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To the Penang State Government

Non-Trading of the Ringgit Isolates Malaysia from the Current Thai Baht Crisis

Malaysia's fears about the vulnerability to turbulent fluctuations of local currencies have come to past yet again with several months of continuous downward pressure on the Thai Baht. The solution, Malaysia has always said, lies in a revamp of the world's financial architecture, for which several options have been suggested by leading economists, and not in turning the local economy upside down, which would have been the case had IMF prescriptions been adopted.

It is not that the IMF prescriptions have no merit, but they look at the problem entirely from within an economy. Internal inconsistencies among the various factors of production may, among other things, arise from wrong leading signals such as inflation and interest rates and such inconsistencies result in weak economic fundamentals. Believing that these inconsistencies will soon have to be corrected, speculators quickly take forward positions on the local currency ahead of the time of correction. The volume and the direction in which the forward position is taken put so much pressure on the local currency that it tumbles. To avoid unnecessary speculation is therefore to strengthen the fundamentals. The IMF prescriptions will help do that.

While the right signals will prompt more consistent allocation of production resources at home, they do not give any inkling about how long it will take before economic fundamentals can strengthen. The link between the direction of the signals and how much allocation will be consistent is somewhat rubbery. Thus the weakness of the IMF prescriptions is they cannot pinpoint exactly when and how much to prescribe by way of leading signals. The point is: during the usually very painful time lag needed for the fundamentals to strengthen, the time when domestic factors of production are chasing the signals, the local economy is most vulnerable to speculative attacks.

Demonetising the Ringgit

Malaysia's prescription follows the direct route. Rather than trying to fathom things like leading signals, resource re-allocation and time lags for corrections just to indirectly avoid speculative attacks, why not just stamp out speculation altogether? The way this is done is unprecedented. Malaysia demonetised the ringgit in the forex market making it no longer tradable. The ringgit is isolated. Speculation stops completely.[1]

The upside of taking this direct route is it avoids subsequent rounds of currency turmoil, creating the stability needed so that domestic resources can concentrate on production with less uncertainty. Many local industrialists have voiced their satisfaction with what the government has done. They say doing business in the exports market has been delightful because the ringgit, rock-steady at RM3.80 to the dollar, is relatively weak; but even more so because there is price stability from such fixed ringgit conversion. Industrialists also do not have to worry about taking for-

(Continued on page 2)

Inside this issue:

Socio-economic &
Environmental Research
Institute (SERI)
10 Brown Road
10350 Penang, Malaysia

Phone: 604-2283306
Fax: 604-2267042
Email: seripg@tm.net.my
Website:
http://www.seri.com.my

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(Continued from page 1)

ward positions to avoid conversion losses.

This stability is exactly what is needed now when there is yet another wave of pressure on the Thai Baht, which is likely to produce contagion effects upon neighbouring economies. Even though there is popular belief that Malaysia will not be spared during the current crisis, there is absolutely no likelihood of any negative effect on the ringgit coming through via the forex market which is usually the source from which a crisis occurs. In any case, it is undeniable that Malaysia will be able to withstand the current crisis much better than had the government not taken the ringgit out of the forex market.

Determining Conversion Rates

Strangely, there is another upside for Malaysia in the wake of the current crisis. Over the period of economic recovery from the previous crisis there was some concern that the ringgit, fixed at its 3.8 to 1 conversion to the dollar, was becoming more and more undervalued. There was much talk of the possibility of the government revising the rate of conversion to better reflect the value of the ringgit. Local industrialists don't want this because Malaysian exports will become less competitive. This new crisis dispels any current need for the conversion rate to be revised. The rate can be safely held for a long while yet and exchange rate stability will continue to rule.

However, on the downside, the more serious issue is that once the ringgit conversion is fixed in this manner, there is virtually no mechanism to allow the conversion rate to be adjusted. Although it is generally accepted that the floating exchange rate determined by international dealings in the forex market has its problems, among which is the massive volume of speculative flows of so-called hot (basically short term) money, at least the rate of exchange among currencies is market determined and the information produced by arbitrage among speculators will help ensure more accurate price signals across the different currencies.

The open market is also in theory beyond the control of any individual or groups of individuals. This is the reason why some quarters say that Malaysia's government, by announcing its 3.8 to 1 conversion from ringgit to dollar will result in a lack of confidence in the country because this rate was not market determined. None of the local businesses hold any forward position on the ringgit to cover their payment obligations with foreign business counterparts and will most likely suffer losses should a revised conversion end up against their favour. Hence, when it becomes necessary to revise the conversion rate, it must be done through an accepted market mechanism. Any arbitrary revising of rates by specific individuals outside the market will not result in confidence.

