

The Dynamic Behavior of the Real Exchange Rate in Sticky Price Models

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Since the breakdown of the Bretton Woods system of fixed exchange rates, the real exchange rates of the world's largest economies have been highly volatile. Furthermore, swings in these real exchange rates have been highly persistent. A large recent literature has studied whether the volatility and persistence of real exchange rates can be understood in the context of sticky price models with staggered price setting. This literature was pioneered by V. V. Chari, Patrick J. Kehoe, and Ellen R. McGrattan (2002). They concluded that such models can explain the volatility of the real exchange rate but that they cannot match its persistence. A number of subsequent papers have sought to address this “persistence anomaly” by introducing various forms of strategic complementarity and asymmetry, as well as sticky wages and persistent monetary policy (Paul Bergin and Robert C. Feenstra 2001; Gianluca Benigno 2004; Jan J. J. Groen and Akito Matsumoto 2004; Jens Sondergaard 2004; Hafedh Bouakez 2005). While these features increase the persistence of the real exchange rate considerably, they are not sufficient to match the half-life of the real exchange rate seen in the data.

Existing empirical evidence suggests that real exchange rates exhibit hump-shaped dynamics (John Huizinga 1987; Martin S. Eichenbaum and Charles L. Evans 1995; Yin-Wong Cheung and Kon S. Lai 2000). I show that this is a robust empirical fact for nine large, developed economies. I estimate an autoregressive model for the real exchange rate of each economy. The estimated short-term dynamics cause impulses to be amplified for several quarters before they start dying out. Figure 1 illustrates this by plotting the estimated response of the US real exchange rate to a unit sized impulse. After the impulse, the real exchange rate keeps rising for over a year. It takes the real exchange rate ten quarters to fall below the initial size of the impulse. After this short-term amplification, the real exchange rate mean reverts quite rapidly, falling below $\frac{1}{2}$ the size of the impulse in 18 quarters and below $\frac{1}{4}$ the size of impulse in fewer than 26 quarters.

These hump-shaped dynamics can help explain why existing sticky price business cycle models have been unable to match the persistence of the real exchange rate. Following Chari, Kehoe, and McGrattan (2002), the literature has mostly focused on the response of the real exchange rate to monetary shocks. I present a two-country sticky price model with staggered price setting, and show that, in response to a monetary shock, the model implies an exponentially decaying response for the real exchange rate. Even with very large amounts of strategic complementarity, the rate of decay of the real exchange rate is such that the model is nowhere close to matching the empirical persistence of real exchange rates.

Empirical work on vector autoregression (VAR) models suggests that only a small fraction of the variability of most macroeconomic aggregates is due to monetary shocks (Lawrence J. Christiano, Eichenbaum, and Evans 1999). I show that, in response to several different types of

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real shocks—productivity shocks, labor supply shocks, government spending shocks, shocks to the world demand for home goods, and cost-push shocks—my model implies hump-shaped dynamics for the real exchange rate. These hump-shaped dynamics are a powerful source of endogenous persistence that allows it to easily generate a half-life equal to the estimated half-life of the US real exchange rate. Contrary to conventional wisdom, I show that these real shocks generate slightly more real exchange rate volatility in the model than does the monetary shock. My model is therefore able to match the persistence of the real exchange rate and its humped dynamics, as well as the volatility of the HP-filtered real exchange rate relative to HP-filtered output.

The paper proceeds as follows. Section I presents the empirical analysis. Section II presents the model. Section III presents the theoretical results. Section IV concludes.

I. Empirical Evidence

In this section, I extend the analysis of Cheung and Lai (2000) by studying the dynamics of the trade weighted real exchange rate of nine large, developed economies. I obtain data on these trade weighed real exchange rates from the Bank of International Settlements.¹ I also use data on aggregate consumption for the nine economies I study. I obtain data on aggregate consumption from the International Financial Statistics database published by the International Monetary Fund. The empirical specification I adopt is an AR(p) model with an intercept but no time trend. This model may be written in augmented Dickey-Fuller regression form as

$$(1) \quad q_t = \mu + \alpha q_{t-1} + \sum_{j=1}^p \psi_j \Delta q_{t-j} + \varepsilon_t,$$

where q_t is the log of the real exchange rate, μ , α , and ψ_j are parameters, and ε_t is an error term. I calculate median unbiased estimates of μ , α , and ψ_j using the grid-bootstrap method described in Bruce E. Hansen (1999).² Point estimates of other statistics—such as the half-life—are calculated from the point estimates for α and ψ_j . I calculate confidence intervals and p -values using a conventional bootstrap.

My primary interest is the extent to which the impulse response of the real exchange rate is hump-shaped. It is useful to define scalar measures of how hump-shaped an impulse response function is. As building blocks toward such measures, I calculate the “up-life,” half-life, and “quarter-life” of the real exchange rate series I study. I follow the recent empirical literature on the real exchange rate in defining the half-life as the largest time T such that $IR(T-1) \geq 0.5$ and $IR(T) < 0.5$, where $IR(T)$ denotes the impulse response of the real exchange rate at time T .³ I define the up-life and the quarter-life analogously. The up-life is the largest time T such that $IR(T-1) \geq 1$ and $IR(T) < 1$. The quarter-life is the largest time T such that $IR(T-1) \geq 0.25$ and $IR(T) < 0.25$. Just as the half-life is meant to measure the time it takes for the impulse response

¹ These real exchange rates are trade weighted using manufacturing trade for 27 economies. They are published at a monthly frequency. I constructed a quarterly series by using the first month of each quarter. My sample period is 1975:1 to 2006:3. Marc Klau and San Sau Fung (2006) describe how these real exchange rate series are constructed.

² Hansen (1999) uses the grid-bootstrap method to calculate confidence intervals, i.e., to estimate the fifth and ninety-fifth quantile of the distribution of the statistics of interest. I use this same method to estimate the fiftieth quantile of the statistics I am interested in. These estimates of the fiftieth quantile are median unbiased point estimates. Hansen’s grid-bootstrap method is closely related to the method proposed by Donald W. K. Andrews and Hong-Yuan Chen (1994).

