

Overview

The market for foreign exchange can be usefully thought of as a market where demand and supply are derived from more fundamental demands and supplies—for goods and services, and for assets.

We assume a world with two traded goods: (1) X , which is exported from the home country and imported into the foreign country, and (2), M , which is produced and exported from the foreign country to the home country. Each country also produces (and consumes) its own non-traded good, N, N^* .

We first look at demand and supply for FX arising from underlying demands for imports and exports of goods and services. We then append to these demands demands and supplies arising from underlying demands for assets.

Market for X

Home country supply

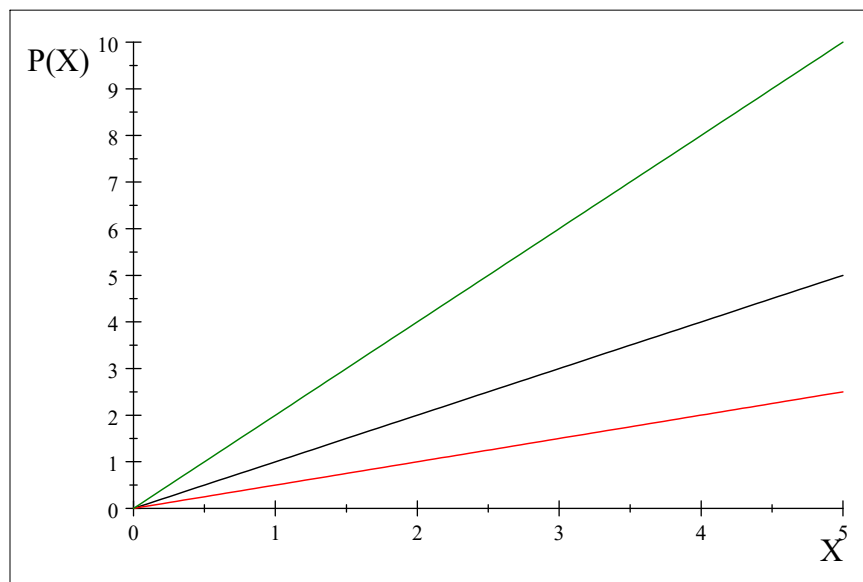
$$X^S = \frac{P_X}{P_N}$$

supply functn

$$P_X = X^S \cdot P_N$$

InvrS Sup.

$$y = x (A_X^S = 1) :$$



$$P_N = .5, (red), 1, (Bl), 2(Gr)$$

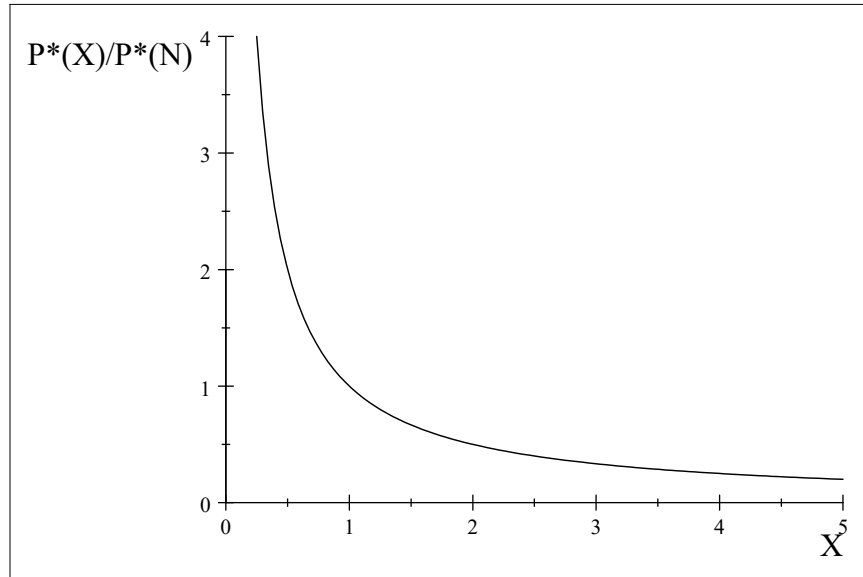
1. To keep things simple, let's focus on the *short run* by which I mean P_N is constant. Let's make it constant at $P_N = 1$. Our inverse supply function is thus

