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**Pegging amidst the Floaters:
Post-Crisis Exchange Rate Policy in Malaysia
vis-à-vis the Neighbours’***

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Abstract

Prior to the 1997 crisis, observers claim that Indonesia, Malaysia, Singapore and Thailand were unofficially pegging their currencies to the US dollar despite the *de-jure* classification of managed or independent floating exchange rate regimes. One of the reasons that led to the crisis was thought to be the inability of these countries, starting with Thailand, to defend the peg. Following the financial turmoil, ASEAN crisis countries moved towards more flexible or floating exchange rate systems, except Malaysia which adopted a hard peg, thus reinforcing the *bipolar* view of exchange rate regimes. This paper examines the arguments for and against a fixed exchange rate regime for a small open economy like Malaysia and looks at the post crisis actual performance of exchange rate movements of its neighbouring economies. The paper also evaluates the economic performance of Malaysia vis-à-vis that of the rest of ASEAN and discusses whether the differences could be attributable, at least partly, to the differing exchange rate policies adopted.

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Introduction

There is no unambiguous answer to the question “which is better, fixed or floating?” At any particular time in history of the modern world one of these two exchange rate regimes may prove to be more popular or “fashionable”. The Great Depression in the 1930s, saw the collapse of one of the most rigid fixed exchange rate system ever used-the Gold Standard. The fixed exchange rate system was thought to be too rigid to meet the demands of expanding economies. The system that followed was the Brettons Woods System which was essentially a system of pegging with a small degree of flexibility.

By the early 1970s, the system was under intense pressure as major currencies started to float, with the pound sterling floated in June 1972 and the US dollar in 1973. Since the collapse of Brettons Woods, the world witnessed what was to be called a generalized floating system. With major currencies now floating, developing countries tend to follow suit or at least it was thought to be “fashionable” to claim to have an exchange rate regime that was “flexible.” Countries that reported to IMF to have floating exchange rate regimes have increased from 5 in 1976 to 50 in 1996, and the number of countries which had pegged regime has reduced from 86 to 45 during the same period (Edwards and Savastano 1999: 9).

Despite the increasing trend for more flexible exchange rate regimes, in practice, many of the countries which claim to be using a flexible or floating system are in fact “managing” the exchange rate. Theoretical perspective suggests that neither extremes of permanently fixed or completely flexible is optimal in seeking macro stability. Intermediate degree of flexibility is more likely to succeed in stabilizing an economy in the face of shocks. That is why “managed or “flexibly fixed” exchange rate constitute the most common arrangement in developing countries (Aghevli et al 1991:5).

However, since the waves of currency crises that occurred towards the end of the last century (Mexico, East Asia, Russia, and Brazil), there has been a rising popularity of the “bipolar” or

sometimes referred to as the “corner solution.”¹ This view holds that the only effective exchange rate regimes are the extremes, either the free float on one extreme or totally fixed regime on the other. The middle of the road solutions--the soft pegs and the managed floating-- are inefficient because they represent “soft” commitments on the part of the monetary authorities. In times of shocks these policies can be swayed by speculations. The extremes--free floats on one hand--represent a faith that the market has built-in automatic mechanisms to adjust to shocks and allows the government to have independent domestic policies. The hard peg on the other hand, represents firm commitment to maintain the parity and to have all other policies subservient to the policy on the peg (Saadiyah Mohamad 2003: 34).

In a way, post- crisis exchange rate policy among ASEAN 5 countries do reflect this bipolar view where we have Malaysia on one hand adopting the fixed exchange rate and the others particularly the hard hit crisis countries of Thailand and Indonesia moving to independent floats. Not long after the crisis however observers claim that these East Asian countries seem to have resorted back to soft pegging.² The prospect for the return of the dollar peg raised concern over the fragility build up through reduced incentive for exchange rate management as well as real exchange rate misalignment. The reluctance to truly float the currencies could be associated with the “fear of floating” (Calvo and Reinhart 2000) that comes about due to the apparent problems associated with floating especially for developing and emerging economies that are quite integrated with the world economies.

This paper examines the arguments for and against a fixed exchange rate regime for a small open economy like Malaysia and looks at the post crisis actual performance of exchange rate movements of its neighbouring economies. The paper also evaluates the economic performance of Malaysia vis-à-vis that of the rest of ASEAN and discusses whether the differences could be attributable, at least partly, to the differing exchange rate policies adopted.

¹ There has been many writings on the bipolar view. See for example Hernandez and Montiel (2001).

² See for example McKinnon (2000), Calvo and Reinhart (2000) and Mussa et al (2000).

Fixed Vs Floating

The issue of what kind of an exchange rate regime should be adopted by any economy has been debated for quite some time now. An exchange rate regime means a system that is adopted by the monetary authority (the central bank) of any government to determine the exchange value of the domestic currency against other currencies in the world.

Basically, there are two main exchange rate regimes: the fixed exchange rate regime where the exchange rate is not allowed to vary and the floating exchange rate system where the value is determined by market forces. In practice, there are many kinds of exchange rate regimes that are in between, including those that allow some kind of flexibility into an otherwise fixed system and others which are “managed floats” allowing some degree of stability into a floating system. There are very few completely free floaters around, even those economies that claim to have a floating system such as the United States would have its central bank intervene inside the foreign exchange market whenever they deem necessary to do so. Thus, in practice, exchange rate regimes are more likely to operate along a continuum where movement towards or away from one extreme would involve tradeoffs between flexibility and stability.

In a completely free floating system the exchange rate of the domestic currency is being determined by market forces-the supply and demand for the currency. A supply of a currency, ringgit for example can arise when we demand foreign currencies to pay for our imports. Similarly a demand for ringgit arises when overseas people who buy our products require ringgit to pay to the exporters or when exporters who are paid with foreign currencies exchange these with ringgit. So basically if we have a current account surplus that is when our exports are greater than imports, ringgit will appreciate (increase in value) and when we have a current account deficit, ringgit tends to depreciate (fall in value). Of course in the real world things get more complicated because exchange rates are determined not only by the trade in goods and services but more so now by events and happenings with regards to capital flows.

A floating exchange rate system has its own advantages. One of it is to relieve the government of constant intervention and the burden of having to have a large supply of foreign currency reserves to support the par-value if it is fixed. The system also has automatic mechanism to correct problems in the balance of payments-if currency depreciates, then exports would be cheaper and thus more competitive and this helps a current account deficit to improve.

In terms of export promotion, flexibility in exchange rates provides opportunities for increased competitiveness when exchange rates depreciate. If a country fixes its ER and the neighbours do not, then neighbouring depreciations or depreciations in a competitors' currency would mean losses in external competitiveness. The harder the fix, the more rigid the system is to changes.

