How Monetary and Fiscal Policies Affect Exchange Rates

Changes in a nation's monetary and fiscal policies affect its exchange rates and its balance of trade through the interest rate, income and the price level. Changes in the value of a country's currency may affect the balance of trade and aggregate demand. The value of real output and price levels may also be affected. Domestic policies influence currency values, and currency values influence domestic policies. The complexity of the connection leads to careful evaluation of any change in domestic policy goals. Policy makers cannot ignore the international effects of changes in monetary and fiscal policies.

A series of situations is presented below. In each case:

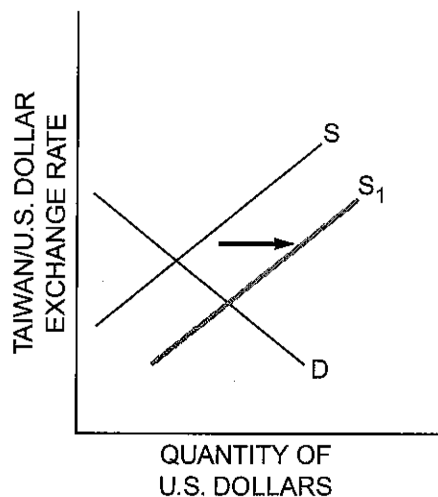
- Evaluate the expected effects on exchange rates in the United States and the other country. Use the currency graphs provided to reflect changes in the currency values.
- Analyze the impact of the currency changes on the U.S. economy as it applies to net exports, balance of trade, aggregate demand and price levels. *Work out the situations in the short run only.*

1. The U.S. government initiates a personal income tax reduction plan, leaving every tax-paying American with more disposable income.

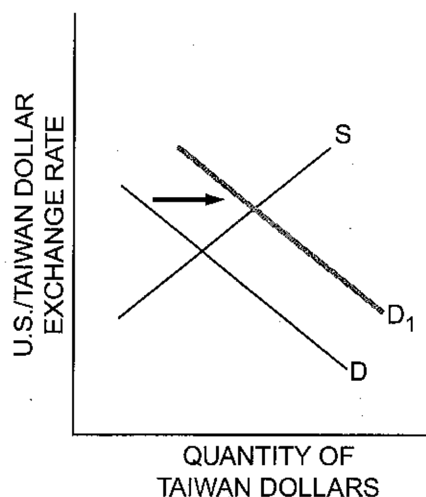
   (A) What will happen as a result to trade between the United States and Taiwan?
   Americans will buy more Taiwanese and domestic goods.

Figure 54.1
U.S. Government Reduces Taxes

Graph A



Graph B



(B) In Graph A, what happens to the U.S. dollar? ***It depreciates.***

(C) In Graph B, what happens to the Taiwanese dollar? ***It appreciates.***

(D) As a result of the fiscal policy,

(i) U.S. aggregate demand shifts (*left* / ***right***).

(ii) Price levels in the United States (***rise*** / *fall*).

(iii) U.S. imports (***increase*** / *decrease*). Explain why. ***The increase in disposable income increases the demand for all goods, including foreign goods. Furthermore, the increase in U.S. prices makes foreign goods relatively less expensive.***

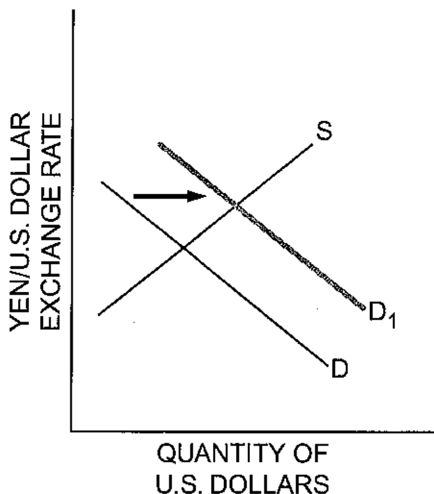
(iv) U.S. exports (*increase* / ***decrease***). Explain why. ***The relative price to foreigners of U.S. goods has increased, so foreigners buy less.***

2. Japan's fiscal policies lead to an increase in Japan's real GDP.

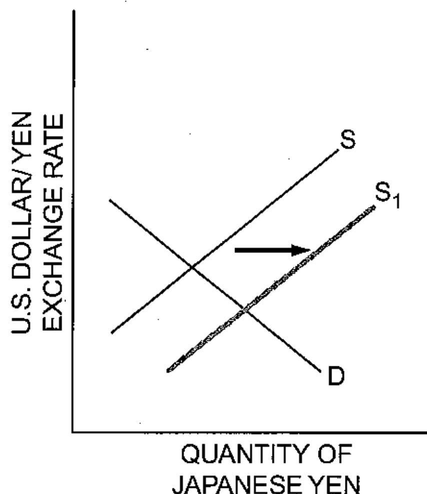
(A) What will happen as a result to trade between the United States and Japan?
Japan buys more U.S. goods because Japanese incomes rise.

