Explaining Changes in Exchange Rates

FIN 204 Lecture 14.1.

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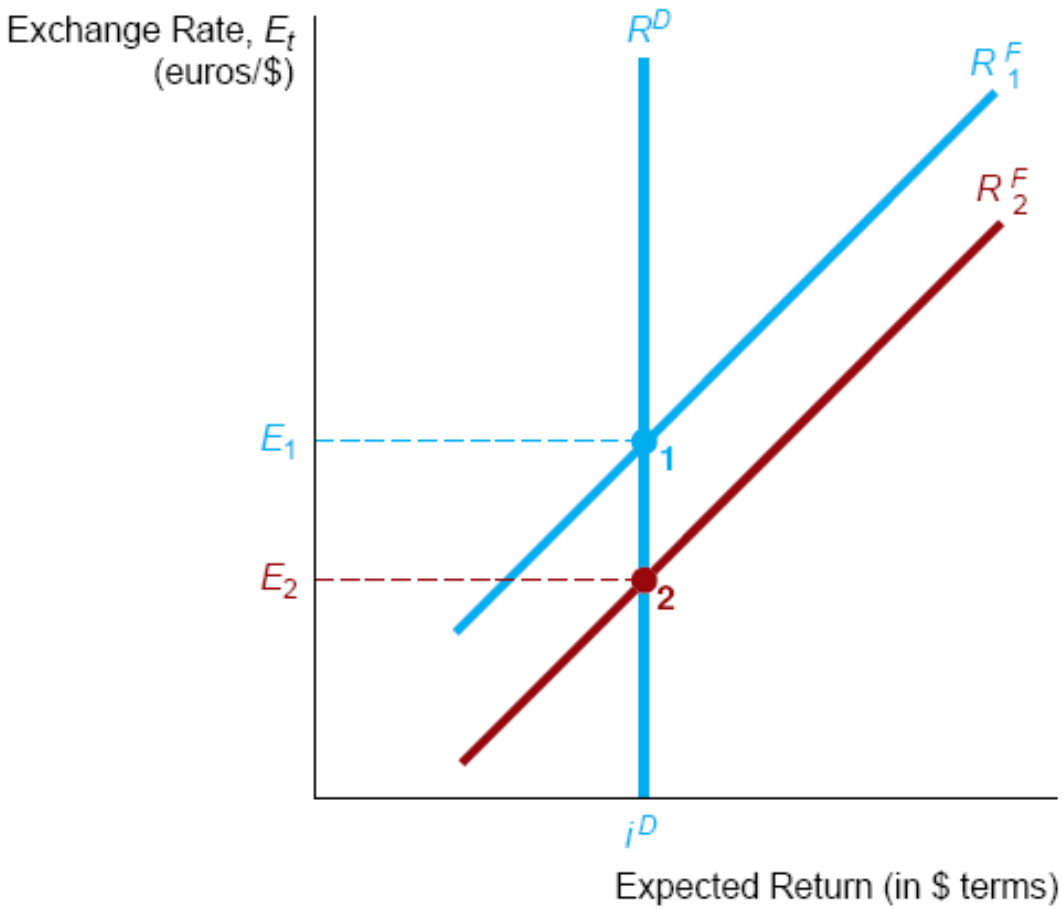
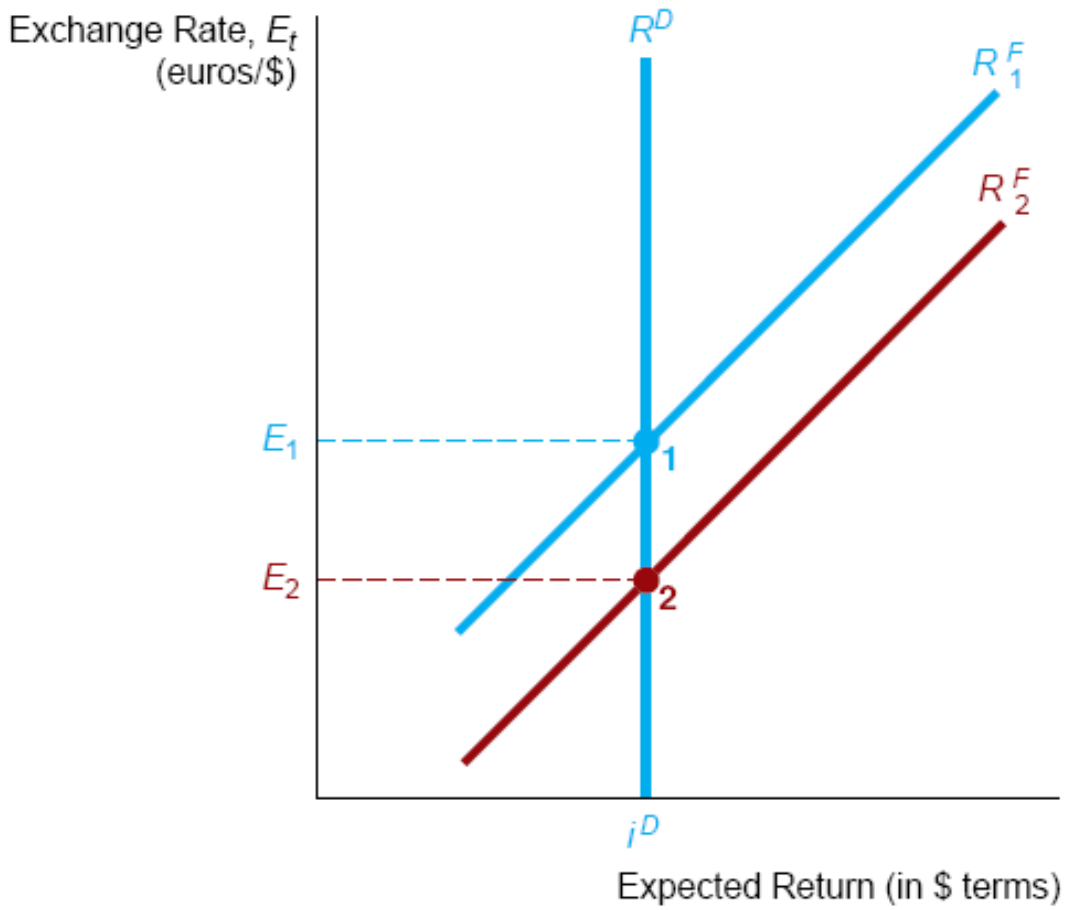
Outline

