Malaysia On The Jagged Edge

One of the lessons learned well in Silicon Valley is to ask the question, "If we were starting this business today, what would we do?" This is how Gordon Moore and Andrew Grove of Intel decided to exit the low-margin DRAM chip business in the 1980s to focus on high-margin microprocessors. Companies who try to defend historic business models are destined to become future business school cases.

To a certain extent, this lesson applies to the establishment of national boundaries. In some instances, such as Japan, the boundaries are drawn by nature, although the indigenous Ainu people might disagree. In other cases, such as India or Italy, what is really a geographic expression is turned into a political entity out of force of history. Malaysia falls into this category as well; its main peninsula looks like a homogenous entity on a map, but its mountainous rainforest-covered terrain had been the home of multiple independent political entities prior to the Muslim and then European colonial eras. Its second half, covering the northern coast of the island of Borneo, is separated from the peninsula by several hundred miles of the South China Sea.

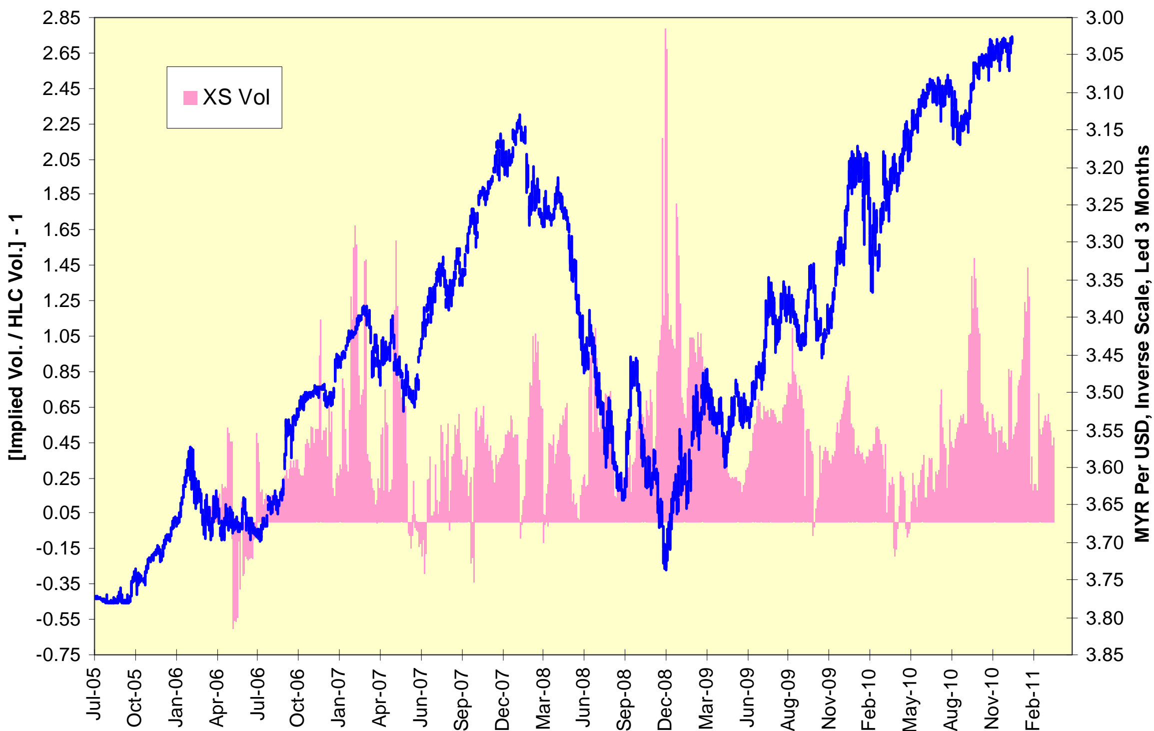
While the Suez and Panama canals had to be excavated by human effort, the Straits of Malacca operate effectively as a natural chokepoint for waterborne commerce. If you want to move a crude oil tanker from the Middle East to Singapore or eastward to Japan or Korea, the Straits are the place to be. Pirates have figured this out, too, and the Malaysian Navy has been fighting pirates there before the world discovered the pirates of Somalia.

