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THE CHOICE OF EXCHANGE RATE REGIMES IN AN EMERGING ECONOMY: THE CASE OF MALAYSIA

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1. ABSTRACT

Since the Asian or global financial crisis of 1997-98, people have started back debating about the best exchange rate regime. The question has actually been asked ever since the collapse of the Bretton Woods system. Overtime, the answers to the questions keep on changing. Now, the preference for picking one of the extremes: fixed or flexible, and avoiding the middle ground has spread from professional economists to policy makers. The paper discusses the positive and negative effects of the use of the two extreme regimes and the intermediate regimes. In addition to that, the other alternative exchange rates, such as Big McCurrency, Global Currency and The Islamic Dinar impacts are mentioned too. The data has shown that each particular regime has its positive and negative impacts. In searching for the best exchange rate regime that provides stability and prevents crisis from recurring to an emerging economy, none, so far that has been a perfect regime to be selected without particular control. However, with a particular control on the system, the most preferred regime to be selected based on the survey and consensus through Delphi Technique is the intermediate regime, the target zones or similar regimes.

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3. INTRODUCTION

3.1 BACKGROUND

From 1965 to 1990, Japan, the Four Tigers - Hong Kong, Singapore, Taiwan, and South Korea, and the NIEs - Malaysia, Indonesia, and Thailand had been popular in reference to the "Asian Economic Miracle". They managed to record high and sustainable economic growth. However, in late 1997, East Asian currencies had been attacked and depreciated tremendously and stock market swung wildly. The incident had placed East Asian countries into financial and economic crisis.

There were quite a number of factors contributing to the crisis. One of the major causes which was often mentioned was the exchange rate regime that had been adopted by the countries of the region which involves a variety of mechanism for pegging more or less closely to the dollar. The other factors were crony capitalism, weak banking systems, and excessive bank loans for property in a buyer's market. However, Paul Volcker, the former Federal Reserve Board chairman, believes that the swamp of the East Asian economies was due to the combination of volatile capital flows and huge shifts in the dollar-yen exchange rate during 1996 and early 1997. Since their currencies were pegged to the dollar, they rose with dollar and this slowed down their exports to the vital Japanese market. The decrease in exports gave worse effect to the Southeast Asian companies that had borrowed in dollars due to its lower interest rates. They could not service their debt.

The government had to come to the difficult conclusion that if ''drastic'' measures were not taken and taken immediately to get growth going again, the economy would continue to drop, with no end in sight. A number of measures had been taken such as offering high interest rates to attract people to deposit their money and government policy to fully guarantee all deposits in the banking system to stop massive run on the bank. However, they failed.

Then in September 1998, Malaysia pegged its currency and reduced interest rates. The 1999 government budget aimed to support businesses and steer the economy out of recession through a big deficit financing. Since then, Malaysia has been running one of the biggest surpluses in the region and managed to obtain the economic growth without the help of IMF. However, there is a question left unanswered. "Is pegged currency the best currency to be adopted by Malaysia and other emerging economy?"

3.2 OBJECTIVES

The aim of the study is to use Delphi technique to develop a theory on what is the preferred exchange rate regime to be adopted by an emerging economy, like Malaysia. The preferred exchange rate regime is the regime that provides the stability of the exchange rate and prevents crisis from recurring to the nations. Other than delphi technique, questionnaires have also been used to give greater support on the study.

Before analyzing the delphi technique and questionnaires data, the paper will identify the choice of exchange rate regimes in an emerging economy. The exchange rate systems have been divided into four groups: Fixed, Free Floating, Intermediate, and other regimes. Fixed exchange rate regime consists of pegged currencies, currency board, dollarization, and monetary union. Free float is by itself. Intermediate regime consists of managed floating and target zones. Other systems are Big Mac Currency, global currency, and Islamic Dinar. Each of the regime shall be examined based on its positive and negative effects.

