Practice Exam 1

- You have 75 minutes to complete this exam.
- You may use a calculator; you may **not** use any other device (cell phone, etc.)
- You may consult one page of notes (both sides); you may not use books, notebooks, etc.
- Show your work.

I understand that the honor code applies: I will not lie, cheat, or steal to gain an academic advantage, nor tolerate those who do.

Signature

Printed Name

1. [5 pts] Assume that prices are perfectly flexible. The money supply in England (£) is expected to grow at 3% percent per year and the money supply in Canada (CAD) is expected to grow at 7% per year. Each country's real output growth rate is expected to be 2%. What is $d^e_{CAD/£}$, the expected CAD-pound depreciation rate?

2. [5 pts] If the Japanese interest rate is 0.5%, the U.S. interest rate is 2.5% and the expected dollar-yen exchange rate is $E^e_{\$/¥} = 0.01$, what theory could you use to find the spot dollar-yen exchange rate? What is the value of the spot exchange rate according to the theory?

3. [5 pts] Why do we not use purchasing power parity theory in the short-run? Explain your reasoning.

4. [5 pts] The quantity theory of money can be written as $M/P = L(i)Y$. What is the function $L(i)$? Why is $L(i)$ decreasing in i?

Consider a world with two countries, home and foreign. **Assume that prices are sticky in the short run but perfectly flexible in the long run.**

At time T, there is a **temporary decrease in the home money supply**. Assume that nothing in the foreign economy changes and nothing else in the home economy changes.

5. [15 pts] What happens to $E_{H/F}$, the home-foreign spot exchange rate, in both the short- and long-run? Explain your answer using whatever figures and equations you find suitable.

6. [15 pts] Is the short-run exchange rate, $E_{H/F}$, above or below the expected long-run exchange rate? Will it stay this way forever? Explain your answer.

Consider a world with two countries, home and foreign. **Assume that prices are sticky in the short run but perfectly flexible in the long run.**

At time T, there is a **permanent decrease in the home money supply**. Assume that nothing in the foreign economy changes and nothing else in the home economy changes.

7. [15 pts] What happens to $E_{H/F}$, the home-foreign spot exchange rate, in both the short- and long- run? Explain your answer using whatever figures and equations you find suitable.

8. [15 pts] Is the short-run exchange rate $E_{H/F}$ above or below the expected long-run exchange rate? Will it stay this way forever? Explain your answer.

Assume prices are perfectly flexible. Goods and assets are freely traded between Mexico and Spain. The Mexican expected inflation rate is 10% per year and the Spanish expected inflation rate is 5% per year.

9. [10 pts] Which country has the higher expected real interest rate? Explain your answer.

10. [5 pts] Which country do you expect to have the higher nominal interest rate? Explain your answer

11. [5 pts] *Challenging.* Assume the U.S. and Europe are the only countries in the world. Suppose we observe the nominal interest rate in the United States fall and the dollar appreciate. Does the long-run approach (monetary approach) or the short-run approach (asset approach) better explain this phenomenon? Explain your reasoning.

Extra Space

Clearly label the question number, and leave a reference to this page near the question.