# RINGGIT POLICY – A CONFIDENCE GAME

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Three years after the onset of the Asian currency crisis, Malaysia's monetary conduct has again come under increased scrutiny. The yen has fallen significantly to reach a low of Y126 against the US dollar towards end-March, the lowest level in two and the half years. This has created uncertainty and instability in regional financial markets, threatening a new round of competitive devaluation to levels not seen since the height of the Asian crisis. With the fall in regional currencies, there has been some concern that the involuntary appreciation brought about by the rigidity of the ringgit peg is rendering Malaysia increasingly uncompetitive. This has prompted a number of critics to predict a re-pegging or even an imminent demise of the peg.

To a degree, the current episode bears some resemblance to the events that unfolded before the onset of the financial crisis in 1997. Many East Asian countries including Malaysia then had adopted a somewhat rigid quasi-US dollar peg exchange rate system (a managed float system with an explicit band around a central rate). When the dollar started to appreciate against the yen beginning early 1995, the real effective exchange rate of these regional currencies started to appreciate sharply, hence pricing their products out of the world market. Consequently this led to a sharp deterioration in their current account of the balance of payments which undoubtedly has been seen as a major catalyst to the onset of the Asian currency crisis.

Hence shock absorbers were needed to cushion future external shock and to shield the economy from unnecessarily abrupt dislocation. Most of the crisis-hit countries (Korea, Thailand and Indonesia), except Malaysia, chose the conventional IMF approved method of a more flexible exchange rate regime. Under an inflation targeting monetary framework, interest rates are used as the key policy instrument. Malaysia, on the other hand, chose to fix the ringgit exchange rate to the US dollar in September 1998. Under a fixed currency regime, a country faces the policy dilemma (irreconcilable trinity of independent monetary policy, free capital flow and a stable exchange rate) of losing monetary control. To circumvent that, Bank Negara imposed capital control. This acts as a circuit breaker allowing Malaysia to set monetary policy in line with domestic needs.

Apart from developments in the currency market, recent economic numbers have also exacerbated the fear of a possible devaluation. The growth momentum of external demand is clearly decelerating. Exports, the key driver of the recent recovery, came off sharply to expand by only an annual rate of 4.6 per cent in February from a peak of 25 per cent in August last year. Likewise, February's industrial output growth, a good proxy of the health of the economy, also decelerated markedly to only 4.3 per cent (from the peak of 25 per cent in January last year). This was the lowest rate of factory output growth in nearly two years.

Much of the fall was due to manufacturers scaling back sharply on output in the face of slowing overseas orders for electronic products. Going forward, the outlook appears dimmer. Growth of electronics orders in the US, which normally leads Asia's electronic output by about 3 to 6 months, has plummeted from 9 per cent in December to a 1 per cent contraction in February, foreshadowing weaker numbers ahead for Malaysia.

But given that other countries in the region have also suffered similar fate, the deceleration in export growth in Malaysia can only be attributed to the sharp contraction in external demand rather than a loss of competitiveness. Conversely, China, under a fixed peg, is still enjoying surprisingly brisk export growth.

Amid the worrying factors mentioned above, the brutality of the fall in Dow Jones further spooked the KL stock market, sending the KLCI reeling to below 600 points, the lowest in two years. As foreign selling played a big part in the recent sell-off, this would eventually feed back into the loop, causing further falls in Malaysia's external reserves.

Under a flexible exchange rate system, a currency depreciation normally takes the pressure off the foreign exchange reserves to accommodate the outflow. But under a pegged system like in Malaysia, external reserves will have to bear the brunt of the adjustment process. Already Bank Negara's foreign reserves have fallen considerably because of short-term portfolio outflows, higher overseas investment, repayment of external loan payment for services and transfers and losses due to revaluation. Apart from that, we believe the fall in reserves could possibly be attributed to the perceived rise in the ringgit risk premium, causing the private sector to move funds offshore. From the peak of US$34.5 billion in April 2000, the reserves have fallen steadily to US$26.3 billion as at 14 April, a considerable paper loss of US$8.2 billion.

The government, however, has made it very clear that Malaysia would not re-peg for the sake of certainty and predictability. In it's Annual Report, Bank Negara also said that it would continue to maintain a stable and fundamentally sound exchange rate, and would not respond to marginal and short-term misalignments that can reverse within a short period in response to changes in sentiments. The central bank also said that it is the country's policy to maintain international competitiveness through efficiency and productivity gains rather than on the exchange rate. This is because competitive devaluation of currencies would not bring any significant gains but instead would lead to higher costs and a destabilized environment.

Prime Minister Mahathir went even further, reiterating that Malaysia would review the peg only when the ringgit exchange rate appreciates by a significant 20 per cent against regional currencies. Taken the policy statements together, this could only mean that the government would review its current policy only when (1) the overvaluation of the ringgit exchange rate is seen to be large and (2) when the actual value of the ringgit exchange rate is out of line with its observed underlying fundamentals (long-term exchange rate misalignment).

