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Ways to curb ringgit volatility

ADOPT EXCHANGE RATE MANAGEMENT

WAYS TO CURB RINGGIT VOLATILITY

IN the first half of this year, the ringgit again ranked among the worst-performing currencies in Asia.

During this period, intraday volatility in the ringgit, measured in terms of the average high-low spread, exceeded that of the first half of 2022.

A statistical estimation indicates that this increase in volatility is significant.

Recent volatility in the ringgit has been widely attributed to the interest rate differential amid the aggressive Federal Reserve's rate-hiking campaign. This has triggered portfolio outflows, or what is commonly referred to as a "flight to quality", as investors seek better returns, thus diminishing demand for the local currency.

This is only a partial explanation for exchange rate volatility. The asset market approach to exchange rate determination explains that the exchange rate is highly volatile because of changing expectations or sentiments among market participants about factors that affect the expected return on assets.

These include expectations about inflation, economic growth, import and export demand, and macroeconomic policies.

The ringgit exchange rate remains vulnerable to speculation even though the central bank has prohibited ringgit trading in the offshore foreign exchange market.

Excessive fluctuations in the ringgit's exchange rate have raised concerns among politicians, business sectors and the public.

Significant swings in the exchange rate, although short term in nature, can have notable effects, especially during periods of heightened political and macroeconomic uncertainty.

The surge in exchange rate volatility was recently evident during periods of high uncertainty over the Russian-Ukrainian war, Malaysia's hung Parliament, the Chinese economic slowdown and monetary policy actions.

Based on a dataset sourced from Bank Negara, Malaysia experienced worsening net portfolio outflows in the first quarter of 2023, with almost 25 per cent increased net outflows from the fourth quarter of 2022.

Consistently, the investor participation statistics published daily by Bursa Malaysia showed that foreign investors were net sellers of Bursa Malaysia equities for 12 consecutive weeks up to the first week of this month.

Most, if not all, speculative traders are not interested in the underlying economic fundamentals of the countries involved. Their trading aims to capitalise on asset price movements.

Consequently, substantial speculative trading has led to deviations between exchange rate fluctuations and the underlying economic fundamentals.

Speculative behaviour in asset and currency markets is inevitable and likely to persist. Certain politicians have suggested re-pegging the ringgit against the greenback.

However, re-pegging the ringgit could impose significant costs on the financial stability. The central bank's ability to maintain the pegged level is constrained by its foreign exchange reserves.

Continuously supporting the ringgit's value to sustain the peg would require significant reserve expenditure, potentially exposing Malaysia to currency speculation risks.

Historically, the ringgit performed relatively well during the first decade of the managed floating regime, trading within 3.00 to 3.78 against the US dollar.

Under the managed float arrangement, the central bank monitored the ringgit's value against a basket of foreign currencies representing Malaysia's major trading partners.

Considering the growing magnitude of speculative trading in the currency and asset markets, the ringgit, as well as other currencies of emerging economies, are likely to remain vulnerable to changing sentiments.

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Recent academic studies provide theoretical and empirical evidence supporting exchange rate management as an optimal policy device for emerging economies during periods of undesirable economic shocks. Therefore, under the current circumstances, policymakers should adopt practical interventions while remaining committed to welfare-enhancing measures without compromising overall financial stability.

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