

FIXING MALAYSIA'S FIXED EXCHANGE RATE REGIME: SOME OPTIONS*

Mohammed Ariff
Executive Director
Malaysian Institute of Economic Research
Kuala Lumpur, Malaysia

In the wake of the financial crisis of 1997, Malaysia imposed capital controls and opted for a fixed exchange rate. Although these moves provide some breathing space in the short-term, they are not necessarily the best for the economy in the longer-run. This article examines the various exchange rate options available for the ringgit and suggests "least cost" solutions for the future.

Ekoran daripada krisis kewangan tahun 1997, Malaysia mengamalkan dasar kawalan modal dan kadar pertukaran tetap. Walaupun respons ini memberi sedikit ruang bernafas dalam jangka pendek, ianya tidak merupakan dasar yang paling sesuai dalam jangka panjang. Artikel ini meneliti beberapa dasar kadar pertukaran alternatif yang terbuka kepada ekonomi Malaysia dalam jangka panjang dan cadangkan penyelesaian :berkos minimum".

INTRODUCTION

The July 1997 currency turmoil emanating from Thailand had spread swiftly to other countries in the region. Malaysia, despite being one of the better economies in the region, could not insulate itself from the crisis. The impact on Malaysia turned out to be more than a contagion effect. Malaysia, like other crisis-hit countries, became mired in difficulties of sorts. No one would now argue that Malaysia's macroeconomic management and governance were so impeccable prior to the crisis that it did not deserve the beating unleashed by market forces.

The market has always been mean and ruthless. The fact, however, remains that the market is also admittedly imperfect. The market is not always guided by fundamentals, as sentiments sometimes override objectivity. Arguably, speculators are often driven by greed when the going is good or by fear when

* An earlier version of this paper was presented at the MIER National Outlook Conference in Kuala Lumpur, November 2000.

things apparently begin to sour. And combine this tendency with herd behaviour, we get a recipe that would only accentuate the amplitude of market fluctuations. Explosive expectations, where speculators continue to buy when prices are rising and rush to sell when prices are falling, are extremely destabilizing, quite unlike text book speculations where speculators buy when prices fall and sell when prices rise thus contributing to market stability.

Events that began to unfold in the second half of 1997 were due as much to systemic flaws as to market excesses. It was estimated that the ringgit was overvalued by roughly 25 per cent and that the stocks were overpriced by about 30 per cent before the crisis, suggesting a major market correction was around the corner. The market clearly overshot when the panic button was pushed, with the ringgit plunging by over 50 per cent and the stock market shrinking by over 60 per cent. Although neither the timing nor the magnitude of the crisis was predictable, there were unmistakable signs of an impending crisis such as persistent current-account deficits in the balance of payments, increased dependence on short term capital inflows, high domestic debts, rapid growth of bank loans and money supply, falling total factor productivity, and rising reverse investments, to mention a few (Ariff et. al., 1998).

The rest is history. Malaysia imposed capital and exchange controls, touted as "unorthodox measures", in September 1998. Exchange controls were seen as unorthodox or heretical, not because it was unheard of or unthinkable before, but because it ran counter to the IMF prescriptions adopted by other crisis-hit countries. The external value of the ringgit was fixed at 3.80 ringgit to the US dollar. Currency trading of the ringgit was forbidden. Travelers were not allowed to carry more than RM1,000 or foreign currencies exceeding in value RM10,000. All these are still in vogue, although currency declaration forms are no longer required for sums within the above limits.

The main purpose of this paper is to examine the various options available for the ringgit and to suggest "least-cost" solutions. The paper is structured as follows. The next section outlines the exchange rate regime prior to the crisis. This is followed by an analysis of the ringgit movements vis-à-vis other major regional and international currencies since the imposition of exchange controls, in Section 3. The near-term prospects for the currency are examined in Section 4. Several policy options are discussed in Section 5. Finally, the concluding section zeros in on what may be termed as a "practical" solution.

EXCHANGE RATE REGIME

Before Independence, the Malaysian currency, then known as the Malaysian dollar, was tied rigidly to the British sterling with a fixed exchange rate. After Independence until mid-1972, Malaysia was pegging the ringgit, under the Bretton Woods system, using the sterling as the intervention currency with a margin of 0.3448 to 1.0 per cent on either side of the par. It was only in June 1972 that Malaysia adopted the US dollar as the intervention currency with a support margin of 2.25 per cent, in the aftermath of the floating of the sterling and the dismantling of the sterling area. The parity of the ringgit was then set at RM2.81955 to the US dollar. Following the 10 per cent devaluation of the dollar in February 1973, the ringgit-dollar parity was reduced to 2.5376, with the support rates being set at RM2.4805 and RM2.5947, which represent the new ceiling and the floor, respectively. However, in June 1973, the Central Bank allowed the ringgit to float upward vis-à-vis the dollar.

In September 1975, the Malaysian authorities adopted a new foreign exchange rate regime which determined the external value of the ringgit in terms of a basket of representative currencies. Thus, the exchange rate of the ringgit was no longer determined in terms of the dollar only, although the dollar continued to be intervention currency. The composition of the currency basket was not specified. In fact, the composite basket, believed to be weighted on the basis of the key currencies of settlement as well as those of the major trading partners of Malaysia, was only known to the Central Bank. There was a somewhat strong adherence to the US dollar and the Singapore dollar (the former, being an international heavy weight, and the latter, given its historical-cum-psychological importance). This norm was broken towards the end of 1984 when the authorities opted for a more flexible exchange-rate management policy in the face of an economic downturn and overvalued exchange rate.

