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What is the ringgit telling us?

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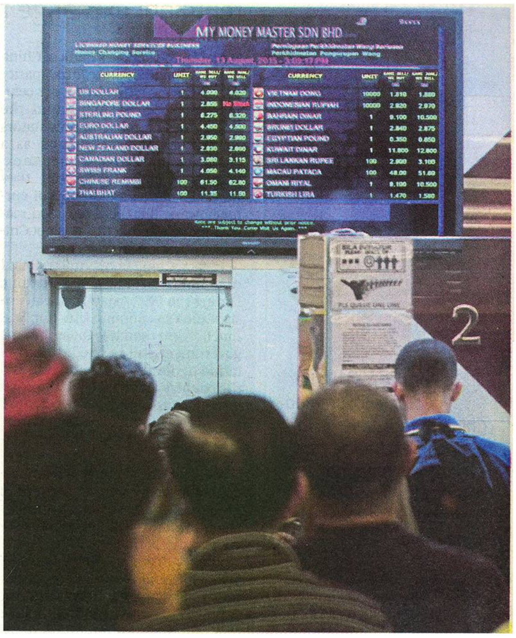
FACTORS: *A weaker ringgit can absorb the shock of external deflation and help the economy to bounce back or it can be a symptom of investment confidence*



Customers checking the prices at a money exchange. The value of the ringgit is determined by a combination of factors, rather than one or a few acting in a direction.

ONE year ago, on Aug 21, the US dollar was worth RM3.17. At the time' of writing, the selling rate was RM4.11. The loss of almost 30 per cent in value of the currency is simply massive and causing nightmares for all who buy products or services in hard currencies.

Exporters whose prices are cheaper may not fare much better as they are "forced to contend with slower global demand. Add to this the prospect that the weaker currency will also push up production costs and fuel inflation.

So what accounts for the ringgit's precipitous drop? Like most things in life, the ringgit is determined by a combination of factors, rather than one or a few acting in a direction. It is not just about fundamentals but also perception. And it is not just about perception but also fundamentals.

FIRST, and indisputably, the greenback is appreciating against most currencies and not the ringgit alone. This is on the back of a recovering US economy and an impending hike in US interest rates, originally anticipated in September but now being questioned.

Last month, the International Monetary Fund scaled back its US economic forecast from 3.1 per cent to 2.5 per cent for 2015 as the result of an unexpected output slump and declining labour productivity. The sharp decline in the Chinese yuan this month adds further uncertainty by slowing US exports.

SECOND, commodity prices, notably oil and gas prices, have fallen, as a direct result of the strong US dollar and, concurrently, concerns about world economic growth and demand. With commodity price forecasts pointing downwards, the demand for the currencies of commodity producers like Malaysia have declined.

THIRD, the move to a more market -based pricing of the yuan on Aug 11 was mistakenly taken as a signal that China's slowdown was greater than anticipated. There was a flurry of panicky currency trading as currencies, including the ringgit, sought to realign themselves and this tipped the US dollar over the RM4 mark.

FOURTH, despite unexpectedly strong second quarter aggregates, the Malaysian economy is clearly slowing. Higher public sector consumption and induced infrastructure spending helped offset the decline in net trade contribution to growth.

Elsewhere though, private in- vestment is declining as a result of lower external demand, domestic credit and fiscal tightening, while private consumption shows signs of easing.

FIFTH, the ringgit's weakness has been driven by portfolio investment outflows, both foreign and domestic. Changes in ringgit bank deposits by companies and households started to fall from early 2014 and have done so more sharply of late, even as foreign currency deposits have increased.

How much of this is due to increased domestic political developments is a matter of opinion, and there are many. It should be noted that the size of the ringgit market is not particularly large and driven primarily by trade and investment. Despite what is sometimes reported in the media, the ability to accumulate large short (or long) positions, i.e. speculation, is no simple matter.

On the plus side, there were signs earlier this year that even in the midst of a declining ringgit, there was still investor confidence in Malaysia. In March, Petronas managed to sell US$5 billion of bonds at finely priced rates and it was reported that demand exceeded supply.

On the downside, the cost of insuring Malaysian bonds against default has been rising. In mid-August, credit default swaps (CDS) increased 44 basis points over the period of just three weeks. In contrast, CDS prices of comparable countries have not moved as much.

If one needs further evidence that the ringgit value responds to domestic developments, in June this year, there was selling on expectations that a major credit rating agency would downgrade Malaysia's sovereign rating. This did not happen and the currency rebounded.

The idea that the ringgit is dictated entirely by external forces and is insulated against domestic political developments is therefore as erroneous as the opposite.

The government's defence that the currency is "undervalued" is as much a matter of opinion as is those who attribute it entirely to the political scandals wracking the country.

A weaker ringgit will absorb the shock of external deflation and help the economy to bounce back or it can be a catalyst of a crisis and symptom of investment confidence. Global factors certainly affect the value of the ringgit but only quality governance can determine which of these outcomes becomes a reality.

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