Floating regimes, on the other hand, has the main disadvantage of volatility, which in itself is damaging to trade and the export sector. Post 1973 developments indicate that volatilities in exchange rate movements can be severe. Increased volatility can create an environment that is not conducive for trading and economic growth by making pricing and investment decisions difficult in the face of exchange rate uncertainty. Historically, trading in foreign exchange was the result of international trade as buyers and sellers need foreign currencies to settle transactions. Now, ironically, currency trading has little to do with international trade, which accounts only about 2 percent of currency movements (Singh 1999). This explains why exchange rate can be very volatile. The role of currency speculators can also increase the volatility of exchange rates.³ Because there are many factors that can influence speculators to react one way or the other, an economy adopting a floating exchange rate is very much at the mercy of the market.⁴ Post Bretton Woods has seen much higher exchange rate volatility and the end of the 20th century witnessed many countries that went into crises because of huge

³ Although some would argue that in floating regimes speculation can be stabilizing where as under fixed speculation is often one way and thus can be destabilizing. For example if a country under fixed regime is seen to be unable to defend the parity, then speculation is only one way—devaluation, where as under floating speculation could be in both directions and thus could stabilize the situation.

⁴ And the market may not always be rational or right for that matter. As an example, during the 1997-98 financial crisis the ringgit depreciate from RM2.47 to the USD in mid-1997 to the lowest RM4.88 to the USD in early 1998, a depreciation of about 80%. This happens despite claims that the Malaysian economic fundamentals were good. Although there are limitless number of explanations to the crisis, one of the more popular one being offered is the “contagion effect” theory that is the Malaysian ringgit was attacked by virtue of the fact that speculators view the economy to be not much different from Thailand and Indonesia.

fluctuations or severe depreciations in the domestic currencies, including the Asian 1997-98 crisis.

Thus, a floating regime may expose a local currency to many factors that can make its value unstable. A small open economy like Malaysia would be more vulnerable because it is exposed and influenced by so many factors at the global level. An emerging economy like Malaysia is also especially vulnerable because financial markets are less developed and mature unlike those in the more developed economies. Hedging activities are more expensive and less common, thus exchange rate crises can result in more serious damage to the economy.⁵

The Asian crisis probably brought different lessons to different people. Prior to the crisis, countries like Indonesia, Malaysia, Singapore and Thailand were unofficially pegging their currencies to the US dollar. The official regime may state that the exchange rate is being determined by a basket of currencies but many observers noted that because of the presence of very low nominal exchange rate fluctuation, the monetary authorities in these countries were essentially pegging the currencies to the US dollar.

It is often argued that the Asian crisis was due to the weaknesses of pegging, Thailand for example could not maintain the peg and had to float the baht in July 1997 marking the beginning of the Asian crisis. It was natural therefore that as a result of the crisis, these countries in particular, Thailand and Indonesia have moved towards more flexible exchange rate arrangements. Malaysia on the other hand moved in a different direction, from a somewhat “managed float” to a more formal arrangement of fixed exchange rate system by pegging the ringgit to the USD on 2 September 1998.

⁵ The presence of “original sin” that is the inability of many developing country agents to borrow in their own currencies represent a problem that is common in many less mature financial markets. In the presence of original sin currency mismatches will prevail in emerging economies that are open to capital flows. Such mismatches make currency crises more likely to happen and aggravate real consequences of such crises when they do happen (Montiel 1999). McKinnon (2000) argues that in the presence of original sin the optimal exchange rate policy could be one that is fixed.

Why Peg the Ringgit? And Why to US Dollar?

The decision to peg was to remove large fluctuations in the exchange rate which proved to be damaging to the economy. Besides, the fixing of the ringgit enabled Bank Negara to use lower interest rates in order to support economic recovery without having to worry about what happened to exchange rates. If the rate was not fixed, lowering interest rates could have depreciated the ringgit even further because of capital outflow. Has the decision to peg the ringgit been justified? Has the peg hindered the economic growth of Malaysia relative to its neighbours?

One of the problems studying exchange rate regimes across countries is the difference between official exchange rate regime and the *de-jure* policy (exchange rate policy in practice). Research to relate exchange rate regime to macroeconomic performance will be flawed if analysis is based solely on the official classification. This is because what appears to be countries with “floating regimes” which could be associated with say higher economic growth may in fact be managing and actively targeting their exchange rates to some other currencies-- the so called *closet - peggers*. These countries try to gain the advantage of both systems by officially announcing a regime of managed floating to gain the favours of the IMF and the like while effectively pegging to a major currency usually the US dollar, believing in the practicality and benefits of stable exchange rates. Soft pegging gives them the cushion and the flexibility to keep options open. Thus, despite what appears mainstream corner solution, the practice is still middle of the road.

In the era of increasing market integration countries need to consider not only its own ER policy but also others in the region and the ER policy of major currency countries and main trading partners. Policy coordination is essential. For example, while policy makers in Southeast Asian countries acknowledge that a policy of US dollar pegging may be in the best interest for their countries, they may prefer a policy of undisclosed parity or unofficial pegging and announce that theirs are basket currency pegging or even managed floating. A country whose neighbours do not officially peg may find that it is best not to as well because this leaves a bigger option to manage exchange rates whenever others change theirs. This experience can be illustrated with the case of Singapore, which has deliberately devalued the currency even though it was not hit by the 1997-

98 crisis versus the case of Hong Kong that did not. Singapore devalued to lessen the impact of the devaluing currencies of its neighbours, whereas Hong Kong because of its commitment to the currency board could not do that. Rajan (2002) argues that the ER policy of Singapore has enabled it to response better and more quickly to the shocks that occurred in the region.

Post crisis, it may look as if Malaysia is pegging alone amidst the neighbours who chose to be floaters.⁶ What then are the advantages of official pegging as in the case of Malaysia after September 1998? Both Thailand and Indonesia have abandoned pegging during the crisis and in fact as part of the recovery plans were seen to be more committed to more flexible exchange rates. Malaysia has officially pegged its ringgit to the US dollar at RM 3.8 to the dollar in September 1998. However, McKinnon (2001) return to the dollar pegging analysis and other studies (Baig 2001, Hernandez and Montiel 2001) provide support for the existence of active exchange rate management with objectives of stabilizing exchange rate movements and moderating appreciations in the post crisis era among the *floating* ASEAN countries.

Our analysis shows that during the post crisis exchange rate volatility has reduced compared to during the crisis but the fluctuation is more than the pre-crisis. We conclude that because there is wider fluctuation in the post crisis, instead of a return to the pre-crisis level these countries in particular Thailand and Indonesia have moved further in the continuum of greater flexibility (see Table 1), but their levels of fluctuations are still being managed (lower levels of standard deviation of exchange rate volatility of ASEAN 4 compared to other independent floaters such as Japan and Switzerland, see Baig 2001).

