US Monetary Policy and the Behaviour of Ringgit

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Any decision of the Federal Reserve System (also widely known as the Fed) on monetary policy is very important to the world economy. It influences many world economies mostly through trade and capital flows.

Fed is the central bank of the United States of America (US). The Fed is responsible for implementing the monetary policy of the US. The main objectives of monetary policy are to create employments in the economy and to stabilize prices. The Fed will use the monetary policy to influence the aggregate demand in the economy. One of the monetary policy instruments is the federal funds rate or simply known as fed funds rate.

Recently in the middle of March, Fed has raised the fed funds rate by 25 basis points. It was a well anticipated decision due to the state of the US economy as reflected by common leading indicators, inflation and unemployment rates. The US economy is growing healthily as unemployment registered a lower rate of 4.7% and it is declining. This rate is not far from the full-employment rate of 4.0%. Strong domestic demand has put an upward pressure on prices, as inflation escalating to a nearly 2.0%, which is the target rate for the Fed.

The Fed's decision is expected to have implications on Malaysian economy through trade and capital flows. Interest rates differential between US and Malaysia causes short-term capital outflows from Malaysia to the US as short-term investors will be rebalancing their portfolio.

In the longer run, the US domestic demand is expected to slow down if the monetary contraction policy is effective. This will have negative implication on the demand for Malaysian exports. Nevertheless, slowdown in the US demand is not expected to have

[1] The views and opinions expressed herein are those of the author and do not necessarily reflect the views of MIER.

major ramification on the overall performance of the Malaysian economy as the bulk of growth contributed by domestic demand.

The US interest rate hike is expected to exert pressure on ringgit exchange rate against the US dollar (USD). This is coming from the two channels mentioned above, trade flows and portfolio rebalancing. Lower demand for Malaysian export to the US causes ringgit to depreciate against USD. Similarly, short-term capital outflows will also put a downward pressure on ringgit.

A weaker ringgit pushes up the demand for export as Malaysian products are cheaper in dollar terms. In fact, this is good for Malaysian exports to other countries as well because the transactions are normally denominated in USD. Nevertheless, the impact of weak ringgit on export performance is transitory. What more important for a lasting impact on exports is the behaviour of other fundamentals. After all, Bank Negara is expected to intervene the market to stabilize ringgit in order to maintain overall confidence on the Malaysian economy.

It is imperative to look at the long-term behaviour of the US monetary policy and its relation with ringgit exchange rate against USD. This long-term relationship is more fundamental as one can establish a trend on the movement of both variables. Whereas, less inferences can be made by merely looking at the short-term relationship as it is subjected to short-term volatility due to many factors.

The accompanying chart shows long-term movements of the fed rates and the ringgit against USD exchange rates for the past five years. One general conclusion can be made from the trend of both variables is that ringgit tends to be stronger against USD when the fed's rates are lower. Of course there are other factors as well influencing the value of ringgit. We need to do a thorough study to establish those other factors. However, simple association between the two variables ascertains that ringgit tends to be stronger during a period of easy monetary policy in the US and vice versa for a period of tighter monetary policy.

There are two distinctive stages of the fed funds rates during the five-year period, 2013 to present. First, the stage of an easy monetary policy stance, reflected by lower rates of below 0.20% prior to mid-2015. This was corresponded to a healthy growth of the US economy. Strong demand from the US during that period matched with a strong performance of Malaysian export, which in turn, characterized by stronger ringgit against USD.

The second stage, from mid-2015 until present, underlined by tightening monetary policy as reflected by series of fed funds rate hikes, or widely dubbed in the market as normalization process. Fed's objective was to slow down domestic demand as prices are heating up. The demand on Malaysian exports are negatively affected and putting a downward pressure on the value of ringgit.

Nevertheless, ringgit exchange rate against USD is also weakened due to the strengthening of the USD. Strong USD is associated with lower crude oil prices. The collapse in crude oil prices in August 2014 has driven the value of ringgit against USD crumpled. The effect of crude oil prices on the devaluation of ringgit, through the strengthening of the USD, is certainly greater than the effect of monetary policy normalization. Ringgit has drifted from its normal trend as crude oil prices collapsed, whereas, US monetary policy stance influenced its volatility.