1. How Do the Factors Changing the Exchange Rate Work?
2. Monetary Policy Impact on the Exchange Rates
3. Empirical Evidence of the Monetary Policy Impact on Exchange Rates

Changes in Expected Returns on Assets Abroad

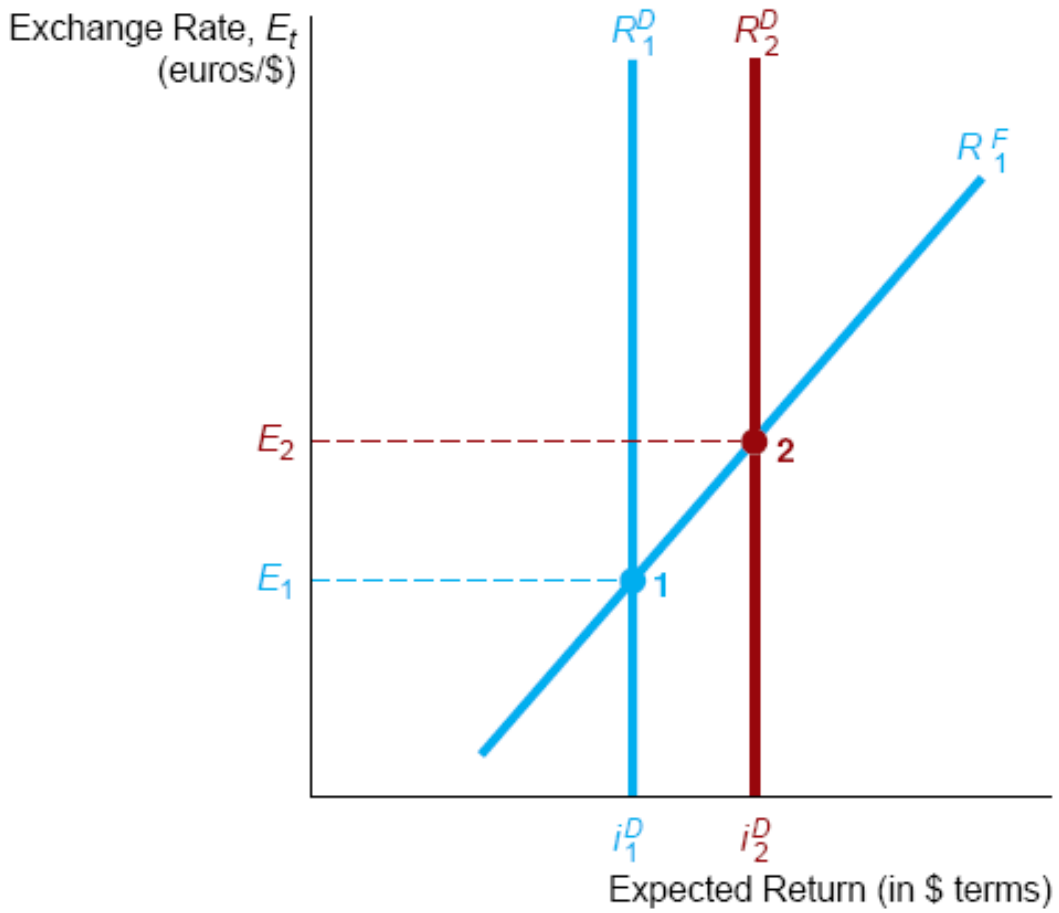


Changes in Expected Returns on Assets Abroad

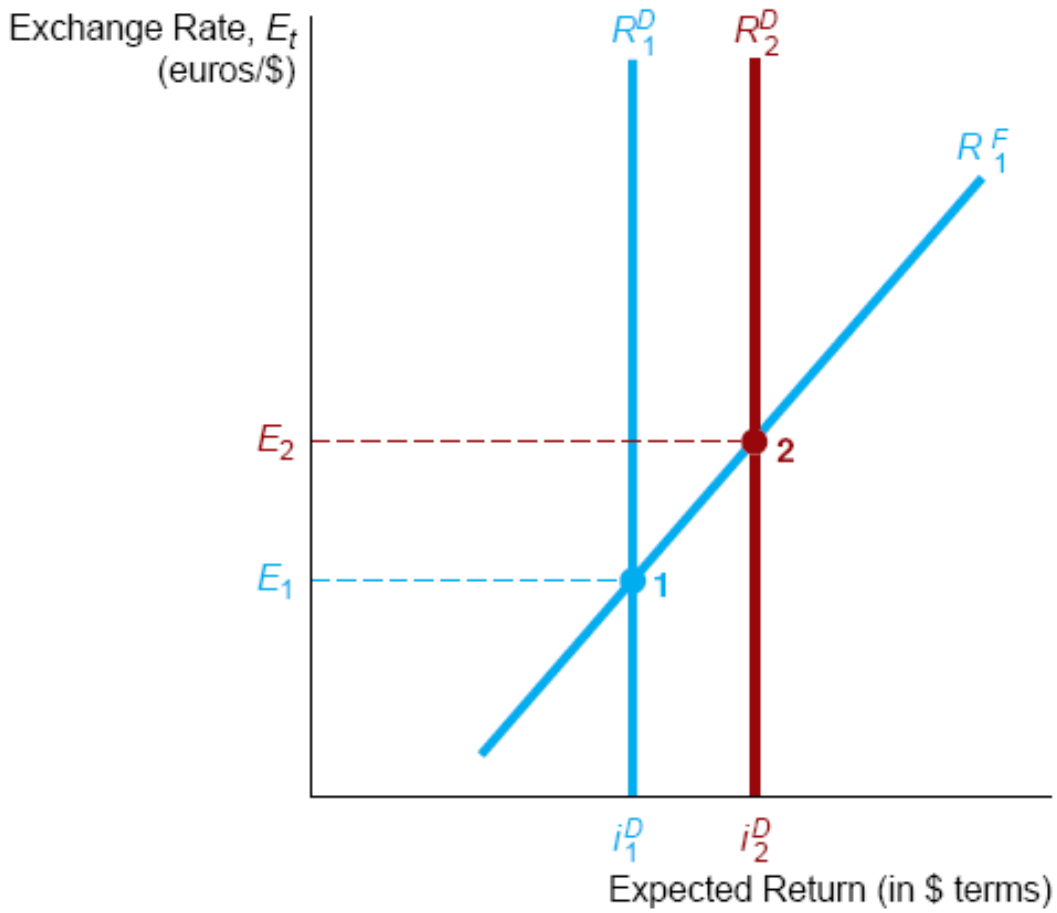


Expected returns on assets, and expected changes in nominal exchange rates shift the Euro ER curve.

Changes in Expected Returns on Assets at Home

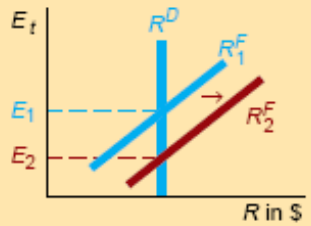
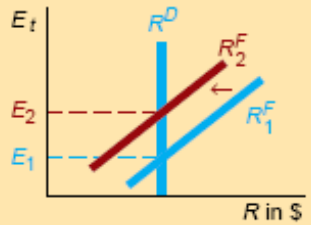


Changes in Expected Returns on Assets at Home



Changes in domestic interest rates shift domestic ER curve.

Changes in Other Factors (1)

Factor	Change in Factor	Response of Exchange Rate E_t	
