

Chapter 4

EXIT STRATEGIES AND EXCHANGE RATE REGIMES

4.1 Introduction

In this chapter, the aim of this study is to discuss the various issues related to exit strategies, including the move from a fixed currency regime to a flexible system. In addressing this chapter, it must be emphasis that a country's exchange rate regime is but one component which makes up for the entire macroeconomic policies and instruments of the country, which must be consistent with the conduct of other domestic policies. In Malaysia, the central bank objective is to maintain low inflation and stable price levels. Thus, any discussion on strategies to exit form the controls and the choice of a currency regime must take into account the preceding fact.

Furthermore, for the Malaysian economy to function efficiently and effectively, resident and non-resident economic agents must have a clear understanding of the government and BNM policies in order to form and exercise reasonable expectations under changing circumstances. An exchange rate regime, which is fragile and loose to its commitment, would only invite possible speculative attacks and abandonment of the local economy by these economic agents, as they are unable to act and decide rationally. A sudden shift in any major economic policy into an untested ground could only do more harm than good and could easily damage Malaysia's economic performance. In addition, the exchange rate regime cannot be the regime of choice if it falls to the whim and fancy of convenience and political appeal of the country.

In general, there are three major reasons to support Malaysia's exit from the current regime. First, since Malaysia has become more open and exposed to international trade and capital, and with the upcoming financial and trade liberalization near in sight, the nation has to be able to withstand the detrimental effects of short-term capital flows while at the same time reap their benefits. Countries' experiences with capital and exchange controls have shown that over time these regimes would develop leakages that rendered them ineffective and costly in the long run. New laws would have to be introduced to tighten the current regime, which in effect could be harmful to Malaysia's businesses and in general, the economy

Second, Obstfeld and Rogoff (1995) have also argued that a fixed exchange rate tend create a false sense of security. The recent crisis has exemplified how a de facto peg could lead to moral hazard problems in the long run. It was clear that the pegging of currencies to the US dollar by the affected East Asian nations was among the reasons that led to their vulnerability against external shocks.

Third, maintaining a tight exchange rate link with an industrial nation like Japan or the U.S.A. while conducting trade and other financial activities with other industrial nations has proved to be difficult. As time goes by, exchange rate fluctuations between the three major currencies namely the US dollar, the Japanese Yen and the Euro are likely to become common. Adopting a more flexible exchange rate seems to be more preferable to Malaysia as other regional neighbors such as Thailand and Indonesia have began to abandon their fixed currency regimes.

The organization of this chapter is as follows. In section 4.2, the discussion centers on the conditions of exit. Section 4.3 looks at the considerations for adopting an exchange rate for developing countries are presented. This chapter ends with a summary in section 4.4.

4.2 Conditions for an Exit

Before any attempt is made to exit from the current selective capital and exchange controls and the exchange rate peg, Malaysia has several important issues that have to be addressed as presented by Eichengreen et al. (1998c & 1999b) in the interest of a smooth transition to a flexible and sustainable regime.

First, the selection of a new anchor once the fixed exchange rate is removed as the key anchor for monetary policy and the expectation of inflation. Based on past BNM monetary policy conduct, it is likely that the central bank will continue on its pre-crisis approach, which focused on interest rate targeting (BNM, 1999a). This approach should be continued, as Malaysia is a trade oriented nation and with its financial deregulation and liberalization measures already underway, the role of the interest rate in monetary and exchange transmission have become more prominent. Another reason is due to the change in the financing pattern of the economy following the 1980s recession, as the government securities market shifted from an interest inelastic market to become a more interest rate sensitive market of bank credit and capital market (BNM, 1999a).

The recently released Bank Negara Malaysia's Annual Report 1999 showed an additional important reason for the maintenance of the interest rates as the key anchor. Since the central bank has to maintained positive real interest rates of

return on deposits, it holds the view that interest rates stability is an important policy variable, which could be used to promote financial soundness and at the same time contribute towards a more effective monetary transmission. Likewise, the central bank would have to monitor other macroeconomic indicators such as monetary aggregates, credit growth, asset prices, levels of consumption and investment to augment the key anchor. This is to ensure the general price levels are within manageable limits so that the inflation rate does not erode household wealth and purchasing power as well as firms' ability to produce at a much lower cost of production.

