

Accepted Manuscript

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Jean-François Rouillard

PII: S0261-5606(17)30259-0

DOI: <https://doi.org/10.1016/j.jimonfin.2017.12.005>

Reference: JIMF 1871

To appear in: *Journal of International Money and Finance*



Please cite this article as: J-F. Rouillard, International Risk Sharing and Financial Shocks, *Journal of International Money and Finance* (2017), doi: <https://doi.org/10.1016/j.jimonfin.2017.12.005>

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Jean-François Rouillard[†]
Université de Sherbrooke & GREDI

November 14, 2016

Abstract

A canonical two-country real business cycle model with complete international asset markets fails to replicate the correlation between relative consumptions and real exchange rates—*i.e.* the *consumption–real exchange rate anomaly* or *Backus-Smith puzzle*. I show that when preferences are non-separable between consumption and leisure, the same two-country model augmented by domestic financial frictions and shocks can account for this correlation. Positive financial shocks create important fluctuations in the labor wedge, inducing firms to demand more labor. These procyclical movements in hours worked significantly affect the marginal utility of consumption and help to explain the correlation between relative consumptions and real exchange rates.

JEL identification: E44, F34, F44

Keywords: *Backus-Smith puzzle*, borrowing constraints, labor wedge, working capital, financial shocks, non-separable preferences

[†]Assistant Professor - Département d'économique - Université de Sherbrooke & GREDI - 2500 boul. de l'Université, Sherbrooke, Québec, Canada, J1K 2R1; e-mail: j-f.rouillard@usherbrooke.ca.

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