



**The Northern Trust Company**  
**Economic Research Department**  
**Positive Economic Commentary**

*"The economics of what is, rather than what you might like it to be."*

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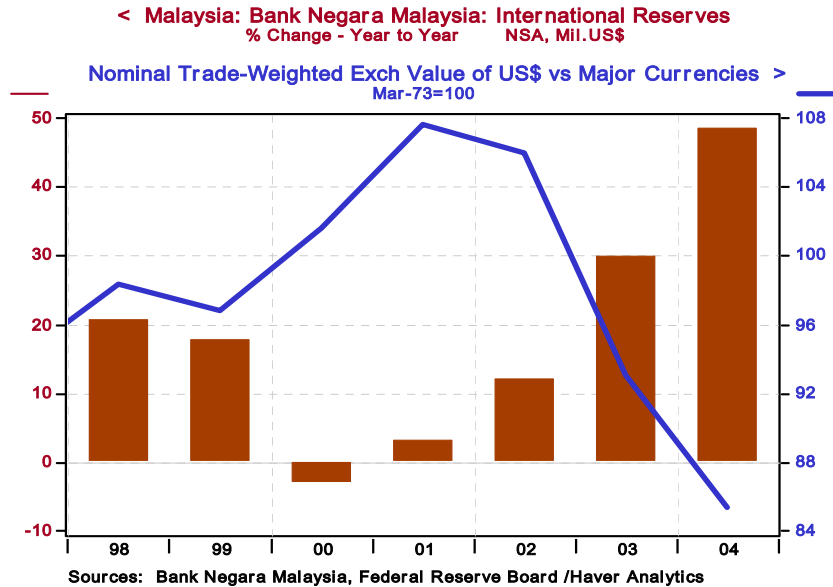
Wednesday, April 13, 2005

**Case Study On Costs Of Hitching Your Wagon To A Dollar "Star" – Malaysia**

After the Asian economic implosion of 1997, Malaysia decided, among other things, to peg its currency to the greenback at a rate of 3.8 ringgits per U.S. dollar. Although this exchange-rate-pegging policy might have served the Malaysian economy well in the years immediately following the Asian financial crisis, it now is imposing costs on the economy, not the least of which is higher inflation. Although the People's Bank of China and, to a slightly lesser degree, its subsidiary, the Hong Kong Monetary Authority, are the only other Asian central banks that pursue a formal dollar-pegging policy, a number of other Asian central banks attempt to manage their currencies' values relative to the dollar. In the past two years as *private* foreign investors have reduced their share of financing the growing U.S. external deficit, Asian central banks have become the marginal, or buyers of last resort, of dollars and, hence, dollar-denominated assets. The inflationary costs of Malaysia's dollar-pegging policy is a "model" for what is in store for other Asian economies if their central banks continue to prop up a dollar that fundamentally "wants" to sink. The Malaysian example is reminiscent of what Western Europe experienced from the late 1960s through the early 1970s when its central banks also followed a dollar-pegging policy at a time when the greenback was fundamentally weak versus other currencies. The costs of dollar-pegging being incurred by the Malaysian economy and the likely response by Malaysian policymakers may hasten the abandonment of dollar-pegging policies of other Asian central banks.

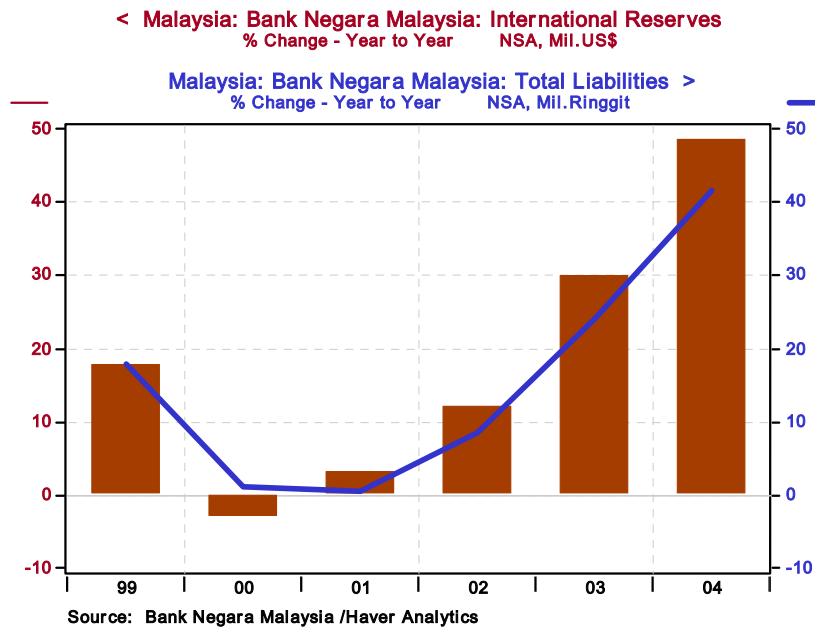
To understand the origin of the inflationary implications of Malaysia's dollar-pegging policy, we have to outline the mechanics of the policy. If the dollar's natural inclination is to fall against the ringgit, then the central bank of Malaysia, Bank Negara, must purchase dollars in the open market to maintain the 3.8 ringgit per dollar exchange rate. The purchase of dollars will add to Bank Negara's foreign reserve holdings. Chart 1 shows that as the U.S. dollar, on a trade-weighted basis versus major currencies, fell sharply in 2003 and 2004, growth in Bank Negara's foreign reserves accelerated in these years, reaching almost 50% in 2004.

