Naked economics notes chapter

Economics

Exchange Rate Mechanism This agreement was designed to manage large fluctuations in the exchange rate between European nations The ERM created targets for the exchange rates among the participating countries Each government was obligated to pursue policies that kept its currency trading on international currency markets within a narrow band around this target Currencies are no different than any other good; the exchange rate, or the " price" of one currency relative to another, is determined by supply elated to demand Two tools for propping up the value of the currency in the face of market pressure pushing it down: The government could use its reserves of other foreign currencies to buy their currency- directly boosting demand for the currency The government could use monetary policy to raise real interest rates which makes the country's bonds (and the currency necessary to buy them) more attractive to global investors and attracts capital Capital flows across international border for the same reason it flows anywhere else: Investors are looking for the highest levels of turn (at any given risk) Individuals, firms, and governments borrow funds from abroad because it is the cheapest way to " rent" capital that is necessary to make important investments or to pay the bills International transactions have a higher level of complexity when compared to domestic trading since different countries have different currencies and have different institutions for managing and creating these currencies When people trade across borders, it must be exchanged at an exchange rate A yen has value because it can be used to purchase things, a dollar has value for he same reason. In theory we ought to be willing to exchange $1 for however many yen would purchase roughly the same amount of stuff in the relevant country.

This is the theory of APP (purchasing power parity) If one country buys less stuff than it used to then anyone trading for that currency is going to demand more of it to compensate for the diminished purchasing power APP is useful because it's the tool used by official agencies to make comparisons across countries In the long run, basic economic principles suggest that exchange rates would roughly equal APP A typical basket of good- the source of comparison for APP- has both treatable and nontaxable goods Currencies that buy more than APP would predict are said to be overvalued and currencies that buy less than the APP would predict are said to be undervalued If the dollar has weakened or depreciated against the Euro, this means that the dollar buys fewer euros than it used to . The Euro has appreciated When the US dollar has depreciated: Foreign goods become more expensive Goods are less expensive for the rest of the world Good for American exporters: cheaper prices but not lower profits! Makes imports more expensive for Americans Good for exporters and bad for importers in the US Imports are more expensive-bad for consumers A strong US dollar NAS the opposite detect A government that deliberately keeps its currency undervalued is essentially taxing the consumers of imports and subsidizing producers of exports.

AN overvalued currency does the opposite The exchange rate is the function of the demand of some currency relative to the supply The most important factors affecting the demand of a runners are global economic forces Country with booming economy will usually have a country with appreciating currency because growth promotes investment opportunities that attract capital around the world Great demand for a country's imports will cause the currency to appreciate Higher interest rates make a currency more valuable since they provide investors with a greater return on capital Ways to value currencies against one another: The gold standard: no modernized industrial country uses this standard anymore.

Countries pegged their currencies to a fixed amount of gold and therefore to each there. Floating exchange rates: allows exchange rates to fluctuate as economic conditions dictate. Most developed countries use floating exchange rates. Governments have no obligation to maintain a certain value of their currency Fixed Exchange Rates (currency bands): countries pledge to maintain their exchange rate at some predetermined rate with a group of other countries.