, who was particularly hostile to the Malaysia's measures initially, has conceded that "nonstandard" methods such as those adopted by Malaysia could sometimes be justified; and IMF board members "broadly agreed that the regime of capital controls—which was intended by the authorities to be temporary—had produced more positive results than many observers had initially expected".

3. The Vietnamese case
A transitional country towards market economy, Vietnam has adopted capital controls since the end of 1980s and, therefore, aimed at excluding the free movement of capital flows in an attempt to fully tap the benefits of deeper economic integration while maintaining the autonomy in its monetary and foreign exchange rate policy.

3.1 Objectives of the control measures
Vietnam is running a large current account deficit, which is considered by some economists unhealthy and unsustainable, especially in compared with other Asian countries (see Table 3.3.1). This huge current account deficit had put pressure on Vietnamese currency (dong, or VND) and would have resulted in a stiff devaluation, particularly in the context of regional crises where afflicted countries' currencies have been devalued drastically. However, as analyzed below, a large devaluation is unwanted by Vietnamese authorities. Accordingly, capital and exchange controls, among other available policy instruments, were imposed with the aim to: (1) stabilize the value of dong, which was pegged against the value of US dollar; (2) contain short-term foreign loans in favor of FDI in order to ensure sustainability

16 "World Bank to study Malaysia's capital controls", Malaysian News Agency (Bernama), 19 October 1999.
of current account deficit; and (3) prevent outflows when there is a negative change in public sentiment as a result of policy adjustment in business environment or external shocks.

Table 3.3.1: Current account balance to GDP ratios of six Asian countries, 1993–1998

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<td>Indonesia</td>
<td>-1.6</td>
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<td>-1.8</td>
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<tr>
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<td>-4.2</td>
</tr>
<tr>
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<td>-4.6</td>
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<td>1.9</td>
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<td>Korea</td>
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<td>-1.0</td>
<td>-1.7</td>
<td>-4.4</td>
<td>-1.7</td>
<td>12.5</td>
</tr>
</tbody>
</table>

Source: “Country selected issues”, Country Information, IMF.

3.2 Types of the control measures

Vietnam had adopted capital controls long before the time in which the regional crisis occurred. *Permanent and comprehensive capital and exchange restraints and regulations* predominantly on *outflows* were first introduced in late 1988, and revised in 1994, giving centralized control over all aspects of foreign exchange to the State Bank of Vietnam (the central bank of Vietnam), including:

1. Vietnamese firms and individuals must place their foreign exchange receipts from the export of goods or from the provision of services into bank accounts held with banks approved by the State Bank to deal with foreign exchange.
2. The State Bank of Vietnam must approve the conversion of currency on behalf of foreign businesses. Foreign businesses do not have the automatic legal right to convert currency. Foreign businesses are required to ensure that foreign currency receipts derived from exports will cover foreign currency expenditures (including the repatriation of profits).
3. Firms (except banks and financial companies licensed to deal with foreign exchange) are banned from directly lending, paying, transferring and trading in foreign exchange to one another. All foreign exchange transactions are required to be conducted at banks, financial companies and foreign exchange booths licensed by the State Bank.
On the Financial Policy Management of Capital Controls to Reduce Volatility of Capital Flows; Case Studies in Chile, Malaysia, and Vietnam in 1990s

(4) All foreign exchange transactions are conducted at approved banks’ exchange rates. These exchange rates are supposed to fluctuate within a band around the State Bank’s official exchange rate. The State Bank sets the band and may alter it from time to time.

(5) Public and private firms are no longer allowed to make business transaction in foreign currency, with the exception of selected enterprises investing in the hotel, tourism, shipping, petroleum, transport, and telecommunications sectors. The State Bank of Vietnam tightly regulates the official exchange rate of the Vietnamese dong, thus eliminating any currency “black” market.

(6) Carrying or transferring foreign exchange into Vietnam are encouraged, and not restricted.

