THE IMPACT OF REAL EXCHANGE RATES ON EXPORTS: THE MALAYSIAN CASE

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MARCH 2000

Abstract

Many studies have yielded contradicting results on the impact of real exchange rate volatility on exports. Therefore, this paper attempts to examine the relationship between real exchange rate volatility and Malaysian exports. The model of this study is adapted from Caballero and Corbo's (1989) paper. In this respect, this paper also uses the same standard calculation for real exchange rate (RER) volatility. However, a minor adaptation was made whereby the standard deviation, the measurement of real exchange rate volatility is refined by using trade weighted settlement in its computation. This would be a more accurate way of measurement, as the weights would have an impact on the sensitivity of the exports to RER volatility. Moreover, Malaysia's trade settlement is skewed towards USD. Therefore, if the proper weights were not assigned to USD, the study would have underestimated the impact of RER on exports. This paper analyses both the short-run and long-run impact. The distinction in the time frame is made by having a lagged variable in the short-run equations and instrumental variables (IV) and ordinary least squares (OLS) methods are applied to both the short-run and long-run equations. Before proceeding with the regression, the time series data was checked for stationarity. Although the variables are individually nonstationary, their linear combination is stationary. Hence, there is a long-run or equilibrium relationship between the variables which means that the regression is real and not spurious (Gujarati,1999). The results of the paper confirm the negative sign of the relationship between exports and RER thus suggesting that RER volatility has a dampening impact on exports. However, the impact is small as every 1% change in RER volatility depresses exports by less than 1%. Generally, the quantum of impact is the same in both the short-run and long-run. This suggests that Malaysia exports adapt quite well to the volatility of the RER and their production schedules are flexible enough to absorb the impact of the volatility of RER. Though the impact is small, it is still important to maintain RER stability as risks arise when there is a long run divergence of the RER from its equilibrium value. Therefore, the importance of a stable exchange rate has been discussed in the final part of this study and various policy recommendations were also made in the final part of this paper.

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