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 \( (i^* + \text{expected change in exchange rate}) \)

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