All this, however, did not mean that the ringgit was pegged strictly to the composite currency basket up to the end of 1984. Thus, for example, the composite index had deviated during 1981-84 from the September 1975 baseline of 100 to a range of 103.5 to 109.5 which amounted to an appreciation of up to 5 per cent a year (Lin, 1989). The appreciation of the ringgit during the sluggish years of 1980-84 was partly due to the massive inflow of long-term capital and partly to the periodic central bank interventions to shore up the ringgit in the face of the growing strength of the US dollar.

Until the end of 1984, there was apparently a policy bias in favour of benchmarking against the Singapore dollar as well, in addition to a close alignment with the US dollar. Consequently, during 1980-83, the premium of the Singapore dollar was checked at about 9 per cent and the depreciation of the

ringgit against the US dollar was kept at 4.3 per cent. Concern over the growing debt burden and inflationary fears were also among the considerations which could explain the Central Bank's stance then against any sharp ringgit depreciation (Ariff, 1993). In fact, the policy preference for strong ringgit was seen as an anti-inflationary device that would keep tabs on the domestic prices of imports.

In August 1984, the composite index of the ringgit peaked at 110.7 against the basket, appreciating 67 per cent against the sterling, 34 per cent against the Deutschmark, and 14 per cent against the Japanese yen. It was estimated that the ringgit had been overvalued to the tune of about 20 per cent by the end of 1984 (Semudram, 1985), while the real effective exchange rate had appreciated by 10 per cent from the first quarter of 1981 to the fourth quarter of 1984 (Ariff and Semudram, 1987).

During 1975-84, the real effective rate of the ringgit had been appreciating, as a result of the boom conditions and rising commodity prices. During 1981-83, both the real and nominal exchange rates had appreciated significantly. Since 1985, the ringgit was depreciating against all major currencies except the US dollar, as the latter itself was still depreciating. The real effective exchange rate of the ringgit began to depreciate marginally in early 1985, leading to an effective depreciation of nearly 9 per cent by the second quarter of 1986 (Ariff and Semudram, 1987). The ringgit continued to depreciate until end-March 1989, followed by a period of exchange rate stability.

With the economy growing at near double-digit rates in the first half of the 1990s, the ringgit was appreciating all over again. Current account deficits were financed by FDI inflows and short-term capital inflows, which led to the strengthening of the ringgit in the foreign exchange market. Interestingly, the exchange rate for the ringgit had been affected more by capital account than by current account transactions in the balance of payments. Thus, the ringgit was appreciating at times when the current account balance was worsening and depreciating at times when the current account balance was strengthening, quite contrary to text-book expectations. This can be easily explained: the strength of the ringgit during 1981-84 and 1993-96 stemmed mainly from the substantial inflow of official capital and private capital, respectively, while the weakness of the ringgit in the late 1980s was associated largely with the sizeable repayment of external debts.

The ringgit was a high flyer until the crunch came in July 1997. Large inflows of foreign direct investments and portfolio investments provided the fuel for the ringgit to fly high, despite the widening trade and current account deficits. It is no secret that the Central Bank was constantly aligning the ringgit to the US

dollar at around RM2.50 to the US dollar through its interventions. As the US dollar was concurrently appreciating against major currencies, this *de facto* pegging meant that the ringgit, too, grew stronger against other currencies. The outbreak of the financial crisis in Thailand in July 1997 led to a panic withdrawal of foreign short-term capital from the region, causing regional currencies, including the ringgit, to plummet.

THE NEW PEG REGIME

Well ahead of the currency crisis, as early as March 1997, there were already symptoms that the ringgit was undergoing a gradual downward correction, with the exchange rate against the US dollar softening from 2.48 in March to 2.52 in June. In July 1997, the ringgit depreciated to an average of 2.57 before plunging to an all-time low of 4.88 in the first week of January 1998. The ringgit subsequently strengthened to an average of RM3.73 to the US dollar in April 1998, but this somewhat jerky upward adjustment was derailed by another round of volatility which sent the ringgit again on a downward spiral to a 4.23 level in late August 1998 when the Government decided to tie the ringgit to the US dollar at RM3.80.

It is not difficult to say many things in praise of the new peg regime. For starters, it brought an abrupt end to exchange rate uncertainties. The business community was more than pleased. It has been quite easy for the authorities to manage the new regime, thanks primarily to the fact that the ringgit has remained significantly undervalued. Weak ringgit has apparently helped strengthen the current account of the balance of payments and external reserves by redirecting resources from imports to exports and import substitutes. Undervalued exchange rate serves to reduce domestic labour costs and to promote the production of tradable goods. Besides, Malaysian exporters of primary commodities, the prices of which are determined in US dollars, like palm oil, petroleum and gas, in particular, have benefited much from the undervalued ringgit, as it meant additional export earnings in ringgit terms. Undervalued fixed exchange rate was also a boon to the stock market as foreigners found the Malaysian stocks attractive without foreign exchange risks.

