



Despite Call To Change, The Ringgit Will More Likely Stay Pegged At 3.8

Introduction

The ringgit peg, introduced at the beginning of the last quarter of 1998, has been an important strategy that had helped Malaysian industries grow out of recession. Yet today, it is also widely seen as a major encumbrance that is holding them back. The peg was just what that was needed to address the problems faced during the 1997 recession, which was more confined to East Asia, but turned out to be exactly what not to have in the face of more widespread recession faced during 2001. This is why there are many calls by Malaysian industries over the past months for the peg, at its current rate, to be reviewed. Very fortunately, wisdom prevails in Bank Negara and all government announcements have consistently maintained that the peg will continue to be held steadfast at the 3.8:1 rate against the dollar for an indefinite length of time to come.

Capital controls and pegs

Many confused capital controls with exchange rate pegs. They are not synonymous. Before the ringgit was pegged, capital controls were not imposed. However, there are many countries adopting floating exchange rates alongside strict capital controls. With pegged currencies, of course, capital controls would be necessary so that currency board operations can be carried out.

The ringgit is an extreme case. Capital controls in Malaysia were imposed not typically to monitor currency movements but instead to prevent ringgit outflows. In a sense, the ringgit has been "demonetised". By design, it has no exchange value outside Malaysia in order that forex trading of the ringgit would completely cease thus enabling the peg to be held, whatever the domestic interest rate. Exports and imports would be conducted using U.S. dollars. Bank Negara then becomes the sole money changer converting between the ringgit and other currencies through the pegged rate against the dollar.

Unorthodox strategy

It is important to point out that pegging the ringgit outside of a proper currency board system is highly unorthodox and seen by the rest of the world as something that not only should not be done but also cannot be done. But pegged the ringgit we did in a manner by which controlled currency flows create no direct effects on domestic interest rates; i.e. contrary to the very thing currency boards are set up to do. The trick was to ensure stability for the ringgit amidst international financial turmoil that occurred in 1997 while domestically pursuing a low interest rate regime aimed at helping to boost the local economy. Both of these would have been impossible either with a floating exchange rate or pegging within a currency board system.

How industry employers benefited

To Malaysian industries, the pegged ringgit translates into painless cost savings on the factory floor that turned out very useful when global exports demand was still strong. As mentioned, all Malaysian exports sales have been in dollars since the peg. Those dollar revenues at the pegged rate, earn more than one and a half times more ringgit than before the peg. Since domestic factor payments such as rents, fees, utility charges, as well as salaries, are paid in ringgit, employers are able to hold on to the extra ringgit obtained from the pegged rate. US\$1000 worth of sales abroad, pay RM3800 ringgit worth of factor costs at home instead of only RM2500 before the peg. This implies a more than 50 percent cost savings from domestic factor costs.

Ill advised call for an even lower peg

When the global exports market began falling towards the end of 2000, contracting economies across the world saw the natural downward adjustments of their respective currencies except for Malaysia, which remained stuck at its 3.8:1 peg against the dollar. The result is the loss of competitiveness because Malaysian exports become relatively expensive. This should never have become an issue. Increasingly, countries are recognizing that



competitiveness stem not from cheaper currencies that are subjected to fluctuations. Instead competitiveness should be on the basis of core competence that creates efficiency and productivity gains over competitors. Rather than find such more appropriate ways to deal with the problem, factory firms again sought the painless option, by recommending a repeg at a rate below 3.8. This would not only help achieve cost competitiveness vis-à-vis neighbouring economies but also produce even more ringgit for the dollar revenues earned.

Essentially the plan is to pay workers (along with other factor payments) less; in dollar terms that is. This is an unsustainable proposition, because even if salaries will remain sticky for a while, price pressures on domestic factors will eventually have to adjust upwards nullifying whatever savings that local industries expect.

