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Risk Sharing and Real Exchange Rates: The Role of Non-tradable Sector and Trend Shocks

Hüseyin Çağrı Akkoyun Yavuz Arslan Mustafa Kılınç[1]

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Abstract

In this paper, we show that the tradable and non-tradable total factor productivity (TFP) processes of the US and Europe have unit roots and can be modelled by a vector error correction model (VECM). Then, we develop a standard two-country and two-good (tradable and non-tradable) DSGE model. Our model implies that using cointegrated TFP processes and including non-tradables help solve the real exchange rate (RER) volatility and risk sharing puzzles. Cointegrated TFP shocks, or trend shocks, generate significant income effects and amplify the mechanisms that produce high RER volatility. Moreover, trend shocks can break the tight link between relative consumption and RER for low and high values of trade elasticity parameters. The non-tradable sector in the model improves the results for the risk sharing significantly.

Key Words: Trends Shocks, Risk Sharing, Real Exchange Rates

Jel Classification: E32, F41, F44

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