

Research Note

Artha Vijnana
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A Note on the Theoretical Significance And Empirical Relevance of Dornbusch's Overshooting Model

D. Sambandhan

Introduction

The frontiers of exchange rate economics have deepened and widened thanks to the evolution of Asset Market Approach, Rational Expectations and New Classical Macro Economics. The implications of these evolving approaches and the crucial interdependence between current and capital accounts of BOP in the analysis of exchange rate determination have been increasingly realized by the profession. While Allen and Kenen's integrated approach to BOP and exchange rate theory (1980) is the best representative of Portfolio Model, Dornbusch's sticky-price over-shooting Monetary Model (1976) is a classic example of macroeconomic disequilibrium model. This paper attempts to evaluate the theoretical significance and empirical relevance of the latter.

Theoretical Significance

The theoretical significance of sticky-price monetary model of Dornbusch lies in the conceptual intergration of the valid elements of classical and Keynesian approaches towards exchange rate economics. Dornbusch rightly ignores almost completely the influence of Purchasing Power Parity theory (PPP) relation, as is legitimate in short period analysis of exchange rate determination. In a typical true Keynesian tradition, he invokes the assumption of sluggish price adjustments in the goods market. As will be shown below, the fusion of classical and Keynesian attributes, generate exchange rate dynamics in the medium run, leading to long run configuration of exchange rate and price consistent with the normal homogeneity property of the system.

The merit of Dornbusch's work is that it corrects the major deficiency of Mundell-Fleming model which is static and hence precludes exchange rate dynamics. He accomplishes this task by postulating that asset market equilibrium must explicitly take into account expected exchange rate changes.

Synthesis Of Classical And Keynesian Attributes

Looking beyond the simplistic steady state long run implications of the monetary model, he introduces short run dynamics in the behaviour of crucial macro variables. The dynamics comes from the price level variable that is not free to jump at a moment in time. The logical starting point is therefore to relax PPP assumption and untie exchange rate from PPP. In other respects, his model shares the common elements of the basic flex-price monetary model. They are : (1) Perfect capital mobility is assumed and uncovered interest parity condition exists, (i.e., there is no risk premium). Exchange rate and interest rate adjust instantaneously in such a fashion that rates of return on domestic and foreign assets are