

27/07/1997

Historical aspect of forex rates regime

Shaik Osman Majid

AS the ringgit eased against the US dollar by four per cent over the past month, we last week looked at the question of how foreign exchange rates are worked out.

Since then the ringgit had weakened further. What happened?

First let us recapitulate how the exchange rate works. In a normal situation, importers and exporters venture into this market. People like you and I might desire foreign currency, both in currency notes and travellers cheques when we travel abroad. But the quantum travellers require pales into insignificance compared with the volume foreign exchange businessmen demand.

The importers have to exchange the foreign currencies to ringgit to pay for their sales. They might also like to have some funds in foreign exchange to finance future sales, perhaps as a hedge against the fluctuating regime of foreign exchange rates. They are now allowed to maintain foreign currency accounts in at least 10 of the 32 commercial banks that are designated as Tier One banks and permitted, among other things to provide foreign currency account service without the approval of Bank Negara.

Exporters also require a similar service. They would prefer the revenue from exports to be exchanged in ringgit in the country, although some if not many might desire to maintain foreign currency accounts in the designated banks to pay for imported components.

Besides the Tier One banks, the rest of the commercial banks as well as eight appointed foreign exchange brokers provide this foreign exchange service, though the latter two groups cannot provide clients with foreign currency accounts. To serve you and I who want to travel abroad we have also access to over 500 authorised money-changers who often give a better rate.

This is the backdrop of the foreign exchange rates regime. But question remains: how are the rates worked out? Going through the pages of history gives us some insights.

In the past, the Malayan dollar and later the ringgit which entered the world of international currencies on June 12, 1967, cut their umbilical cord to the Sterling and the US dollar by 1973, resulting in a free floating rate. No longer was the central bank bound to buy the US dollar at the floor rate of 2.485. The old imperial rate of over eight Malaysian dollars to the British pound was thrown into the dustbin of history.

Banks were left alone to determine their own rates of exchange. The central bank only intervened to maintain an equilibrium in the market and preserve the value of the ringgit. Still it was not the best of regimes. For a host of factors determined the value of currencies.

Black gold or oil was spouting in voluminous amounts from the soils of several countries. For long these countries accepted the terms of the infamous seven sisters of oil-companies; all except one, were American. The rates of extraction were cheap; the royalties were low; and the profits for the Seven Sisters was unconscionably high.

In 1972 the Gulf countries joined forces with other major oil producing countries, which produced more than a million barrels of oil per day, to form the Organisation of Petroleum Exporting Countries. Opec began to dictate terms. They forced changes in the profit-sharing contracts and exacted greater profits. This galvanised the price of crude oil from less

than US\$10 (about RM25.80) to over US\$35 by the early 1980s.

The result was far-reaching. Countries that had to have millions of barrels of refined petrol suddenly found themselves at the wrong end of the economic stick. Their currencies in the international market plunged.

Malaysia in the early 1970s was a nascent economy with a Gross Domestic Product of less than RM10 billion, heavily dependent as it then was on basic commodities, like rubber and oil palm, which then did not include petroleum. And so the country went into a recession as a result of the spiral in the price of oil. The Government had to reintroduce cost of living allowances to public servants.

But on the international exchange market, the ringgit stood its ground. Indeed it appreciated against the US dollar, the sterling and even the Japanese yen. Consider the facts.

Bouts of repeat increases in price of crude oil in the late 70s and early eighties realigned the value of major currencies in the international exchange market. The once redoubtable British pound was humbled and exchanged for a mere RM2.6 in 1986. Hardly 16 years earlier it commanded 8.8 Malayan dollars. The US dollar weakened to almost RM2 to a dollar. And the Japanese yen could be exchanged for 110 for a single ringgit that year.

And the common thread that binds the three weakened currencies then was their dependence on imported crude oil. And they had to pay more, far, far more for the oil. And they dug deep into their international reserves to pay their bills. Thus as a former merchant banker who is also an economist says: "Reserves are a big factor in determining the rate of the local exchange vis-a-vis other major currencies. If any country has large enough reserves, it will be able to endure the fluctuations of currency exchange rates."

This, to be sure, is just one thesis, that explains past pressures on some major currencies and the present squeeze on some of the Southeast Asian currencies.

The assault on the baht that eventually resulted in a loss of 20 per cent to the US dollar is only partially explained by the weak external reserves of Thailand.

The primary problem of the baht was that it was pegged to a basket of currencies dominated by the US dollar. But banks and finance companies, in the 1990s, were munificent in parcelling out huge loans to developers. These builders suffered when they discovered few takers for their units, resulting in a property glut.

The lenders had to meet their obligations to the providers of funds in US dollars. This obligation plus a contraction in exports in April by a hefty 11 per cent chipped away at the current account deficit. Which hit a high of eight per cent of the country's GDP, the highest compared with those of the Philippines, Malaysia and Singapore.

In addition the financial system could not capture the disposable income of the Thais, the primary reason why lending interest rates continued to climb higher and higher from May to the first week of July when it was 13.75 per cent per annum.

Monetary and fiscal leadership was, to say the least, inconsistent and vacillating. Three changes in Government in as many years and six Finance Ministers in five years do not foster confidence among the business and finance community.

True, some assume the currency turmoil in Thailand raises questions about the region's prospects. The question is: what are the consequences of the Thai de facto devaluation on our currency.

It has been widely speculated that some "rogue speculators", as Prime Minister, Datuk Seri Dr Mahathir Mohamad put it last Thursday, have been

mounting assaults on the currencies of some of the Southeast Asian countries. Last Wednesday Dr Mahathir, upon his return from his two-month leave, said that one individual with billions of dollars at his disposal might be the culprit who is attempting to change the equilibrium of the ringgit vis-a-vis major currencies.

Among the individuals widely rumoured to be behind the assault on the regional currencies is George Soros, who in 1992, through vocal campaigns, coerced Great Britain to get out of the European Monetary Union. He is a very powerful man with a very, very deep pocket. But he had issued a denial on Wednesday that he is not the shaker or mover of money markets in Southeast Asia.

Be that it may, we should examine our own foreign exchange market and address two primary questions: one, why is our ringgit weakening against the US dollar and why are our interest rates going up and up.

(END)