Figure 54.2
Japan's Real GDP Increases

Graph A



Graph B



(B) In Graph A, what happens to the U.S. dollar? ***It appreciates.***

(C) In Graph B, what happens to the Japanese yen? ***It depreciates.***

Advanced Placement Economics Teacher Resource Manual © National Council on Economic Education, New York, N.Y.

(D) As a result of the changing value of the U.S. dollar,

(i) U.S. exports *(increase / decrease)*. Explain why. ***It takes more yen to buy each dollar; therefore U.S. goods cost more in yen than previously, and exports to Japan decrease.***

(ii) U.S. imports *(increase / decrease)*. Explain why. ***Each dollar buys more yen; therefore Japanese goods are cheaper in U.S. dollars, and imports from Japan increase.***

(iii) U.S. aggregate demand shifts *(left / right)*.

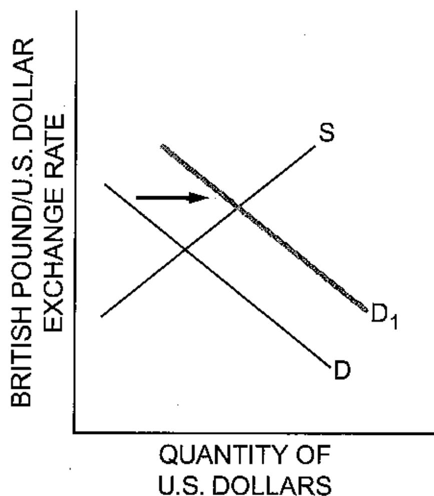
(iv) Price levels in the United States *(rise / fall)*.

3. The U.S. federal budget deficit increases, which causes increases in the interest rate. (Assume trade with Great Britain.)

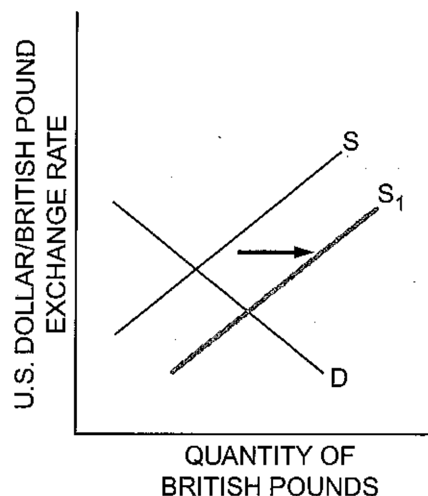
(A) What will happen as a result to trade between the United States and Great Britain? ***British investors will want to buy U.S. bonds.***

Figure 54.3
Interest Rates in the United States Increase

Graph A



Graph B



(B) In Graph A, what happens to the U.S. dollar? ***It appreciates.***

(C) In Graph B, what happens to the British pound? ***It depreciates.***

(D) As a result of the changing value of the U.S. dollar:

(i) U.S. exports *(increase / decrease)*. Explain why. ***It takes more pounds to buy each dollar; therefore U.S. goods cost more in pounds than previously, and exports to Great Britain decrease.***

(ii) U.S. imports *(increase / decrease)*. Explain why. ***Each dollar buys more pounds; therefore British goods are cheaper in U.S. dollars, and imports from Great Britain increase.***

(iii) U.S. aggregate demand shifts *(left / right)*.

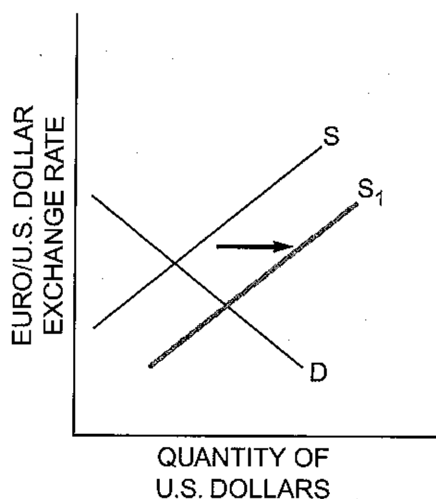
(iv) Price levels in the United States *(rise / fall)*.

