Revisiting The Ringgit Peg

Summary:

- *Speculation of a change in the ringgit peg has resurfaced as Chinese officials spoke on increasing RMB flexibility.*
- *While there is little domestic pressure to move the ringgit anytime soon, politicians and policy makers have expressed their intention to re-look at the ringgit peg.*
- *The 12-month ringgit NDF has priced in 2% appreciation.*
- *Several players have already called for a move towards a managed float regime sometime next year, although we believe it is still contingent to Chinese RMB policy.*
- *In terms of the ringgit's fair value, consensus is that the currency (NEER terms) is about 5-7% weaker than Sep 98.*
- *With the authorities likely to keep the currency a little undervalue, expectation is that ringgit will only appreciate in line with the RMB appreciation of 3-5%.*
- *Market expects USD/MYR to trade around 3.61-3.68.*

The ringgit, which is pegged at RM3.80 against the USD, has fallen significantly in the last three years against other major currencies. It is now more than 50% and 30% cheaper against EUR and JPY, respectively. Recently, speculation of a change in the ringgit peg has resurfaced as Chinese officials spoke on increasing RMB flexibility, in which markets are now pricing a move of 3-5% within the next 3-6 months. While there is little domestic pressure to move the ringgit anytime soon -- except for our usual argument of a change during economic strength and a market based FX regime to further endorse PM Badawi's market friendly leadership - politicians, policy makers have expressed their intention to re-look at the ringgit peg in the event of a RMB revaluation. In the MYR NDF markets, trading activities have extended to 12-mth tenor from the usual 1-3 months play. The 12-mth NDF is currently priced at around 3.72 (about 2.0% ringgit appreciation). Indeed, capital inflows have pushed the FX reserves to $63bn on Nov 30, rising $8.4bn over the last three months. Several players have already called for a move towards a managed float regime sometime next year, although we believe it is still contingent to Chinese RMB policy.

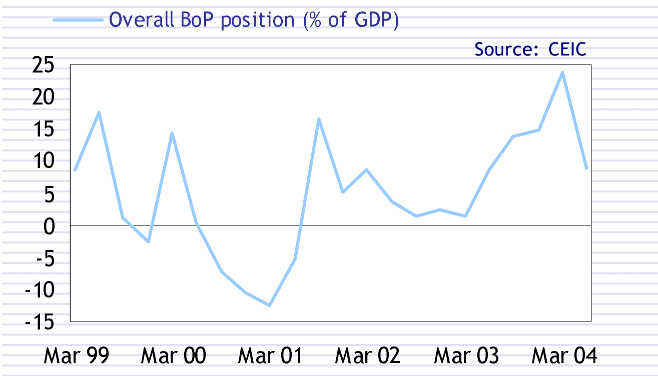
In terms of the ringgit's fair value, it is actually quite difficult to ascertain, although consensus is that the currency (NEER terms) is about 5-7% weaker than Sep 98 (which the authorities then assumed the ringgit was fairly valued). With the authorities likely to keep the currency a little undervalue, given the lack of inflationary pressure as well as recent capital inflows betting on the ringgit move likely to cash out, expectation is that ringgit will only appreciate in kind with the RMB appreciation of 3-5%. Markets expect USD/MYR to trade around 3.61-3.68, with the BNM likely to aggressively moderate the extent of ringgit gains.

However, the current capital restrictions are likely to stay, as most Asian CBs have put in place some sort of FX restrictions to ward off speculators' activities. Thus, a proxy for the ringgit story will be via buying SGD given its similar export make-ups and destinations. Indeed, we are already hearing options strikes on USD/SGD at sub-1.60 over the next 9 months.

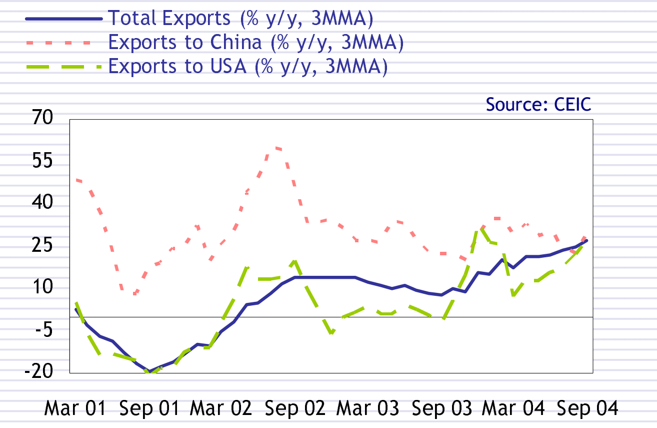
A change in strength rather than in weakness

Malaysia's external position remains robust, even though the BoP surplus fell to 9% of GDP in Q2-04 from 24% of GDP previously. This is mainly due to higher export earnings amid rising demand for the electronics products and firm commodity prices. On the back of a firmer BoP, the foreign reserves position stood at US$63bn as at 30 Nov 2004, equivalent to 7.8 months of retained imports and 5.8X of s-t external debt. Certainly, a change in a position of economic strength is easier to manage than the market forcing a change during a period of weakness, which could trigger severe FX volatility.

