Economics – Exchange Rate Report

JRL Consulting
Cross-Cultural Technology Management
E-Mail: tech@jrleeconsulting.com
Website: www.jrleeconsulting.com

A. What has happened to the value of the U.S. dollar in relation to the euro over the past month? (Feb. 2008)

Figure 1 the fluctuations in exchange rates between US dollar and Euro.

The value of the U.S. dollar in relation to the Euro varied from 0.672 to 0.690 as shown in figure 1 that was recorded from January 16, 2008 to February 15, 2008. The exchange rate between U.S. dollar and Euro changed in response to change in a variety of economic conditions that change the demand for or supply of dollars in European exchange markets. Six major influences on demand for and supply of dollars that determine U.S. Dollar/Euro exchange rate are: (1) European Union's demand for U.S. exports (2) U.S. demand for imports from European Union (3) Real Interest rates in the U.S. relative to E.U. (4) Profits of direct investments in the U.S. vs E.U. (5) Expections of future price of U.S. dollar vs E.U. (6) Price level of U.S. vs E.U.

B. Identify two or more factors that might account for the changes in the value of the U.S. dollar with respect to the Euro. Reference some current events to support your case. Explain and support your answer by *referring to the textbook theories* on exchange rate determination.

1) Reduce interest rate: The Fed has already done a lot to stave off a recession but stands ready to do more if circumstances warrant, (02/14/08) Fed chief Ben Bernanke testified before the Senate Banking Committee. He highlighted downward growth risks and leaving the door open for more interest-rate cuts. While U.S. is cutting the interest rate to 3%, the E.U. voted and decided to keep the rate at 5.5%. With inflation in the U.S. smaller than E.U., the real interest rate of U.S. is getting even smaller than E.U. The lower U.S. real interest rate, the less the demand of E.U. to hold dollar financial assets and other things being equal, the lower the exchange rate of the dollar as shown in figure 2. The exchange dropped from p1 to p2.

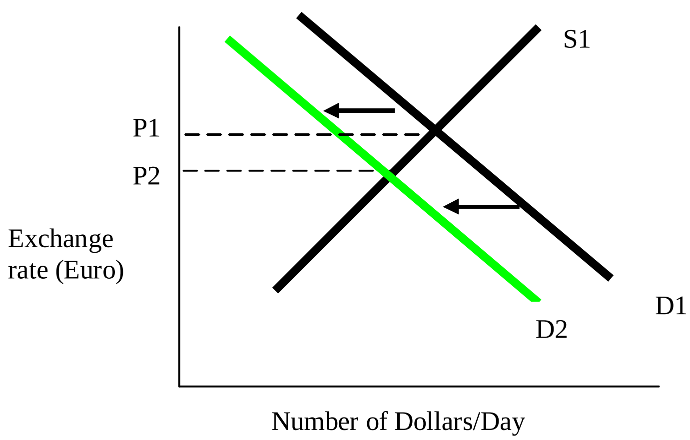

Figure 2 Change of relative real interest rate between U.S. and E.U.

(2) Consumer spending reduced: As the wealth and income effects of falling home prices (because of subprime mortgages problem) and weakening job growth dampen consumer demand, reduce U.S. demand for imports. A reduce in U.S. demand for imports will reduce the supply of dollars offered in foreign exchange market as shown in figure 3. The inward shift of supply curve from s1 to s2 will increase the exchange rate of the dollar from p1 to p3.

The use of these two factors together, we can not decide whether the p? shown in figure 3 is greater or smaller than p1. Since there are six major influences can be used to determine the Dollar/Euro exchange rate. We will need to fudge in the other factors for the prediction of the exchange rate. Since the exchange rate dropped substantially right after Fed chief Ben Bernanke's testimony, we know other factors outweigh the increase part of the exchange rate.

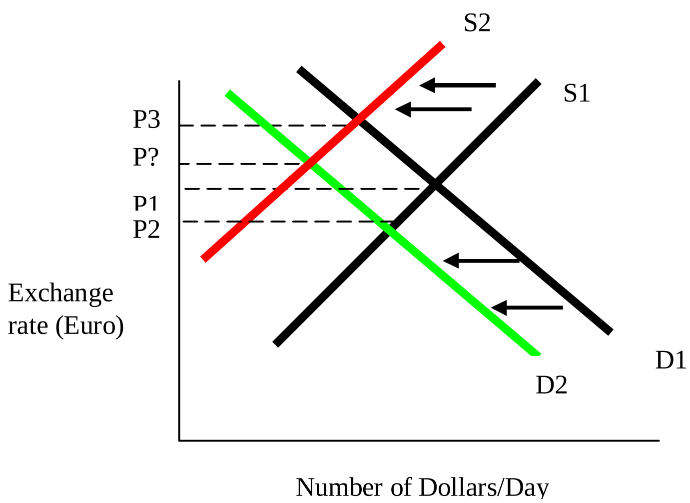

Figure 3 The combined effects of dropping real interest rate and reduce consumer spending on exchange rate.