4. LITERATURE REVIEW

4.1 THE PROS AND CONS OF EACH EXCHANGE RATE REGIME

In search for the best exchange rate regime to be adopted by the country, the study then looks through the literature to check on the benefits and the drawbacks of adopting each regime. The paper will first discuss the different types of fixed exchange rate regimes, namely pegged currency, currency board, dollarization, and monetary union, followed by the discussion on flexible regime and intermediate regime. Lastly, the paper will also take a look at the other alternative regimes such as the Islamic Dinar.

4.1.1. FIXED EXCHANGE RATE REGIME

4.1.1.a PEGGED CURRENCIES

Pegged or Fixed exchange rate system is defined by Shapiro (1999) as a system that requires commitment from the government to maintain target exchange rates. It resembles the Bretton Woods System. Whenever the exchange rate is about to sheer from its stated par value by more than the agreed-on percentage, the central bank will actively buy or sell its currency in the foreign exchange market. This process requires the coordination of monetary policy to ensure that all members have the same inflation rate. Therefore the monetary policy becomes subservient to exchange rate policy.

The use of Fixed Exchange Rate gives some good and bad effects to the country. The country has to take advantage of the good opportunities given by the Fixed-Rate System. However, at the same time, it should also be aware of the drawbacks which can put the country into economic crisis.

According to Jeffrey Frankel (1999), "the two big advantages of fixing the exchange rate are: (i) to reduce transactions costs and exchange rate risk which can encourage trade and investment, and (ii) to provide a credible nominal anchor for monetary policy."

In his discussion on the reduction of transaction cost and exchange rate risk, he pointed out that:

> 'Twenty or thirty years ago, the argument most often made against floating currencies was that higher exchange rate variability would create uncertainty; this risk would in turn discourage international trade and investment. Fixing the exchange rate in terms of a large neighbor would eliminate exchange rate risk, and so encourage international trade and investment. Going one step further, and actually adopting the neighbor's currency as one's own, would eliminate transaction costs as well, and thus promote trade and investment still more.

Most academic economists tend to downplay this argument today. One reason is that exchange rate risk can be hedged. Another reason is that there have been quite a few empirical studies of the effect of exchange rate volatility on trade, and some on investment; most of them find small adverse effects, if they find any at all.'

Having a stable exchange rate reduces business transactions costs, is also mentioned by Jeffrey Sachs (1999) in his article, "Why dollarization is more straitjacket than salvation."

Frankel's second point stresses that a fixed exchange rate provides a clear and easily monitored commitment to anchor monetary policy. This can be done by having a clear articulated monetary rule, such as a commitment to control the growth of monetary aggregate, or a commitment to target inflation or the growth of nominal income. The other alternative to guide monetary policy is by maintaining macroeconomic balance, raising interest rates if the economy appears to be overheating and lowering them if growth falls below potential. Having a credible commitment to fixity ensures the market to believe the country through thick and thin and desist from speculative attack.

Economist Newspaper Ltd (1997) stated that pegged exchange rate helps countries parry attack on their currencies. Pegged exchange rate also offers the prospect of a stable exchange rate as stated by Dr. Zeti (2001). This promotes trade and investment.

Pegged exchange rate could also influence external price competitiveness of a country by pegging the currencies at a low level. Moreover, the Economist Newspaper Ltd (1997) reported that if a country goes for the option of adjusting the 'fixed' rate, this provides a country with an additional policy tool that can be used to correct an excessive external deficit or surpluses.

Furthermore, government cannot use central bank's printing presses to fund large deficits. It is such a rule-based nature. A pegged exchange rate system enforces discipline. Jeffrey Sachs (1999) stated that if an irresponsible central bank is given freedom to issue currencies without worrying about the consequences for the exchange rate, it will simply print currencies to fund a large budget deficit or to provide cheap credits to the banking systems. In the long run, this will soon lead to inflation and a collapsing exchange rate. As a result, a fixed exchange rate system forces the central bank to avoid issuing excessive currencies, since doing so will deplete its reserves.