³ The impulse response is defined as $IR(t) = \partial(E_s q_t - E_{s-1} q_t) / \partial \varepsilon_s$, where E_s denotes the expectations operator conditional on information known at time s . It is the moving average representation of the process estimated for the real exchange rate.

to fall below half (the size of the impulse), the up-life is the time it takes for the impulse response to fall below one, and the quarter-life is the time it takes for the impulse response to fall below a quarter.

I consider an impulse response that dies out at a constant exponential rate as the benchmark “no hump” case. Such a process will have an up-life of zero. A nonzero up-life can, therefore, be viewed as evidence that the process has a hump-shaped impulse response. This fact suggests that one sensible measure of the degree of hump in the impulse response is the ratio of the up-life to the half-life (UL/HL). The UL/HL is a measure between 0 and 1. It measures the fraction of time before the impulse response falls below 1 out of the total time before it falls below $\frac{1}{2}$.

Another feature of an impulse response that dies out at a constant exponential rate is that it takes the process the same amount of time to fall from $\frac{1}{2}$ to $\frac{1}{4}$ as it takes to fall from 1 to $\frac{1}{2}$. In other words, the half-life is equal to the quarter-life minus the half-life ($HL = QL - HL$). For a process that has a hump-shaped impulse response, the half-life is larger than the quarter-life minus the half-life ($HL > QL - HL$). Or, written slightly differently, $2HL - QL > 0$. These facts suggest that $2HL - QL$, or, equivalently, the difference between HL and $QL - HL$, can be viewed as a measure of the degree of hump in the impulse response.

The first issue that arises in estimating equation (1) is the choice of lag length. I considered a range of values for p from 1 to 8. For values of p smaller than 4, the shape of the estimated impulse response function is quite sensitive to the chosen lag length. For values of p between 4 and 8, however, the estimated impulse response is virtually identical. From this, I conclude that a lag length of at least 4 is needed to flexibly estimate the impulse response. I choose to set $p = 5$.

Table 1 presents results for the US real exchange rate. The half-life estimate I obtain is consistent with the results of Christian J. Murray and David H. Papell (2002) and the earlier literature surveyed by Kenneth Rogoff (1996). The point estimate is 4.5 years and therefore within the “consensus range” of 3 to 5 years. Also, consistent with Murray and Papell (2002), the 90 percent confidence interval for the half-life is very wide. Even 30 years after the breakdown of Bretton Woods, it is not possible to estimate the half-life of the real exchange rate with much precision.

Figure 1 plots the impulse response of the US real exchange rate. It exhibits a pronounced hump. Rather than dying out exponentially, the impulse response rises further—peaking at about 1.2—before it starts dying out. The impulse response doesn't fall below 1 (the size of the impulse) until 10 quarters after the impulse. Table 1 reports that the up-life of the US real exchange rate is 2.4 years, which implies that the UL/HL is 0.53. In other words, 53 percent of the time that it takes the real exchange rate to fall below $\frac{1}{2}$, it is actually above 1.

A comparison of the quarter-life and the half-life shows that once the real exchange rate starts reverting toward its mean, it does so quite quickly. I estimate the quarter-life of the US real exchange rate to be 6.4 years. This implies that the $QL - HL$ —the time it takes the real exchange rate to fall from $\frac{1}{2}$ to $\frac{1}{4}$ —is only 1.9 years. The literature on the dynamics of the real exchange rate has tended to interpret the half-life as its rate of mean reversion. The results discussed above show that this is misleading. The rate of mean reversion of the real exchange rate is far from being constant. The half-life measures the rate of mean reversion in the short run. It is, therefore, heavily affected by the short-term dynamics of the real exchange rate. The $QL - HL$, however, measures the rate of mean reversion farther out, when the short-term dynamics have mostly died out. The results in Table 1 show that the rate of mean reversion of the real exchange rate is very slow initially, but becomes substantially faster after the short-term dynamics die out.

Table 2 reports results for trade weighted real exchange rates of Canada, the Euro Area, France, Germany, Italy, Japan, Switzerland, the United Kingdom, and the United States. For all nine economies, the half-life is larger than $QL - HL$. The median half-life is 3.7 years while the median $QL - HL$ is 1.9 years. For eight of these nine economies, UL/HL is positive. The median

TABLE 1—EMPIRICAL PROPERTIES OF THE TRADE WEIGHTED US REAL EXCHANGE RATE

<i>Panel A: Point and interval estimation</i>		
Statistic	MU point estimate	90% confidence interval
α	0.954	[0.879, 1.000]
Half-life	4.46	[2.05, ∞]
Up-life	2.37	[0.00, ∞]
Quarter-life	6.36	[2.85, ∞]
UL/HL	0.53	[0.00, 0.74]
QL – HL	1.91	[0.64, 14.45]
2HL – QL	2.55	[0.01, 7.14]
$\rho_{1, hp}$	0.78	[0.64, 0.85]
St.Dev(Q)/St.Dev(C)	5.51	
<i>Panel B: Hypothesis testing</i>		
Hypothesis	<i>p</i> -value	
$\alpha = 1$	0.05	
UL/HL = 0	0.15	
HL < QL – HL	0.05	

Notes: An AR(5) model was estimated for the trade weighted log real exchange rate for each country. The sum of the AR coefficients (see equation (1)) is denoted by α . HL, UL, and QL denote the half-life, up-life, and quarter-life of the real exchange rate, respectively. These statistics are measured in years. $\rho_{1, hp}$ denotes the first-order autocorrelation of the HP-filtered real exchange rate. St.Dev(Q)/St.Dev(C) denotes the ratio of the standard deviation of the HP-filtered real exchange rate to HP-filtered consumption. For each statistic, I report a point estimate, and a 90 percent confidence interval. Median unbiased point estimates for the parameters in equation (1) were calculated using the grid-bootstrap method of Hansen (1999) with parameters $G = 80$ and $B = 249$. Confidence intervals and *p*-values were calculated using a conventional bootstrap with sample size 1,000. Confidence intervals for UL/HL and 2HL – QL were calculated conditional on these statistics being defined.

