

Abstract

This paper explores the consequences of imperfect knowledge for exchange rate dynamics within the monetary class of models. The framework we develop, which we call the theories consistent expectations (TCE) framework, provides a particular formalization of a world in which agents use theories in order to look forward, but in which these theories provide only qualitative knowledge rather than quantitative knowledge about the economy. In doing so we abandon the RE assumption that agents act as if they are capable of generating quantitatively correct forecasts. 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 find that as long as agents possess at least some degree of imperfect knowledge, the monetary models of the exchange rate generate movements that are consistent with observed behavior, but which are anomalous in the context of the monetary models with RE.