

# The floating exchange rate system of malaysia economics essay



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**Abstract.**

The article is describing about the ringgit's appreciation which is backed by strong fundamentals, a solid banking system and positive sentiments in the region's economies. There is a concern regarding the products being less competitive and the currency's value becoming more volatile due to offshore trading. The ringgit's strength is also due to the interest rate differential in comparison to the US dollar. However, since other currencies in the region had also strengthened, it will not make much difference regarding the product prices and exporters. Despite the disadvantages of having strong currency, Malaysia gains a lot of benefits that will help the economic growth.

Malaysia practices a floating exchange rate system. Floating exchange rate is an exchange rate regime where the value of a currency is allowed to be determined solely by the demand for, and supply of, the currency on the foreign exchange market[1]. According to the report, ringgit's appreciation is backed by strong fundamentals, a solid banking system, positive sentiments in currencies in the region as well as interest rate differential in comparison to the US dollar.

A strong currency would create problems like damaging the export and domestic industries. Export industries may find it difficult to sell goods and services abroad because of their relatively high prices while domestic producers may find that the increased competition causes a fall in the demand of their goods and services because imports are now relatively less expensive and are being purchased with greater levels.

In the long run, if the situation stays the same, high level of unemployment may occur as exporters and domestic producers start to lay off their workers due to the loss they suffer. Economist predicts that government would be unlikely to allow offshore trading of ringgit so soon because this could worsen the situation. This would later make local products and services much more expensive to be selling domestically and abroad and thus, create higher levels of unemployment. The currency's value would also be more volatile due to offshore trading. Government is unlikely to allow offshore trading of ringgit so soon because they want the currency to be stable so that it can withstand any speculation because strong ringgit is exposed to the vagaries of speculative trading that could affect real economic activities and the country's aspirations to become a high-income, high-value added economy in the medium term.

In the future, if government allows offshore trading of ringgit, the ringgit will keep appreciating. So, in order to curb with this situation, government needs to intervene as to protect the export and domestic industries. Hence, government should consider lowering the value of the currency by buying foreign currencies and lowering the level of interest rates in the country. Buying foreign currencies on the foreign exchange market can be done by using ringgit and this increases the supply of ringgit on the foreign exchange market and so lowers its exchange rate. This will also increase the foreign currency reserves. Lowering the interest rate will make the domestic interest rates relatively lower than those abroad and should make financial investment abroad more attractive. In order to invest abroad, the investors will have to buy foreign currencies, thus exchanging ringgit and increasing

the supply of it on the financial exchange market. This will lower the value of the ringgit.

Diagram 1 : An increase in the supply of ringgit

Based on the diagram, an increase in the supply of ringgit on the ringgit/US dollar market will shift the supply curve of the ringgit to the right to the  $S_1$ . When this happens, the value of the ringgit will depreciate and it will now be worth 0.70\$ from 0.80\$. Each ringgit may be exchanged for a smaller amount of US dollar. Hence, in order to protect export and domestic industries, the supply of money should be increased by buying foreign currencies and lowering the level of interest rates.

However, there are a lot of advantages of appreciation of the ringgit. It will cause downward pressure on inflation, high levels of imports as well as forcing domestic producers to improve their efficiency. The high value of exchange rate will cause the price of finished imported goods to be relatively low because the price of imported raw materials and components will reduce the cost of production for domestic producers. Hence, each unit of the currency will be able to buy more foreign currencies leading to more purchase on imports including visible and invisible imports such as technology and foreign travel respectively. Since more imports can be bought, this will then threaten international competitiveness of the domestic producers. They will be forced to lower costs and increasing efficiency in order to maintain competitiveness which will result in greater economic productivity for Malaysia.

The ringgit was seen in an upward trend ever since it was depegged from the US dollar in 2005. Hence, the concerns over volatility were valid should be the ringgit be traded offshore, Bank Negara confidents that the ringgit's movement had always been in an orderly manner due to market forces.