

Beliefs Based Exchange Rate Overshooting

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Abstract

The paper introduces habit persistence in consumption decisions in an infinitely-lived agents open economy monetary model with a cash-in-advance constraint. We first show that high enough — but still reasonable — values for habit persistence yields indeterminate equilibria. We however show that real indeterminacy is not *per se* sufficient to generate volatile and persistent fluctuations in exchange rate dynamics. The form of the beliefs matters. When agents do not trust in money, the nominal exchange rate essentially mimics the dynamics of money supply growth and never overshoots. Conversely, when beliefs are positively correlated with money supply shock, the model is capable of generating overshooting and therefore volatility and persistence in exchange rate dynamics.

Keywords: Habit persistence, cash-in-advance, beliefs, real indeterminacy, overshooting, exchange rate dynamics.

JEL Class.: E21, E32, F41

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