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The Relationship Between Reserve Items and Exchange Rate in Malaysia: Evidence from Non-linear Model

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Abstract

The objectives of this study are first, to examine a nonlinear long-run relationship between exchange rate and reserve and related item in Malaysia. Second, to examine the causal relationship between exchange rate, reserve and related item, money supply, interest rate, foreign direct investment, and price in Malaysia. Third, to forecast the relationship between exchange rate, reserve and related item, money supply, interest rate, foreign direct investment, and price in Malaysia for the next 50 years. To achieve our objective, we employed the nonlinear autoregressive distributed lag model (NARDL), Toda Yamamoto causality test and variance decomposition. We utilize a time series dataset from 1982 to 2018. We find reserve items are significant to have a negative relationship with exchange rate. However, it limits to only a decrease in reserve items will encourage the Ringgit to be depreciated. On the other hand, reserve items are expected to influence more in exchange rate fluctuation in the next 50 years. On the other hand, reserve items are significant to cause FDI inflow in Malaysia.

Keyword: Non-linear Model, Exchange rate, Reserve Items

Introduction

Malaysia is a small open economy. Malaysia is experiencing the openness index that is more than one. According to the statistics that publish in Worldbank development indicator (WDI), the value of openness index of Malaysia in 2018 was recorded at 1.31. Meaning to say here, Malaysian economy is an open economy, and their international trade are valued more than domestic production. In other words, Malaysian economy is highly dependent on global market and their export activities are driving towards their economic growth. Therefore, an internal and external sector are important to support their international trade activities, consequently, it can contribute to a rapid economic growth in the future. In 2018, the share of import was about 61.7% (of GDP), while the share of export was about 68.8% (of GDP). Tellingly, the share of import input content in Malaysia is very high. It is approximately about 58% of total import is accounted in the year 2017.