Second, the formulation of government fiscal policies would also need to be reviewed so that there would be a smooth transition towards a regime of greater exchange rate flexibility. While acting as a stimulator and facilitator to revive the economy, the government must ensure that fiscal prudence and discipline are continued at all times in order to be able to maintain and contain the fiscal deficit, reported at 3.4 percent in 1999 and projected to reach 4.5 percent in 2000, so as not to jeopardize long term economic growth (Ali, 2000). This is important not only for the previous reason but also for a stable and flexible exchange rate to persist. As Malaysia makes its return to the international capital market without the cover of selective capital and exchange controls, uncertainty and risks are abounding. In this regard, Alesina and Perotti (1996) suggested that, based on experiences, a country with a more centralized budgetary institution that clearly vest the responsibility and authority for budgetary and outcomes in the hands of the prime minister or the finance minister, and requires the parliament to vote on the overall size of the budget is often associated with smaller deficits and public debts. In principal, reform and prudent measures would give markets greater confidence in the government, indirectly lifting the pressure on the current account and the central bank for

inflationary financing. In Malaysia, this should not be a problem as the finance minister is responsible for formulating the overall budget, with some help from various branches within the government, and is also answerable to the parliament. Indeed, Malaysia has managed to maintain relatively small budget deficits, although there were other reasons that contributed to this.

Besides the issues of fiscal prudence and budget deficits, the interactions between large influx of capital flows and fiscal policy also merit attention. Usually, these large capital flows have been associated with high economic growth such as those experienced by emerging market economies and as such, led to buoyant tax revenues. It is clearly pertinent for Malaysia to recognize the value of using its accumulating and high tax revenues to build up its international reserves as an insurance against any future crisis. The opportunity cost of foregoing current spending against the potential gains from economic stability must be at the center stage of Malaysia's fiscal policy. As alternative financings are rare and limited during a financial and currency turmoil, relying on one's own international reserves would be beneficial as the nation no longer needs to borrow overseas and at the same time act as a deterrent against any speculative attacks. It has been argued that large international reserves of Taiwan and Hong Kong have shielded these nations against the recent crisis (Rogoff, 1999). The key point here is that the larger the international reserves the better it would be for the economy. The recent financial crisis has also showed that a good public debt management is of critical importance. Albeit the crisis was largely triggered by the private sector, the build up of short-term debts by the government could easily render fiscal policy impotent. High short-term debts with expensive debt servicing obligations and high interest rates would only create more unwarranted expectations of a government in distress. Therefore, good fiscal management that aims to avoid a large build up of short-

term debts and the debt trap should be among the main objective of Malaysia's fiscal policy.

Third, the conversion to a flexible exchange rate regime also requires the government to prepare the local populace and financial system for the change (Eichengreen et. al 1999b). If the financial institutions, businesses and households are accustomed and comfortable with the current regime, especially those who benefited from an undervalued Ringgit, like domestic exporters and commodity producers, they maybe ill prepared for the risks associated with a flexible exchange rate. Thus, it may feasible and advisable for BNM to move in the direction of a flexible regime in a gradual manner with enough time to adjust and under a preannounce schedule. This could be achieved by widening the exchange rate band from time to time until it reaches the targeted band aimed by BNM. Examples of this approach are Poland and Chile in which their governments' efforts to move their exchange rate band wider were combined with a detailed framework to strengthen the financial sector (Williamson, 1999b).

Another obstacle that must be addressed is the possibility that domestic local producers, especially those in the export oriented industry, have become accustomed to the current undervalue of the Ringgit peg and as such, become price dependent in order to stay competitive in the global market. As Mahani and Loke (2000) concluded, manufacturers for the export market have become increasingly heavily dependent on price factors (labor costs and the level of the exchange rate) in order to stay competitive. A viable solution is to encourage domestic producers to engage in automation production facilities, which have the potential to reduce cost and increase efficiency. This issue merit some attention on the part of the authorities and although steps have been taken to

rectify this problem, any potential obstacle and delay could retard Malaysia's export competitiveness in the long run.

