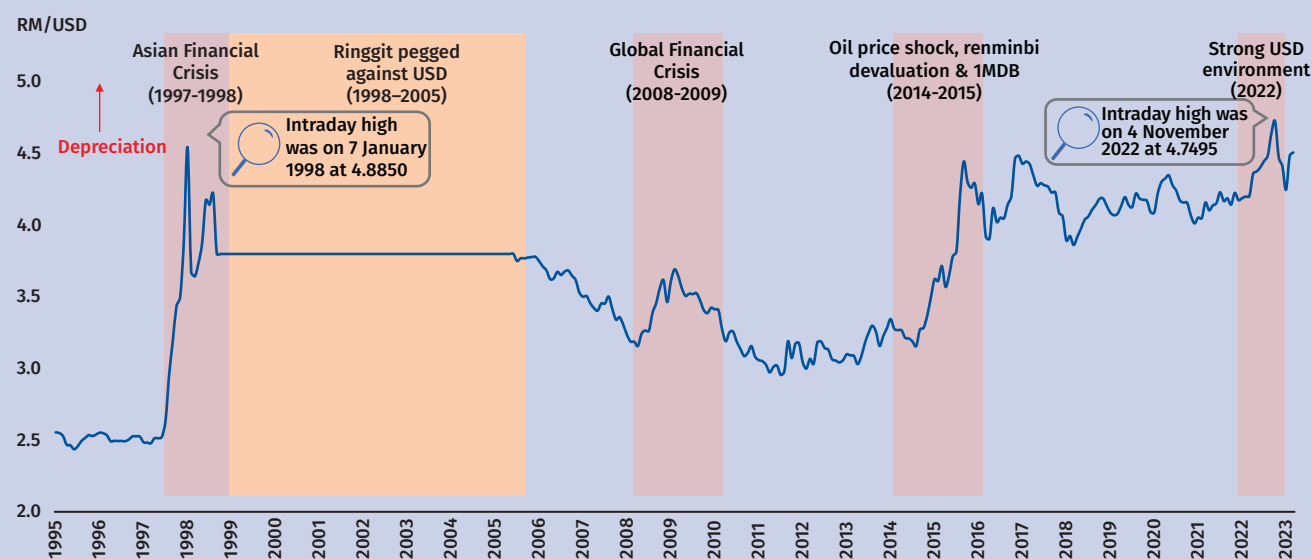


The Exchange Rate and the Malaysian Economy

In 2022, the ringgit exchange rate experienced a period of sustained depreciation against the US dollar. While small movements in the ringgit exchange rate are common, large fluctuations in the level can create lasting impact for businesses, households and the economy. As the ringgit against the US dollar hovered close to levels last experienced during the Asian Financial Crisis (AFC) (Figure 1), this became a concern. There were even some calls for the ringgit to be pegged to prevent it from falling further.

Figure 1: Performance of the Ringgit against the US Dollar



Note:

1. RM/USD is as at end-month, up to 20 March 2023.
2. The RM/USD exchange rate used here is the average of buying and selling rates at noon in the Kuala Lumpur Interbank Foreign Exchange Market.

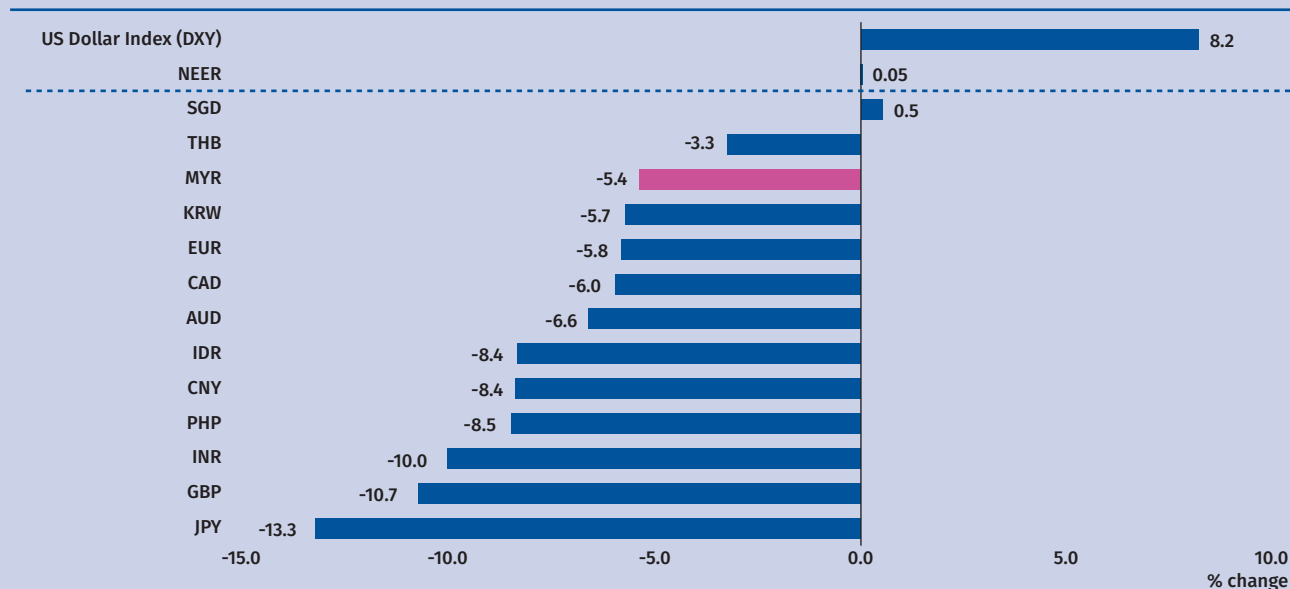
Source: Bank Negara Malaysia and Bloomberg

