Such shifts could occur because of changes in beliefs or misperceptions about the future exchange rate. Even under rational exchange rate expectations (i.e., optimal exchange rate forecasts based on all available information), expected values of future exchange rate could change in response to "news" that provide new pieces of information about fundamental macro-economic conditions.

- In the presence of free capital mobility, the exchange rate is likely to exhibit considerable variability under flexible rates.

Since prices of goods tend to adjust slowly, volatility in the nominal exchange rate would also produce volatility in the real exchange rate (the nominal exchange rate divided by the ratio of the home to foreign price level).

- Wide swings in the real exchange rate can cause serious adjustment problems for firms and workers in traded-goods industries.

Moreover, uncertainty produced by fluctuations in the exchange rate is generally believed to reduce international trade and discourage foreign investment. Fixed exchange rates are often advocated to avoid these undesirable effects of exchange-rate variability, but as we discuss below, this system also poses serious policy problems.

2.3. Adjustable Exchange Rate Peg

Under fixed exchange rates, the central bank announces buying and selling rates for its currency (in relation to a single foreign currency or a basket of currencies), and commits itself to buying and selling unlimited amounts at these rates. We first consider an exchange rate regime where the buying and selling rates are very close and the exchange rate can thus fluctuate only between very narrow bands.

If the country is perceived as fully committed to fixed rates, it would be expected not to devalue or re-value its currency under any circumstances. In this case, the price of the currency would be expected to remain within permanently-fixed narrow bands, and the interest parity would dictate that the home interest rate is always very close to the foreign rate. Under these conditions, the country would