UL/HL is 0.44. Table 2 reports *p*-values for three sets of hypothesis tests. The null hypotheses tested for each economy are: $\alpha = 1$, UL/HL = 0, and HL < QL – HL. The statistical significance of all three hypotheses varies greatly from economy to economy. The median *p*-value for $\alpha = 1$ is 5 percent, while the median *p*-value for UL/HL = 0 and HL < QL – HL are 18 percent and 8 percent, respectively.

Earlier evidence of hump-shaped dynamics in the real exchange rate includes Eichenbaum and Evans (1995) and Cheung and Lai (2000). Eichenbaum and Evans (1995) estimate an identified VAR that includes the real exchange rate. They show that the real exchange rate exhibits hump-shaped dynamics in response to their identified monetary policy shocks. They refer to this result as “delayed over-shooting.” Jon Faust and John H. Rogers (2003) estimate VARs under a range of alternative identifying assumptions. They argue that the delayed over-shooting result is sensitive to the choice of identifying assumptions. Cheung and Lai (2000) estimate ARMA models for four bilateral US real exchange rates, and find evidence of hump-shaped dynamics in all four cases. My results differ from those of Cheung and Lai (2000) in two ways. First, I consider trade weighted real exchange rates for nine economies. Second, I employ median unbiased estimation methods.

II. The Model

The model I employ to understand the dynamics of the real exchange rate is a two-country model in the tradition of Maurice Obstfeld and Rogoff (1995). It incorporates a number of features that have been developed in the subsequent literature, such as staggered price setting, local

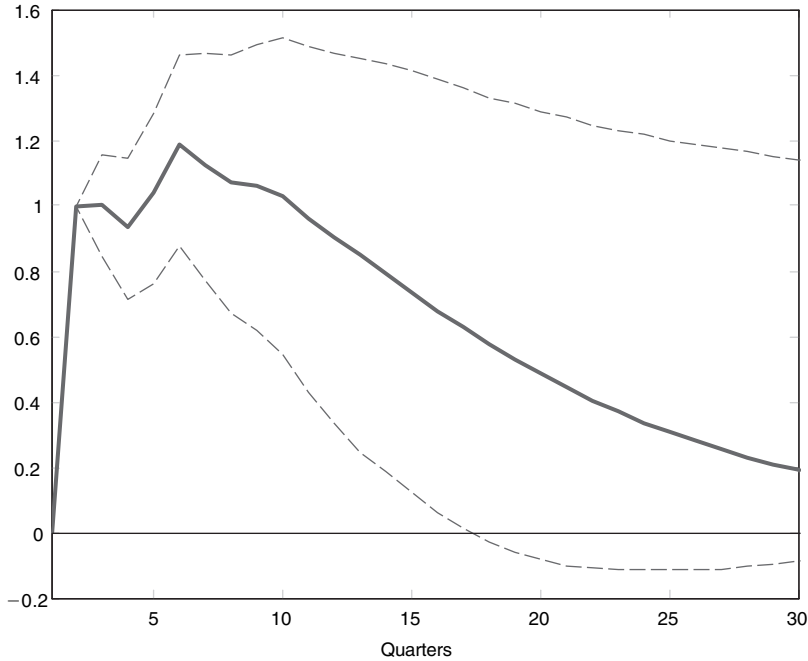


FIGURE 1. IMPULSE RESPONSE OF THE US REAL EXCHANGE RATE

Notes: The figure plots an estimated impulse response function for the trade weighted log US real exchange rate. The impulse response is based on median unbiased estimation of an AR(5) model on quarterly data from the period 1975:1–2006:3. The dotted lines denote a 90 percent bootstrap confidence interval.

currency pricing, home biased preferences, and heterogeneous factor markets. The core of the model consists of five equations. Aggregate consumption in each country evolves according to consumption Euler equations:

$$(2) \quad c_t = E_t c_{t+1} - \sigma(i_t - E_t \pi_{t+1}),$$

$$(3) \quad c_t^* = E_t c_{t+1}^* - \sigma(i_t^* - E_t \pi_{t+1}^*).$$

The dynamics of inflation in each country are governed by New Keynesian Phillips curves:

$$(4) \quad \pi_t = \beta E_t \pi_{t+1} + \kappa \zeta [\phi_H c_t^M + \phi_F c_t^{M*}] + \kappa \gamma_q q_t - \eta_t,$$

$$(5) \quad \pi_t^* = \beta E_t \pi_{t+1}^* + \kappa \zeta [\phi_F c_t^M + \phi_H c_t^{M*}] - \kappa \gamma_q q_t - \eta_t^*,$$

and international risk-sharing implies that

$$(6) \quad c_t - c_t^* = \sigma q_t.$$

Here, c_t denotes home consumption, π_t denotes home CPI inflation, i_t denotes the home short-term nominal interest rate, q_t denotes the real exchange rate, and η_t is a composite of five different types of shocks: productivity shocks, labor supply shocks, government spending shocks, shocks to the world demand for home goods, and cost-push shocks. All variables denote per-

TABLE 2—EMPIRICAL PROPERTIES OF TRADE WEIGHTED REAL EXCHANGE RATES

<i>Panel A: Point estimates</i>					
	HL	QL – HL	UL/HL	$\rho_{1,hp}$	$\frac{\text{St. Dev}(Q)}{\text{St. Dev}(C)}$
Canada	7.44	3.58	0.54	0.83	3.83
Euro area	2.69	1.22	0.53	0.80	
France	3.23	2.66	0.35	0.79	1.89
Germany	3.84	2.20	0.44	0.77	2.72
Italy	3.76	3.57	0.00	0.73	2.38
Japan	3.69	1.92	0.46	0.80	6.01
Switzerland	1.59	0.85	0.37	0.76	2.82
UK	2.02	1.40	0.28	0.76	3.92
US	4.46	1.91	0.53	0.78	5.51

