

EXCHANGE CONTROL SYSTEM – AN OVERVIEW

NORASHIKIN ISMAIL

Universiti Teknologi Mara, Kampus Jengka,
26400 Bandar Jengka, Pahang,
MALAYSIA

ABSTRACT

The scope of the exchange control system is considerably wide and its development is never static. As far as possible, the paper attempts to outline the general aspects of control, including its definition and classification, its objectives and historical development. The practical aspects such as the control environment, the legal, administrative and implementation, as well as the common problems, effectiveness and the need to revise and reform the control system will also be included

INTRODUCTION

The system of exchange control began to be applied in the world as soon as the monetary systems came into full use. Since its emergence and existence, its impacts to the individual nations as well as the international economics have become increasingly critical.

Controls, within the scope of international finance and economy, can be generally defined as the measure applied by nations in order to affect the volume, direction, or nature of specific transactions and settlements. The transactions referred to include any actions, activities or contracts that involve both residents and nonresidents and which usually result in international settlements. International settlements, in this respect, include payments by a given country to other countries and payments by the residents of a country to nonresident

Following that, controls can therefore, in a wider sense, be defined as the measures to change the volume of transactions and settlements, and also to shift payments or receipts, imports or exports, services or capital transactions from one country to another. In addition, controls can alter the technique of effecting transactions and settlements, for example, by substituting bilateral transactions and settlements for multilateral ones.

When controls are imposed for the purpose to affect settlements, trade transactions and services or capital transactions, they are termed 'active controls'. There are also controls, which could be termed 'neutral'. They can be used to record settlements, foreign trade or non-trade transactions involving nonresident interests, without affecting the volume, direction or nature of transactions or settlements. Such information can help the economic authorities of a country detect trends in the movement of funds, goods and services or capital between that country and other countries, to give early warning of impending balance-of-payments and other economic difficulties and to indicate the need for appropriate corrective measures. In practice, a given control measure may be both an active and a neutral control at the same time.

Active controls are divided into three groups:

- Controls on settlements - exchange controls.
- Controls on foreign trade - trade controls.
- Controls on non-trade transactions - other controls.

Active controls in each of the three categories can be applied in order to affect direct settlements, foreign trade or other transactions or actions. Generally, exchange control is the regulation of foreign exchange transactions by the government or central bank of a country to avoid an excessive expansion of the local money supply or depletion of the country's external reserves. Such control is usually imposed when a country has undesirably large capital inflows or outflows.

While the exchange controls can be used to regulate settlements, the trade and other controls can also be employed in a secondary capacity to strengthen exchange controls. Similarly, controls over foreign trade can be strengthened by exchange and other controls. In fact, all types of controls are interrelated, interlocked and complementary.

Arguments and Objectives for Controls

Since time immemorial, external trade and international settlements have been subject to regulations. With the growth of international trade and settlements, regulations have been expanded to encompass controls. Among the various reasons justifying controls on external trade and settlements are: the establishment of some standard of justice and fairness in trade; the protection of given political or economic community against exploitation by outsiders; the possibility of raising additional revenue; maintenance of a monopoly in a sector of the business community; protection of domestic production and/or employment; and the easing or prevention of currency outflow.

Although the reasons for maintaining controls do change, and controls can take many forms, almost all are imposed with the aim of reducing either capital inflows or capital outflows. Under fixed exchange rates, the purpose of the measures has almost always been to protect official reserve, and in the case of capital inflows to preserve domestic monetary autonomy. Under flexible exchange rates, the main purpose of controls has been to prevent the exchange rate from fully adjusting.

Ultimately, the various forms of controls are commonly employed to adjust the balance-of-payments of a country via the regulation of its settlement with other countries, and to regulate its foreign trade in order to protect its domestic producers and to achieve other economic goals.

Historical Outlines of Controls

Exchange controls began to be applied probably as soon as monetary systems came into full use, and separate economic units, cities, states, etc. were firmly established. The initial purpose of exchange controls was to prevent the outflow of currency from the country by applying strict limitations to movements of specie. Thus, controls were particularly prevalent in Europe in mediaeval times when the production of precious metals was inadequate for monetary purposes, and the consequent deflation hampered economic developments and produced a prolonged fall in prices, unemployment and other economic difficulties.

Before 1914, controls on international trade were applied mainly to protect the so-called infant industries. It was generally assumed that such protection should be terminated as soon as these industries were strong enough to compete against foreign competition. In many cases, however, protection of these industries was maintained for a long period of time, if not indefinitely. International settlements and transfers were in general free in this period.

During the thirties, various sophisticated exchange control measures were widely applied, including quantitative exchange controls, multiple currency practices and bilateralism in payments. These measures were used not only to influence country's balance-of-payments, but also to protect domestic production, encourage exports and restrict imports in the very difficult circumstances of the Depression

During the forties, exchange controls expanded and became entrenched - particularly in connection with the war economy. Despite adverse world events and developments since the World War II, considerable progress has been achieved in the areas of exchange, trade and other controls and of reducing multiple-currency and bilateralism in payments and trade. In 1946, the international Monetary Fund (IMF) was

established, and in 1950, the European Payments Union (EPU), which included practically all western European countries, providing free transferability of the currencies of participating countries.

