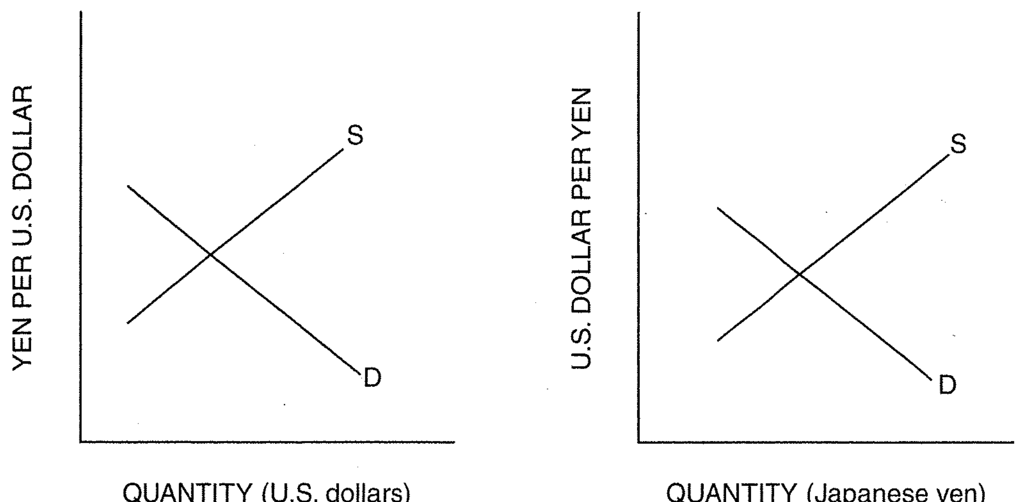
Policies and Economic Conditions Affect Exchange Rates

Changes in a nation's monetary and fiscal policies affect its exchange rates and its balance of trade through the real interest rate, income, and the price level. Changes in the value of a country's currency affect the balance of trade, which affects aggregate demand. Changes in aggregate demand affect real output and the price level. In other words, domestic policies influence currency values, and currency values influence domestic policies. Policy makers cannot ignore the international effects of changes in monetary and fiscal policies.

For each scenario, show the effect on equilibrium exchange rate and quantity of currency in the foreign exchange market graphs in Figures 7-4.1 through 7-4.5. Use the graphs to show the starting equilibrium exchange rate and equilibrium quantity of currency, the shift that occurs, and the new equilibrium exchange rate and quantity. Following each set of graphs, indicate the short-run effect of the change in the foreign exchange market on net exports, aggregate demand, and the price level in the United States. (Ignore the effects on the financial account, that comes next.)

Figure 7-4.1
Japan's Real GDP Increases



on FOREX market

1. Effect if Japan's real gross domestic product (GDP) increases:

As a result of the FOREX change, (A) U.S. imports (*increase / decrease*). Explain.

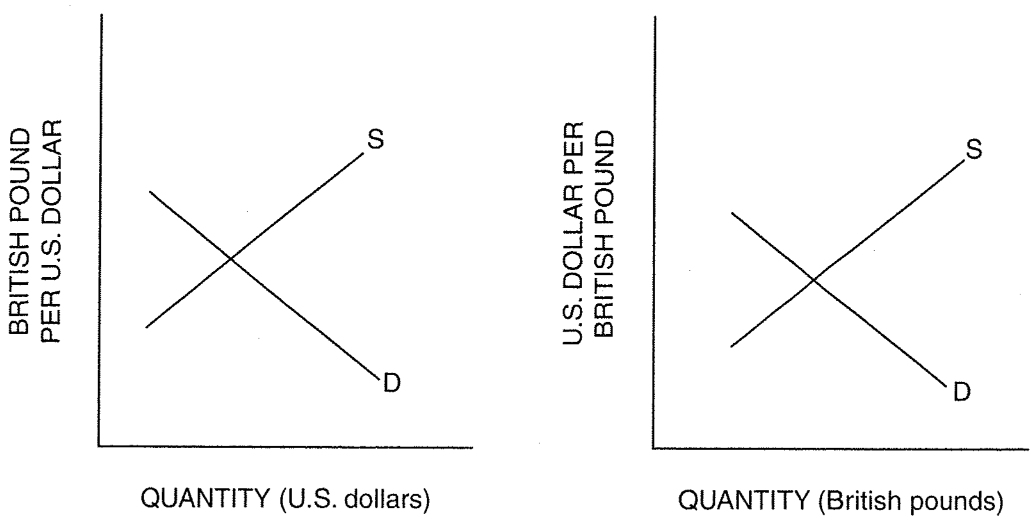
As a result of the #1 scenario, (B) U.S. exports (*increase / decrease*). Explain.

