1) The Canadian Dollar is currently trading at $0.9503 on the spot market, and the annual yield on two-year U.S. Treasury Bonds is 0.81%. If the equivalent yield on Canadian treasuries is 1.41%, what is the two-year forward rate for the Canadian Dollar, to three decimal places (i.e., a tenth of a cent)?

\[
\text{Canadian Dollar 2-yr Forward Rate} = 0.939
\]

2) If U.S. money supply is expected to grow by 4.6% over the next year, and real GDP is predicted to grow by 3.6%, what is the expected U.S. inflation rate (to the tenth of a percent) if we assume liquidity demand (L) is a constant?

\[
\text{Expected U.S. inflation rate} = 1.0\%
\]

3) If Canada’s real GDP is expected to grow by 3.0% over the next year, and money supply is expected to grow by 6.5% over the next year, what is the expected Canadian inflation rate if we also expect Canadians to increase their liquidity demand (L) by 1.4%?

\[
\text{Expected Canadian inflation rate} = 2.1\%
\]

4) According to the most recent Big Mac Index, the Canadian Dollar is overvalued against the U.S. Dollar by 10%. Including your answers to #2 and #3 above, if the annual rate of convergence to purchasing power parity is 15%, what would you expect the Canadian Dollar to be worth in one year?

\[
-1.5\% -1.1\% = -2.6\%
\]

\[
\text{Expected Canadian Dollar} = 0.926
\]

5) Ignore your answers above. Assume instead that the U.S. inflation rate was expected to be steady at 3%, and the Canadian inflation rate was expected to be 4%. What is the expected rate of annual change of the Canadian Dollar? If the real rate of interest is 2%, what is the nominal rate in the U.S. and Canada?

\[
\text{Expected Change in Canadian Dollar} = 1.0\%
\]

\[
\text{Nominal U.S. interest rate} = 5.0\%
\]

\[
\text{Nominal Canadian interest rate} = 6.0\%
\]

6) See next page.
6) Starting with your answer in #5, suddenly the U.S. Federal Reserve announces it will set a new permanent inflation target of 2%. How would this affect U.S. interest rates \(i\), and how would that affect liquidity demand \(L(i)\)? How would the change in liquidity demand affect U.S. prices now? Show your answers on graphs for variables over time below.