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International Finance Discussion Papers: The Syndrome of Exchange-Rate-Based Stabilization and the Uncertain Duration of Currency Pegs

By Enrique G Mendoza, Martin Uribe

Bibliogov, United States, 2013. Paperback. Book Condition: New. 246 x 189 mm. Language: English . Brand New Book ***** Print on Demand *****.This paper conducts a quantitative examination of the hypothesis that uncertain duration of currency pegs causes the sharp real appreciations and business cycles that affect chronically countries using fixed exchange rates as an instrument to stop high inflation. Numerical solutions of equilibrium dynamics of a two-sector small open economy with incomplete markets show that uncertain duration rationalizes the syndrome of exchange-rate-based stabilizations without price or wage rigidities. Three elements of the model are critical for these results: (a) a strictly-convex hazard rate function describing time-dependent devaluation probabilities, (b) the wealth effects introduced by incomplete insurance markets, and (c) the supply-side effects introduced via capital accumulation and elastic labor supply. Uncertain duration also entails large welfare costs, compared to the perfect-foresight credibility framework, although temporary disinflations are welfare-improving. The model's potential empirical relevance is examined further by reviewing Mexico's post-war experience with the collapse of six currency pegs.



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