The tendency to use capital control has been following cycles at least among the developed countries. Most European countries retained well into the 1950s a complex structure of controls on international capital movements introduced before World War II. However, as the European economies grew in strength, the restrictions were dismantled, and towards the end of 1958, a number of IMF countries in Europe established external convertibility for their currencies.

The process of liberalization was reversed during the 1960s. The development of the Eurodollar market, the growth of multinational corporations, and the intensification of international banking ties resulted in international capital becoming more mobile. The international financial integration had reduced the maneuvering room for monetary authorities and encouraged a resumption of controls on international capital movements.

The process of liberalization was resumed in the mid-1970s and has continued since then. The United States dismantled controls in 1974; Germany, Switzerland, and Japan gradually reduced controls over the years; the United Kingdom abolished them in 1979; and France, under the pressure of its European Economic Community (EEC) partners, was also reducing its capital controls.

Practical Aspects of Controls

Control Environment

Controls should be thought of as operating in a specific environment - the control environment, consisting of the various conditions, circumstances and factors. These elements of the control environment must be taken into account when establishing, operating and revising controls.

Major elements of control environment can be grouped as follows:

- Economic elements, which include the balance-of-payments position of the country, the country's exchange reserves, the elasticity of demand for and supply of specific exports, imports and services and movements of capital and the economic possibility of carrying out appropriate monetary and credit policies and changes in exchange

- rates to achieve price-income adjustments and restore external equilibrium.
- Control administration and policy, which covers factors such as the volume and nature of transactions and settlements which have to be made subject to specific controls, the definition of resident and nonresident status in general and in relation to particular settlements and transactions, channels of communication between the control administration and control customers, and the feasibility of revising controls as the environment changes.
- Control customers, including the persons and businesses regulated by controls, especially in the foreign trade field and their territorial distribution; their educational, ethical and moral levels, and the extent of their understanding of the nature and purpose of controls, and their general attitude toward controls.
- International obligations under bilateral trade, payments and other arrangements, or in connection with the country's membership in regional economic, monetary, exchange or trade blocs; commitments in connection with the country's membership in international economic organizations.

The elements of the environment do not remain constant. Thus, they must be supplemented and modified according to the nature of a given control environment in a specific country or control area.

Legal, Administrative and Implementation Aspects

Legal Aspect

The economic authorities of the country must examine the manner in which exchange, trade and other control laws should be enacted, implemented and published. Control legislation is usually on two levels. The first consists of the basic control law, and the second, the regulations to implement it. One problem normally associated with control laws is the language in which they are couched. Such laws are usually so worded that even control experts, advisors and lawyers - not to mention the average control customers - have difficulty in understanding and interpreting them.

Administrative Aspects

The administrative set-up in various countries is the outcome of historical developments and the result of various concepts and influences. The administration of controls should satisfy at least three requirements:

- It should be relevant to the control environment.
- It should be conducive to integrity and honesty in operation.
- It should be efficient and cheap to operate.

These three requirements are not completely independent of one another, and compromises are usually struck in practice.

Implementation

Control authorities must decide whether a very strict, bureaucratic and routine implementation of controls is justified, with no allowance for special cases. They should also ensure that the benefits achieved through application of controls are not obtained at the price of creating a hostile and non-cooperative attitude, which may be conducive to control avoidance and the creation of illegal channels of settlements and trading between residents and nonresidents.

In practice, the position of the control administrators is often very difficult. On the one hand, they must reduce exchange expenditure or imports in the case of balance of payments difficulties, or to protect domestic production, while at the same time they are pressed to satisfy 'legitimate' demand for foreign exchange of imports and to avoid the application of negative controls to the extent that illegal activities are encouraged.

Common Problems and Effectiveness of Controls

In principle, controls should be applied flexibly in response to changing conditions within the country and abroad, but achievement of such flexibility may not always be feasible.

In many countries the systems are somewhat rigid. Controls on transactions and settlements are applied in accordance with established priorities, and the freedom of action of the authorities may be impaired. The introduction or extension of control measures which reduce confidence in the stability of domestic currency may, to a varying extent, produce phenomena such as hoarding of foreign bank notes, gold and silver, in coins and other forms, and illicit transfer of funds abroad and similar actions.

Another restriction on the freedom of the authorities in applying controls arises from the obligation assumed by countries under bilateral or multilateral trade and payments arrangements, or towards international organizations.

Also, authorities of the country may find it inadvisable to apply control measures to certain transactions because other countries can impose retaliatory measures when their economies are too unfavorable. As the outcome of the war of controls, the country initially establishing specific controls may find that its balance-of-payments or competitive export position deteriorates rather than improves. Even political repercussions can arise from the application of certain controls by a country.

In total, the economic, political and social environment in which controls are operated can determine the degree of effectiveness they enjoy or the efficiency with which they are operated. The response of the control customers to the obligations laid down, the degree of their cooperation with the control authorities and their inclination to take advantage of loopholes also obviously affect the effectiveness of controls, irrespective of the technical features incorporated in the system.

