

Weak Ringgit, Strong Ringgit

Towards regaining strength amidst domestic and global uncertainty

SUMMARY

- After three decades since its official birth in 1967, the underlying strength of the ringgit (MYR) was truly tested during the 1998 Asian Financial Crisis (AFC). Despite having gone through several economic growth cycle since AFC, it has not really regained its lustre to reflect the potential growth dynamism of an emerging economy.
- Amongst ASEAN-5, MYR is perhaps one of the most undervalued currency, followed by IDR, whilst SGD, THB and PHP have been either fairly valued or even sometimes overvalued since 2010.
- MY and ID have demonstrated higher average GDP growth over the last ten years, but our analysis showed that the IDR and MYR have been underperforming relative to SGD and THB.
- Post-AFC, ID and MY have recorded higher interest rates relative to TH and SG, but the accompanying greater inflationary pressure and structural weakness in the domestic economy contributed to a weaker IDR and MYR.
- MY's FX reserves only expanded 3.6 times since 2000, marking the smallest gain amongst ASEAN-5 economies which averaged 5.3 times.
- While a sustained and higher CA surplus resulted in a stronger SGD and THB, MYR seemed to be relatively weak though it recorded a sustained CA surplus over the last 20 years.
- Despite MY's lower and manageable government debt level compared to SG, MYR hugely underperformed SGD.
- An unpredictable political climate may continue to weigh on the MYR as evidenced by the fact that it has remained above the USDMYR peg-level of 3.80 primarily since the revelation of the 1MDB scandal which eventually toppled the Barisan Nasional government in the 2018 General Election.
- Efforts to realise the underlying value of the MYR, shifting from the prolonged state of being undervalued to fairly valued would require a multi-pronged strategy focussing on restoring investors' confidence: strengthening economic fundamentals, long-term political stability, better governance, as well as progressive and forward looking policies.
- Aside from the lingering uncertainty, the weakening USD due to the Fed's conviction to remain status quo on its monetary policy as well as the impact of huge stimulus and COVID-19 vaccine optimism would support a relatively firmer MYR till at least next year. Our year-end 2021 USDMYR forecast is 3.95.

Introduction

- **History shows that the ringgit's journey has been a mix of ups and downs from its historical peak at RM2.105/USD in October 1978 to its trough at around RM4.770/USD at the height of the Asian Financial Crisis (AFC) in January 1998**
 - Since independence from Britain in 1957, the relative strength of Malaya and British Borneo dollar, which was the official currency then, was crucial to support the fledgling economy. For a young and struggling nation, it helped to lower the price of imported goods, stimulate domestic consumption and support economic development. It lowered the cost of production, increased efficiency in order to maintain competitiveness, prompting greater productivity and spurring economic growth for Malaya at that time till it became Malaysia (MY) in 1963. Since MY was an agricultural-based economy and its manufacturing industry was still at its infancy, the main policy focus was to ensure a stable and strong currency to facilitate economic development.
 - Conversely, as MY shifted its focus towards an industrial-based economy in the 1980s, it becomes increasingly obvious that a reasonably weak or an undervalued ringgit would be beneficial for exporters, boosting the competitiveness of their goods and services. In addition, it would also attract foreigners to invest in Malaysia, creating more jobs and business opportunities.
 - On the flipside, an undervalued or weak currency over a prolonged period could cause a leftward shift of the aggregate demand curve due to weaker purchasing power, adversely impacting consumer confidence, weakening domestic demand, resulting in the economy to remain anaemic over a prolonged period, and ultimately limiting long-term economic growth potential.

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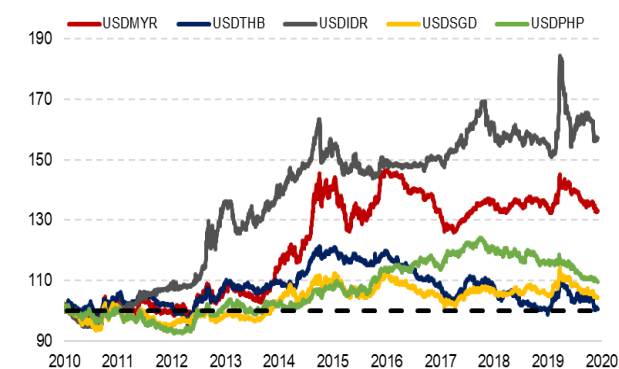
However, towards the end of 1975, the value of the local note was set to be determined against a basket of currencies, comprising of the country's significant trade partners.