The Greenback Versus the Ringgit

Individual nations issue their own currencies so that their national banks can pursue monetary policies either by targeting growth or inflation rates to ensure economic stability. When Bank Negara says Malaysia will quote her exports in dollars and pay for imports in dollars, Malaysia in the economic sense becomes the fifty-something state of the U.S., along with American protectorates like the Virgin Islands, Puerto. Whatever policies the U.S. Federal Reserve pursues and however the dollar responds to the currencies of the world, the ringgit will react in exactly the same way.

So why waste good quality paper printing ringgit? Why not just use the greenback to pay our salaries or use it directly for transactions in Malaysia? This might mean that many people will have only triple digit monthly incomes in U.S. dollars but there will be no difference in purchasing power apart from the notion of money illusion. Monetary controls can continue to monitor greenback flows in and out of Malaysian borders. Nothing changes there compared to what goes on now except for one

(Continued on page 3)

(Continued from page 2)

critically important point: the volume of Malaysia's foreign exchange reserves can once again become indicative of its actual strength, say in terms of how many months of retained imports.

All foreign currencies held as reserves by Bank Negara will be truly sovereign and can be used for dealing with current account deficits and other balance of payment functions. At the present moment, this is no so because when Bank Negara declares the quantum of our reserves, one cannot tell how much of the total amount is sovereign and how much must be held in trust as a pledge to pay off foreigners who sell off ringgit assets in Malaysia and want to convert those into his own currency.

This situation came about because all in-coming foreign currencies intended for private business goes to the Bank Negara which then issues the equivalent amount of ringgit to facilitate transactions within the country. Such foreign currencies should not form part of the reserves even though they are held by Bank Negara. They have to be pledged because at any time foreigners who now owns ringgit might want to take their money back and Bank Negara has to pay them back the equivalent amount of foreign currency from its reserves. This is what is meant by such reserves not being truly sovereign.

Stopping the Inflow of Hot Money

The real danger is when such foreign inflows and outflows are short term hot money dealing in the KLSE. Imagine this scenario: *a substantial inflow of foreign funds buys stocks in the KLSE; American dollars are converted into ringgit for the purchase and Bank Negara's foreign exchange reserves shoots up; the market rallies; having profited handsomely the foreigners sell out, earning their winnings in ringgit; they go to Bank Negara which now has to pay out more foreign reserves than the amount that came in; the reserves tumbles, or worse, runs out*. In other words, for every RM3.80 that a foreigner profits from Malaysia's economy, our reserves has to fall by one dollar. This relationship between foreign profits and a country's reserves is also unprecedented.

Typically, when an investor aims to invest in another country, he has to worry about two things: whether investing abroad will bring better returns than what can be expected from investing in the home country, and, whether a future shift in exchange rate in the country where the investment is going will eat away all the returns. For instance, before the fixed conversion was invoked in Malaysia, some foreign funds may have made a handsome profit in the KLSE. They sell out and collect lots of ringgit. But this will not have to concern Bank Negara. If they want the ringgit to be converted into dollars they will have to do so in the forex market and at whatever rate they can secure. If the outflow of the ringgit is massive and weakens the rate of conversion so much that it eats into profits, the foreign investor might elect to hold on to part or all the ringgit - giving the ringgit a soft landing. Taking the ringgit out of the forex market and fixing the rate of conversion removes one of the two worries of the foreign investor. Now he has only to worry about profitability, the conversion rate has been guaranteed.

The back-to-back convertibility between the ringgit and the U.S. dollar actually makes Malaysia attractive to the foreign investor. The steady rebound these past couple of years is testimony of that fact. Being able to maintain very low interest rates to fuel economic activities while not worrying about exchange rate deterioration was the unique feature of Malaysia's strategy. But this will only work if the country guards itself from any possibility of sudden outflows of funds as this will impact negatively on its reserves. Staying clear of short-term hot money must be made mandatory as a matter of policy. ***§ Chan Huan Chiang***

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Footnote

1. This action taken by Malaysia's government is generally referred to as capital controls. One does not imply the other. Many countries impose capital controls, even under floating exchange rates but in the world only Malaysia has demonetised its currency in the forex market. I have avoided using terms like fixed exchange rates, U.S. dollar peg, revaluation or devaluation of the ringgit because these terms apply to the operations of a currency board like the case of the Hong Kong dollar. The ringgit does not operate under the rules of a currency board.

East Asian Export Share in International Import Markets

Worldwide Markets

East Asia's export share in the international import markets increased by 6.9% between 1985 (9.3%) and 1995 (16.2%). However, the onset of the economic crisis in 1997 affected East Asia's exports and thus, the export share of the region in the international import market declined to 16.0% in 1998.