To be sure, all these benefits are not without costs in the form of distortions in resource allocations. It introduced a bias in favour of trade denominated in US dollars at the expense of other currencies. It also meant that Malaysians are shortchanged through unfavourable terms of trade. If it is not corrected, it may even lead to brain drain, as it would make working in strong currency areas financially more rewarding. By the same token, cheap ringgit will not help Malaysia attract skilled guest workers for the emerging K-economy. What is

more, undervalued ringgit with strong revaluation prospects tends to discourage greenfield foreign direct investment to the extent that it makes imports of machinery and equipment more costly at the current exchange rate, while the output may have to be exported at a revalued exchange rate when the project comes on stream. The chances are that foreign investors would delay the implementation of approved investments in anticipation of exchange rate adjustments. A fixed exchange rate system also means that burden of macroeconomic adjustments will fall heavily on fiscal and monetary policy instruments.

Another word of caution is also in order. The positive impact of undervalued ringgit on manufactured exports may well be considerably smaller than assumed. This is not to deny that weak ringgit has rendered resource-based manufactures with little import content (e.g. wood products and rubber manufactures) more competitive abroad. But this advantage of cheap ringgit is partially offset by high cost of imported intermediate inputs for other manufactures with a high import content. The risk in this case is that manufacturers will rely on the cheap ringgit for export competitiveness rather than on productivity improvements that would cut unit cost. In the case of multinational corporations, transfer pricing practices may render any exchange rate advantage somewhat redundant. Thus, the sharp increase in exports that Malaysia has experienced in recent times may have little to do with the peg regime, as other countries in the region have also posted similar export growth which is largely due to favourable external demand conditions, especially in the electronics sector.

Much, of course, would depend critically on the magnitude or the extent of undervaluation or overvaluation present in the system. The higher this magnitude, the greater the distortions. It is fairly obvious that the ringgit is currently undervalued, although estimates of this undervaluation would vary considerably depending on the yardstick used and the base year adopted.

Table 1: The Ringgit versus Major Currencies, 1990-Sept 2000

(+Appreciate/-Depreciate)	1990	Sep-00	% change
RM/US\$	2.7044	3.8000	-28.8
RM/100yen	1.8762	3.5583	-47.3
RM/Sing\$	1.4938	2.1865	-31.7
RM/Pound	4.8253	5.4481	-11.4
RM/DMark	1.6772	1.6929	-0.9
Trade-weighted (1990=100)	100.00	66.37	-33.6

Arguably, the year 1990 may be taken as a "normal" year for the ringgit without serious distortions as there was no severe BOP problem. Between 1990 and August 2000, the ringgit has depreciated by a trade-weighted average of 33.6 per cent against four major currencies (Table 1). It is remarkable that between June 1997 (prior to the crisis) and January 1998 (when the currency had hit the bottom) the extent of depreciation on a trade-weighted average scale was 36.5 per cent (Table 2). If the ringgit was overvalued by an estimated 25 per cent prior to the crisis, this would mean that the ringgit is currently undervalued by roughly 11 per cent.

Table 2: The ringgit versus Major Currencies, June 1997-January 1998

	Jun-97	Jan-98	% change
RM/US\$	2.5158	4.3985	-42.8
RM/100yen	2.2020	3.3796	-34.8
RM/Sing\$	1.7630	2.5076	-29.7
RM/Pound	4.1373	7.1902	-42.5
RM/DMark	1.4585	2.4212	-39.8
Trade-weighted (1990=100)	94.08	59.73	-36.5

The nominal effective exchange rate (NEER) had depreciated by 8.1 per cent between 1990 and 1996, by 28.8 per cent between 1996 and August 2000, and by 34.6 per cent between 1990 and August 2000, with 1990 as the base year (Table 3). The use of 1995 as the base year yields results that are only marginally different (Table 4). Given an estimated 25 per cent overvaluation of the ringgit prior to the crisis, all this means that the ringgit is currently undervalued by about 10 per cent. In terms of real effective exchange rate (REER), however, the extent of undervaluation is considerably smaller.

Table 3: The Ringgit: Nominal and Real Effective Exchange Rates, 1990-August 2000 (1990=100)

Base 1990=100 (+Appreciate/-Depreciate)	arithmetic REER	geometric REER	arithmetic REER	geometric NEER	arithmetic REER%	geometric REER%	arithmetic NEER%	geometric NEER%
1990	100	100	100	100				
1991	95.74	95.66	95.07	95.00	-4.3	-4.3	-4.9	-5.0
1992	101.66	101.45	98.83	98.62	6.2	6.1	3.9	3.8
1993	99.75	98.85	95.74	94.88	-1.9	-2.6	-3.1	-3.8
1994	96.61	95.33	90.23	89.04	-3.1	-3.6	-5.8	-6.2
1995	98.17	96.37	89.46	87.83	1.6	1.1	-0.8	-1.4
1996	103.92	102.81	92.88	91.89	5.9	6.7	3.8	4.6
1997	99.87	99.23	88.74	88.17	-3.9	-3.5	-4.5	-4.0
1998	77.82	77.64	66.23	66.07	-22.1	-21.8	-25.4	-25.1
1999	79.34	78.73	66.23	65.72	1.9	1.4	0.0	-0.5
Jan-Aug 2000	79.61	78.54	66.31	65.42	0.3	-0.2	0.1	-0.5
(+Appreciate/-Depreciate)	REER%	REER%	NEER%	NEER%				
1990-1996	3.9	2.8	-7.1	-8.1				
1996-2000 (Jan-Aug)	-23.4	-23.6	-28.6	-28.8				
1990-2000 (Jan-Aug)	-20.4	-21.4	-33.7	-34.6				