Had Bank Negara yielded to the call for a review, it would have been disastrous for the country's economy. There would be loss of confidence, because it would mean that Malaysia's exchange rate would not be determined through the forex market nor managed via clear rules of a currency board. There was much dismay when the rules-defying peg was announced in 1998. In retrospect, having seen the positive results of Malaysia's economic recovery, excuse could be granted. But you can only get one chance at breaking the rules.

There would no real stability as the peg would be subjected to occasional reviews and worse when the revised pegs are not forex market determined nor based on currency board operations. Furthermore, without the existence of a ringgit forex market, traders as well as investors, Malaysian or from abroad, cannot avail themselves to hedging instruments such as money market futures.

Reviewing the peg may be bad, but an even lower peg would be further distorting the already under valued ringgit. Based on purchasing power parity or PPP calculations a year ago the ringgit's exchange rate should have been RM1.78 to the dollar instead of RM3.80, in other words, being already undervalued by as much as 53 per cent (Based on PPP comparisons for McDonald Big Macs shown in *The Economist* April 21 2002). Given the relatively more buoyant and hence inflationary economy between Malaysia and the U.S. this year's PPP calculations work out to be RM2.02 to the dollar, which remains well below even the ringgit's exchange rate before the peg (Based on PPP comparisons for McDonald Big Macs shown in *The Economist* April 27 2002).

Current economic circumstance bought the ringgit some breathing space

Had economic circumstance similar to those felt in 2001 remained the same through 2002, the effects would have become very severe for Malaysian industries. Nearly all of their markets are non-domestic and with the ringgit propped up at the pegged level exports sales would be lost. Further lowering the peg outside of an acceptable adjustment mechanism may eventually become necessary leading to loss of confidence.

But two critical changes in economic circumstance today bought the ringgit the needed breathing space. First, the rebound in the American economy during the first quarter of 2002 offered signs of an upswing in the business cycle that should point towards an expanding exports market and likely recovery of various currencies. Second, it turned out that the recovery of the exchange rates of various currencies has left the dollar behind. Since January, the currencies of New Zealand, Iceland, Norway and Australia have strengthened by more than 10 percent. Taiwan's dollar has strengthened by 7 percent and about the same rate for the Euro. Even the yen, has strengthened by nearly 5 percent, and the Singapore dollar and Thai baht by about 3 percent. All these meant that the over valued American dollar is flattening out to a more reasonable rate. At the current pegged rate, the ringgit will become even more undervalued but its relative decline against other currencies would, as desired, boost competitiveness for Malaysian exports without short changing domestic factor owners.

Outlook

The current outlook is that the dollar will further undergo downward adjustments. However, the declining dollar is a double-edged sword. On the one hand, the falling dollar offers blessings of the needed inflationary effects that will help drive up nominal growth and corresponding rise in interest rates. On the other hand, if the decline is too sharp or too much, various negative effects will begin to trigger: loss of consumer and business confidence and downward pressures on interest rates as a response to anticipating deflation.



The world will again need to watch and wait, looking at the positive aspects of U.S. dollar decline yet cautiously concerned. The real issue, however, when addressing economic outlook and growth, as one cannot over emphasise, is not the exchange rate but efficiency and productivity. Therefore the good news is not that the exchange rate can still be maintained but that prospects of exports sales going up is in our midst.

There have been two consecutive quarters of growth and by the end of June it is more than likely that yet another quarter of continuous growth would be achieved. True, as we read in *The Edge's* economic watch (June 10 2002) the trade surplus as of April have shrunk by half of the RM4 b. to RM5 b. enjoyed during the recovery years, but much of this is the effect of expanding imports of capital, intermediate as well as consumer goods that have taken place in response to the recent economic recovery. Industrial production have risen by 4.5 percent and in turn manufacturing output have risen 3.8 percent. Exports have risen, 6.4 percent up year on year as in April. For electrical and electronic goods, the exports growth look even better at 8.7 percent. This means that Penang, with its focus in E&E, stands to benefit. Global semiconductor sales grew by 3.1 percent in April.