China, which was not affected by the Asian economic crisis, increased its export share in the international import markets by 2.9% between 1985 (1.6%) and 1995 (4.5%). By 1998, its export share rose to 4.6%. Likewise, the export share of the Philippines rose 0.1% during the 1985-1995 period and increased further by another 0.2% to 0.6% in 1998. Philippines was able to increase its export share despite the fact that it was affected by the Asian economic crisis. This could mainly be due to the fact that Philippines' exports are increasingly dependent on the export of electronics products and components, which were not affected by the Asian economic crisis.

The export share of Hong Kong and Indonesia dropped during the 1985-1995 period by a marginal 0.1% but managed to retain their export share in 1998 despite the Asian economic crisis. On the other hand, the export share of Thailand, Taiwan and South Korea increased significantly during the 1985-1995 period (Thailand : 0.7%, Taiwan : 0.8%, S. Korea : 1.0%) but dropped in 1998 (Thailand : -0.1%, Taiwan : -0.3%, S. Korea : -0.1%). Both Singapore and Malaysia managed to maintain their export share in 1998 and experienced increases between 1985 and 1995 (Singapore: 0.9%, Malaysia: 0.7%). As in the case of Philippines, Singapore's and Malaysia's exports are increasingly dependent on the export of electronics goods. (Figure 1)

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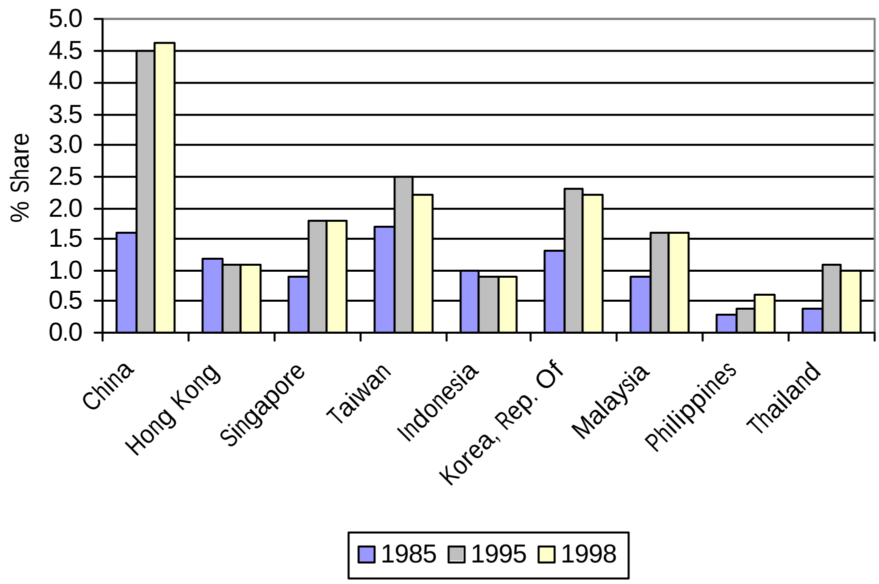
Figure 1: Export Shares in Worldwide Import Markets (%)



Source: Derived from IMF

Markets In Industrial Countries

As in the case of East Asia's exports to the industrial countries, its export share rose by 4.5% between 1985 (8.8%) and 1995 (13.3%) and dropped to 13.1% in

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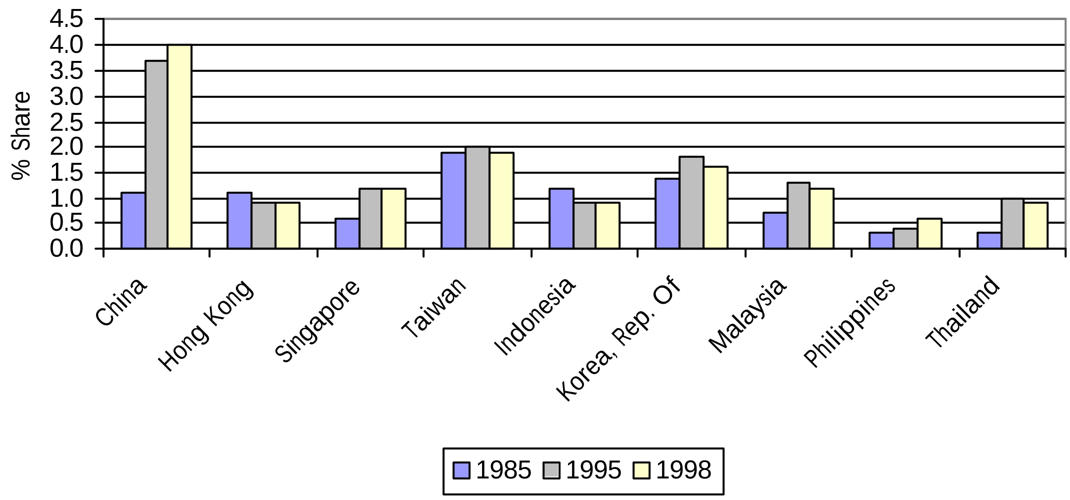
1998. The same trend is observed for East Asia's export share to the import markets in the industrial countries as in the worldwide markets, with the exception of Malaysia. Although Malaysia was able to maintain its export share to the worldwide market between 1995 and 1998, its export share to the industrial countries dropped by 0.1% from 1.3% in 1995 to 1.2% in 1998. (Figure 2)

