How Monetary and Fiscal Policies Affect Exchange Rates

Changes in a nation's monetary and fiscal policies affect its exchange rates and its balance of trade through the interest rate, income and the price level. Changes in the value of a country's currency may affect the balance of trade and aggregate demand. The value of real output and price levels may also be affected. Domestic policies influence currency values, and currency values influence domestic policies. The complexity of the connection leads to careful evaluation of any change in domestic policy goals. Policy makers cannot ignore the international effects of changes in monetary and fiscal policies.

A series of situations is presented below. In each case:

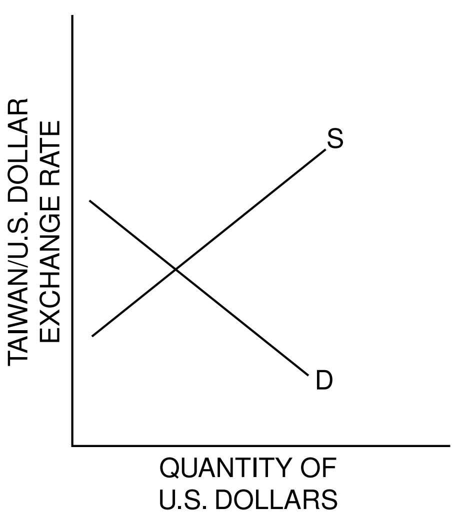
- Evaluate the expected effects on exchange rates in the United States and the other country. Use the currency graphs provided to reflect changes in the currency values.
- Analyze the impact of the currency changes on the U.S. economy as it applies to net exports, balance of trade, aggregate demand and price levels. *Work out the situations in the short run only.*

1. The U.S. government initiates a personal income tax reduction plan, leaving every tax-paying American with more disposable income.

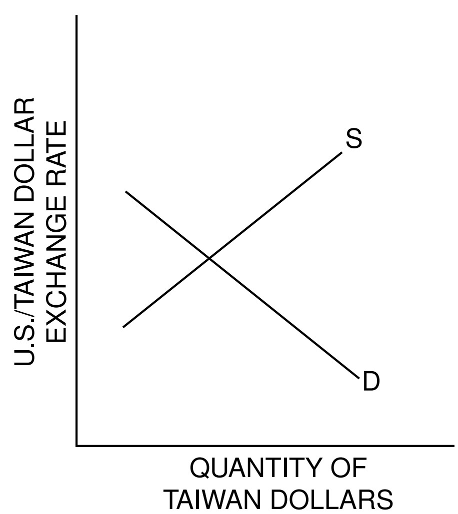
   (A) What will happen as a result to trade between the United States and Taiwan?

Figure 54.1
U.S. Government Reduces Taxes

Graph A



Graph B



Activity written by James Spellicy, Lowell High School, San Francisco, Calif.

(B) In Graph A, what happens to the U.S. dollar? ________________________

(C) In Graph B, what happens to the Taiwanese dollar? ________________________

(D) As a result of the fiscal policy,

(i) U.S. aggregate demand shifts (*left / right*).

(ii) Price levels in the United States (*rise / fall*).

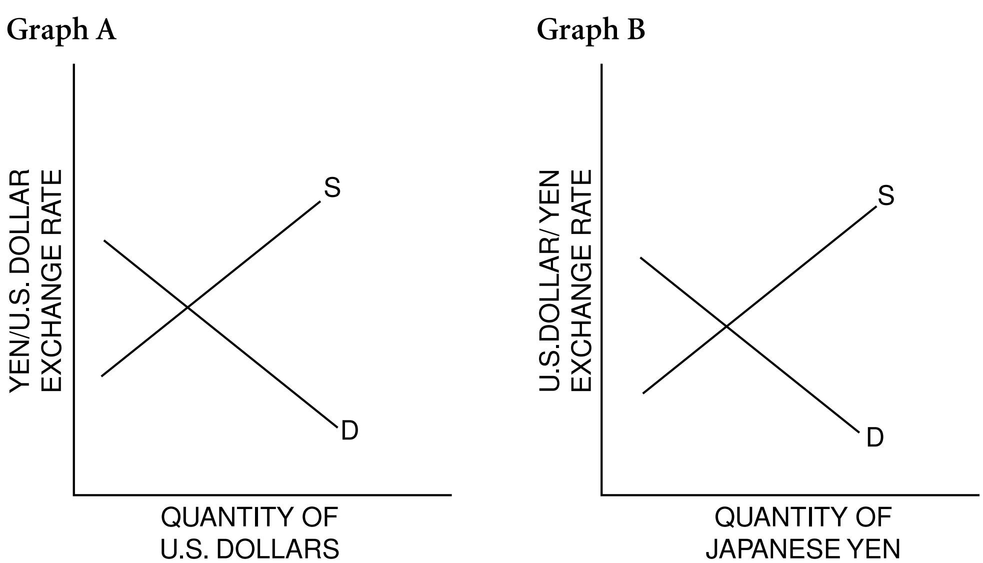
(iii) U.S. imports (*increase / decrease*). Explain why.

