Crude Oil Price and Exchange Rates - The Case of Malaysia and Brunei

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Abstract

This study is driven by the motivation to investigate the impacts crude oil price fluctuations on Malaysian and Brunei exchange rates as proxied by RM/USD and BD/USD respectively. Even though there is no specific economic theories that can help explain the interaction between commodity and foreign exchange markets, the study is research-worthy as both Malaysia and Brunei are major oil-exporting countries in South East Asia. This study is considered quite extensive involving 370 data points spanning from January 1988 till October 2018. Using Engle-Granger 2-Step Cointegration Test (1987) as an estimation tool, the empirical results show the presence of long-term equilibrium relationship between the two national currencies and crude oil price. Interestingly, there is also a significant short-run causality between them in both countries. With respect to the short-run dynamics, there is a unidirectional causality running from crude oil price to the two exchange rates. The study also posits that RM is less prone to changes in crude oil price during the period before Asian Debt Crisis in 1997. After the removal of RM peg in June 2005, RM is found to be more sensitive towards changes in crude oil price over short haul. In summary, the significant equilibrium and dynamic relationships between the national currencies and crude oil price are therefore confirmed and perhaps the quotation of crude oil price in USD could be one of the explanations.

Keywords: Malaysian exchange rate, Brunei exchange rate, Asian debt crisis 1997, Engle-Granger cointegration test, West Texas intermediate price and OPEC

1. Introduction

In December 2016, Malaysia, Brunei and other non-OPEC members negotiated with Organization of Petroleum Exporting Countries (OPEC) to reach an agreement to cut production so as to stabilize the price of crude oil. The fact is plummeting crude oil price affects the economy of all oil producing countries. Both Malaysia and Brunei are the major exporters of crude oil in South East Asia and it is intriguing to investigate to what extent that changes in crude oil price over the past thirty years could affect Malaysia and Brunei exchange rates. The fluctuation in crude oil prices since August 2014 has caused many oil-producing countries, particularly their governments to review their fiscal and monetary policy (Abdul Hadi and Yap, 2012; Anunciação, et. al 2016). The Asian Debt Crisis in 1997 is one of the important events that have influenced the way South East Asia governments manage their foreign currencies. This financial meltdown has led the world to witness how Malaysia turned down the prescription given by International Monetary Fund (IMF) and decided to peg its Ringgit Malaysia (RM) to USD, coupled with massive domestic government borrowing (Baharumshah *et al*., 2009). Malaysia had its RM Peg to USD in September 1998, while Brunei had its Brunei Dollar (BD) peg to SGD in 1967 under the Currency Interchangeability Agreement. Malaysia and Brunei are picked because both are Malay sultanate centred in South East Asia and they are also non-OPEC countries. This study is motivated to investigate the causal-effect relationship between national currencies and movements of crude oil prices from January 1988 till October 2018. The RM/USD and BD/USD are the variables of interest, while crude oil price is assigned as the explanatory variable. The crude oil price has started to decline since September 2014 and it reached the bottom of USD37 per barrel in March 2016. Such a price swing detrimentally affects the oil and gas industry, particularly the revenue from export activities. This study is narrowed towards a number of pertinent issues within the international trade theory.

It has been argued that the soaring in the crude oil price has strengthened RM in tandem with the adjustment of base lending rate in the financial market. In the past, a rise in crude oil price led to increase in US Dollar exchange rate due to a change in current account deficit which depreciates the local currency (Anwar, 2018;Beckmann and Czudaj, 2013;