Our analysis also shows that these countries are still far from being true floaters and that the countries appear to be still committed to managing exchange rates because of the apparent advantages of exchange rate stability. If stability in exchange rates is important in open economies (and could be an overriding one) there appears to be advantages with an officially pegged exchange rate system. For one thing, official pegging provides clarity and transparency that can move the economy ahead, bringing the focus back to real economic activities and away

⁶ In the bigger East Asia scenario, of course Malaysia is not alone. China is receiving a lot of attention from observers regarding its pegged exchange rate regime. It also receives a lot of pressure to revalue the currency especially from the US because of the problems in the US increasing trade deficit, said to be due to the undervalued Yuan.

from the unproductive activities of currency speculation. Secondly, official pegging states a long term commitment for currency stability which is an aspect much needed in the currencies of the emerging market to induce market credibility and maturity.⁷ Further, an officially pegged system reduces the need for a crafty exchange rate management which is costly and places such high demand for expert manoeuvring.

Why peg to the US dollar? This is because over 85% of the Malaysian trade is done in US dollars. It makes sense therefore to reduce exchange rate fluctuation by removing the fluctuation against the currency where most of the transactions are carried out. This of course does not remove all fluctuations entirely because movements of US dollar against other currencies such as the Yen and Euro mean that the ringgit would also fluctuate against these currencies.

One of the advantages of pegging to a basket of currencies is that it would reduce risks associated with fluctuations in the major currencies. The US dollar pegging in the East Asia region, while bringing stability of domestic currencies to the US dollar, was not able to insulate against the impacts of fluctuations in the other major currencies. As Japan is a large trading partner to most East Asian countries, the yen-dollar movement has brought a large impact. For example, the fluctuations in the yen-dollar ER has affected the competitiveness of currencies pegged to the US dollar and have influenced the export performance and inflows of foreign direct investment. Thus, in the period of mid-1980s to mid-1990s when the dollar was rather weak compared to the yen, this has coincided with the period when Southeast Asian exports experienced rapid growth suggesting that the weak currencies compared to the yen have helped made export more competitive. The weak currencies have also attracted significant inflows of Japanese foreign direct investment into the Southeast Asian economies. The appreciation of the dollar since 1995 after the Plaza II accord has meant that currencies pegged to it were becoming stronger relative to the yen. Interestingly, this has also coincided with declines in export performance in the regions. This is worsened by currency devaluation by China in 1994 that has made this region less competitive. In fact, the growth of exports in Southeast Asia has already

⁷ McKinnon argues that while there is high frequency pegging in East Asia, the system lacks commitment for longer term stability. This results in the absence of recursive expectation that is common in more mature systems of developed financial markets. Recursive expectation helps restore stability since market participants expect changes in Exchange rate to be restored and thus avoid panic behavior in times of shocks. See McKinnon (2001).

slowed down by the mid-1990s—well before the crisis--and this could be attributed partly to less competitive exchange rates in the years prior to the crisis. The increasing economic integration among Japan's neighbours-China, Hong Kong, Korea and the Southeast Asian economies of Indonesia, Malaysia, Singapore and Thailand in the last two decades has been associated with highly synchronised business cycles. These cycles have been closely linked to fluctuations in the yen-dollar ER through changes in export competitiveness and inflows of foreign direct investment (McKinnon & Schnabl, 2002).

Basket pegging, however, is more complicated. Under this system, while the average movements of a domestic currency against any one currency in the basket are reduced (by maintaining the movement of the effective ER within a certain band) it also means that there will, for most part, be movements in all the currencies. So there will still be fluctuations and this situation creates fuzzy pictures regarding the movement of exchange rates a whole.

The single pegging, whether the parity is fixed or otherwise and official or undisclosed, certainly provides a clearer and easier to understand picture of ER movement. The clarity and transparency of the system as well as a strong commitment to stick to the peg regardless of mainstream views contributes to the credibility of the system. Thus, despite the disadvantages of official pegging in a neighbourhood of floaters (who can in fact be “closet peggers”), the decision by Malaysia to opt for a fixed ER regime has been based perhaps on some of these reasons.

Exchange Rate Movements and Macroeconomic Performance

On the whole, the pegged system has managed to bring the needed exchange rate stability which benefited the business sector especially those with large export sectors. Are there long term costs to this? At the moment there appears to be little problems with pegging especially because since the crisis Malaysia has managed to have current account surplus and there has been no serious attack on the ringgit. This means that we have been accumulating reserves and there was no pressure on the part of Bank Negara to have to support a depreciating ringgit. In the long term, if the current account continues to be in surplus there could be some effects due to excess liquidity

and the possibility of higher inflation. Or if the current account may turn out later to be in deficits for many number of years then foreign reserves can get depleted and the ability to support the fixed rate can diminish. In the second part of this paper we will analyse the movement of the exchange rate and the macroeconomic performance of the ASEAN 5 countries during the three time periods: the pre crisis, the crisis and the post-crisis period.