On the other hand, there are also arguments against fixed exchange rates. Firstly, Fred Bergsten (1999) and Edouard Balladur (1999) emphasized that exchange rate cannot be used to help economy adjust to outside shocks. When there is a decrease in export prices or high shifts in capital flows, domestic wages and prices need to be adjusted. If wages and prices are sticky, the exchange rate is highly overvalued. As famously pointed out by John Maynard Keynes over 70 years ago to Winston Churchill, the Chancellor of the Exchequer, a wage cut is a messy business. It would require the renegotiations of thousands of separate wage contracts, and any such wholesale drop in wages would likely be accompanied by severe social stress. A much simpler solution would be to allow the currency to depreciate vis-à-vis the dollar. By changing just this one price, all of the country's export products would suddenly become cheaper in world markets and therefore more attractive to foreign buyers. The shock would be absorbed and the economy would continue to hum.

Many emerging markets had experienced this matter after the start of the Asian Crisis in 1997, as stated by Jaffrey Sachs (1999). Those countries had experienced sharp declines in world prices for their commodity exports. As a result, they encountered a sharp loss of income. They had two choices, whether to have a currency depreciation or a fall in wage levels. Those countries, which were committed to maintain a pegged

exchange rate, ended up with sharp rises in unemployment and sharp declines in real economic output. However, countries like Australia and New Zealand, which implement floating exchange rate are able to absorb the shocks without significant damage to domestic output and employment.

In addition, banks and other financial institutions, as claimed by the Economist Newspaper Ltd. (1997), are no longer able to increase interest rate when investments decline. If bank depositors and currency holders try to shift out of their currencies and into dollars, for example, then the banks will become illiquid, unable to provide the currency to household that want to remove their funds.

There is also an argument that central banks cannot be trusted with floating exchange rates – that they will simply print too much money if given the chance. Therefore, the remedy to chronic, irremediable irresponsibility are pegged exchange rates, or even dollarization.

To implement a fixed exchange rate system, "sufficient foreign reserves" is required. The Economists Newspaper Ltd. (1998) and Forbes Inc. (1999) claimed that if households and businesses in large try to convert their currencies to dollars, for example, the central bank will almost surely run out of reserves, since the number of local currencies in

circulation plus bank deposits is almost always higher than the dollar reserves held at the central bank.

This scenario may also be due to markets expectation that their local exchange rates will depreciate. This expectation of a currency collapse can become a self-fulfilling prophecy. The rush out of local currencies is often greater than the reserves held by the central bank. Countries like Mexico (1994), Thailand and South Korea (1997), and Russia and Brazil (1998-99) had experienced the collapse of pegged exchange rates, even though the governments and central banks were committed to defending them to the bitter end of reserve holdings.

The growth of domestic money supply cannot exceed the growth of nominal demand for money. Otherwise, local money will gradually replace the foreign reserves. Once it happens, the peg will have to be broken as the domestic money supply is pegged to a small quantity of foreign reserves. In other words, a country that pegs its currency to the dollar is, in effect, tying its monetary policy wholly to US. Monetary policy. That decision make sense only if US. Monetary policy is wholly appropriate for its national economy, which is rarely the case.

According to Jeffrey Sachs (1999) and Su Zhou (1998), the U.S. monetary policies seldom appropriate for countries whose currencies are

pegged to the dollar. For instance, for several years before 2001, the U.S. economy has been booming due to high rates of return and high capital inflows from the rest of the world especially in the excitement of the information technology revolution. The dollar has surged in value relative to the Euro and the yen. Therefore, developing countries that pegged their currencies have seen their currencies soar in value relative to the euro and the yen. However, what was good for U.S. was not so good for these developing countries since they needed weaker currencies to maintain their export competitiveness. As a result, in order to keep their currencies linked to the dollar, they had to tighten their monetary policies. The defenses of rates pegged to the dollar helped bring on recessionary conditions in those countries, including, Brazil, South Korea, and Thailand.

A failed defense can be very costly. Once central bank runs out of reserves, a country will be in big trouble. Foreign banks often flee when they know that they will not be well protected. On the other hand, domestic banks collapse. The central bank will not have the dollars to help the banks meet their obligations. As a result, the collapse of the pegged exchange rate will be followed by a financial panic, in which foreign banks abruptly demanded repayment of loans and domestic banks could not meet the demands and had to default. Since a pegged

exchange rate is a conditional promise, not an unconditional guarantee, both a banking crisis and a currency collapse can occur together.