Such more friendly economic circumstance is a window of opportunity - but only just that. Difficult repositioning, much talked about, that will allow Malaysian industries to move from its fabrication phase up into the next level must occur as lower cost location options appeal to foreign investments. The government has acted in a variety of ways to bring this about. But, clearly a more focused effort beyond incentives packaging and enveloping policies would be needed, because ever so often, the government sets up a plan to achieve one goal but instead the plan produces positive results elsewhere rather than where it was originally aimed at. **§ Chan Huan Chiang**

The State Of Innovation In Penang (Part 2)

(continuation from May 2002 Economic Briefing)

Barriers to Innovation

There are barriers to innovation activities in both the MNCs as well as local firms. Sometimes ideas are mooted at the local plant level or at the middle management or shop floor levels. It is noted that sometimes, ideas do not get to the top management. This could be due to the fact that the top management at the HQ or even at the off-shore plants are not receptive to innovative ideas from the workers. Locally based engineers at the MNCs offshore plants might have innovative ideas in either product or process development/improvement. However, they might not receive the right attention from the top management. This could be due to the lack of managerial and technopreneurial skills or the lack of knowledge management. Knowledge management is an increasingly essential component of innovation and value creation. The Mckinsey Quarterly 2001 #1 indicated that the less successful companies tend to take a top-down approach, pushing knowledge to where it is needed. On the other hand, the successful companies reward employees for seeking, sharing, and creating knowledge. As such, to develop a desire for knowledge, it requires effort to develop a "knowledge pull" or a 'grassroots' desire among employees to tap into their company's intellectual resources. Failure to get the right attention and recognition will result in declining interest to innovate.

Likewise, a shortage of personnel with managerial and technopreneurial as well as knowledge management skills poses a barrier to innovation. Companies need leaders/managers who could promote and motivate their workers to be more efficient, creative and excel in their jobs. As such, training is deemed to be very important to inculcate innovative values in the Malaysian management team. In this aspect, the MNCs seem to fare better than the local companies, although the Penang Skills Development Centre (PSDC) seems to be successfully and effectively filling the gap in terms of basic knowledge training to the workers of both MNCs and local companies. MNCs normally provide 'higher-knowledge' training for their engineers overseas. In the case of the US-based companies, training is normally held in the US while for the German companies, training is held in Germany. In addition, experts are also brought in to train the workers locally.

Another barrier or problem with innovation is resource management, which comprises cost and lead-time. Companies are reluctant to innovate because they do not know if the product will be viable in the market. Furthermore the lengthy timeframe to develop the product/service, from ideas to drawings, to prototyping, to actual product, and finally to introduce the product to the market place is another issue. This lengthy time frame is also related to cost. This is especially so if the local company does not have a team of engineers specially dedicated to R&D. The company has to release its engineers from their other duties to focus on R&D (D&D). As such, innovation activities are expensive and thus, local firms, particularly the small and medium-sized firms could not afford to innovate. For example a manufacturer of machinery & equipment needs to constantly upgrade its technological capabilities as well as market know-how to compete in the global market.

Sometimes, local workers are innovative but they could not achieve a breakthrough in their innovation ventures. As such, these people sometimes become disillusioned and discouraged. The lack of skilled and qualified workers, especially in hardware, software and mechanical engineering further inhibits efforts to innovate. This is mainly attributed to the fact that although the local universities have increased their intake of science & technology (S&T) students, they are still not producing enough S&T graduates that meet the requirements of the companies to undertake innovation activities. Many industry representatives also claim that most of the local universities are disconnected from the high-tech industries as well as the foreign universities. This state of 'disconnectedness' results in the graduates not meeting the demands and needs of the industries. However, technology transfer is not only possible through human capital. Technology transfer is also possible through established links between companies and public research institutes. However, presently, such links are restricted to the provision of testing or other facilities.

