Topics for Today

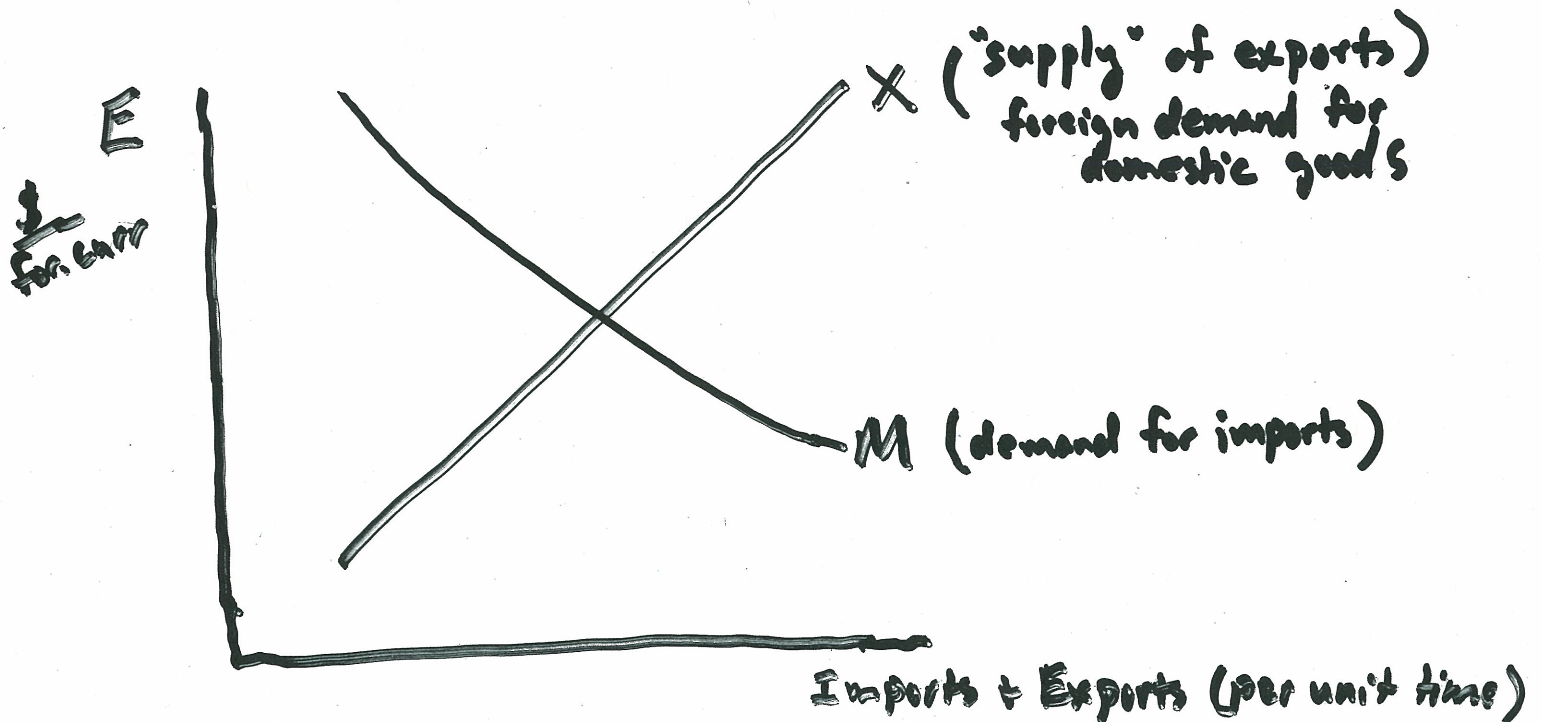
1. The Asset Market Approach to Exchange Rate Determination vs. the Goods Market Approach to Exchange Rate Determination

2. Equilibrium in the FX Market
   - Uncovered Interest Parity (UIP)

3. Comparative Statics
   - Changes in R, R^*, E^e

4. Testing UIP

The Goods Market Approach to Ex. Rates



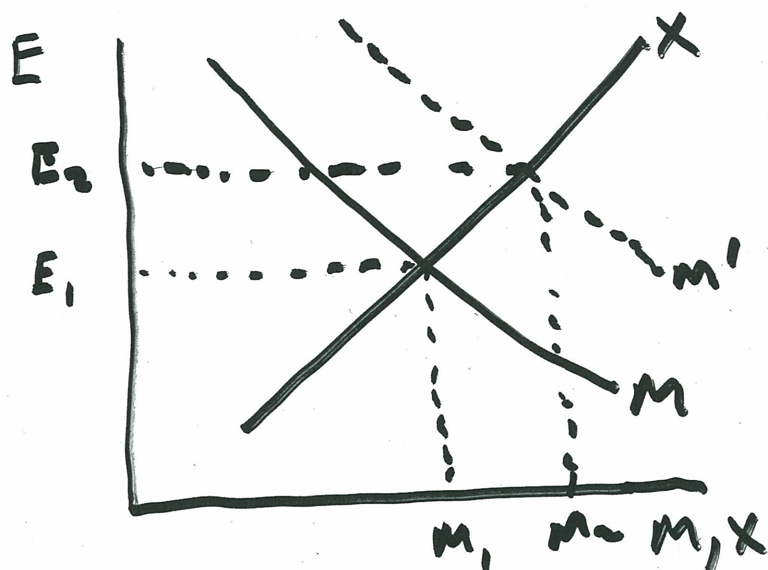
E↑ ⟹ Price of foreign goods ↑ for domestic residents

⟹ M↓

E↑ ⟹ Price of domestic goods ↓ for foreigners

⟹ X↑

Suppose there is an exogenous increase in demand for M (unrelated to E).



Demand for M↑ ⟹ E↑

Problem with Goods Mkt. Approach:

- It ignores capital mobility. With international capital mobility trade does not have to balance each period. Countries can borrow and lend.

- In the short-run, it is better to think of exchange rates as equilibrating the supply + demand for asset <u>stocks</u>. (Stocks vs. flows)