Model of foreign exchange

- Characteristics of Excel model
  - One “product”: foreign currency
  - Supply and demand of foreign exchange
  - “Price” of foreign exchange is exchange rate
  - In model, you can shift fixed exchange rate, supply for foreign exchange, demand for foreign exchange, and income
  - Output shows effect with fixed exchange rate and market (floating) exchange rate
- How to use the Excel model
  - **GREEN** represents cells you can change to calibrate model
  - **BLUE** represents cells you can change to simulate a shock
  - **ORANGE** shows the output cells, which should not be changed
  - Table shows “before” and “after” simulated shock
  - Solid lines represent “before”, dashed lines “after”

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- What factors determine supply of foreign exchange?
- What factors determine demand for foreign exchange?

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- What factors determine supply of foreign exchange?
  - Exports of products
  - Exports of services (e.g. tourism)
  - Foreign direct investment
  - Inflow of international remittances
- What factors determine demand for foreign exchange?
  - Imports of products
  - Imports of services
  - Speculative demand

Model of foreign exchange - Exercises

- Suppose there is a burst of economic growth and income rises 25%
  - If exchange rate floats, what happens to exchange rate?
  - Who benefits from this change in exchange rate?
  - Who loses from this change?
  - If exchange rate is fixed, what happens to exchange rate?
  - What happens to excess demand?

Model of foreign exchange - Exercises

- Suppose the cost of imported goods rises 30%, causing an increase in demand for foreign exchange
  - If exchange rate floats, what happens to exchange rate?
  - If exchange rate is fixed, what happens to excess demand?

Model of foreign exchange - Exercises

- Suppose the price of the main export rises, causing a 20% increase in inflow of foreign exchange
  - If exchange rate floats, what happens to exchange rate?
  - What does this do to other exports?
  - Concept of Dutch disease
  - If exchange rate is fixed, what happens to excess demand?
- Suppose oil is discovered in a country, causing a large foreign direct investment
  - If exchange rate floats, what happens to exchange rate?
  - If exchange rate is fixed, what happens to excess demand?