$$P_X = X^S$$

2. Our goal is to derive the (inverse) supply function for FX. To do this, we need to determine the equilibrium quantity and price in the market for X. Hence, we need a demand function from the foreign country. Let's look at a really simple example:

$$X^d = \frac{1}{\left(\frac{P_X^*}{P_N^*}\right)}; \left(\frac{P_X^*}{P_N^*}\right) = \frac{1}{X^d};$$

black



Again, let's set $P_N^* = 1$, but remembering that each demand curve would shift "out" if P_N^* were to increase.

How can we link these demand and supply curves? We invoke arbitrage—the limiting case of zero transport costs—which implies:

$$P_X = EP_X^*.$$

Hence,

$$\overbrace{E \cdot P_X^*}^{P_X} = X^S \cdot P_N;$$

$$P_X^* = \frac{X^S \cdot P_N}{E}$$

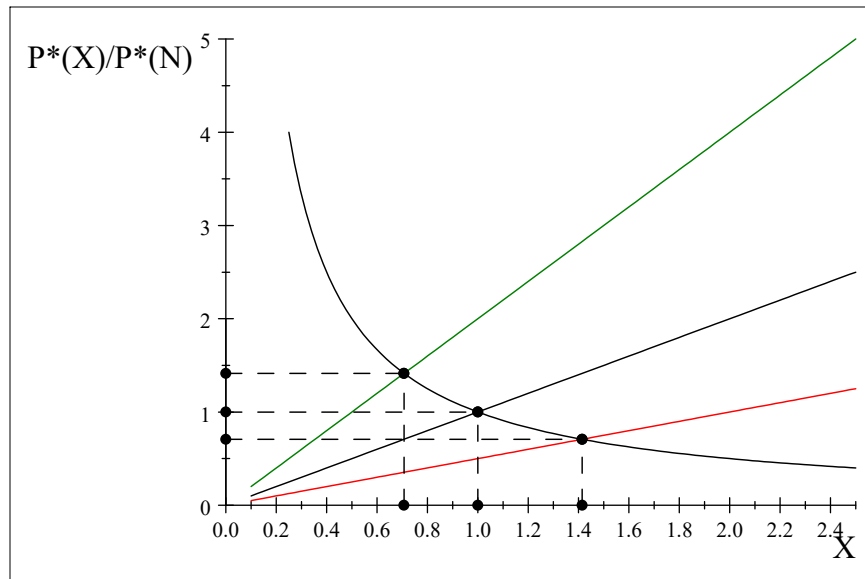
We have a "family" of inverse supply curves, each member associated with a different value of E . For example, if $E = .5$, $E = 1$, and $E = 2$ (again, keeping $P_N = 1$) the inverse supply functions are

$$P_X^* = \frac{X^S \cdot \overbrace{P_N^*}^1}{\underbrace{.5}_E};$$

$$P_X^* = \frac{X^S \cdot \overbrace{P_N^*}^1}{\underbrace{1}_E};$$

$$P_X^* = \frac{X^S \cdot \overbrace{P_N^*}^1}{\underbrace{2}_E}$$

Our diagram now looks like this:

