

## How Monetary and Fiscal Policies Affect Exchange Rates

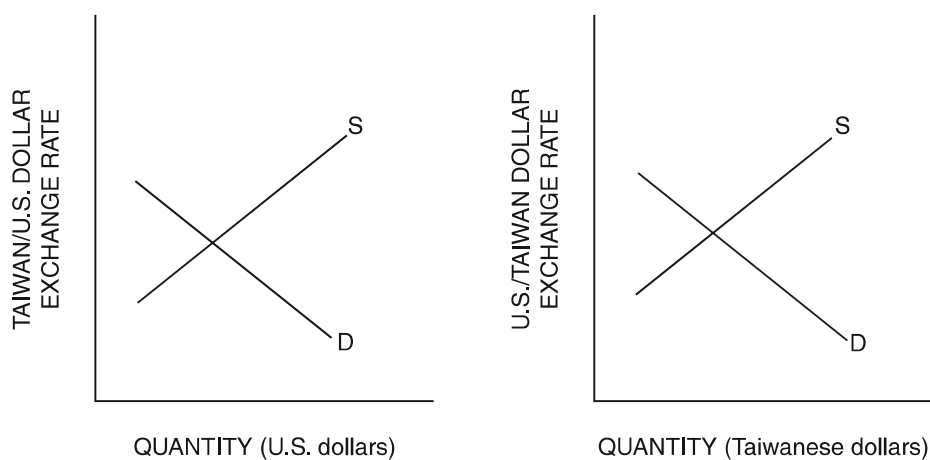
Changes in a nation's monetary and fiscal policies affect its exchange rates and its balance of trade through the real interest rate, income, and the price level. Changes in the value of a country's currency affect the balance of trade, which affects aggregate demand. Changes in aggregate demand affect real output and the price level. In other words, domestic policies influence currency values, and currency values influence domestic policies. Policy makers cannot ignore the international effects of changes in monetary and fiscal policies.

For each scenario, show the effect on equilibrium interest rate and quantity of currency in the foreign exchange market graphs in Figures 7-4.1 through 7-4.5. Use the graphs to show the starting equilibrium exchange rate and quantity, the shift that occurs, and the new equilibrium exchange rate and quantity. Following each set of graphs, indicate the short-run effect of the change in the foreign exchange market on net exports, aggregate demand, and the price level in the United States.



Figure 7-4.1

### Effect on Taiwan If U.S. Government Decreases Taxes



1. Effect on Taiwan if U.S. government decreases taxes:

(A) U.S. imports (*increase / decrease*). Explain.

(B) U.S. exports (*increase / decrease*). Explain.

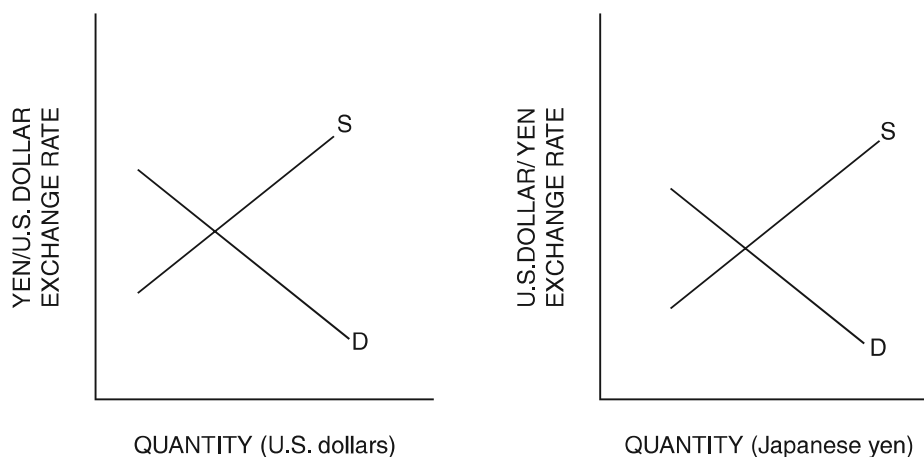
(C) U.S. aggregate demand (*increases / decreases*). Explain.

(D) The price level in the United States (*increases / decreases*). Explain.



Figure 7-4.2

### Japan's Real GDP Increases



2. Effect if Japan's real gross domestic product (GDP) increases:

(A) U.S. imports (*increase / decrease*). Explain.

(B) U.S. exports (*increase / decrease*). Explain.

