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”
Model of foreign exchange

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

- 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
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?
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?