Malaysia National Economic Recovery, in its homepage (2001), stated, "A return to fixed rates in today's world of highly mobile capital is unsuitable. A fixed peg is also a fixed target for speculators".

4.1.1.b CURRENCY BOARD

According to Charles Enoch (1998), currency board is a monetary authority commits to trade foreign exchange rate for domestic currency on demand as a fixed rate of exchange. Those who fix their exchange rate via a currency board system surrender all control of monetary policy. The central bank or the currency board needs to hold reserves of foreign currency or gold at the fixed rate of exchange at least 100% of domestic currency issued. In other words, the currency (base money, MO) is issued only in exchange for dollars. It follows that each dollar's worth of domestic base money is backed by at least a dollar of foreign exchange reserves.

Under a strict currency board regime, interest rates adjust automatically. Once investors decide to switch out of domestic currencies into dollars, then the supply of domestic currency will automatically shrink. Thus,

interest rate will rise until eventually it becomes attractive for investors to hold local currency again. In addition, once the country has decided to implement currency board, it has to have a long-term commitment to the system.

The benefits of currency board are almost the same as implementing pegged exchange rate regime. The greater significance of currency board system emphasized by the Economist Newspaper Ltd. (1997) is that the confidence can be well developed since the issuance of local currency must be fully backed by a foreign currency. The predictability and the rule-based nature of a Currency Board are two off its biggest advantages. Once confidence has been developed that a Currency Board offers the prospect of a stable exchange rate, trade and investment will be well promoted. Thus, the economy will become more credible and the inflation and interest rates will also be lowered. This has been proved by Argentina, Estonia, Bulgaria, and Hong Kong. Estonia's Currency Board helped stabilize the Baltic country's economy. Hong Kong's has kept the colony's currency steady despite the massive changes in China. Argentina has put an end to decades of inflation. This success has tempted others like Bosnia-Herzegovina and Bulgaria to introduce boards soon.

The disadvantages of currency board system are also almost the same as the pegged currency. Government is prevented from setting its own interest rate. In Hong Kong for example, the interest rate is set up by US Federal Reserves. If interest rate is greater than the US, real interest rate will be low or negative. Thus will create a bubble in property and share price. If the inflation remains high, currency is overvalued and uncompetitive.

According to John Williamson (2000), conventional wisdom pointed out that countries should adopt either fixed exchange rate backed up by a currency board or floating exchange rate, but should not do anything in between. The logic of the statement is that intermediate regimes are prone to get countries into crisis, which is something to be avoided. The statement has been supported by the success of two countries: Argentina and Brazil. Argentina adopted currency board in 1990 and Brazil adopted floating exchange rate in 1999.

However, Charles Enoch and Anne-Marie Gulde (1998), in their studies, found out that the currency board arrangements may not be appropriate for all countries. For instances, the success stories of smaller nations such as Hong Kong, may not necessarily be true in larger countries.

4.1.1.c DOLLARIZATION

Jeffrey Sachs (1999) defined dolarization as a system where a country abondons its national currency in favor of the U.S. dollar. The case for dollarization is essentially the same as the case for currency boards, the gold standard in bygone days, or any system of irrevocably fixed exchange rates as outlined above. For him, the system makes sense for two types of countries:

- those which are very small and very dependent on the world economy, like Hong Kong, and hence would simply be buffeted too sharply by constant exchange-rate fluctuations;
- those with a history and/or recent experience of hyperinflation, like Argentina in 1991, which desperately need a strong anchor for domestic monetary stability and whose population is willing to pay the price thereof (in terms of high interest rates, recession and unemployment).

Relatively few countries meet these criteria. Certain countries for which currency boards or dollarization have recently been proposed—Brazil, Indonesia, Mexico, and Russia—clearly do not. Fred Bergsten (1999), the Director of Institute for International Economics, John Williamson (2000), Senior Fellow of IIE, Andrew Berg and Eduardo Borensztein (2000) believed that there is a very limited universe of countries where this approach would make sense.