Abstract

This paper develops a new approach to modeling exchange rate expectations that brings the implications of the standard monetary models of the exchange rate more closely in line with actual exchange rate experience. The approach extends the work Frydman and Phelps [1990], which proposes an alternative expectational assumption called the Theories Consistent Expectations Hypothesis (TCEH). With TCE, market agents are endowed with a number of leading theories, all of which inform agents as to the algebraic signs of the weights attached to fundamental variables, rather than the true parameter magnitudes as in the standard RE approach. The paper shows that implications of the monetary approach with TCE include the following: 1) In a world where agents do not know the true value of the long-run exchange rate, exchange rate movements *should* be characterized by persistent movements away from established equilibrium values (e.g., PPP and/or current account balance); 2) These persistent movements will alternate in direction as market agents switch the set of fundamentals they use in forecasting and/or policy officials react and alter the way the driving variables are moving; 3) The divergent behavior generated in the model provides the rationale for such behavior on the part of market agents and policy officials; 4) Once movement in the exchange rate changes direction and moves toward the equilibrium level, there will be no tendency to stop at this level, and instead, shooting through will be the norm; and 5) Standard empirical exchange rate models *should* experience periodically structural instability that is proximate to the major turning points in the value of the currencies. These implications, together with the empirical record, lead to conclusion that the monetary approach with TCE provides a reasonable macroeconomic framework for examining exchange rate dynamics. An interesting difference between the approach with TCE and the alternative approach of Frankel and Froot [1987] with noise trading is that the former approach explains the seemingly anomalous behavior as the result of agents focusing on the wrong combination of fundamentals, whereas the latter approach relies on some agents ignoring fundamental news altogether.