(C) U.S. aggregate demand (*increases / decreases*). Explain.

(D) The price level in the United States (*increases / decreases*). Explain.

Figure 7-4.2

Real Interest Rates in the United States Increase Relative to Great Britain



2. Effect if real interest rates in the United States increase relative to Great Britain:

FOREX Δ ⇒ (A) U.S. imports (*increase / decrease*). Explain.

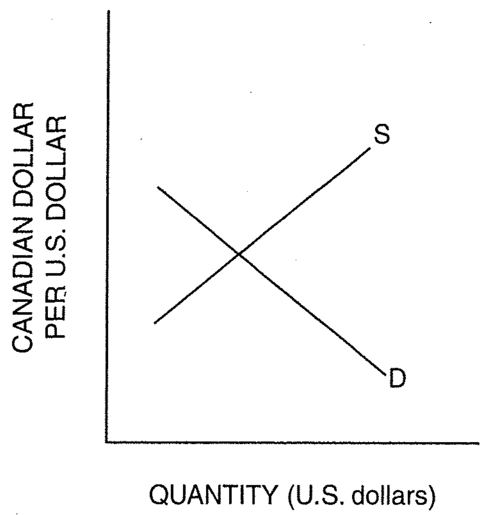
FOREX Δ ⇒ (B) U.S. exports (*increase / decrease*). Explain.

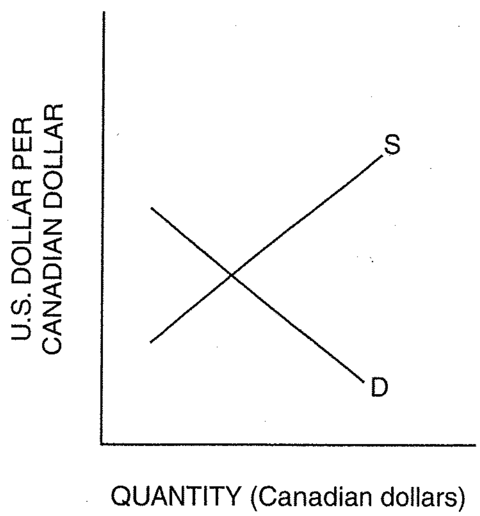
(C) U.S. aggregate demand (*increases / decreases*). Explain.

(D) The price level in the United States (*increases / decreases*). Explain.

Figure 7-4.4

The Price Level in Canada Increases Relative to the United States





4. Effect if the price level in Canada increases relative to the United States:

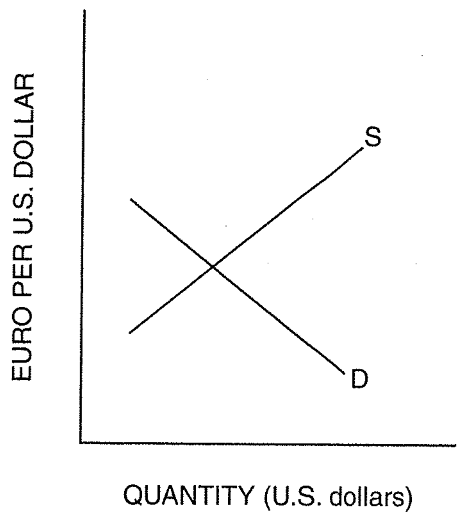
Scenario (A) U.S. imports (*increase / decrease*). Explain.

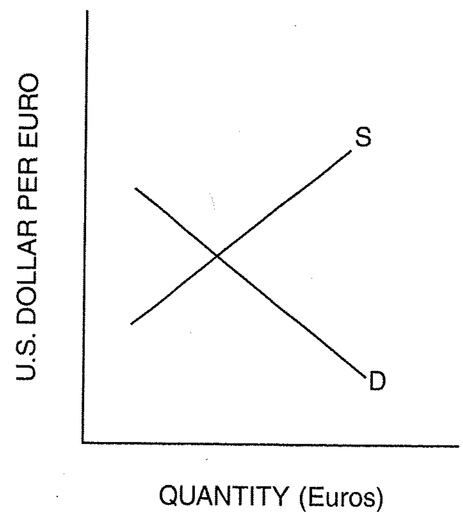
Scenario (B) U.S. exports (*increase / decrease*). Explain.

