The ringgit still under the dollar's spell

The Malaysian ringgit had remained shackled to the US dollar since September 1998 in the aftermath of the Asian financial crisis of 1997/98. It was often argued that the currency peg had outlived its usefulness. Finally, at long last, Malaysia plugged courage and de-pegged the ringgit on 21 July 2005 immediately after China abandoned its own currency peg.

Nothing much has happened to the exchange rates since then, quite contrary to market expectations. Bank Negara Malaysia (BNM), the central bank, has now in place what is termed as a "basket peg", which means that the ringgit is now tied to a basket of currencies. In fact, BNM has reverted to time-tested practices. The ringgit is now tied to an unknown basket of currencies with unknown weights, as was indeed the case before the crisis. What is "new" about the new regime is that it appears that there is no more exchange rate targeting or offshore currency trading.

The disbanding of the peg on 21 July 2005 has turned out to be a non-event in the sense that it has not led to significant exchange rate changes. Some would argue, like BNM, that the ringgit was at "fair value" when the currency was de-linked from the dollar and the conditions have not changed much subsequently to disturb that equilibrium. The ringgit-dollar exchange rate reached 3.746 on 2 August 2005 before sliding to 3.780 on 15 November 2005. In other words, MYR has appreciated by 0.5 per cent from the previously fixed rate of 3.80.

That the ringgit has not appreciated much against the US dollar since de-pegging is not really a big surprise. Yes, estimates had shown that the ringgit was undervalued by 10-12 per cent as at end-2004. But, it is important to underline that the ringgit had already appreciated by over 12 per cent against the euro and over 10 per cent per cent against both the yen and the sterling, between 2 January and 21July 2005, thanks to the currency peg. To be sure, this trend has continued even more strongly after the de-pegging. All in all, during January-November this year, the ringgit strengthened by 18.6 per cent against the yen, 15.8 per cent against the euro, and 12.4 per cent against the sterling. It is also noteworthy that during this period the ringgit has appreciated vis-a-vis regional currencies as well: 6.5 per cent against the baht, 8.5 per cent against the rupiah and 4.1 per cent against the Singapore dollar.

More recent estimates, after the de-pegging, have shown that the ringgit is undervalued only to the tune of 5-6 per cent, which of course is subject a wide margin of error. It is only against the US dollar that the ringgit has remained almost stationary since the de-pegging, which is attributed apparently to the strength of the US dollar. Another plausible explanation is that the ringgit is still shackled to the dollar, despite the de-pegging.

It is fairly obvious that the ringgit is on a tight leash, despite the claim by BNM that the currency is on a “managed float”. The reality is that the ringgit is hardly floating. At best, one might condescendingly call it a “controlled float”. Recent calculations using econometric techniques have shown that the ringgit still remains too close to the dollar, quite unlike other regional currencies. Chinese yuan, Singapore dollar, Thai baht and Korean won are also basket-pegged, just like the ringgit. However, the econometric exercise has shown that the ringgit and the yuan are still too close to the dollar in comparison with other currencies, although the dollar remains the single most dominant factor in all cases. The econometric study, which tracks daily movements in exchange rates during the period 22 July – 30 Nov, suggests that the US dollar weighs 63 per cent for both the Singapore dollar and the Thai baht, 54 per cent for the Korean won, 96 per cent for the Chinese yuan and 100 per cent for the Malaysian ringgit.

As alluded to above, it is not hard to figure out that the ringgit is still under the spell of the greenback. Interestingly, the ringgit stays very close to the dollar, moving almost in tandem. The ringgit has been strengthening against the regional currencies whenever the dollar was gaining and weakening against them whenever the dollar was losing. One may infer from all this that the dollar is clearly the single most important element in BNM’s currency basket. The weights assigned to the various currencies in the basket are said to be trade-weighted. The US share in Malaysia's total trade is roughly one-fifth. However, the bulk of Malaysia's trade is denominated in US dollars.

The main concern of BNM is understandably exchange rate stability. Malaysia's exchange rate policy will remain unchanged so long as the dollar remains strong and stable. The other major currencies, including the euro and the yen, have been quite volatile lately. The ringgit is likely to stay somewhat glued to the dollar for now and in the near term. The chances are that BNM would distance itself from the dollar only when the dollar rally ends and the downtrend begins. It is almost certain that the current dollar rally will not last long. The ballooning balance-of-payments (BOP) current account deficits and huge budget deficits in the US will definitely warrant major corrections, which must include substantial exchange rate depreciation and significant expenditure adjustments. The ringgit will not drift away from the dollar until this begins to happen.

In the near term, the ringgit is expected to maintain its current position vis-a-vis the greenback, although it would continue to appreciate against other major currencies, as the dollar would. During the last two months, Malaysia has gone into a huge overall BOP deficit for the first time since the last financial crisis, despite running a substantial current account surplus. In October, the capital account suffered a deficit of RM17 billion, according to estimates, as some of the foreign speculative capital, estimated at RM50 billion, quit the ringgit assets and bolted out. This has led to a sharp fall in foreign exchange reserves and consequently a marked deceleration in broad money growth, which in turn has caused the equity market to be bearish.

To avoid a weaker ringgit in the wake of foreign capital outflows, the central bank has undertaken large-scale money-market operations, neutralizing the impact of its foreign exchange operations. BNM has been unwinding its borrowings from the banking system, so as to augment liquidity in the system.

There are concerns that foreign short-term capital outflows may be followed by domestic capital outflows as well, now that the restrictions on capital outflows by domestic residents have been lifted. The fact that BNM has been pursuing a loose monetary policy with a low interest rate regime further fuels such concerns. The nominal interest rate on 3-month deposit is below the current inflation rate, which renders the real interest rate negative. Inter-bank rates have been lower in Malaysia than in the neighbouring countries. It is not unreasonable to assume that such considerations had led BNM to raise the interest rate on 30 November by 30 basis points. The increase in the Overnight Policy Rate (OPR) is understandably small, as BNM is mindful of the adverse impact it may have on domestic consumption and investment at a time the economy is gliding into a lower growth mode.

It is worth mentioning in passing that the recent interest rate increase does not necessarily imply a policy reversal. The monetary policy remains accommodative, considering the fact the real interest rate is still negative. It is pertinent to note that, according to BNM, interest rates are still below their “neutral” rate, which means that there is still room for future rate hikes. What all this implies for the exchange rate is that the ringgit should grow stronger, not weaker.

Emeritus Professor Mohamed Ariff Abdul Kareem is the executive director of the Malaysian Institute of Economic Research (MIER)