This strategic location between the Middle East and India to the west and China to the east has made Malaysia a stomping ground, literally, for invading colonial armies forever. The word for its currency, "ringgit," is a Malay term for "jagged," a reference to the serrated edges of Spanish silver dollars which arrived there on mainly Portuguese and Dutch ships in the 15th and 16th centuries (see "Islamic Currencies: What's For Dinar?," February 2010 for some other colorful currency etymologies).

Malaysia's history, including its relatively recent brutal occupation by Japan during World War II and its long struggle for independence from the British thereafter, a struggle motivated in large part by resentment of Chinese and Indian nationals being given equal treatment by the British, has led Malaysia to protect its independence fiercely. Nowhere was this seen more than the decision to impose capital controls after the early stages of the 1997-1998 Asian crisis and by the willingness of its then-prime minister Mahathir bin Mohamad to blame anyone and everyone else, including the uninvolved George Soros, for the crisis. Even after China loosened its peg to the dollar in July 2005, the MYR remained a managed floating currency. This history of controls has made the long-term analysis of the MYR more a short-term analysis than we would like.

No Real Trend

Can a managed currency trend? Absolutely; all we need do is look at the Brazilian real of the late 1990s or the Chinese yuan between July 2005 and July 2008. All you needed in either case was a ruler and a willingness to find out after the fact policies either had failed, as was the case in Brazil, or changed, as was the case in China. What a managed float does do, however, is change the dynamics of both implied and realized volatility. Both are of necessity lower than they would be otherwise. In the case of the MYR, excess volatility or the ratio of implied to high-low-close volatility minus 1.00, has had a weak leading relationship to the MYR. It rises before the ringgit falls and vice-versa, but this relationship is nowhere near tight enough to trade.



As we have done for other South Asian currencies such as the Philippine peso and Thai baht (see, “No Whacks At The Philippines” and “The Baht And I: Time To Tie One On,” April & May 2011, respectively), let’s add in the MYR’s cross- rate to the Japanese yen in recognition of Japanese banks’ importance in the region. This cross-rate has been rather confined as well, and there is no active options market between the two currencies.

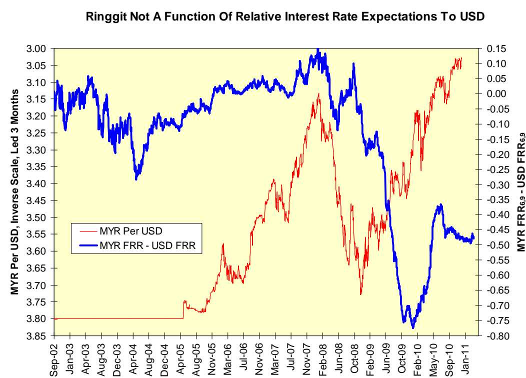
Interest Rates

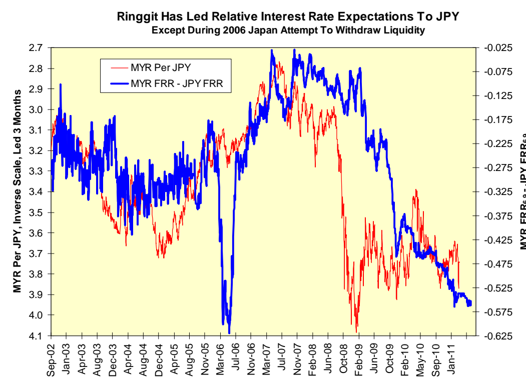
If a currency is managed, short-term interest rates must be allowed to fluctuate. In practice, managed floating or the pegging that comes with a currency board arrangement often produces greater short-term interest rate volatility than would exist otherwise. The general principle is you can fix a currency or fix an interest rate, but you cannot fix both.

Let's see how this comes into play with one of the key variables we have used to analyze nearly all currencies, the interest rate expectation differential as measure the forward rate ratios between six and nine months ($FRR_{6,9}$). This is the rate at which we can lock in borrowing for three months starting six months from now, divided by the nine-month rate itself. The more this $FRR_{6,9}$ exceeds 1.00, the steeper the money market yield curve is.

