In principle, an “escape-clause” arrangement of this sort (such as the one present in Stage Two of the plan for European Monetary Union) can raise welfare. It allows exchange-rate flexibility in those extreme situations where it is most needed, while restraining inflationary proclivities otherwise; and this effect provides a potential rationale for imposing a realignment cost c. In practice, however, a beneficial escape clause may be hard to implement. The reason for this difficulty, as (31) shows, is that the trigger points \( \mu \) and \( \bar{u} \) at which the escape option is exercised depend on prior expectations of depreciation \( \pi \), and these, in turn, depend on market perceptions of where the realignment trigger points lie. This element of circularity creates the potential for multiple equilibria, and a sudden shift in equilibria can trigger a crisis for an exchange rate that previously appeared strong on the basis of fundamentals.

To illustrate this possibility, it simplifies matters to assume temporarily that devaluation requires policymakers to pay a cost c, but that revaluations aren’t possible at all. (The validity of this presumption will be verified later for a particular example.) For concreteness, the disturbance \( u \) is assumed to be uniformly distributed over the interval \([- \mu, \mu]\). I suppose that market participants believe the domestic currency will be devalued whenever a shock more severe than a threshold level \( \bar{u} \) occurs (i.e., when \( u > \bar{u} \)). In an equilibrium, the market assessment of \( \bar{u} \) equals the highest value of the shock at which the government still finds it optimal to defend the exchange parity.

Identification of equilibria requires two steps: (1) the calculation of market depreciation expectations given an anticipated devaluation threshold \( \bar{u} \), and (2) calculation of the actual threshold given market expectations.

When market participants believe on date \( t-1 \) that the date \( t \) exchange rate will be changed if \( u > \bar{u} \), they expect the date \( t \) depreciation rate to be

\[
\pi = \text{Prob} \{ u \leq \bar{u} \} \cdot 0 + \text{Prob} \{ u > \bar{u} \} \cdot E[\varepsilon | u > \bar{u}],
\]

where the last expectation is a date \( t-1 \) expected value of what depreciation will be next period conditional on \( u \) exceeding \( \bar{u} \). (\( \pi \) is not a function of time because the shock \( u \) is serially independent.) Under the assumed uniform probability distribution for \( u \),

\[
\text{Prob} \{ u > \bar{u} \} = \frac{\mu - \bar{u}}{2\mu}, \quad E[|u| | u > \bar{u}] = \frac{\mu + \bar{u}}{2}.
\]

and, given the devaluation reaction function (27),

\[
E[\varepsilon | u > \bar{u}] = \lambda \left( \frac{\mu + \bar{u}}{2\alpha} \right) + \lambda \pi + \lambda \left( \gamma^*/\alpha \right).
\]

Thus, (33) implies that

\[
\pi = \left( \frac{\mu - \bar{u}}{2\mu} \right) \left[ \lambda \left( \frac{\mu + \bar{u}}{2\alpha} \right) + \lambda \pi + \lambda \left( \gamma^*/\alpha \right) \right],
\]

which reduces to

\[
\pi = \delta(\bar{u}) = \lambda \left( \frac{\mu - \bar{u}}{2\mu} \right) \left[ \left( \frac{\mu + \bar{u}}{2\alpha} \right) + \left( \gamma^*/\alpha \right) \right] + \left[ 1 - \lambda \left( \frac{\mu - \bar{u}}{2\mu} \right) \right].
\]

The government takes the expectations in (34) as given and minimizes its loss. Equation (31) implies that the largest shock consistent with a continuing fixed exchange rate is a solution \( \bar{u} \) to the equation

\[
\frac{1}{2} \lambda \left( \alpha \delta(\bar{u}) + \bar{u} + y^* \right)^2 = c.
\]

Since \( \bar{u} \) must equal \( \bar{u} \) in equilibrium, and since, moreover, we are only interested in devaluation situations such that \( \alpha \delta(u) + u + y^* > 0 \), the condition for \( \bar{u} \) to be an equilibrium devaluation threshold is that

\[
\sqrt{\lambda \left( \alpha \delta(u) + \bar{u} + y^* \right)} = \sqrt{2c}.
\]

(1) When this quantity is negative devaluation is never optimal but revaluation (which has been excluded) is.

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