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.

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Before the inflation, a dollar bought just as much in Mexico as in the US. So too after the inflation.

Two Versions of PPP

• A dollar buys just as here as it does abroad.
  – If US (or Mexican) prices adjust, the exchange rate adjusts to keep purchasing power constant in the two countries.
• If a dollar buys (say) 10% more in Mexico, and Mexico has inflation, exchange rates will adjust to keep that ratio.

And Neither Works

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Wrong, wrong, wrong!

How many proofs does it take?

• A dollar does not buy as much in NYC as it does in Cleveland.
• We have seen months when exchange rates move by 15-20%. Clearly not consistent with Purchasing Power Parity.
• The Big Mac index is on point.
Two Cases where PPP Works

- Traded Goods
  - Goods that can easily be transported
  - The price of a barrel of oil in Osaka Harbor must be the same as a barrel of oil in New York Harbor.
  \[
  \frac{\text{Price of Crude Oil in Yen}}{\text{Price of Crude Oil in Dollars}} = \frac{\text{Yen}}{\text{Dollar}}
  \]

- Hyperinflation.
  - If Mexico started increasing prices by 100% per week, then the exchange rate would rise by 100% per week.
Testing your Knowledge of Traded Goods

- Gold sells for $400 an ounce in San Francisco and €400 in Paris. A good loaf of French Bread sells for $3 in San Francisco and €2 in Paris. What is the exchange rate between dollars and Euros?

1€ = 1$  

Summary

- Exchange Rates Fluctuate
  - Much of the fluctuation is due to changes in supply and demand.
  - In hyperinflations, differences in the inflation rate will predict exchange rate movements.

End

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