Expected domestic price level*	↑	↓	
Expected trade barriers*	↑	↑	

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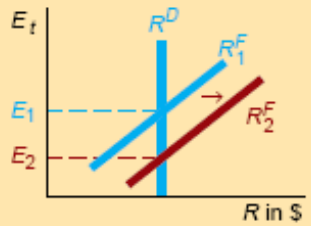
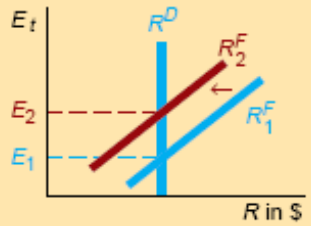
Expected domestic price level*	↑	↓	
Expected trade barriers*	↑	↑	

Changes in domestic price level shifts domestic ER curve to the right.

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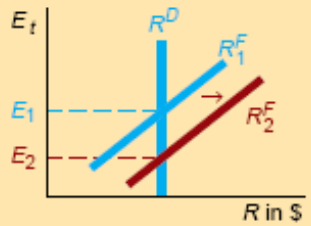
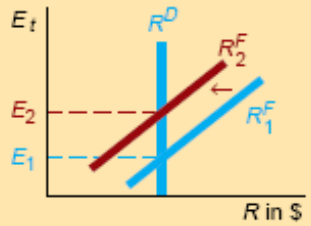
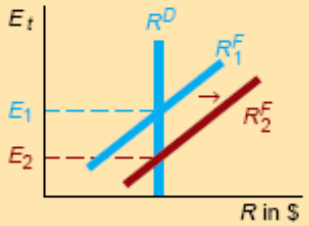
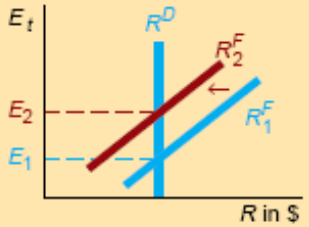
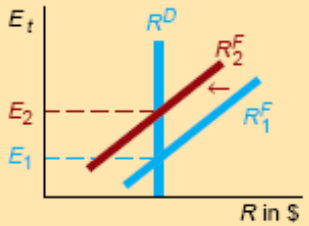
Expected domestic price level*	↑	↓	
Expected trade barriers*	↑	↑	

Changes in domestic price level shifts domestic ER curve to the right.
Imposition of trade barriers shifts back the demand for foreign assets.

