The yuan-ringgit axis

China's yuan and Malaysia's ringgit have one thing in common: they are wedded to the US dollar. In 1994, China devalued its currency and pegged it to the US dollar at around 8.3 yuan to the US dollar within an extremely narrow band that permits no more than infinitesimally small variations in the yuan-dollar exchange rate. Four years later, Malaysia fixed its exchange rate at 3.80 ringgit to the US dollar in the midst of the 1997/98 financial crisis.

To be sure, the term "peg" is a misnomer in both cases. A true peg implies limited flexibility within a ceiling and a floor. Strictly speaking the ringgit is rigidly fixed, not pegged, to the dollar. At best, it is a quasi-peg for the yuan, as its exchange rate band is extremely thin with hardly any space for flexibility.

Be all that as it may, the market perceptions are that both these currencies are significantly undervalued. China today is very different from what it was in 1994. The Chinese economy has been growing at near-double digit rates year after year. All signs are that China is unable to rein in economic growth, despite policy efforts. The Malaysian economy too has turned 180 degrees since 1998, growing at a creditable, albeit somewhat unsteady, pace. Both China and Malaysia have increased their external reserves enormously. China's reserves have swelled from US$143 billion in 1997 to US$578 billion in 2004, while Malaysia's reserves have grown from US$21.7 billion to US$66.7 billion during the same period. It is quite obvious that the growing inherent strengths of the fundamentals of these two economies are not reflected in the exchange rates.

The fact that both China and Malaysia have been able to enjoy persistently large trade and current account surpluses also suggests that there are serious exchange rate misalignments. What is more, these currencies are depreciating now that the US dollar, to which they are shackled, has been declining in value in the wake of the ballooning US current account deficits. It is not difficult to understand why the US dollar must depreciate, but there is absolutely no reason for the yuan or the ringgit to follow suit.

According to estimates, the yuan is undervalued by 20 to 38 per cent, while the ringgit is undervalued by 6 to 12 per cent. It is impossible to be accurate in equilibrium exchange rate calculations and all estimates are usually subject to 5-6 per cent margin of error. Even so, it is fairly clear that exchange rate realignment is long overdue for both the yuan and the ringgit, if balance of payments (BOP) is any measure.

China has come under intense international pressure to let its currency appreciate. The United States, which has a huge bilateral trade deficit with China, is spearheading efforts to persuade, if not force, China to de-peg its yuan. It is noteworthy that China accounts for roughly one-quarter of the US trade deficit. In theory, dollar appreciation would help reduce the US trade gap, but in practice the problem for the United States is that some currencies are tied to the greenback. A sizeable appreciation of the yuan would allow the United States to export more to, and import less from, China. Hence the pressure from the United States. Euro-zone is also exerting much pressure on China, because the euro has been bearing the brunt of exchange rate adjustments thus far and an appreciation of the yuan would relieve the pressure on the euro.

Malaysia is not under such international pressure, partly because Malaysia is comparatively a small player and partly because the extent of ringgit undervaluation is also relatively small. Nonetheless, there are market pressures of sorts on the Malaysian ringgit, if the recent surge in short-term capital inflows is any indicator. Last year, Malaysia registered a BOP surplus of RM83 billion, up sharply from RM39 billion in 2003. It is pertinent to note that portfolio investment (equity and debt securities) accounted for nearly 40 per cent of the overall BOP surplus in 2004, up dramatically from 10.7 per cent in the preceding year.

There are ominous signs that the fixed exchange rate regime is beginning to hurt the Malaysian economy. Large speculative inflows placed largely on the money market have to be sterilised. Depreciating ringgit has caused the cost of imports to rise significantly, fuelling inflationary pressures. The fixed exchange rate system is also causing distortions in resource allocation at the expense of the non-traded sector, not to mention the bias created against imports from countries whose currencies have appreciated markedly, especially the European Union, Japan and South Korea. It does not bode well for foreign direct investment (FDI), as foreign investors tend to delay investments pending anticipated exchange rate changes: it will not be profitable for them to bring in their machinery and equipment at current rates now and sell their output at a different rate later on. Hence, the wait-and-see attitude. Moreover, undervalued ringgit tends to negate the government's efforts at brain gain, as it tends to encourage employment abroad.