To understand the role of the exchange rate in the Malaysian economy, it is worth noting that movements in the exchange rate will influence households' and businesses' decisions, and thus in aggregate, will impact economic activity. For a country with a flexible exchange rate like Malaysia, the ringgit can periodically appreciate and depreciate. Over the longer term, the exchange rate should be determined by our economic fundamentals relative to key trading partners. In a financially integrated world, short-term movements in the exchange rate are also strongly influenced by cross-border financial flows and investor risk sentiments, which are often affected by global developments and are not necessarily reflective of our country's economic fundamentals.

This was certainly the case in 2022 when the US Federal Reserve raised its policy interest rate aggressively by 425 basis points to a target range of 4.25-4.50% to address inflation.¹ The higher returns on US financial assets raised demand for these assets and led to a period of sustained US dollar appreciation. Consequently, other currencies including major currencies and the ringgit, depreciated against the US dollar during the year (Figure 2). This depreciation was a global trend and not generally indicative of any fundamental weaknesses in the affected economies within the region and globally.

¹ Since the start of 2023, the US Federal Reserve has continued to increase its policy interest rate by another 50 basis points to a target range of 4.75-5.00% (as at end-March 2023).

Figure 2: Performance of Major and Regional Currencies against the US Dollar in 2022



Note:

1. The RM/USD exchange rate used for calculation here is the average of buying and selling rates at noon in the Kuala Lumpur Interbank Foreign Exchange Market.
2. NEER refers to the ringgit nominal effective exchange rate. It is an index measuring ringgit's performance against currencies of Malaysia's major trading partners.

Source: Bank Negara Malaysia and Bloomberg

With this in mind, the effects of the exchange rate on the Malaysian economy are not only determined by developments in the bilateral exchange rate against the US dollar. As a trading nation that also has key investment relationships with many countries, assessments should consider ringgit movements against our major trading partners. This would provide insights on whether Malaysia's relative competitiveness has been affected by movements in the exchange rate.² A common gauge for this is the nominal effective exchange rate (NEER).³ In 2022, despite the ringgit's sharp depreciation against the US dollar, Malaysia's NEER was relatively stable (Figure 2). As the currencies of key trading partners were similarly affected as the ringgit, Malaysia's relative competitiveness remained unchanged.

Whether the exchange rate appreciates or depreciates, there will always be winners and losers in the domestic economy. A depreciation in the ringgit hurts those who consume imported goods and services, and if sustained, can lead to a rise in the overall cost of living. At the same time, a weak ringgit could increase exporters' earnings. On the other hand, when the ringgit appreciates, it benefits those who import goods, services, and travel abroad, but hurts exporters and the domestic tourism industry. When these exchange rate movements occur, it is important for the adjustments to be orderly to ensure that economic activity can continue. The focus of the country's exchange rate regime should not be on picking sectoral winners or losers. Instead, the goal is to ensure long-term benefits for the overall economy.

Malaysia's exchange rate regime and financial system have evolved over the years to serve the growing needs of an increasingly market-oriented domestic economy. In this regard, the current flexible exchange rate regime has brought benefits to Malaysian businesses and households. As an external price, the exchange rate conveys an important signal to businesses to guide them towards sustainable investment opportunities and to allocate their resources optimally. Similarly, for households, the exchange rate helps to inform them of their consumption choices such as purchasing more or less imported goods, as well as travelling abroad or locally.

² The exchange rate is just one of many other factors that can affect Malaysia's relative competitiveness. This includes structural factors such as position within the global supply chain, as well as the domestic business and investment climate.