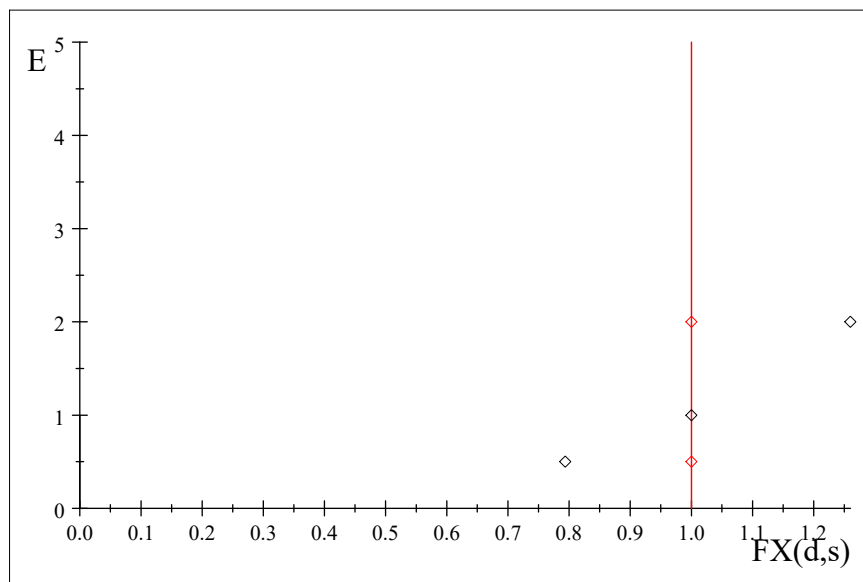


Of the straight lines (which represent the family of supply curves), the steepest line is the one for which $E = \frac{1}{2}$, the next-steepest is the one for $E = 1$, and the least steep is for $E = 2$.

What is the earnings of foreign exchange from our, i.e., home-country, exports? It's price times quantity, or the area in the rectangles, each associated with a particular E . Here's the math (remember $P_N = P_{N^*} = 1$):

$$\begin{aligned}
X^s &= EP_x^*; X^d = \frac{1}{P_x^*}; \\
X^s &= X^d; \\
EP_x^* &= \frac{1}{P_x^*}; \widehat{P}_X^* = \frac{1}{\sqrt{E}}; \\
\widehat{X}^s &= \widehat{X}^d = \widehat{X} = E \widehat{P}_X^* = \frac{E}{\sqrt{E}}; \\
\widehat{P}_X^* \cdot \widehat{X} &= \frac{1}{\sqrt{E}} \cdot \frac{E}{\sqrt{E}} = 1.
\end{aligned}$$

For this case, we have a perfectly inelastic supply of foreign exchange wrt E . This is not the general case, but will suffice for our purposes.



Market for M

The simplest case:

$$\begin{aligned}
M^d &= \frac{1}{P_M}; M^s = P_M^*; \\
P_M &= \frac{1}{M^d}; P_M^* = M^s.
\end{aligned}$$