Changes in Other Factors (2)

Factor	Change in Factor	Response of Exchange Rate E_t	
Expected import demand	↑	↓	
Expected export demand	↑	↑	
Expected productivity*	↑	↑	

Changes in Exchange Rates and Monetary Policy

An application (1): Increase in expected inflation at home

Suppose ${i_r}^{US} = {i}^{US} - {\pi_e}^{US}$, and ${i_r}^{EU} = {i}^{EU} - {\pi_e}^{EU}$.

Changes in Exchange Rates and Monetary Policy

An application (1): Increase in expected inflation at home

Suppose ${i_r}^{US} = {i}^{US} - {\pi_e}^{US}$, and ${i_r}^{EU} = {i}^{EU} - {\pi_e}^{EU}$. Suppose ${\pi_e}^{US} \uparrow$.

Changes in Exchange Rates and Monetary Policy

An application (1): Increase in expected inflation at home

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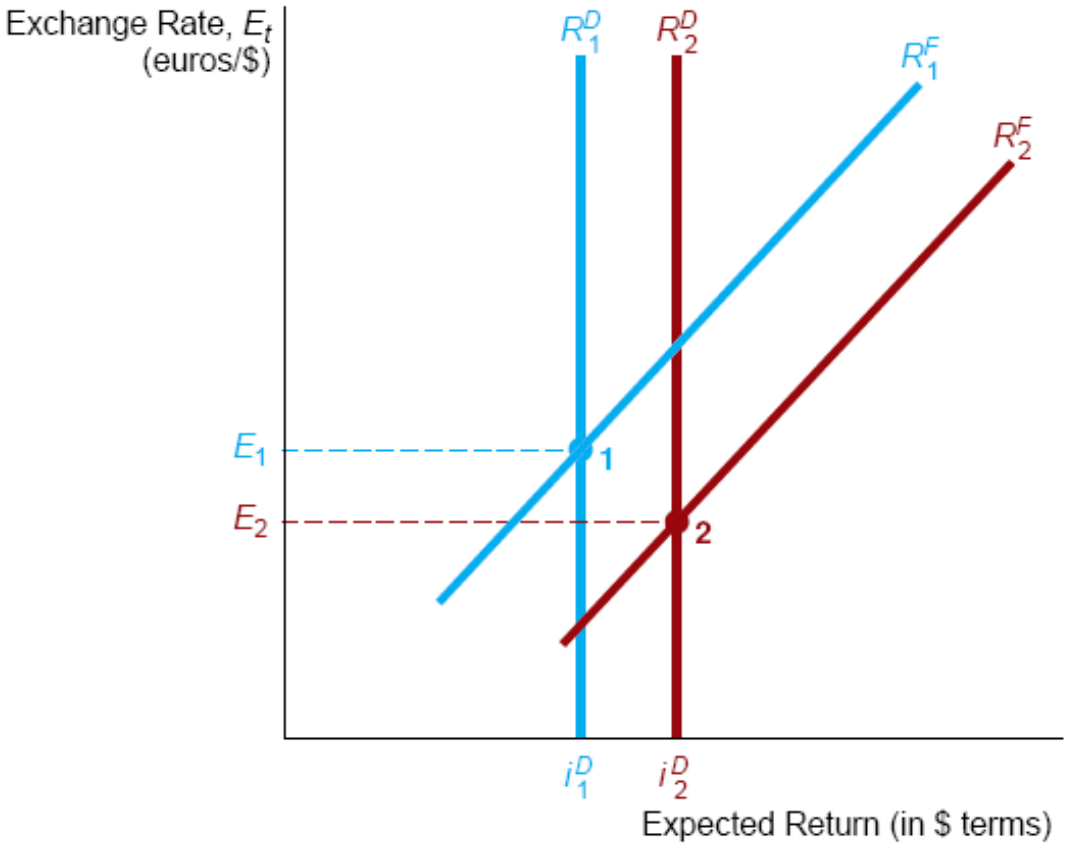

Inflation in US rises more than in the EU, and the US $ depreciates.

