The ringgit debate

By TEE LIN SAY

Experts see many benefits in a stronger currency.

Malaysia's macroeconomic health appears to be better than ever, and while it is easy to attribute this to the roaring stock market, a big reason for the rally is the strengthening of the ringgit.

Manokaran Mottain

Since the seven-year peg was removed in July 21, 2005, the local currency has appreciated 12% against the US dollar. It now trades in a managed float against a basket of undisclosed currencies and hovers at the RM3.40 level versus the dollar.

Across the globe, many central banks have diversified their portfolio of international reserves by reducing their holdings of US dollars because it is regarded as a less valuable currency in light of uncertain US economic fundamentals. This has resulted in the appreciation of all regional currencies, and the ringgit was not left out.

The ringgit is influenced by a variety of reasons, and is affected by the movements of US interest rates, market expectation of a stronger Chinese yuan, inflation, and capital inflows into Malaysia.

There is almost a consensus view that the ringgit will strengthen to RM3.30 to RM3.35 by end-2007 and to RM3.10 in 2008. And economists even foresee the ringgit breaking the RM3 level and trading at RM2.95 in 2009.

These ringgit predictions have been a big catalyst in wooing dollar-based investors to put their money in ringgit-denominated assets, be it stocks or real estate.

The inflow of foreign funds into Malaysian stocks has risen to record levels. Anticipation of a “still undervalued ringgit” has lead many to come in droves, both to capitalise on the appreciation of the stock market and the foreign currency exchange.

The booming net inflows are understandable. Apart from being the second best performing bourse in the region, the Kuala Lumpur Composite Index (KLCI) offers an average dividend yield of 3.3%, which is also the second highest in South East Asia after Thailand's SET Index.

The net international reserves of Bank Negara as of June 15 amounted to RM339.4bil, or the equivalent of US$98.4bil.

Government spending increases have also drawn investors. Malaysia has grand fiscal ambitions, and plans to spend RM200bil on mega infrastructure projects in the 2006-2010 period.

Teoh Kok Lin

The themes are aplenty. Down south, there are determined policies to turn Johor into the next Shenzen, via the Iskandar Development Region project. Up north, there's Penang fever, with its undervalued property prices to whet investor appetite. On the east, there's the Eastern Corridor, which will mainly focus on oil and gas development activities.

CIMB opines that prospects for further upside to the ringgit remains bright. Still-firm economic growth and positive economic stimulus measures to draw foreign investments are likely to provide a boost to the ringgit. More importantly, Bank Negara appears increasingly comfortable with the rising ringgit as long as the strengthening is in an orderly manner.

“Though Bank Negara has raised its tolerance level for the ringgit, we think they will still assess whether the Malaysian currency is fundamentally undervalued or overvalued relative to a basket of the currencies of its major trading partners, rather than any particular currency,” says CIMB.

While its been consistently argued that a weaker currency benefits emerging markets like Malaysia, more and more analysts are beginning to disagree. It sure appears that better times have rolled since the ringgit was lifted off its peg.

CIMB is retaining its end-2007 target of RM3.40 for the ringgit, while raising the end-2008 target to RM3.10 from RM3.30 previously.

Weak ringgit not always good

There has always been the widespread belief that a weaker currency gives a country more competitive edge, especially for an exporting nation like Malaysia.

Economists say that investors ought to get used to the fact that a stronger currency is here to stay. While there are always two sides to a story, the pros far outweigh the cons when it comes to the argument for a stronger ringgit.

For starters, the wealth of its residents increases almost immediately. Just think of the many times when we Malaysians went holidaying overseas, and the foreign exchange itself gives us an inferiority complex. Just across the Causeway, the wealth of Malaysians is instantly halved by the superior Singapore dollar.

“A strengthening currency indicates that demand for the currency is on the rise. It is a reflection of how people see the economy performing,” says a senior economist with a local research outfit.

CMS Dresdner Asset Management Sdn Bhd chief investment officer Scott Lim foresees the ringgit rising sustainably over the long term. He says that the direction of the ringgit will depend on the economic polices of the central bank.

“If it is the Government's policy to transform Malaysia into a more developed economy, then we will see the development and emergence of service sectors. We will start doing away with the manufacturing sector or let them die naturally,” he says.