The tricky issue here is whether Malaysia should maintain the Ringgit peg to the US dollar or re-peg it or float. Worse, how would Malaysia fare if a sudden currency misalignment were to occur? Based on report by Metrowangsa Sdn. Bhd. (Metrowangsa, 2000a) the current obvious choice for policymakers would be to maintain the peg. The report argued that despite the government efforts to run a budget deficit during the crisis, key interest and inflation rates have remained subdued. This has allowed the expansionary policy to continue unabated. On another matter, a full passing trough effect, which arises due to currency conversion losses, would not occur in Malaysia should there be any change in overseas prices or large deviation in the exchange rate. This is due to the fact that most of the essential items, such as petrol oil and rice, are price controlled. Moreover, the market structure of the Malaysian economy does not reflect in anyway a perfect competition environment and as such, helps to alleviate the pass through effect from affecting domestic consumers. The low capacity utilization in the construction sector, for instance, has avoided the erosions of producer's gain by depressing the price levels. Imports of capital and intermediate goods are not expected to rise dramatically in the near term and this should allow the preceding status quo to remain.

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Nonetheless, should there be any large deviations in economy like increasing imported inflation rate or large and significant inflows of short-term capital or deteriorating external environments (a slowdown in the U.S. economy), the Malaysian government has the option of either re-pegging the Ringgit or re-float it within a certain band. If the Malaysian government decides to re-peg the Ringgit, a currency misalignment could occur. In this scenario, Mohamed Ariff

(2000) warned of the potential consequences. First, as the value of the Ringgit is expected to appreciate in the future, foreign fund managers who have parked their investment in the local stock market in anticipation of an imminent stronger Ringgit could be making huge profits if the authorities decide to re-peg or abandon the system entirely. A possible solution to this potential problem is to appreciate the Ringgit in stages under a certain time frame until it reaches a certain targeted exchange rate level. As the Ringgit is appreciated, the government can impose a progressive tax on the amount withdrawn from the stock market and thus, acting as a deterrent to large capital outflows. Secondly, even if the government uses the Real Effective Exchange Rates (REER) in its effort to derive the desired level for the Ringgit, it is difficult to pin point exactly the ideal exchange rate even though Williamson (1999a) proposed a ± 10 percent band around the central parity should be an ideal zone. Nonetheless, an off target level of exchange may benefit potential speculators at the expense of BNM. Thirdly, Malaysia's openness to world trade may possibly force the government to abandon the Ringgit peg altogether. Even if proponents strongly reject the idea of floating, the fact that floating is often associated with increase efficiency and utilization of resources may benefit Malaysia in the long run. Therefore, ideally Malaysia should re-float the Ringgit within a certain trading band.

It is also important to ensure that Malaysia's gradual move towards an exit should be made together with adjustments and reforms in the financial and government sectors in a manner which is consistent with economic fundamentals. This does not imply delays, which could jeopardize Malaysia's exit from the current fixed exchange rate regime. Likewise, the government must have a clear agenda and a strong commitment to perform the above changes within a stipulated time frame. Furthermore, the authorities should and

must identify any financial and private institution, which is in need of financial assistance. This is to prevent any of them from causing unnecessary negative effects on the financial system, in general the economy. The latest crisis has showed how weakened financial institutions were vulnerable to external and internal shocks. In addition, prudential framework must also be enhanced. An area that merits attention is the introduction of prudential limits on domestic corporations that borrowed from abroad. Laurens and Cardoso (1998) presented an example to this sort of practice. In Chile financial institutions are required to obtain a rating of BBB+ and BBB for domestic corporations. These measures have several consequences. First, domestic corporations borrowing on the international capital markets were subjected to the best international practices regarding disclosure and accounting standard. Second, only strong corporations, with solid cash flows and business structure, were allowed to borrow from the international capital market. This hindered them from taking excessive risks. Third, the rigorous requirements imposed on financial institutions have acted as a restraint to weak domestic financial institutions and as such, prevented them from relying on external financing.

As for the offshore markets, Malaysia should at least maintain the current restrictions on the Ringgit until new developments occur such as a newly reformed international financial architecture is introduced or increased cooperation between regional countries on surveillance and monitoring of speculative activities is attained. Albeit this step is rather backward, the Malaysian authorities should not rush to uplift the current restrictions, as there is no guarantee that the nation would be able to avoid another round of speculative attacks. Moreover, the economy is still in its recovery process and may take sometime before it could reach its peak. Succumbing to domestic and external pressures to remove these restrictions would be detrimental to the

economy. Furthermore, the government should instead refocus its macroeconomic policies to cater for long-term capital flows. This would surely reduced Malaysia's heavy dependence on short-term capital flows, which are often highly volatile in nature. Above all, the government should also ensure that BNM is not understaffed at any particular time. It is possible that as a result of its downsizing in the 1990s, the lack of experienced officers with audit experience may have led to a growth of hazardous and risky behaviors on the part of domestic businesses and financial institutions and created an opportunity for loopholes and regulation oversights.

