



Agenda

I. Review

II. Purchasing Power Parity (PPP)

III. Exchange Rates

IV. Balance of Payment

V. Crisis Management



Review

Monetary Policy

- Money supply and interest rates

Fiscal Policy

- Government spending and taxation

GDP Accounting

- Consumption (Multiplier), Investment (Accelerator), Government Expenditures, Net Exports (Exports – Imports)



Purchasing Power Parity (PPP)

Explains the currency exchange rates between two countries using price levels:

$$P_{us} = (E)(P_E)$$

P_{us} = US price level

E = exchange rate \$/Euro

P_E = European price level

Take away: If price level of the goods in one country becomes more expensive, the demand for that country's currency and product will fall, causing the exchange rate to adjust until the above equation holds true again.



Relative PPP

The “Big Mac” Index

$$\frac{E - E(t-1)}{E(t-1)} = \text{Inflation US} - \text{Inflation Europe}$$

Example 1: if US prices rises 10%, European Prices rises 3%
US dollar will depreciate 7% against the euro

Measure	U.S.	Japan
Inflation Rate	5%	3%
Productivity Growth	4%	1%



Exchange Rates

Factor in country A	Change	Effect on Country A's currency
Interest rate in A	Increase	appreciate
Inflation rate in A	Increase	depreciate
Demand for A's goods	Increase	Appreciate
Country A output growth	Increase	Appreciate



Balance of Payments

Record of the transaction of the residents of a country with the rest of the world.

- Current account – trades in goods and services, and transfer of payments
- Capital account – purchase and sale of capital assets (stocks, bonds, and land)

Current account + Capital account surplus = 0

ie: you must balance a deficit in the current account with a surplus in capital account.



Exchange Rate Systems

Least
Flexible

Dollarization

Currency board

Fixed exchange rate

Crawling peg

Dirty flexible rate

Most
Flexible

Clean flexible rates



Crisis Management

IMF List

Privatize

Deregulate

Run a budget surplus (crowding in)

Run a Provident Fund (increase savings)

Free trade

Free the exchange rate

Control Population growth