Chart 1



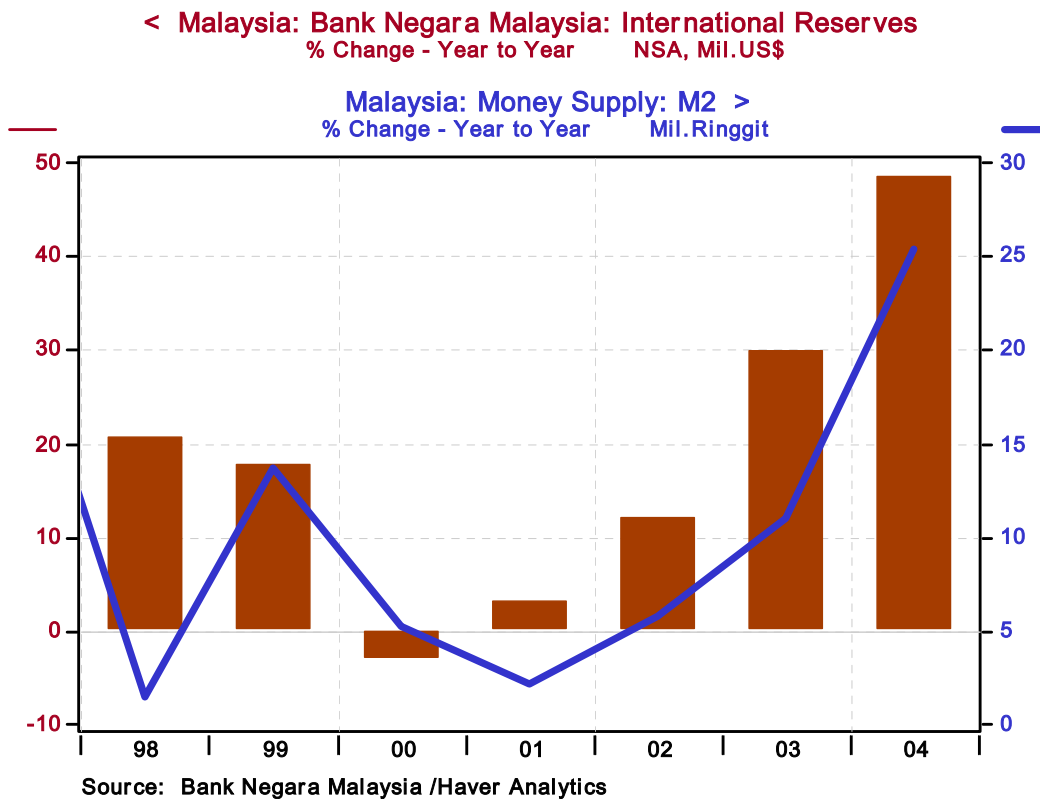
What does Bank Negara use to buy all of these dollars it is buying in the foreign exchange market? Ringgits. And where does the Bank Negara get these ringgits? It figuratively prints them just as does the Federal Reserve when it buys securities. These ringgits created out of thin air by Bank Negara show up on the Bank's balance sheet as liabilities. Chart 2 shows the tandem growth in recent years between Bank Negara's foreign reserve holdings and its ringgit liabilities.

