CN - 13470
4/08

THE IMPACT OF CURRENCY PEGGING ON THE MANUFACTURING SECTOR

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8 OCTOBER 2004

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ABSTRACT

Exchange rate pegging is one of the economic measures undertaken by the Malaysian government in containing the financial crisis in 1998. The question as to whether it is really an effective measure in improving the overall economic performance of Malaysia has been the subject of serious discussion amongst academician, economist, researchers and other parties concerned. This project paper will attempt to examine whether the pegging of Ringgit Malaysia (RM) to the US Dollar has any impact on the country's manufacturing sector. For this purpose, the contributions of the manufacturing sector towards the overall Gross Domestic Product (GDP) and Capital Investments (CI) of both local and foreign investors will be the variables to be analyzed.

The application of hypotheses testing, T-test and ANOVA statistical tools on data collected from secondary sources have produced somewhat perplexing but welcome result. The finding was that, the pegging of the RM to US Dollar did not have significant impact on the manufacturing sector, both before and during the imposition of the exchange control. The manufacturing sector has in fact continued to be one of the major contributors, if not the catalyst, to the overall Gross Domestic Product.

1. INTRODUCTION.

1.1 Background of study.

Malaysia has, in general, achieved impressive economic growth since independence. However, the development process has been neither easy nor smooth during the past few decades. Malaysia has in fact experienced five major crisis between 1956 and 1999 namely, the commodity crisis (1956-1972), the first oil crisis (1973-1975), the commodity or second oil crisis (1979-1983), the electronic or third commodity crisis (1985-1986) and the financial or currency crisis (1997-1998). The causes of the existence of crises greatly varied from one crisis to another. It was during the financial or currency crisis that the Malaysian Ringgit (RM) was pegged to the United States of America currency (US Dollar).

Before the crisis, when the RM was strong, The Central Bank of Malaysia (BNM) role was to intervene in the ordinary market in order to smoothen the fluctuations and has usually been concerned to hold the exchange rate down rather than support it. However, in early 1996, in response to adverse movements, BNM intervened briefly to support the RM and drew on foreign exchange reserves until higher interest rate restored stability to the exchange rate. This increased inflationary pressure, both by increasing demands on national resources and by attracting speculative international hot money. In the early 1990s, the Kuala Lumpur Stock Exchange (KLSE) (Now

2. LITERATURE REVIEW

2.1 Currency Pegging Defined

Exchange rate is the relative price of one currency in terms of another. It can be fully market determined by the interaction of demand and supply of foreign exchange. This is referred to as a flexible exchange rate. The demand for foreign exchange arises from import demands (and capital outflow) while supply is from export (and capital inflows). If a country's imports exceeds its exports and the country experiences overall deficit in the balance of payment, the demand for foreign exchange will exceeds its supply resulting in a rise in the price of foreign currency (depreciation of the domestic currency).

Exchange rate system can be classified according to the degree the exchange rates are controlled by the government. Pegging or Target –Zone Arrangement System is one of the categories of the exchange rate system. In a pegged exchange rate system, a country pegs or sets its home currency value to a foreign country currency. Since it is pegged, it moves in with that foreign currency against other currency. By fixing its exchange rate to that of another country, a particular country could stabilize its own currency. When exchange rates are fixed, the Central Bank must be ready to sell or buy foreign currency whenever there is an excess demand (supply) of foreign currency at the official rate. Selling of foreign currency is possible for a longer period of time if the country in question has sufficient reserves of foreign currency.