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My Say: Exchange rates matter for long-term wage growth, productivity and national well-being

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Of late there has been much hand wringing about the performance of the Malaysian ringgit. The ringgit's depreciation has been steady and sustained against several key currencies, in particular the US dollar. Indeed, there is cause for concern as exchange rates do matter for the long-term well-being of a nation. The experience of countries like Japan, South Korea, Taiwan and China show that cleverly managed exchange rates can be the enabler for national growth and prosperity. Yes, a nation needs much more than just exchange rate policies to succeed. But a well-formulated exchange

rate regime can enhance competitiveness, incentivise the right type of industry formation, enable the macroeconomy to evolve as needed and optimise allocative efficiency. On the other hand, an ill-conceived exchange rate regime can stunt economic progression and nudge countries into a low-value-added, low-income trap.

So, what are exchange rates and why are they so important? An exchange rate is simply the price of a foreign currency in terms of the local currency. And like all prices, they are determined by demand and supply. However, unlike the prices of goods and services, the mispricing of which will only affect the producers and consumers of that particular product or service, a mispriced exchange rate, especially against a key currency, can affect everyone. For example, even a civil servant with no foreign currency exposure whatsoever can be affected by a misaligned MYR/US\$ exchange rate through higher imported food prices and imported pharmaceuticals. More than being systemic and broad based, misaligned exchange rates when sustained over time can cause serious damage to an economy through the provision of wrong signals, incentivising the wrong kinds of industry or the wrong labour-capital ratios and overall output inefficiency. While numerous factors affect the demand/supply of a currency, three key factors would be the interest/inflation differential, growth and return potential of assets denominated in the currency and the foreign exchange reserves position, which acts as a proxy for faith/confidence worthy of the currency. Factors like poor governance, political instability, trade and fiscal imbalances would all work through demand/supply forces to cause the currency to depreciate.

The origins of the ringgit's current problems can be traced to the period just prior to the 1997/98 Asian financial crisis. The seven-year period prior to the crisis saw Malaysia achieving GDP growth averaging a spectacular 11.6% per annum. That growth, however, was being funded in three rather unsustainable ways — rapid domestic monetary growth, large current account deficits and capital inflows, including short-term portfolio inflows. Consider this, for the seven-year pre-crisis period, growth in M1 and M2 money supply averaged 15% and 17% respectively, domestic credit had grown at 19.5% per annum and the current account deficit averaged -6%, having peaked at -10% in 1995. As at end-December 1996, short-term loans were 56% of total foreign loans and 47% of reserves. Total foreign loans were 84% of reserves. Further, based on purchasing power parity, the ringgit was at that point overvalued against the US dollar by about 12.5%. Clearly, the ringgit and the economy were highly vulnerable to a speculative attack, which then happened. If debt-funded growth had made the ringgit vulnerable, the subsequent policy response may have further entrenched that weakness.

Malaysia chose unorthodox measures of pegging the ringgit at 3.80 against the US dollar and imposing capital controls including a one-year moratorium on outflows. For a nation that has always had liberal capital flows, the controls, especially the moratorium, shook the faith and goodwill of foreign investors. All of a sudden, the ringgit and the country underwent a risk rerating. Of longer lasting damage, however, was the peg. At 3.80, it was sharply undervalued against the US dollar. It may have been a traded rate the ringgit had then reached, but it was a period of crisis, not a normal one. The problem with an undervalued currency is that it effectively protects domestic producers, including inefficient ones. For Malaysia's commodity exporters, being price takers, the undervaluation gave no competitive advantage whatsoever but caused windfall profits since their products, rubber, palm oil, petrol and so on were priced in US dollar while their costs were in ringgit. Similarly, since the domestic price of imported goods rises with the undervaluation, even inefficient domestic producers reap higher profits. If the incentive to improve efficiency gets diminished with easy profits, there was yet another policy error that compounded the problem. This was the policy of importing cheap, unskilled foreign labour. Though foreign labour had been present even before the financial crisis, the combination of an undervalued currency and easy availability of cheap foreign labour meant that the industries that thrived were the low-skill, low-value-added variety that relied on cheap unskilled foreign workers. Since the undervalued currency made them profitable, there was little incentive to innovate, automate or move up the value chain. As productivity remained low, so too did wages.

Development theory argues that nations progress through several stages of industrial development. Typically, nations begin industrialisation through import substituting industries. These tend to be low-skill, labour-intensive industries producing basic consumer goods. As these industries expand and more labour gets absorbed, wages begin to rise. Rising wages force firms to first automate and then move up the value chain in order to survive. As a result, industrial productivity increases, the nation becomes more competitive and incomes rise. This industrial evolution took place in Japan, South Korea, Taiwan and most recently in China, but not thus far, in Malaysia. The likely reason: the above combination of undervalued currency and easy availability of cheap foreign labour. Economic progression had been stunted and the nation nudged into a low-value-added, low-productivity, low-income trap.

Interestingly, the East Asian economic powers — Japan, South Korea, Taiwan and China — had all used undervalued currencies at various points to industrialise and pull themselves up. The Plaza Accord of 1985 had first forced Japan and then South

Korea and Taiwan to abandon their policy of keeping their currencies undervalued. The West even now continues to accuse China of currency devaluation. All these raise the question of why, if an undervalued currency had worked wonderfully for those countries, has it not for Malaysia. The answer lies in domestic value added. When the domestic value added is large, meaning the value of imported content is small relative to the value of the final output, currency undervaluation is sensible and works favourably. For example, suppose the imported content is 10% of final value and domestic value added 90%, a 30% undervaluation of the currency will work wonders to improve export competitiveness and foreign market share. Note that the undervaluation merely increases the cost of imported content from 10% to 13% of total value, domestic value added is still 87% and the nation benefits from increased export competitiveness, bigger market share and increased export earnings and income. Now suppose another nation's factories are mere assembly line operations with very high import content. Consider a flip of the above example, suppose imported contents are now 90% of total value and domestic value added is 10%. What happens if there is a 30% devaluation of the currency? Can the nation benefit from increased competitiveness? The answer is clearly no. A 30% devaluation would cause the value of imported content to rise by 27% to 117% of the earlier total cost, meaning product prices have to be raised overseas to avoid losses, effectively rendering the devaluation useless. Thus, the benefit to a nation of an undervalued currency is clearly dependent on the size of its domestic value added.

In a highly acclaimed economics paper, the late Nobel laureate Paul Samuelson and his co-author Ben Balassa ask why haircuts are so much more expensive in Tokyo when Japanese barbers do exactly the same thing barbers everywhere do. What justifies their price, as Japanese barbers cannot be so much more productive than barbers elsewhere. Their answer is: because the Japanese industry is highly automated and capital-intensive, it results in very high labour productivity. Factory workers earn very high incomes and unless barbers earn similar incomes, they will give up cutting hair and work in factories. So, the equilibrium price for barbers has to be high enough to equal factory worker incomes. Simply put, high productivity in the industrial sector (tradable goods/exports) will raise wages elsewhere in the economy. Note that until the mid-1980s, the Japanese maintained a deliberately undervalued yen, but they were wise enough to avoid imported cheap foreign labour.

Exchange rate policies can and should be part of the overall development strategy. The underlying lesson is this, exchange rates being prices that determine a nation's

terms of trade can have a long-term impact on productivity, wage growth and national well-being.

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