Changes in Exchange Rates and Monetary Policy

An application (2): Increase in M_s at home

Suppose ${M_s}^{US} \uparrow \Rightarrow {i_r}^{US} \downarrow$.

Changes in Exchange Rates and Monetary Policy

An application (2): Increase in M_s at home

Suppose ${M_s}^{US} \uparrow \Rightarrow {i_r}^{US} \downarrow$.
Moreover, ${M_s}^{US} \uparrow$ leads to ${\pi_e}^{US} \uparrow$.

Changes in Exchange Rates and Monetary Policy

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Suppose ${M_s}^{US} \uparrow \Rightarrow {i_r}^{US} \downarrow$.
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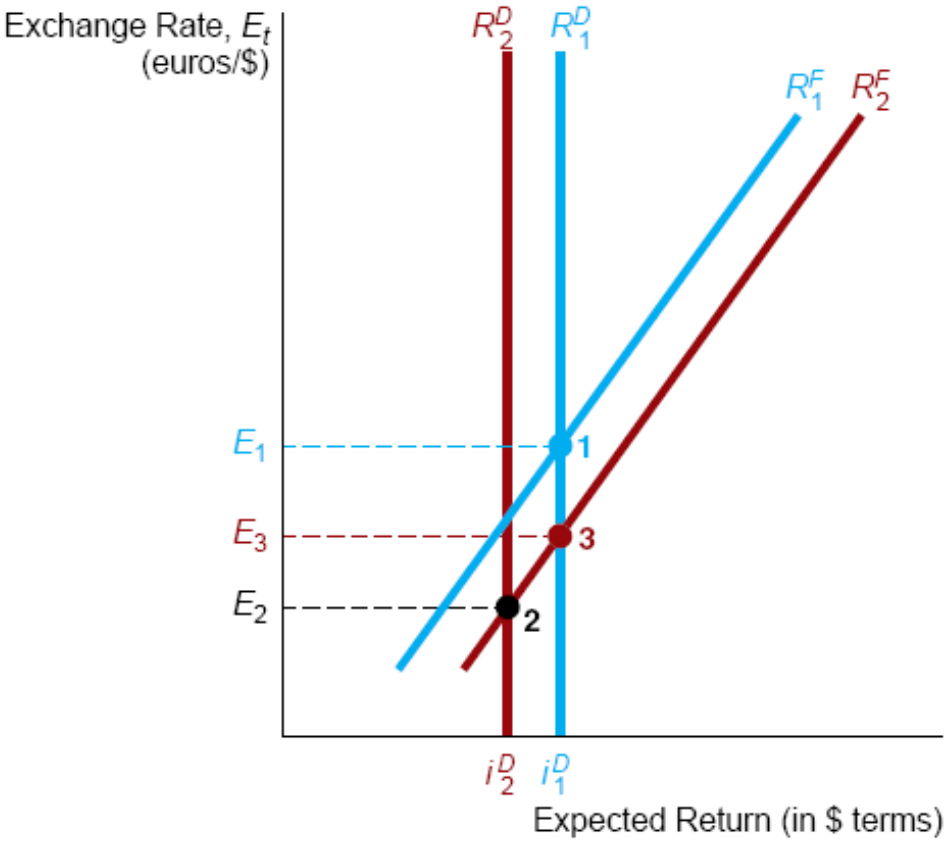
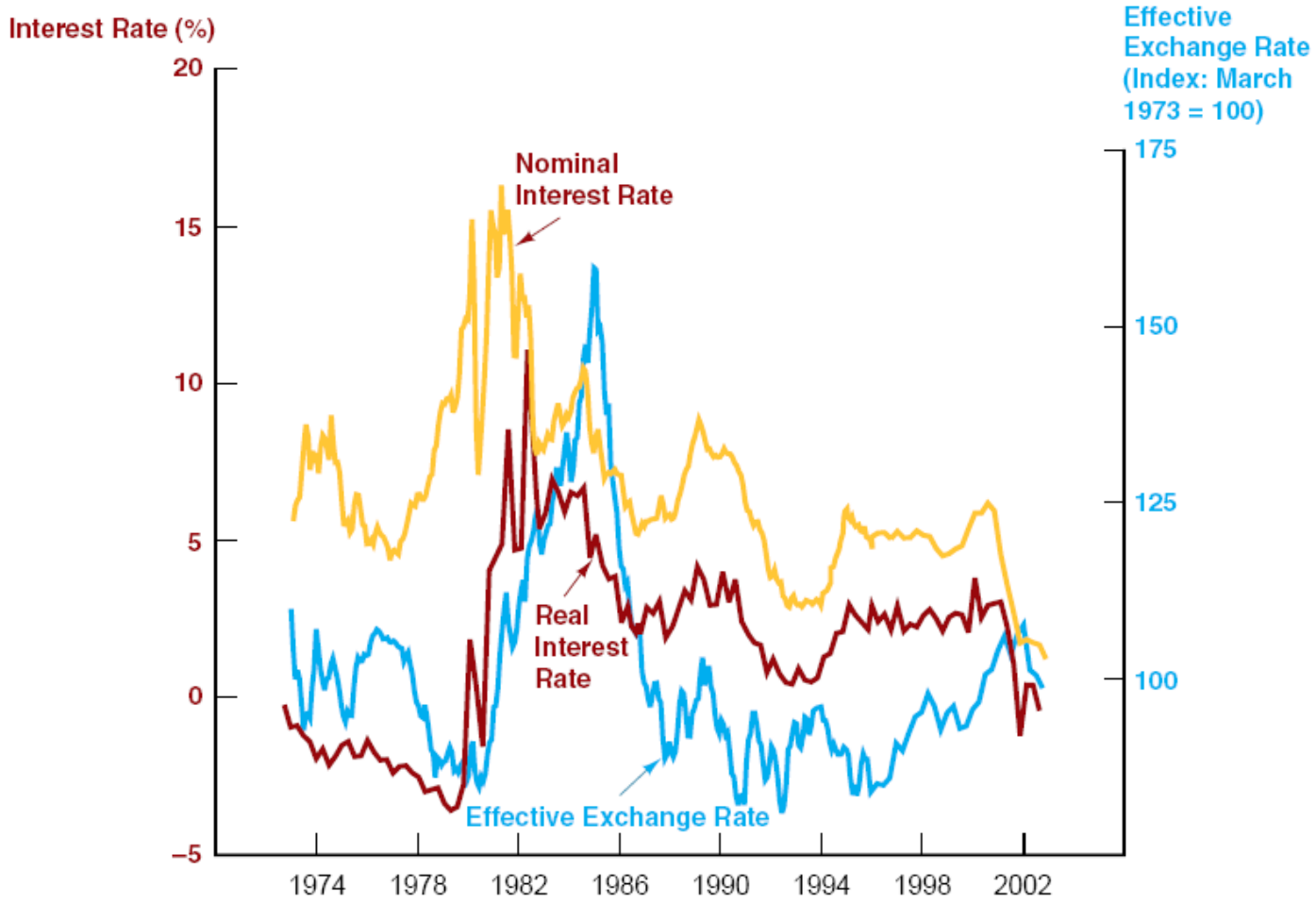


Money supply in US rises, and the US $ depreciates.

Changes in Exchange Rates and Monetary Policy

Empirical evidence



In the long-run, the exchange rate follows the movements of the Real Interest Rate.