The LOOP implies

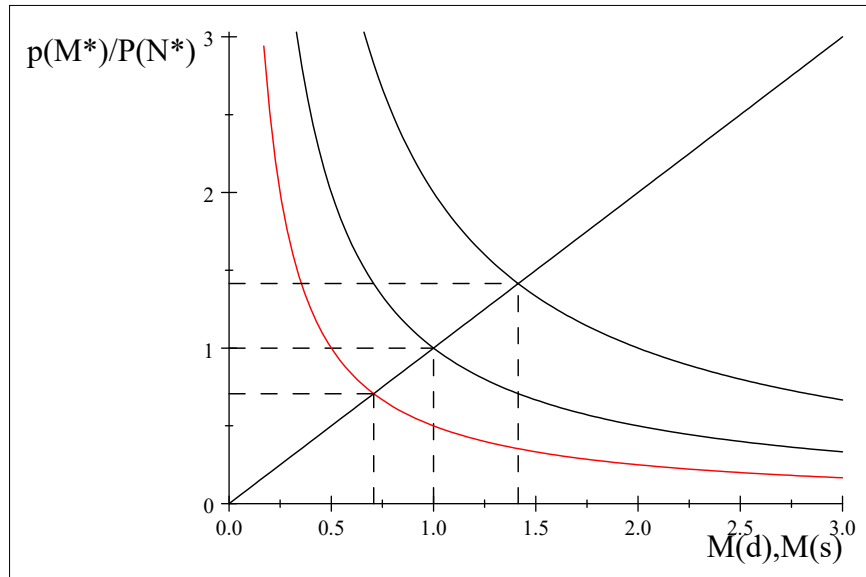
$$P_M = EP_M^*$$

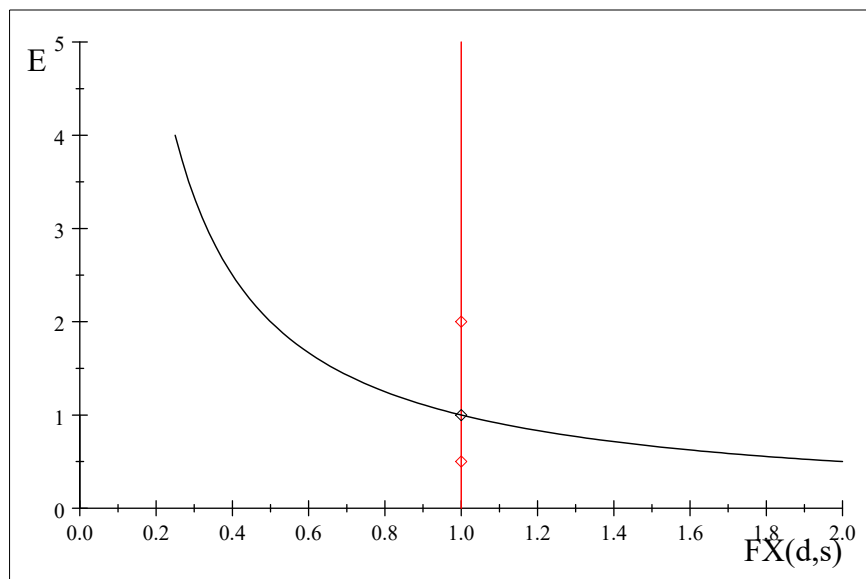
so

$$EP_M^* = \frac{1}{M^d};$$

$$P_M^* = \frac{1}{EM^d}.$$

Bi-directional logic: for any value of P_M^* , if E goes up, M^d must go down. So the family of inverse demand curves displayed below has the red innermost curve associated with the largest value of E . Hence, as E gets smaller, we move to inverse demand curves farther away from the origin, and equilibrium in the market for M at higher values of M and P_M^* . So, as E falls, the rectangular area that represents the demand for foreign exchange ($P_M^* \cdot M$) gets bigger: there is a downward-sloping demand curve for FX.





Comparative statics

1. Changes in the money supply.

a. It might help to go back and re-do our example without assuming $P_N = P_N^* = 1$. We introduce a little "trick."

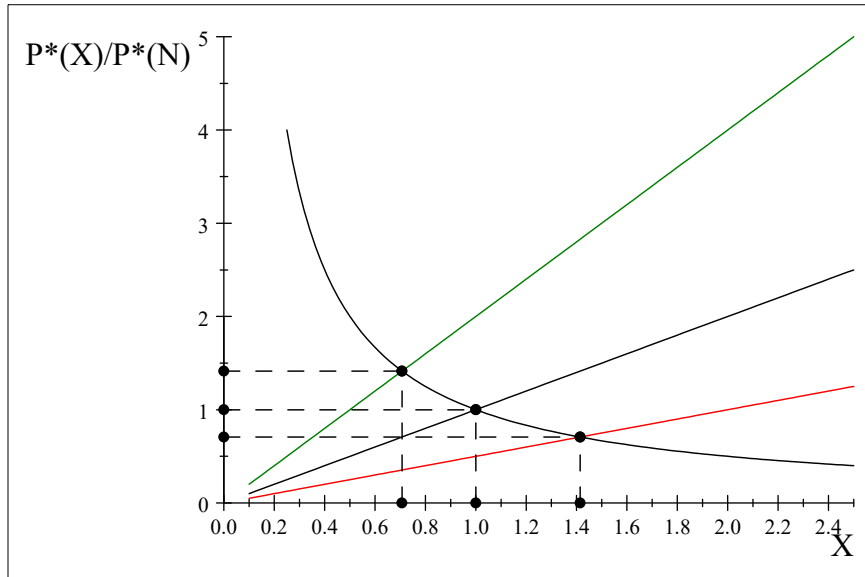
$$X^S = \overbrace{1}^{A_X^S} \cdot \frac{P_X}{P_N}; \quad X^d = \frac{1}{\frac{P_X^*}{P_N^*}};$$

