

## Qualitative Rationality and Behavior in the Foreign Exchange Market

### Abstract

This paper develops an alternative framework for modeling exchange rate expectations, which we call the theories consistent expectations (TCE) framework. On the one hand, the TCE framework attempts to preserve the spirit of the RE paradigm, in that it supposes rational economic agents are forward looking and use extant economic theories in forming their forecasts. On the other hand, the TCE framework attempts to meet in part the problems of arbitrariness and inconsistency inherent in any attempt at moving away from RE. The main characteristics of the TCE framework are: 1) it recognizes the existence of a pluralism of theories describing exchange rate dynamics and allows agents to base their forecasting functions on one or more of the existing theories; 2) it does not assume that the precise magnitudes of the parameters of economic models are known to agents, i.e., the stock of extant theories provides qualitative rather than quantitative knowledge about the economy; and 3) it replaces the assumption of perfect foresight with the assumption that agents are able to correctly predict the *direction* of change of the exchange rate, which we call qualitative rationality. We show that when the TCE framework is used to close otherwise standard monetary models of the exchange rate, their implications match up much more closely with the empirical record than those obtained with RE.