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Abstract

This paper studies the real exchange rate response to a government-spending shock in a two-country model with productive government purchases and non-Ricardian households. In this economy, the real exchange rate depreciates following an increase in domestic public spending, consistently with most empirical evidence. Importantly, and consistently with empirical evidence, the depreciation occurs both on impact and in the transition. The transmission mechanism works through an increase in domestic private-sector productivity, spurred by government purchases, which reduces real marginal costs at home allowing for accommodating monetary policy response.

JEL classification: E52, E62, F41, F42.

Keywords: Exchange Rate, Fiscal Shocks, Endogenous Monetary and Fiscal Policy.

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