Comment on Sven W. Arndt's "On Exchange Rate Dynamics"

By Bruce Brittain*

In his paper "On Exchange Rate Dynamics", *Sven Arndt* raises issues that have bothered economists since exchange rates were floated: Why do exchange rates move so much? Are destibilizing speculators responsible? Or do economic actors that influence underlying conditions take the blame? The current literature, including contributions by *Frenkel* (1976), *Dornbusch* (1976), *Kouri* (1976) and *Mussa* (1976) emphasizes the role of monetary authorities who, for a set of ill-specified reasons, alter the quantity of money in circulation, setting in motion a rational market response that adjusts some or all prices — including the exchange rate — to a new level incorporating the information about the new stock of money. Money stocks are highly variable, holders of money rationally recognize that money influences prices and exchange rates so exchange rates are highly variable too.

Sven Arndt concurs in this judgment although his reasons — incorporated in his model of exchange rate dynamics — are slightly different. *Sven's* model is supposed to be a simple period model of asset price determination in which goods prices are immutably fixed at the beginning of the period and cannot change during the period. Other prices, such as forward exchange rates, spot exchange rates and interest rates are free to move. Consumption, production and accumulation plans are laid at the beginning of the period presumably for end of period realization.

When something disturbs equilibrium, the home country money stock rises, for example, exchange market participants predict that prices in the home country will rise and they bid this information into the forward value of the currency — increasing the number of domestic currency units it takes to buy a unit of foreign currency for delivery in the next period so that expected purchasing power parity will hold. Producers also realize that prices will rise in consequence of the money stock increase but are incapable of changing prices which were frozen at period's beginning and they withhold goods from the market. They pre-

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