How Exchange Rates Change

Comparative Advantage & Supply and Demand set relative prices of goods

Domestic Prices are set via the Quantity Theory

The Combination Sets Exchange Rates

The Process

Comparative Advantage & Supply and Demand set relative prices of goods

Domestic Prices are set via the Quantity Theory

The Combination Sets Exchange Rates

Determining Exchange Rates

• Domestic monetary policies in the US mean that CDs cost $15 each. (T-shirts = $5)
• Domestic monetary policy in Mexico means that T-shirts cost 50 Pesos. (CDs = 150P)

$p_{TS} = 3 \times p_{CD}$

$1=10 \text{ Pesos}$

The Market for Dollars and Pesos

• Assume a Floating Market
• No Intervention by either Government.

Determining Exchange Rates

• Domestic monetary policies in the US mean that CDs cost $15 each. (T-shirts = $5)
• Domestic monetary policy in Mexico means that T-shirts cost 50 Pesos. (CDs = 150P)

$p_{TS} = 3 \times p_{CD}$

$1=10 \text{ Pesos}$

Determining Exchange Rates

• Domestic monetary policies in the US mean that CDs cost $15 each. (T-shirts = $5)
• Domestic monetary policy in Mexico means that T-shirts cost 50 Pesos. (CDs = 150P)

Changes in domestic money supplies.

Changes in preferences for CDs and t-shirts

$p_{TS} = 3 \times p_{CD}$

$1=10 \text{ Pesos}$

The Market for Dollars and Pesos

• Assume a Floating Market
• No Intervention by either Government.
Inflation

• The Mexican Monetary Authority Increases the supply of Pesos by 50%.
  • Mexican Prices must rise by 50%
    – T-shirts at 75 Pesos
    – CDs at 225 Pesos
  • The Exchange rate must go to $1 = 15 Pesos.

Shift in Demand

• Mexicans grow tired of American CD’s and the demand curve shifts to the left.
  \[ p_{CD} = 2p_{TS} \]
  • T-shirts stay at 50 Pesos; CD’s at $15.
Shift in Demand

- Mexicans grow tired of American CD’s and the demand curve shifts to the left.

\[ p_{CD} = 2p_{TS} \]

- T-shirts stay at 50 Pesos; CD’s at $15.
- The exchange rate must be $1 = 6 \frac{2}{3} \text{ Pesos.}

\[ CD = 15(6^{2/3}) = 100 \text{ pesos} \]
\[ T-shirt = 50/(6^{2/3}) = $7.50 \]