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International Business Cycles and Risk Sharing with Uncertainty Shocks and Recursive Preferences

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This paper analyzes the effects of output volatility shocks on the dynamics of consumption, trade flows and the real exchange rate, in a two-country, two-good world with consumption home bias, recursive preferences, and complete financial markets. When the risk aversion coefficient exceeds the inverse of the intertemporal substitution elasticity, then an exogenous rise in a country's output volatility triggers a wealth transfer to that country, to compensate for the greater riskiness of the country's output stream. This risk sharing transfer raises the country's consumption, lowers its trade balance and appreciates its real exchange rate. In the recursive preferences framework here, volatility shocks account for a non-negligible share of the fluctuations of net exports, net foreign assets and the real exchange rate. These shocks help to explain the high empirical volatility of the real exchange rate and the disconnect between relative consumption and the real exchange rate.

Key words: international business cycles, international risk sharing, external balance, exchange rate, volatility, consumption-real exchange rate anomaly.

JEL codes: F31, F32, F36, F41, F43.

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