Chart 2



These ringgit liabilities are the seed, or base, money enabling Malaysian commercial banks to expand their loans and investments. Double-entry bookkeeping suggests that increases in commercial bank assets will be matched by increases in commercial bank liabilities. Deposits typically represent the largest component of commercial bank liabilities. And commercial bank deposits represent the largest component of most nations' money supplies. So, there is a linked relationship between Bank Negara's acquisition of foreign reserves through its dollar-pegging policy and the Malaysian money supply. This relationship is shown in Chart 3. As growth in Bank Negara's foreign reserve holdings has picked up in recent years, so has growth in Malaysia's M2 money supply. Last year, Malaysian M2 grew by more than 25%.

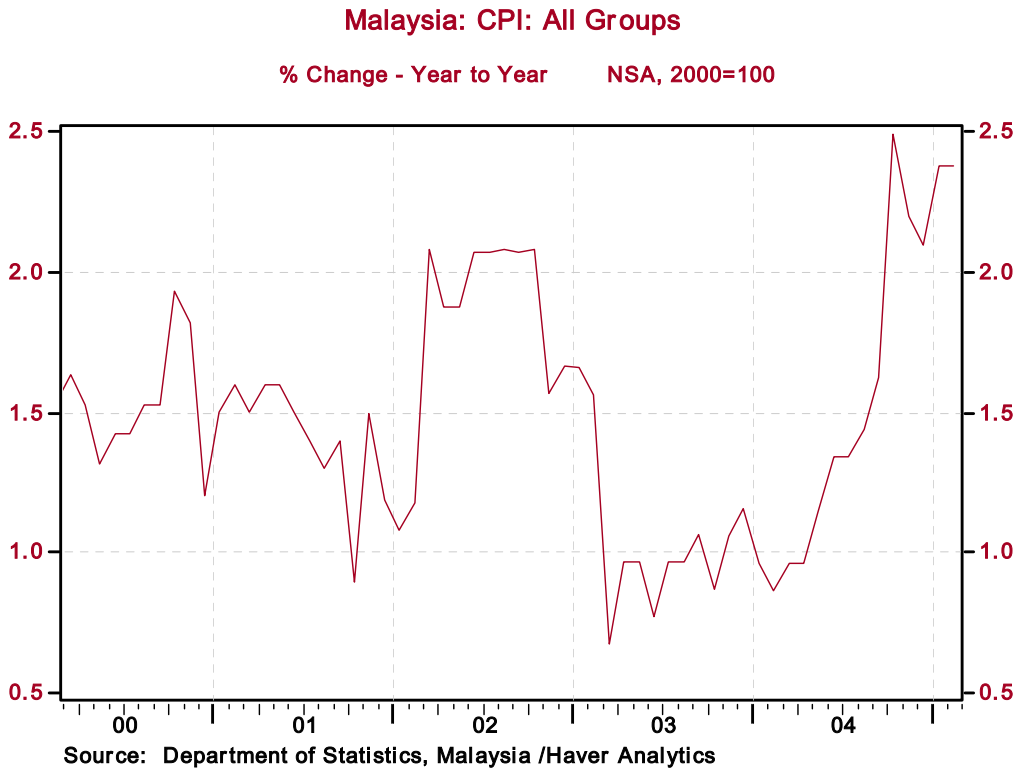
Chart 3



To classical economists, inflation was defined as an increase in the money supply. The *consequences* of inflating the money supply would be rising prices of goods, services and assets – both financial and tangible. We have established that the Malaysian money supply has been inflating at a faster pace in recent years as a result of Bank Negara's dollar-pegging policy. What about the consequences of this. Are Malaysian goods and services prices rising faster? Chart 4 shows that they have started to. After slowing to about 1% in December 2003, the year-over-year growth in the Malaysian CPI has accelerated to 2.4% in February of this year. Although still relatively low, it is an acceleration in inflation nonetheless. Moreover, if the lead-lag relationship between money supply growth and the rate of increase of prices for consumer goods and services in Malaysia is anything like it is in

the U.S., then growth in the Malaysian CPI will continue to trend higher for several years because of the current high rate of M2 inflation.

