Chapter 1

1.00 Introduction

1.10 Asian Financial Crisis

Paul Krugman believed that the root of the Asian financial crisis began with financial intermediaries – institutions whose liabilities were perceived as having an implicit government guarantee, but were essentially unregulated and therefore subject to severe moral hazard problems (Krugman 1998). The excessive risky lending led to asset inflation and same classes of assets were in turned used to leverage for more lending. When the asset bubble collapsed upon the once envied Asian economic tigers, the falling asset prices translated to financial intermediaries being inadequately capitalised, as a remedy, credit crunch followed and led to further asset deflation. This vicious cycle was the last straw that broke the Asian tigers' back.

Krugman in his August 1998 seminar address in Singapore said that Asian economies were reaching the end of the road and it was time to "do something radical" including implementing foreign exchange control since pressures on the Asian economies were too high. Krugman added that after having gone to International Monetary Fund (IMF) and finding that its policies (which he called Plan A) did not work it was time now for Asian countries to adopt what he termed "Plan B" which comprised foreign exchange control." (Krugman 1998)

On 1 September 1998 during the peak of the Asian financial crisis and its regional currency turmoil, Bank Negara Malaysia (BNM), the Malaysian central bank, pegged the Ringgit at 3.80 to USD1. The pegging was initiated to curb speculative pressures to devalue Ringgit. Malaysian authorities at first implemented an orthodox adjustment policy (Kuan 2002). Interest rates were raised to stem the decline of the Ringgit and in December 1997 a drastic cut of 18% in government spending was announced. This policy package mimicked IMF programs imposed on other affected countries such as South Korea, Thailand, and Indonesia. However, the Malaysian economy failed to respond to the orthodox policies. Consumption and investment demand plunged as a result of capital outflows, high interest rates and a pessimistic outlook. Kuan also found that the high interest rates did not deter speculators from borrowing heavily in Ringgit via offshore institutions such as Singapore to bet against a collapsing currency.

1.11 Purpose of Capital Controls

Six years has passed since Ringgit was pegged at 3.80 against the US dollar. National Economic Recovery Plan (NERP) conceived in 1998 with its six important objectives as follows had largely been met: -

a) Stabilising the Ringgit,

b) Restoring market confidence,

c) Maintaining financial market stability,

d) Strengthening economic fundamentals,

e) Continuing the equity and socio-economic agenda, and

f) Restoring adversely affected sectors.

1.12 Ringgit's Peg Outlived its Usefulness?

The question arises recently on whether the Ringgit peg had outlived its original purpose? Since the adoption of a pegged Ringgit regime, the Malaysian economy has emerged stronger and more resilient when compared to its position in the aftermath of 1997/98 financial crises. Fundamentals supporting the statement can be derived from a record high foreign exchange reserves (USD44.9 billion in Dec 2003), seven consecutive years of strong current account surpluses since 1998, strengthened banking systems, manageable total external debt levels (USD51 billion or 67.4% of GDP as at Sept 2003) and low inflation.

Essentially, Malaysia's current account deficits were curtailed and progressively turned into a healthy surplus. As of December 2004, Malaysia's trade balance stood at around RM7.0 billion. Malaysia's industrial output recorded a increase of 9% year on year (y-o-y) while external reserves stood at USD59.9 billion (BNM Dec 2004). Most of the capital controls have been removed save for the Ringgit's peg amongst others.

Over the years, strong imports by the US have culminated two large deficits in their current account as well as their federal budget. These two huge figures are putting US Dollar's credibility at question. Against a backdrop of a depreciating US dollar, Ringgit benefited from export competitiveness and a surge in demand from China for components and raw materials to feed its 9% or more on economic growth. Many economists from the region opinioned that China and others should take the opportunity now, while their economies are booming, in order to loosen their ties to the US dollar.

1.13 Speculation rumours surfacing

Speculators are alert of the well being of an economy if the fundamentals are out of line, corrective arbitrage trade will occur. Speculators' presence is known to wreak havoc in the economy. Previous speculative aftermaths were the fall of Pound Sterling from ERM, Latin American crises, etc. According to Economist's Big Mac index (proxy measure of purchasing power parity), China has the most undervalued currency in the world. In similar studies, UBS, a Swiss bank, reckons that the Yuan is now more than 20% undervalued against the US dollar. UBS argued that there is two tell tale signs that a currency is undervalued. Firstly, there must be a rapid rise in official reserves and the countries basic balance (the sum of its current account balance and net inflow of long-term capital, such as FDI).

