Real Rigidities and Real Exchange Rate Volatility (6/9/06)

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Abstract

This paper shows that certain real rigidities can help explain high volatility of real exchange rates relative to other macroeconomic aggregates. An international real business cycle model demonstrates that real exchange rate volatility increases if (i) it is costly to move labor between sectors and (ii) the consumption of tradable goods requires distribution services. Model dynamics are generated by shocks to productivity and preferences based on sectoral output, employment and consumption data from G-7 countries. The introduction of intersectoral adjustment and distribution costs substantially increases the real exchange rate volatility generated by the model.