CLAREMONT MC KENNA COLLEGE
Lowe Institute of Political Economy

DATE ____________

TO Notes for Econ 140 FROM Professor Willett

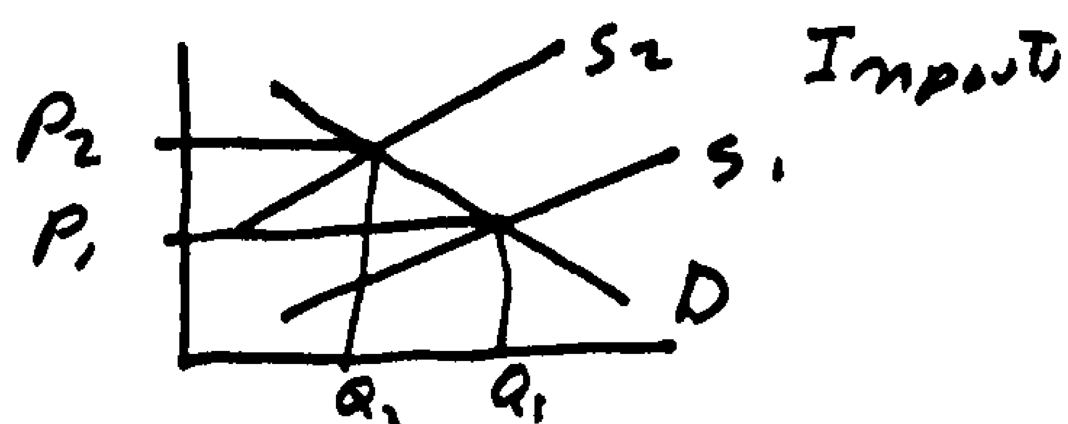
MEMORANDUM

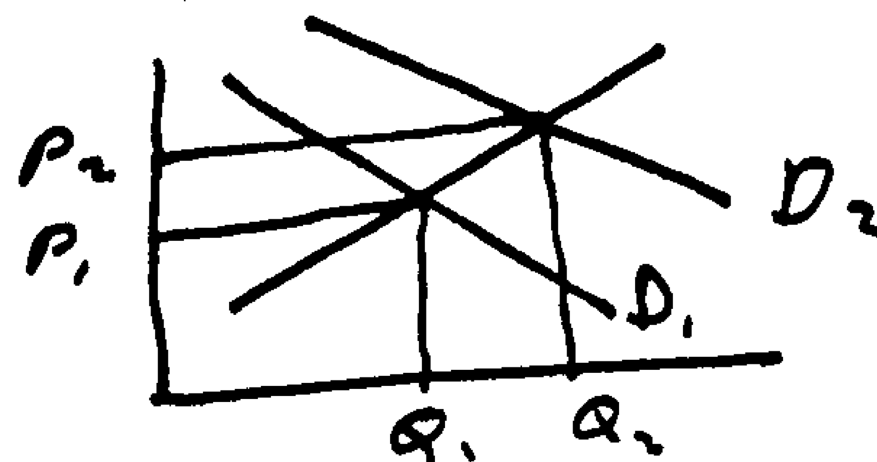
Devaluation

Devaluation acts like a tax on imports shifting up import supply curve and like a subsidy to exports, shifting out the demand for exports.

(The foreign curve shifts in each case. The domestic curve stays constant)

In domestic currency both export and import prices will rise. The terms of trade can go either way depending on which rises more.





Exchange rate determination.

The strong form of the monetary approach assumes purchasing power parity, ie no change in the real exchange rate, so that the exchange rate is just a function of the price level at home and abroad. Variables like interest rates & income operate through their effects on money demand relative to money supply.

$\therefore Y\uparrow \Rightarrow D_m\uparrow \Rightarrow$ appreciation

$i\uparrow$ = quantity of money demanded $\downarrow \Rightarrow$ depreciation

In the Keynesian model the equilibrium real exchange rate can change.

an increase in the real interest rate attracts capital inflows and leads to appreciation

an increase in $Y \Rightarrow \uparrow$ in imports so the trade balance worsens.

but interest rates & profit expectations may also rise, attracting capital inflows.

Thus the balance of payments under pegged rates and currency under flexible rates can go either way, depending on size of capital flows relative to Δ in trade balance