

Exchange-rate volatility, exchange-rate disconnect, and the failure of volatility conservation

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June 5, 2006

Abstract

Empirical analysis of exchange rates has produced puzzles that conventional models of exchange rates cannot explain. Here we deal with four puzzles regarding both real and nominal exchange rates, which are robust and inconsistent with standard theory. These puzzles are that both real and nominal exchange rates: i) are disconnected from fundamentals, ii) are much more volatile than fundamentals, iii) show little difference in behavior, and iv) fail to satisfy conservation of volatility. We develop a two-country, two-currency version of the random matching model to study exchange rates. We show that search and legal restrictions can produce exchange-rate dynamics consistent with these four puzzles.

JEL: F31, C78

Keywords: exchange-rate puzzles, exchange-rate volatility, bargaining, search.

*We are grateful to Ed Green, Barry Ickes, James Jordan, and Neil Wallace for most valuable discussions. All errors are ours.