

Quiz 1: *Use both graphs and a short written explanation to answer each of the questions below. Be clear and precise. Answer below, and on back of page if necessary.*

1. Using the E-R-M diagram, show how you would expect an unexpected, one-time increase in the domestic money supply to affect domestic interest rates and the domestic price of foreign exchange.
2. Using Krugman & Obstfeld's AA-DD diagram, show and explain how the above increase in the money supply would affect real GDP. Explain why there might initially be "overshooting" in the spot exchange rate as real GDP changes.
3. Now suppose that forward exchange markets adjust to the expectation that the increase in the money supply is permanent. How would this affect the E-R-M and AA-DD diagrams? Would there still be overshooting in E?
4. Now suppose instead that the central bank is committed to maintaining a fixed exchange rate. What would it have to do to maintain equilibrium in the foreign exchange market? How does this affect its balance sheet? How would this affect the AA-DD diagram?