<i>Panel B: Hypothesis testing</i>					
	$\alpha = 1$	UL/HL = 0	HL < QL – HL		
Canada	0.15	0.03	0.01		
Euro area	0.02	0.12	0.08		
France	0.06	0.18	0.24		
Germany	0.06	0.22	0.08		
Italy	0.12	0.60	0.38		
Japan	0.05	0.04	0.08		
Switzerland	0.00	0.29	0.15		
UK	0.01	0.34	0.24		
US	0.05	0.15	0.05		

Notes: An AR(5) model was estimated for the trade weighted log real exchange rate for each country. α denotes the sum of the AR coefficients (see equation (1)). HL, UL, and QL denote the half-life, up-life, and quarter-life of the real exchange rate, respectively. These statistics are measured in years. $\rho_{1,hp}$ denotes the first-order autocorrelation of the HP-filtered real exchange rate. St.Dev(Q)/St.Dev(C) denotes the ratio of the standard deviation of the HP-filtered real exchange rate to HP-filtered consumption. Median unbiased point estimates for the parameters in equation (1) were calculated using the grid-bootstrap method of Hansen (1999) with parameters G = 80 and B = 249. *p*-values were calculated using a conventional bootstrap with sample size 1,000.

centage deviations from a steady state with balanced trade. Foreign variables are denoted with asterisks. Superscript M and M^* denote the following weighted averages: $c_t^M = \phi_H c_t + \phi_F c_t^*$ and $c_t^{M^*} = \phi_F c_t + \phi_H c_t^*$, where ϕ_H is the steady-state fraction of total spending allocated to domestic goods, and ϕ_F is the corresponding fraction allocated to imports.

A fully microfounded model that yields these equations up to a log-linear approximation is presented in detail in the Web Appendix.⁴ This model features a continuum of household types, each of which consumes and supplies labor. Each type of household consumes a basket of all goods produced in the world economy, but supplies a differentiated labor input. Household preferences are biased in favor of home goods. There is a continuum of monopolistically competitive firms. Each firm demands labor and produces a differentiated good. Goods prices are sticky. The opportunity to revise prices arrives randomly, as in Guillermo Calvo (1983). Firms are able to price to market and their prices are sticky in the local currency. Households have access to complete financial markets. The government in each country finances spending through lump-sum taxation of households.

⁴ This Web Appendix is available at <http://www.aeaweb.org/articles.php?doi=10.1257/aer.98.1.519>.

TABLE 3—PARAMETER VALUES

<i>Benchmark calibration</i>	
Discount factor	$\beta = 0.99$
Elasticity of intertemporal substitution	$\sigma = 1/5$
Marginal cost elasticity	$\omega = 3$
Elasticity of demand	$\eta = \theta = 10$
Fraction of firms that change prices	$1 - \alpha = 0.25$
Home bias parameters	$\phi_H = 0.94, \phi_F = 0.06$
Taylor rule parameters	$\rho_i = 0.85, \psi_c = 0.5, \psi_\pi = 2$
Monetary policy shocks	$\rho_i = 0.9, \text{corr}(v_t, v_t^*) = 0.5$
Phillips curve shocks	$\rho_\eta = 0.9, \text{corr}(v_{a,t}, v_{a,t}^*) = 0$
<i>Composite parameters:</i>	
$\kappa = \frac{(1 - \alpha)(1 - \alpha\beta)}{\alpha} = 0.086$	$\gamma_q = 2\phi_H\phi_F = 0.113$
$\zeta_{\text{homog.}} = \omega + \sigma^{-1} = 8$	$\zeta_{\text{heterog.}} = \frac{\omega + \sigma^{-1}}{1 + \omega\theta} = 0.26$

To close the model, one must specify a monetary policy for each country. Recent work has stressed the importance of the systematic component of monetary policy, as opposed to monetary shocks, in shaping macroeconomic dynamics. I assume that the central bank in each country sets nominal interest rates according to a rule as in John B. Taylor (1993):

$$(7) \quad i_t = \rho_i i_{t-1} + (1 - \rho_i) \psi_c c_t + (1 - \rho_i) \psi_\pi \pi_t + \varepsilon_t,$$

$$(8) \quad i_t^* = \rho_i i_{t-1}^* + (1 - \rho_i) \psi_c c_t^* + (1 - \rho_i) \psi_\pi \pi_t^* + \varepsilon_t^*,$$

where ε_t and ε_t^* denote home and foreign monetary policy shocks, respectively. In keeping with recent empirical work, I include a lagged interest rate term in the central banks' interest rate rule (Richard H. Clarida, Jordi Galí, and Mark Gertler 1998, 2000).

Finally, I assume that all four exogenous shocks— η_t , η_t^* , ε_t , and ε_t^* —follow AR(1) processes. Given initial conditions, equations (2)–(8) and the processes for the exogenous shocks constitute a fully specified general equilibrium model of the world economy.

III. Theoretical Results

The theoretical question I address in this section is whether the model described above can replicate the stylized facts about the dynamics of the real exchange rate discussed in Section I. The model consists of a set of linear equations with expectations terms. This type of model may be solved using standard methods based on the work of Olivier J. Blanchard and Charles M. Kahn (1980).⁵ To aid comparison with earlier work, I use values for the parameters of the model that correspond closely to values used in the recent literature. I list the values of the parameters in Table 3.⁶

⁵ I use code described in Christopher A. Sims (2002).

⁶ Let me briefly describe the rationale behind a few of the parameter values: I follow Chari, Kehoe, and McGrattan (2002) in choosing $\sigma = 1/5$. This value is chosen to roughly match the relative volatility of the real exchange rate and consumption. The value $\omega = 3$ results from assuming a Cobb-Douglas production function with a labor share equal to $2/3$, disutility of labor that yields a Frisch elasticity of labor supply equal to $1/5$, and a steady-state labor supply of $1/4$. The value $\phi_H = 0.94$ is chosen to roughly match the fraction of total spending allocated to domestic goods in the United States.