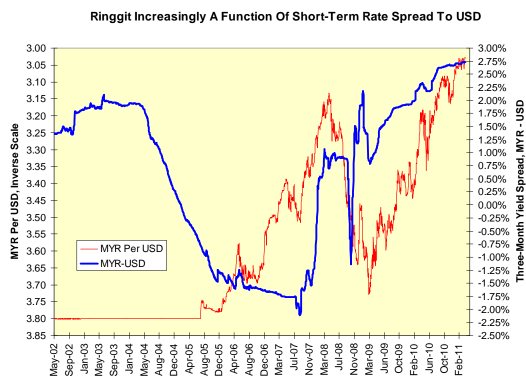
We should expect the differential between the MYR $FRR_{6,9}$ and those of both the USD $FRR_{6,9}$ and the JPY $FRR_{6,9}$ to lead the MYR by three months, with the normal effect being a greater differential leading to a stronger MYR. This does not appear to be a strong relationship for the USD. As the USD $FRR_{6,9}$ steepened in 2008-2009, the expected interest rate differential turned negative, but the MYR both weakened and then strengthened during this period.

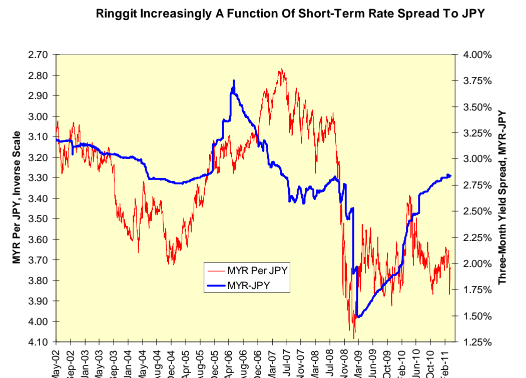
The picture is different for the MYR per JPY cross-rate. Here movements in the cross-rate have led changes in the expected interest rate differential; this indicates the exchange rate tail is wagging the expected interest rate dog, as distasteful as that metaphor may sound. Note the rather prominent feature in the spring of 2006 associated with the Bank of Japan's failed attempt to end quantitative easing and raise short-term interest rates; the JPY $FRR_{6,9}$ steepened sharply and then contracted just as rapidly as the Bank of Japan backed away from its actions.





Now let's see if the answer changes much if we use the simple three-month interest rate spread between the MYR and both the USD and JPY. As we have seen in a wide range of minor currencies, this spread often is more telling than the forward expectation differential. The gist of the answer is similar to that seen for the expected rate differential itself: While the absolute rate spread between the USD and MYR has only recently been linked to the MYR's dollar rate, it has matched the cross-rate to the JPY fairly closely until July 2010. Both the expected interest rate differential and the absolute three-month yield spread indicate the yen had been the more important currency for the ringgit market even though Japan's prominence in global banking is not what it once was.

