No imminent threat to the ringgit peg

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Speculation about a seemingly impending devaluation of the ringgit has been quite rife in recent times, fuelled primarily by the continuous decline in the central bank's international reserves. Malaysia's external reserves have been falling from a peak of US$34.5 billion in April last year to a low of US$26.1 billion mid-May this year, at the rate of aboutUS$800 million a month. To be sure, there are other reasons as well, which include weak export performance, bleeding capital account with huge domestic capital outflows and the depreciating the regional currencies, for the on-going ringgit speculation.

The irony of it all is that, not too long ago, there were talks of the ringgit being undervalued, with many analysts calling for a revaluation of the ringgit. The pendulum is now swinging in the opposite direction. It cannot be denied that the ringgit peg has come under increasing pressure in recent times. The ringgit has appreciated against all major currencies by default, as it is tied to the US dollar, which has been growing stronger and stronger. What makes it all the more risky is the fact that the ringgit has become relatively expensive vis-à-vis other regional currencies, rendering Malaysia a more costly place for foreigners to do business with. The real effective exchange rate of the ringgit has appreciated by 6 per cent during the preceding 12 months by end-March, with adverse implications for the competitiveness of Malaysian exports.

Since the beginning of the year the Indonesian rupiah has depreciated against the US dollar by over 18 per cent, Taiwan dollar by over 15 per cent, Japanese yen by over 6 per cent, Thai bhat by about 5 per cent and the Singapore dollar by over 4 per cent. What is more, the relative strength of the ringgit now vis-à-vis Thai bhat, Indonesian rupiah, Philippine peso and Singapore dollar far exceeds that of the pre-crisis early July 1997 situation. In other words, the ringgit has moved clearly out of sync with the rest of the regional currencies.

There are, however, some redeeming features, which tend to take the heat off the ringgit. For starters, the trade balance is still favourable and the BOP (balance of payments) current account balance still remains positive. In April, trade surplus increased significantly, thanks to import compression, which is not unusual for a slowing economy.

The chances are that import compression will continue to exceed export decline so that trade surplus will grow in the near term. The recent strengthening of the Japanese yen also augurs well, as it tends to arrest, if not reverse, the depreciation of regional currencies.

External reserves are still substantial, nearly six times the size of the country's short-term debts, the highest ratio among the crisis-hit countries, including South Korea, by virtue of the fact that Malaysia's short-term external debt is the lowest in the region. Inflation and unemployment rates in Malaysia are also the lowest in the region. It even appears that the ringgit is undervalued, not overvalued, in PPP (purchasing power parity) terms. For the so-called "hamburger (BigMac) index" suggests that the ringgit is in fact undervalued by as much as 53 per cent. One must, however, hasten to add that other regional currencies are also in the same league on the BigMac scale.

There are no overt signs of any overvaluation of the ringgit, as anyone can obtain any amount of foreign currencies at current exchange rates. There is no shortage of foreign currencies in the market either. Nor is there any strong evidence of dollarization in the domestic economy. Equally important is the observation that the room for destabilizing currency speculation is limited by the small role foreign capitalization now plays in KLSE (Kuala Lumpur Stock Exchange) accounting for just 15 per cent, with the so-called "hot money" amounting to US$2-3 billion only. Besides, there are substantial Petronas reserves, estimated at RM40 billion.

It is not clear if a devaluation of the ringgit would help the Malaysian economy under the present circumstances. Exports are falling at the moment primarily because there is economic slowdown in export markets, and this hardly has anything to do with currency misalignment. Exports will not increase, even if the ringgit is devalued, under depressed demand conditions. In any case, transfer pricing practices of the MNCs (multinational corporations) can help neutralize, to some extent, the adverse impact of overvaluation of the ringgit on export sales. A re-peg, far from putting an end to currency speculation, may spawn further speculation inducing an even sharper devaluation of the ringgit. It is in this sense that any re-peg will inevitably lead to a total loss of faith in the peg system.

