BORDERS AND NOMINAL EXCHANGE RATES IN RISK-SHARING

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Abstract
Models of risk-sharing predict that relative consumption growth rates are positively related to changes in real exchange rates. We investigate this hypothesis using a new multi-country and multi-regional data set. Within countries, we find evidence for risk-sharing: episodes of high relative regional consumption growth are associated with regional real exchange rate depreciation. Across countries however, the association is reversed: relative consumption and real exchange rates are negatively correlated. We define this reversal as a 'border' effect. We find the border effect and show that it accounts for over half of the deviations from full risk-sharing. Since cross-border real exchange rates involve different currencies, it is natural to ask how much of the border effect is accounted for by movements in exchange rates. Our measures indicate that a large part the border effect comes from nominal exchange rate fluctuations. We develop a simple open economy model that is consistent with the importance of nominal exchange rate variability in accounting for deviations from cross-country risk-sharing. (JEL: F3, F4)

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