Table 4: The Ringgit: Nominal and Real Effective Exchange Rates, 1990-August 2000 (1995=100)

Base 1995=100	arithmetic REER	geometric REER	arithmetic NEER	geometric NEER	arithmetic REER%	geometric REER%	arithmetic NEER%	geometric NEER%
(+Appreciate/-Depreciate)								
1990	105.73	103.83	115.99	113.90				
1991	100.60	99.35	109.62	108.26	-4.9	-4.3	-5.5	-5.0
1992	106.41	105.46	113.51	112.49	5.8	6.1	3.6	3.9
1993	102.55	102.27	108.01	107.70	-3.6	3.0	4.9	-4.3
1994	98.79	98.70	101.24	101.15	-3.7	-3.5	-6.3	-6.1
1995	100	100	100	100	1.2	1.3	-1.2	-1.2
1996	107.13	106.86	105.06	104.80	7.1	6.9	5.1	4.9
1997	103.93	103.23	101.33	100.65	-3.0	-3.4	-3.6	-4.0
1998	81.40	80.57	76.01	75.24	-21.7	-21.9	-25.0	-25.2
1999	81.85	81.46	74.97	74.61	0.6	1.1	-1.4	-0.8
Jan-Aug 2000	81.49	81.08	74.48	74.10	-0.4	0.5	-0.7	-0.7
(+Appreciate/-Depreciate)								
1990-1996	REER%	REER%	NEER%	NEER%				
	1.3	2.9	-9.4	-8.0				
1996-2000 (Jan-Aug)	-23.9	-24.1	-29.1	-29.3				
1990-2000 (Jan-Aug)	-22.9	-21.9	-35.8	-34.9				

Interestingly, since the fixing of the ringgit on 2 September 1998 until end-September 2000, the ringgit depreciated against major currencies by only 3.6 per cent on a trade-weighted basis (Table 5). It is quite obvious that this ringgit depreciation against other major currencies is attributable to the depreciation of the US dollar itself, given the currency's fixed exchange rate vis-à-vis the US dollar. In other words, the ringgit is more undervalued than that suggested by the depreciation of the ringgit vis-à-vis major currencies.

Table 5: The Ringgit versus Major Currencies, 2nd Sept 1998-Sept 2000

	2-Sep-98	Sep-00	% change
RM/US\$	3.8000	3.8000	0.0
RM/100yen	2.7742	3.5583	-22.0
RM/Sing\$	2.1998	2.1865	0.6
RM/Pound	6.3708	5.4481	16.9
RM/DMark	2.1743	1.6929	28.4
Trade-weighted (1990=100)	68.87	66.37	-3.6

Against the regional currencies, too, the ringgit has been sliding since the imposition of the currency peg. It has depreciated against regional currencies by a weighted average of 7.9 per cent until end-September 2000 (Table 6). This is because these regional currencies have been appreciating against the greenback, while the ringgit-dollar exchange rate has remained constant. As the regional currencies themselves have remained largely undervalued due to political and other uncertainties, it can be surmised that the magnitude of undervaluation of the ringgit is considerably larger than the depreciation of the ringgit vis-à-vis regional currencies.

Table 6: The Ringgit versus Regional Currencies, 2nd Sept 1998-Sept 2000

	2-Sep-98	Sep-00	% change
RM/100 Korean won	0.2827	0.3406	-17.0
RM/100 Thai baht	9.3713	9.0767	3.2
RM/100 Indo rupiah	0.0354	0.0442	-19.9
RM/100 Philip peso	8.8302	8.2981	6.4
Trade-weighted (1990=100)	73.10	67.35	-7.9

The ringgit has exhibited considerable volatility vis-à-vis major currencies other than the US dollar, with the exception of perhaps the Singapore dollar (Figures 1 and 2) which is not surprising, as the latter too has been aligned closely to the US dollar through market inventions by the Monetary Authority of Singapore.

Although the ringgit has depreciated generally against crisis-hit regional currencies after the introduction of the currency peg, there has been considerable fluctuations in the exchange rates of the ringgit against these currencies (Figures 3). However, the regional currencies have been fairly stable against the US dollar, with the notable exception of the Indonesian rupiah (Figure 4).