A. EXCHANGE RATE VOLATILITY IN THE ASEAN 5

I. PRE-CRISIS: JANUARY 1993 – MAY 1997

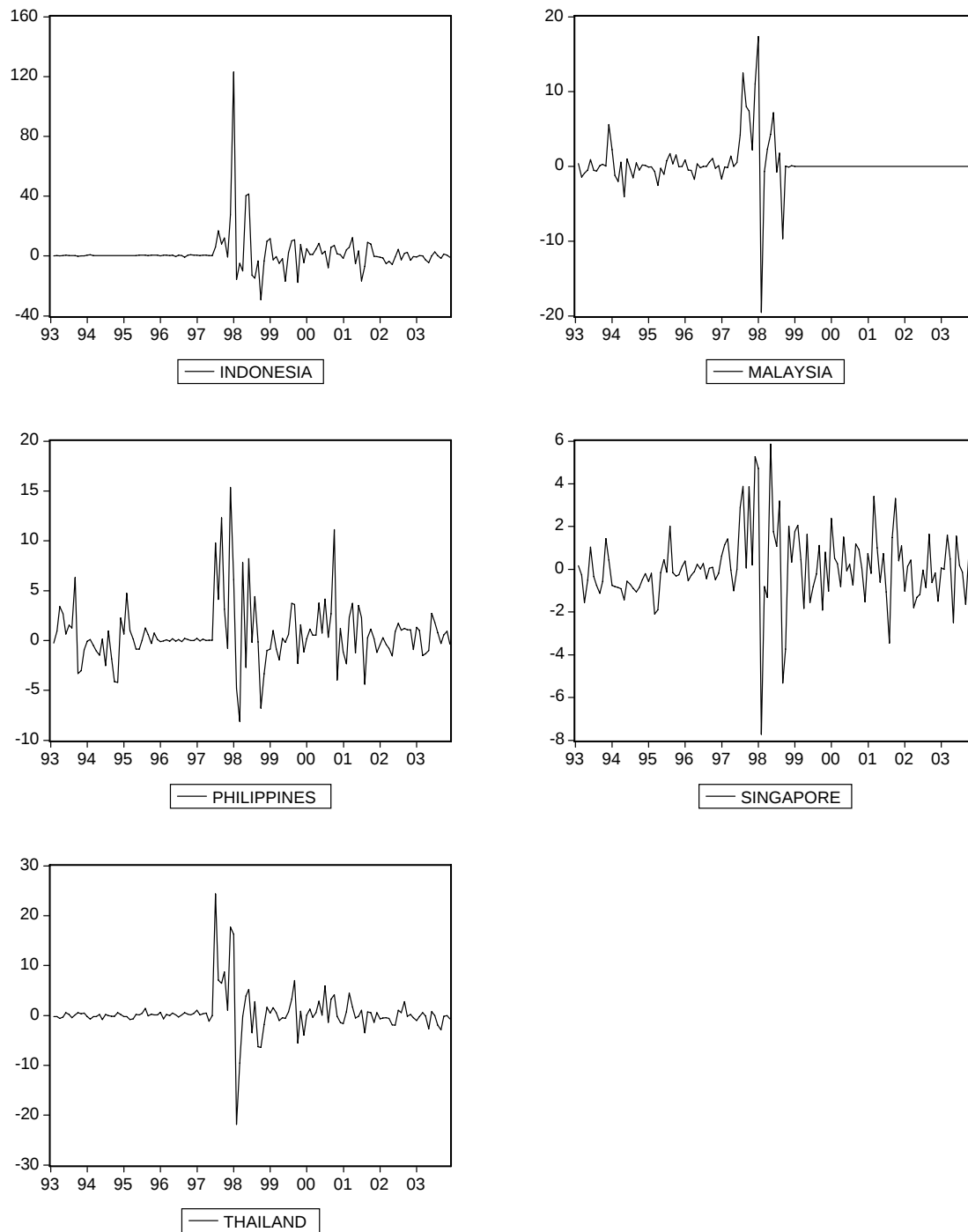
Figure 1 and Table 1 shows very stable exchange rate movements during the pre-crisis period among the ASEAN 5 compared to during the crisis and after the crisis period.

Table 1 computes the volatility of exchange rates of each five countries using monthly data, defined as the standard deviation of the percentage changes of the exchange rates against US dollar. This table supports further the graphical evidence of exchange rate volatility. Overall, the pre-crisis period showed that the five ASEAN members' currencies were much more stable. This low volatility varies from one country to another as indicated in the month-to-month exchange rate fluctuations. Indonesia had the lowest value of 0.27 followed by Thailand with 0.45, Singapore with 0.80 whereas Malaysia with 1.36 and Philippines stated the highest with 1.82. Indonesia and Thailand experienced very low volatility of fluctuations in their currencies compared to Malaysia, Singapore and Philippines. Singapore, despite a staunch policy of price stability (inflation targeting rather than exchange rate targeting) still exhibit very low exchange rate volatility. In evaluating the low currencies fluctuations during the pre-crisis period, one would question on the official exchange rate policy adopted by these countries. With the exception of Thailand pegging its currency to an undisclosed currency basket, Malaysia and Indonesia adopted a managed floating exchange rate regime whereas Singapore and Philippines were having independently floating regimes.⁸

The extremely low volatility experienced by the ASEAN members was not only to enjoy having stable currencies but more importantly, their movements have had significant effects on trade and the countries' domestic policy.

⁸ On this issue see Hernandez and Montiel (2001)

Figure 1: Exchange Rate Volatility against the US Dollar of ASEAN -5
January 1993 – December 2003 (Monthly)



Source: Bloomberg

Table 1: Standard Deviations of Month-to-Month Exchange Rate Fluctuations

Currency	Pre-crisis	Crisis	Post-crisis
Indonesian Rupiah	0.27	33.08	6.21
Malaysian Ringgit	1.36	8.01	0.01
Philippine Peso	1.82	6.44	2.26
Singapore Dollar	0.8	3.61	1.35
Thailand Baht	0.45	10.44	2.13

Source: Bloomberg

II. CRISIS: JUNE 1997 – DECEMBER 1998

During this period, attempts to stabilise the five ASEAN currencies against the dollar broke down due to large capital outflows and high volatility of the foreign exchange markets.⁹ Table 1 supports further the greater volatility in the month-to-month exchange rate fluctuations for the five countries during the crisis in comparison to pre-crisis period. For all ASEAN countries except Singapore, standard deviations calculated from monthly data are significantly higher during the crisis. The volatility has fluctuated more than 10 times for Indonesia and Thailand compared to Philippines and Malaysia stating 6 – 8 times respectively. In the case of Singapore, the standard deviation was still higher for this period compared to pre-crisis period.

It is evident that the crisis period has reflected the extreme fluctuations in the ASEAN regional currencies leading to two of its members, Indonesia and Thailand to join Philippines and

⁹ See further Ronald McKinnon and Gunther Schnabl (2002)

Singapore adopting the independently floating regime. On the other hand, Malaysia has opted for a more extreme regime that is fixing its currency against US dollar.

III. POST-CRISIS: JAN 1999 – DECEMBER 2003

The table highlights the sharp modifications that have taken place between the pre- and post-crisis periods in the behaviour of the exchange rate in Malaysia, Indonesia and Thailand. For all the ASEAN members except Malaysia having a hard peg, the standard deviations calculated from the monthly data are significantly **lower compared with the crisis period but higher compared to the pre-crisis period**. Much of the post-crisis variation in the monthly exchange rates is actually showing a recovery from the overshooting devaluations of the crisis. However the range of the variations of the exchange rate fluctuations has increased since the outbreak of the crisis. This evidence also suggests that there has been a fundamental change in the exchange rate policies of Malaysia, Indonesia and Thailand.

Overall one cannot deny that the two ASEAN members namely Indonesia and Thailand have their currencies floated much more flexibly than the pre-crisis period. Table 1 proves this statement since the post-crisis values of the standard deviations for both countries are much higher, Indonesia with 6.21 and Thailand 2.13 compared with 0.27 and 0.45 during pre-crisis period respectively. A flexible exchange rate would enable a country to adopt an independent monetary policy catering for its domestic requirements and confers a greater flexibility to respond to any foreign shocks. However, some economists have argued regarding the variability of these currencies being less than the “true floaters” (see for example Hernandez and Montiel 2001 and Baig 2001)

B. ASSESSING THE RELATIVE ASEAN 5 ECONOMIC PERFORMANCE

The second part of the research will examine the macro-economic performance of the five ASEAN members measured by each country’s real GDP growth rate, inflation rate current account balance, fiscal balance and the unemployment rate. In this his analysis, we would like to compare the economic performance among the members before the crisis, during the crisis and

the post crisis period and to assess the performance of the only pegger—Malaysia—in relation to the “floaters”.

