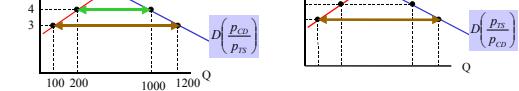


Allowance for Capital Flows

$$Imports_{T-shirts}^{US} P_{T-shirts} + Imports_{Tequila}^{US} P_{Tequila} = Imports_{CDs}^{Mexico} P_{CDs} + Imports_{BigMacs}^{Mexico} P_{BigMacs}$$

Equilibrium

$$Imports_{T-shirts}^{US} P_{T-shirts} = Imports_{CDs}^{Mexico} P_{CDs}$$



Mexican Demand for CD Imports

US Demand for T-shirt Imports

Equilibrium (Cont)

$$Imports_{T-shirts}^{US} P_{T-shirts} + Imports_{Tequila}^{US} P_{Tequila} = Imports_{CDs}^{Mexico} P_{CDs} + Imports_{BigMacs}^{Mexico} P_{BigMacs}$$

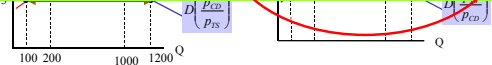


Mexican Demand for CD Imports

US Demand for T-shirt Imports

Capital Flows

$$Imports_{T-shirts}^{US} P_{T-shirts} + Investment_{Mexico}^{US} = Imports_{CDs}^{Mexico} P_{CDs} + Investment_{US}^{Mexico}$$



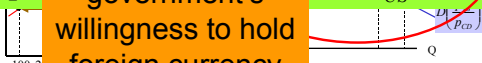
Mexican Demand for CD Imports

US Demand for T-shirt Imports

Capital Flows

$$Imports_{T-shirts}^{US} P_{T-shirts} + Investment_{Mexico}^{US} = Imports_{CDs}^{Mexico} P_{CDs} + Investment_{US}^{Mexico}$$

And in some cases, an allowance for a government's willingness to hold foreign currency



Mexican Demand for CD Imports

US Demand for T-shirt Imports

An Issue

- You are considering investing in Mexico, buying a firm now worth 10,000,000 Pesos.
- You have been assured that, a year from now, it will be worth 11,000,000 Pesos. Guaranteed.
- What will be the exchange rate?

The Calculation

- Assume
 - 1\$ = 10 Pesos.
 - r_N (US) = 5%
- If the Peso falls to 11 to the dollar next year, this is not a good investment.
 - \$1,050,000 vs
 - \$1,000,000

The Calculation

- Assume
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 - \$1,050,000 vs
 - \$1,000,000

Conclusion:
Investment flows depend on both domestic and foreign returns and *expected* exchange rate movements.

End

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