aN EMPIRICAL TESTING OF PPP IN CHINA AND A DELAYED OVER-ADJUSTMENT OF THE FOREX RATE

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Abstract

This paper re-examines the exchange rate dynamics model of Dornbusch(1976), and sets up a structural VAR(SVAR) model which policy assignment including monetary policy and foreign exchange policy are incorporated, then we impose long-run identification restrictions according to the theoretical model and economic assumptions. We find that facing the impulse of the contractionary monetary policy, the monetary authorities will adopt a reversed intervention to prevent the appreciation effect, and this makes exchange rate delayed overshooting during the period of managed floating exchange rate system since Chinese exchange rate policy reform on 2005/07/21. In addition, we examine the relative explanatory ability of monetary policy shocks to real exchange rate under short-run and long-run sample periods, and find that monetary shocks may embody more its importance under larger information set as extending the sample period.

Key Words: exchange rate dynamics, monetary policy shocks, policy assignment, structural VAR

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