“When the low-cost sectors eventually die, the service sector prospers, and this breeds new industries and sectors. A new and better engine will be created to replace the old one.”

For instance, Chinese stocks, which are the best-performing stocks in Asia this year, have been surging due to the strengthening currency and a blistering economy that draws record overseas inflows.

China posted a record trade surplus of US$26.9bil in June, giving more ammunition to critics who say Beijing's weak currency gives it an unfair trade advantage. China has US$1 trillion of foreign exchange reserves, the most in the world, and buys dollar-denominated assets to limit gains in the yuan.

The yuan has risen by about 6.9% against the US dollar since it was revalued by 2.1% and decoupled from a dollar peg in July 2005, but many analysts say that is not enough. They are expecting the Chinese government to widen its band, causing the yuan to strengthen further,

Tan Teng Boo

As the yuan appreciates, returns that dollar-based investors derive from assets denominated in yuan increase. In addition, expectation of a revaluation of the yuan is another key factor in fuelling hopes of a much stronger ringgit in time to come.

Capital Dynamics Asset Management managing director Tan Teng Boo says the ringgit will strengthen if the country's economy improves.

He says: “It is more important to understand why a currency appreciates. The yen and Swiss franc have appreciated because their economies are very competitive and they produce global companies. This in turn attracts inflows of foreign funds.”

“If a country adopts distorted policies that do not promote productivity, but in fact protect inefficient industries simply because they are local, then how can the currency appreciate?”

Lim of CMS Dresdner agrees and points out that the economy cannot always depend only on its cost advantage. “As the economy develops, low-cost sectors will be phased out, and we will see tariffs for water, petrol and electricity being increased. The price of goods will reflect these,” he says.

“If we refuse to accept change and refuse to allow the ringgit to strengthen, the market will eventually punish us. A strengthening ringgit reflects positive changes to come. The smart money will see that. Structural changes do not happen overnight, but when it does, the impact will be great.”

Myth: Exporters need a weak currency

Certainly, exporters who remain at the bottom of the value chain with no motivation to innovate and to add value to products will remain the losers. A good example is low-end companies that manufacture small parts for the technology giants.

"Of course they remain the loser as these products are easily sourced elsewhere, and margins are thin in the first place. Thus, if the ringgit strengthens, importers will choose to go to another country where the product is cheaper," says the senior economist.

Quite simply, a stronger currency will encourage the exporter to export more and become more competitive. The result is that the exporter earns more.

At the other end of the spectrum, a cheap currency makes the exporter idle as he is able to sell his product in abundance with no corresponding increase in value.

"Export demand could suffer from the sharp appreciation of a currency. However, the extent of loss in competitiveness depends on the performance of other currencies in the basket. Therefore, the argument of loss of competitiveness from a stronger ringgit does not hold. As long as this trend continues, we believe local products will remain globally competitive. On the positive side, the strengthening currency helps to mitigate inflationary pressures via lower imported cost," says AmInvestment Bank economist Manokaran Mottain.

He adds that when the ringgit was pegged at RM3.80, it did not reflect the true state of the economy. Since the peg was taken off, the appreciation has better mirrored the improving economic fundamentals of the country,"

Scott Lim

Singular Asset Management founder and chief investment officer Teoh Kok Lin says that the pace of appreciation for the ringgit will be important.

“As we have seen in Japan, after the Plaza Accord in 1985, if the currency appreciates way too fast, it can end up being disastrous, and would take years to restructure the economy,” he points out.

Tan of Capital Dynamics says that over the longer term, the direction of the ringgit will move according to government policies.

“If the political situation is stable and the economic policies are good, then yes, the ringgit will strengthen. Over the next year or so, I don't expect the ringgit to appreciate very much as the export sector isn't doing very well, and we cannot divorce the exports from our currency,” he adds.

According to the May trade figures released earlier this month by the International Trade and Industry Ministry, year-on-year growth of imports outpaced that of exports. Imports increased 3.5% to RM42bil, while exports expanded 2.7% to RM50bil.

The May trade surplus of RM8bil represented a 1.3% contraction year-on-year although the decline was not as sharp as that seen in April (11.6%) or March (31.9%).

“A strengthening currency in the long run should be positive for the country and its companies. It forces companies to be globally competitive and value-added. Any country that depends purely on its cheap currency as its edge will lose out big time. When the currency is appreciating, it shows that there are revamps, restructuring and improvements being implemented,” says Singular's Teoh.