³ NEER refers to the ringgit nominal effective exchange rate. It is an index measuring the ringgit's performance against currencies of Malaysia's major trading partners.

Crucially, the flexible exchange rate regime provides Malaysia with the flexibility to naturally adjust to international economic and financial shocks. For instance, a ringgit depreciation can help to cushion the domestic economy from external shocks such as a sudden decline in global commodity prices. An example would be Malaysia's experience during the oil price shock in 2015. Brent crude oil prices declined by 68% from USD115 per barrel on 19 June 2014 to USD37 per barrel on 22 December 2015. Given Malaysia's position as a net oil exporter, the domestic oil and gas sector was hit hard by this situation, leading to restructuring exercises within the industry. In fact, the oil and gas sector went through considerable structural changes, involving the rightsizing of many industry players. Nevertheless, the diversified structure of the Malaysian economy helped to limit the negative spillovers to the rest of the economy. Specifically, the ringgit's depreciation also supported our non-commodity sectors' competitive standing. These sectors provided support to employment and overall economic growth during that period.

In 2022, the flexible exchange rate regime similarly helped the Malaysian economy to adjust to shifting external conditions without disrupting our economic recovery. Despite a major external shock in the form of fast and sizeable adjustments of interest rates in the US which led to the rapid appreciation of the US dollar against most currencies, Malaysia's competitiveness was relatively unaffected. The domestic economy remained on its recovery path, registering a growth rate of 8.7% for the year.

It is recognised that the depreciation in the exchange rate did lead to higher import costs. The pass-through to domestic inflation was most pronounced for directly imported fresh food items, such as beef and selected vegetables. As food items tend to make up a larger share of the consumption basket among vulnerable groups, this led to cost-of-living concerns. To some extent, domestic price controls and subsidies on fuel prices, have helped to contain the broader impact of an exchange rate depreciation on inflation.

Nevertheless, a highly volatile exchange rate can itself be a source of vulnerability for the domestic economy. Large swings in the exchange rate within a very short time can exacerbate uncertainties and cause individuals and firms to delay their decisions to consume and invest. If this is prolonged, it could pose risks to the longer-term domestic economic outlook. To mitigate such risks, Bank Negara Malaysia (the Bank) undertakes foreign exchange operations⁴ to stem excessive volatility and maintain orderly market conditions.

The flexible exchange rate has also contributed to making domestic markets more open and attractive to global investors. With greater financial openness, this also means that domestic markets are now more susceptible to global financial developments. Spillovers, however, have been contained due to two main factors. First, is the presence of a large domestic institutional investor base comprising among others, banks, pension funds and insurance institutions, to facilitate foreign investment flows. Over the years, this has mitigated outsized adjustments in domestic asset prices. In turn, this has helped to preserve and support returns on household savings managed by these institutions. Secondly, the domestic hedging market has also grown over the years to insulate firms from unanticipated moves in the exchange rate, leading to lower external vulnerabilities.

The rapid and sizeable depreciation of the ringgit against the US dollar in 2022 led to some calls for the ringgit to be re-pegged to the US dollar, similar to the policy undertaken during the AFC. Would this have been the right policy move? Using a medical analogy, it is important to properly diagnose the problem before prescribing the treatment. Just as the right type and dosage of medication must be chosen to address an identified ailment, it is important to pinpoint the root cause of an economic issue before determining a solution. Even if two patients present the same symptoms, the underlying cause may not be the same; thus, the course of treatment can differ. Furthermore, a good physician must ensure that the treatment does not worsen the patient's condition.

During the AFC, the Malaysian economy and financial system ran into deep problems when the balance sheets of banks, firms, and households were severely affected by the rapid depreciation of the ringgit and valuation losses in the domestic equity market. As part of the immediate policy measures, the ringgit was pegged to the US dollar at RM3.8000 alongside the introduction of selective exchange controls. These measures worked to

⁴ Foreign exchange operations by the central bank is the act of maintaining orderly market conditions in the domestic foreign exchange (FX) market by managing liquidity via buying or selling foreign and domestic currency with counterparties such as commercial banks.

provide banks and businesses with a stable external environment and space to strengthen their balance sheets. However, things are different today (Table 1). Reforms and policy measures have since been implemented to reduce Malaysia's external vulnerabilities. Businesses' and banks' balance sheets are much more resilient now than they were back then. Domestic financial markets are also much more developed and capable of withstanding external financial shocks without affecting banks' capacity to support economic activity.