(C) U.S. aggregate demand (*increases / decreases*). Explain.

(D) The price level in the United States (*increases / decreases*). Explain.

Figure 7-4.3
Europe Experiences a Recession





3. Effect if Europe experiences a recession:

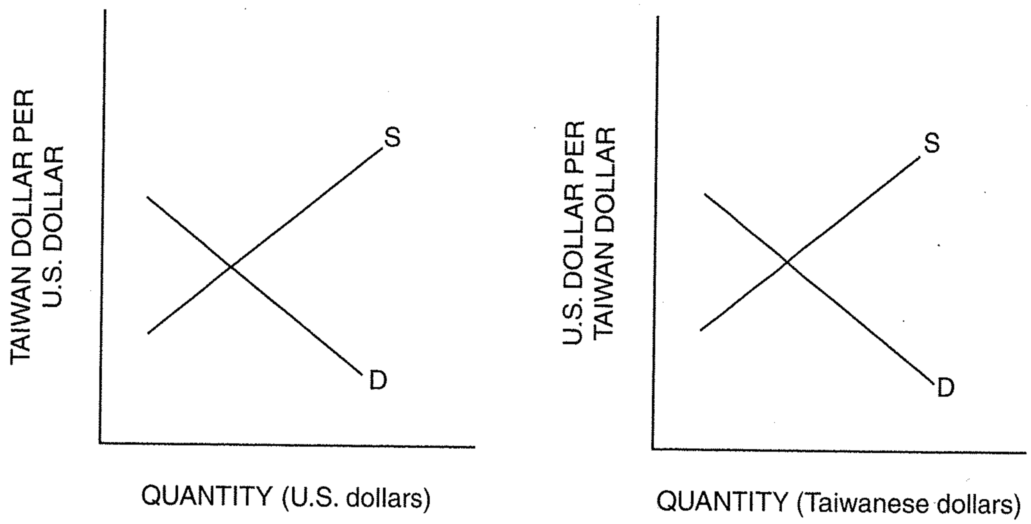
FOREXΔ → (A) U.S. imports (*increase / decrease*). Explain.

Scenario → (B) U.S. exports (*increase / decrease*). Explain.

(C) U.S. aggregate demand (*increases / decreases*). Explain.

(D) The price level in the United States (*increases / decreases*). Explain.

Figure 7-4.5
Effect on Taiwan If U.S. Government Decreases Taxes



5. Effect on Taiwan if U.S. government decreases taxes:

(A) U.S. imports (*increase / decrease*). Explain.

(B) U.S. exports (*increase / decrease*). Explain.

(C) U.S. aggregate demand (*increases / decreases*). Explain.

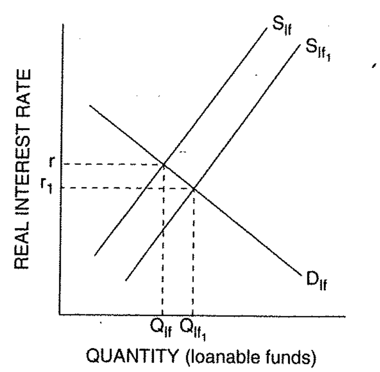
(D) The price level in the United States (*increases / decreases*). Explain.

Net Exports and Capital Flows: Linking Financial and Goods Markets

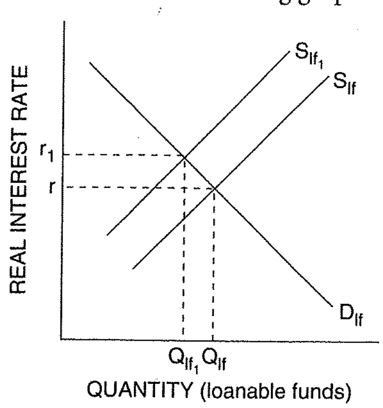
The term *capital flow* refers to the movement of financial capital (money) between economies. *Capital inflows* consist of foreign funds moving into an economy from another country; *capital outflows*, or capital flight, is the opposite—domestic funds moving out of an economy to another country. For example, from the perspective of the U.S. economy, the construction of a new plant by a Japanese automobile manufacturer within the United States is an example of capital inflow. Likewise, when an American manufacturer finances the construction of a plant outside of the United States, it is an example of capital outflow.

The loanable funds market is used to analyze capital flows in an economy. Because financial capital affects the amount of money available for borrowers, changes in capital flows shifts the supply curve for loanable funds.