In Asia, the richest countries by GDP per capita are Japan, Singapore, Brunei and South Korea. What do these countries have in common? Apart from being rich, they also have strong currencies.

A country with a strong currency is generally one that is developed, has a high level of technology and enjoys lower unemployment rates. Such a country invests in human capital and imports skilled professionals to increase the economic and technological know-how.

Strong currency benefits everyone

A strong currency means that raw materials can be imported at cheaper prices and then converted into relatively expensive finished products. An observer adds that the biggest profits are made in finished goods, not in raw materials.

For instance, Malaysia exports rubber to be converted into finished goods such as tyres, shoes, rainwear materials, inflatable boat material, tank covers, waterproof roofing and coatings ... the list is endless.

“Imagine if our exporters value-add on their own and converts rubber into these products. Now, wouldn't they produce it for a much higher profit margin and at the same time, create job opportunities in these downstream activities?” asks the observer.

He adds that pricing power is not with manufacturers, but with retailers and those in the service industries.

“Some exporters complain, but a lot of them are importers too, and their costs of production have fallen because of the decline in the value of their imported items,” he says.

The observer adds that many are under the illusion that a weak currency leads to more foreign income. However, it is extremely inflationary and this is evident in the higher cost of living in countries with weak currencies. Simple everyday goods are extremely expensive.

This means that a person earning RM2,000 in Malaysia would be worse off than an American earning US$2,000 and a Singaporean earning S$2,000 because the Malaysian has to pay a lot more ringgit to buy the same shirt sold in the other two countries.

“So, yes, even when we get additional foreign income, we are poorer because we need much more money to live in this country. Meanwhile, raw materials get even cheaper for the foreign countries and their companies and their profits go sky high,” explains the senior economist.

Another myth many love to believe is that a weakening currency is good for local industries. The assumption is that because local exporters make more money, they naturally earn better profits for their shareholders.

Wrong. The shareholders are actually at the losing end. This happens because many exporting companies rely heavily on the depreciating ringgit over the past few decades to make easy money instead of increasing efficiencies and productivity.

“A company with huge US$ borrowings may make extremely good profits in one quarter because of an extraordinary gain. But these are one-off items, and analysts still look at their operating efficiencies to see whether the company is worth its salt,” explains the senior economist.

Common sense tells us that a stronger currency gives more flexibility and purchasing power. When the ringgit strengthens, a business can import raw materials at lower prices. This leads to lower inventory cost, lower borrowing requirements and hence lower interest payments. Thus, the price of the finished goods also goes down. Does this not lead to better margins?

CMS Dresdner's Lim sums it up best: “Malaysia is an open economy. Yes, we export, but we also import a lot. The strengthening ringgit, in fact, decreases the cost of business for these importers and hence, gives them more opportunities.”

He adds: “To bet on the ringgit depreciating is to work against a trend. We have no choice, as all Asian currencies are appreciating. The strength of a currency is an indicator of economic health. It doesn't necessarily mean that the economy of that particular country is strong, but it shows efforts to improve.”

Market to take a hit?

The CI has certainly been a beneficiary of the strengthening ringgit. Recently though, there have been some outflow of funds, and this could be due to hedge funds taking profit or moving to cheaper markets such as Thailand.

The privatisation of Maxis Communications Bhd could have also contributed to some of the funds exiting. The Templeton Fund, which has been a long term shareholder of Maxis would have made handsome gains and may have wanted to park its money elsewhere," says one analyst.

Thus, is there cause for worry that the CI may take a tumble should hedge funds exit the CI? Lim does not think so.

"Right now, Malaysian assets are still underpriced. The inflow of foreign funds to correct this mispricing is a good thing. If things overheat like China due to unwarranted optimism, then there's reason to worry. For now, our asset classes are still undervalued."

He adds that he is comfortable with the Malaysian market as developments that have been taking place are positive, and more rights than wrongs are being done.

Leaving a note of caution to investors, he adds: "If you welcome money into your country, then you should also be prepared for the money to leave. If you enjoy the positive effects of the monies coming in, you need to be prepared to also suffer when the money leaves,"

"Being a small country, we will definitely be affected by the US, but if our economic policies are right, it doesn't mean that we cannot make a comeback."