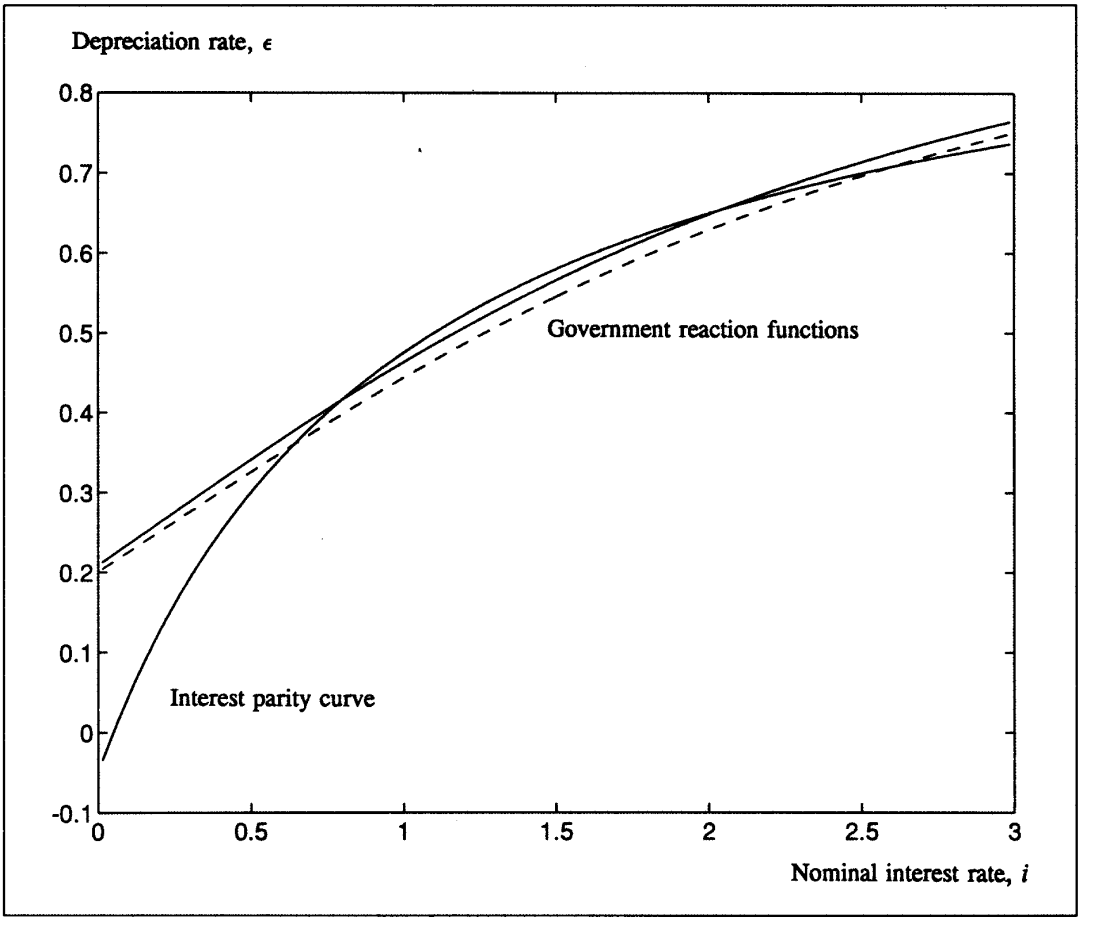
requirements. The model applies equally to other situations, such as Britain's in the 1950s and 1960s, when authorities sought to avoid the "twin disasters of internal and external collapse of the value of the pound sterling"[1] in the face of a large and increasing public debt.

Figure 7



2.2. The role of aggregate demand shocks

A second model, based on closed-economy models by Barro and Gordon (1983) and Kydland and Prescott (1977), shows that a regime of fixed but adjustable parities can engender multiple equilibria. In some equilibria the economy may be worse off than under irrevocably fixed exchange rates, as nominal wage-growth expectations erode competitiveness and make devaluations more frequent[2]. In this model devaluations are triggered by the government's desire to offset negative output shocks, but a sudden shift in market sentiment regarding the government's willingness to tolerate unemployment can trigger a devaluation that would not have occurred under different private expectations.

In this model, lower case variables denote natural logarithms and PPP holds, so that e, the (log) home-currency price of foreign exchange, equals p, the (log) money price of domestic output, given

(1) Goodhart (1973, p. 513).
(2) For a more detailed discussion of a similar model, see Obstfeld (1991).