Full Length Research Paper

On the exchange rates behavior by PPP: A test on Malaysian ringgit and US dollar

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Exchange rates are important to innumerable economic activities and the exchange rate behavior has long been at the top of the list of research agenda in international finance. This article is another test of the Relative Purchasing Power Parity (RPPP) to explain exchange rate behavior in short terms. The study examine the relative form of Purchasing Power Parity theory with recent monthly exchange rate data of US Dollar and Malaysian Ringgit starting from year 2005, which was the time Malaysia's currency went back to floating system after a few years pegging to US dollar since 1997 Asian Financial Crisis (AFC). Within this study, correlation and Ordinary Least Square (OLS) methods were applied to test the proposed RPPP model. Both the statistical and the observational results show significance power of Relative PPP on explaining exchange rate behavior of the chosen currencies.

Key words: Exchange rate, purchasing power parity (PPP), Malaysian ringgit, US dollar.

INTRODUCTION

Exchange rate predications is one of the most challenging and critical decisions in international finance area. Its challenging aspect is due to its direct effect on one of the most important goals of any firm, doing international trade, which is exchange risk hedging. Nowadays, restricted in current monetary system, any firm who involves with import and export activities outside of its home country borders will encounter a major risk called exchange rate risk that can be a major determinant for successfullness of business. Hence, finding and evaluating various theories that may help and facilitate future exchange rate prediction is toward the benefits of any global trader and investor and has made busy a lot of economic and financial academicians so far.

One of the major theories that explain exchange rate determination is Purchasing Power Parity (PPP), which in its absolute and relative forms, has been numerous studied before. Despite all the studies that have been done in different markets to evaluate persistency of Purchasing Power Parity in different time horizons and to evaluate it as a determinant factor for exchange rate, the results are contradictory. It is amazing to see contradictory results independent of applied statistical methods for both absolute and relative type of PPP. But, as the studies shows, it may trust more on relative PPP as a tool for short term exchange rate prediction probably along with some other financial tools and theories. As it can ignore the actual levels of exchange rate and prices in relative forms of PPP, it can be said that being exempt of strong assumptions; it is much easier to hold relative PPP than absolute PPP. It should be considered that absolute PPP is much broader than relative PPP in a sense. Therefore, when absolute PPP holds, relative PPP should also hold; however, absolute PPP does not necessarily holds if relative PPP holds.

There are various questions that can be asked on this issue in context of Malaysia. Knowing that most of the studies regards PPP has been done in Malaysian market before Asian Crisis on 1997, and considering that Malaysia's currency system is switched back to floating system after 2005, how is the validity of PPP since 2005 for Malaysian ringgit? How significant is the relation between price and exchange rate for Malaysia in deal with its major trading partner US based on relative form of PPP? How does the validity of this relation prove to be useful for exchange rate forecasting?

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