DANCING WITH THE DOLLAR

The US dollar has long been playing a dominant role worldwide. In a sense, it is *de facto* the currency of the world. Given its impressive track record, the greenback is trusted and accepted by all countries as a fairly stable and reliable currency. The US Federal Reserve (Fed) takes pains to ensure that the confidence that the dollar enjoys everywhere is augmented by sound macroeconomic fundamentals at home. This explains why the US is particularly sensitive to domestic inflation numbers.

Not surprisingly, almost all countries use the dollar as *the* benchmark for their own national currencies. Exchange rates are often expressed vis-à-vis the dollar. Most international commercial and financial transactions are denominated in dollars. The dollar is also a major reserve currency for most countries. In some places, especially in the transition economies, the dollar is freely, albeit unofficially, used as a medium of exchange even for domestic transactions. There have been cases of the dollar being used formally as the legal tender outside the United States. Panama is a case in point. There have been talks of "dollarising" some of the Latin American countries to contain runaway inflation in their economies.

To be sure, the Malaysian ringgit is not the only currency that is pegged to the dollar. The Saudi riyal has long been pegged to the dollar at 3.75 riyal to the dollar. Until recently the Argentina's peso was pegged to the dollar at one-to-one. The Hong Kong dollar, under the Currency Board system, is also shackled to the dollar, just as China's yuan. The main advantage of the dollar link is that it eliminates exchange rate risks vis-à-vis the dollar, while it stabilises exchange rates vis-à-vis other major currencies so long the dollar itself remains stable. This, however, does not mean that a currency that is pegged to the dollar enjoys immunity against speculative attacks by currency traders. If the latter have reasons to doubt the ability of the monetary authorities to defend the peg, the currency may well come under intense speculative pressure, as it did happen to Argentina lately. The ability to defend the peg would depend critically on the size of external reserves, which in turn would depend largely on the competitiveness of the country in terms of export earnings and foreign capital inflows. The main danger of such pegging is that the domestic currency might appreciate with the dollar, which means that its exports will run into the risk of being priced out of the market, in which case the peg would become indefensible.

In the Malaysian context, before the 1997/98 financial crisis, the dollar was used not only as the intervention currency by the central bank in its interventions in the forex market to stabilise the ringgit, but also as a benchmark for exchange rate 'targeting' at around RM2.50 to the dollar. It is this *de facto* link to the greenback that caused the ringgit to be overvalued, as the dollar grew stronger and stronger in the wake of rising productivity in the US. This currency misalignment was one of the many causes of the currency meltdown that began in July 1997. The rest is history.

Since September 1998 the ringgit is again linked to the dollar, this time formally fixed to the latter at RM3.80. The ringgit peg has worked fairly well, confounding the critics. Import compression, triggered by the crisis, has helped the peg through sizeable current account balance-of-payments (BOP) surpluses. It was easy for the peg to hold in the early stages as the ringgit was undervalued apparently by design. The real threat to any such peg will come only if the currency concerned is overtly overvalued.

The ringgit peg seemed threatened when the country's reserves declined from US$34.5 billion in April 2000 to US$25.9 billion in May 2001. The pressure subsequently eased remarkably as the decline in reserves was arrested and reversed. The current level of external reserves, which stands at US$32.7 billion as of mid-June 2002, sufficient to finance 5.4 months of retained imports and equivalent to 4.5 times the size of short-term external debts, is comfortable enough for the peg to hold.

The weakening yen in recent times was also seen by many analysts to be posing a serious threat to the ringgit peg, as it could possibly derail the current delicate equilibrium among regional currencies. Currencies with fixed exchange rates are understandably more vulnerable than those with flexible rates. This threat, too, has receded considerably from the January peak of 135 yen to the dollar. The yen has subsequently strengthened vis-à-vis the dollar, presently hovering around 121 yen to the dollar, thanks partly to yen's own internal strength following signs of economic recovery in Japan and partly to the dollar's inherent weakness despite the impressive US economic recovery numbers.