Capital inflows increase the supply of loanable funds, resulting in the decrease in domestic real interest rates shown in the following graph:



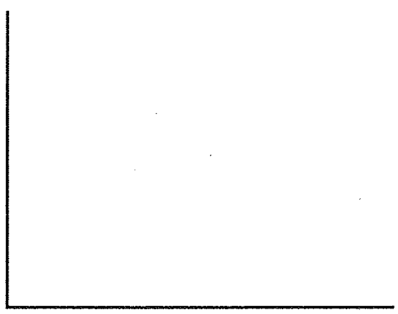
Capital outflows deplete a nation's supply of loanable funds, causing domestic interest rates to increase, as shown in the following graph:



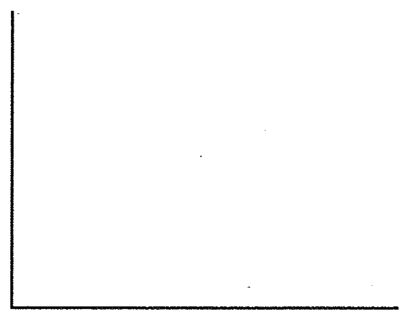
4. Assume that inflation in the United States begins to rise while prices throughout the European Union remain relatively stable. The U.S. current account moves toward (*surplus / deficit*) and U.S. net exports (*increase / decrease*).

5. Illustrate on the graphs provided how the relative exchange rates of the U.S. dollar and euro will change as a result of this change in relative inflation rates. Be sure to label your graphs correctly (e.g., the price of dollars should be stated in terms of euro per dollar, and vice versa).

Euro

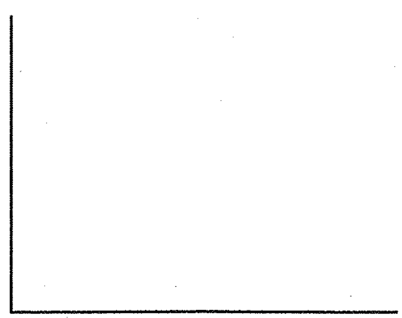


U.S. Dollar



6. Illustrate on a graph of the loanable funds market in the United States the changes that result when the relative inflation rates change. *Hint:* Current account deficits are offset by financial account surpluses (capital inflow) while current account surpluses are offset by financial account deficits (capital outflow).

U.S. Loanable Funds Market

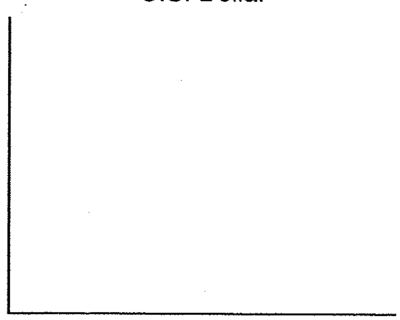


Capital Flows Resulting from a Change in Net Exports

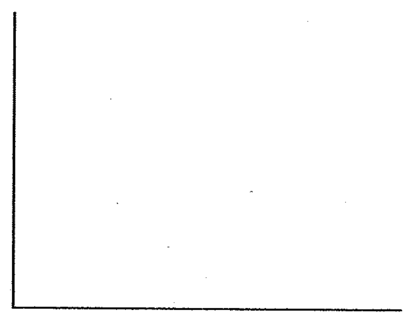
1. Japanese firms have recently increased their imports of American made semiconductors. As a result, the U.S. current account moves toward (*surplus / deficit*) and U.S. net exports will (*increase / decrease*).

2. Illustrate on the graphs provided how the relative exchange rates of the U.S. dollar and Japanese yen will change as a result of the increase in Japanese purchases of U.S. semiconductors. Be sure to label your graphs correctly (e.g., the price of dollars should be stated in terms of yen per dollar, and vice versa).

U.S. Dollar

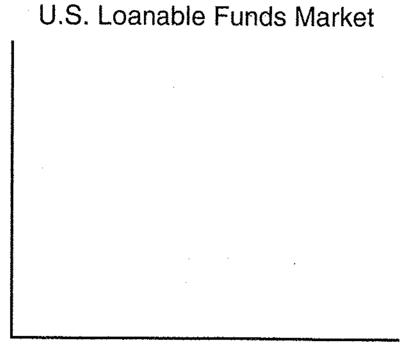


Yen



3. Illustrate on a correctly labeled graph of the loanable funds market in the United States the changes that result from the Japanese importation of U.S. semiconductors. *Hint:* Current account deficits are offset by financial account surpluses (capital inflow) while current account surpluses are offset by financial account deficits (capital outflow).