In addition, Park (1994) cautioned that the removal of capital controls may also cause balance of payments crisis as households and businesses adjust their portfolio holdings and accumulate foreign assets. According to Park, the outflows would continue until these economic agents have amassed sufficient foreign assets and as the economy move to a new steady state. In this view, foreign exchange liberalization, including the uplift of the capital and exchange controls, could lead to the collapse of a fixed exchange regime, such as the one practice by Malaysia, if improper steps are taken when exiting from the current regime. Such a reminder further proves that the government must ensure that the exit would not create unnecessary stress or pressure on Malaysia's balance of payments conditions and its financial sector.

Malaysia's previous experience with its two-tier regulatory system in which domestic banks were divided into two separate categories has proved to be an important lesson (Islam, 2000). Tier one banks, which had double the capital requirements of those in the second tier, were allowed to offer various financial products. The large minimum paid in capital requirements led several substantial shareholders to engage in risky behavior, such as borrowing short-

term debts, as they tried to enhance their capital base. Tier one financial institutions, which had much higher paid up capital, were forced to perform in order to ensure that their earnings per share (EPS) would increase. A quick remedy to increase the EPS was to increase total loans and as a result, banks were keen to lend even to those who have poor reputations and financial records. The share and property markets were clearly the beneficiaries in this process, which in the end led to excessive loan disbursements in 1996 and subsequently the cause of Malaysia's vulnerability against the recent crisis. Therefore, requiring banks to have high capital adequacy is one of the obvious solutions towards reducing risky behaviors. This approach should be supported by requiring the banking institutions to recapitalize via non-debt resources such as equity, internally generated funds and long-term debts in excessive of ten years in maturity.

The recent East Asian crisis has pointed out at the weakness in risk management suffered by local firms as they engaged in long-term projects, with longer gestation period, which were financed by external short-term debts. As a result, maturity mismatches occurred when the Ringgit was under tremendous selling pressure and interest rates were also pushed too high by weak domestic financial institutions trying to attract fresh funds. The first issue that must be address is the lack of transparency due to asymmetric information and rent seeking activities. Therefore, timely release of data and accounts should be the standard practice of the industry. In order to do that, the adoption of international accounting standard by the sector should be encouraged and the requirements imposed by the authorities in this area must be strictly enforced and delays must be dealt with severe punishment. And secondly, the crisis has also showed that financial institutions distress were closely linked to corporate distress, especially those that belonged to the same corporate or political

group. South Korean and Indonesian conglomerates, which owed several banks in their groups, are among the best examples of the preceding statement. Hence, it is relevant that Malaysia disallow such practices from taking place in the long term. This could improve Malaysia's credit worthiness and limit herd behavior in times of financial distress.

Beyond the choice of an exchange rate, the Malaysian authorities could also widen the scope of cooperation among the Association of South East Asia Nations (ASEAN) and its regional neighbors like Japan, Taiwan, China and Hong Kong to include monetary and exchange rate monitoring and surveillance. Since the possibility of a monetary arrangement is remote, due to differences in political ideologies and economic fundamentals (Jadresic, Masson, and Mauro, 1999; Bayoumi and Mauro 1999), increased cooperation among these member nations as to how should their currencies respond to changes in the global economy should be a grim reminder to currency speculators of the potential backlash they could received. The latest move to set up a web of bilateral pacts to swap and repurchase central bank reserves between members of ASEAN, Japan, South Korea and China to fend off future financial crises is clearly in the right direction (Goad, 2000). In addition, setting up an Asian Monetary Fund (AMF), which was mooted by Japan in 1997 and works similarly like the IMF but only faster in funds decimation, would stand to benefit any regional country in distress. The fund if realized would be able to add local expertise in areas where the IMF has failed to recognize during the recent financial and currency crisis. The AMF would be not only a regional institution but also a global mechanism that could easily assist the IMF in its rescue operations. These ideas rest strongly on the basis of thrust, flexibility and cooperation among the East Asian nations as a strong regional grouping would pose as a powerful deterrent to any currency speculators.