(7) Both non-resident and residents, when enter into or leaving Vietnam, are to declare at the custom gates the amounts of foreign exchange they carry. Non-residents are allowed to carry out of Vietnam the remaining amount of foreign exchange, which they had carried into. Residents shall have to obtain permissions by licensed banks to carry out of Vietnam foreign exchange.18

(8) Approvals by the State Bank are required for firms to open foreign exchange accounts abroad.

(9) Foreign borrowing by firms is subject to be controlled by the State Bank and the Ministry of Finance. To be allowed to borrow from abroad, firms must fully meet various requirements set up to ensure the foreign loans are manageable, productive and repayable.19

3.3 Evolution of the control measures

Up to 1988, a multiple exchange rate system was applied for difference transactions involved foreign exchange. For example, as of Nov. 1988, the exchange rate for most invisible transactions was VND360 per US $ 1, while the exchange rate applied for external trade transactions outside the foreign exchange plan and for those of local firms was VND900 per US $ 1. The exchange rates were also adjusted from time to time (in fact, a devaluation).

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18 This was stipulated specifically in Decision 236/1999-NHNN7 issued in July 1999 which rules that individuals entering Vietnam with over US $ 500 or the equivalent in other foreign currencies have to declare it to custom gates. Those leaving are allowed to bring with them a maximum of US $ 500 or the equivalent in other foreign currencies. Individuals who make declarations at the customs office are allowed to depart with over US $ 500 but this amount cannot exceed the amount they declared when entering Vietnam.

19 For instance, conditions to be eligible to borrow, interest rates, terms, etc.
During the second half of 1996, Vietnamese banking sector was faced with a danger of crisis due to defaults on deferred letters of credit (a type of short-term borrowing) owed by Vietnamese banks to their foreign counterparts, a practice which became particularly popular during 1994 and 1995. This device was used to circumvent rules limiting the percentage of a bank's funds that could be lent to a single customer. To deal with this circumvention, the State Bank came to further tighten the conditions for foreign borrowing and banks' guarantees, such as requiring all enterprises to deposit a foreign currency amount of at least 80% of their imports' value under deferred letters of credit facility, as well as other strict requirements imposed on the commercial banks to deal with letters of credit, in an attempt to enhance the soundness of foreign borrowings and reduce short-term loans, which expose banks and companies to external vulnerability.20

3.4 The impact of the Asian crisis on Vietnam's economy and the countermeasures

It is said that Vietnam has been largely shielded from the Asian crisis so far because of the insularity of its economy. Vietnam's economic expansion slowed to a respectable 5.8% in 1998 after a long period of high growth of around 8-9% annually. Unlike Thailand, and South Korea, Vietnam is not deeply integrated into the region's economy. The absence of stock markets (the first trial bourse was opened in 2000), layers of restrictions, tariff barriers and exchange and capital controls make Vietnam less exposed to the regional crisis, and shield it from the immediate fallout.21

In fact, despite the country's relative protection from the vagaries of global markets and its economic insulation, Vietnam has been feeling the blow of the regional crisis, though its growth figures looked good compared with neighboring countries' contracting economies. The impact of the East Asia crisis on the economy is reflected in the slower growth of industrial output, slowing exports, a downturn in foreign investment, higher unemployment, as well as growing pressure on domestic currency (Table 3.3.2).

