

Ringgit Lore

It's time to examine the myths that obscure the Malaysian currency peg's questionable history

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By Dan Fineman

The time has come to adjust the Malaysian ringgit peg. The peg has delivered vastly fewer benefits than commonly claimed, while it poses significant risks for the economy. Current conditions provide an ideal opportunity to make this outdated currency regime more flexible.

Myths surrounding the peg's history distort the ringgit debate. Despite strong evidence to the contrary, a bizarre consensus has arisen that the peg rescued Malaysia's economy in the late 1990s. Former Prime Minister Mahathir Mohamad introduced the peg, along with capital controls, at the height of the Asian financial crisis in September 1998, and since then his supporters have somehow convinced the world that his stern measures saved the country. Even the International Monetary Fund has adopted the Mahathir line, surely a troubling sign.

The peg and capital controls proved at best irrelevant, and possibly harmful, to the recovery. Had Mahathir blocked hot-money inflows in 1993, he could have prevented the crisis. Had he implemented controls in July 1997, when Thailand floated the baht and capital fled Malaysia, he could have eased the pain of the downturn. But pegging the ringgit and closing the capital account in September 1998 after a full year of capital flight accomplished nothing.

Mahathir could not have timed his moves worse. Two weeks before he introduced the peg and capital controls, currencies throughout Asia—including the ringgit—began to rally, and interest rates tumbled. In the year that followed, interest rates elsewhere in Asia fell as much or more than in Malaysia and currencies matched or bettered the ringgit's revaluation. In neighbouring Thailand, lending rates dropped by 6.25 percentage points against 4.9 points in Malaysia, while the baht's 9% rise roughly equalled the ringgit's September 1998 10% increase.

Peg supporters claim that Mahathir's measures provided the stable environment needed to revive the banks, but Korea and Thailand achieved more impressive reforms with floating

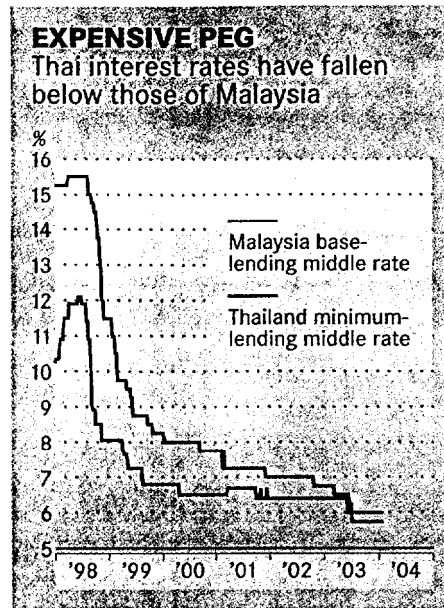
currencies and open capital accounts. An underperforming stockmarket represents the most notable legacy of Mahathir's measures.

Since the crisis ended, the peg has delivered no discernible benefits. Foreign direct investment has fallen 25% over the past two years from 1998-99 levels and 2003 export growth of approximately 6% has lagged that of other Asian countries. The peg added little to price stability. Inflation has averaged 1.7% since 1998, against 1.8% in Thailand. Interest rates in both countries have remained similarly steady.

Even if Malaysia retains capital controls, it could loosen the peg. Although simultaneous implementation of the peg and controls linked the two in the public eye, nothing in reality ties them. Hong Kong maintains both Asia's tightest currency peg and its most open capital account. Indeed, assuming capital controls are designed to free governments to set exchange rates as they see fit, a discretionary managed float makes more sense than a binding peg.

While the peg has helped Malaysia little, it presents unlikely, but serious, risks. Throughout the developing world, currency pegs have promoted financial crises. Where pegs have held, as in Hong Kong and China, they contributed to deflation. Malaysia now faces neither crisis nor deflation, but currency pegs' dismal history marks them as obsolete.

The timing for an adjustment of the peg is ideal. Supporters rightly note that the peg is at present not under pressure. The country boasts ample reserves, stable prices and reasonably priced asset markets. But currencies are better floated at times like these, when gradual currency movements are likely, than when market stress forces the government's hand. Lack of urgency explains why politicians maintain pegs, not why flotation is unwise.



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Malaysia need not float the ringgit freely. It could maintain a managed float similar to Singapore's hugely successful currency regime. But with that modest change, the country could enjoy the best of both worlds—currency flexibility and economic stability. ■