

“A Behavioral Explanation for the Puzzling Persistence of the Aggregate Real Exchange Rate”

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Abstract

It has long been argued that the deviations from the purchasing power parity (PPP) are too persistent to be explained solely by nominal rigidities. Moreover, the micro price evidence suggests that the deviations from the Law of One Price (LOP), the basic building block of PPP, are often less persistent than the PPP derivations. We adapt the model of behavioral inattention of Gabaix (2014, 2019b) to the standard two-country sticky-price model. We show that our model can reconcile the PPP and LOP evidence. Calibrated to match micro-evidence, the model produces an aggregate real exchange rate that is 112--132% more persistent than the degree of price stickiness while also