(iv) U.S. exports (*increase / decrease*). Explain why.

2. Japan's fiscal policies lead to an increase in Japan's real GDP.

(A) What will happen as a result to trade between the United States and Japan?

Figure 54.2
Japan's Real GDP Increases



(B) In Graph A, what happens to the U.S. dollar? ________________________

(C) In Graph B, what happens to the Japanese yen? ________________________

(D) As a result of the changing value of the U.S. dollar,

(i) U.S. exports *(increase / decrease)*. Explain why.

(ii) U.S. imports *(increase / decrease)*. Explain why.

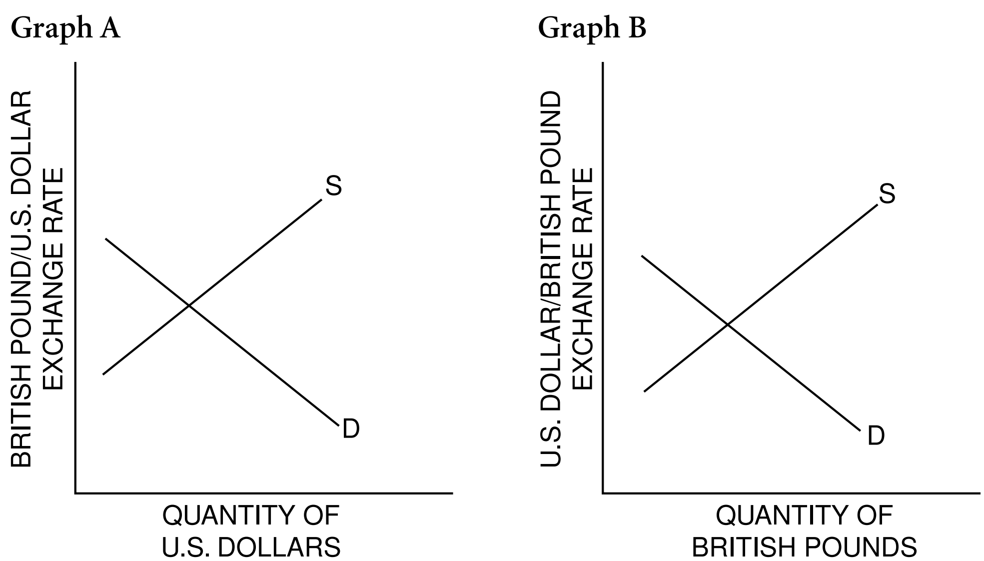
(iii) U.S. aggregate demand shifts *(left / right)*.

(iv) Price levels in the United States *(rise / fall)*.

3. The U.S. federal budget deficit increases, which causes the interest rate to rise. (Assume trade with Great Britain.)

(A) What will happen as a result to trade between the United States and Great Britain?

Figure 54.3
Interest Rates in the United States Increase



(B) In Graph A, what happens to the U.S. dollar? ____________________

(C) In Graph B, what happens to the British pound? ____________________

(D) As a result of the changing value of the U.S. dollar,

(i) U.S. exports *(increase / decrease)*. Explain why.

(ii) U.S. imports *(increase / decrease)*. Explain why.

