CHAPTER V

Conclusion

In this study, we examined the equilibrium exchange rate for RM against USD by using three different methods namely the Big Mac index, Purchasing Power Parity theory and the Edwards' model. The main objective is to understand whether the ringgit Malaysia is over-valued or under-valued after pegging to RM3.80 per USD.

Big Mac index calculates the exchange rate based on the Purchasing Power Parity Theory that equalizes the price of Big Mac between Malaysia and United States. This is a very basic index without consideration of other product prices in the market, cost of production, rules and regulation, monetary and fiscal policies. The Big Mac index is quite stagnant due to a fixed pricing policy of Big Mac price that McDonald's need to maintain a competitive pricing in the market.

Then, we examined the exchange rate using the Purchasing Power Parity Theory. The cointegration technique is employed to examine this long-run relationship among the exchange rates and inflation rates. The results show that Purchasing Power Parity does not hold in Malaysia. This may be due to the substantial foreign exchange speculations and capital movements that have caused the exchange rate to deviate largely from the Purchasing Power Parity. Similarly to both the Big Mac index and the Purchasing Power Parity Model do not take into consideration the rules and regulations, fiscal or monetary policies and different production cost of the economy. The Purchasing Power Parity shows more general price movement in the market through consumer price index and producer price index.

Lastly, exchange rate is examined through the Edwards' model. External competitiveness and exchange rate policies are accounted for in the Edwards' model. Equilibrium exchange rate is estimated empirically, that is, the rate that is consistent with the fundamentals. The Edwards' model has not only a long-run version, but has also a short-run version. Short-run Edwards' version comprises of monetary and fiscal policy variables as well as the fundamental variables. In the long-run Edwards' version, only the fundamental variables of economy are considered.

The results of the Big Mac index show that the ringgit Malaysia is under-valued by 53%. From 1994 till January 1997 the actual logarithm of CPI Malaysia is higher than estimated logarithm of the CPI Malaysia. As such, we can suggest that the ringgit Malaysia is under-valued. On the other hand, the Edwards' model shows that after the ringgit Malaysia has been pegged at RM3.80 against USD, ringgit Malaysia was over-valued from September 1998 till September 1999. Since September 1999, the RM against USD has been under-valued.

Under valuation of RM does not have immediate threat as compare to over valuation of RM. On the other hand, under valuation of RM will increase competitiveness of RM as well as products that manufacturing for export. This further improve current account, and increase foreign reserve of Malaysia. Therefore under valuation of RM will have positive impact on economy Malaysia especially during the recovery stage after economic crisis in 1997.