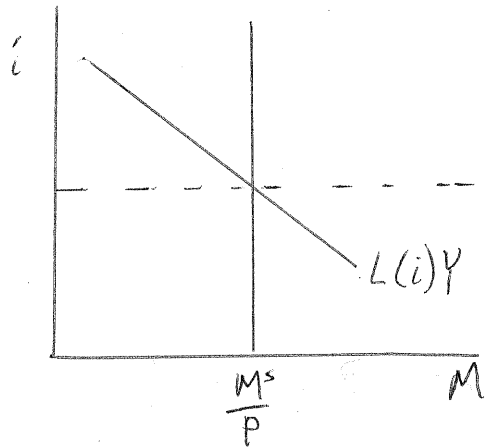


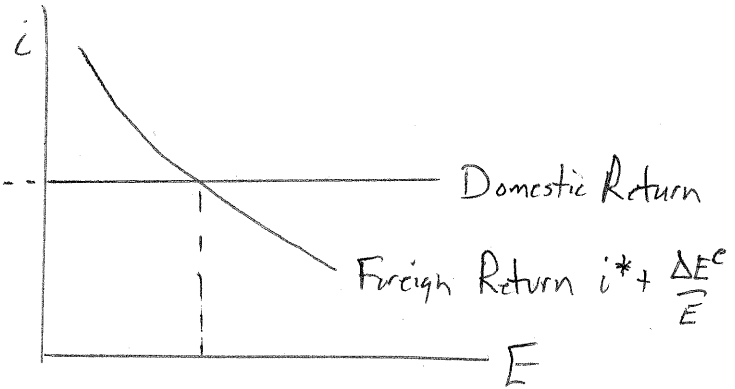
GROUP _____ NAME Key

5 pts.

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.



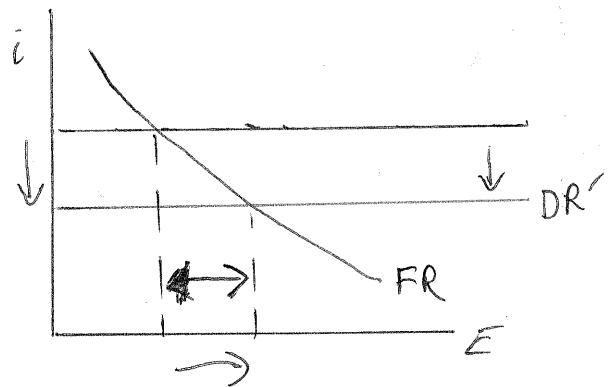
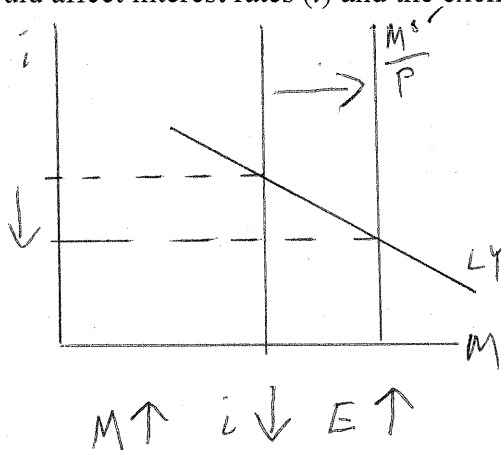
$$\frac{M^s}{P} = L(i)Y$$



$$i = i^* + \frac{E^e - E}{E}$$

5 pts.

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.



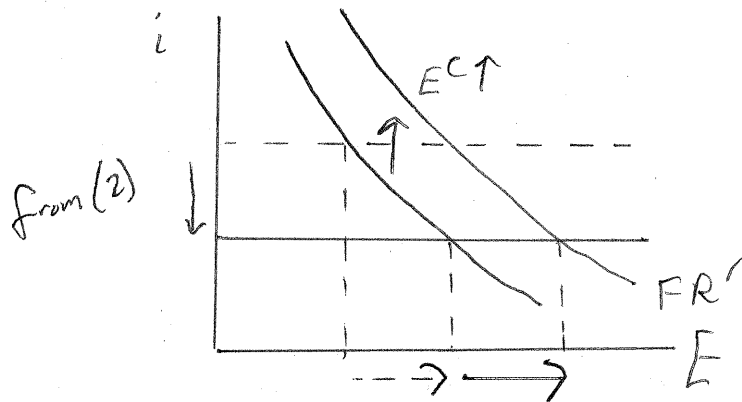
(Continued on back)

5 pts.

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 should rise too. $E = P/P^*$ in long-run, so $E^e \uparrow$.

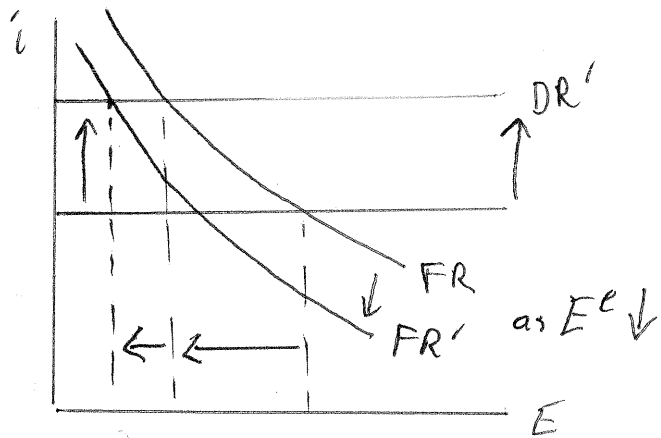
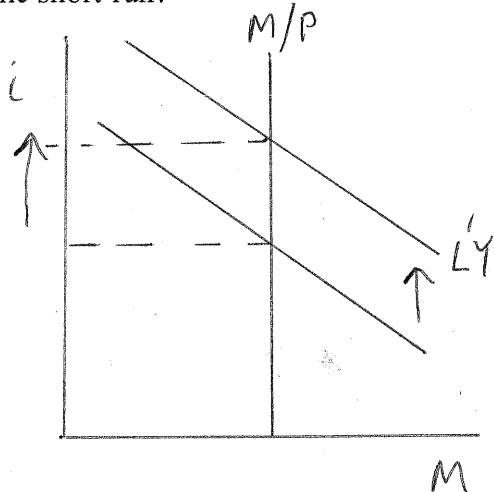
No change in Money Market



E rises more.

4. Suppose instead that 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?

5 pts.



In the short-run, $i \uparrow$ and $E \downarrow$.

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