- **Conventional peg:** In September 1998, to prevent further massive outflow of capital as a result of the AFC, the Malaysian government launched several drastic policy measures, mainly pegging the ringgit to the USD and selected capital controls. Its main aim was to insulate MY's monetary policy from external volatility. Apart from prohibiting the MYR from being traded offshore, the selected capital control measures included, prohibiting the transfer of funds into the country from externally held ringgit accounts except for investment in MY and shutting down the offshore market in Malaysian shares conducted through the Central Limit Order Book (CLOB) in SG.
- **Managed float:** In July 2005, BNM removed the peg and reinstated the managed float exchange rate regime. Consequently, most of the controls were dismantled or eased in recent years. While the currency is allowed to trade according to the market forces, BNM could intervene to prevent extreme movements in the exchange rate that could destabilise the real economy. Though the ringgit operates under a managed float against several major currencies, it is only allowed to be traded onshore. In November 2016, BNM issued a warning that it will penalise Malaysian-registered banks, both local and foreign, that facilitate MYR transactions on the offshore non-deliverable forwards (NDF) market, which is largely traded in Singapore.

• Perspective – The underlying value and trend

- By examining the Real Effective Exchange Rate (REER) and Nominal Effective Exchange Rate (NEER) of the ringgit, both indicators showed an upward movement and were overvalued (above 100.0) during the pre-AFC period. However, both measures of the underlying strength plummeted following the AFC in 1997. Hence, it remained undervalued (below 100.0) from December 1997 to October 2000, before fluctuating around its benchmark value of 100.0 until November 2014. Following MYR sharp depreciation in October 2014, both indicators plunged below 90.0 in August 2015 and fluctuate between 81.6 and 91.3 for the rest of the period.
- MY's REER depreciated by 1.3% on average in 2019 relative to 2018. Year-to-date (Jan-Nov) average suggested that the REER was 3.6% weaker than the 2019 Jan-Nov average, mainly driven by a sharp depreciation of the ringgit due to the impact of the COVID-19 pandemic and a sharp fall in Brent crude oil price. To compare, Thailand's (TH) REER (Jan-Nov average) weakened by 2.6%, followed by SG (-2.5%) and Indonesia (ID) by -1.5%. Bucking the trend, Philippines' (PH) REER appreciated by 6.0% mainly as a result of falling imports, which has helped to flip the PH's current account into a surplus, benefiting the PHP. In general, by looking at the REER trend, countries like MY and ID continue to have an undervalued currency as their REER remained below 100, while SG, TH and PH currencies with a REER value above 100 remained relatively overvalued.

Graph 2: FX Indices Relative to Dollar (end-2010=100)



Source: Bloomberg, Kenanga Research

Graph 3: FX Indices Relative to Ringgit (end-2010=100)