1. Economic Growth Performance

Table 2: Real GDP of ASEAN-5 (Annual change in percent), 1992-2003.

Country	Pre-crisis	Crisis	Post-crisis
Indonesia	7.30	-4.22	3.38
Malaysia	8.68	-0.02	4.89
Philippines	3.48	2.30	4.25
Singapore	9.24	3.83	3.36
Thailand	8.1	-5.95	4.60
Average	7.36	-0.81	4.10

Source: Authors’ calculations based on BNM Annual Report 2003

Table 2 above simply shows the average percentage of yearly growth of real gross domestic product of each member measured from 1992 to 1996 for the pre-crisis period, 1997 to 1998 for the crisis period and 1999 until 2003 for the post-crisis period. The pre-crisis period highlights the annual growth rate for the ASEAN members was remarkable except for Philippines, which stated below average that is 3.48 percent. The rest of the members were enjoying a high rate of economic growth of above 7 percent for the five consecutive years. During the crisis period the growth rate for all members had plunged as low as –5.95 percent. However Philippines growth rates were rather stable for all the three periods. Although Singapore stated the highest average rate of GDP in the pre-crisis and crisis periods, in the post-crisis period Singapore stated the lowest rate. In contrast to the other members of ASEAN Malaysia has recorded the highest

yearly average after the crisis, beating the other non pegged countries of ASEAN, including Thailand which has been claimed to be a fast grower because of its greater commitment towards exchange rate flexibility.

Figure 2 illustrates the movements of changes in nominal exchange rates and gross domestic product of the ASEAN 5. The figure highlights the possible inverse relationship between exchange rate and GDP i.e. when the countries' currency depreciates against US Dollar, the GDP will increase and when the currency appreciates the GDP will fall, although this relationship breaks down during the crisis, where a sharp devaluation in the countries' currency (except Singapore) has all brought a sharp decline and/or negative growth rates. Philippines has been less integrated and has seen less repercussion of the crisis. Singapore is an interesting case where not only it was not really affected by the crisis, even though it was highly integrated with the world economies but it began to experience problems with the economy after the crisis hit countries had begun to recover. It has since then recorded lower growth rates compared to its previous records and relative to Malaysia and Thailand.

2. Inflation Rate

Table 3: Inflation Rate of ASEAN- 5 (Annual Average in percent), 1992-2003.

Country	Pre-crisis	Crisis	Post-crisis
Indonesia	8.62	32.3	11.56
Malaysia	3.78	4.0	1.76
Philippines	8.56	7.8	4.7
Singapore	2.14	0.85	1.42
Thailand	4.94	6.85	1.2
Average	5.61	10.36	4.13

Inflation rate measures the general increase in the price level of an economy. A mild inflation is desirable indicating a boom economy. On the other hand high inflation more than 10 percent brings costs to the economy and society. Table 3 above measures the average yearly inflation rate for the three periods. The pre-crisis periods show the rate of inflation for Malaysia, Singapore and Thailand was below average 5.61 percent whilst Indonesia and Philippines were much higher. During the crisis period the inflation rate for members had increased significantly except for Singapore, it dropped to 0.85 percent. Indonesia has since reduced its inflation rate but at more than 10 %, still remain the highest. Malaysia maintains its good track record of very low inflation rates, at less than 2 % after the crisis it is among the lowest in the region

3. Current Account Balance

A current account balance refers to the exports of goods and services of a nation less its imports of goods and services plus its net investment income and net transfers. Eventhough a current account surplus is favourable, a deficit is not necessarily a bad thing if the deficit is financed by sustainable capital flows. Table 4 indicates in 1996 (pre-crisis period), the yearly current account balance for the four members exhibited a deficit, except Singapore stood out with a large surplus of 15.2 percent. In 1997 again Singapore had a surplus while Malaysia had stated the highest current account deficit of 6.2 percent. Interestingly in 1998 Malaysia had recovered with an amazing 13.2 percent and maintained the surplus up to the post-crisis period. Overall the ASEAN members had managed to halter the current account deficit almost immediately after the crisis and then maintain the surplus since then. Either boosted by the fixed exchange rate or in spite of that, Malaysia is able to achieve large trade surpluses and together with capital inflows enable it to accumulate large stocks of foreign reserves.

Table 4: Current Account Balance as % of GDP of ASEAN-5, 1996-2003

Country	1996	1997	1998	Post-crisis (1999-2003)
Indonesia	-3.40	-2.20	4.20	4.20
Malaysia	-4.40	-6.20	13.20	11.28
Philippines	-4.80	-5.30	2.40	7.36
Singapore	15.20	15.70	22.60	19.48
Thailand	-7.90	-2.00	12.70	6.90
Average of 5-ASEAN	-1.06	0.00	11.02	9.84

Source: Author's calculation based on data from Bank Negara Annual Report 2000-2003

4. Fiscal Balance

Table 5 provides each of the ASEAN 5 size of the fiscal balance either budget deficit or surplus as percentage of GDP for 1996 as pre-crisis period, 1997 to 1998 as crisis period and 1999 until 2003 as post-crisis period. Fiscal balance involves a country's government expenditure and its revenue collected from tax. Running a deficit would mean a country's central government increasing their expenditure and / or cutting taxes. A surplus is where tax revenues exceed a country's central government expenditure.

Table 5 shows majority of ASEAN members were having a budget surplus in 1996, except Indonesia which was running for a balanced budget. This trend continues during the crisis period for Indonesia, Malaysia and Singapore except for Philippines and Thailand which opted for fiscal deficits. The post-crisis period shows ASEAN members except for Singapore have all moved to having fiscal deficits and Malaysia notably marks the highest deficit of 5.26 percent of the GDP. Malaysia was not alone as Philippines also states a deficit higher than the average value. In comparison Indonesia and Thailand their fiscal deficits were much lower than the average value even though their growth rates were lower than Malaysia. One should realize that

a fiscal deficit would mean a country needs to borrow money to finance the deficit. However, it is not clear how differences in the exchange rate policy could contribute to the differences in the fiscal balance among these these countries.

