Problem set on price levels and open economy macro

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Problem Set on Price Levels and Open Economy Macro a) In spite of the statistical rise in the general level of prices on non traded products will not affect currency's real exchange rates against foreign currencies. Increased demand of non traded goods will lead to considerable price rise whereas those for exports will remain the same eventually export industries will be forced by competition to pay higher wages etc. which may take long owing to the immobility and imperfections of the market.

b) By shifting demand away from their own goods the resultant effect will be increased imports suggesting a weak currency in value as compared to the other country's currency. However the purchasing power parity (ppp) theory holds that over the long-term, the average value of exchange rate between two currencies depends on their relative purchasing power.

2. When national income rises due to increased payments, imports are likely to increase in value relative to exports and as a result, the external value of the currency will depreciate thus weakening real and nominal exchange rates in the long run. For example, the 1986 fall in the price of oil led to a depreciation of the sterling pound on the foreign-exchange market. On the other hand, a reduction in national income reduces import in value relative to exports the resultant effect being the appreciation of external value of currency thus strengthening real and nominal exchange rates in the long run.

3. Factors such as indirect taxes, subsidies and transport costs may change prices of goods in a country but not affect the exchange rates. If a country imposes tariff on imports from abroad, the price in the home market would rise but since less foreign currency would be spent on it, the long run exchange rate will tend to improve. The long run nominal exchange rate will

also improve.

4. Short-term capital moves from one country to another as changes take place in the rate of interest being offered by each country. Governments can therefore vary interest rates to attract of repel foreign capital. The expected real interest rate of nine percent in the USA; will lead to reduced imports and increase exports which will strengthen the dollar exchange rate against the Euro. The low interest of three percent per year in Euro will attract foreign capital resulting in increased imports thereby weakening the Euro against the Dollar.