GDP fell continually from around 8.7% between 1990 and 1997 to 5.8% and 4.7% in 1998, 1999 respectively. Meanwhile, Vietnam was faced with deflation beginning in the late half of 1998 through the year 1999, which inflation plummeted

20 Direction No. 06/NH7-CT by the Governor of the State Bank, dated 6 June 1996 on intensification of the enforcement of foreign borrowing and repayment.
Table 3.3.2: Vietnam - Some key economic indicators, 1995-1999

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</thead>
<tbody>
<tr>
<td>GDP (US $ billion)</td>
<td>20.8</td>
<td>24.6</td>
<td>26.83</td>
<td>27.1</td>
<td>28.7</td>
</tr>
<tr>
<td>Real GDP growth rate (%)</td>
<td>9.5</td>
<td>9.3</td>
<td>8.1</td>
<td>5.8</td>
<td>4.7</td>
</tr>
<tr>
<td>Export (US $ million)</td>
<td>5,449</td>
<td>7,256</td>
<td>9,145</td>
<td>9,365</td>
<td>11,450</td>
</tr>
<tr>
<td>Export growth (%)</td>
<td>13.4</td>
<td>13.3</td>
<td>12.6</td>
<td>2.4</td>
<td>22.6</td>
</tr>
<tr>
<td>Import (US $ million)</td>
<td>8,155</td>
<td>11,144</td>
<td>11,622</td>
<td>11,494</td>
<td>11,636</td>
</tr>
<tr>
<td>Import growth (%)</td>
<td>14</td>
<td>13.6</td>
<td>10.4</td>
<td>-1.1</td>
<td>1.2</td>
</tr>
<tr>
<td>Capital account balance (US $ billion)</td>
<td>2,326</td>
<td>2,079</td>
<td>1,662</td>
<td>216</td>
<td>-334</td>
</tr>
<tr>
<td>External convertible debt (US $ million)</td>
<td>6,452</td>
<td>8,283</td>
<td>9,590</td>
<td>10,760</td>
<td>11,140</td>
</tr>
<tr>
<td>Urban unemployment</td>
<td>6.4</td>
<td>5.9</td>
<td>6.0</td>
<td>6.9</td>
<td>7.4</td>
</tr>
<tr>
<td>Exchange rate (annual average, dong/US $)</td>
<td>11,029</td>
<td>11,050</td>
<td>11,689</td>
<td>13,613</td>
<td>13,932</td>
</tr>
<tr>
<td>Change (%)</td>
<td>-</td>
<td>0.2</td>
<td>5.7</td>
<td>18.5</td>
<td>2.4</td>
</tr>
<tr>
<td>Foreign exchange reserve (US $ million)</td>
<td>1,376</td>
<td>1,798</td>
<td>2,260</td>
<td>2,077</td>
<td>2,461</td>
</tr>
<tr>
<td>Equivalent to weeks of imports</td>
<td>8.7</td>
<td>8.4</td>
<td>10.1</td>
<td>9.4</td>
<td>11</td>
</tr>
<tr>
<td>Budget deficit (% of GDP)</td>
<td>0.7</td>
<td>-0.8</td>
<td>-0.8</td>
<td>-0.2</td>
<td>-0.5</td>
</tr>
</tbody>
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Note: Figures in italic are estimates. *Converted from VND into US$ at the annual average exchange rate listed below in the same table.

from an average rate of 9.2% in 1998 to an estimate of 0.1% in 1999.

The World Bank argues that Vietnam’s dependence on Asia for exports and investment is huge and that makes the impact of the regional recession inevitable. FDI inflows, which had in recent years financed the current account deficit, declined in 1998 and 1999 (see Table 3.3.2) due to the Asian crisis (nearly two thirds of Viet Nam’s foreign investors are from the region) and to disenchantment in the international community with the business environment. With foreign-invested projects now representing around 10% of Vietnam’s total GDP, 20% of Vietnam’s export earnings, contributing around US$300m to government revenues, and registering annual industrial output growth of over 20%, it has been a valuable element of Vietnam’s business community and plays an increasingly important role. Its slowdown means negative to Vietnam’s sustainable growth.

With regard to export, slower export growth in the recent years, which dropped from 12.6% in 1997 to 2.4% in 1998, was the direct result of Vietnam’s exposure to Asian markets, which account for about 70% of its exports.