On the whole, East Asia commands a bigger export share in the worldwide import markets compared with that in the industrial countries. This implies that most of its exports are to the non-industrial countries.

Figure 2: Export Shares In Industrial Countries



Source: Derived from IMF

East Asian Markets

The East Asian export share among the import markets in East Asia increased by 11.8% from 21.3% in 1985 to 33.1% in 1997. Despite the onset of the Asian Financial/Economic Crisis in 1997, the share of East Asian exports to the import markets within its member countries increased further to 37.0% in 1998. These could be due to measures taken by the East Asian governments to reduce imports from the rest of the world due to fluctuating foreign exchange rates.

As in the case of worldwide markets, China's export share in the East Asian markets are on an increasing trend from 8.9% in 1985 to 13.1% in 1998. Likewise, Singapore's export share in the East Asian markets have also increased significantly from 3.2% in 1985 to 5.7% in 1998. Similar trends are observed in the crisis-hit countries like Indonesia, South Korea, Thailand as well as Malaysia (Malaysia: 3.4% to 4.1% during the same period). (Figure 3)

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Implications

The export share of the East Asian countries in all the import markets mentioned above did not vary much between the pre-crisis (1995) and crisis (1998) years. Marginal shifts in export share are not significant enough to indicate whether these countries have gained or lost their competitive edge in the export markets.

Countries, which experienced slight increase in or managed to maintain their export share during the crisis years, had taken the following measures:

- Sold their products at lower prices to take advantage of their exchange rates.

(Continued on page 6)

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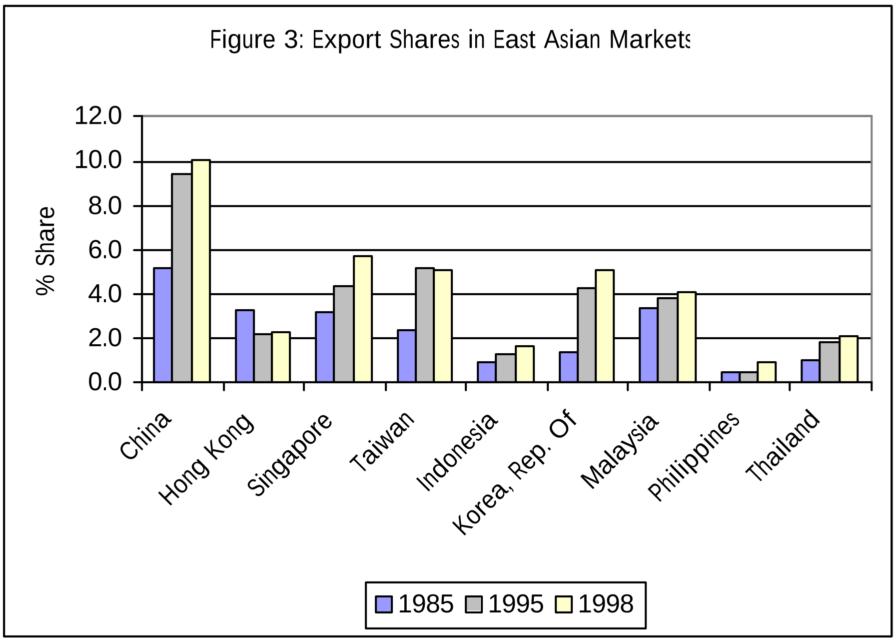
- Pegged their currency (as in the case of Malaysia) to remain competitive in the global markets.
- Increased their exports to augment economic growth/sustainability due to poor domestic demands.

……….. it is envisaged that the exporting countries in East Asia would bounce back and regain better export share in the international import markets.