TABLE 4—BEHAVIOR OF THE REAL EXCHANGE RATE IN THE MODEL

	HL	UL/HL	QL – HL	$\rho_{1, hp}$	$\frac{\text{St. Dev}(q_t)}{\text{St. Dev}(c_t)}$
1. Median empirical value for 9 countries	3.7	0.44	1.9	0.78	3.3
2. Homogeneous labor market monetary policy shocks	0.6	0.00	0.7	0.49	5.1
3. Heterogeneous labor market monetary policy shocks	1.3	0.00	1.3	0.64	3.7
4. Extreme model monetary policy shocks	1.4	0.00	1.4	0.65	3.3
5. Homogeneous labor market Phillips curve shocks	3.3	0.41	2.1	0.82	6.9
6. Heterogeneous labor market Phillips curve shocks	4.1	0.40	2.6	0.84	4.2

Notes: The table reports median unbiased estimates. HL denotes half-life (measured in years), UL/HL denotes up-life divided by half-life, QL – HL denotes the quarter-life minus the half-life (measured in years), $\rho_{1, hp}$ denotes the first-order autocorrelation of the HP-filtered q_t , and $\text{st.dev}(q_t)/\text{st.dev}(c_t)$ denotes the standard deviation of HP-filtered q_t divided by the standard deviation of HP-filtered c_t . Point estimates of HL, UL/HL, and QL – HL were calculated by estimating equation (1) with $p = 5$ using the grid-bootstrap method described in Hansen (1999) with parameters $G = 80$ and $B = 249$. The point estimates for $\rho_{1, hp}$ and $\text{st.dev}(q_t)/\text{st.dev}(c_t)$ were calculated by simulating 1,000 data series from each model—each of length 127 (corresponding to the length of my dataset). The point estimate is the median value of the resulting distribution.

My main theoretical results are presented in Table 4. The first row of this table repeats, for convenience, the key empirical features of real exchange rates established in Section I. The second row reports results for the model presented in Section II under the assumption that there exists a perfectly frictionless economy-wide labor market in each country, and business cycles are due to monetary policy shocks.⁷ This “homogeneous labor market” specification of the model is designed to correspond to the benchmark model in Chari, Kehoe, and McGrattan (2002). The results in Table 4 confirm that it does. The real exchange rate is much less persistent than in the data. This is true whether one measures persistence by the half-life of the impulse response—0.6 years versus 3.7 years in the data—or by the autocorrelation of the series after it has been HP-filtered—0.49 versus 0.78 in the data. As Chari et al. (2002) emphasize, this model can, however, match the volatility of the HP-filtered real exchange rate relative to HP-filtered consumption.⁸

A large number of papers have in recent years argued that one reason why simple, largely frictionless models—such as the model used by Chari et al. (2002)—are unable to match the persistence of key business cycle variables is that they seriously underestimate the degree of strategic complementarity in price setting (Taylor 1999; Bergin and Feenstra 2000; Michael Woodford 2003). In the model presented above, the parameter ζ is a measure of the average degree of strategic complementarity of firm pricing decisions. If $\zeta < 1$, the pricing decisions of firms are strategic complements on average. If, however, $\zeta > 1$, firm pricing decisions are strategic substi-

⁷ The structure of the labor market affects the model through the parameter ζ . This is discussed in more detail below and in the Web Appendix.

⁸ I study the volatility of the real exchange rate relative to consumption because consumption plays a more central role in the model than output. In the model, however, the volatility of consumption and output are very similar. For an extensive discussion of the HP-filter and other filtering methods, see Marianne Baxter and Robert G. King (1999). I use code written by Baxter and King to filter the data.

tutes on average. Under the assumption of homogeneous labor markets, $\zeta = \omega + \sigma^{-1} = 8$. This specification of the model therefore implies a substantial degree of strategic substitutability.

Bergin and Feenstra (2001) and Sondergaard (2004), attempt to solve the problem of generating persistence in the real exchange rate by increasing the degree of strategic complementarity in the model. They find that increasing the degree of strategic complementarity increases the persistence of the real exchange rate somewhat. But they are unable to match the persistence seen in the data. The third row of Table 4 reports results for my model under the assumption that the labor market in each country is highly segmented. All other assumptions are the same as before. In this “heterogeneous labor market” case, $\zeta = (\omega + \sigma^{-1})/(1 + \omega\theta) = 0.26$, implying a large degree of strategic complementarity. In this respect, this specification is meant to resemble the models used in Bergin and Feenstra (2001) and Sondergaard (2004). The results for this model confirm that increasing the degree of strategic complementarity in the model increases the persistence of the real exchange rate. However, the real exchange rate is still substantially less persistent than in the data.

The fourth row in Table 4 reports results for a calibration of the model that I have dubbed “extreme.” It is extreme in that I have set $\zeta = 0.01$. As the name suggests, this is not meant to be a realistic calibration. Rather, I have included it to illustrate that even given very extreme assumptions about the degree of strategic complementarity, the model does not fit the empirical features of the real exchange rate. In this case, the half-life of the real exchange rate is only 1.4, and the autocorrelation of the HP-filtered real exchange rate is only 0.65.

Another striking shortcoming of the three specifications of the model discussed above is the fact that they totally fail to capture the humped shape of the impulse response of the real exchange rate. For all three of these specifications, UL/HL is 0.00 and QL – HL and HL are almost identical. Figure 2 plots the impulse response of the real exchange rate to a home monetary policy shock in the heterogeneous factor markets model. The impulse response dies out exponentially like an AR(1) processes.

