

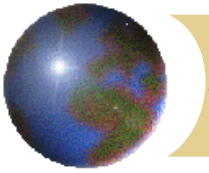
Model of foreign exchange

✚ 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”



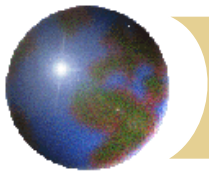
Model of foreign exchange

⊕ What factors determine supply of foreign exchange?



⊕ What factors determine demand for foreign exchange?





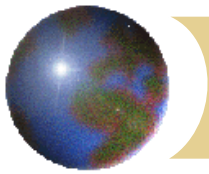
Model of foreign exchange

⊕ What factors determine supply of foreign exchange?

- ⊕ Exports of products
- ⊕ Exports of services (e.g. tourism)
- ⊕ Foreign direct investment
- ⊕ Inflow of international remittances

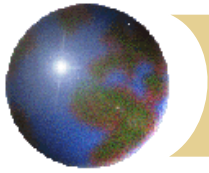
⊕ What factors determine demand for foreign exchange?

- ⊕ Imports of products
- ⊕ Imports of services
- ⊕ Speculative demand



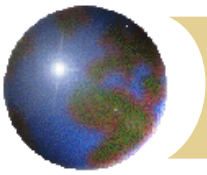
Model of foreign exchange - Exercises

- ❖ 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?