

Government Spending, Trade Openness and Real Exchange Rates: The Role of Endogenous Tradability

Preliminary: Please do not quote.

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Abstract

In this paper, utilizing a two-country dynamic stochastic general equilibrium (DSGE) model with heterogeneous firms, I disentangle how trade integration level affects the response of real exchange rates to a government spending shock. Endogenous tradability goes a long way toward explaining the dynamics of empirically relevant measure of real exchange rates in response to a government spending shock. I find that fiscal expansion tends to generate the appreciation of the real exchange rates more if countries become more integrated in trade.

Keywords: Endogenous tradability, Government spending, Real exchange rates, Trade integration

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