However, those countries that experienced declining exports during the crisis years encountered:

- Political instability.
- Institutional support that is inadequate.
- Weak political will.
- Inadequate skilled and professional human resources.
- Inadequate support infrastructure.
- Inadequate technological capabilities.

However, with the recent rapid economic recovery and the various measures taken by the governments to enhance economic development in these countries, it is envisaged that the exporting countries in East Asia would bounce back and regain better export share in the international import markets. *§ **Anna Ong***



Source: Derived from IMF

Asia-Pacific's Local Area Network (LAN) Market

There has been a surge of interest in IT usage, with China and other developing countries coming on board in a big way. The use of the Internet has become a very convenient tool for the IT savvy population of these nations. All these have an impact on the LAN market as more IT companies and other organisations gear up to network and connect to the rest of the world. LAN vendors can anticipate sizeable profits in the present and near future as more service providers come into the market as well as increase their capacity.

A recent study by International Data Corporation (IDC) Asia/Pacific shows that the regional LAN market in terms of vendor revenues grew by 16%. Revenues totalled US$ 802.7 million in Q1 2000 compared to US$693.6 million in Q4,'99. When compared to the same quarter (Q1'99) the previous year, this growth is even more apparent at 37%. Korea recorded the highest growth in terms of revenue (US$231.5 mil) followed by China and Australia. The reason for Korea's significant growth was said to be due to its online game industry, which has caused an increase in broadband traffic as online game users continue to soar. Service providers have increased their backbone capacities and this has led to a rise in the networking market in general and routers in particular.

Malaysia ranked 8th in the Asia-Pacific LAN market revenues with US $19.2mil. during the first quarter of the new millennium. Malaysia also saw a 4% increase in revenues when compared to the last quarter of 1999. In South-east Asia alone, it ranked 2nd only after Singapore and fared much better than its other neighbours.

This positive growth is attributed to the increased spending from the corporate segments such as the banking and finance sectors. In addition to this, service providers have continued to invest in networking and purchase of high-end routers in the first quarter of this year to cater for the surge in potential sales as e-businesses and other online operations in Malaysia increase.

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Table 1: Asia-Pacific LAN Market By Country (US$Mil)

Country	Q4'99	Q1'00	Q1'00/Q4'99	Q1'00/Q1'99
Korea	118.6	231.5	95	142
China	213.5	188.8	(12)	13
Australia	141.5	130.4	(8)	4
Singapore	38.4	51.6	34	24
Hong Kong	45.8	50.9	11	59
Taiwan	45.9	48.2	5	9
India	29.3	36.3	24	16
Malaysia	**18.6**	**19.2**	**3**	**10**
New Zealand	13.2	13	(2)	13
Philippines	9.2	12.3	34	41
Thailand	12.5	12	(4)	58
Indonesia	7.1	8.5	20	85
Grand Total	693.6	802.7	16	37

Source:IDC Asia/Pacific, June 2000

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In June, the Ministry of International Trade and Industry …….. awarded a RM20 million grant for SMEs to encourage them to participate in e-commerce.

This steady trend of growth for LAN system also holds true in the case of Penang as SERI's recent survey of local CEOs shows that many companies intend to use IT in their operations in the near future. CEOs are also beginning to spend more time online to gather information on their competitors, and catch up with the latest developments and technology in their particular fields. This new excitement about e-business is reflected in the sentiments of the remaining half of the CEOs in Penang who say that they intend to be involved within the next 2 years. Companies who presently do not have IT departments in their organisations also indicated that they have plans to set up IT sections within the next 2 years.

In June, the Ministry of International Trade and Industry, through the Small and Medium Industry Development Corporation (SMIDEC) awarded a RM20 million grant for SMEs to encourage them to participate in e-commerce. This grant will assist SMEs to integrate their operations into the mainstream of information and communication technology to ensure their survival in the evolving global market. Our Prime Minister has also said that small and medium industries should use single portal services to advertise their products and services on the Internet.

Three states – Perlis, Penang and Negeri Sembilan – have submitted proposals and blueprints to the National Information Technology Council (NITC) for their electronic-government projects.

With this promising trend, LAN vendors on the local scene are expected to be gearing up for a surge in sales. Service providers will be expected to meet the demand with better backup and after sales services. Companies like Jardine One Solution (JOS), a regional service provider, who claims to be the no. 1 or 2 in Malaysia also reported that they saw a lot of regional customers and MNCs in the last 2 years in Malaysia. Skali.net, a provider of managed Internet and one-stop-to-dot-com services, indicated that about 30% of the more than 40,000 SMEs in Malaysia will have some form of Internet presence by the end of 2001. ***§ Khor Hung Teik***