Table 1: Comparison of Economic Fundamentals

	AFC (1997-98)	2022
RM/USD (annual % change)	-47% ¹	-5.4%
Real GDP (annual % change)	-7.4% ²	8.7%
Net international investment position (IIP, end-year)	-RM 137.6 billion ³	RM 63.0 billion
International reserves (end-year)	USD 21.7 billion ⁴	USD 114.6 billion
International reserves coverage of short-term external debt ⁵	1.4 times ⁴	1.0 time
Current account (annual)	-RM 16.7 billion ⁴	RM 47.2 billion
Banking system gross impairment loans ratio (% of total loans)	18.6% ²	1.7%
Government foreign currency debt (% of total Government debt)	19.1% ⁵	2.7%

¹ From 10 July 1997 to 7 January 1998 ² 1998 ³ 2001 ⁴ 1997 ⁵ 2000 ⁶ In 2014, Malaysia's external debt was redefined. Specifically on short-term external debt, the new definition included 1) inter-bank foreign currency borrowing, 2) inter-company foreign currency borrowing, 3) other foreign currency loans which include non-related company borrowing, 4) trade credits, 5) non-resident holdings of domestic money market instruments, 6) currency and deposits and 7) other liabilities (IMF allocation of SDRs, and liabilities of pension funds and life insurance companies to non-residents). By comparison, the previous definition of short-term external debt only included items 1) to 3). For more information, please refer to 1Q 2014 Quarterly Bulletin Box Article on 'The Redefinition of External Debt'.

Note: The RM/USD exchange rate used here is the average of buying and selling rates at noon in the Kuala Lumpur Interbank Foreign Exchange Market.

Source: Bank Negara Malaysia, Ministry of Finance Malaysia and Department of Statistics, Malaysia

Introducing and maintaining a peg today in the same way that was done during the AFC would require implementation of capital controls on financial flows. Without capital controls, such an exchange rate regime would require the Overnight Policy Rate (OPR) to match the rise in interest rate of the country to which the ringgit is pegged. This being the US dollar, the OPR would need to be raised by 475 basis points (more than four times higher than the cumulative 100 basis points hike) to match the rise in the federal funds rate. This will constrain the economy much more due to significantly higher costs of borrowing. In addition, a significantly higher amount of international reserves would be needed to maintain the credibility of the peg as defence against speculators.⁵ Besides that, maintaining large foreign exchange reserves can incur higher opportunity costs as these assets are typically invested in highly liquid but lower yielding financial assets.

Selective exchange controls were needed and worked during the AFC due to the circumstances at the time.⁶ The implementation of selective exchange controls during the AFC was targeted at stabilising short-term capital flows and have since been liberalised. More importantly, the controls allowed us to implement the necessary reforms to strengthen the banking system and the corporate sector. Heeding to calls to re-peg every time the ringgit depreciates could mean switching capital controls on and off. This would create a highly unstable and unpredictable environment for investors and businesses. For international investors, this could deter them from choosing Malaysia as their preferred investment destination. In the long run, this could hinder investments, innovation as well as the growth potential of the domestic economy. Eventually, this would come at the expense of future economic productivity, and lead to significant welfare losses (Forbes, 2007; Gadanecz and Mehrotra, 2013).

⁵ If the stock of international reserves is assessed to be insufficient to maintain the exchange rate at the pegged level, it could force the central bank to devalue its currency during times of financial market stress. The sharp adjustments and its impact to sentiments could be more detrimental to the economy compared to orderly exchange rate adjustments under a flexible exchange rate regime.

⁶ The implementation of selective exchange controls was intended to eliminate access to currency speculators and stabilise short-term capital flow movements. As such, the controls required capital inflows to remain in the country for a minimum period of 12 months. Importantly, controls were not imposed on current account transactions, repatriation of income from portfolio investment and other forms of ringgit assets and foreign direct investment flows.

Given Malaysia's flexible exchange rate regime, fluctuations in the ringgit should be expected to occur from time to time. In fact, since reaching a peak of RM4.7477 on 4 November 2022, the ringgit did rebound to reach RM4.2435 on 30 January 2023.⁷ As challenges in the global economy continue to evolve, US dollar developments are likely to continue to be the main factor affecting the ringgit exchange rate. Our financial system has held up well throughout this period and continued to facilitate intermediation to support the broader economy. Reflecting on the events of the year, the Bank will continue to proactively monitor developments and ensure that our economy continues to be served by an exchange rate regime that supports our mandate to achieve monetary and financial stability conducive for sustainable growth of the Malaysia economy.

References

Forbes, K. J. (2007). The microeconomic evidence on capital controls: no free lunch. In *Capital Controls and Capital Flows in Emerging Economies: Policies, Practices, and Consequences* (pp. 171-202). University of Chicago Press.

Gadanecz, B., & Mehrotra, A. N. (2013). The exchange rate, real economy and financial markets. *BIS paper*, (73b).

⁷ These RM/USD rates are as of end-day.