Thus, it is vital that Malaysia takes the current tranquility in the international scene to plan for an orderly exit from the selective capital and exchange controls. Evidences of countries moving away or abandoning fixed exchange rates in developing countries during financial and currency crisis, such as Mexico (1994) and Thailand (1997) strongly indicate that the economic losses were substantial, consisting of a major devaluation in the local currency, macroeconomic consequences and financial turmoil, as these economies lost their credibility. To some extent it is quite desirable for Malaysia, with fixed currency regime to maintain its status quo and to exit when there is tranquility within the world economy.

4.3 Considerations for Adopting an Exchange Rate Regime

For a developing nation like Malaysia to consider and adopt a particular exchange rate, an important proposition by Frankel (1999) must be bear in mind. As emerging economies become more integrated with the world financial markets under continuous strains due to capital flows, policymakers would have to choose between exchange rate stability and monetary independence. The 'Impossible Trinity' of enjoying and maintaining an open market, a fixed exchange rate regime and monetary independence is a notion that Malaysia could not afford. Any open market sterilization operation by the central banks would only delay this trade off from taking place. The experience of the Exchange Rate Mechanism (ERM) of the European Monetary System only after a few years after the last barriers to European capital mobility were removed is often cited as an example in which the conflict involving the 'Impossible Trinity' between the German's Bundesbank desire for higher interest rates and non-German counterparts intent for lower interest rates and stable exchange rates took place (Rose, 1996).

In this second section, the discussion will center on various considerations for adopting an exchange rate regime for less developing countries, like Malaysia. The main goal of this section is to present these various issues that await Malaysia once it decides to exit from the current fixed exchange rate. It must be emphasized, however, that the list is not comprehensive as there may be other considerations that were not covered although the following discussion have tried to gather some of the most analyzed and discussed issues.

The organization of this section is divided into two. The first subsection discusses the major characteristics of less developing countries and the second subsection takes a look at the debate between credibility and flexibility of an exchange rate regime. Finally, this section ends with a summary.

4.3.1 Characteristics of Less Developing Countries

The characteristics of a country could determine whether a country is better off with a fixed or flexible exchange rate. Firstly, a country needs to deal with the criterion of optimality (Aghevli, et al. 1991). A standard welfare related criterion should be specified and applied when choosing an exchange rate system. The objective here is defined in terms of minimizing variances in real output, the price levels and households consumption under random shocks to the local economy. Whether a fix or flexible regime does better depends strongly on the nature of the shocks. Typically, a fixed regime is more likely to succeed if the shocks emanated from domestic disturbances such as money demand shocks. The conventional view here is that maintaining a fixed exchange rate system would be more effective in stabilizing output. Since money supply in this example is endogenous, any disturbance in the domestic money market would be absorbed by changes in the international reserves, without affecting the goods market. In contrast, if the shocks were predominantly foreign shocks or

real domestic shocks, then a flexible regime would be preferable. The rationale is that when such shocks are real, an exchange rate should be able to adjust in order to stabilize output by creating external demand.

Next, the openness of a country should be able to determine the choice of an exchange rate regime. Economic growth in Malaysia for example, is significantly dependent upon capital flows. Foreign capital inflows and international aids play a role in supplementing domestic savings and increasing the rate of growth as domestic savings may not be sufficient to enable a country to attain its desire growth rate. Next, since capital equipments are mostly manufactured abroad, some nations like Malaysia depends heavily on imported capital equipment. Thus, domestic savings in this sense may not be adequate as a mean of capital formation and the availability of foreign exchange plays an important role in channeling domestic savings into productive investments (BNM, 1995). As a general rule of thumb, the more open a less developing country is (the larger the share of the traded goods sector) the stronger the case for a fixed regime to be adopted since the potential costs associated with an unstable foreign exchange market is often high (IMF, 1997).

As Stockman (1999) pointed out, nominal wage rigidity does have some bearing on the effectiveness of an exchange rate policy where the effects of a nominal devaluation on macroeconomic variables depend critically on how nominal wages and prices respond to a devaluation. The larger the increase in nominal wages in response to a devaluation, the smaller the change in real wages. For instance, while nominal prices can adjust, nominal wage stickiness induces short-run changes in real wages and employment. If a change in the real exchange rate can be accomplished at least partly through a change in nominal exchange rate, these short run results of changes in the price levels

can be mitigated. In short, the argument for a floating exchange rate becomes stronger as the real social cost, like foregone output, that is changes in nominal prices becomes larger.

