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How Do Shocks to Domestic Factors Affect Real Exchange Rates of Asian Developing Countries?

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Abstract

This paper examines real exchange rate responses to shocks in exchange rate determinants for fourteen Asian developing countries. The analysis is based on a panel structural vector error correction model, and the shocks are identified using sign and zero restrictions. We find that trade liberalization generates permanent depreciation, and higher government consumption causes persistent appreciation. Traded-sector productivity gains induce appreciation but their effects are not immediate and last only for a few years. Real exchange rate responses to unexpected monetary tightening are consistent with the long-run neutrality of money. The evidence suggests that trade liberalization and government consumption have a strong effect on real exchange rates, while the effects of traded-sector productivity shocks are much weaker.

Keywords: Asian developing countries, Domestic economic policy effects, Panel vector error correction model, Real exchange rates, Sign restricted impulse response.
JEL classification: C33, C51, E52, F31

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