**Table 5: Fiscal Balance as % of GDP of ASEAN-5
1996-2003**

Country	1996	Crisis (1997-1998)	Post-crisis (1999-2003)
Indonesia	0.00	0.21	-1.95
Malaysia	0.72	0.29	-5.26
Philippines	0.29	-0.91	-4.35
Singapore	6.82	2.92	0.71
Thailand	0.94	-2.15	-1.79
Average of 5-ASEAN	1.75	0.07	-2.53

Source: ASEAN Statistical Yearbook 2003

5. Unemployment Rate

To end the analysis, the final macroeconomic indicator we shall look upon is the unemployment rate. Table 5 presents the average annual unemployment rate for the five ASEAN members where in 1996, taken to be the pre-crisis period all members had a relatively much lower rate if compared with 1997 to 1998 during the crisis period and 1999 to 2002, the post-crisis period. Although Malaysia and Thailand's unemployment rates were increasing for the past three periods, the rates were still much lower than the average rate of 5-ASEAN countries. In contrast, Philippines and Indonesia, their unemployment rates were increasing above the average of the members. Again, it is difficult to assess the effects of exchange rate policy on unemployment except perhaps through the indirect effects of exchange rate policy on export competitiveness. Thailand which had adopted a more flexible policy, the unemployment rates were relatively low but this was not the case for Indonesia. In Malaysia's case, it was still able to maintain a relatively low rate of unemployment for the country. Figure 5 highlights further the unemployment trend for each of the ASEAN members.

Table 6: Unemployment Rate of ASEAN-5, 1996-2002

Country	1996	Crisis (1997-1998)	Post-crisis (1999-2002)
Indonesia	4.90	5.10	6.08
Malaysia	2.60	2.85	3.40
Philippines	7.40	8.75	9.88
Singapore	3.00	2.80	4.18
Thailand	1.10	2.70	3.30
Average of 5-ASEAN	3.80	4.44	5.37

Source: Author's calculation based on data from ASEAN Statistical Yearbook, 2003

Conclusions- Pegging indefinitely?

It is of course difficult to accurately ascertain the independent effects of the exchange rate regime on the overall macroeconomic performance of an economy. Literature on this either involving country specific studies or multi country studies has often cautioned on the difficulties and problems in drawing general conclusions on this matter. Among some problems involved are the gap between official classification and the actual practice of exchange rate policy, the changes in regimes during the period of study, and the direction of causality. For example both Aghevli et al (1991) and Edwards (1993) found in their studies that fixed exchange rate regimes were associated with lower rates of inflation than more flexible regimes. But a reverse causality could be possible, in that rather than the ability of fixed exchange rate regime delivering lower rates of inflation, it is possible that the causality runs the other way, ie that countries with lower inflation rates tend to adopt fixed exchange rate because it is possible for them to do so compared to high inflation countries.

Given these limitations, we are aware that our analysis linking exchange rate policy and macroeconomic performance is a simple one. Based on simple evidence specifically to growth rates, current account balance and inflation rates, Malaysia's performance is superior relative to

its neighbours. Trade surpluses together with improved capital inflows and sterilisation activities of the Bank Negara have contributed to the accumulation of high foreign reserves adding to the credibility and sustainability of the pegged regime. Developments in the post crisis has often cited ringgit as undervalued,¹⁰ giving the advantage of export competitiveness and avoiding the problem of an inability to defend the rate if it were to be overvalued instead. The Malaysian performance so far does not give credence to predictions regarding the perils of fixed exchange rate system, such as high inflation rates leading to current account deficits and the depletion of reserves.¹¹

Can Malaysia be pegging indefinitely? Certainly we need more robust models to determine the net welfare effects of the pegged system. Some sectors may benefit more than others and it is possible that some of the costs are hidden and we may not be able to quantify these or may not see them until some time in the future. Technology transfer either in the form of imported advanced high- tech machineries or more in the form of knowledge through foreign experts has been made more expensive because of the undervalued pegged ringgit. Coupled with a very expensive foreign education, all these changes may have some impact to the development of the much aspired k-economy.

However, the pegged system as it is does allow for many opportunities for important shifts to be made in the economy. Since the devaluation during the crisis and then the pegged system, certain industries have clearly thrived and the government has tried to boost domestic consumption, through retailing, local tourism, agricultural and the education industry. This development has seen important shifts towards less reliance on the external sector, and the building of capacities in the domestic industries particularly retailing, education and the tourism industry .

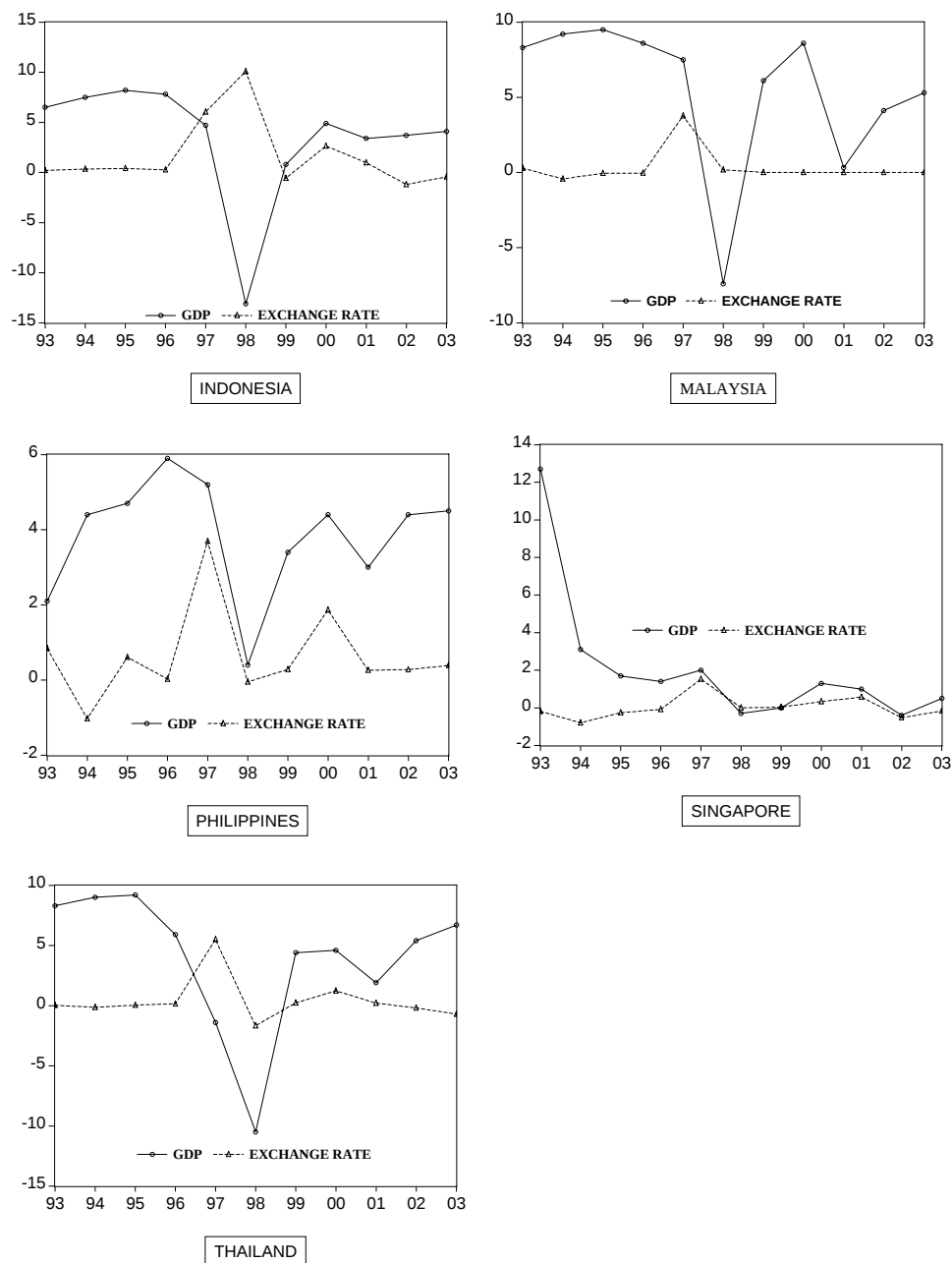
¹⁰ Because ringgit is pegged to the dollar, a falling dollar would depreciate ringgit relative to other currencies including those of ASEAN. This may contradict the true value of ringgit based on economic fundamentals, which should appreciate making the ringgit undervalued at its current pegged value to the dollar.

