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Call to free up exchange rate to avoid cost pressures

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MALAYSIA should free up its exchange rate, as over time the undervaluation of the exchange rate would generate cost pressures and drive up inflation, said managing director and head of Salomon Smith Barney Hong Kong Ltd's Asia Pacific Economic and Market Analysis Division Donald Hanna.

He said given Prime Minister Datuk Seri Dr Mahathir Mohamad's statement on the importance of containing inflation, Malaysia is likely to get a managed exchange rate rather than allowing the present cost pressures to rise.

"At the rate the Malaysian economy is growing, you should see these issues (cost pressures) within a year," he said, referring to it as the "beach ball" effect where if something is suppressed, it rises to the surface in one way or another.

Hanna said there should only be interference from the regulators when there is market instability. "I don't think we're going to get a repeat of the market instability in 1997/1998."

Malaysia locked in the ringgit at RM3.80 to US\$1 in September 1998 when it took the ringgit out of circulation due to the high volatility of the currency at the time.

The main argument against freeing up the ringgit would be that it would make the country vulnerable to speculative attacks which were rampant at the time.

However, Hanna pointed out that this argument is not valid as the "... mechanisms that exacerbated that volatility are not there any more".

"There has been a restriction in lending ringgit to non-residents so it makes it difficult to get access to the currency," he said.

"Currency speculators don't wake up and decide that its time to attack X, Y or Z, because if they are on the wrong side of the track they will get crushed."

He said this had actually happened during the turmoil in 1997 and 1998.

"The same hedge funds who were shorting the ringgit went long on the rupiah. They got the stuffing kicked out of them. Lessons have been learnt on both sides."

He said currency speculators will only attack a currency if they are able to corner the market and given the existing regulatory regime, that will not be possible in Malaysia.

At the moment, he said, at equilibrium the ringgit would be valued at RM3.40. "You will have to have higher levels of inflation as your costs move towards equilibrium."

However, he does not think the ringgit should be re-pegged at RM3.40. "My sense is that Malaysia will be better off with flexible exchange rates rather than re-pegging it at RM3.40."

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