Reviewing the ringgit peg

M I E R S C O P E
By Mohamed Ariff

A lot of water has flowed under the bridge since the ringgit peg was introduced in September 1998 during the heat of the Asian financial crisis. The conditions facing the Malaysian economy now hardly have any semblance to that which had prevailed half a decade ago. The situation has stabilised fairly well, with the economy registering a remarkable turnaround. The Malaysian economy has been posting creditable GDP (gross domestic product) growth rates in recent years (5.1 per cent in the third quarter of 2002) in contrast to a sharp 7.4 per cent contraction in 1998. The stock market has revived, although it has not reverted to the pre-crisis levels. The country has yet to completely regain foreign exchange reserves lost during the crisis, but significant progress has been made, with external reserves rising to comfortable levels. External reserves, standing now at RM170.6 billion (US$44.9 billion), are equivalent to 7.1 months of retained imports and they are 4.8 times larger than the country's short-term external debts. The employment situation has also improved markedly, although full employment remains elusive. Public debt has been growing, as a result of five consecutive years of budget deficits, but stays within prudent limits. The domestic economy is doing well also in PPP (purchasing power parity) terms, thanks to the remarkably stable CPI (consumer price index).

Whichever way one looks at it, the Malaysian economy is clearly in a much better shape now than it was in 1998. Paradoxically, all this can be used to argue a case for keeping the currency peg intact as well as to craft a case for lifting it. On the one hand, it can be argued that the ringgit peg has worked quite well, judging by the outcomes, and therefore it should remain in place. On the other hand, it can also be argued that the conditions warranting the imposition of the currency peg no longer exist and hence it is the time to de-peg the ringgit. Upon closer scrutiny, it appears that both these arguments are somewhat untenable.

The above argument in favour of the ringgit peg is flawed in two ways. First, one may question whether the currency peg really had anything to do with the subsequent performance of the economy in the first place. Did the economy do well *because* of the currency peg or *in spite* of it? Would the economy have done even better in the absence of the currency peg? Admittedly, these are hypothetical questions for which there can be no ready answers. If we were to look for clues by comparing notes with others in similar situations, we would find that Thailand and South Korea have performed just as well or even better without currency pegs. But such comparisons, strictly speaking, are tantamount to comparing apples with oranges, as there are important inter-country differences. Besides, what works in one country may not work in another.

Second, even if one were to concede that the currency peg played a key role in the revival of the Malaysian economy, it does not necessarily follow that what worked in the past will work in the future as well. The world ahead of us is far more competitive and complex than what we had experienced before. Considerations such as this underscore the need for flexibility, not rigidity, in policies and strategies.

Equally, the case for de-pegging the ringgit, based on the fact that the Malaysian economy has considerably strengthened, is not unassailable. Yes, the economy is much stronger now and a flexible exchange rate regime would have allowed the ringgit to reflect the economy's strong fundamentals. But, a counter argument would be that the current recovery cannot be taken for granted or that the situation is not irreversible, not to mention the outcry that the international monetary system and financial architecture remain outmoded and ill equipped.

To be sure, there are other reasons for keeping the ringgit peg. The currency is under no market pressure, as it is comfortably undervalued. The pressure exerted on the ringgit in the first half of 2001 in the face of falling external reserves receded definitively when the decline in foreign exchange reserves was arrested and reversed. Likewise the pressure felt in early 2002, caused by the sharply depreciating yen, also dissipated quickly as the yen began to strengthen shortly thereafter. Meanwhile, an undervalued ringgit is seen as a boon for Malaysia's exports, as it renders them cheaper and hence more competitive. What's more, the currency peg is viewed by many as a good thing, as it seems to have removed one major source of uncertainty for the businessmen.

Be all that as it may, a review of the currency peg is not unthinkable. The peg may have served a purpose during the currency turmoil, but subsequently it may also have outlived its usefulness. The point about certainty in the exchange rate is only partially valid, as the ringgit still fluctuates through cross rates vis-à-vis all currencies except the US dollar and those that are pegged to the US dollar. Since July 2001 the ringgit has depreciated 31.4 per cent against euro, 14.7 per cent against the yen, and 22.7 per cent against the sterling.

The ringgit has also depreciated considerably against regional currencies such the Singapore dollar (5.9 per cent), Thai baht (15.0 per cent), and Indonesian rupiah (12.3 per cent) since July 2001.