Figure 1: Ringgit versus Major Currencies

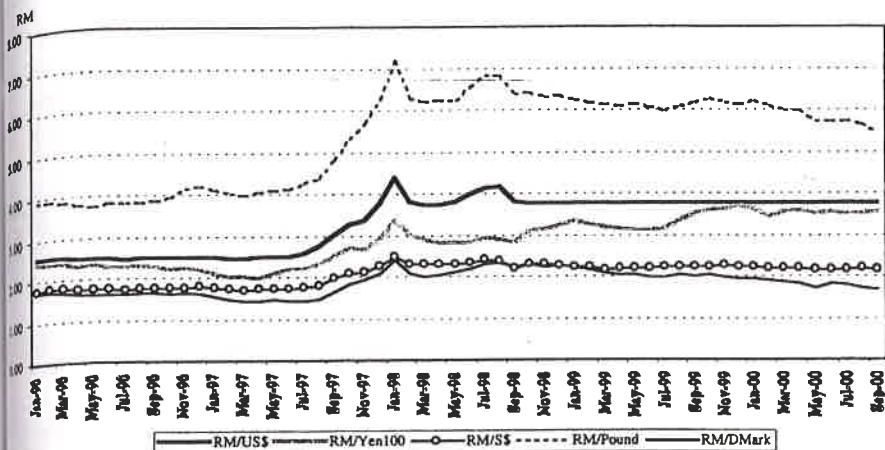


Figure 2: Index of Ringgit versus Major Currencies (June 1997=1.00)

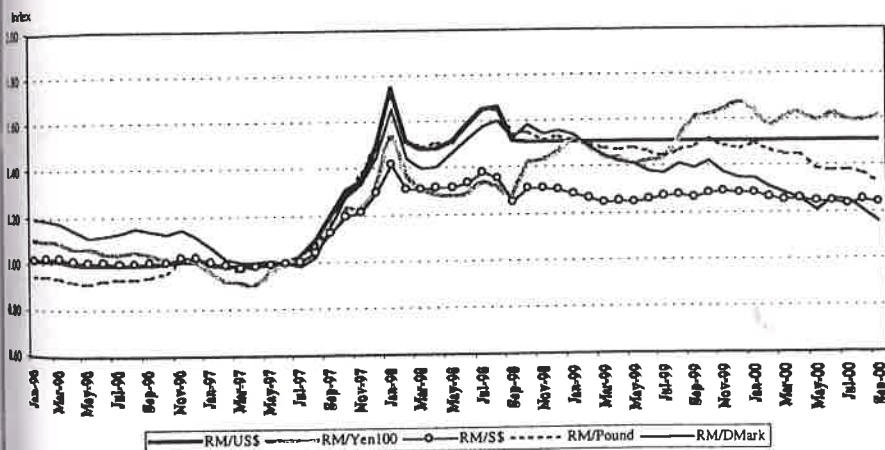


Figure 3: Index of Ringgit versus Regional Currencies (June 1997=1.00)

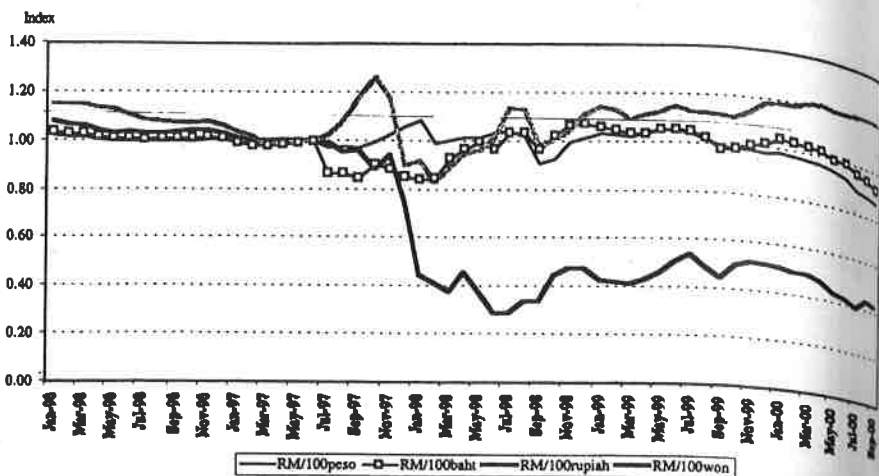
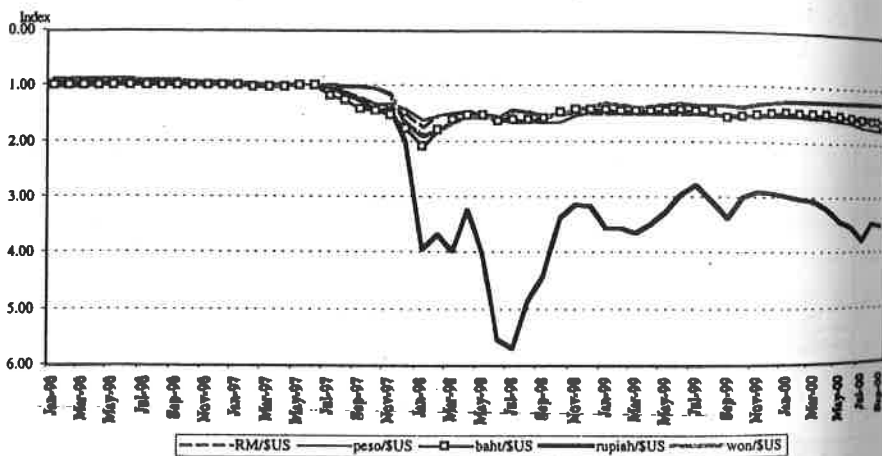


Figure 4: Exchange Rate Index, Regional Currency per \$US (June 1997=1.00)



THE RINGGIT OUTLOOK

All indications are that the ringgit peg will not be revised anytime soon, despite the fact that the ringgit is clearly undervalued with implicit costs. The chances of any major revision or review in the near term are slim, not only because there is no strong market pressure for change, but also because the ringgit peg is politically viewed as a symbol of prestige that distinguishes Malaysia from other crisis-hit regimes.