Revision and Reform

Controls should be reassessed, and the appropriate revision and reform undertaken, when the specific control environment and circumstances justify it. In practice, however, controls tend to remain unchanged when the external position of the country is improving, or during a period of diminished need for controls. On the other hand, when the external position of the country is deteriorating, or there is increased need for control, they are frequently made stricter than is justified by the circumstances.

Among the various reasons for revising and reforming controls is exchange rate adjustment, which should be accompanied by a revision and overhaul of the entire control system. However, the authorities of the country may be opposed to a far-reaching revision, as they may think that exchange rate adjustment might not eliminate fundamental causes, which have previously necessitated imposition of controls. They may fear that if optimistic expectations about exchange rate adjustment do not materialize, the reintroduction or reinforcement of controls will be necessary. This would indicate the inadequacy of the adjustment and could result in deterioration in the balance-of-payments, the outflow of funds, and other undesirable economic phenomena, because the revised control system is unsatisfactory for the new situation. Another possible reason for the economic authorities opposing the revision of controls is their reluctance to weaken the country's competitive position.

The revision of controls could also be associated with the preparation and introduction of a control manual and an improvement in disseminating information about controls.

Whether toward liberalization, or the opposite, the economic authorities of the country may revise the control measures progressively, or at a stroke. Taking liberalization as the purpose, progressive liberalization might be preferred, as it avoids the excessive risks associated with a bold general relaxation of controls and give the national economy the chance to adjust gradually.

Finally, over the time, the control systems can become very complex and costly. When they reach the point of diminishing returns, a decision might be taken by the authorities to restore relative freedom of transactions and settlements and also the movement of goods, services and capital, though initially this may entail unpopular or harsh and costly economic adjustment.

Exchange Control Policy in Malaysia

The development of the exchange control in Malaysia could be traced back to the provisions of the Exchange Control Act, 1953 whereby Bank Negara Malaysia (BNM) is given the authority to administer and manage the policies, regulations, and procedures of the exchange control.

In exercising its power under the Act, the Controller of Foreign Exchange issues administrative notices, which are known as the Exchange Control of Malaysia (ECM) Notices, which embodies the administrative requirements under the Act. The main purpose of this Act is to provide the necessary machinery to control, record and manage the fund flows in Ringgit and other foreign currencies, which are coming in and leaving Malaysia. The information gathered is mainly for statistical monitoring of funds flow and the data obtained forms a vital ingredient in the formulation of exchange control policy for the country.

One of the main roles of BNM in the foreign exchange market is to ensure that the conditions in the market are conducive to the orderly trading of Ringgit and to protect the market from over-exposure to exchange risks. Under this condition, monitoring of developments in the money and foreign exchange markets, therefore, became the responsibility of the central bank.

In fact, BNM is undertaking the function of developing and administrating the country's exchange control regulations on behalf of the government. Before BNM was established, this role was performed by the Treasury. The provisions of Exchange Control Ordinance, 1953 empowered BNM to operate the system of exchange control regulations. On 1 August 1960, BNM was given the responsibilities over the development and administration of the country's exchange control regulations. The Governor of BNM became the Controller of Foreign Exchange under the Act.

In this respect, the exposure of the foreign exchange risk of the commercial banks is regulated. The commercial banks are allowed to hold a certain amount of foreign currency without being hedged. The limit for the Ringgit vis-a-vis all currencies were set for the individual banks by BNM, taking into account a variety of factors. These include the resources of the bank, the volume of its foreign exchange business and its expertise in foreign exchange dealings. The aim was to provide sufficient flexibility for each bank to be effective in "making" the market without undue restrictions on its exchange exposure.

CONCLUSION

The solutions for international monetary issues are based on the major factors and developments, which underlie national and international economics, political and social relations. Among the factors considered by international planners and reformers include the attempts by government to reach and maintain full employment; desire to attain economic and social justice for various groups of the population; the importance attached to continuous and extensive economic growth in individual countries; the superabundance of liquid funds to reconcile the need for maximum yields with the need to avoid exchange losses, etc. - all of which are closely related to the system of exchange controls.

As shown by histories, various approaches of exchange control systems have been undertaken; each aims to achieve certain economic goals. Since the prediction of future world economic outlook is of very high difficulties, all nations should make fair and wise judgment in the implementation of the control system, suitable to the respective environment and circumstances, at the same time also strive to promote prosperity of the world.

REFERENCE

- Dornbusch, R. "Expectations and Exchange Rate Dynamics" *Journal of Political Economy* 84 (December 1974), pp. 1161-76.
- Fleming, J.M. "Dual Exchange Markets and Other Remedies for Disruptive Capital Flows" *IMF Staff Papers* 21 (March 1974), pp.1-27.
- Jozef Swidrowski, "Exchange and Trade Controls - Principles and Procedures of International Economic Transactions and Settlements" Great Britain: Gower Press Limited, 1975
- Maurice D. Levi, "International Finance – The Markets And Financial Management Of Multinational Business " Mc Graw-Hill , Inc, 1996
- Robert Z. Aliber, "The Handbook of International Financial Management" US: Dow Jones-Irwin, 1989.