BoP Position Remains Robust



Exports Growth Recovered On Higher Global Demand



A step towards market based reforms

Since Badawi took over the helm, efforts have been geared towards market based reforms. Over the last one year, PM Badawi has embarked on widespread reforms, in particular improving public sector governance and efficiency. Budget 2005 also focuses on increasing competitiveness and enhancing the effectiveness of government financial management. The new mood of Malaysia seems to be based on productivity growth and less reliant on FDI. Indeed, a ringgit move towards a more market oriented regime is very much perceived as a finale of Badawi's market based reforms.

Politicians say so....

Perhaps, more importantly, any move on the ringgit regime is because politicians have expressed their intention to do so. Here are some of the statements made by policy makers over the past months…

Jan 2004 …PM Badawi made it clear that the government is not dogmatic about the peg and if the situation warrants a change, then they will go for it.

Jan 2004 …Malaysian Institute of Economic Research (MIER), the think-tank for Malaysian government, identified three breaking points that will prompt a ringgit repeg. These are – (i) if China revalues its yuan, (ii) if the dollar hits 1.40 against the euro and (iii) if the yen falls below 100 to the USD.

Nov 1, 2004 …PM Badawi said that Malaysia is closely monitoring the developments in China's monetary policy and the government is in touch with the monetary authority in China. However, at the moment, they are maintaining the peg. He later added, "If the Asian currencies fluctuate by about 20% either way and that seems to be permanent, or at least to last a length of time, then an adjustment will have to be made to the exchange rate of Malaysia."

Nov 3, 2004 …BNM governor Zeti Akhtar Aziz said that Malaysia's ringgit is close to its fair value at its pegged rate of 3.8 to the dollar. However, from time to time the prevailing and expected conditions will be reviewed and all options will be considered.

Nov 6, 2004 …Second Finance Minister, Nor Mohamed Yakcop (also the architect of the peg) said that Malaysia would seriously consider reviewing its peg if the US currency falls to 1.40 per euro and below 100 yen. He said, "If the two currencies strengthen to beyond those levels (against the USD) we do not want the ringgit to be out of whack."

Nov 21, 2004 …The PM said that Malaysia's decision on whether to change its peg would not depend on any adjustments to China's foreign-exchange regime.

Nov 30, 2004 …The CB governor stressed that Malaysia intends to retain its RM3.8 peg to the USD, noting that "right now, the exchange rate level is not misaligned." She further added that Malaysia would review the ringgit peg only in a case of structural change in the region.

While there has been some moderation in the tone of policymakers' remarks, we think it is more related to not overly committing themselves. In all, we think there is still a good chance of a ringgit change in the event of a RMB change. Further, policymakers have repeatedly affirmed that they are no dogmatic about the ringgit peg and are open to drop it when the structural change happens.

Little domestic pressure to move the ringgit

The economy is expected to grow by 7% y/y in 2004 and another 5.6% y/y in 2005, while the fiscal gap is expected to improve to 3.8% of GDP in 2005 from 5.3% in 2003. Meanwhile, the country's current account surplus remained at a robust 12% of GDP. More importantly, although the government may remove the subsidies on petroleum products next year (if global crude oil price breaches US$60 a barrel), the impact on inflation is still manageable. Average inflation is only expected at 2.3% in 2005 from 1.4% this year, well below the BNM's perceived threshold of around 3.5-4.0%. Indeed, if anything, domestic interest rate is only expected to rise in H2-05. As the CB Governor had said, "We do not expect inflation to rise significantly. There will be some marginal increase in prices but it would not necessitate interest rates to be increased".

The new ringgit... What is the best alternative?

