Lecture session 2

2. Exchange Rates
   - 2.1. Defining the exchange rate: TOT, LOOP, and PPP
     - 2.1.1. Exchange rate (E) and the terms of trade (TOT)
     - 2.1.2. Law of one price (LOOP): assumptions and conditions
     - 2.1.3. Law of purchasing power parity (PPP): absolute and relative PPP
   - 2.2. PPP and deviations from E
     - 2.2.1. PPP and why E deviates short/long-run eqlbm rate of E
     - 2.2.2. Fundamental eqlbm exchange rate (FEER): capital and foreign assets and liabilities
     - 2.2.3. Real exchange rates
   - 2.3 Examples of unstable E, P relationships
   - 2.4 Exchange rate, arbitrage, speculation and hedging

3. Modeling the Currency Markets
   - 3.1. Interpretation of the demand for a currency
     - 3.1.1 Trade in goods and services
     - 3.1.2 Capital flows
     - 3.1.3 Demand for a foreign currency: negatively sloped
   - 3.2. Interpretation of the supply of a currency
     - 3.2.1 Trade in goods and services
     - 3.2.2 Capital flows
     - 3.2.3 Supply of a foreign currency: positively sloped
   - 3.3. Equilibrium and changes in equilibrium E
     - 3.3.1 Equilibrium in currency market, E* (BOT, capital account and reserves)
     - 3.3.2 Changes in equilibrium: appreciation, depreciation
   - 3.4. Exchange rates as a tool for trade policy
     - 3.4.1 Review of partial equilibrium trade modeling: 3-panel diagram (ES, ED curves)
     - 3.4.2 Trade policy analysis
     - 3.4.3 Appreciation, depreciation, revaluation, devaluation, fixed vs flexible regimes
     - 3.4.4 Manipulation of E to affect imports, exports; multiple exchange rate regimes
   - 3.5. Partial equilibrium modeling of changes in exchange rate: Houck's 3-country model
     - 3.5.1 Increase/decrease in the value of currency in which trade is denominated
     - 3.5.2 Increase/decrease in the value of currency of competing exporter
     - 3.5.3 Increase/decrease in the value of currency of importing country

Study questions: What is an exchange rate and how is this concept relate to the terms of trade, the law of one price, and purchasing power parity? Under what conditions should PPP hold? Can PPP deviate from the exchange rate in the short run or long run? What is the limitation of using PPP to understand the value of equilibrium exchange rates? How useful is PPP for forecasting exchange rates? How is the fundamental equilibrium exchange rate different? What is arbitrage and how does it differ from speculation? What is hedging and how does it differ from speculation? What is the role of speculation and hedging in international transactions? Does speculation stabilize/destabilize markets or economies? What is the demand for a currency? Why is the demand for a currency negatively sloped? What is the supply of a currency? Why is the supply of a currency upward sloping? What is equilibrium in currency exchange? What does it mean for the supply of a currency to change? What does it mean for the demand of a currency to change? How does equilibrium change, given some supply and demand scenario? How is the exchange rate used as a tool for trade policy? Which type of country would use the exchange rate as a tool for trade policy? Does it work -- why or why not or upon which conditions does it depend? Which type of country would use a multiple exchange regime? Does it work -- why or why not or upon which conditions does it depend? Illustrate the effects of an appreciation or depreciation of a currency on competing exporters and importing countries (using the 3-country model with a 5-panel diagram as presented by Houck). How do changes in hard currencies value affect the terms of trade of countries that have their currencies pegged to the hard currency? Can devaluation/depreciation be successful?