ABSTRACT

Based on macroeconomic theory, export and import growth, and thus the trade balance, are usually determined by changes in price competitiveness, economic growth of trading partners and income growth in the home country. Such changes are often caused by movements in exchange rates with respect to major trading countries. Since Malaysia's international trade is mostly denominated in US dollars, and the US being the largest single importer of Malaysian exports, the performance of the Malaysian trade is highly dependent on the US economy. Thus, the ringgit - US dollar exchange rate may have a significant impact on both the Malaysian effective exchange rates and trade balance. Hence, the main objective of this research is to analyse the impact of the US dollar on Malaysian real effective exchange rates and trade balance from the period of 1975:1 to 2003:4.

In this research, the export, import and trade weighted effective exchange rates were computed and analysed. The analysis showed that the RM/US$ nominal bilateral exchange rates has some significant impact on the Malaysian real effective exchange rates. In addition, an analysis was undertaken to capture the impact of the US dollar on Malaysian trade balance. Thus, it has been found that the impact of US dollar on Malaysia's trade balance is quite significant as the estimated vector error correction models yielded results that support underlying economic theory. It has been found that the RM/US$ bilateral exchange rate improves the demand for exports and thus, the trade balance. In addition, the analysis shows that the export weighted and import weighted real effective exchange rates are more appropriate to analyse the relationship between exchange rates and demand for exports and imports respectively rather than the trade weighted real effective exchange rates.