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Real exchange rate targeting and macroeconomic instability

Martín Uribe*

University of Pennsylvania and NBER, Department of Economics, 3718 Locust Walk, Philadelphia, PA 19104-6297, USA

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Abstract

Using an optimizing model of a small open economy, this paper studies the macroeconomic effects of PPP rules whereby the government increases the devaluation rate when the real exchange rate—defined as the price of tradables in terms of nontradables—is below its long-run level and reduces the devaluation rate when the real exchange rate is above its long-run level. The paper shows that the mere existence of such a rule can generate aggregate instability due to self-fulfilling expectations. The result is shown to obtain in both flexible- and sluggish-price environments.

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1. Introduction

In developing countries, policymakers often link the rate of devaluation of the domestic currency to the level of the real exchange rate with the intention of maintaining a desired level of competitiveness in foreign markets. Devaluations often take place when the real exchange rate is overvalued, that is, when the relative price of tradables in terms of nontradables is low relative to a target or

*Tel.: +1-215-898-6260; fax: +1-215-573-2057.

E-mail address: uribe@econ.upenn.edu (M. Uribe).

trend level. Empirical support for this observation is robust. Klein and Marion (1997), for example, analyze 61 episodes of exchange rate management drawn from 16 Latin American countries and Jamaica. They find strong evidence that a more appreciated real exchange rate is associated with a higher likelihood of a devaluation. Similar relationships have been found by Frankel and Rose (1996) and by Kaminsky and Reinhart (1999) for a large number of developing countries. Calvo et al. (1995) review the empirical literature on real exchange rate targeting and conclude that the real exchange rate is perhaps the most popular real target in developing countries.

The purpose of this paper is to theoretically study the macroeconomic effects of exchange-rate rules whereby the government increases the devaluation rate when the real exchange rate is below its long-run level and decreases it when the real exchange rate is above its long-run level. We refer to this type of rule as purchasing-power-parity (PPP) rules. In particular, the paper focuses on the question of whether the mere adherence to a PPP rule can generate endogenous aggregate instability by allowing for the existence of equilibria in which agents base their expectations about economic variables on non-fundamental signals. The central result of this investigation is that tight PPP rules can generate indeterminacy of the rational expectations equilibrium and endogenous fluctuations due to arbitrary revisions in expectations. Thus, PPP rules can give rise to situations in which exchange rate instability, both nominal and real, occurs simply because the public expect it. This instability is shown to be welfare decreasing.

We begin by formalizing this idea in a simple perfect-foresight, flexible-price environment. We embed a PPP rule in a model of a small open, monetary economy in which the use of money is motivated by assuming that it facilitates transactions à la Kimbrough (1986). The key to understanding the intuition behind our indeterminacy result lies in the relationship between the current level of the real exchange rate and expected devaluations implied by the model. In a small open economy, the nominal interest rate is, loosely speaking, an increasing function of the expected devaluation rate. Hence, an increase in next period's expected devaluation rate causes an increase in the domestic interest rate in the current period. In response to an increase in the nominal interest rate, agents reduce their demand for real money balances. A lower demand for money, in turn, pushes transaction costs up and induces agents to reduce their current consumption expenditure. Given the supply of nontradables, this decline in aggregate consumption puts downward pressure on the relative price of nontradables, that is, it generates a real depreciation of the domestic currency. Thus, expectations of higher future devaluation rates are associated with current real exchange rate depreciation. Consider now a negatively serially correlated sunspot variable and assume that economic agents associate high values of the sunspot variable with high current devaluation rates and low values of the sunspot variable with low current devaluation rates. Then a high realization of the sunspot variable today, induces people to believe that next period's devaluation rate will be small,

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