

Place your name on the back of this sheet of paper and nowhere else. Staple your answers on the front of this sheet of paper. Failure to follow these directions will cost you 1 point. Your assignment will be typed, except graphs can be drawn by hand and mathematical equations can be done by hand. Failure to type it will cost you 10 points. If you use double-sided printing or print on the back of scrap paper, I will give you one additional point.

- 1) (25 points) Draw the supply and demand for foreign exchange such that they cross at three points. Which of the intersections are stable and which are not stable equilibria? Explain your logic.
- 2) (15 points) Why would you expect that the supply curve for a currency would bend backwards as drawn in Question #1?
- 3) (20 points) State the Marshall-Lerner Condition. Why must both demand curves be very inelastic for the exchange rate to be unstable? (Hint: It may help if you relate it to what we did before the test of deriving the supply curve for currency, but do not re-derive the graph.)
- 4) (25 points) What is the J-curve? Why does it take its shape? What problem might that cause for a flexible exchange rate?
- 5) (15 points) What might the Marshall-Lerner Condition imply about the stability of the exchange rate in the short-run versus in the long-run? Why do you say that?