Lately, reports of an interest rate cut by the Chinese central bank, was viewed by some market players as a prelude to China moving to a more flexible exchange rate regime. China is also constantly being pressured by US to float its Yuan owing to competitive reasons as well as US' trade deficit. Economists in general opined that the Yuan revaluation would have significant implications on the Ringgit peg. They argued that a Yuan appreciation would create an avalanche effect on Asian currencies. Speculative capital inflows will make it very difficult for Ringgit's peg to hold.

Speculative inflows or 'hot monies' would have been highly geared from foreign borrowings to invest in Malaysian equity markets or to take advantage of a revalued Ringgit before repatriating with a higher amount of foreign currency. Evidence of such inflows were recorded by Bank Negara during the first half of 2004 when portfolio inflows ballooned to RM17.6 billion, three times the amount seen in the second half of 2003 (RM5.5 billion). On 1st of Dec 2004, Barclays Capital in Hong Kong reported that a widening yield gap and prospects of a currency revaluation make a strong case for buying 10-year Malaysian government bonds and selling 10-year US Treasuries.

The Finance Ministry reaffirmed the Malaysian community that the government does not see "any material misalignment" in the Ringgit's exchange rate with other currencies that warrants it to drop the six-year-old peg to the US dollar. Bank Negara Malaysia's governor also shared a similar view of Ringgit pegging remaining status quo. She indicated that there is no misalignment of the currency to warrant a review. She also argued that Malaysia's export competitiveness is based on lower cost of doing business, a delivery system that is efficient and of quality. If regional currencies appreciate against the US dollar and the Ringgit does not, the result will be higher import prices, which will filter through all domestic prices i.e. imported inflation.

1.14 To Re-peg or not to Re-peg?

There is now divided opinion amongst economists, local manufacturers, and the government on whether Ringgit will be re-pegged, will remain status quo, or move to a managed float. In Kuan's 2002 survey to understand the public's opinion on the effectiveness of the capital controls, revealed that stability and certainty were important to the growth of the economy. Since September 1998, businessmen and especially exporters had the benefits of certainty under the fixed exchange rate regime. Under such uncertainties, how will the Small and Medium Entreprises (SME) in Malaysia fare in the event of a re-peg of Ringgit?

1.15 Small and Medium Enterprises (SME)

SME is classified by Bank Negara Malaysia as a corporation with turnover not exceeding RM25 million per annum and workforce of not more than 150 workers (BNM 2004). SMEs number around 700,000 as at 2003 and contributes 25% to Malaysia's economic performance. Recently, the Finance Ministry mooted the idea of setting up of a bank solely for SMEs. It idea was brought up due to the existing situation where commercial banks tended to focus on big business loans, sidelining SMEs which also require finances to expand. SMEs are the backbone of the economy since this group of businesses populates bulk of the Malaysian economy. The Finance Minister indicated that SMEs would be the main focus in the 9^{th} Malaysia Plan 2006-2010 during his dialogue with the National Economic Action Council (NEAC) members. SMEs are generally not financially savvy. Some SMEs may not even have trade services such as foreign exchange lines for hedging of their export payments or receipts. On the other hand, some of them simply do not wish to hedge their payments or receipts in view of the costs of hedging and their perception of the Ringgit to maintain its ground at 3.80/USD. More often than not, it is the commercial banks' practice to ask for profit records than deterred many start-up SMEs from securing a working capital line. In the event of a re-peg of Ringgit, the SMEs are likely to be losers especially the export-based companies and those that have long-term contracts to supply goods at the prevailing RM3.80/USD exchange rate. The commodity, mining, and manufacturing sectors will suffer exchange rate valuation losses in Ringgit terms given that the bulk of trade settlements are in the US dollar or the prices are quoted in the US dollar. Economists stated that the valuation impact will only be a one-off adjustment and will normalise later. It is noted that the SMEs' profit margin is slim and any significant appreciation of Ringgit would erode their bottom-lines significantly.

In summary, economists alike opined that Malaysia's fundamentals are ripe for an eventual revaluation basing on China's recent hike in interest rates as well as their agreement to allow Chinese firms to retain more foreign-exchange earnings and relax restrictions on residents and firms wanting to buy foreign currencies. The Chinese central bank's actions were seen as a way to reduce the pressure for Yuan revaluation. Malaysia's BNM had also 'admitted' to an undervalued Ringgit via their revision of the restriction on overnight foreign currency balances that an exporter can retain from RM10 million to RM50 million of equivalent foreign currencies. With effect from 1st April 2005 onwards, Bank Negara Malaysia had further allowed unlimited retention of export proceeds by resident exporters and unlimited oversea investment for individual or corporations without domestic borrowings (BNM 2005).