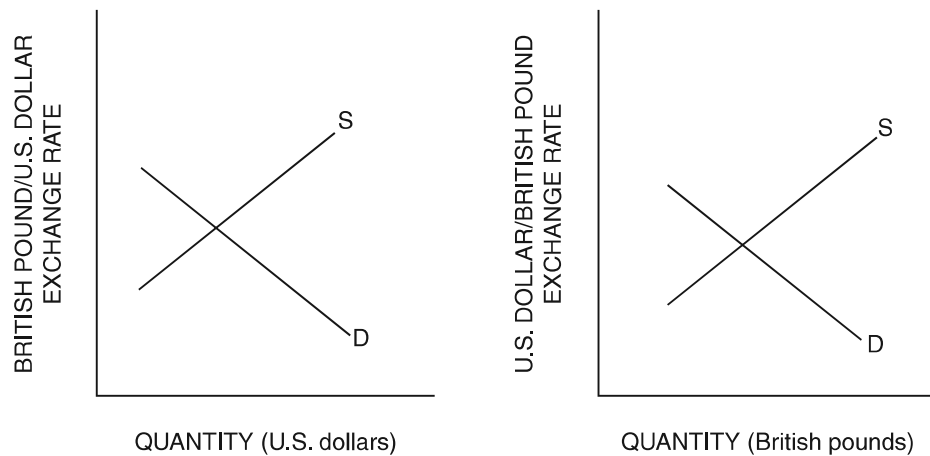
(C) U.S. aggregate demand (*increases / decreases*). Explain.

(D) The price level in the United States (*increases / decreases*). Explain.



Figure 7-4.3

### Real Interest Rates in the United States Increase Relative to Great Britain



3. Effect if real interest rates in the United States increase relative to Great Britain:

(A) U.S. imports (*increase / decrease*). Explain.

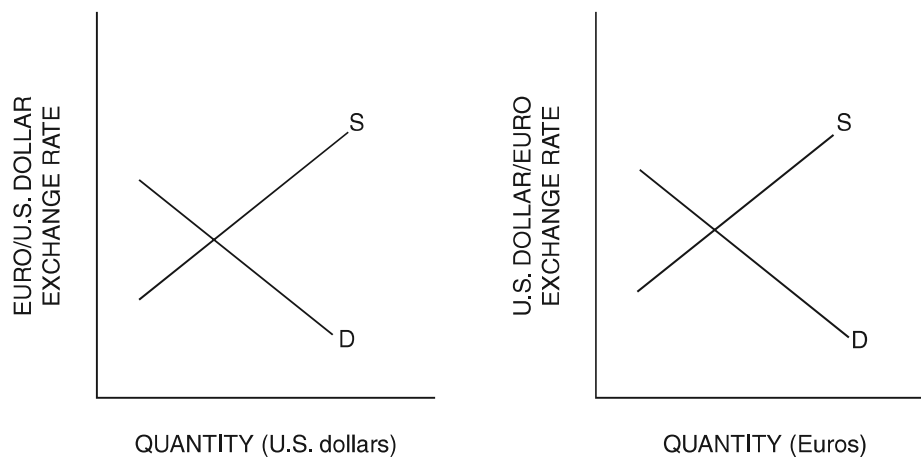
(B) U.S. exports (*increase / decrease*). Explain.

(C) U.S. aggregate demand (*increases / decreases*). Explain.

(D) The price level in the United States (*increases / decreases*). Explain.



Figure 7-4.4  
Europe Experiences a Recession



4. Effect if Europe experiences a recession:

(A) U.S. imports (*increase / decrease*). Explain.

(B) U.S. exports (*increase / decrease*). Explain.

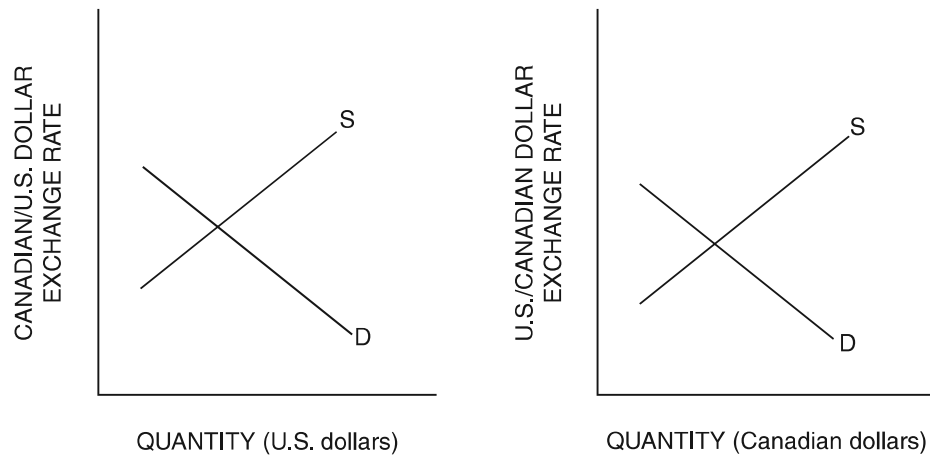
(C) U.S. aggregate demand (*increases / decreases*). Explain.

(D) The price level in the United States (*increases / decreases*). Explain.



Figure 7-4.5

### The Price Level in Canada Increases Relative to the United States



5. Effect if the price level in Canada increases relative to the United States:

(A) U.S. imports (*increase / decrease*). Explain.

(B) U.S. exports (*increase / decrease*). Explain.

(C) U.S. aggregate demand (*increases / decreases*). Explain.

(D) The price level in the United States (*increases / decreases*). Explain.