

Can new open economy macroeconomic models explain business cycle facts?¹

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Abstract

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We assess the ability of new open economy models to match OECD business cycle data. We adopt a canonical new open economy model with varying degrees of nominal inertia, monopolistic competition and distribution costs and assess the contribution of each facet of this model to help explain jointly the volatility and persistence of real exchange rates and the dynamics of the current account. Building on Chari, Kehoe and McGrattan (2002) and Schmitt-Grohé and Uribe (2003) we find that standard models do not capture these important relative price and quantity dynamics at the business cycle frequency. We explore the extent to which three extensions to the existing literature further our understanding: (i) overlapping generations; (ii) sunspots and (iii) financial frictions.

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