Unemployment has been in upward trend again after some improvement in the first half of 1990s, which was at the peak of 8.3% in 1992. The increase in unemployment is considered a direct result of the stagnant growth of the export sector.

Government responded to weakening demand and falling prices by adopting several measures. This includes supplementary fiscal spending on infrastructure, extra-budgetary spending through several funds and through directed bank lending on rural infrastructure. Monetary policy was also eased to increase total liquidity in the economy through providing more credit to both state and private sectors supported by lowering interest rates. In parallel with these relaxation measures, structural reforms has also been the focus of policy package; the government has continued to announce and implement various reform measures since 1998 to date, related to state enterprises, banking, private sector, and trade, etc.

However, as a result of demand stimulation program and monetary relaxation by the authorities, inflation moved upward and put greater pressure on the exchange rate, while the State Bank’s intervention capability in the foreign exchange market is limited because of its tiny size of international reserves (e.g. in 1997 its reserves were equivalent to barely 10 weeks of imports). Therefore, further tightening of exchange controls to stabilize exchange rate and prevent all kinds of exchange speculation leading to high volatility of exchange rate was implemented.

3.5 Exchange rate evolution and policy

To cope with the hyperinflation of 3 digits in the second half of 1980s, Vietnam adopted a contracted financial and monetary policy. As a result, inflation was brought down to 3.6% in 1997 (see Table 3.1.1). The main factor contributed to this success was the "nominal anchor" exchange rate policy. During 1994-1996, the exchange rate was kept substantially stable at around VND 11,000 against US$ 1 (Yoshitomi and Ohno (1999)).

However, Vietnam abandoned trying to keep a fixed exchange rate in the face of the crisis. As a response to the crisis’ negative effects, the exchange rate of the dong and / or its determination mechanism were gradually adjusted five times, starting in February 1997, through redefinitions of the central parity and / or adjustments in the width of the band. On 27 February 1997, the State Bank of Vietnam widened the foreign exchange trading band between commercial banks from ±1% to ±5%, and on 13 October 1997, widened it further to ± 10%. On 16 Febru-
ary 1997, the official exchange rate was devalued by 5.6% from 11,117.5 to 11,800 VND to the US dollar. On 7 August 1998, the State Bank decided to devalue the official exchange rate from 11,800 to 12,998 VND to the US dollar, and at the same time narrowed the foreign exchange trading band to ±7%. These changes, approximately every six months since end-1997, tended to have negative psychological effects on enterprises, investors, and the general population.24

On 25 February 1999, the foreign exchange rate mechanism was further adjusted, to a "crawling peg" system, as there was little pressure on the dong in the foreign exchange market, and on the balance of payments because of solid export growth and slack demand for imports of capital equipment.25 Effective 26 February 1999, the State Bank publicized only the previous trading day’s interbank exchange rate, instead of official exchange rate. Institutions could determine their own exchange rate, which must fluctuate within a tiny band of 0.1% from this publicized interbank exchange rate. The move was aimed to allow the exchange rate to be set more in line with the foreign currency supply and demand and other economic factors, including inflation, after years of being isolated and held overvalued.

Figure 3.3.1 illustrates the movement of Vietnamese dong rate against US dollar through out 1996-1999.

Figure 3.3.1: Month-end Vietnamese dong exchange rate against US $, 1996-2000 (Interbank, median bidding rate)

Source: The State Bank of Vietnam

24 ADB's Vietnam Residence Mission's "Economic update"  
The government has long ruled out a hefty devaluation because of possible negative social impact, especially if the move sparked a sharp rise in inflation, though doing so may boost its exports.\textsuperscript{26} The government argues that the main result of a devaluation would be an increase in the cost of imports, which would push up prices and lead to lower demand, which would in turn lead to a dramatic fall of production. A devaluation might also create dangerous tensions in the general population. Further, a devaluation would render the country's external debts more expensive. For instance, the government had to earmark 7\% of the state budget to service foreign debt, and Vietnam had to repay foreign debt totaling US$ 857 million in 1999 (or roughly 36\% of its GDP).\textsuperscript{27} Therefore Vietnam's stance of exchange policy is to emphasize the need for safety and stability by implementing the following policies:

First, encouraging export and foreign investment: New incentives have been offered to investing foreign companies and exporters by further tax reductions, lower land rents and service charges, and by moving hindrance to investment.