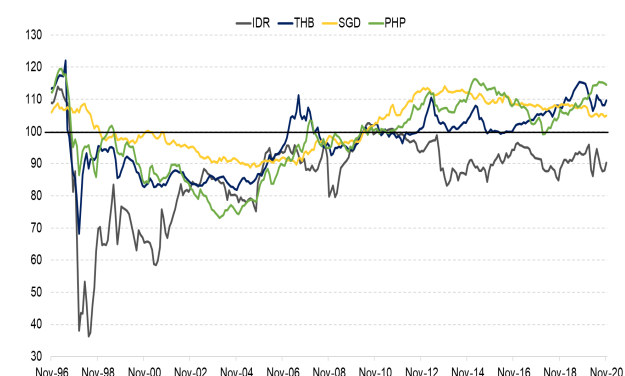
Source: Bloomberg, Kenanga Research

Graph 4: Ringgit Real and Nominal Effective Exchange Rate



Source: CEIC, BIS (2010=100), Kenanga Research

Graph 5: Peers' Real Effective Exchange Rate



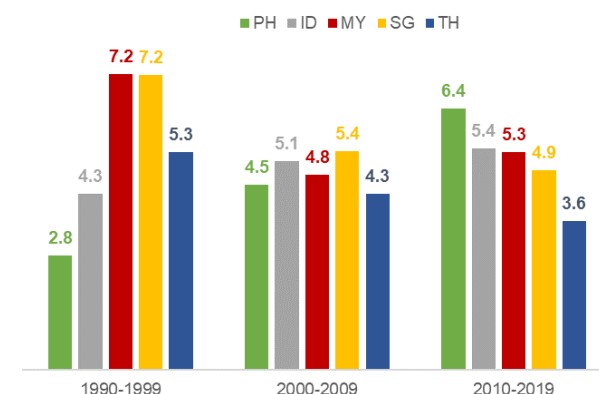
Source: CEIC, BIS (2010=100), Kenanga Research

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Factors Affecting the Value of the Currency

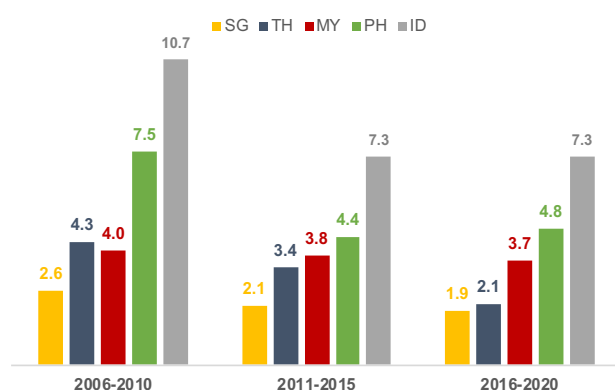
- Economic Growth:** Generally, stronger economic growth would lead to a stronger currency. However, the relationship between economic growth and the strength of a currency is often viewed with a mixed of critical observation as it depends on the different stages of a country's economic development and priorities.
 - Export-driven economies (e.g. CN, MY) would want to keep their currency weak to achieve export competitiveness in the global market. Most developed economies, such as SG and the G7 countries, have low economic growth relative to most emerging economies but have a stronger currency.
 - Over the last decade, MY and ID have demonstrated higher average GDP growth (>5.0%) than SG (4.9%) and TH (3.6%). However, our analysis showed that the IDR and MYR had underperformed its two peers for the last ten years, with SGD and THB appreciated against the USD by more than 20.0% (10-year average).
- Interest Rates and Inflation:** Countries offering higher interest rates would be more appealing to foreign investors, resulting in higher inflows and demand for their financial assets, invariably lifting the relative strength of their currencies. However, the direct relation is often complicated by the existence of higher inflation, which moderates real interest rates.
 - Over the years, ID, PH and MY have generally recorded higher interest rates (10-year bond yield) relative to TH and SG. However, with the accompanying relatively higher inflationary pressure in ID and MY, we observed that IDR and MYR have generally underperformed THB and SGD.
 - Of significance, from 2016 to 2020, the average inflation-to-interest rate ratio for ID and MY are much higher at 42.6% and 37.4% respectively, compared to 18.1% and 9.5% for TH and SG respectively, which partly explains the stronger performance of THB and SGD.

Graph 6: GDP Growth (average, %)



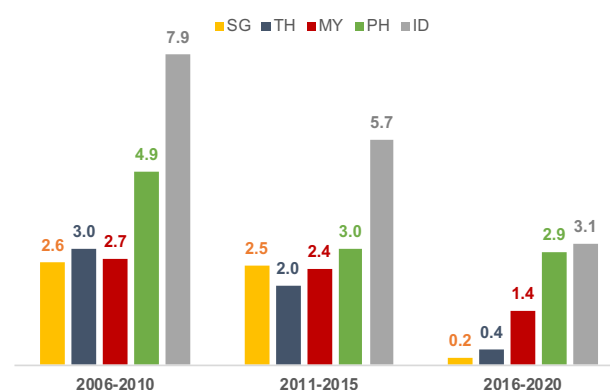
Source: CEIC, Kenanga Research

Graph 7: 10-year Bond Yield (average, %)



Source: Bloomberg, Kenanga Research

Graph 8: Inflation (average, %)