Finally, the degree of financial deepening in less developing countries also plays a major role in influencing the choice of an exchange rate system. Usually, most less developing countries have financial markets, which are rudimentary, if not slight better. The process of financial intermediation is prone to weaknesses due to poor regulations and supervisions on the part of the institutions and the relevant authorities. Poor financial derivatives and underdeveloped forward market hinder private sector ability to hedge against exchange rate risks are among the apparent drawbacks of most developing countries. Moreover, these nations are often ill equipped to handle large influx of capital into their economies once they decided to liberalize their financial sector. Since their financial institutions are weak when compared to their foreign competitors, the political will to shield these domestic institutions would usually lead the government to adopt a fixed exchange rate. As institutional and legal frameworks could be developed overtime, the economic stability bestowed by the fixed currency regime would certainly assist the government in its economic planning. In addition, the tendency to establish a fixed exchange rate regime is strong, not only for trade purposes, but also for protecting the domestic economy against the unstable exchange rate fluctuations. Once the exchanged rate is pegged or fixed, it is generally a common belief that the de facto pegging will likely continue forever. There is little, if any, perceived foreign exchange risks for domestic firms and financial institutions to worry. Any adjustment against currency misalignment would be strongly resisted due to their adverse impact on domestic corporations and banks as any substantial

appreciation would undoubtedly raise the burden of foreign currency debt obligations.

Thus, the connection between exchange rate crisis and bank crisis make the stability of a country's financial system a key factor in choosing an exchange rate system. As the recent financial crisis in East Asia showed speculative attacks on a pegged exchange rate can lead to banking system crisis, which could lead to even worse problems for the foreign exchange markets (Cooper, 1999). In this matter, the general conclusion is to promote less developing countries to adopt a more flexible exchange rate regime to a fixed system.

4.3.2 Credibility and Flexibility

The second generation of literature centers around the debate on whether developing countries should focus more on a hard peg or also known as 'credible' exchange rate system or choose a more flexible regime. In general, a fixed exchange rate like a peg can help to establish the credibility of a reform program in order to reduce the inflation rate. In fixed regimes, such as the currency board in Argentina and Hong Kong, the central banks and the government have to subordinate their monetary and fiscal policies in order to maintain the former (Hausmann et al., 1999). This effectively limits the authorities' ability to manipulate the exchange regime for other purposes and focuses their commitments to the currency regime. Thus, so long as the authorities are seen to be committed to maintain the regime by the market players, expectations of inflation will be restrained.

Nonetheless, competing government objectives usually renders the above commitment useless (Obstfeld and Rogoff, 1995). Very few central banks would hold on to its exchange rate commitment without any regard to what is taking

place in the domestic economy. For instance, under pressure from speculative attacks the central bank may be obliged to raise the domestic interest rates. Such a rise can cause detrimental consequences to the local economy, as experience by Malaysia in the early period of the East Asia Crisis. Moreover, if the increase in the interest rates is sustained for a longer time, it could have profound negative long-term effects on employment, investment, government budget deficits and income. Thus, if the authorities still decide to ignore these problems and continue to hold on to their commitment to defend the fixed exchange rate, then the exchange rate regime's credibility would be in doubt.

A fixed exchange rate can also help to discipline the fiscal policy as in some nations the separation between monetary and fiscal policies is not always clear. It can limit the ability of the government to use the inflation tax as a source of income. This would enable the authorities to control private sector expectations of inflation. On the contrary, a more flexible regime does provide the authorities with greater scope for revenue from seigniorage at the expense of future commitments (Frankel, 1999; and Eichengreen and Hausmann, 1999c).

An important lesson from the recent financial crisis, with respect to exchange rate regimes, is that pegged exchange rates are usually inherently crisis prone. For example, most emerging market economies like Thailand, Indonesia, Malaysia and South Korea had either a hard peg or limited movement in their exchange rate variations (Ohno, 1998). Their exchange rate regimes were clearly important factors that led to their economic crises and a source of their vulnerability against external developments. Clearly, the demand for maintaining a currency peg or fixed exchange rate regime has increased tremendously.