Second, mobilizing foreign currencies held by companies and general public, as well as remittances from abroad:

\textit{By companies:} Decrees 63 and 173 (October 1998) by the government forced resident companies to sell 80\% of their foreign exchange holdings within 15 days of deposit, in exchange for a "conversion certificate" from the State Bank, an assurance that they can convert dong earnings to foreign currencies to pay for "current transactions" such as imports or interest payments.\textsuperscript{28} The move was aimed to wipe out the possibility of hoarding foreign exchange or keeping them offshore and out of banking system, and prevent companies with earnings in foreign exchange from selling their holdings directly to importers or smugglers in black market at preferential rates, cutting out of the banks and the control of the government. It is worth noting that in 1997, illegal smuggling, probably amounting to US$1 billion, put further pressure on the exchange rate and trade balance.

\textit{By the general public:} The Vietnamese are customary to hoard their wealth under forms of gold, foreign currencies (mostly US dollar) and real estates, which are estimated worth of billions of US dollar (e.g., over US$2 billion are estimated

\textsuperscript{26} Reuters News Service, 2 August 1999.

\textsuperscript{27} Reuters News Service, 21 May 1999.

\textsuperscript{28} Adjusted later in 1999 to 50\% when there was less pressure on foreign currency reserves.
in circulation in the informal market). That is partly because of the fear of high inflation and devaluation, and other monetary risks, which have in fact occurred from time to time; and partly because hurdles in, or lingering distrusts of, the banking system or the related regulations and the unattractiveness of banking products. All these factors have discouraged people to keep their assets in the banks. More often people react so sensitively and drastically in response to some move by the State Bank to alter its foreign exchange policy that sometimes worsen the market fundamentals very much more than it is deemed to be appropriate, and make these changes ineffective and even harmful. That is also why the Vietnamese government is very concerned about consequences of a future devaluation, though small. To deal with this fact, the government has been offering incentives to attract these assets into the banking system, denominated particularly in Vietnamese dong, in efforts to help stabilize the foreign exchange market and shrink the size of the black market.

Remittances from abroad: are believed to amount to more than US$1 billion annually. It is large, representing about 5% of GDP, or the equivalent of 11% of export earnings. The remittances flow form abroad helps maintain the value of dong and finance part of the sizable current account deficit. However, less than half of that amount passes through banks and other licensed remittance-server organizations. The remains enter as cash (called “unrecorded remittances”), out of the banking system. The inflow of unrecorded remittances plays an important role in fuelling the black market for foreign exchange, and this in turn makes it easier for smugglers to find the dollars they need to finance their clandestine imports. Therefore, the government has offered further incentives and lifted all barriers to encourage greater inflow of remittances from abroad through banking system.

On the other hand, the demand for foreign currencies have so far been reduced mainly by curbing “unessential” imports, major part of which is deferred payment imports, and by further raising requirements by the State Bank of Vietnam, the Ministry of Finance and/or the Ministry of Planning and Investment to access to domestic dollar-denominated.

Third, tightening foreign borrowing regulations: Although assessed that

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30 The public keeps as much as 45% of broad money as cash outside the banking system. Over 50% of local business transactions are conducted outside the banking system (Export Hotline, op. cit.).
Vietnam’s debt and debt-servicing burden is sustainable, the World Bank still argued for the need to pursue a prudent debt-contracting strategy. To improve monitoring and debt management capacity and strictly control external borrowing at commercial rates, the government has revised its decrees and regulations governing external debt. A new Decree has clarified the roles of different agencies in external debt management and sought monitoring of all debt, not only public debt, the conditions to borrow such as interest rates, terms, amounts, etc. Another Circular has outlined most important criteria for controlling enterprises’ foreign loans, based on annual plans for foreign loan quotas permitted by the Prime Minister.