Chart 4

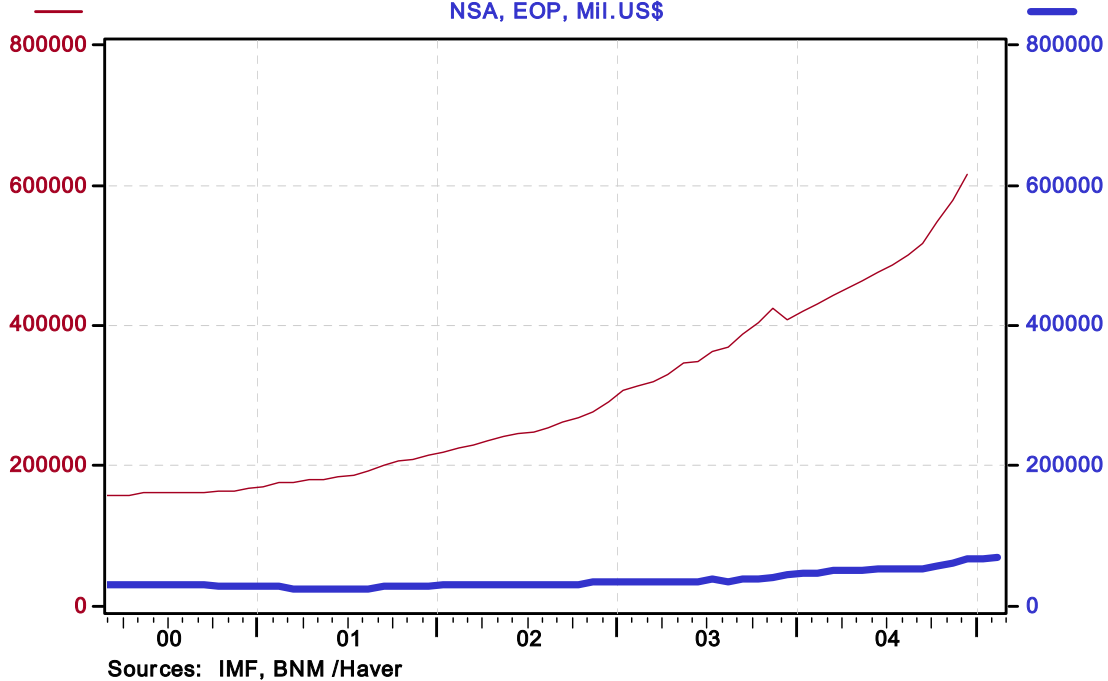


By pegging its currency to the dollar, the Malaysian central bank has effectively abdicated monetary policy to the behavior of the dollar in the foreign exchange markets. The cost to Malaysia of this policy is higher inflation. If the fundamental inclination for the dollar to fall persists, then the cost to the Malaysian economy of maintaining the dollar peg of the ringgit will increase. What holds true for Malaysia holds true for other Asian economies whose currencies are managed in relation to the dollar. Although Malaysia's foreign reserves of \$71.5 billion are large for Malaysia, they pale in comparison to China's \$614.5 billion (see Chart 5). If Malaysia waited to begin diversifying its foreign reserves out of dollars *after* China did, Malaysia would likely suffer massive capital losses on its dollar-denominated asset holdings given how big China's holdings are and, therefore, how large China's impact on the markets would be if word got out it was diversifying. So, there is an incentive for Bank Negara and the central banks of other relatively small Asian economies to begin diversifying out of dollar assets *before* the big guys, China and Japan, do. But if the small fry start diversifying out of dollars, that will put all the more pressure on the big guys to have to buy even more dollars and, thus, inflate their money supplies all the more. In turn, this will hasten China's and Japan's diversification out of dollars.

Chart 5

< China: Intl Liquidity: Total Reserves Minus Gold  
NSA, EOP, Mil.US\$

Malaysia: Intl Liquidity: Total Reserves Minus Gold >  
NSA, EOP, Mil.US\$



At the outset, I mentioned that the dollar-pegging environment that exists in Asia today is much like the one that existed in Western Europe in the late 1960s. By the early 1970s, the inflationary costs of maintaining fixed exchange rates with the dollar became so costly in terms of inflation that western European central banks unhitched their currency wagons from the hitherto star, the dollar. The dollar plunged and U.S. inflation and interest rates spiked higher. Similarly, because of the inflationary implications of their current dollar-pegging policies, Asian central banks are likely to unhitch their currencies from the dollar in the next year or so.. Although the quantitative consequences of this for U.S. consumer prices and interest rates may differ from the early 1970s' experience, the qualitative effects are likely to be similar

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