$$P_X = EP_X^*; \quad X^S = \frac{EP_X^*}{P_N} \cdot \frac{P_N^*}{P_N^*} = \frac{EP_N^*}{P_N} \cdot \frac{P_X^*}{P_N^*};$$

$$\frac{P_X^*}{P_N^*} = \frac{X^S}{e}, \quad e \equiv \frac{EP_N^*}{P_N}.$$

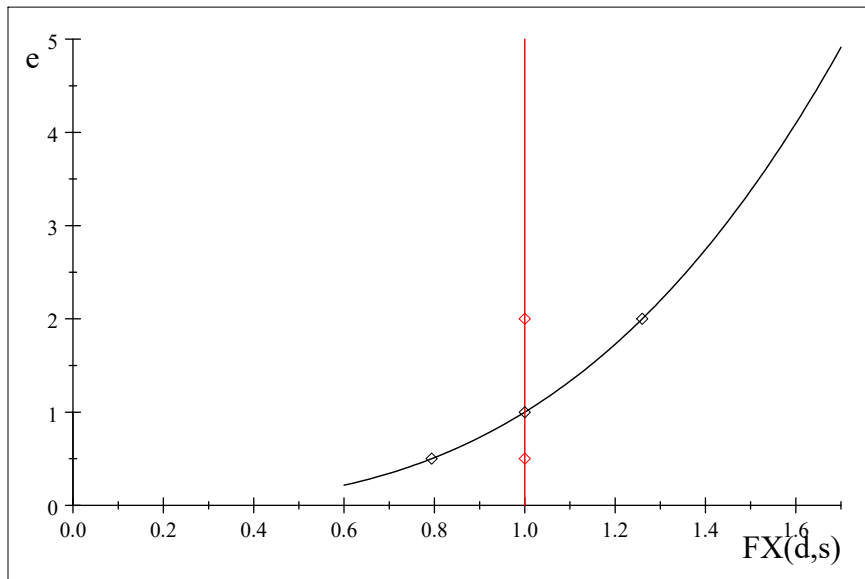
b. e is the thought-experiment "Big Mac" exchange rate.

c. So, the diagram that underlies the supply of FX is now:



$$e = \frac{1}{2}(g), e = 1(b), e = 2(r)$$

All that is changed is we have e instead of E . The diagram of the supply of FX is just



$$\varepsilon = 2(b); \varepsilon = 1(r)$$

d. Mkt for M :