We believe a "managed float system" would be the most plausible outcome for Malaysia. While the country can re-peg the ringgit to another level, for example, 3.50/3.60, uncertainty in

Compared To Sept-98, USD Is Currently Weaker Against Most Asian Currencies

Currency pair	Sept-1998 (mth avg)	Current Rate (14 Dec'04)	% change	Currency pair	Sept-1998 (mth avg)	Current Rate (14 Dec'04)	% change
USD/MYR	3.81	3.8	-0.3	USD/PHP	43.77	56.28	28.6
USD/IDR	10700	9321	-12.9	USD/RMB	8.27	8.27	0.0
USD/TWD	34.47	32.44	-5.9	AUD/USD	0.59	0.76	28.8
USD/SGD	1.73	1.65	-4.6	USD/JPY	135.72	104.96	-22.7
USD/KRW	1373.6	1058.16	-23.0				($ deprec)
USD/THB	40.37	39.48	-2.2	GBP/USD	1.68	1.92	14.3
							($ deprec)

Source: CEIC, Bloomberg

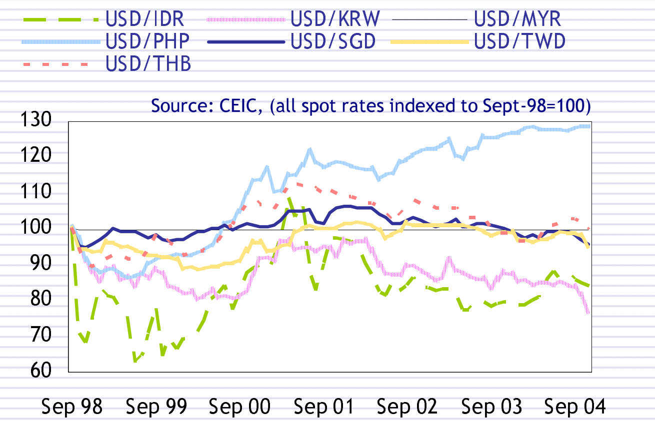
the global FX markets may force Malaysia to re-look the peg regime again over the next two years. This will only add more uncertainties for corporates managing their FX risks. Also, with the global structural changes, we have seen policymakers employing FX as a monetary policy tool, reflected on USD decline of more than 25% since Jan 2002. In contrast, a "managed float system" enables corporates to actively manage such risks, and the existing capital restrictions will help moderate the extent of ringgit volatility as speculators are kept out of the currency.

The ringgit – Close to its fair value

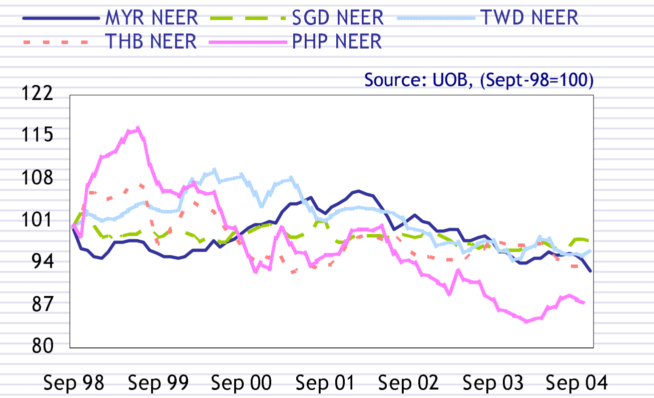
Purchasing Power Parity (PPP): It is really difficult to ascertain a 'fair value' for the ringgit. Based on the PPP concept, which states that the rate of appreciation of a currency is equal to the difference in inflation rates between two countries, we estimate the current 'fair' value of the ringgit to be at 3.70, about 2.5% stronger than the current pegged level. This probably explains the CB Governor's statement in early Nov-04 that the local unit is close to its fair value.

Nominal Effective Exchange Rate (NEER): Using our MYR trade-weighted (NEER) estimation, we see that the ringgit has depreciated 7.3% since its Sept-98 level, which the Malaysian authorities then assumed the ringgit to be fairly value. With the authorities likely to keep the currency a little undervalue, especially given the lack of inflationary pressure as well as recent capital inflows betting on the ringgit move likely to cash out, consensus is that ringgit will only appreciate in kind with the RMB appreciation of 3-5%. Consensus is that USD/MYR should trade around 3.61-3.68, as BNM is also expected to aggressively moderate the extent of ringgit gains.

Market Pushing Currencies Towards MIER Signposts - USD/JPY 100 And EUR/USD 1.40



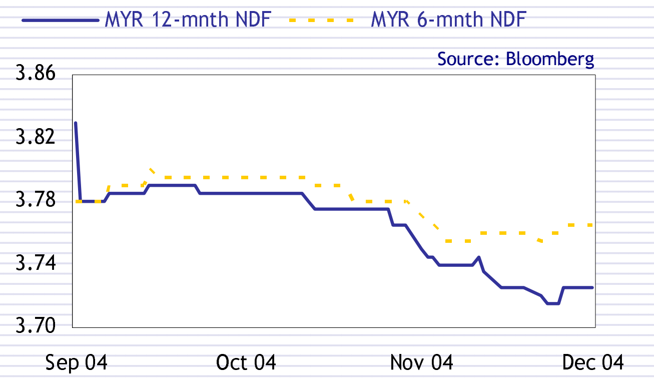
MYR NEER Is In Line With Other Asian Currencies