It is estimated that the ringgit is undervalued by over15 per cent, which admittedly is rough, subject to a wide margin of error. While an undervalued ringgit is good for exports, it is bad for imports. The competitive advantage conferred by undervalued ringgit on exports is negated to a large extent by the higher cost of imported inputs in the production of manufactured exports, given the high import content. Seen in these terms, the argument that an undervalued currency is good for exports is overblown in the Malaysian context. In any case, one cannot seriously attribute export growth to the cheap ringgit. It is of relevance to note that the exports of South Korea, Singapore and Thailand are growing more impressively at double-digit rates, despite the fact their currencies have appreciated significantly in recent times. Irrefutably, export competitiveness is a product of efforts to raise productivity and reduce cost. It will be a costly mistake for exporters to rely on an undervalued currency.

While the manufacturers of goods for the export market may have reasons to be pleased with the undervalued ringgit, the manufacturers of goods for the domestic market have little to cheer about, especially those with high import content as is indeed the case with the national carmakers. Undervalued currency creates distortions of sorts with a bias in favour of the external sector at the expense of the domestic sector, which does not jive well with the on-going government attempts at making the domestic sector the main driver of economic growth. This line of reasoning suggests that the fiscal stimulus would be more effective if the ringgit is unshackled.

Pump-priming the economy makes sense as the Malaysian economy is under-performing way below its potential growth rate, which is estimated to be about 6.5 per cent. But pump-priming alone cannot lift the economy to its potential growth rate so long as there are serious distortions in the system. Undervalued exchange rate is one such distortion that has to be eliminated in order to ensure efficient allocation of resources and to place the economy back on the growth trajectory.

To be sure, foreign investors prefer flexible but stable exchange rates. The accent is on stability, not rigidity. Flexible exchange rates act like shock absorbers in a car so that the passengers do not hit the ceiling when the car goes over a hump, providing an automatic adjustment mechanism against changes in external demand. What the economy needs is an exchange rate regime that would ensure flexible but not unstable exchange rates. Honestly, there is no pretension that such a system is easy to devise, and there is no such thing as an ideal or perfect exchange rate system, which is good for all situations, although there are several options, such as the basket peg and managed float, to consider.

There are, of course, pros and cons to the current ringgit peg. It benefits some and hurts some others. Apparently, the jury is out on whether the currency peg confers a *net gain* or a *net loss* on the economy. While there is a need for some debate on this, there are no signs that the currency peg will go anytime soon. Understandably, there is reluctance on the part of the policymakers to undo something that is perceived to be working reasonably well. Besides, getting out of a currency peg is not as easy as getting into it. The safest way to exit will be to do it from a position of strength with robust GDP growth, comfortable external reserves and a currency that is undervalued. A currency peg is best dismantled while it is still working. And, it will be a folly to wait until its stops working, if the mistake of Argentina is to be avoided.

One must hasten to add that there is no discernible threat to the ringgit peg, as the currency is not overvalued. One mitigating factor is that China's yuan is even more undervalued and it may not be in the immediate interest of Malaysian exporters to revalue the ringgit, unless the yuan is also revalued. Nonetheless, there will be a breaking point. Malaysians are becoming increasingly conscious of the fact that they are forking out more than they need to when they travel abroad, invest abroad or pay for their children's education abroad, as the ringgit continues to slide with the dollar. There will be a limit to the extent to which Malaysia would allow itself to be short-changed.

As the ringgit is significantly undervalued, it is easy for the monetary authorities to hold on to the peg, albeit at a cost. The cost to the economy stems mainly from the distortions in resource allocation and terms-of-trade losses. Yet it is difficult to say what will trigger a change in Malaysia's exchange rate regime. It is safe to surmise that if the US dollar continues to fall steadily, the ringgit peg will have to be reviewed. Many are predicting that the US dollar will fall to 1.30 against the euro in the near term. There is a 30-35 per cent chance that the US dollar would hit the 1.50 level against the euro later this year. Should all this happen, Malaysia must either revalue the ringgit by re-pegging it against the US dollar or allow the ringgit to appreciate through such other means as the basket peg or managed float.

Re-pegging is not a good idea, especially if the greenback continues to remain weak, if not volatile. More importantly, the credibility of the exchange rate regime will be lost the moment the peg is tempered with. Besides, there is the risk of exchange rate adjustment not going far enough, in which case further adjustments will be anticipated, or adjustment going too far, in which case the new ringgit-dollar rate will become indefensible. In the final analysis, the market, though imperfect, is a better judge than the administrative rule of thumb. This is not to deny that market is by no means averse to overshooting. That is why free float is not a good idea either, hence the need for government interventions to iron out short-term fluctuations in exchange rates.

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