Asian values, such as diligence and discipline, which are considered to be the assets of the Malaysian workers, can also be a disadvantage, especially in innovation activities. The discipline and obedience instilled in the local workforce denote that 'the boss is always right'. As such, the employees would not oppose the decisions of their bosses even if their findings and results were correct in any innovation activities.

Conclusion

The state of innovation in Penang at the moment is mainly private sector driven, particularly by the electronics cluster. It is irrefutable that Malaysians are capable of carrying out innovation activities as evidenced in some local companies particularly the fabricated metal/automation and service providers. Despite the fact that Malaysians possess the capabilities and skills to innovate, most of the knowledge they possess is tacit knowledge and as such, is not well documented for future application and knowledge transfer. The MNCs, on the other hand, are more advanced in documenting their experiences, knowledge as well as milestones. This contributes to the innovation accomplishments of some MNCs in Penang.

The new wave of globalisation, which is generally the transformation of the industries towards global outsourcing, will see less manufacturing activities in the MNCs' plants. The MNCs, however, will look at more value-added activities such as R&D (D&D), sales, marketing, distribution, as well as developing their brandname. The capabilities of Malaysians, as evidenced in some key MNCs in Penang will be the thrust for more value-added and innovation activities among the MNCs in Penang. These Malaysians will also be the catalyst for maintaining and attracting high-end and high-tech FDIs (foreign direct investments) to Penang.

While the 'best brains' among the Malaysians in Penang would probably be employed by the MNCs, because of the attractive remunerations and challenging careers, the local companies should not be left out in the pursuit for innovation. In view of the fact that Penang is principally an export-oriented economy with the electronics industry being its largest contributor, the local companies are mainly supporting and ancillary industries that complement the electronics cluster in the Northern Region of Peninsular Malaysia. As such, the local companies should concentrate on their core or niche business, with continuous upgrading to meet the requirements of the MNC and global customers. The niche areas for the local companies to develop could be summarised as contract manufacturing; fabricated metal products, precision machining & automation; as well as software development. However, it is also important that the local companies do not depend on a single-clientele but should diversify their customer-base. This will leverage risks in business as well as in innovation activities.

As contract manufacturers, the local companies will get the opportunity to learn from their MNC customers, especially if they are given the title 'turn-key'. At this 'turn-key' stage, the local companies will require minimal support or



input beyond product specifications from their customers. This is the trend that the MNCs are moving towards, as stated by Sturgeon (1998) " ... American final product-level, or 'brand-name' electronics firms have reasserted control over product definition, product design, and marketing functions, which are largely being kept in-house". With further upgrading, these local companies will eventually get to be roped in by their customers to collaborate on areas such as product design specification as well as relocation/expansion plans to other locations/countries.

Quite a number of the local fabricated metal products, precision machining and automation companies have embarked on innovation activities, producing parts, components and equipment to substitute imported inputs. Findings from Norlela (2000) indicate that many local firms are already focussing on building niche capabilities to innovate in equipment, precision tooling and stamping. Many of these companies are also suppliers to global companies and with further upgrading, these companies will be able to increase their market share in the global market.

Some of the foreign-owned solution providers set up office in Penang not only to tap on the local market but also to tap on the local expertise. In fact, some of these companies are taking advantage of the relatively lower cost of operation in Penang to tap on the regional markets like Singapore. Recently, the number of solution provider companies, especially in software development has increased considerably in Penang. These companies provide software solutions to the private as well as public sectors in Penang and the region. Further upgrading in terms of human capital as well as marketing will help to expand the markets for these companies.

The government will have to play a bigger role in promoting and encouraging innovation activities if the government desires Penang to achieve the status of a post-industrial state. This includes the establishment of a more conducive environment for the companies to carry out innovation activities, which comprises infrastructure for innovation activities (R&D or D&D), supply of skilled and qualified human capital as well as other fiscal and non-fiscal incentives.

