CHAPTER 6

CONCLUSION

6.0 Limitations of the Study

The major drawback of this analysis is due to data availability. In this analysis, the Consumer Price Indices were used to compute the real effective exchange rates, as no other alternative was available. "The disadvantage of using CPIs as proxy for prices of non-traded goods is that it includes the prices of services, which are mainly non-traded. Most international trade is in intermediate goods and does not take place at consumer goods" (Ha and Fan 2003:16). Besides that, CPIs are often subject to different rates of indirect taxes and subsidies and even administrative price regulation (Bogov 2001:136). It is thus preferable to use the Producer Price Index (PPI) or the Wholesale Price Index (WPI) to reflect the price indices. But the PPI and WPI indices are not available for some countries. Besides that, only 15 countries are included in this study as quarterly data for some countries are not available. Thus, the real effective exchange rates computed in chapter 4 only covers about 70 to 80 percent of Malaysia's total trade.

6.1 Suggestions

Since the weights used to compute the real effective exchange only taken account of merchandise trade, perhaps other alternative measures of Real Effective Exchange Rates should be considered for future research[1] as have been discussed below:

1. REER based on Trade in Services

   Currently, Malaysia is placing greater emphasis on services sector (tourism, transportation, trade-related services and etc) rather than concentrating only on

[1] Based on Ha and Fan 2003:18-19.

manufacturing sector. Thus, consideration should also be given for a service-based index. Unfortunately, the major the drawback is that data on trade in services are difficult to come by.

2. REER based on Third-Country Effects

   "This analysis mainly focuses on bilateral trade shares and it would be only useful when assessing the competitiveness of the domestic economy relative to its trade partners. It does not take account of "third-country" effects that is the competition that Malaysia's exports face in foreign markets from other countries that produce the similar type of goods. Thus, the weighting scheme should take account of the competitors' exports to Malaysia's major trading partners. In this way, it would be easier to assess the competitiveness of Malaysia's exports in the foreign markets.

3. REER based on FDI Weights

   Investments are quite important for the growth of a particular economy. Malaysia's is quite dependent on foreign direct investments especially for the manufacturing industries. Exchange rate movements in the country would have an impact on investments. For instance, the 1997 financial crisis was exacerbated by the "contagion effect" which caused massive capital flight dampening economic growth in the country. Thus, REER indices based on FDI might be useful to analyse trade performances.

6.2 **Summary**

Thus, this chapter concludes the analysis on the impact of the US dollar on Malaysian real effective exchange rates and trade balance. ***Chapter 2*** summarises various literature on the impact of exchange rates on trade. In that chapter, the advantages and disadvantages of fixed and flexible exchange rate regimes for international trade were reviewed. Besides that, literature on the impact of a devaluation or depreciation of one's currency on trade in the short and long run were also considered. ***Chapter 3*** discussed the developments in the international financial environment that have been crucial for the development of Malaysia exchange rate system. The chapter also discussed the movements in the Malaysian exchange rates against its major trading countries as a result of changes in the international monetary scene. In ***Chapter 4***, 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, a comparison was made between the computed effective exchange rates and the ones computed by the IMF and the results showed that the export weighted real effective exchange rates correlates best with real effective exchange rates published in the International Financial Statistics. Finally, in ***Chapter 5***, an analysis was undertaken to capture the impact of the US dollar on Malaysian trade balance. 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.