The Impact of Exchange Rate Appreciation on Malaysian Trade

In 2010, the ringgit appreciated by 11.1% against the US dollar. Given that the US dollar is a key currency used globally to conduct trade and investment, this box article discusses how the appreciation would impact the Malaysian economy. The United States is Malaysia’s fourth largest trade partner and accounts for 10%1 of total trade. In this regard, the real effective exchange rate (REER)2 is a better gauge of Malaysia’s overall competitiveness as it takes into account changes in Malaysia’s competitiveness vis-à-vis all of Malaysia’s major trading partners and not just the United States. By this measure, the REER appreciated by a more moderate rate of 5.9% in 2010. The moderate REER appreciation has allowed the economy to better absorb and adjust to the stronger ringgit exchange rate.

The sectoral impact of ringgit appreciation on trade

The very nature of international trade, which includes both importers and exporters, results in both those who are advantaged and disadvantaged when a currency appreciates or depreciates. Generally, export-dependent sectors in competitive international markets tend to be adversely affected by an exchange rate appreciation. The extent of the impact, however, depends on whether the decline in their exports proceeds can be offset by cheaper imported inputs. When the ringgit appreciates, firms that rely more on export revenue but source their inputs locally (i.e. pay in ringgit) will face a more significant impact on their profit margins. This is especially the case if these firms are price-takers in the international markets. In contrast, firms that source their inputs from abroad but supply the final product domestically will gain from a strong ringgit.

On a relative basis, given the manufacturing sector’s large contribution to total output, the sector appears to be most affected as more than 50% of the sector is export-oriented. As Malaysia is part of the global manufacturing network, a majority of Malaysia’s manufacturers import raw and processed materials and turn them into intermediate goods before exporting them to another destination for further processing or final consumption. Due to such production linkages, there is a strong co-movement between exports and

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1 As at December 2010
2 Refers to the weighted average of the ringgit against the currencies of Malaysia’s major trading partners, adjusted for differences in inflation rates.
imports, which in turn makes trade more responsive to global demand rather than to ringgit performance alone. The close co-movement between exports and imports also broadly serves as a natural hedge for manufacturing firms, thereby limiting the overall impact of exchange rate movements.

The construction sector, on the other hand, stands to gain the most given that it is domestic-oriented. All of its output is priced and consumed domestically, with some of the inputs sourced from abroad. The lower cost of imported inputs, together with stronger demand for properties in domestic markets, has helped construction firms to register stronger operating surplus during the year.

The overall impact on the services sector is broadly balanced. The majority of industries in the services sector will benefit from an exchange rate appreciation given the high import content and limited reliance on exports. The positive impact, however, is partly offset by the adverse effects on the business services industry, as shared services and outsourcing mostly involve exports of services, driven mainly by the Multinational Corporations (MNCs) in Malaysia. These MNCs mostly source inputs domestically in ringgit and export their services internationally in foreign currency.

To assess the overall impact of ringgit appreciation on the economy, Bank Negara Malaysia conducts regular surveys to compile views from various industry players. In a survey conducted in 4Q 2010 that covered 177 companies, 38% of the respondents indicated that the appreciation did not have a significant impact on their profit margins. Another 34% of the respondents indicated that the ringgit appreciation would have some adverse impact on their profit margins, while 28% indicated a more favourable impact on their profit margins.

The survey also showed that should the ringgit appreciate further, the impact on industry players are expected to be broadly contained. The majority of respondents suggested that the impact would be either favourable or neutral. Nevertheless, about 35% of respondents indicated an adverse impact on their profit margins arising from further ringgit appreciation.

**Implications for businesses**

With challenges, come opportunities. While ringgit appreciation could result in some firms facing a decline in profitability, it does open up other growth opportunities. In particular, cheaper costs of imported inputs and capital would facilitate firms’ transformation from labour to capital intensive production, which could...
enhance firm productivity and ultimately profitability. Increased productivity would encourage firms to pay higher wages and promote a more vibrant labour market with a larger pool of highly skilled workers. Higher wages in turn, would empower domestic consumption and open up more opportunities for non-tradable sectors to flourish. This would eventually facilitate the reorientation of the Malaysian economy from being trade-dependent towards one that is driven mainly by domestic demand.

In the medium to long-term, businesses should evaluate whether the strategies being pursued are sustainable and robust to changing circumstances. In the short-term, those adversely affected should undertake steps to hedge their foreign currency exposure. They may also need to re-strategise or even venture into other opportunities. As exchange rate movements are transitory in nature, those benefiting should not be complacent and rely on either a stronger or weaker ringgit, but should instead improve their operations further to cope with the more challenging times when the situation reverses.

**Conclusion**

The recent ringgit appreciation impacted various sectors differently. While the impact on the broad economic sector was either neutral or positive, there were some sectors that were adversely affected. For a highly open economy like Malaysia, with trade in 2010 accounting for 157.8% of GNI, such an outcome is expected. In this regard, the uncertain external environment makes exchange rate volatility unavoidable. Subject to global conditions, the ringgit would continue to strengthen as the underlying economic fundamentals continue to improve. The Bank will focus on maintaining orderly market conditions and ensuring that the ringgit is aligned with economic fundamentals. Businesses, on their part, must be prepared to adapt to the changing environment, taking into account that such changes in relative prices, if sustained, are a signal for a shift in real resources out of sectors with declining comparative advantage into sectors offering new opportunities with strong comparative advantage.