Nominal Rigidity, Desired Markup Variations, and Real Exchange Rate Persistence

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This paper develops and estimates a dynamic general-equilibrium sticky-price model that accounts for real exchange rate persistence. The key feature of the model is the dependence of the firm's desired markup on its relative price. Desired markup variations exacerbate the nominal rigidity that results from the exogenously imposed frictions in the goods market. The model is estimated by the maximum-likelihood method using Canadian and U.S. data. The estimated model successfully replicates the behaviour of the Canada-U.S. bilateral real exchange rate. In particular, the model closely matches the persistence found in the real exchange rate series. More importantly, this is achieved with a plausible duration of price contracts and a moderate convexity of the demand function.

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