¹¹ Gan Wee Beng (2000: 6) questioned the appropriateness of a fixed exchange rate under current macroeconomic environment raising concerns “ whether a fixed exchange rate system can promote the longer term policy goals of sustainable growth with low inflation and the deepening of the financial system.” Citing the fixed regime of Hong Kong and the more flexible Singapore as examples, he argues that a fixed exchange rate would lead to higher levels of inflation, weakening current account position, declining stock of reserves leading to declining confidence on the sustainability of the peg.

The sustainability of the peg is partly dependent on the export performance, and whether or not the country is able to maintain strong reserves. But this can in itself be self-perpetuating, fixed exchange rate benefit exporters, export become competitive, leading to trade surpluses and accumulation of high reserves which in turn help to sustain the peg. The China factor may represent one issue that Malaysia needs to pay attention to. But with political commitment and a strong ability not to bow down to pressures, Malaysia does not have to revalue even if China does because it will prove to be to the advantage of Malaysia not to do so.

APPENDIX

Figure 2: Annual Percentage Changes in GDP and Exchange Rate of Five ASEAN Countries, 1993 – 2003



Source: Authors calculation based on data from Bloomberg & Bank Negara Annual Report, 2000-2003

Figure 3: Inflation Rate of Five ASEAN Countries, 1992 – 2003 (Yearly)

