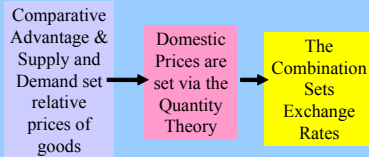
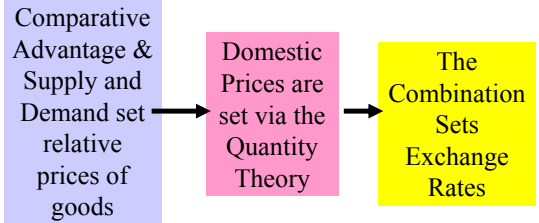


How Exchange Rates Change



The Process



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

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

\$1=10 Pesos

The Market for Dollars and Pesos

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

Inflation

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 - CDs at 225 Pesos

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- 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.

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- The exchange rate must be $\$1 = 6\frac{2}{3}$ Pesos.

Shift in Demand

$$CD = \$15(6\frac{2}{3}) = 100 \text{ pesos}$$

- 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 $\$1 = 6\frac{2}{3}$ Pesos.

$$T\text{-shirt} = 50 / (6\frac{2}{3}) = \$7.50$$

End

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