INCIDENCES OF CURRENCY MISALIGNMENT ACROSS EXCHANGE RATE REGIMES IN MALAYSIA

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ABSTRACT

This paper is set out to examine the claim that pegged exchange regimes are often more prone to risks of currency misalignments. It focuses on real exchange rate misalignment (RERMIS) in an emerging country, Malaysia and assesses the relationship between currency misalignment and its exchange rate regimes. We evaluate the incidences of currency misalignment during the last three decades between 1975 and 2007 across regimes. We then begin with analyses on long-run relationships between real exchange rates (RER) and a set of macroeconomic variables that are hypothesized as the major factors driving the RER. Drawing on a single-equation framework based on augmented autoregressive distributed lag (ARDL) model, this paper employs Pesaran, Shin and Smith's (2001) new bounds test approach to find evidence of a long-run relationship between RER and our hypothesized determinants. However, the critical values for small samples are extracted from Narayan (2005). We further illustrate the currency misalignment upon estimating the equation of equilibrium RER. The basic conclusion from the tests is that at least a slight undervaluation was seen throughout the period after the exit from peg in 2005. This study differs from the extant literature in two novel ways. First, for the first time, the RERMIS nexus for Malaysia is investigated across fixed and floating regimes. Second, the treatment of the data series is both comprehensive and unique. Our results not only corroborate the view that pegged exchange regime poses greater currency misalignment incidences, they also suggest that a sustainable exchange rate regime requires an appropriate macroeconomic framework and a stable RER with minimal misalignment episodes.