A Two Sector Model In a Small Open Economy

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This paper aims at solving the consumption correlation anomaly in a small open economy using a two sector approach. By dividing the goods into tradable and nontradable both theoretically and empirically, I show that the tradable consumption goods is more volatile and less correlated with output because of the linkage with international markets, while the nontradable consumption goods is less volatile and more correlated with output because of its own goods market clearance within the border. Also, because tradable sector suffers from one more shock, the international shock, than the nontradable sector, the investment in tradable sector is more volatile. This approach is modelled, calibrated and simulated for the Canadian economy. It solves the consumption anomaly and produce more accurate correlation with output, and a better match with the empirical regularities. This approach may also be easily extended to a two-country framework and explain the international comovement puzzle.

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