

OUTLINE — November 6, 2017

- International Trade
 - Determinants of EX & IM
- International Finance: Exchange Rates
 - Demand & Supply of Foreign Currency
- Interest Rates in an Open Economy

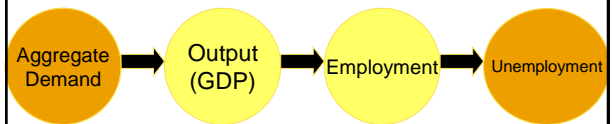
Announcements sent by e-mail

Review

Question: Unemployment depends on?

Answer: Ultimately, aggregate demand

- $AD = C + I + G + (EX - IM)$



Review Determinants of EX & IM Exchange Rates Interest Rates, Exchange Rates, & NX

Determinants of Aggregate Demand

- **Consumption spending by households (C)**
 - YD, wealth, credit availability, ? i ?, expectations
 - YD changes when TA or TR change
- **Investment spending by businesses (I)**
 - Interest rates, expected rates of return, credit availability
- **Government spending (G, Nov. 8)**
 - Direct fiscal policy (G)
- **Net exports (EX & IM) – today!**
 - Exchange rates, health of world economy

Review Determinants of EX & IM Exchange Rates Interest Rates, Exchange Rates, & NX

Organizing today's info

- Three take-aways
 1. Using model of D&S to understand exchange rates
 2. Interest rates affect exchange rates
 3. Exchange rates affect IM & EX
- And of course remember . . . And then there are multiplier effects

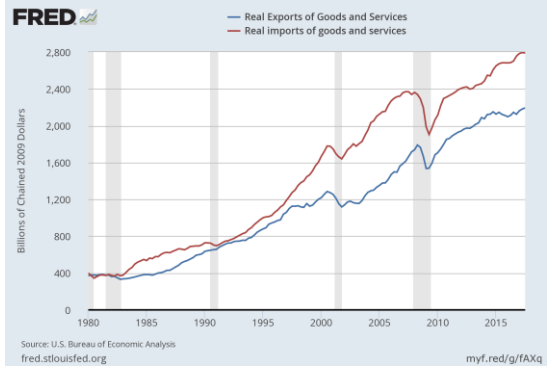
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International Trade

- Exports (EX)
- Imports (IM)
- EX depends on
- IM depends on

Review **Determinants of EX & IM** Exchange Rates Interest Rates, Exchange Rates, & NX

Exports & Imports, 1980-2017



Price of foreign currency (P_{FX}) is a price

P_{FX} = U.S. \$ price of 1 unit of foreign currency

- 114.2 Japanese ¥ for 1 \$ so $P_{¥} =$
- 0.86 € for 1 \$ so $P_{€} =$
- 22.2 Mexican peso for 1 \$ so $P_{\text{peso}} =$

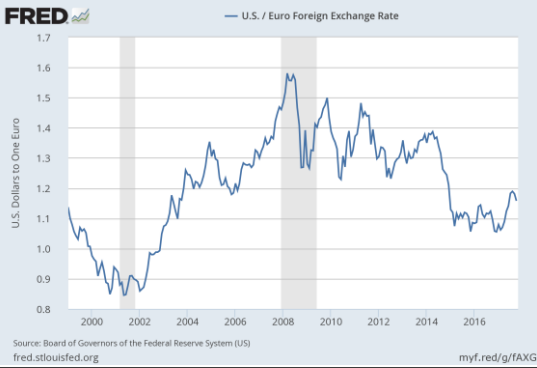
Review **Determinants of EX & IM** **Exchange Rates** Interest Rates, Exchange Rates, & NX

International Finance

- Exchange Rates (price of foreign currency) affect EX & IM
- Cost of Imported Good to U.S. Buyer ?
Cost of Good = 20 €
Exchange rate = \$1.16 for each €

Review **Determinants of EX & IM** **Exchange Rates** Interest Rates, Exchange Rates, & NX

Exchange rates change over time



Pounds per Euro: Where's Brexit vote?

XE Currency Charts: EUR to GBP



Determining exchange rates

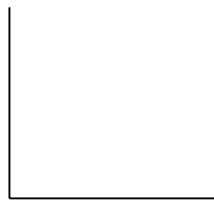
- Demand and Supply



Effect of Changing D or S

↑ Demand of FX

↑ Supply of FX



Terminology

$\uparrow P_{FX}$	$\downarrow P_{FX}$
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Review
Determinants of EX & IM
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Interest Rates, Exchange Rates, & NX

Demand & Supply of Foreign Currency (FX)

<ul style="list-style-type: none"> ▪ D_{FX} ▪ D_{FX} depends on 	<ul style="list-style-type: none"> ▪ S_{FX} ▪ S_{FX} depends on
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Review
Determinants of EX & IM
Exchange Rates
Interest Rates, Exchange Rates, & NX


Interest Rates & Wealth Allocation

- Put yourself in shoes of **lenders** (wealth-holders) when thinking about interest rates & exchange rates
- Interest rates
 - For **borrower**: cost of borrowing
 - For **lender**: return from lending
- Higher interest rates
 - Deter **borrowers** (more costly borrowing)
 - Entice **lenders** (higher return from lending)

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Interest rates affect P_{FX}

- Suppose interest rates rise in the U.S. (but not in Europe)



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. . .and P_{FX} affect EX & IM

- $\downarrow P_{FX} \Rightarrow$

Review Determinants of EX & IM Exchange Rates **Interest Rates, Exchange Rates, & NX**

Interest Rates in Open Economy

Suppose \downarrow interest rates in U.S.

[Closed economy]: $\uparrow I$

[Open economy]: Also $\uparrow NX$

You should be able to answer "Why?"

Review Determinants of EX & IM Exchange Rates **Interest Rates, Exchange Rates, & NX**