Next, consider the behavior of the model in response to Phillips curve shocks. In the Web Appendix, I show that at least five different types of disturbances appear in the model as shocks to the Phillips curve. These are productivity shocks, labor supply shocks, government spending shocks, shocks to the world demand for home produced goods, and cost-push shocks. The fact that all these different disturbances enter the model in the same way—as shocks to the Phillips curve—implies that they all have the same implications regarding the dynamics of consumption, inflation, interest rates, and the real exchange rate. For the purpose of analyzing the dynamics of the real exchange rate, I therefore need not make any assumptions about the relative importance of these five types of disturbances.⁹

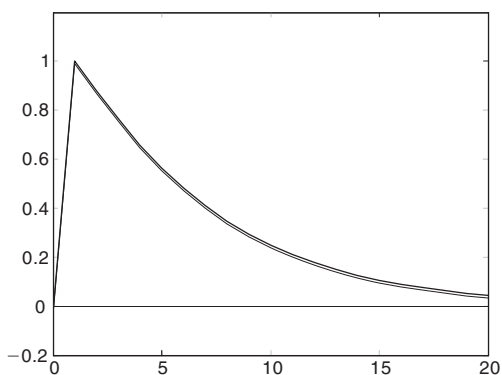


FIGURE 2. RESPONSE OF THE REAL EXCHANGE RATE TO A MONETARY SHOCK

Note: This figure plots the response of the real exchange rate to a home monetary policy shock in the model with heterogeneous labor markets ($\zeta = 0.26$).

⁹ It is important to note that, while the five shocks that I lump together as Phillips curve shocks imply the same dynamic behavior for consumption, inflation, the interest rate, and the real exchange rate, they don't all imply identical behavior for other variables such as output. For example, a positive productivity shock and a negative government

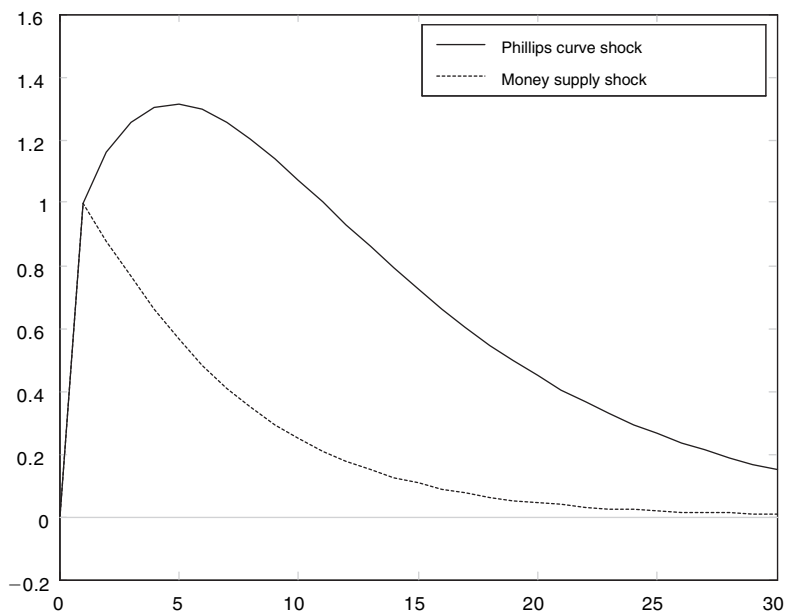


FIGURE 3. RESPONSE OF THE REAL EXCHANGE RATE TO A PHILLIPS CURVE SHOCK

Notes: This figure plots the response of the real exchange rate to a shock to the home Phillips curve in the model with heterogeneous labor markets ($\zeta = 0.26$). The response of the real exchange rate to a home monetary policy shock is also reported.

The fifth and sixth row of Tables 4 report results for the model with homogeneous and heterogeneous labor markets, respectively, when business cycles are driven by Phillips curve shocks. The dynamics of the real exchange rate differ in two ways from what they are when business cycles are driven by monetary policy shocks. First, in this case the model is able to match the persistence of the real exchange rate in the data quite well. The half-life of the real exchange rate is between 3.3 and 4.1 years, depending on the degree of strategic complementarity, while it is 3.7 years in the data. The autocorrelation of the HP-filtered real exchange rate is between 0.82 and 0.84, compared with 0.78 in the data.

Second, the model also generates a hump-shaped response of the real exchange rate to Phillips curve shocks. The UL/HL is roughly 0.40 in the model, while it is 0.44 in the data, and the difference between QL – HL and HL is between 1.2 and 1.5 years, while it is 1.8 years in the data. Figure 3 plots the response of the real exchange rate to a home Phillips curve shock in the case of heterogeneous labor markets. The response of the real exchange rate to a monetary policy shock is plotted, as well, for comparison. Clearly the qualitative feature of the impulse response is very different and much more in line with the empirical impulse response in Figure 1.

Conventional wisdom says that real shocks cannot generate the same level of volatility in the real exchange rate as monetary shocks can. This notion—while intuitively appealing—is not supported by models such as the model I analyze in this paper. In these models, the volatility of

spending shock both imply that inflation will fall and consumption will rise, but they have different implications for output. Output will rise in response to a positive productivity shock but fall in response to a negative government spending shock. By writing the model the way I have, I have been able to solve for the dynamics of the real exchange rate without making any reference to the dynamics of output. The impulse response of the real exchange rate in response to a Phillips curve shock is therefore consistent with a wide range of dynamics for output (and other variables) depending on the relative importance of the five shocks that make up the Phillips curves shock in my model.

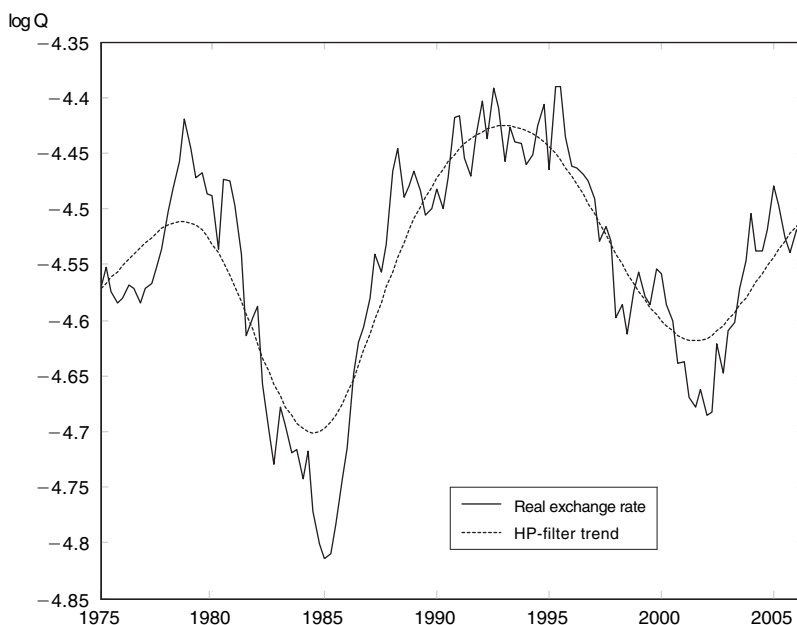


FIGURE 4. US REAL EXCHANGE RATE AND ITS HP-FILTER TREND

Note: This figure plots the log of the quarterly trade weighted US real exchange rate and a trend line from the HP-filter with bandwidth 1,600.