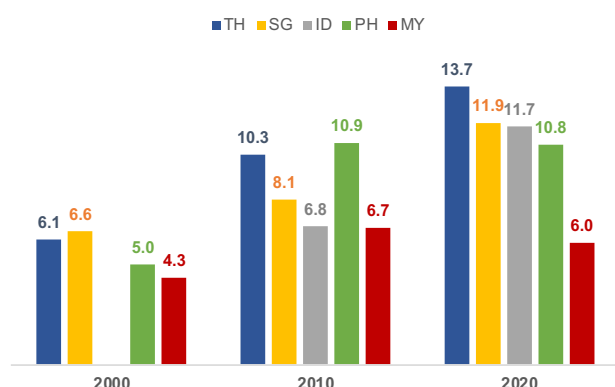


Source: CEIC, Kenanga Research

- Foreign Exchange (FX) Reserves:** Larger FX reserves would bolster foreign investors' confidence in a currency, by demonstrating the country's ability to finance external obligations, insulate the economy from major shocks and stabilise domestic currency with the aim of preventing hyperinflation and supporting exports.
 - Since the AFC, stockpiles of foreign currencies have expanded for the ASEAN-5 countries, registering above the international standard of at least three months of imports.
 - However, since 2000, the pace of increase is much faster for TH (7.4 times bigger), PH (6.9 times), ID (4.4 times) and SG (4.2 times). MY's FX reserves only expanded 3.6 times, marking the smallest value (USD99.7b) amongst all five economies.

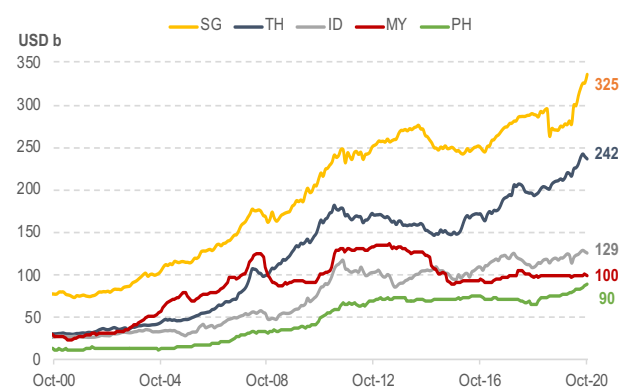
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Graph 9: FX Reserves (months of imports)



Source: CEIC, Kenanga Research

Graph 10: FX Reserves (USD billion)

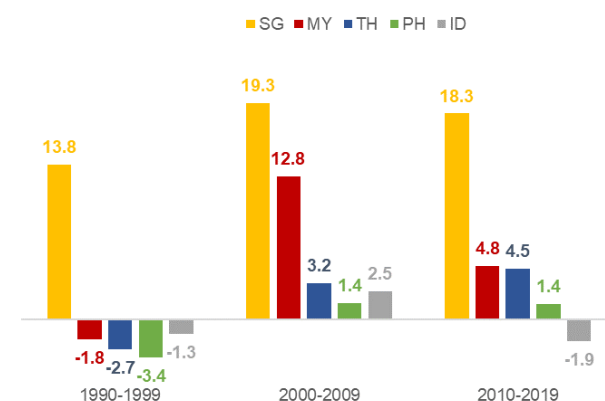


Source: CEIC, Kenanga Research

- **Current Account (CA):** CA reflects the balance of exports-imports as well as mirrors the savings-investment ratio in an economy. The excess of exports or savings are typically accumulated as reserves and used as a buffer against external vulnerabilities or to finance the consumption and investment activities of other economies. Generally, countries with a consistent higher CA surpluses tend to experience an upward pressure on their currencies.

- Since the AFC, MY has consistently recorded a CA surplus, whereby its exports of goods have outpaced imports and offset the deficit in the services and income accounts. However, MY CA surplus has gradually narrowed since the GFC, touching 2.2% in 2018, the lowest in 21 years.
- Over the last 20 years, SG and MY have maintained a larger CA surplus compared to TH, PH and ID. While SG's higher CA surplus is reflected in its stronger currency, MYR seemed to be relatively weak, despite having relatively strong fundamentals.

