which is simply a weighted average of $\bar{p}$ and p/e. The weight, θ, depends on uncertainty surrounding $\bar{p}$ and p/e:

$$\theta=\frac{\gamma^2+\alpha^2}{\gamma^2} \quad . \tag{4}$$

In forming foreign price expectations, consumers possess two pieces of information, each of which enables them to compute a forecast of foreign price. Expected foreign price is found by combining the two forecasts where the weight depends on the degree of uncertainty surrounding each forecast. For example, if consumers are less confident regarding the accuracy of the forecast based on purchasing power parity (due to an increase in α^2), then consumers attach greater weight to $\bar{p}$. In this case, the value of θ rises, which according to expression (3), suggests that consumers rely more on $\bar{p}$ rather then p/e in calculating $E[p^*]$. If, in contrast, consumers are relatively less confident with the accuracy of the forecast $\bar{p}$, then greater weight is attached to p/e in forming foreign price expectations.

The consumer's planning problem involves maximizing (1) subject to (2), (3), and (4). The first order conditions are

$$u_{c^*}(\cdot)=\lambda e\left[\theta\bar{p}+(1-\theta)\frac{p}{e}\right] \tag{5}$$

$$u_c(\cdot)=\lambda p \tag{6}$$

and the budget constraint (2), where λ is the Lagrange multiplier.

The solution is given by the continuous functions $c=c(\bar{p},p,e,y,\theta)$ and $c^*=c^*(\bar{p},p,e,y,\theta)$. The relationship between domestic and foreign travel spending is described in the following