Floating Exchange Rates

Econ 434 Lecture

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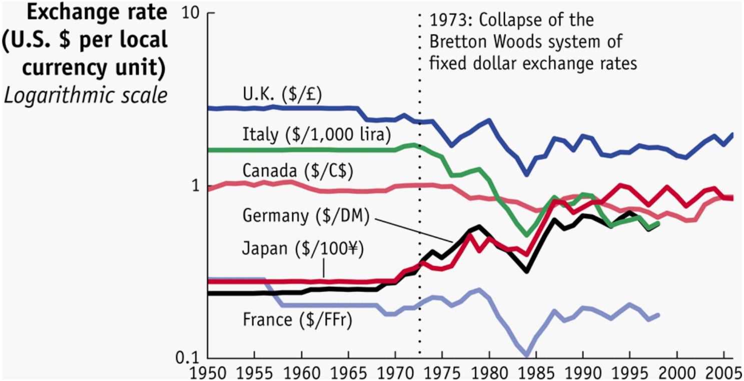
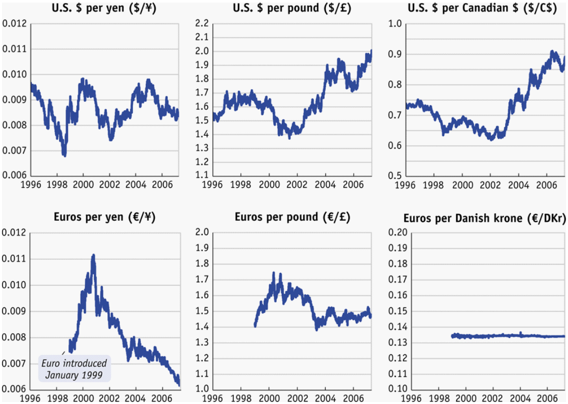
- All would be easy if PPP were true

Fixed versus Floating Rates



Floating Rates in Developed Countries



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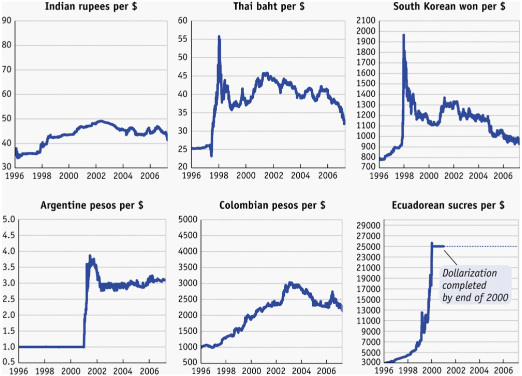

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Figure 1

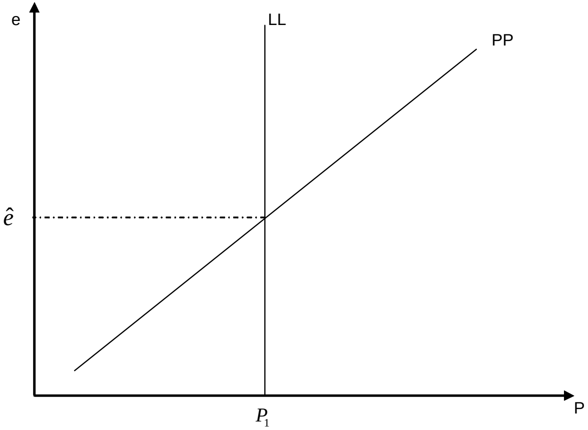

Figure: Full Equilibrium

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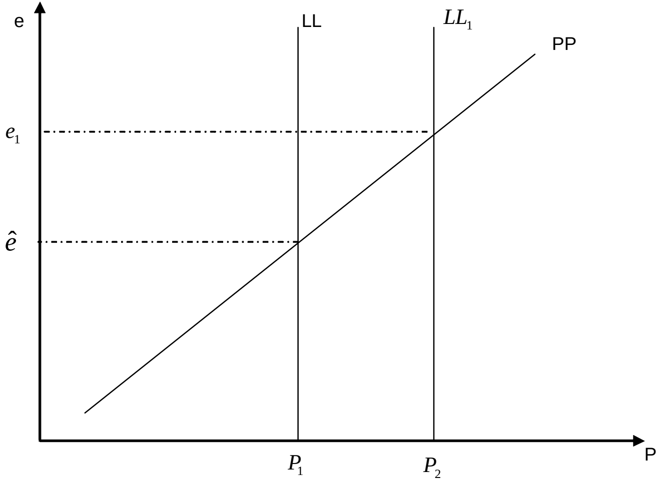
Statics
Figure 10