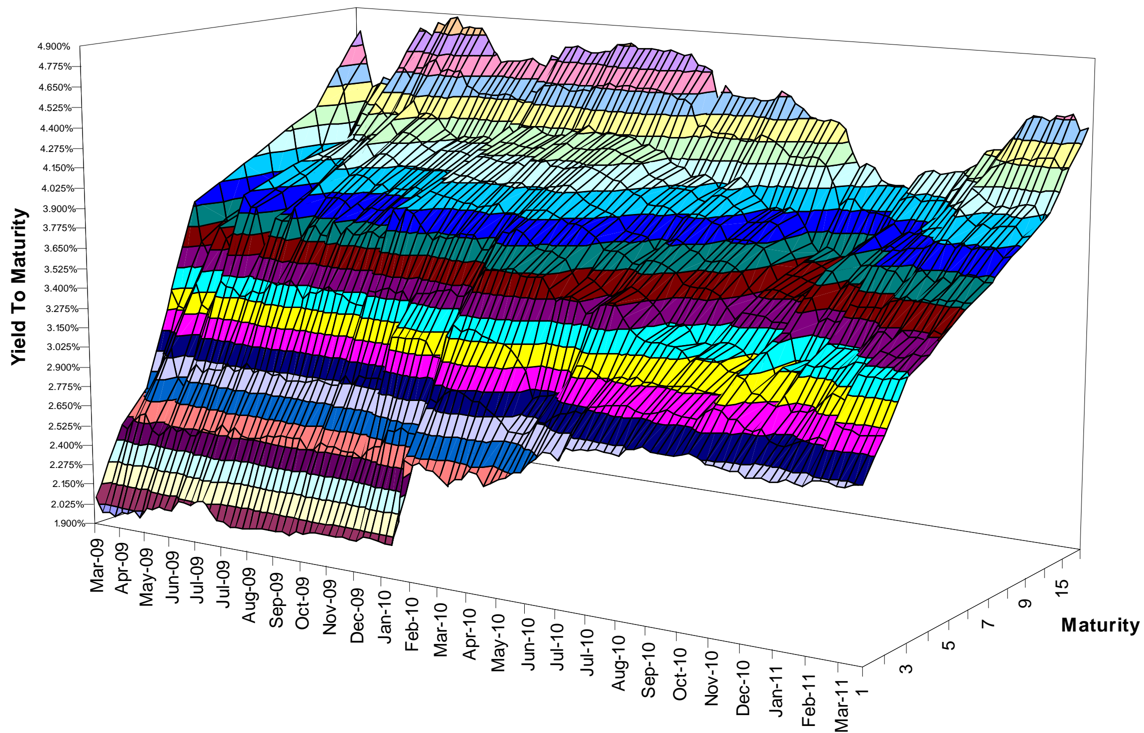




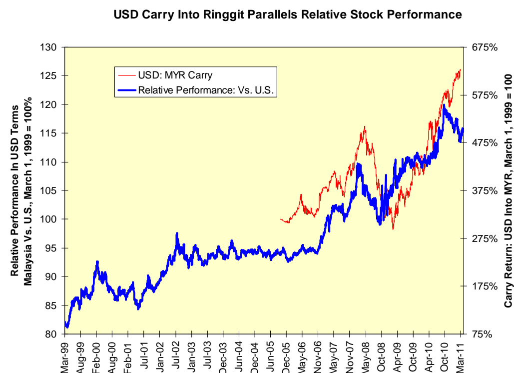
Capital Market Horizons

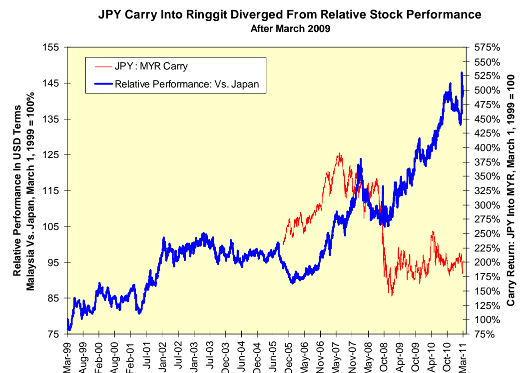
If the MYR's managed float is being policed by short-term interest rates, then we should expect to see a very stable capital market yield curve with nearly all of the shifts occurring at the short end of the curve. This does appear to be the case for the Malaysian yield curve after the March 2009 global market low.

Malaysian Yield Curve Flattened From Short End In Early 2010



The role of relative stock market returns is more difficult to assess completely given the MYR's peg up until July 2005. We can map the total return on the Malaysian stock market in USD terms to both the U.S. and Japanese markets and overlay the total carry return for borrowing the dollar and the yen and lending in the ringgit. The post-September 2005 history until the hint of QE2 in August 2010 indicated Malaysian equities led capital flows from the U.S. However, what had been a leading relationship for Malaysian equities relative to Japanese equities broke after the March 2009 global market low and never recovered. The implication here is the move of U.S. short-term interest rates to and then below their Japanese counterparts made the dollar the preferred funding currency for Malaysian stock market investment.





This switchover behavior between the yen and the dollar and the observed greater importance of interest rate differentials between the ringgit and the yen as opposed to the dollar indicate Malaysia enjoys an option. It is situated to take advantage of whichever major currency is offering cheaper funding. In a twist of fate, this parallels Malaysia's history and geography: It stands in the middle of larger entities, gets knocked about on occasion but in the end seems to endure.