Abstract

This paper analyzes the sustainability of fixed exchange rates by extending the Barro-Gordon framework to a fully dynamic context in which the level of a state variable (in this case debt) determines the payoffs available to the government at each point in time. The model yields the following results. If debt is sufficiently low, there is an equilibrium in which the government does not devalue. For an intermediate range of debt levels, the government devalues in response to an attack but not otherwise, so that self-fulfilling attacks can occur. Finally, for yet another debt range there can also be sunspot equilibria in which an attack (and the corresponding devaluation) occurs with positive probability. *J.E.L. Classification Numbers E52, F31, O23. Key Words: Fixed Exchange Rates, Credibility, Sustainability, Multiple Equilibria.*