An Estimation and Policy Implication of the Changing Relationship between Forex Rate and Unemployment Rate in the Period of 1978—2006 in Taiwan

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Abstract

Keynesian economists advocate that a country may stimulate its aggregate effective demand, create employment opportunity and lower overall unemployment rate via its currency devaluation such that the changing relationship between forex rate and unemployment rate will move in the opposite direction. However, Edmund S. Phelps (1994, 2004), Nobel prize laureate in economics of 2006, claims that currency devaluation may lead to over mark-up pricing in the market and capital outflow which may contract the aggregate effective demand and raise the overall unemployment rate such that the changing relationship between forex rate and unemployment rate will move in the same direction.

This paper examines the changing relationship between forex rate and unemployment rate in the period of 1978—2006 in Taiwan. We analyze the interaction manners and causality channels for both rates. The whole empirical period is divided into two subperiods of the NTD appreciation period from 1978 to 1992 and the NTD devaluation period from 1992 to 2006. We compare the estimation results of both subperiods, and then propose the policy suggestions for the Central Bank of Taiwan.

Keywords: Forex Rate, Unemployment Rate, Currency Revaluation