The political costs of a re-peg are high. It may be seen as an admission of policy failure with loss of credibility. It will raise the cost of imports and hence production costs, given the high import content in Malaysian manufactures, and rekindle inflationary pressures in the domestic economy. It will also increase the country's external debt burden, as it will take more ringgit payments for settling existing debts.

Given the high political as well as other costs and uncertain benefits in the near term, the chances are that the government will not opt for a re-peg anytime soon. That there is a strong political will to maintain the peg for as long as possible is readily obvious. How long will the government be able to hold on to the peg still remains a moot question. Much will hinge critically on the external reserves. Malaysia's reserves are now equivalent to less than 4 months of imports, which is low, not only by the country's own standards of 6-7 months previously, but also in comparison with Singapore's 12.3 months, Taiwan's 9.6, Indonesia's 6.1 and Thailand's 5.7. If the BOP capital account continues to bleed and the trade balance in the current account turns red, reserves are likely to fall, exerting increased pressure on the ringgit.

As alluded to above, the costs of a re-peg would clearly outweigh the benefits in the near term. For, costs are immediate, while benefits will only accrue much later. Equally pertinent is the question: what are the costs of not adjusting the exchange rates in the face of changing supply-demand equation? Malaysia may lose out to other countries in the region in the export markets, especially when the US economy recovers and the electronics demand rebounds. Foreign investors may opt to skip Malaysia for another destination in the region. All this may serve to sedate Malaysia's GDP growth rate. It is in this sense that Malaysia has to make a hard choice between the currency peg and economic growth.

In any event, re-peg cannot be the solution. If the peg is allowed to break once, many would only expect it to break again and again. What the economy needs is exchange rate stability, not rigidity. It is flexibility, not rigidity, which can ensure economic resilience under fluid conditions. All prices, including exchange rates, will have to be flexible enough to clear the market. Crawling peg cannot be the answer, as it is fraught with risks of destabilizing speculation. It would be wiser to abandon the peg system altogether than to have the ringgit re-pegged. To start anew with a clean slate, a different exchange rate regime is called for.

Free float would be a wrong option, given the turbulence in the forex market. The authorities may consider some forms of managed floating with a built-in automatic adjustment mechanism. Experience has shown that managed floating works fairly well, if it is well managed. Exchange rates tend to be quite stable for well-managed economies. This system, however, tends to take regimes to task when domestic policies are not in order. Countries that follow prudent policies with transparency have nothing to fear from international disciplinary actions through exchange rate convulsions.

A transparent basket-peg would appear to be a better option than a single currency peg, as it would provide exchange rate stability against a basket of currencies, without exchange rates rigidity against any one currency. The US dollar itself may soon come under downward pressure, as it is believed to be overvalued by as much as 15-20 per cent. The huge trade deficits of the United States at the rate of roughly US$1 billion a day is simply unsustainable.

How long will the current peg hold? As argued, the peg is under no immediate threat. This situation, however, may not last long. In the final analysis, it is the external reserves that will call the shots. The reserves would, in turn, depend not only on the trade balance but also, more importantly, on international capital flows. Much would also depend on the exchange rates of other currencies in the region, which, in turn, would hinge critically on the Japanese yen. If the reserves were to fall below a level that is equivalent to 3 months of imports or if the yen were to breach 130 yen to the dollar, the pressure on the ringgit peg would become manifest. Two other trump cards in the pack are China's yuan and Taiwan's dollar which may also face devaluation, despite huge reserves behind them, given their lacklustre exports.

Arguably, all said and done, the ringgit peg has served well as a stop-gap, emergency measure in 1998/99. However, exchange rate inflexibility does not jive well with other liberal policy measures in an open economy which thrives on manufactured exports and foreign investments. It is easy to get into a peg system but it is not so easy to get out of it. It makes considerable strategic sense to make the exit voluntarily from a position of strength well before arriving at a point where the exit is no longer an option.