$$M^d = \frac{1}{P_M/P_N}; M^s = \frac{P_M^*}{P_N^*};$$

$$\frac{P_M}{P_N} = \frac{1}{M^d}; \frac{P_M^*}{P_N^*} = M^s.$$

The LOOP implies

$$P_M = EP_M^*$$

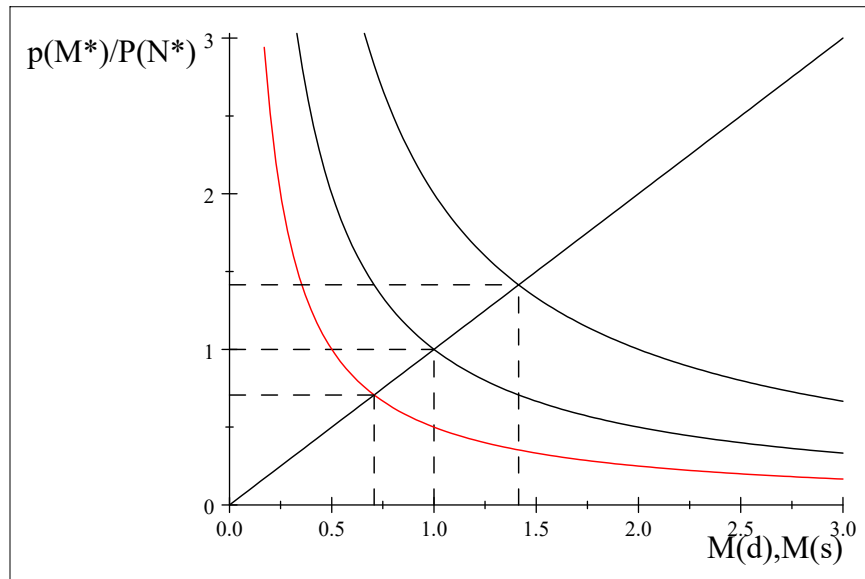
so

$$\frac{EP_M^*}{P_N} \cdot \frac{P_N^*}{P_M^*} = \frac{1}{M^d};$$

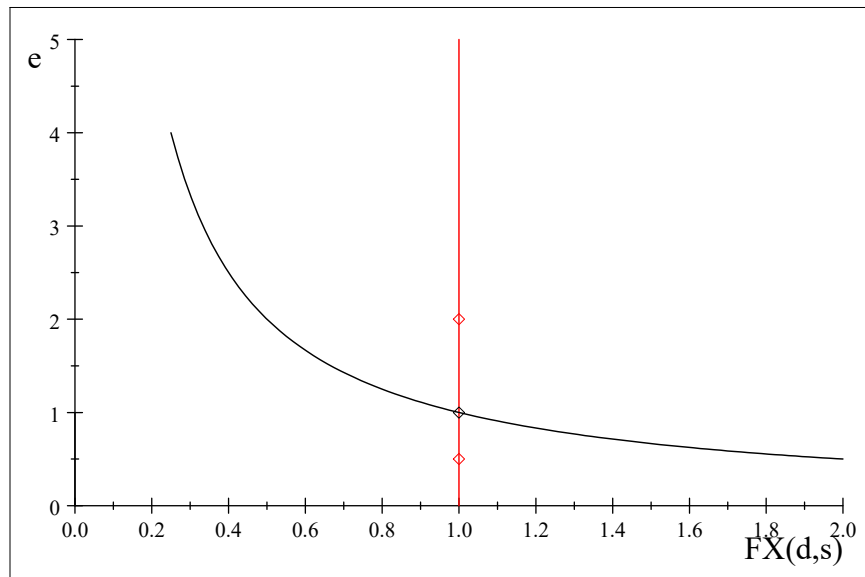
$$\frac{P_M^*}{P_N^*} = \frac{1}{eM^d};$$

$$\frac{P_M^*}{P_N^*} = M^s.$$

Again, all that has changed is we replace E by e .



$$e = 2(r), e = 1(b), e = \frac{1}{2}, (g)$$



e. Money mkt equilibrium implies (P_N is proportional to money supply):

$$P_N = \alpha L^S;$$

$$P_N^* = \alpha^* L^{S*}.$$

- f. Money shot: Above graph determines $e = \frac{EP_N^*}{P_N} = \frac{E\alpha L^S}{\alpha^* L^{S*}}$. With e fixed, any change in M^S is matched by a proportional decrease in E .
2. Shifts in demand, supply for X, M will shift FX D and S curves, change e (and E if P_N, P_N^* remain unchanged).