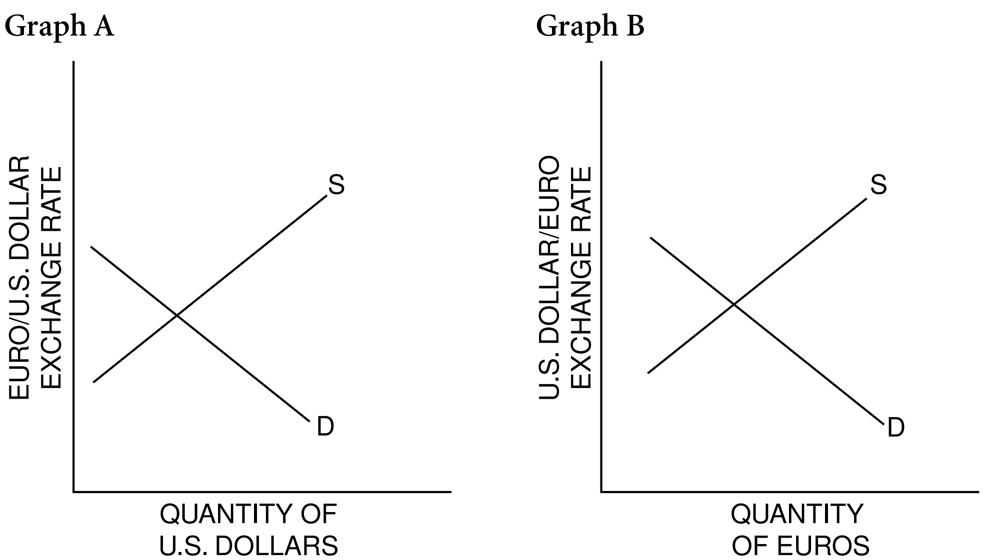
(iii) U.S. aggregate demand shifts *(left / right)*.

(iv) Price levels in the United States *(rise / fall)*.

4. Europe's interest rates are increasing, while the U.S. interest rate remains relatively constant.

(A) What will happen as a result to trade between the United States and Europe?

Figure 54.4
Interest Rates in Europe Increase



(B) In Graph A, what happens to the U.S. dollar? ________________________

(C) In Graph B, what happens to the European euro? ________________________

(D) As a result of the changing value of the U.S. dollar,

(i) U.S. exports *(increase / decrease)*. Explain why.

(ii) U.S. imports *(increase / decrease)*. Explain why.

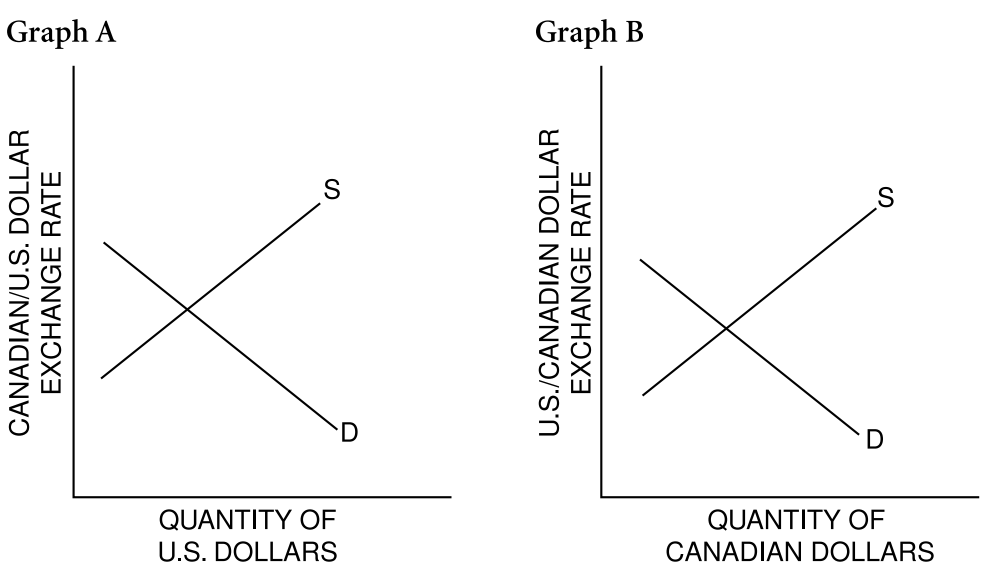
(iii) U.S. aggregate demand shifts *(left / right)*.

(iv) Price levels in the United States *(rise / fall)*.

5. There is a rapid increase in the Canadian price level while the U.S. price level remains relatively constant.

(A) What will happen as a result to trade between the United States and Canada?

Figure 54.5
The Price Level in Canada Increases



(B) In Graph A, what happens to the U.S. dollar? ____________________

(C) In Graph B, what happens to the Canadian dollar? ____________________

(D) As a result of the changing value of the U.S. dollar,

(i) U.S. exports *(increase / decrease)*. Explain why.

(ii) U.S. imports *(increase / decrease)*. Explain why.

(iii) U.S. aggregate demand shifts *(left / right)*.

(iv) Price levels in the United States *(rise / fall)*.