

FIGURE 19.2 Determinants of the Exchange Rate in the Short Run

Change in Variable	Direction of International Financial Repositioning	Implications for the Current Spot Exchange Rate ($e = \text{Domestic currency/Foreign currency}$)
Domestic Interest Rate (i)		
Increases	Toward domestic-currency assets	e decreases (domestic currency appreciates)
Decreases	Toward foreign-currency assets	e increases (domestic currency depreciates)
Foreign Interest Rate (i_f)		
Increases	Toward foreign-currency assets	e increases (domestic currency depreciates)
Decreases	Toward domestic-currency assets	e decreases (domestic currency appreciates)
Expected Future Spot Exchange Rate (e^{ex})		
Increases	Toward foreign-currency assets	e increases (domestic currency depreciates)
Decreases	Toward domestic-currency assets	e decreases (domestic currency appreciates)

The analysis for each change in one of the variables assumes that the other two variables are unchanged.

Uncovered interest parity (whether exact or approximate) links together four variables: the domestic interest rate, the foreign interest rate, the current spot exchange rate, and the expected future spot exchange rate. (The two exchange rates together imply the expected appreciation or depreciation.) Change in any one of these four variables implies that adjustments will occur in one or more of the other three. We will here focus on implications for the current spot exchange rate of changes in each of the other three variables. Figure 19.2 provides a road map by summarizing the effects.

The Role of Interest Rates

Foreign exchange markets do seem sensitive to movements in interest rates. Jumps of exchange rates often follow changes in interest rates. The response often looks prompt, so much so that press coverage of day-to-day rises or drops in an exchange rate typically point first to interest rates as a cause.

If our interest rate (i) increases, while the foreign interest rate (i_f) and the spot exchange rate expected at some appropriate time in the future (e^{ex}) remain constant, the return comparison shifts in favor of investments in bonds denominated in our currency. If international financial investors want to shift toward domestic-currency assets, they first need to buy domestic currency before they can buy the domestic-currency bonds. This increase in demand for domestic currency increases the current spot exchange rate value of domestic currency (so e decreases). Given the speed with which financial investors can initiate shifts in their portfolios, the effect on the spot exchange rate can happen very quickly (instantaneously or within a few minutes).

Let's consider an example involving the United States, Switzerland, and 90-day bonds. Initially, the U.S. interest rate is 9 percent per year, and the Swiss interest rate is 5 percent per year. The current spot rate is \$.50 per Swiss franc (SFr), and the spot rate expected in 90 days is about \$.505 per SFr. The franc is expected to appreciate about 1 percent during the next 90 days, so the annual rate of expected appreciation is about