Undeniably, there are serious imbalances in the US economy. By preventing a recession last year, the US has missed an opportunity to correct these imbalances. The most glaring of them all is the yawning BOP deficit at the rate of US$1 billion a day. No other economy in the world could possibly have survived the imbalance of such magnitude for

so long. Fortunately for the US, foreign capital inflows are sufficient to finance its current account deficit, but for which the US dollar would have taken a severe beating.

Be all that as it may, one must not underestimate the clout the dollar enjoys as a reserve currency. Prior to the floating of the dollar in 1973, the greenback had accounted for nearly 90 per cent of the total currency reserves. Although this share has declined over the years, the dollar still dominates, accounting for roughly 76 per cent of total official foreign exchange reserves estimated at US$1.91 trillion as of year-end 2000, albeit down marginally from 78 per cent in 1999. It is in this sense that the dollar has a huge advantage over all other currencies. The closest rival, euro, has a long way to go in this regard.

Needless to say, the dollar's 76 per cent share of the reserves market is completely out of proportion to the US share of the world economy or its share of world trade. In purchasing power parity (PPP) terms, the US share of the world economy amounts to 21 per cent, while its share of world trade stands at roughly 15 per cent.

However, there is no basis to argue that the dollar is on the decline as a reserve currency, even though its share of official currency reserves has fallen. Even at 76 per cent, it still exceeds the 1996 level by more than 7 percentage points. Going back to the 1996 level alone would release a hefty US$140 billion, unleashing untold pressures on the dollar. Some analysts tend to view this brutally as the "dollar bubble". The bubble may get bigger if the world's major central banks were to opt for reserve diversification. Nonetheless, it is highly unlikely that this bubble would burst anytime soon.

Regardless, the dollar is still too strong for the own good of the US. The strong dollar is hurting US exports and its domestic substitutes for imports. It is estimated that the real effective exchange rate of the dollar was overvalued by roughly 14 per cent at the beginning of this year. The extent of overvaluation must have narrowed recently, now that the dollar has been softening since March this year. The dollar now stands at a seven-month low against the yen and at a two-year low against the euro. According to a recent estimate by Merrill Lynch, the dollar has slid 6 per cent down from its recent high in late February. The prognosis is that the dollar would continue to weaken in the short term, but a crash landing for the dollar is very unlikely in the foreseeable future.

What does all this portend for the ringgit peg? The ringgit grew stronger, after the peg, against regional currencies, mainly because the dollar got stronger, with adverse implications for Malaysia's export competitiveness. The stronger the dollar, the more difficult the task of holding the peg intact, especially if productivity gains in Malaysia fall far behind that in the US. The recent softening of the dollar makes the job a lot easier, with regional currencies appreciating against the ringgit. In other words, a weakening dollar is good for the ringgit peg, as it eases yet another source of pressure. Consequently, the concerns about overvalued ringgit have eased considerably.

All this means that the ringgit peg is quite safe for now. The viability of the prevailing dollar-ringgit axis, in the longer term, will however hinge primarily on Malaysia's willingness and ability to ensure that its key macroeconomic indicators, including productivity growth, inflation numbers and interest rates, move generally in tandem with that of the US. It will not be easy and may not be wise to jive with the dollar in such a coordinated manner and a synchronised fashion.

The fact that the ringgit peg is not facing any immediate threat is no argument in favour of its continuity, let alone perpetuity. This is not to deny that the peg has played an important role in the crisis management of the country's economy. Notwithstanding the positive attributes of the peg, it will be imprudent to ignore the risk that the peg can outlive its usefulness with serious cost implications for the economy. Like all prices, exchange rates too must remain flexible enough to reflect changes in supply and demand so as to avoid costly resource misallocation. The hallmark of a sound exchange rate regime is stability, not rigidity.