It is quite easy to manage an undervalued fixed exchange rate. At the current rate, the supply of foreign exchange exceeds the demand for it. The Central Bank is thus in a position to meet the demand for foreign exchange. Reserves have risen since August 1998 by US\$12.1 billion. With reserves of US\$32.3 billion (end-September 2000) which is equivalent to 5.2 months of retained imports, 6.3 times the short-term external debt, the Central Bank can breathe very comfortably. The fixed exchange regime would have fallen apart had the ringgit been overvalued, in which case a parallel market would have emerged. An overvalued ringgit peg would be more vulnerable to downward pressures than an undervalued one to upward pressures.

The country's BOP situation is likely to remain fairly healthy, given the strong global demand for electronics and the buoyant oil prices, although surging imports may continue to reduce trade and current account surpluses. BOP difficulties, which seem remote, will only narrow the margin of undervaluation and thus reduce, not increase, the pressure for change unless the pendulum swings to the other extreme with the ringgit getting overvalued.

There will be no pressure for change so long as the costs of undervalued exchange rates remain implicit rather than explicit. Thus, the lack of FDI inflows and the inability to lure back Malaysian brainpower staying abroad or to entice foreign knowledge workers at the current exchange rate would only impinge on future, not current, growth. Inflation is also likely to remain benign, even though it is likely to edge up in the near term. This means that government will not be forced to use the exchange rate instrument to contain the inflationary pressure by bringing down the price of imports in ringgit terms, unless high world oil price persists for some time with threats of imported inflation. Besides, private consumption in Malaysia is yet to return to its pre-crisis heights. Consequently, the subdued consumer demand for imports also tends to keep the spectre of imported inflation at bay which would otherwise compel the authorities to reconsider the peg. In any case, an increase in inflation would only serve to weaken the ringgit in the purchasing power parity (PPP) sense and thus downsize the margin of undervaluation. The irony of all this is that there

will be reduced rather than increased pressure emanating from inflation for any revaluation of the ringgit.

Recent unsettling trends in regional currencies also do not bode well for a review of the currency peg by the Malaysian authorities. For one thing, the ringgit now seems less undervalued than earlier vis-à-vis regional currencies, with growing concerns over the erosion of export competitiveness. For another, the volatility of regional currencies in recent times has apparently strengthened Malaysia's resolve to hang on to the peg. While it is true that the regional currencies have appreciated since September 1998, the magnitude of appreciation is not large enough to induce a policy review of the ringgit peg.

The margin of undervaluation appears to have narrowed somewhat, if the reserve position is any indicator. In fact, reserves have been falling from US\$34.5 billion in April 2000 to US\$32.3 billion in September 2000. The fact that reserves are not rising with current account surpluses may mean that there is no rush to bring home export proceeds. If imports overtake exports, the situation may reverse itself with the ringgit becoming overvalued. Besides, low interest rates in Malaysia juxtaposed with high interest rates in the US may not support the current peg for long. One cannot, therefore, rule out the chances of the ringgit becoming overvalued in again in the near term. Risks associated with an overvalued currency are more worrisome than that of an undervalued one. Revaluation or devaluation by arbitrarily adjusting the peg upward or downward cannot be the right solutions as such adjustments are likely to be either excessive or inadequate.

POLICY CHOICES

It is easier to get into a fixed exchange rate regime than to get out of it. The fixing of the ringgit worked very effectively and very smoothly mainly due to perfect timing. By end-August 1998 the Malaysian authorities had sufficient market information that enabled them to fix the external value of the ringgit realistically at RM3.80 to the dollar. For the ringgit had swung from RM2.498 on July 11, 1997 to RM4.725 (intra-day RM4.88) on January 7, 1998 before it climbed back to RM3.460 on February 11, 1998, sliding thereafter to RM4.232 on August 24, 1998 when the authorities thought enough was enough. Intuitively, then, at 3.46 the ringgit was overvalued and at 4.23 it was undervalued. The mid-point around 3.80 would thus appear to be not too far off the mark. Besides, it would be safer to have the ringgit artificially undervalued than overvalued. At the beginning of the crisis, such information was not, of course, available and if the authorities had decided to fix the ringgit at the outbreak of the crisis, the ringgit would probably have been fixed at a much

higher level around RM3.00, in which case the exchange rate regime would have got into serious trouble.

Arguably, the timing does matter for undoing it as well. The weak ringgit has been a boon for primary commodities the prices of which are quoted in US dollar, which has enabled the producers to obtain more export earnings in ringgit terms at the current exchange rate. Any revaluation or appreciation of the ringgit at the present juncture would cause considerable pain, now that the prices of primary commodities, especially palm oil, remain depressed. This line of reasoning suggests that it would be opportune to de-peg the ringgit when primary commodities are performing reasonably well. Petroleum prices have reached a 10-year high and the windfall could more than offset any adverse effect of an exchange rate correction on export earnings. But then it looks like a Catch-22 situation with Petronas being a major player in corporate restructuring exercises. Seen in these terms, it is unlikely for any time to be a good time for a revaluation or appreciation of the ringgit.