the real exchange rate relative to consumption is determined largely by the households' elasticity of intertemporal substitution. The last column in Table 4 shows that the real exchange rate is actually slightly more volatile relative to consumption when business cycles are due to real shocks than when they are due to monetary policy shocks.

Chari, Kehoe, and McGrattan (2002) emphasize the fact that their model is able to match the volatility of the HP-filtered real exchange rate relative to HP-filtered output if the coefficient of intertemporal substitution is assumed to be $1/5$. The last column in Table 4 shows that my model also matches this statistic regardless of which shocks drive the business cycle. The fact that this class of models is able to match this particular statistic has been interpreted to mean that they can explain the large volatility of the real exchange rate. This interpretation ignores the fact that the HP-filter assigns the vast majority of the volatility of the real exchange rate to its "trend." Figure 4 plots the US real exchange rate along with its HP-filter "trend." According to the HP-filter, most of the large movements in the US real exchange rate over the last 30 years—such as the large appreciation and subsequent depreciation in the 1980s—have been movements in the "trend."¹⁰

A. Understanding the Humped Dynamics of the Real Exchange Rate

To understand why Phillips curve shocks yield a hump-shaped impulse response for the real exchange rate, while monetary policy shocks do not, it is helpful to take a closer look at the structural equations of the model. If the home consumption Euler equation—equation (2)—is "solved forward," it yields

¹⁰ Diego Comin and Gertler (2006) find that conventional business cycle filters assign a sizable amount of cyclical variation to the trend when they are applied to macroeconomic quantities such as output and consumption.

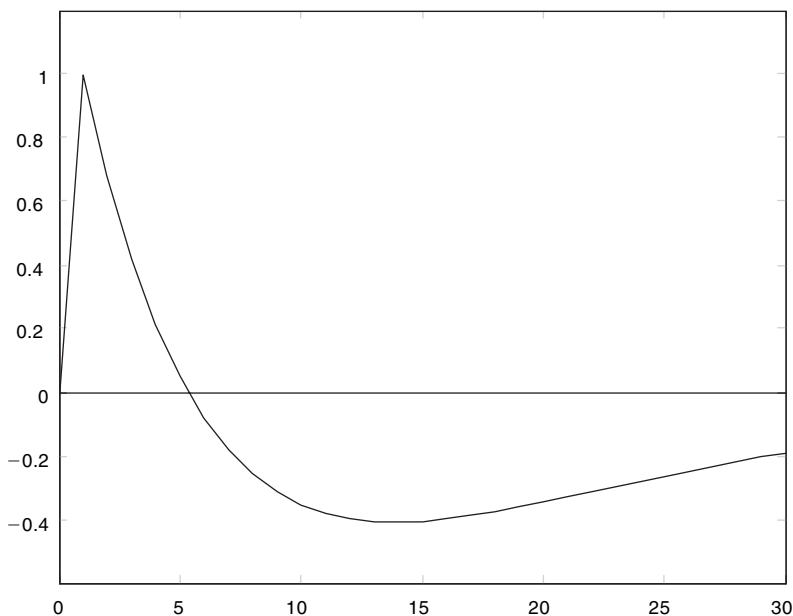


FIGURE 5. DESIRED PATH OF THE REAL INTEREST RATE

$$(9) \quad c_t = -\sigma E_t \sum_{j=0}^{\infty} (i_{t+j} - E_{t+j} \pi_{t+1+j}).$$

Risk-sharing implies that $q_t = \sigma^{-1}(c_t - c_t^*)$. Due to the large amount of home-bias that I have assumed (in order to match the empirical ratio of imports to consumption), home shocks have very muted effects on foreign variables, and vice versa.¹¹ This implies that the impulse response of the real exchange rate is close to being a scaled version of the impulse response of home consumption when the impulse in question is a shock to the home country. Shocks that imply hump-shaped impulse responses for consumption will therefore also imply hump-shaped impulse responses for the real exchange rate.¹²

If consumption is to be hump-shaped, the sum on the right-hand side of equation (9) must be hump-shaped. Considering, for concreteness, a shock that raises home consumption, this means that while the sum on the right-hand side of equation (9) must become negative on impact, the first few elements of the sum must be positive. This pattern implies that the sum will become more negative for a few periods as the positive terms drop out of the sum. In other words, for consumption to be hump-shaped, the impulse response of the real interest rate must be shaped roughly as in Figure 5.

The crucial difference between monetary policy shocks and Phillips curve shocks is that monetary policy shocks lead inflation and consumption to move in the same direction on impact,

¹¹ My results are not very sensitive to the high degree of home-bias I assume. Decreasing the degree of home-bias weakens my results somewhat, i.e., makes the real exchange rate less volatile and less hump-shaped. But even if I calibrate the home-bias to match the import share in consumption for a small country such as Sweden, my results don't change significantly.

¹² In a model in which utility is not time separable or not separable between consumption and leisure, the risk-sharing condition would become $q_t = \sigma^{-1}(\lambda_t - \lambda_t^*)$, where $\lambda_t = \partial U / \partial C_t$. This is why adding habit formation to the model does not yield a hump-shaped response of the real exchange rate to monetary shocks. In such a model, the response of consumption to a monetary shock is hump-shaped but the response of marginal utility is not.

