1. Show the side-by-side graphs for the money market and the forex market (what I will call the iME diagram), and give the equations representing equilibrium in each.

\[ \frac{M^s}{P} = L(i)Y \]

\[ i = \bar{i} + \frac{E^e - E}{E} \]

2. Using this diagram, show how a significant one-time increase in the money supply \((M)\) would affect interest rates \((i)\) and the exchange rate \((E)\) in the short-run.

\( M \uparrow \quad i \downarrow \quad E \uparrow \)

(Continued on back)
3. How should the above increase in $M$ affect the price level $P$ in the long-run? What is the equation for purchasing power parity in the long-run? Using this diagram, how should this change in the expected forex rate ($E^e$) affect $i$ and spot $E$ in the short-run?

\[ P \text{ should rise too. } E = P/P^* \text{ in long-run, so } E^e \uparrow. \]

4. Suppose instead that normalized money demand ($L$) rises independent of any effect from $i$, as people move from bonds and other financial assets to cash and guaranteed deposits. How would this affect $i$ and spot $E$ in the short-run? How would this affect $P$ and $E^e$ in the long-run, and would it matter if the change in $L$ was expected to be temporary or permanent? If it was permanent, how would this in turn affect spot $E$ in the short-run?

In the short-run, $i \uparrow$ and $E^e$. This should cause $P \downarrow$ in long-run (Deflation), if it is permanent. So $E^e \downarrow$ in long run, if permanent. So $E \downarrow$ more now.

If $L \uparrow$ is temporary, $P$ and $E^e$ should not fall.