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Peg unplugged

EVER SINCE THE MALAYSIAN RINGGIT was pegged to the US dollar in September 1998, speculation on its fate never ceased to make the rounds. The latest came upon the heels of the weakening of the Japanese yen against the US dollar. It began towards the end of last year with Japan's ailing economy showing no signs of improvement.

The intensity of the ringgit peg went into high gear in mid-January when Prime Minister Datuk Seri Dr Mahathir Mohamad was reported to have said Malaysia may review the peg if further weakening of the Japanese yen forces China to devalue its own currency. 'if it goes down, I'm worried because it may cause China to devalue, and if China devalues then of course it will force us to rethink about our ringgit peg,' the Malaysian premier reportedly remarked.

What failed to sink in among the speculators is that the potential action by Malaysia is conditional on a conjunction of events occurring in other countries. Immediately after Mahathir's remarks, James Malcolm, regional currency strategist at JP Morgan Chase in Singapore, was reported to have said: 'That's a very big if in the first place.' He noted that none of Asia's fixed currencies, whether China's, Hong Kong's or Malaysia's, were overvalued on a historical basis over the post-Asian crisis period.

Mahathir's remarks came about when the yen was moving towards its lowest level against the dollar since mid-1998. As expected, the Japanese currency continued its decline, with the tacit support of its authorities. The lowest point for yen for the first quarter of the year was on Feb 8 when it closed at 134.7 to the dollar.

The yen however steered clear from touching 138 to the dollar, the low it touched when Malaysia implemented the ringgit peg on Sep 2 1998. Conventional economic advice was for implementing managed float operations but the government decided to go the pegged exchange rate way. It fixed the Malaysian currency at RM3.80 to the US dollar, then deliberately undervalued so as to stem capital outflows.

The move to anchor the ringgit to the US dollar was triggered by the 1997 Asian financial crisis. The strategy was designed to reduce the ringgit's exchange rate volatility and to promote a stable environment conducive to economic recovery. It proved to be the right decision. All these things came about, with the economy showing signs of recovery and the peg able to withstand pressures from various forces. More than 42 months later, the peg is still standing at the original level.

In a recent interview with the media, Bank Negara assistant governor Latifah Merican Cheong reiterated the sustainability of the ringgit peg. 'The ringgit exchange rate at 3.80 is still sustainable. It is in line with the economic fundamentals and it has promoted trade and investments,' she said.

Latifah stressed the exchange rate regime will not be changed just because of short-term developments; if it continued to promote trade and investments, the regime should remain unchanged. On a further reassuring note, she added it is important for the country to ensure the regime is sustainable.

No budging of the yen

As for the potential devaluation of the yuan, China put all speculation to rest when it recently assured the yuan will stay put at its present

level. On March 10, its central bank governor Dai Xianglong said the authorities will leave the peg about where it is 'for the foreseeable future'. Dai, head of the People's Bank of China, said the yuan may appreciate if freed from its peg to the US dollar. 'The long-term stability of the yuan exchange rate is beneficial both to China and the rest of Asia,' he said. To prevent the currency from appreciating, China currently maintains the yuan's peg by buying up surplus dollars from China's state-run banks.

The assurance from China must have calmed down some nerves on the foreign exchange front. A local economist from a local research house observes that, generally, developing countries such as China and Malaysia which require infrastructure development and where the role of imported input is essential, may not benefit too much from devaluation. Hence, the existence of the pegged exchange rate is envisaged to provide a stable financial market environment, in particular to avoid the necessity for domestic monetary policy to shadow the tightening cycle of US monetary policy in spite of the dollar/ringgit peg.

But there is still a potential hitch. Under the present fixed currency regime, a country faces the policy dilemma of losing monetary control. This is due to the irreconcilable trinity of independent monetary policy, free capital flow and a stable exchange rate. However, to circumvent this, Bank Negara has imposed capital control. This acts as a circuit breaker, allowing Malaysia to set monetary policy in line with domestic needs.

It has therefore been made clear Malaysia would not re-peg, for the sake of certainty and predictability. In its Annual Report, Bank Negara also said it would continue to maintain a stable and fundamentally sound exchange rate, and would not respond to marginal and short-term misalignments that can reverse within a short period in response to changes in sentiments.

The central bank went on to add it is the country's policy to maintain international competitiveness through efficiency and productivity gains rather than via the exchange rate. This is because the competitive devaluation of currencies would not bring any significant gains but would instead lead to higher costs and a destabilized environment.

Moreover, tweaking with the peg rate has its disadvantages. If the ringgit is re-pegged too often, the unpredictability factor would return. The very speculators whom the authorities are trying to evade will be back in force as there would be speculation as to whether there will be another re-pegging in future.

Therefore, re-pegging would be done, if at all, only as a last resort when the situation really warrants it. The re-pegging also carries serious downside economic risks such as higher import bills, imported inflation, higher US dollar external debt and an erosion of the nation's living standards. A Malaysian independent economic research group felt re-pegging may also cast doubt on Bank Negara's commitment and its ability to further maintain the peg. This could heighten the ringgit's vulnerability to future pressures.

Position of the peg, now and in the future

There have been many voices out there calling for an outright abandoning of the peg. That does not seem likely to happen in the near future. There have also been some observers who have called on the authorities to consider migrating to a more flexible form of foreign exchange regime. The main argument for such a move is that bottling up the exchange rate protects against exchange rate volatility but many other effects will ultimately show up over time in some other aspects of the economy that cannot be, or are not, controlled.

Some quarters have even suggested a crawling peg, seen as a midway

option between the two extremes of totally fixed and completely free-floating exchange rates. Under the crawling peg theory, the government adjusts the peg by small amounts, but frequently. Another possible option is a joint float, another midway choice. Here, a group of countries have a fixed or adjustable peg system between their own currencies, but jointly float against all other currencies.

Yet another alternative is the basket option where the ringgit is pegged to a basket of chosen currencies, avoiding over-exposure of the local currency like the US dollar.

For the present, the advantages of having the peg are too good to ignore. Since locking the exchange rate to the US dollar, the effect on the economy has been positive. Observers note the advantages of the pegged regime in ensuring speculators are unable to influence or manipulate the currency level. Financial authorities are also able to bring down the interest rate or boost public spending through deficit financing, without being constrained by how the currency markets will react.

Another direct benefit has been for the business community. They have been able to import and export products at prices fixed either in the US dollar or the ringgit, with certainty as to how much these prices will be worth in terms of the other currency.

All things considered, the peg seems set to stay and weather any storm coming its way.

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