

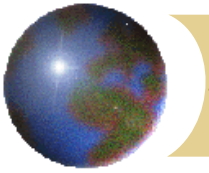
Model of foreign exchange

✦ Characteristics of Excel model

- ✦ One “product”: foreign currency
- ✦ Supply and demand of foreign exchange
- ✦ “Price” of foreign exchange is exchange rate
- ✦ In model, you can shift fixed exchange rate, supply for foreign exchange, demand for foreign exchange, and income
- ✦ Output shows effect with fixed exchange rate and market (floating) exchange rate

✦ How to use the Excel model

- ✦ **GREEN** represents cells you can change to calibrate model
- ✦ **BLUE** represents cells you can change to simulate a shock
- ✦ **ORANGE** shows the output cells, which should not be changed
- ✦ Table shows “before” and “after” simulated shock
- ✦ Solid lines represent “before”, dashed lines “after”



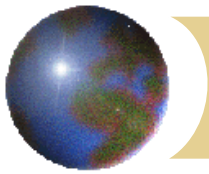
Model of foreign exchange

⊕ What factors determine supply of foreign exchange?



⊕ What factors determine demand for foreign exchange?

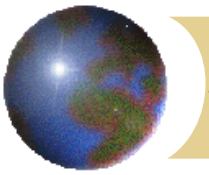




Model of foreign exchange

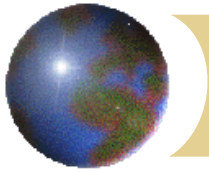
- ⊕ What factors determine supply of foreign exchange?
 - ⊞ Exports of products
 - ⊞ Exports of services (e.g. tourism)
 - ⊞ Foreign direct investment
 - ⊞ Inflow of international remittances

- ⊕ What factors determine demand for foreign exchange?
 - ⊞ Imports of products
 - ⊞ Imports of services
 - ⊞ Speculative demand



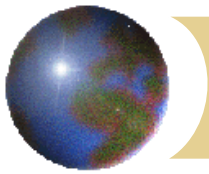
Model of foreign exchange - Exercises

- ✿ Suppose there is a burst of economic growth and income rises 25%
 - ✿ If exchange rate floats, what happens to exchange rate?
 - ✿ Who benefits from this change in exchange rate?
 - ✿ Who loses from this change?
 - ✿ If exchange rate is fixed, what happens to exchange rate?
 - ✿ What happens to excess demand?



Model of foreign exchange - Exercises

- ⊕ Suppose the cost of imported goods rises 30%, causing an increase in demand for foreign exchange
 - ⊕ If exchange rate floats, what happens to exchange rate?
 - ⊕ If exchange rate is fixed, what happens to excess demand?



Model of foreign exchange - Exercises

- ✿ Suppose the price of the main export rises, causing a 20% increase in inflow of foreign exchange
 - ✦ If exchange rate floats, what happens to exchange rate?
 - ✦ What does this do to other exports?
 - ✦ Concept of Dutch disease
 - ✦ If exchange rate is fixed, what happens to excess demand?

- ✿ Suppose oil is discovered in a country, causing a large foreign direct investment
 - ✦ If exchange rate floats, what happens to exchange rate?
 - ✦ If exchange rate is fixed, what happens to excess demand?