One must hasten to add that the undervalued ringgit has a positive facet as well. It is good for the competitiveness of manufactured exports, primary commodities the prices of which are quoted in US dollars, domestic tourism and the local education industry. However, competitiveness based on cheap currency cannot last long, as rising cost of imported intermediate inputs and high domestic inflation will erode away any such competitive advantage. Exchange rate stability is, of course, good for trade and investments, but the ringgit is stable only against the anchor currency and those currencies that are also tied to the dollar, like the Chinese yuan and the Saudi rial. The ringgit is very volatile against all other currencies.

One compelling reason why Malaysia must disband the fixed exchange rate regime is that the status quo is just not sustainable. The dollar is likely to depreciate even more dramatically in the near term. Many analysts think that the dollar will have to depreciate by another 30 per cent by 2008 so that the US current account deficit can be brought down to a sustainable level of 3 per cent of GDP (gross domestic product). If the ringgit were to remain shackled to the dollar till 2008, export competitiveness will suffer, with the cost of imports shooting over the roof and domestic inflation taking a toll. When the crunch comes, the ringgit appreciation will be so large and so sudden that the Malaysian economy will have severe difficulties in coming to terms with it.

Seen in these terms, it is better to untie the ringgit now and allow it to appreciate gradually as the dollars continues to decline. Since any appreciation of the ringgit will dent the country's GDP growth through temporary loss of export competitiveness, it would be better to exit from a position of strength when the economy is growing at a robust pace and commodities are doing well. Primary commodity producers will, no doubt, lose out from ringgit appreciation but high commodity prices can compensate.

The joker in the pack of exchange rate cards is the yuan. China is better connected regionally and globally now than it was a decade ago. China is the second largest economy in Asia. Any move by China on the yuan exchange rate will have far reaching impacts on other currencies, with serious financial and economic consequences. Countries with fixed exchange rate regimes are more vulnerable to such shocks than the ones with flexible exchange rate regimes.

Some observers believe that Malaysia will not review its currency "peg" until and unless China reviews its own. The logic for this is that Malaysia would lose out to China in the export markets for electrical and electronic products, should Malaysia allow its currency to appreciate while China remains stuck to its own peg. There is certainly a point in this argument. But there are other considerations calling on Malaysia to "de-peg" regardless. For one thing, the loss of export competitiveness will be temporary and will be tempered by the falling cost of imported components and parts and lower domestic prices. For another, the cost of "de-pegging" after China will considerably exceed the cost of doing it before China.

China is unlikely to un-peg anytime soon. China may have sound reasons for delaying it. There are concerns that a stronger yuan would impact adversely on China's fragile banking sector, ailing state-owned enterprises, weak agriculture and feeble labour market. For China, what matters most is domestic stability, not external balance. China is unlikely to yield to external pressures to float its currency, if its 3,000 years of history is anything to go by. China will "use" external pressure – like acupuncture - only if it wants, at its own pace and on its own terms. China may also use an exchange rate regime change as a "bargaining chip" in exchange for better market access or geopolitical concessions from major trading partners. In other words, it is not advisable for Malaysia to wait for China on exchange rate policy.

While China may have valid reasons for delaying shifts in the yuan exchange rate, these are of no relevance to Malaysia. Malaysia's economic fundamentals are much stronger: its financial sector, in particular, rests on solid foundations. Besides, by pre-empting China, Malaysia can avoid bigger losses. If China were to do it first, there will be massive capital inflows into Malaysia, forcing, and profiting from, large ringgit appreciation. China, with its huge domestic market to fall back on, can afford to make mistakes, but not Malaysia with a small domestic economy.

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