A policy option that the government has is to maintain the status-quo and do nothing until pressures build up to have it changed. Such a decision will however represent a reactive, not a proactive action mode that cannot augur well for the medium or long term. One should not wait till all implicit costs, alluded to above, become explicit before corrections are made. Notwithstanding this, one must also be wary of a sudden de-pegging, as it may cause a shock to the system. Besides, it is also somewhat risky to de-link the ringgit from the dollar at a time when regional currencies are still experiencing some turbulence. Considerations such as these would call for a gradual phasing out of the current peg regime.

What is referred to as a "crawling peg" in the literature can be a useful implement. Instead of de-pegging the ringgit in one stroke, the ringgit can be re-pegged in small steps a number of times over a short period so that it gets closer to the perceived equilibrium level. The primary objective of this exercise is to ensure a smooth transition from the peg regime to a floating one. There are many unanswered questions about the latter. The options available include free float, managed float and narrow band. To these one may add currency board.

Free float would mean clean float with no government interventions. Such a system, however, is fraught with risks for the national currencies of emerging economies. Only countries with strong institutions can withstand the rigour imposed by market forces, where the economies are subject to harsh international discipline. The market is merciless and unforgiving when it decides to punish. But, the market is by no means perfect. It tends to overshoot in both upward and downward directions, often driven by either greed or fear.

Nor are currency traders subject to rules or regulations with any transparency or accountability. Under such circumstances, free floating can be very hazardous.

Under managed floating, the central banks intervene, from time to time, to iron out fluctuations caused by destabilizing speculations, by buying or selling the national currencies in the foreign exchange market. To do this, the monetary authorities should have a fairly clear idea of the equilibrium exchange rate. Central bank interventions, strictly speaking, are aimed not at influencing the trend but minimizing fluctuations around the trend. How successful such interventions are depends critically on how realistic the targeted exchange rate is and how large the reserves are.

The monetary authorities may opt to impose a ceiling and a floor within which exchange rate is allowed to fluctuate freely. Under this mode, central bank interventions take place whenever the ceiling or the floor is breached by the market rate. The band within which market rate floats freely can be narrow or wide. A narrow band would require more frequent interventions than a wider band. It is in this sense that it is a lot easier to manage a wider band than a narrower one. Currency speculations can destabilize the market if currency traders doubt the ability or the willingness of the authorities to defend the ceiling or the floor, regardless of the width of the band. The inherent danger in all this is that the Central Bank can lose its reserves in its attempt to defend a currency that cannot or should not be defended.

Pegging is not a bad idea if it is meant to be purely a benchmarking tool. Strictly speaking, pegged exchange rate is not the same thing as fixed exchange rate. In the past, the Singapore dollar and the US dollar had been used as benchmarks for the ringgit without clearly defined thresholds which would mandate central bank interventions. The main problem with single currency pegging is that the national currency would tend to move in tandem appreciating or depreciating with the benchmark currency, instead of reflecting its own relative strength or weakness. This problem can be overcome if the currency is pegged to a composite currency basket. As a matter of fact, Bank Negara Malaysia had used such a composite currency basket prior to the crisis, although there was no transparency about the composition of the basket or the weights attached to various currencies.

Given the present international financial architecture, a sensible long-run option for the ringgit is to have it pegged against a trade-weighted composite basket of 4-5 currencies of major trading partners such as the US dollar, Japanese yen, British sterling, Singapore dollar and the Euro with total transparency. This can ensure exchange rate stability not just against one currency, as under the single

currency pegging case, but against all the major ones. The establishment of a band, within which the exchange rate can fluctuate, may create more problems than it can possibly solve. The thresholds represent boundaries that currency traders are warned not to cross, which is tantamount to drawing the battle lines. Instead of being a deterrent, the ceilings and floors may entice currency speculators to step up pressure to test the nerves of the Central Bank, forcing it to intervene and even making profits at the latter's expense.

It is wrong to assume that exchange rates will fluctuate wildly in the absence of a band. Free float does not necessarily mean free fall for a currency during a downslide. The adjustments in either direction tend to be gradual in a flexible exchange rate system except under extremely abnormal circumstances as in the case of a contagion. Flexible rates will not lead to wide fluctuations so long as sound monetary and fiscal policies are constantly in place. What is more, continuous adjustments serve to preclude the adverse effects of prolonged periods of disequilibrium associated with fixed rates. It is also pertinent to note that flexible exchange rates permit a certain independence from BOP considerations in determining domestic policies (Friedman, 1953). A major advantage of flexible rates is that it reinforces the effectiveness of monetary policy through corresponding changes in BOP (Sohmen, 1961; Mundell, 1962).

The currency board option does not appear to be the right choice for Malaysia. The currency board system is not new to Malaysia as it was practiced by the colonial regime. A number of countries have adopted such systems, including Hong Kong since 1983 and Argentina since 1991. A main drawback of the currency board system is that any reserve loss gets translated into a deflationary impact on the domestic economy (Williamson, 1997), but it imposes fiscal discipline because expenditures cannot be financed by printing money (Perry, 1997) and reins in inflation (Corden, 1997).