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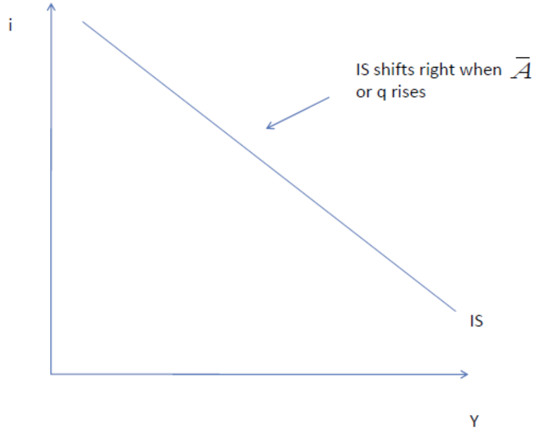
  - Since $q \equiv \frac{eP^*}{P}$, $\implies \frac{\Delta Y}{\Delta e} > 0$, this is *YY* curve

IS Curve



Increase in Money Supply

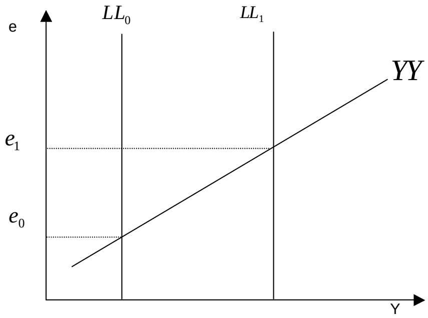


Figure: Output and the Exchange Rate

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  - It is when there are nominal rigidities that Δe may be preferred

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- Easy to see with IS-LM diagram

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- So best insulation depends on source of shocks to economy

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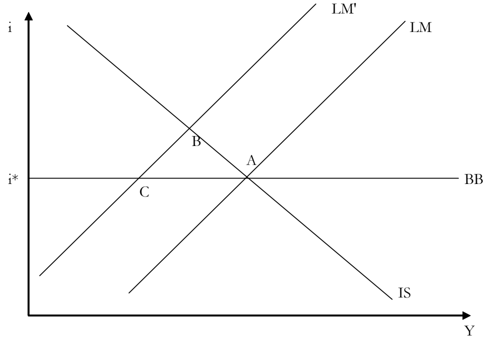
- or, $i = i^* + \frac{1}{\beta}\left(\overline{T} - mY + \phi q\right)$: equation of BB curve
- If $\beta \longrightarrow \infty$ we have perfect capital mobility and BB is horizontal: i must equal i^*

Money Demand Shock

IS-LM diagram



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- Asset prices adjust faster than other prices

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  - we know that $e \longrightarrow \widetilde{e}$, its long-run equilibrium value

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Overshooting
Figure 3

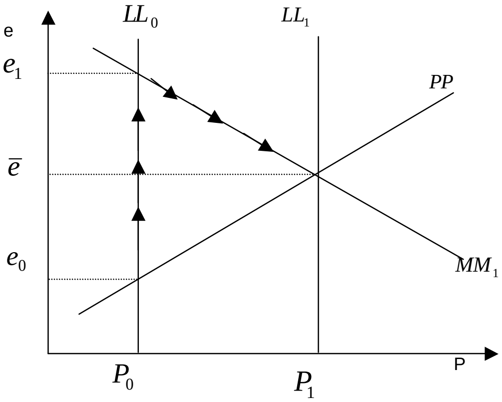

Figure: Overshooting

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  - requires e to fall along the adjustment path, but this means e must *initially* overshoot

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  - Until agents expect sufficient currency appreciation to make them once again willing to hold domestic currency.

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- The overshooting model thus offers an explanation of why asset prices respond rapidly to new information.
- Of course in practice the economy is subject to many shocks, so asset prices fluctuate in the kind of saw-tooth pattern that is characteristic of these markets.

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    - model implies that in the wake of monetary shocks, the spot rate would be more volatile than forward rate; we don't tend to see this

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Source: IMF, *International Financial Statistics* .

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- When $\Delta M > 0$ actually occurs, there is no discontinuous effect on e, because that has already been *absorbed* in the price.

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    - Then once the uncertainty is resolved (the Fed raises the money stock or does not), the *MM* curve either shifts up again or down.
- The key point is that asset prices move when there is news, or new information. Not on old information.