Dynamics of RMB Misalignment: A Markov Switching Approach

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ABSTRACT

This paper examines the question of RMB exchange rate misalignment, by applying a Markov switching approach to a standard empirical exchange rate model. The Markov switching model, as applied here, allows us to consider possible state shifts in the evolution of the misalignment process, which may better represent the actual behavior of the RMB exchange rate. Based on the smoothed probabilities of alternative states underlying the misalignment, we find evidence that the quarterly RMB exchange rate alternated between overvaluation and undervaluation (relative to long-run equilibrium) from 1992 to 2009. Moreover, there was asymmetry in the duration of exchange rate misalignment, with overvaluation tending to have greater persistence than undervaluation.