To be sure, a re-pegging also carries serious downside economic risks such as higher import bills, imported inflation, higher US dollar external debt and an erosion of the nation's living standards. In addition, a re-pegging now would also call into question the credibility of Bank Negara's commitment and its ability to further maintain the peg. This could heighten the ringgit's vulnerability to future pressures. Furthermore, there is no guarantee that a re-peg would be a cure-all for Malaysia's recent currency problems. Such recourse could even go terribly wrong – go ask Mexico.

Without a doubt, Malaysia's underlying economic fundamentals again are clearly still heads and shoulders above that of her neighboring countries (except Singapore). Total foreign debt is not unduly high and inflation, which is hovering at slightly above 1 per cent, does not pose a problem. Short-term external debt has also fallen to very low levels thus lowering the probability of a sharp and sudden reversal of outflows. Furthermore, banks' non-performing loans (NPLs) remain relatively low and the risk weighted capital

adequacy rate for the banking system is at least 4 percentage points above the international thresh-hold. And there is no asset bubble. In addition, external reserves, despite having fallen significantly over the past few months, are still sufficient to finance about 4 months of retained imports and they exceed short-term external debt by 5.7 times.

So far the ringgit exchange rate has only appreciated modestly against most regional currencies. Apart from the Indonesian rupiah, the local currency, year to date, has appreciated by about 3 to 4 per cent against the Korean won, the Thai baht and the Singapore dollar. Based on the real effective exchange rate (REER) calculation, most studies conclude that the ringgit exchange rate, at this moment, is either at fair value or only slightly overvalued. Certainly the appreciation is not anywhere near the level that would justify a policy change. Hence, it is clear that the recent rumblings for a re-peg are caused mainly by unjustifiable and perhaps prejudiced expectation.

But the economics of exchange rate isn't simply a function of observed fundamentals alone. It is also a confidence game (market psychology). Unfortunately, unjustifiable market expectations can sometimes turn into economic fundamentals if enough market players believe in them. Under such situation, a loss of confidence can lead to an economic crisis that justifies that initial loss of confidence. This means that sometimes bad things do happen even to well-managed economies. The monetary authorities therefore need to halt the current slide in confidence from worsening into a self-validating panic.

So what can the government do to lessen the pressure on the peg? Firstly, they should stay clear of controversies that could further hurt market sentiment. Secondly, there is a need for the government to maintain fiscal prudence. With the main engine of growth weakening, the Malaysian economy is clearly at a weaker point. The economy this year is likely to weaken substantially well below the government's recent forecast range of 5 to 6 per cent. Without an external safety net, it is tempting to pump-prime the economy as an attempt to help cushion the current slump in economic activity. In fact, a RM3 billion mini-Budget was announced recently with the promise of more to come, if necessary. However, it is important to note that this year marks the fourth year of successive deficit financing. Furthermore, in the face of a fall in export earnings, spending on projects could lead to further reserve leakage via higher import bills, especially if the projects are funded domestically.

Continuing deficit spending is clearly not desirable given that unsustainable fiscal policy, even if it is only perceived, could trigger off further pressure on the peg. Empirical evidence does suggest that unsustainable fiscal policies could invite an attack on the fixed peg system sometimes even well before the monetary authorities run out of reserves.

Already, partly due to our weakening fiscal situation, international rating agency Standard and Poor's (S&P) has recently lowered its outlook for Malaysia's long-term foreign currency rating to stable from positive. This inevitably has further hurt sentiment.

Thirdly, instead of re-pegging, Bank Negara could raise domestic interest rates to make it more attractive to hold ringgit deposits. But surely an increase in interest rates, through the normal monetary mechanism, could derail an already fragile economy through higher lending rates. To avoid that, the monetary authorities may instead instruct the banks (burden sharing) to raise their deposit rates while keeping their lending rate stable. The central bank has done this before in August last year and it currently remains a possible policy avenue. After all, banks are currently enjoying a fairly wide margin. Deposit rates at the moment average at about 3.5 per cent while the average base-lending rate is about 6.8 per cent, a spread of more than 300 basis points!

Lastly, as a last resort, the government could again re-impose capital controls. This, however, is inadvisable given its potentially dire effects on investor's confidence.

Salvation could also come in the form of a narrowing interest rate differential between international and domestic rates. Also, it is hoped that intervention and jaw-boning by both the US and Japanese authorities could restore some stability to the US$/yen cross-rate. Additionally, China could help by asserting her strong commitment towards the fixed peg.

Its is hard to predict how the myriad of events would pen out especially in moments such as these. Although the financial markets are now enjoying a period of relative calm, it is still too early to say that the problems are behind us. But this much is clear: at this point, Malaysia's economic fundamentals and developments do not warrant a radical change in the ringgit peg although we hope the government would adopt a more flexible approach under more stable conditions in the future. In the coming months, all eyes will definitely still be on the central bank's foreign reserve position.