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Are Currency Appreciations Contractionary in China? *

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Abstract: The Chinese economy has been in a state of external and internal imbalances for some years, which has something to do with the undervaluation of renminbi (RMB). But the Chinese Government hesitates to allow RMB to appreciate because of the worry that RMB appreciations are contractionary thus have negative impact on China's economic growth and employment. The purpose of this paper is to empirically assess the effects of RMB real exchange rate on China's output. The econometric results of the paper show that (1) even after source of spurious correlation is controlled for, RMB appreciation has led to a decline in China's output, suggesting that RMB appreciations do be contractionary, and that (2) once the international finance linkage of Chinese economy is accounted for, the effect of RMB real exchange rate shocks on China's output and the power of the shocks in explaining the change of China's output are diminished. The paper gives some possible explanations to those findings, and points out that the findings do not necessarily imply that China should continue maintaining the undervaluation of RMB.

Key words: renminbi, exchange rate misalignment, contractionary devaluation, VAR model

JEL classification: F31; F41; O53

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