What determines exchange rates:

Supply and demand for foreign exchange

*Sources of supply*: foreigners wanting to buy domestic goods
foreigners wanting to buy domestic assets

Depreciation usually increases both: makes domestic goods, assets look cheap

*Sources of demand*:

domestic residents wanting to buy foreign goods
domestic residents wanting to buy foreign assets

Depreciation usually reduces both: makes foreign goods, assets look expensive

In modern world: capital account dominates => focus only on supply and demand for assets

Inflows of capital if expected return on domestic bonds ($i$) exceeds expected return on foreign bonds ($i^*$ + expected change in exchange rate)

Outflows if other way around

So basic *arbitrage equation*

$$i = i^* + \frac{E^e - E}{E}$$

What determines $E^e$? Long-run issues, ability of domestic producers to compete, future monetary policy, etc. For now, we simply take expected future exchange rate as given:

$$E^e = \bar{E}$$

So *exchange rate equation*

$$i = i^* + \frac{\bar{E} - E}{E}$$

or

$$i - i* = \frac{\bar{E} - E}{E}$$

The open-economy IS curve:

Now 2 channels through which *i* affects demand:

1. Conventional channel: lower *i* means higher investment

2. Exchange rate channel: lower *i* means higher *E*, hence higher *EP*/P* (real exchange rate), hence higher X-M at any given Y

Monetary policy: higher M means lower *i*, higher *Y*, higher *E*; current account can go either way

Fiscal policy: higher G or lower T means higher *I*, lower *E*, higher *Y*; current account moves toward deficit