Time and again, one Chinese official will comment on the need to revalue, and followed by a rebuttal by another on the next day. If Yuan does revalues, the interest differentials between Yuan and Ringgit will widen and there will be an outflow of funds to capture a higher yield on Yuan-denominated instruments hence, further competing away foreign direct investments (FDIs) that our nation craves. Secondly, Malaysia has a significant portion of imports from China for raw materials as well as components. If Malaysia remains status quo, cost of doing business will shoot up. With evidence pointing to a re-peg of Ringgit, what will the SMEs do about it? Will they be able to formulate a mitigation plan to counter the short-term competitive disadvantages?

1.20 Objectives of the thesis

The Seventh Malaysia Plan accorded an important role to the Small and Medium Scale Enterprises (SMEs) in supporting national industrialization efforts through forging linkages across the manufacturing sector. Of the estimated 20,200 manufacturing establishments operating in Malaysia in 1996, more than 90% were SMEs. SMEs employed 868,000 workers and are concentrated in the food and food products, furniture and fixtures, chemical and chemical products, and metal products sub-sectors (7MP 2000). SMEs in Malaysia have been given the assurance of a fixed Ringgit upon the implementation of the capital controls, which included the pegging of Ringgit to 3.80/USD. This certainty promoted trade as the one-off depreciation from 2.80 to 3.80 to a US dollar made Malaysia's exports more competitive and the economy eventually bottomed-out from an export-led growth. Dilemma surfaces six years down the road when SMEs whom have been 'pampered' with the benefit of a fixed exchange rate this while may not be ready structurally to respond in the event of a re-peg of Ringgit to a higher level. SMEs will be at the mercy of the market. This study intends to understand the following: -

a) SMEs' opinion on the relevance of Ringgit pegging in view of our recovering economy. Has the peg outlived its origin purpose?

b) What will be the short and long term effects on the SMEs?

c) SMEs' mitigation plans to counter Ringgit's adjustment?

1.30 Significance of the thesis

Understanding the effects on SMEs and their corresponding responses to foreign exchange regime changes or adjustment will help local policy makers to better prescribe fiscal, monetary, or exchange policies appropriately in order to achieve domestic or foreign policy objectives without compromising the livelihood of SMEs in Malaysia. Economists believe that there are more losers than winners, at least over short period given that Malaysia is essentially a net exporter of goods and services. It is expected that the media and automotive industries will stand to gain due to lower costs of imported raw materials or components. Loser industries are expected to come from plantations, semiconductor, manufacturing, oil & gas, timber, and transportation. These industries have common similarities; trades are denominated in US dollars and are net exporters or large portion of sales is in foreign currencies.

In addition, knowing the effects of a re-peg of Ringgit on SMEs will be resourceful and beneficial as future pre-emptive measures for the SMEs themselves to counter foreign exchange regime changes or adjustments. With this information in hand, the SMEs will be able to make better informed decisions in terms of trade negotiations, pricing of goods, sourcing of goods, market penetrations, investments etc.

1.40 Scope of the thesis

Information will be gathered via interviews with financial controllers or SMEs' main principals behind the business to gauge the effects of Ringgit repegging. The interviewees will be restricted to SMEs within the Klang Valley from a broad range of industries. Focus will on companies with export and / or import businesses. In this context, SMEs are classified by Bank Negara Malaysia as corporations with an annual turnover of not exceeding RM25 million and a full time workforce of not more than 150.

The results from interviews would highlight the relevance of the existing pegging, the short and long term effects on the SMEs, their mitigation plans in place (if any), SMEs' opinion on the most appropriate foreign exchange regime suitable to them.

1.50 Limitations of the thesis

This thesis is basically an exploratory-based research. The main limitation attributed to exploratory-based researches is its lack of representation. This research is limited to a small sample size (5 case studies), small sample space (Klang Valley), and time. The interview results cannot represent the opinion of the entire population of Malaysian SMEs but only a small segment of the SMEs, which have export and / or import businesses. There is no denying that given ample time and larger sample size, the possibility of more variables could be discovered and / or reported findings may change.

Notwithstanding the limitations mentioned above, this thesis would be beneficial to provide a micro view on the SMEs in the event of a macro change occurs. This will greatly assist in SMEs forward corporate plannings.

1.60 Organisation of thesis

This thesis is divided into 5 chapters. Chapter 1 provides an introduction to the topic at hand, Chapter 2 will highlight the theoretical framework of exchange rate regimes and recent write-ups pertaining to the speculation on currency pegs. Chapter 3 will detail the methodology in data collection and analysis. Chapter 4 will discuss the case studies from the interviews conducted. In chapter 5, the case study will be summarised and concluded. Implications of the findings will also be discussed together with recommendations for future research in this area.