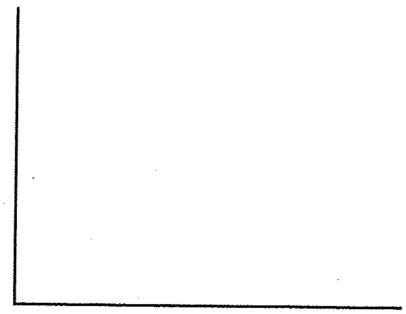
U.S. Loanable Funds Market



Capital Flows Resulting from a Change in Policy

7. Due to a recent recession, expansionary fiscal policies in the United States have led to historically large federal budget deficits. On a correctly labeled graph of the loanable funds market in the United States, illustrate the effects of massive government borrowing.

U.S. Loanable Funds Market



Rationale:

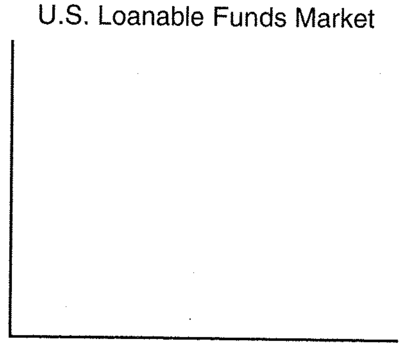
8. The increased borrowing causes real interest rates to (*increase / decrease*) and foreign investors will (*increase / decrease*) their purchases of bonds in the United States. Illustrate this change on your loanable funds graph above.

   Rationale:

9. Assume that the U.S. central bank enacts an expansionary policy of purchasing government securities on the open market. This monetary policy will (*increase / decrease*) real interest rates in the United States. As a result of the change in real interest rates, foreign investors will (*increase / decrease*) their purchases of bonds in the United States.

   Illustrate the effects of foreign investors changing their purchases of bonds on a correctly labeled graph of the loanable funds market.

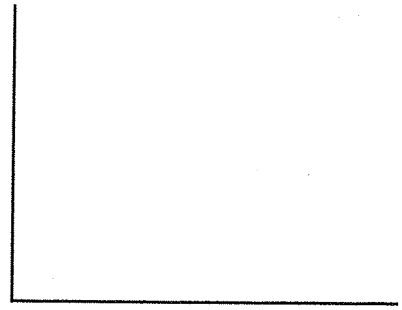
U.S. Loanable Funds Market



Capital Flows Resulting from a Change in Foreign Direct Investment

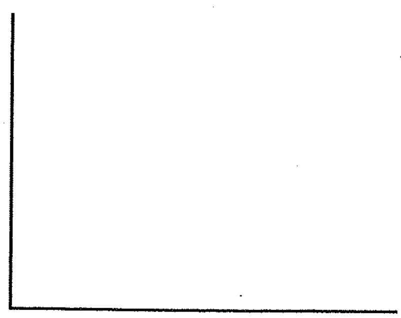
10. Foreign direct investment (FDI) into the United States rose sharply during the second half of the 1990s due to the perceived strength and stability of the U.S economy relative to unstable economies worldwide. On a correctly labeled graph of the loanable funds market in the United States, illustrate the effect of this influx of FDI.

U.S. Loanable Funds Market

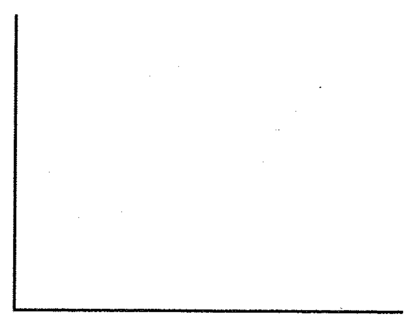


11. Great Britain was a leading investor in American firms at this time. Use correctly labeled graphs of the markets for dollars and pounds to illustrate the relative change in value of these two currencies on the foreign exchange market as a result of British investment in American companies. Be sure to label your graphs correctly (e.g., the price of dollars should be stated in terms of pounds per dollar, and vice versa).

U.S. Dollar



British Pound



12. The changes above will cause U.S. net exports to (*increase / decrease*).

13. The U.S. economy slowed in the early 2000s while American firms discovered less costly production possibilities in foreign countries. On a correctly labeled graph of the loanable funds market in the United States, illustrate the effects of this capital flight.

U.S. Loanable Funds Market