

(H. 19) DETERMINANTS OF EXCHANGE RATES

① CURRENT ACCOUNT BALANCE INPAYMENTS/OUTPAYMENTS

(A DEFICIT $\rightarrow$ \$ GOING $\rightarrow$ \$ SOLD FOR
OVERSEAS $\rightarrow$ £, ¥, £

$\hookrightarrow$ \$ DEPRECIATE $\rightarrow$ TERMS-OF-TRADE
IMPROVE FOR U.S.

$\hookrightarrow$ NX (CA) $\uparrow$ $\rightarrow$ NO MORE DEFICIT

(2000) U.S. DEFICIT CAN BE FIXED
WITH A 30% DEPRECIATION
NO, DOES NOT WORK

② INTEREST RATES (ASSET MARKET APPROACH)

U.S. BOND YIELD ~~4%~~ 0.5%
ISLELAND BOND 3.5%
1 YEAR

UNCOVERED INTEREST PARITY (UIP)

BOND RETURNS SHOULD BE
ROUGHLY THE SAME IN ALL
COUNTRIES

$$3.5\% - .5\% = 3\%$$

£ APPRECIATES BY 3%
OVER 1 YEAR RELATIVE
TO THE KRONA

- UIP FAILS IN STABLE PERIODS
↳ HIGH INT. RATE CURRENCIES
APPRECIATE IN STABLE PERIODS

COVERED INTEREST PARITY (CIP)

FORWARD RATE CONTROLS FOR
THE DIFFERENCE IN INTEREST
RATES

$$3.5\% - .5\% = 3\%$$

FORWARD RATE DENOTES A
3% APPRECIATION OF THE
\$ RELATIVE TO THE KRONA
OVER 1 YEAR

- CIP IS USUALLY VALID...
- CIP + UIP BEHAVE STRANGELY
IN VOLATILE MARKETS

FORWARD PREMIUM PUZZLE

DATA SAYS:

IN GOOD TIMES, HIGH YIELD
CURRENCIES APPRECIATE

INSTEAD OF DEPRECIATE

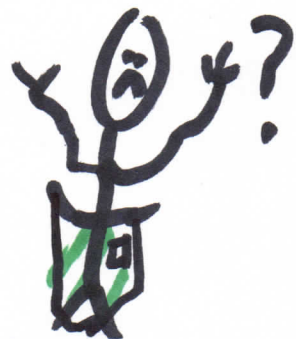
IN CRISIS: RAPID

DEPRECIATION OF HIGH YIELD
CURRENCIES

(ARBITRARY TRADE)

CAN YOU USE INTEREST RATE
DIFFERENTIALS TO PREDICT
EX. RATES?

YES, OVER SECONDS + MINUTES



③ PPP + LOOP

RELATIVE PPP

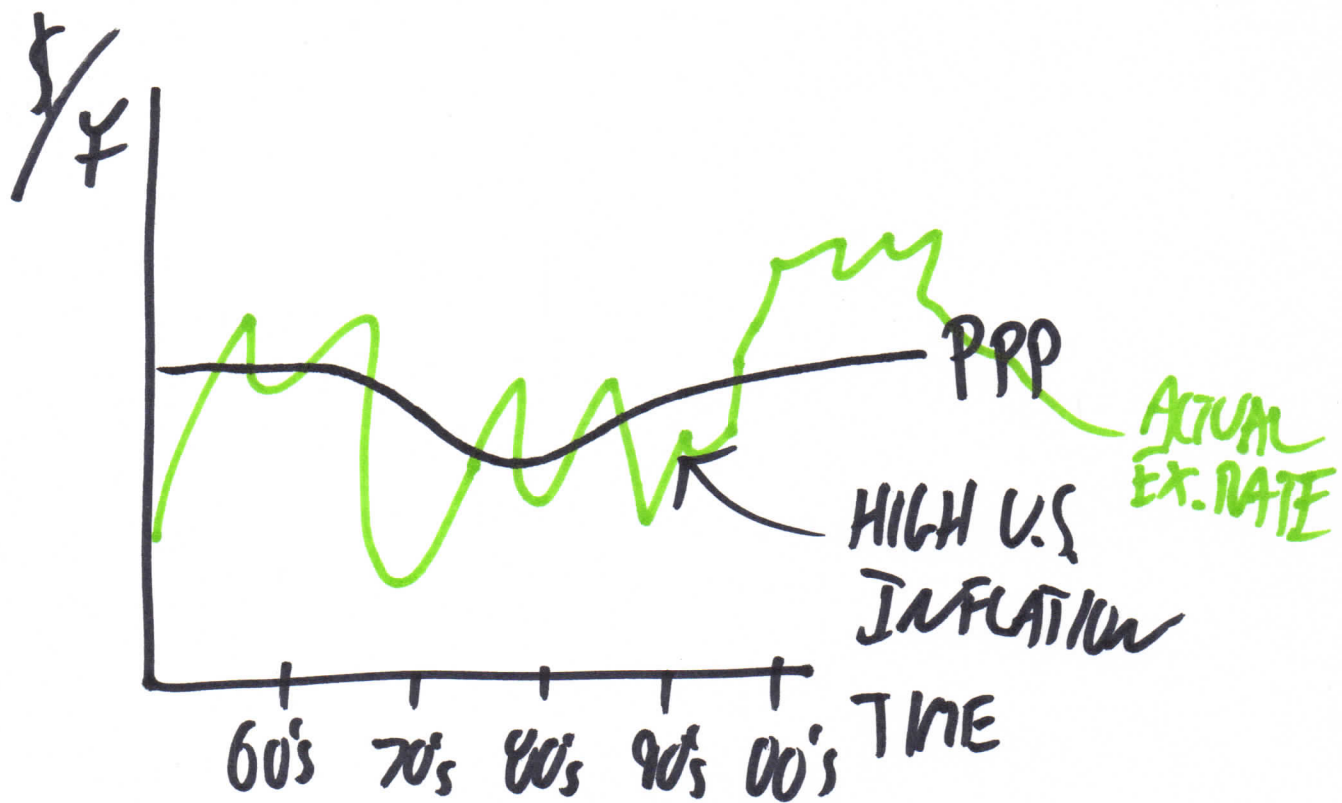
% Δ IN PRICES ACROSS
COUNTRIES SHOULD BE THE SAME

$$\frac{P_{us,t}}{P_{us,t-1}} = \frac{P_{j,t}}{P_{j,t-1}} \times \left(\frac{e_{us/j,t}}{e_{us/j,t-1}} \right) \times \underset{\substack{\uparrow \\ \text{RANDOM} \\ \text{WALK}}}{\epsilon_t}$$

HIGH INFLATION
= DEPRECIATION (VILE VERSA)

ONLY TRUE OVER DECADES

OVERSHOOTING - MARKET VALUE GOES
ABOVE + BELOW FUNDAMENTAL VALUE



④ RANDOM WALK

BEST POSSIBLE METHOD

TO PREDICT EX. RATES OVER
HOURS, DAY, MONTHS, WEEK

YEAR TO YEAR

- UNPREDICTABLE

EXPECTED : CURRENT
EX. RATE EX. RATE