Costs of Adjustment and Exporter Behavior: Rationalizing the International Elasticity Puzzle*

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Abstract

Exports are not very responsive to real exchange rates, though they respond strongly to trade liberalizations, a fact sometimes referred to as the International Elasticity Puzzle. We show that two dimensions of costs of adjustment can rationalize this fact. We present a partial equilibrium model of the firm with both costly customer base accumulation and sticky prices. We calibrate the model to match steady state firm and export dynamics and steady state facts about price stickiness. We simulate the responses of these firms to real exchange rate and tariff processes estimated from data. The simulated responses match actual micro-level responses of exports to tariffs estimated using data for Ireland, and go close to matching actual responses to exchange rates.

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