3.6 Effectiveness of the control measures in Vietnam

1) *Keeping exchange rate under control:* The State Bank has been successful in keeping exchange rate under control and adjusting it discretionally from time to time to maintain the competitiveness of Vietnam’s exports and dampen exchange speculations. It was also able to shift from fixed exchange rate regime to a more market-based regime, i.e., a crawling peg system, without having to experience a drastic devaluation or market turbulence as well. Although such afflicted countries as Indonesia or Thailand experienced a free fall in their national currencies, whose values drop between 50% and 85% against US dollar amid the regional crisis, exchange rate remained manageable in Vietnam as shown in Figure 3.3.1.

2) *More autonomy in monetary policy:* The managed exchange rates have in turn provided the State Bank with greater degree of freedom to implement a low interest rate policy to stimulate the economy without fear of inflation. Figure 3.3.2 shows that real interest rates have been lowered amid the economic slump while inflation has been dampened; and that have contributed to increase the effectiveness of government’s stimulating policies.

3) *Sustaining current account deficit:* Given the strict capital and exchange controls, Vietnam had had only modest rate (in fact the lowest among other countries in the region) of short-term debts as percentage of total external debt during the last decade (Table 3.3.3).

33 Circular No.03 issued by the State Bank on 12 August 1999.
On the Financial Policy Management of Capital Controls to Reduce Volatility of Capital Flows; Case Studies in Chile, Malaysia, and Vietnam in 1990s

Figure 3.3.2: Vietnam-Inflation and interest rate, 1995-1999

Note: *-Lending rates (% per year)

Table 3.3.3: Ratio of short-term debt/total debt of selected Asian countries, 1990-1999 (%)

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<tr>
<td>Korea</td>
<td>-</td>
<td>-</td>
<td>41.4</td>
<td>-</td>
<td>26.8</td>
</tr>
<tr>
<td>Malaysia</td>
<td>21.2</td>
<td>27.8</td>
<td>39.3</td>
<td>-</td>
<td>16.4</td>
</tr>
<tr>
<td>Indonesia</td>
<td>20.7</td>
<td>36.8</td>
<td>32.7</td>
<td>-</td>
<td>13.3</td>
</tr>
<tr>
<td>Philippines</td>
<td>13.4</td>
<td>19.3</td>
<td>29.7</td>
<td>-</td>
<td>11.0</td>
</tr>
<tr>
<td>Thailand</td>
<td>49.4</td>
<td>41.4</td>
<td>39.5</td>
<td>-</td>
<td>24.3</td>
</tr>
<tr>
<td>Vietnam</td>
<td>16.3</td>
<td>14.2</td>
<td>12.4</td>
<td>10.1</td>
<td>9.2</td>
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It should be noted that Vietnam’s short-term debts are mainly related to trade finance in the form of deferred letters of credit. As a result, FDI accounted for about 80% of capital requirements for financing the current account deficit during 1989-1998. And that has helped Vietnam in running large but sustainable current account deficit without risk of sudden outflows.

(4) Lower short-term foreign borrowing: This is reflected in the low and decreasing share of short-term foreign loans in total external outstanding debt (Figure 3.3.3). Like Malaysia and Chile, Vietnam’s lower share of short-term debt has significantly reduced the risk of reversal flows of capital and other costs associated with
them, hence helped strengthen macroeconomic fundamentals.