Demands for FX deriving from underlying demand for assets

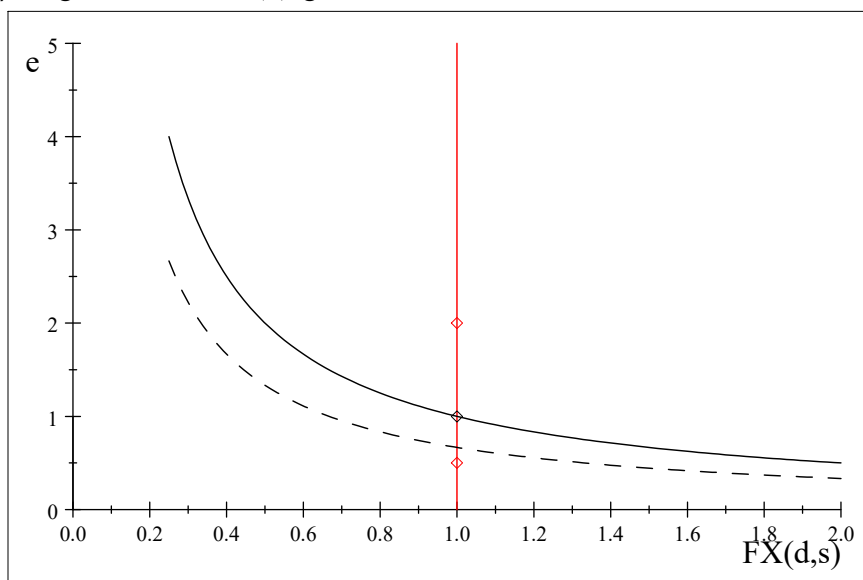
1. Stock demands: e.g.,

$$I_t^d = \gamma(r_t^* - r_t)$$

2. Demand equals supply in FX mkt:

$$TBS_t = \Delta I_t$$

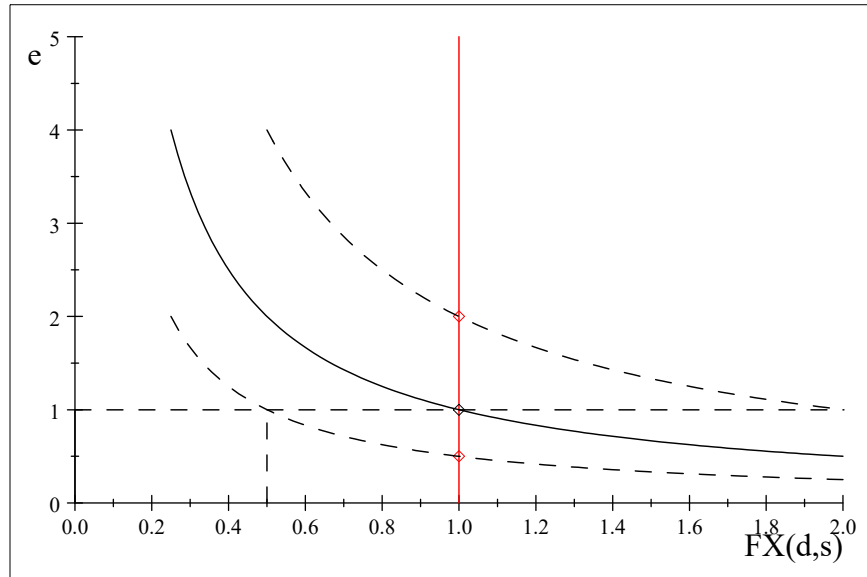
3. Implication: ceteris paribus, if foreign interest rate down (or domestic goes up), I_t goes down, $E(e)$ goes up?



What happens to exports, imports, TBS?

Fixed erates

1. The diagram



- | | Assets | Liabilities |
|---------------|-------------|-------------|
| 2. The CBSMA: | FX | M^S |
| | Bonds, etc. | |
3. Implication: FX holdings go up, M^S goes up, and vice versa.