

CHAPTER OVERVIEW

5: Interest Rate Parity

Interest rate parity is one of the most important theories in international finance because it is probably the best way to explain how exchange rate values are determined and why they fluctuate as they do. Most of the international currency exchanges occur for investment purposes, and therefore understanding the prime motivations for international investment is critical.

The chapter applies the rate of return formula developed in [Chapter 4 "Foreign Exchange Markets and Rates of Return"](#) and shows how changes in the determinants of the rate of return on assets affect investor behavior on the foreign exchange market, which in turn affects the value of the exchange rate. The model is described in two different ways: first, using simple supply and demand curves; and second, using a rate of return diagram that will be used later with the development of a more elaborate macro model of the economy.

[5.1: Overview of Interest Rate Parity](#)

[5.2: Comparative Statics in the IRP Theory](#)

[5.3: Forex Equilibrium with the Rate of Return Diagram](#)

[5.4: Exchange Rate Equilibrium Stories with the RoR Diagram](#)

[5.5: Exchange Rate Effects of Changes in U.S. Interest Rates Using the RoR Diagram](#)

[5.6: Exchange Rate Effects of Changes in Foreign Interest Rates Using the RoR Diagram](#)

[5.7: Exchange Rate Effects of Changes in the Expected Exchange Rate Using the RoR Diagram](#)

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