4. Europe's interest rates are increasing, while the U.S. interest rate remains relatively constant.

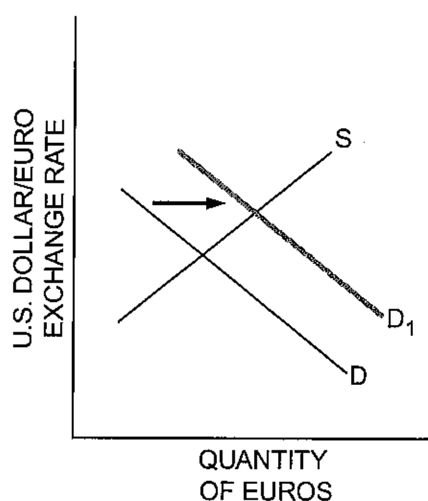
(A) What will happen as a result to trade between the United States and Europe? ***Europeans will sell U.S. bonds to buy European bonds.***

Figure 54.4
Interest Rates in Europe Increase

Graph A



Graph B



(B) In Graph A, what happens to the U.S. dollar? ***It depreciates.***

(C) In Graph B, what happens to the European euro? ***It appreciates.***

(D) As a result of the changing value of the U.S. dollar,

(i) U.S. exports *(increase / decrease)*. Explain why. ***It takes more dollars to buy each euro; therefore U.S. goods cost less in euros than previously, and exports to Europe increase.***

(ii) U.S. imports *(increase / decrease)*. Explain why. ***Each dollar buys fewer euros; therefore European goods are more expensive in dollars, and imports from Europe decrease.***

(iii) U.S. aggregate demand shifts *(left / right)*.

(iv) Price levels in the United States *(rise / fall)*.

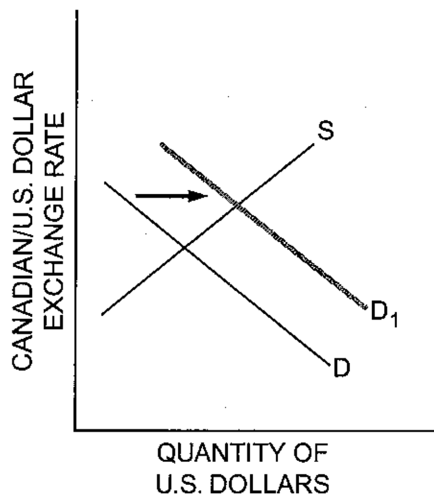
5. There is a rapid increase in the Canadian price level while the U.S. price level remains relatively constant.

(A) What will happen as a result to trade between the United States and Canada? ***Canadians will want to buy U.S. goods.***

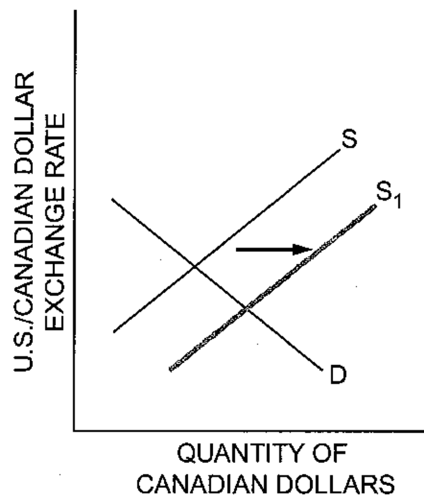
Figure 54.5

The Price Level in Canada Increases

Graph A



Graph B



(B) In Graph A, what happens to the U.S. dollar? ***It appreciates.***

(C) In Graph B, what happens to the Canadian dollar? ***It depreciates.***

(D) As a result of the changing value of the U.S. dollar:

(i) U.S. exports *(increase / <u>decrease</u>)*. Explain why. ***It takes more Canadian dollars to buy each U.S. dollar; therefore U.S. goods cost more in Canadian dollars than previously. Therefore exports to Canada decrease.***

(ii) U.S. imports *(<u>increase</u> / decrease)*. Explain why. ***Each U.S. dollar buys more Canadian dollars; therefore Canadian goods are cheaper in U.S. dollars. Therefore imports from Canada increase.***

(iii) U.S. aggregate demand shifts *(<u>left</u> / right)*.

(iv) Price levels in the U.S. *(rise / <u>fall</u>)*.

Advanced Placement Economics Teacher Resource Manual © National Council on Economic Education, New York, N.Y.