Implications of Long-Run Neutrality for our Model

1.) The nominal exchange rate is just one of the many prices that adjust in response to money supply changes (i.e., the price of foreign currency).

$$P\uparrow \Longrightarrow E\uparrow$$

$$P\downarrow \Longrightarrow E\downarrow$$

2.) If individuals have Rational Expectations, and are aware of a permanent money supply change, then they will revise their expectations accordingly

$$M^s\uparrow \Longrightarrow E^e\uparrow$$

$$M^s\downarrow \Longrightarrow E^e\downarrow$$

Caveats : a.) If M^s reverses course before P has time to adjust, then E^e will not change.

b.) How do you know when a Money supply change is permanent?