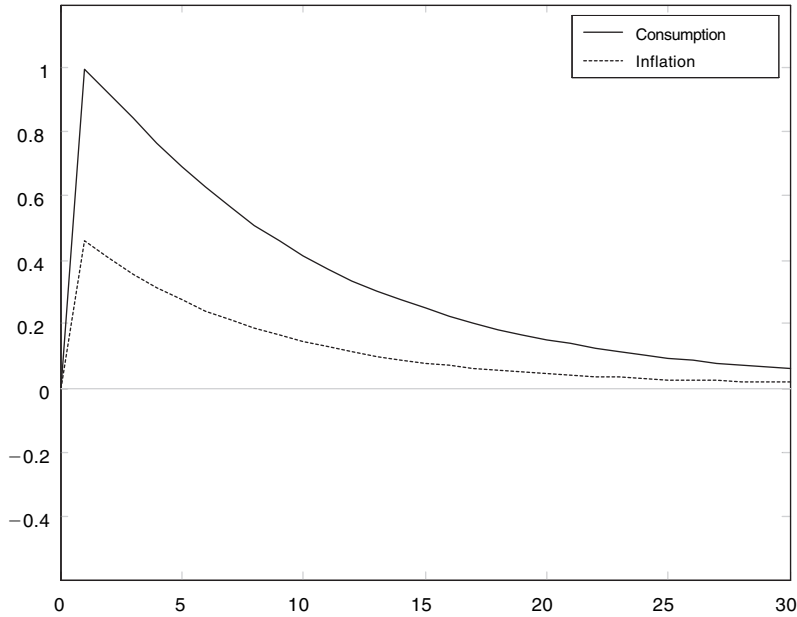


FIGURE 6. RESPONSE OF CONSUMPTION AND INFLATION TO A MONETARY POLICY SHOCK

Note: This figure plots the response of home consumption and inflation to a home monetary policy shock in the model with heterogeneous labor markets ($\zeta = 0.26$).

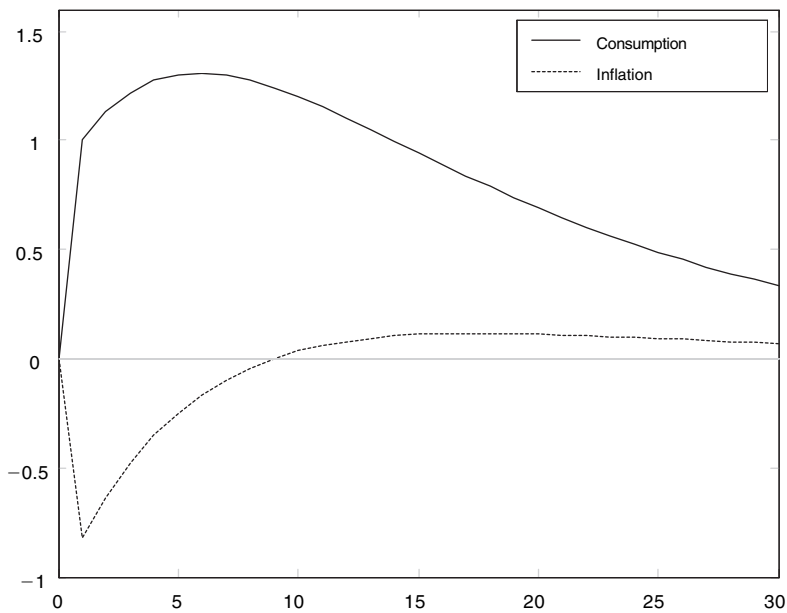


FIGURE 7. RESPONSE OF CONSUMPTION AND INFLATION TO A PHILLIPS CURVE SHOCK

Note: This figure plots the response of home consumption and inflation to a shock to the home Phillips curve in the model with heterogeneous labor markets ($\zeta = 0.26$).

while Phillips curve shocks lead these variables to move in opposite directions on impact. This is illustrated in Figures 6 and 7. Figure 6 plots the response of home consumption and home inflation to a home monetary policy shock. A positive monetary policy shock increases consumption. The boom in consumption, in turn, causes inflation to rise. As the shock dissipates, consumption and inflation return to their steady-state values monotonically.

Figure 7 plots the response of home consumption and home inflation to a home Phillips curve shock. A positive Phillips curve shock, in contrast, increases consumption and decreases inflation on impact. As the shock dissipates, inflation rises above trend due to the boom in consumption. Both series then return to steady state. The Phillips curve shock therefore causes a nonmonotonic impulse response for inflation which yields a similar nonmonotonic impulse response for the real interest rate. It is this nonmonotonic impulse response of the real interest rate that causes consumption, and the real exchange rate, to be hump-shaped.

In my model—as in most other models in the literature—relative consumption and the real exchange rate are highly correlated. In the data, however, these variables are roughly uncorrelated. At present, there are no fully satisfactory solutions to this problem in the literature. However, my main results regarding the hump-shaped response of the real exchange rate to Phillips curve shocks carry over to a model with habit formation in which the correlation of relative consumption and the real exchange rate is substantially lower (around 0.45). In the model with habit formation, the real exchange rate is proportional to the ratio of marginal utility in the two countries, but marginal utility is no longer proportional to consumption. My results also carry over to a model in which international trade in financial assets is limited to noncontingent one-period bonds.

IV. Conclusions

I document empirically that the real exchange rates of nine large, developed economies have exhibited hump-shaped dynamics in the post-Bretton Woods era. I argue that this fact can help explain why existing sticky-price business cycle models have been unable to match the persistence of the real exchange rate. I present a two-country sticky price model with staggered price setting and show that, in response to a monetary shock, the model implies an exponentially decaying dynamics for the real exchange rate. Even with very large amounts of strategic complementarity, the rate of decay is such that the model is unable to match the empirical persistence of real exchange rates. I then show that, in response to several different types of real shocks, the model implies humped dynamics for the real exchange rate. The hump-shaped dynamics generated by the model are a powerful source of endogenous persistence that allow it to easily generate a half-life equal to the estimated half-life of the US real exchange rate.

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