THE RINGGIT'S NEW-FOUND FREEDOM

At long last, the Malaysian ringgit is free, after being shackled to the US dollar for nearly seven years. Some would still insist that the so-called "currency peg" was necessary in the wake of the 1997/98 financial crisis. Some others would argue that it was not, as the "peg" was put in place only 13 months after the beginning of the crisis, at a time when the regional currencies were already stabilizing. Yet some others would hold on to the view that the "peg" had stayed too long by outliving its usefulness. All this is now history. What really matters now is that the ringgit free again.

The ringgit is free but not floating freely. It is now under "managed" float. Cynics would call it "dirty" float. To them, a "clean" float is synonymous with a "free" float. The latter is labeled "clean" as the exchange rate under this mode is determined by supply and demand for the currency without government interventions. In the economics literature, there has always been a never-ending debate if the currency market should be left free or be tempered. In practice, most governments do intervene, as it is too risky to let their currencies to be exposed to the vagaries of market forces which tend to overshoot. Yet it would be a costly mistake to ignore the market signals. Managed float provides a middle ground where one can have the benefit of exchange rate flexibility without excessive instability.

The managed float implies that the central bank would intervene in the foreign exchange market to smoothen short-term fluctuations. Thus, for example, the central bank would sell ringgit if there is a strong demand for the currency and buy ringgit if there is excess supply. This does not necessarily mean that there is a band within which the currency would oscillate. Even if there is a band for operational purposes, it could remain unknown to the market, lest currency speculators would test the will and strength of the central bank to defend the band's ceiling or floor.

It was a wise move on the part of the central bank to opt for a managed float, instead of re-pegging the ringgit. A re-peg would have given vent to more speculation and waiting, without addressing the problems associated with exchange rate distortions. Had the ringgit been merely re-pegged, there would be no flexibility which the currency currently enjoys under the managed float.

In a sense, the ringgit is on a leash connected to a basket of currencies. There is no transparency in the composition of the basket or the weights given to the various currencies in the basket. All this is by no means new. In fact, the current system, for all intents and purposes, is not different from the one the country has had before the 1997/98 financial crisis.

It is comforting to note that the ringgit has not appreciated sharply after the removal of the peg. A sharp appreciation would have posed severe adjustment problems for the Malaysian economy. It was very wise on the part of the monetary authorities not to wait till the ringgit was "substantially" misaligned before abandoning the fixed exchange rate

system. One may recall that the central bank had stated time and again that a review of the peg would be taken only if the ringgit was undervalued by 20 per cent or more. A 20 per cent appreciation in the exchange rate would be very painful, especially for the export sector. Now, the Malaysian economy can breathe more comfortably, now that it has exchange rate flexibility without having to go through a difficult transition phase.

That the ringgit has not appreciated much since the removal of the peg is not surprising. As a matter of fact, the ringgit had already appreciated against the major currencies since the beginning of this year, thanks to the strengthening dollar. It is noteworthy that the ringgit had appreciated by 12.5 per cent against the euro, 9.3 per cent against the sterling, 9.2 per cent against the yen, and 7.4 per cent against the baht between January and mid-July this year. One can anticipate a gradual appreciation of the ringgit against the dollar as the latter must depreciate in the face of the ballooning balance-of-payments deficit in the United States.

Without a doubt, the removal of the peg augurs well for the Malaysian economy. Price distortions under the peg system had cost implications in terms of resource misallocation. Now that the ringgit is no longer linked to any single currency without any built-in bias, one can expect efficiency gains through resource reallocation. The domestic sector will gain considerably, as the bias against the non-traded sector has ceased to exist. As the ringgit gradually regains its strength, imports will cost less, and given the high import content in domestic manufactures, this should translate into lower costs, lower prices, positive wealth effect and greater demand. This should also help reduce inflationary pressures in the domestic economy, as there are concerns over the 3.2 per cent rate of inflation in the month of June this year.

Understandably, the exporters will be wary of the appreciating ringgit, as this would raise the price of Malaysian products in the export market. However, the loss of export competitiveness resulting from an appreciating ringgit will be no more than temporary. It will be offset partially in the near term by the lower cost of imports which constitute the bulk of the total cost of production. In the medium term, the exporters will find ways and means to cut costs and raise productivity. Fortunately, the appreciation is initially small enough for exporters to cope with. Hopefully, subsequent appreciation will be gradual enough as well.

What is more important is the implication of the new exchange regime for foreign investments in Malaysia. The peg had caused many foreign investors in recent times to delay direct investments, as investments would cost more in terms of imported machinery and equipment. The concern then was that the investors would lose if they were to bring in their heavy machinery and intermediate inputs at the undervalued exchange rate and to export the output after exchange rate appreciation. The managed float will be good for foreign direct investment, as it would ensure exchange flexibility with stability. The managed float is also conducive for foreign portfolio investments, as investors may profit from both stock price increases and exchange rate changes.

Most of all, Malaysia has regained monetary independence which is critical for macroeconomic management. Currency pegs always entail a loss of sovereignty especially with respect to the use of monetary policy. However, Malaysia was able to maintain a fairly independent interest rate regime, thanks to capital controls on domestic capital. Now that the ringgit is on a managed float, Malaysia has more ammunition for macroeconomic maneuvers, which include greater monetary policy muscles and exchange rate policy instrument.

As mentioned already, the present managed float is not new to Malaysia. The central bank has reverted to a system that had worked well prior to the financial crisis. Indeed, the financial crisis cannot be blamed on the exchange rate system. Any system would have collapsed under the weight of the crisis of the 1997/98 intensity. For the causes of the crisis one must look elsewhere. The managed float had served Malaysia fairly well before. It can serve just as well now.

However, care must be taken not to repeat the past mistakes in exchange rate management. The objective should be to minimize exchange rate volatility without obstructing the secular trend. In other words, the central bank's role should be to iron out short-term fluctuations in exchange rates, allowing the market forces of supply and demand to determine the long-run trends. This can ensure that the currency will always remain close to the equilibrium level. Exchange rate targeting must be avoided. The mistake made prior to the crisis was that the ringgit's exchange rate was targeted at around RM2.50 to the US dollar, which had led the ringgit to be substantially overvalued, contributing to the 1997/98 currency crisis. If we fail to take lessons from history, we will only let history repeat itself.

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