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Microeconomic Sources of Real Exchange Rate Variability

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Abstract

We document two sets of empirical results on the behavior of annual-frequency microeconomic international relative prices. First, cross-sectional variance in long-term *absolute* deviations from the Law of One Price (LOP) is large relative to time-series variance. Second, time-series variance in *changes* in LOP deviations is dominated by idiosyncratic variation, not country-specific variation such as arises from nominal exchange rates. If you think that annual real exchange rate variability is indicative of nominal exchange rates moving around a distribution of microeconomic sticky prices, you are wrong. There is a great deal of movement *within* the distribution. Microeconomic prices in local currency units move around a lot more than the nominal exchange rate does.

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