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

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The Process

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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)**

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

$1=10 Pesos

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Changes in domestic money supplies.

Changes in preferences for CDs and t-shirts

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The Market for Dollars and Pesos

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

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  - T-shirts at 75 Pesos
  - CDs at 225 Pesos
- The Exchange rate must go to $1 = 15 Pesos.

Shift in Demand

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- T-shirts stay at 50 Pesos; CD's at $15.
- The exchange rate must be $1 = 6 ²/₃ Pesos.

Shift in Demand

CD = $15(6 ²/³) = 100 pesos

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

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- T-shirts stay at 50 Pesos; CD's at $15.
- The exchange rate must be $1 = 6 ²/₃ Pesos.

T-shirt = 50/(6 ²/³) = $7.50

End