

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.

1) (10 points) According to the Economist, the inflation rate in Japan has been -0.4% over the past year. In the USA, it has been +1.9%. A year ago, there were ¥120/\$. Given this information, what would you expect the exchange rate to be today. Show all work and briefly explain how you reached your conclusions.

2) (30 points) What is relative PPP? Why would you expect it to hold? Why might it not hold? Make sure you give at least two reasons why it might not hold.

3) (20 points) So far, we have studied two theories as to what determines the exchange rate, interest rate parity and relative purchasing power parity. Which effect is likely to be stronger in the short-run? Why?

4) (20 points) If GDP increases, then what will happen to money demand? If the central bank keeps D constant, then what will happen to F ? How is the disequilibrium self-correcting? For all answers, explain why that event occurs.

5) (20 points) If the central bank increases the domestic component of the monetary base, then what will happen to F ? How does the disequilibrium correct itself? For both answers, explain why the event occurs.