

3. Long-Term Framework for Exchange Rates

International parity conditions help us determine long term currency exchange rates

1. Long run versus short run
2. Real versus nominal values
3. Expected versus unexpected changes
4. Relative movements

There is no simple model or formula which allows us to precisely forecast exchange rates



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JPY/AUD = 79.25

-3019

(3)

0.7, 2P

→ Risk Neutral

One year forward points = -301.9

One-year Australian deposit rate = 5.00%

One-year Japanese deposit rate = 1.00%

$$\begin{aligned} \textcircled{1} \% \Delta S &= i_p - i_d \\ &= 5\% - 1\% \\ &= 4\% \end{aligned}$$

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Aus 5% Jap 1% 4%

AUS \$ 10% overvalued 900

① AUD ↓ 10% $\frac{JPY}{AUD}$ ↓ 10%

② $\frac{Q_{JPN}}{AUD} = \frac{S_J}{A} \frac{CPI_A \uparrow}{CPI_J \uparrow}$

③ 4%

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