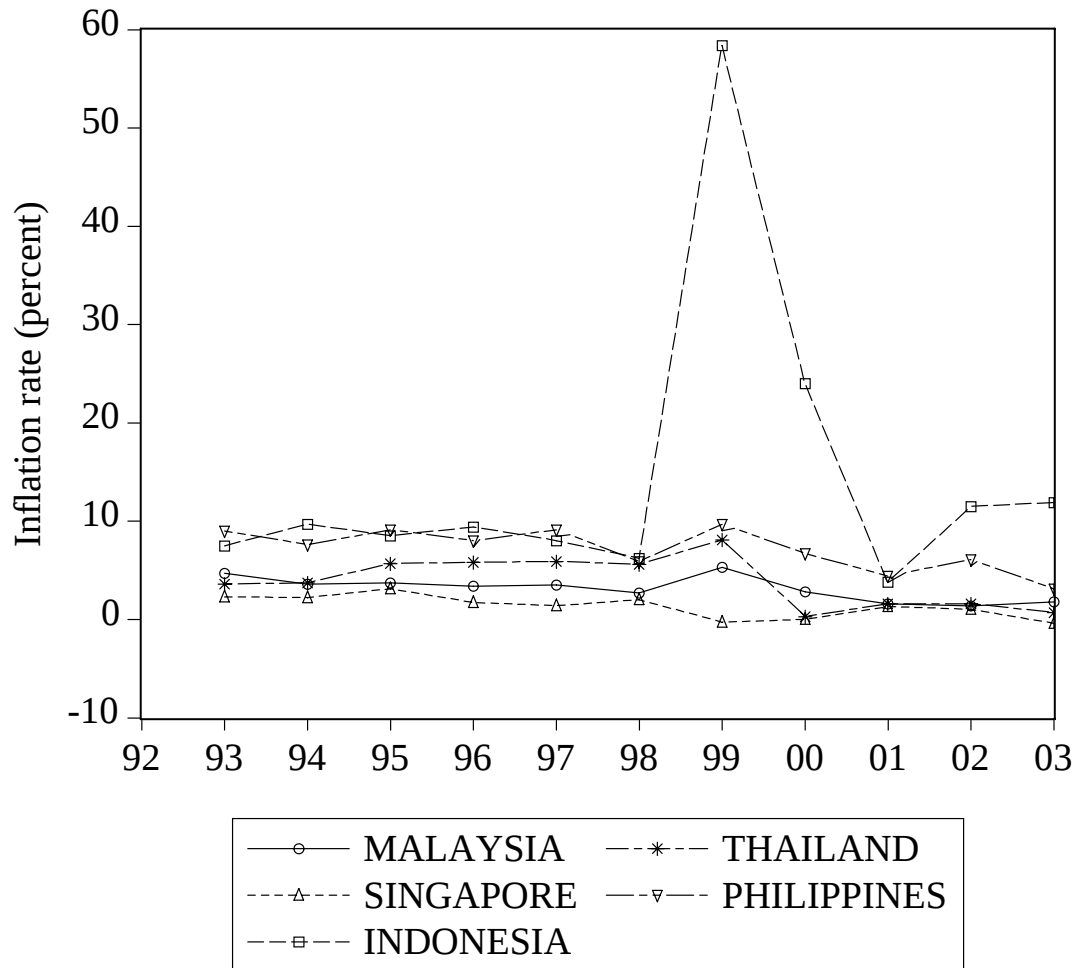
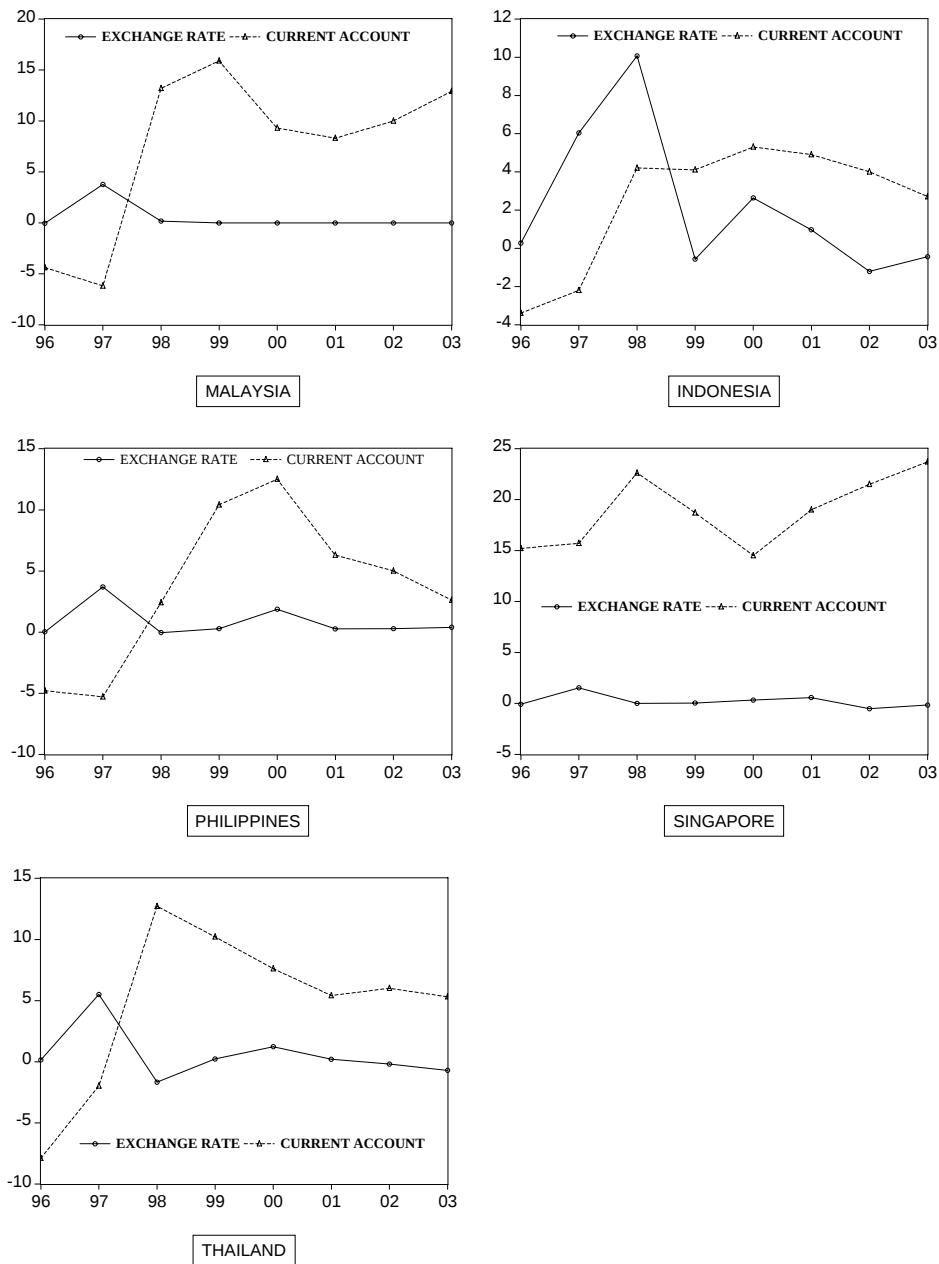
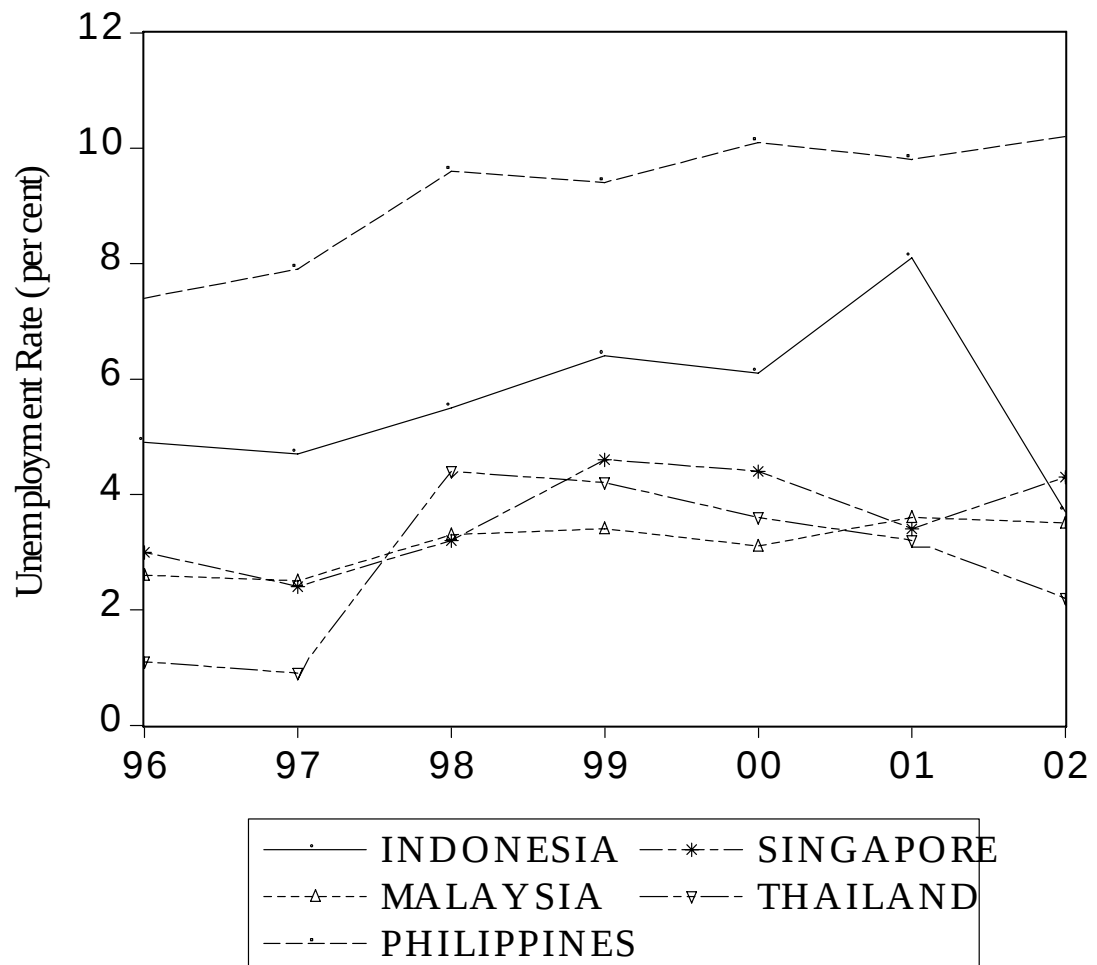


Figure 4: Current Account Balance as % of GDP and Percentage Changes in Exchange Rate of ASEAN-5, 1996 – 2003



Source: Data collected from Bloomberg & Bank Negara Annual Report, 2000-2003

Figure 5: Unemployment Rate of ASEAN-5, 1996 – 2002 (Yearly)



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