

Do not write your name on the assignment. Write your name only on the back of this sheet of paper and staple your answers on the front of this sheet of paper. Failure to follow these directions will cost you 1 point on the assignment.

We will be meeting during my office hours on Thursday. Come by some time between 4:00 and 5:00 to discuss the previous assignment and the material you are reading.

This assignment covers section 15.3 - through section 16.3.

- 1) (15 points) Explain why $R = \frac{M_s k^* Y^*}{M_s^* k Y}$. In other words, for each variable on the right-hand side except k and k^* , explain the economics as to why a change in that variable causes a change in the exchange rate.
- 2) (20 points) What is meant by absolute PPP? Why should it hold? Why doesn't it hold?
- 3) (30 points) For each variable in the equation $D = f(i, i^*, EA, RP, Y, P, W)$, determine if an increase in it will cause an increase or a decrease in D . Explain your logic.
- 4) (15 points) The figure 15.5 has four frames and shows how an unexpected, one-time, change in the money supply causes interest rates, prices, and the exchange rate to change over time. Take the first three panels as given. Explain why those result in the exchange rate taking that path.
- 5) (20 points) Draw the diagram that has the supply and demand curves for US imports priced in £. Use that diagram to derive either the supply or demand for £. Explain (1) the movements in the first diagram, (2) how those movements relate to the second diagram, and (3) how you know whether you have developed the supply or the demand for £.