

Assessing the undervalued ringgit

MONETARY POLICY:

As with life,
exchange rate
gyrations are
cyclical

THE governor of the Bank Negara, Tan Sri Zeti Akhtar Aziz, has been consistent in her assertion that the ringgit is undervalued. The market consensus is that the ringgit will trade at its true value when the current circumstances afflicting the economy are set aright.

The global slowdown and the depressed commodity prices — commodities constitute one-third of our exports — have contributed much to the 20 per cent slide in the ringgit's exchange rate this past year. Added to these factors are the political ructions surrounding 1Malaysia Development Bhd.

Shrinking current-account surpluses or growing deficits and falling foreign-exchange reserves do not inspire confidence in an economy and its currency. As Bank Negara stems the unrelenting fall of the ringgit, its foreign-exchange reserves are at a six-year low, having fallen 20 per cent this year.

The aftermath of the 2008 financial crisis saw the United States Federal Reserve pumping more liquidity into the economy through quantitative easing or QE (printing

money to buy government and corporate bonds). It also reduced the benchmark interest rate to almost zero. This loose monetary policy flooded emerging markets with funds in search of better returns. With the tapering of the QE in late 2013 and the impending Fed interest rate hike, the funds are being sucked back into the perceived safety of US assets, depressing in their wake the emerging-market currencies, including the ringgit. The recent announcement of asset sales by 1MDB, China's support of our bond market and Saudi Arabia's assurance that it will stabilise oil prices have lifted the ringgit higher. Being an open and export-dependent economy, the ringgit swings at the instance of such developments.

To the extent that the ringgit is trading much below the rate at which it was pegged to the US dollar (RM3.80) following the 1997-98 Asian financial crisis, one could surmise that the ringgit is undervalued.

Currencies become overvalued or undervalued when they are misaligned to the economic fundamentals. Such misalignment can pose a threat to a country's financial system.

Many Asian economies boomed in the early 1990s on undervalued currencies. This unsustainable growth portended the Asian crisis. George Soros earned a billion dollars in 1992 by forcing the devaluation of an overvalued British pound. Similarly, the devaluations of the Turkish lira in 1992, the Mexican peso in 1994 and the currencies of South-East Asian countries in 1997-98 revealed economic imbalances.

Some economists consider that a currency is at its true value if the current account is in balance, that is, exports of goods and services equal imports. On this criterion, the Chinese yuan is undervalued given its huge surplus. Indeed, for the past year ending September 2015, China's surplus, at US\$279 billion (RM1.12

trillion), was the biggest in the world, compared with Malaysia's puny US\$8 billion. Notwithstanding, the surplus signifies that the ringgit is undervalued, as current sentiment suggests. The US posted a deficit of US\$429 billion for the year ending June 2015.

We may want to debate if the dollar is overvalued. Although flawed, the purchasing-power-parity theory offers another perspective to assess a currency's exchange rate. The theory posits that over the long term, the exchange rate will move to a position where a particular basket of goods costs the same in any two countries when the cost in one country is converted into another's currency.

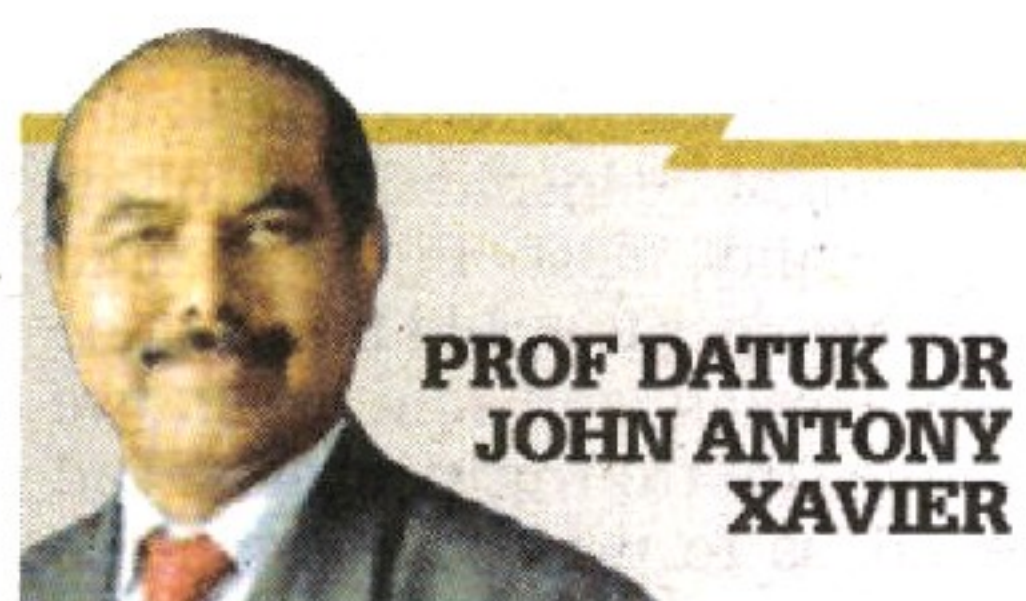
Given the complexity in calculating the prices of the same basket of goods across the world, *The Economist*, a weekly magazine, offers a simplistic yet fascinating index to assess a currency's alignment. The index compares the price of McDonald's Big Mac burger — chosen for its uniformity in quantity and quality — across the globe in equivalent US dollars at prevailing exchange rates. If the cost of the Big Mac is higher in a particular country than in the US, then the exchange rate of that country's currency is overvalued vis-à-vis the greenback and vice versa. On this basis, the ringgit is roughly half its fair value. China is undervalued by 40 per cent, the yen by 38 per cent and the euro by 15 per cent. The rouble is the

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Over the long term, under a flexible exchange rate mechanism, currencies will find their true value through a match between the demand for and supply of them. Many factors determine these forces. Take public debt for example. Our debt, including contingent liabilities, hovers around 70 per cent of gross domestic product (GDP). As such, continued outflows of funds remain a grave risk as the market ponders over the ability of the government to service its debt. Foreign holdings of government securities nudge 46 per cent. Our inflation rate will rise if the ringgit continues to depreciate. Research suggests that a 10 per cent depreciation will spike inflation by two per cent. This might further add pressure on the declining ringgit.

Partly on account of the moribund economic state of our trading partners, excepting the US and India, Malaysia posted the smallest current account surplus of RM5 billion in over two years in the third-quarter this year. Representing two per cent of GDP, the narrowed current surplus could skid into a deficit if our trading partners continue to be poorly in health. Economic performance, albeit within target and nudging five per cent, is short of sterling when compared with the growth rate required to become a rich nation by 2020. It will be a two-fold setback if a trade deficit compounds the persistent budget deficit. India's perennial budget deficits and its widening trade deficit keep the value of its rupee depressed. As with life, exchange rate gyrations are cyclical. They resonate to the rhythm of the heartbeat of an economy. But one should not despair. Difficult times always lead to better days.

Currency depreciation promotes export competitiveness. A 10 per cent depreciation of a currency will boost net exports by roughly one per cent. And Dani Rodrik, a Harvard professor, argues provocatively that an undervalued exchange rate promotes economic growth. The undervalued yuan is a testament to the power of monetary policy to help revive an ailing economy.

There is no foolproof mechanism to determine whether a currency is trading at its fair value. But there is wisdom in the counsel of the multitude. If the market thinks that the ringgit is undervalued, then it should be so!

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