As an alternative, a floating exchange rate that includes options such as the managed float and crawling peg, would allow greater flexibility for monetary policy at times when the exchange rate is under pressure. By adopting such an approach, businesses and financial institutions would be forced to recognize the risks inherent in foreign currency borrowings and other exposure to foreign exchange risks. Although official interventions and adjustments are permissible under the floating regime, a too tightly managed exchange rate would only recreate the risks associated with a fixed exchange rate regime. Obviously, emerging market economies like Malaysia that are heavily involved in the global capital market should be wary not to induce excessive private sector risk taking by providing a high degree of exchange rate stability as it could only invite more trouble.

The choice of an exchange rate regime must be evaluated based on the economic requirements of the nation and its performance overtime and not simply based on a snap shot scenario of the recent financial and currency crisis. The economic and social costs of the recent crisis have been large and only those countries that had a strong commitment to their currency pegs, like Hong Kong and Argentina, were able to maintain their exchange rate regimes.

4.4 SUMMARY

In summary, planning for an orderly exit is vital for Malaysia, as the consequences could be dire if steps are not taken to correct the underlying problems within the economy. First, is to select a desired anchor for monetary policy. The continuation of interest rates as an anchor should be continued as it has showed to be useful in directing monetary policy. Besides it also serves as to ensure depositors do receive positive real rate of return, an important factor that ensures confidence and credibility of the banking sector. Moreover, central

banks in industrial nations such as the US and Japan have also adopted the interest rates as their key anchor to their monetary policy. Second, the formulation of fiscal policy must also be formulated in accordance with the challenges posed by a globalized capital market. Fiscal prudence and an excellent debt management program that minimized Malaysia's exposure to short term external debts should be able to confer additional room for the government to maneuver should the economy faces another financial and currency crisis.

Likewise, it is also pertinent that the government practices fiscal policies that are able to absorb any sudden external disturbance, as this would give the government ample time to react and formulate additional policy responses. The establishment of institutions that allow the public to monitor the government performance should be encouraged and welcomed. Third, financial and corporate restructuring and improving supervisions and regulations are also among the top agenda that need to be looked into. Stringent legal framework, well above international standards, should be developed to monitor the financial sector as this could work as a strong deterrent to any potential risky and moral hazard behaviors. Loans disbursement should be made only to productive sectors that have backward and forward linkages with domestic producers, especially the small and medium sized industries. Promoting corporate governance including areas such as transparency and accountability in a corporate sector dominated by family or political parties should also be stressed. To often than not, political interferences and family ties have made misallocation of resources and corruptions to take place. This in the end led to higher cost of production and inefficiency.

The move towards a flexible exchange rate regime requires that the government prepares the local populace and business community of the possible repercussions that may lie ahead. Similarly, Malaysian producers who rely on their export markets must be reminded that the Ringgit peg will not remain forever. Eventually, they would have to innovate and improve on their productivity and efficiency. In addition, some producers may be forced into new sectors such as information technology, wood based furniture, rubber and oil palm industries and services. The need to broaden Malaysia's economic base is vital and a pressing matter since it could not continue to depend solely on the manufacturing and electronic sectors (Dalila, 2000). Foreign engagement in ASEAN and regional groupings should be welcomed and used as jumping board for Malaysia's economic agenda. While promoting surveillance and observation over short term capital flows, offshore currency markets and currency speculators are imperative, the setting up of AMF must be pushed forward as it would be able to channel any available fund to assist any ailing East Asian country in distress.

With respect to the choice of an exchange rate, it is recommended for Malaysia to really prepare itself for a more flexible exchange rate. Here, it is also important that Malaysia does not repeat the same mistake as it did before the crisis in which the exchange rate was a de facto peg to the US dollar. As a trading nation facing globalization and liberalization, improving productivity and efficiency in the long run should be the long term agenda since competition from neighboring nations would ensure only those that improve would survive. Allowing the Ringgit to depreciate and appreciate when it should, would also create some awareness over the risk of foreign exchange transactions. This would force businesses and financial institutions to hedge their currency

exposure and thus, shielding them from the volatility of the exchange rate market.

Hence, it would be beneficial to Malaysia if it could exit from the current system of capital and exchange controls when the world economy is stable. This could allow for any necessary adjustment to take place without fear of speculative attacks to take place upon exiting. In terms of a choice of an exchange rate regime, it is very likely that Malaysia may opt for a managed float or peg the Ringgit to a basket of currencies. Nonetheless, what is more important here are how the authorities would manage the economy and the system per se, and not what kind of a regime it may choose later.