CONCLUSION

Malaysia took a seemingly big gamble on September 2, 1998 when it decided to fix its exchange rate against the US dollar. There were rumours earlier that the authorities were even thinking of fixing the ringgit against the yen. Fixing the ringgit against any currency, especially yen, seemed such a bad idea. Yen has been very unstable and yen movements apparently have accentuated the pressure on the regional currencies in the run up to the currency crisis, not to mention the fact that very little trade is denominated in yen.

The hindsight seems to suggest that the fixing of the ringgit against the US dollar was not such a bad thing after all. But, then, Malaysia was lucky and the

timing turned out to be perfect. It would have been a shot in the dark, if the authorities had tried to fix the ringgit in July 1997 itself. Malaysia took a calculated risk in September 1998 by settling for a mean between an observed high and a subsequent low. And it worked and was aided by the electronics boom in the export market. As an emergency measure, it has made enormous sense. Its continued existence, however, raises serious concerns about the hidden costs to the economy which may manifest themselves in the near future.

It is argued in this paper that the ringgit should be allowed to find its own equilibrium. A currency float can help it gravitate towards, but cannot guarantee equilibrium rates. In a floating system, exchange rate targeting and government interventions can push the exchange rates towards or away from equilibrium. Admittedly, there is no exchange rate system that is best for all countries or for all times. Upper and lower limits for exchange rate fluctuations would only invite currency speculations and render the management task unduly difficult. The absence of ceilings or floors does not necessarily imply extreme volatility, as the authorities can still exercise their discretion to intervene at any time or at any point. Prior to the crisis, the system did work fairly well. The crisis cannot be blamed on the exchange rate system but on policy failures and errors that led the system to react in the manner in which it did.

Prior to the 1997 crisis, the external value of the ringgit was influenced more by capital inflows than by current account balances. Then, despite persistent current account deficits, the ringgit had remained strong, thanks to massive inflows of foreign capital. The post-crisis situation is markedly different. It is current account surpluses rather than capital inflows that have contributed to increased reserves. Curiously, reserves have not been keeping pace with current account surpluses in recent times, which implies net capital outflows, but for which the ringgit would have been even more undervalued.

The question in front of us revolves around (a) timing and (b) form of change in the exchange rate regime. One argument is that a stronger ringgit would be less painful for primary producers if the suggested revaluation or appreciation takes place when primary commodity prices are doing well. High oil prices would meet this requirement, but then there are other considerations which would militate against any imminent revaluation. Thus, ideal timing can be elusive. Malaysia may have to bite the bullet and unshackle the ringgit. It is advisable to de-peg the currency while the going is still good. It is proposed that the ringgit be aligned to a transparent composite currency basket of key currencies and that the ringgit be allowed to revert to a flexible rate system in a gradual manner transiting through crawling pegs.

No one would deny that all is not well with the present international financial system. But, Malaysia cannot afford to wait till the international financial architecture is restructured before it would review its exchange rate regime. The International Monetary Fund has no authority to ban currency trading. Currency trading cannot be done away with so long as there is no single world currency. To be sure, there is a need for rules, regulations, transparency and accountability in currency trading. None of the existing international institutions are designed to monitor international currency transactions which far exceed the value of trade in goods and services. While international efforts on international financial reforms must continue, a process which will undoubtedly and understandably take much time, countries must learn to accept the world as it is with all its imperfections and make the best out of it.

REFERENCES

Ariff, M et al. 1998, *Currency Turmoil and the Malaysian Economy: Genesis, Prognosis and Response*, Malaysian Institute of Economic Research, Kuala Lumpur.

Ariff, M. 1993, *The Malaysian Economy: Pacific Connections*, Oxford University Press, Kuala Lumpur.

Ariff, M and Semudram, M. 1987, *Trade and Financing Strategies: A Case Study of Malaysia*, Overseas Development Institute, London.

Corden, W.M. 1997, "The Dilemmas of Currency Boards", in G.E. Perry (Ed.) *Currency Boards and External Shocks: How Much Pain, How Much Gain?*, The World Bank, Washington D.C.

Friedman, M. 1953, "The Case for Flexible Exchange Rates", *Essays in Positive Economics*.

Lin, S.Y. 1991, "Exchange rate regimes and practices: Malaysian Perspectives", in M. Ariff (Ed.) *The Pacific Economy: Growth with Stability*, Allen & Unwin, Sydney.

Mundell, R.A. 1962, "Flexible Exchange Rate and Employment Policy", *Canadian Journal of Economics and Political Science*, March 1962.

Perry, G.E. 1997, "Introduction and Summary" in G.E. Perry (Ed.) *Currency Boards and External Shocks: How Much Pain, How Much Gain?*, The World Bank, Washington D.C.

Sohmen, E. 1961, *Flexible Exchange Rates, Theory and Controversy*. The University of Chicago Press, Chicago.

Williamson, J. 1997, "Features and Implications of Currency Boards: Thoughts About the Argentine Situation", in G.E. Perry (Ed.) *Currency Boards and External Shocks: How Much Pain, How Much Gain?*, The World Bank, Washington D.C.