For a start, the State Government has announced the establishment of a state-level Collaborative Resource Centre to promote university and industry collaboration on R&D (D&D) programmes on priority areas that have been identified. It is also important to have continuous collaboration in education between the university and the industry. This 'connectedness' will enable the local universities/colleges to produce graduates who can meet the requirements of the industries.

Presently, the Government of Malaysia offers a host of incentives to manufacturers as well as service providers. These incentives comprise those for the manufacturing sector; R&D activities; information and communication technology (ICT); approved services such as logistics, communications and utilities; manufacturing related services such as integrated logistics, market support and central utility; operational headquarters (OHQ); international procurement centre (IPC); as well as Multimedia Super Corridor (MSC). The most attractive incentive for high-tech companies is the MSC incentive and it would benefit the companies in Penang as well as the greater Northern Region, which encompasses Penang's industrial areas and the Kulim Hi-Tech Park (KHTP) if the MSC status is extended to this Northern Region 'corridor'. However, the primary concern is to ensure that the government reaches out to the industrial community by disseminating relevant and appropriate information as well as to facilitate the industries by expediting the application and approval process.

It should be noted that government involvement is essential in motivating innovation activities in the state. It would be an advantage if Penang could emulate other developed industrial centres in the region like Taiwan and Singapore, which have significant government intervention in developing their local high-tech companies.

For example, the establishment of the Industrial Technology Research Institute (ITRI), a national-level, government-sponsored non-profit organization for applied research in Taiwan to accelerate industrial technology development, promote industrial growth, and enhance the social well being of Taiwan. ITRI helped to establish the foundations of Taiwan's semiconductor industry through continuous technology transfers and spin-offs of IC (integrated circuit) companies such as UMC, TSMC, TMC and VISC to attract investments in IC wafer manufacturing as well as IC design and testing. Today, with a complete semiconductor industry capacity, Taiwan has become the world's fourth-largest IC supplier.

As in the case of Taiwan, the mission of the Agency for Science, Technology & Research (A*STAR or formerly



known as the Singapore National Science & Technology Board) is to foster world-class scientific research and talent for a vibrant knowledge-based economy in Singapore. A*STAR offers more than 10 research institutes for studies in various disciplines as well as a commercialisation arm that offers numerous cutting-edge technologies in various industry clusters for commercialisation.

As for Penang, it is hoped that the establishment of the Collaborative Resource Centre will generate more interest and confidence among the local companies to carry out innovation activities. This will help Penang to achieve its vision of becoming a post-industrial state. **§ Anna Ong**

Reference:

A*STAR website: <http://www.a-star.gov.sg>

ITRI website: <http://www.itri.org.tw/>

Javier Revilla Diez, (February 2000), "The Importance of Public Research Institutes in Innovative Network – Empirical Results from the Metropolitan Innovation Systems Barcelona, Stockholm and Vienna", *European Planning Studies*, Vol. 8. No. 4, 2000

Michael H. Best, (February 24, 1999) "Cluster Dynamics in Theory and Practice: Singapore/Johor and Penang Electronics", Discussion Paper, Centre for Industrial Competitiveness, University of Massachusetts, Lowell

Michael Fritsch (March 2000), "Interregional Differences in R&D Activities—An Empirical Investigation", *European Planning Studies*, Vol. 8, No. 4, 2000, *European Planning Studies*, Vol. 8. No. 4, 2000

Norlela Ariffin (September 2000), *The Internationalisation of Innovative Capabilities: The Malaysian Electronics Industry*, SPRU, University of Sussex, PhD Thesis

Susanne Hauschild, Thomas Licht, and Wolfram Stein, "Creating a Knowledge Culture", *The McKinsey Quarterly*, 2001 Number 1

Timothy J. Sturgeon (December, 1998), "Network-Led Development and the Rise of Turn-key Production Networks: Technological Change and the Outsourcing of Electronics Manufacturing", *Massachusetts Institute of Technology*