Graph 11: Current Account (average, % of GDP)



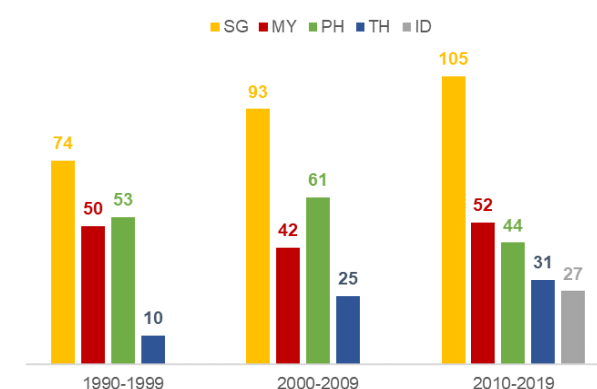
Source: CEIC, Kenanga Research

- **Government Debt:** An unsustainably higher debt affects a nation's ability to support and finance economic development. Higher debt repayment or servicing interest payments would eat into fiscal revenue, raise deficit and the possibility of a credit default. This may prompt credit rating agencies to downgrade the long-term sovereign debt rating and subsequently cause the currency to weaken further. However, there is a mixed perspective between government debt and the performance of the currency.

- MY government debt, on average, hit 52.0% of GDP for the period 2010-2019 (2000-2009: 42.0%), but remained manageable and lower than its self-imposed debt ceiling of 55.0% (recently revised to 60.0%).
- In contrast, SG recorded a massive government debt with sharp expansion over the last 30 years. However, such high debt level is fiscally sustainable for SG as all of its borrowing proceeds are invested and backed by assets, partly the underlying reason for its AAA credit rating. Meanwhile, ID has the lowest government debt in this analysis, while its currency faced downward pressure in the same observed period.

- **Political Climate:** political risk or stability is among the major factors considered when making foreign investment decisions. An unstable political climate – characterised by contentious elections and sudden changes to the political status quo – can lead to an outflow of foreign investment, thereby causing the the currency to depreciate. This outflow stems from investors' fear that economic policy and growth performance may change. On the other hand, stable political systems alone do not necessarily provide an upside boost to currencies.

Graph 12: Government Debt (average, % of GDP)



Source: CEIC, Kenanga Research

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- MYR is prone to fluctuations spurred by political uncertainty. For instance, following the 1MDB scandal and subsequent corruption investigation in 2015, the ringgit depreciated from RM3.78/USD (3rd Jul) to RM4.42/USD (28th Sep). Similarly, the unexpected results of the 2018 General Election saw the MYR value falling from 3.95 (8th May) to 4.05 (4th Jul) and subsequently 4.20 (28th Nov) against the USD.
- SG and ID have appeared politically stable in recent times, however, THB has a history of fluctuation due to TH political climate. By the end of 2013, anti-government protests in TH has led to the parliament to be dissolved and a snap election being called. More recently, the August 2020 cabinet crisis alongside the renewed anti-government protests have added additional downward pressure on the THB (already suffering from COVID-induced weakness), though partially capped by the assurance of policy continuity given the existence of its legally binding 20-year National Strategy. Similarly, PHP plummeted to a 7-year low in 2016 due to concerns surrounding political instability, on the back of President Duterte's sudden announcement of a "separation" between the PH and US.

Conclusion

- The performance of a currency is determined by a wide range of factors. Based on the above analysis, while fundamentally interest rates, inflation and FX reserves have a standardised impact on the exchange rates of the ASEAN-5 countries, other factors such as GDP growth, government debt and political climate have a varying impact on the currencies, largely explained by differences in the stage of economic development, debt management and policy continuity.
- Having said that, efforts to realise the underlying value of the Ringgit, shifting from the prolonged state of being undervalued to fairly valued would require a multi-pronged strategy focussing on restoring investors' confidence: strengthening economic fundamentals, long-term political stability, better governance, as well as progressive and forward looking policies.
- In the meantime, the MYR appears to remain firm relative to the USD due to the weakening dollar index thanks to US Federal Reserve's conviction to remain status quo on its bond purchase programme and interest rate policy till end of next year or possibly 2022. The huge stimulus and fiscal spending along with the general optimism on the COVID-19 vaccines roll out would likewise support the ringgit. At this juncture, our projection of the USDMYR is 3.95 by end of next year.

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