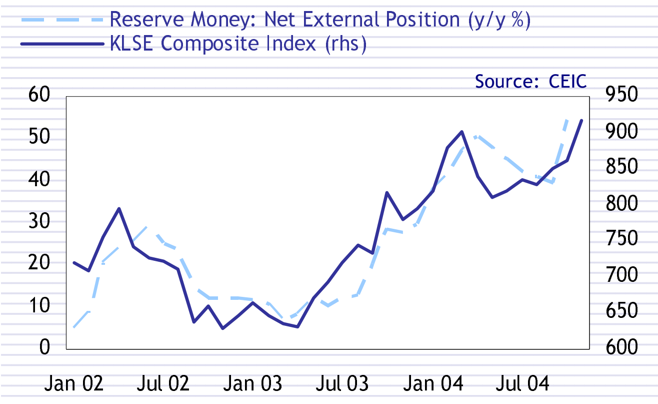
How is the market playing the game?

Speculators are already pouring money into Malaysian assets,

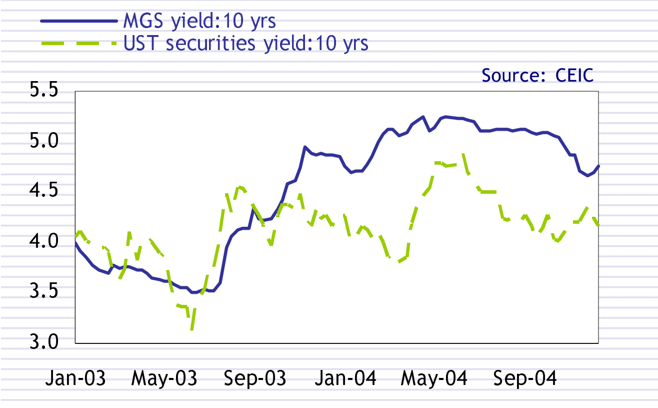
Ringgit NDF Has Priced In 2% Appreciation In 12 Months And 0.9% In 6 Months



The Stock Market Came Alive On Ringgit Revaluation Rumour

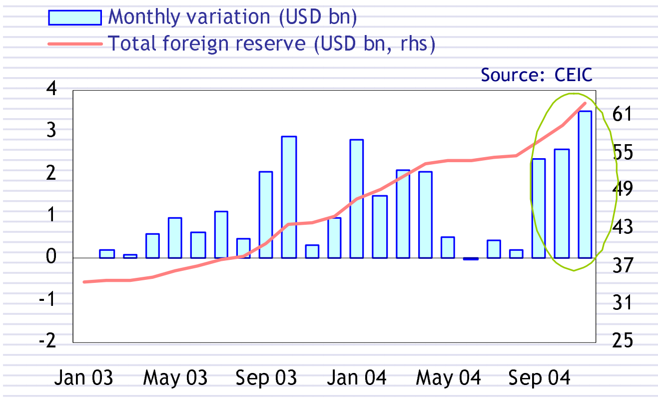


MGS Yields Fell Since Sept04, While UST Yields Remained Rangebound



positioning for the long-awaited ringgit's appreciation. While US 10-yr Treasuries yields have remained rangebound, MGS yields (equivalent tenor) have dipped more than 33 bps to 4.75% over the last three months. Indeed, M2 has expanded 21% y/y in Oct-04, while foreign reserves have risen by

Foreign Reserve Rose Sharply In Last Three Months Compared With The Months Previously



US$8.4bn between Sept-04 to Nov-04, after growth of around US$0.6bn in the 3 months before that. Similarly, trading activities in the ringgit NDFs have also picked up. Previously, trading only extended to the 3-mth tenor. However, of late, we have seen activities even up to the 12-mth tenors, with prices quoted at around 3.72 (effectively pricing in a 2.0% ringgit appreciation over the next 12 months).

Besides a straight ringgit play (via govt bond or other assets markets), the ringgit story can be played with long SGD. Besides the close proximity, which will affect competitiveness of services sectors, the two countries share similar exports make-up and destinations. Also, MAS is now on a tightening mode. Our estimation is that SGD NEER will appreciate about 2.5% over a 12 month period. This means assuming other currencies in the trade-weighted remaining constant, SGD should appreciate to 1.62 over a 12 month period. Indeed, we are hearing investment houses paying for options strikes at sub-1.60 over the next 9-12 month period.