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Fixing true value of the ringgit

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THERE have been calls to remove the ringgit peg at US\$1 to RM3.80 because it is undervalued. However, the calls heard so far to revalue the ringgit do not say much as to how the true value of the ringgit should be allowed to be determined.

There are three basic options, that is, a fixed exchange rate, a flexible exchange rate and a floating exchange rate.

Some have argued that to overcome the problem of being undervalued, the ringgit should be revalued and fixed at RM3.50 or RM3.30 to the US dollar.

However, how this figure has been derived is not clear and has not been elaborated upon. Some have suggested a fixed exchange rate should be one that generates an equilibrium in the current account or the current plus capital account. If this occurs then the foreign reserves of the country will not grow. However, what rate will equilibrate the balance of payments is not known especially in a dynamic external environment.

One way to fix the exchange rate is to calculate the long-run real equilibrium exchange rate of the ringgit. Some researchers have done this for several years before the 1997 crisis and during the crisis year and found that the ringgit was only overvalued by about 6-7 per cent and yet it depreciated by more than 50 per cent. How does then one explain the large and sudden depreciation by 50 per cent when the ringgit was only overvalued or misaligned by 6-7 per cent and hence, only expected to depreciate by 6 per cent or 7 per cent?

Several observers, including former Prime Minister Tun Dr Mahathir Mohamad, have commented that the unexplained sudden and large devaluation was caused by currency speculators as predicted by the second-generation model of currency crises. According to this second-generation model, a currency crisis need not be based on economic fundamentals. It can be triggered by both objective and subjective expectations of the future growth prospects of the economy. If a country is on a fixed exchange rate and exports are not growing and the current account surplus is tending towards the negative, then that news will trigger a speculative attack on the ringgit.

Malaysia's current fixed exchange rate regime has generated huge current account surpluses due to two central factors, that is, the competitive fixed exchange rate and the increased demand from the world economy for Malaysian manufactured exports. The vastly increased current account surplus and foreign reserves have led some, including the London-based Economist magazine, to comment that the opportunity cost of a large foreign reserve is immense and reflects foregone opportunities. However, what is forgotten is that the large reserves are necessary to defend the ringgit from another speculative attack.

Some recollection will indicate that the Singapore dollar and the yuan were not subject to a speculative attack in 1997 because both the countries had large foreign exchange reserves. Thailand abandoned its managed float regime because it had run out of reserves and Malaysia followed soon after. History has taught us one lesson, that is, not to be caught without sufficient reserves to defend the value of the ringgit. This is one aspect of exchange rate management that the "undervalued ringgit" school of thought has ignored.

If one is to recollect, the Singapore dollar was not internationalised in 1997 but the ringgit was. This led to speculation of the true value of

the ringgit in offshore markets and caused a free fall and multiple equilibria in the value of the currency. Once capital controls and a fixed exchange rate were implemented and the ringgit was de-internationalised the speculative activities on the currency ceased.

The speculative activities had nothing to do with discovering the intrinsic value of the ringgit but had all to do with extracting financial rents from the East Asian countries.

Coming back to the current debate on the value of the ringgit, some institutes have suggested that the managed float is the best exchange rate regime because it means that the value of the currency can be allowed to appreciate when its demand goes up. The demand for the ringgit is a derived one because it depends on the demand for Malaysia's exports. So the proponents of the "undervalued ringgit" school are suggesting that when the demand for Malaysia's exports go up, the ringgit can be allowed to appreciate and vice-versa. However, the danger here is that when the demand for the country's exports decline, it may trigger a speculative attack that is likely to be successful because it is staged when exports are declining and hence, reserves are declining. If reserves decline it implies that there may not be sufficient reserves to defend the ringgit. So allowing the ringgit to fluctuate in value as Malaysian exports fluctuate has in-built dangers of generating a speculative attack, which Bank Negara Malaysia, the central bank cannot easily ward off because it will not have sufficient reserves.

There are, therefore, dangers in tinkering with the exchange rate regime because it may lead to speculative attacks. Also it is difficult to estimate the long-run equilibrium exchange rate as it keeps changing with economic fundamentals. The best way to allow the exchange rate to reflect its long-run equilibrium value is to adopt a flexible exchange rate regime. Under the flexible exchange rate regime, however, the exchange rate may fluctuate violently as it did during the 1997-1998 crisis, when Bank Negara abandoned the managed float regime because of insufficient reserves and allowed the ringgit to float to find its true value. The exchange rate overshot and did not settle at a rate that was stable until a fixed exchange rate regime was implemented.

It should be pointed out that there is perhaps only one country that has adopted a flexible exchange rate regime and that is the US. It is a relatively large economy which is not so dependent on international trade. The external trade of the US only amounts to about 10 per cent of its gross domestic product. The value of the US dollar has fluctuated and declined considerably in the recent past, and this has created concern to the

"undervalued ringgit" school.

However, to remove the peg is not an easy task because most of the exports are generated in the foreign enclave sector, which is dominated by American investments. The multinationals (MNCs) find the current fixed exchange rate competitive as evidenced by the burgeoning foreign reserves. Furthermore, the payments system is denominated in US dollars and abandoning the peg with the US dollar seems impracticable. What is often ignored is that there is already some partial dollarisation of the Malaysian economy.

The "undervalued ringgit" school is concerned that the current fixed exchange rate is causing the import bill to rise, especially for imported inputs for the Proton and Perodua cars. Also middle-class consumer goods are getting expensive and affecting the lifestyle of the middle-class. On the other hand, an overvalued ringgit will increase imports after a lag and cause exports to decline, which will cause the current account balance to deteriorate and foreign reserves to decline, and this will in

turn create a depreciation of the ringgit and we may end up where we first started or possibly be worse off.

What is needed is perhaps a more diversified economy to reduce Malaysia's vulnerability to fluctuations in the external demand for its manufactured goods, especially electronics and electrical goods.

The current effort to diversify into high value-added electronics and manufactured goods, biotechnology and agriculture may do more to strengthen the ringgit and ensure its stability than any effort to tinker with the exchange rate regime. Diversified sources of exports will also provide more assurance that the ringgit will not come under a speculative attack. A diversified export base will ensure lower risks and higher returns to holding the ringgit.

Furthermore, the capital controls are effective because some countries like India have been able to avert financial crises because they did not implement capital account convertibility as recommended by the International Monetary Fund. This implies that long-term sustainable capital flows will be encouraged while short-term bank loans and foreign portfolio investments will be discouraged.

Therefore, there are still good reasons to maintain the fixed exchange rate at the present level and regulate the flow of short-term speculative capital.

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