Figure 3.3.3: Vietnam-Net flows of FDI and short-term loans, short-term debt/total debt ratio, 1995-1999

Source: The State Bank of Vietnam

(5) Absence of a surge in private capital outflows: Compared with 5 Asian crisis economies (Thailand, Korea, Indonesia, Malaysia, and the Philippines), where private capital flows plummeted from US$103.2 billion to minus US$1.1 billion or by US$104.3 billion from 1996 to 1997, representing a reversal of about 9.2% of their combined GDP (see Yoshitomi and Ohno (1999)), Vietnam’s net private capital flows was still positive in 1997, while it represented less than 1% of GDP. Consequently, Vietnam has not been involved in immediate fallout though other neighboring countries have when they suffered a surge in abrupt flows of capital.

3.7 Conclusions

The experience of Vietnam seems to suggest that the long-standing and extensive controls on capital transactions may have played an important role in reducing the vulnerability of Vietnam to the effects of the regional crisis. In particular, they helped shift the composition of capital inflows toward the longer-term flows and prevent any potential massive capital flight. Other factors may, however, have played a role as well in reducing their financial vulnerability. These include: relatively weak trade and financial linkages with the rest of the world compared with

35 Calculation is based on World Bank data of external debt and resource flows in 1997.
the other countries in the region, or rudimentary stage of financial market development.

The clearest evidence of the success of capital and exchange controls in Vietnam may be found in the relative stability of the exchange rate throughout the examined period. With the well-managed exchange rate, the authorities have had more room and time to deal with the external shocks while preserving domestic macroeconomic and financial stability without tightening monetary conditions (or using difficult policy measures otherwise needed) and also avoiding immediate fallout from the regional economic turmoil, despite its close economic linkages with the region. In addition, the capital and exchange controls have helped limit excessive foreign exchange exposure of domestic institutions, and helped lengthen the maturity of liabilities of financial institutions. Therefore, they have also helped protect the stability of the financial system.

However, in the Vietnamese case, the costs associated with control measures were not negligible. External debt burden, State budget, and exports were badly affected due to the overvalued domestic currency against other afflicted countries' national currencies. Banking sector, firms and individuals also found themselves in trouble in making daily business concerning foreign exchange transactions.

Nevertheless, having seen that capital controls are just a matter of policy choice, in particular ones concerning foreign exchange rate policy, which must deal with the dilemma of achieving stability and flexibility, the Vietnamese authorities emphasized the need of macroeconomic stability to support the economic reforms and sustainable long-term growth, and therefore chose the monetary policy autonomy and exchange rate stability by introducing and maintaining capital controls, even though these measures naturally were expected to result negative effects and inconvenience for individuals and economic entities.

V CONCLUDING REMARKS

In this paper, we have surveyed some of the more important issues related to capital flows, financial crisis and capital controls. As stated above, we have come to realize these three nations' successful results upon introducing and manipulating their own international policy measures for capital controls to reduce the volatility of capital flows. The literature on these issues, however, is huge, but this study is not meant to be exhaustive. Some of the issues not covered here will be treated
later in some place, and more issues are constantly arising. Among these issues are: the regional or global mechanism and cooperation for managing international capital flows and resolving financial crises in the future; the international mechanism for a fair and effective debt workout for those countries finding themselves in a serious debt-payment crisis and, as a result, vulnerable to a massive attack on their currencies; and the right and effective combination between capital controls with other policies, which include: (1) sterilized intervention; (2) fiscal austerity measures; (3) trade liberalization; (4) revaluation of the nominal exchange rate; (5) greater exchange flexibility; (6) prudential measures (to curb the exposure of the domestic banking sector to the vagaries of real estate prices and equity markets). Some parts have to some extent been dependent on the inherent features of each national economy, while there are common aspects on the other hand. Individual policies interact either to produce unintended effects on the composition of capital flows or to undercut the policies' individual effectiveness. Although the best policy mix still probably cannot altogether avoid the eventual reversal of capital flows, the appropriate policy mix may dampen the amplitude of the volatility of capital flows, thus offering a softer landing when international investors pull back.

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