

Text: chapter 33, chapter 22, pg 490-500, 536-544

Key point: a weak exchange rate makes domestic goods cheap

Forex market

Demand comes from foreigners wishing to buy domestic goods and assets

Supply comes from domestic residents wishing to buy foreign goods and assets (Central Bank)

Example: a rise in the price of domestic goods

What happens to demand? What happens to supply?

High P leads to low e . (Central to PPP dynamic, we will see later.)

Speculation

Interest rate and the exchange rate

Fixed/flexible exchange rates

Euro

Example

Suppose domestic price of good is 100 euros,
 P

Exchange rate is 1 euro=2 dollars, e

Price of good in US is 100 dollars, P^*

Then price of US good in euros is $50 = \frac{P^*}{e}$

And price of good in Europe is 100 euros

Hence Europe is more expensive. Formally

$$P > \frac{P^*}{e}$$

Calculate the real exchange rate ϵ

$$\epsilon = \frac{P}{\frac{P^*}{e}} = \frac{eP}{P^*}$$

This is relative price of domestic good in same currency

A measure of competitiveness: a high ϵ indicates a country is uncompetitive.

A high ϵ can occur for three reasons

- A strong *nominal* exchange rate e
- A high domestic price level P
- A low price of foreign goods P^*

$NX(\epsilon)$

Graph with inverse relationship

Theory of Exchange Rate Determination

Purchasing Power Parity (PPP):

e adjusts until

$$P = \frac{P^*}{e}$$

A basket of goods should cost the same anywhere

PPP implies that

$$\epsilon = 1$$

Example: PPP predicts that if P falls, exchange rate will *appreciate*. This ensures $P = \frac{P^*}{e}$ holds.

What is intuition? Basically, if P is low, foreigners will wish to purchase our relatively cheaper goods. In turn this will raise e . PPP predicts that e rises until foreigners no longer have an incentive to purchase our goods.

Model of labour market (real wage)

Different labour markets (technology, immigration/ outsourcing)

Skilled/Unskilled

Participation Rate (labour force/pop)

Taxation, services

Discouraged Workers

Types of Unemployment

Cyclical: associated with business cycle

Structural: associated with some form of intervention in labour market that keeps real wages too high, and above market-clearing rate. This exists even in an economic boom.

Minimum Wage Legislation

Unions/Collective Bargaining