Multiple Choice: Choose the best answer. (2 points each, 16 points total)

Please record your multiple choice answers here:

1____            2____            3____            4____            5____            6____           7____          8 _____

MC#1) According to the “Monetary Approach” to exchange rates, if the U.S. has higher money growth than Japan and the same output growth (and same liquidity demand constant), then it will have ________ inflation and a ________ nominal exchange rate (U.S. dollar per Japanese yen)?
   a) higher, rising
   b) higher, falling
   c) lower, rising
   d) lower, falling

MC#2) According to the “Monetary Approach” to exchange rates, what will be happening to the real exchange rate of the U.S. above (measured as U.S. goods per Japanese)?
   a) rising
   b) falling
   c) no change
   d) not enough information to know

MC#3) According to the “Monetary Approach” to exchange rates, if money growth is 2% higher in the U.S. than Japan, and output growth is 5% higher in the U.S. than Japan, then the exchange rate (dollar/yen) should a) rise by 7%.
   b) rise by 3%
   c) rise by 2%
   d) fall by 3%
   e) fall by 7%

MC#4) Which of the following is true about the foreign exchange market:
   a) exchange rates are highly volatile
   b) the market is integrated globally
   c) trading volume is high
   d) the forward rate helps avoid risk
   e) all of the above

MC#5) Suppose the following: you have $1000 in cash, the annual interest rate on a dollar account in the U.S. is 3% and on a pound account in the UK it is 5%, you expect the dollar price of pound (E$_{spd}$) to fall 5% over the next year, and you don’t care about risk or liquidity. In what form should you hold your assets?
   a) dollar account
   b) pound account
   c) you are indifferent between the two
   d) hold on to the cash

MC#6) Absolute purch. power parity holds best:
   a) when prices are sticky
   b) in the long run
   c) when there is no risk premium in the foreign exchange market
   d) when there are large transportation and transaction costs

MC#7) According to the “asset approach to exchange rates,” which of the following could explain the recent sudden currency depreciation in Iran (rise in rial/dollar)?
   a) Rise in Iranian interest rate
   b) Fall in U.S. interest rate
   c) Rise in expected future exchange rate
   d) All of the above

MC#8) According to our theory of money demand, you will want to hold more of your assets in the form of liquid money if the interest rate is ____ and your income is ____.
   a) high, high
   b) low, high
   c) high, low
   d) low, low
**Problem 1: Interest Rate and Purchasing Power Parities** (12 points total, 3 points each)

Suppose that the following conditions all hold: uncovered and covered interest rate parity (no risk premium), real interest rate parity, relative and absolute purchasing power parity. And suppose you read the following information in the newspaper:
- The current nominal interest rate for a one year deposit in an Australian bank is 2% (0.02).
- The current nominal interest rate for a one year deposit in a Malaysian bank is 12% (0.12).
- The current spot exchange rate is 1 Aus dollar / Malaysian ringgit.
- The Australian national bank credibly commits to keep inflation at 1% for the next year.

For each of the following variables, compute the value implied by the information above, or state there is not enough information. If there is an answer, show your work and name which parity conditions you are using to derive the result. (One point each for answer, work, and parity condition.)

a) the one-year forward exchange rate (Aus dollar / Malaysian ringgit).

b) expected future spot exchange rate for one year in the future (Aus dollar / Malaysian ringgit).

c) expected inflation in Malaysia for the year.

d) the real interest rate (ex ante) in Malaysia for the year.
2) The Asset Approach and Exchange Rate Overshooting (20 points)

This question considers the relationship between the Indonesian rupiah and the British pound. Let the exchange rate be defined as rupiahs per pound $E_{rupiah/p}$. Suppose that there is a permanent fall in Indonesian nominal money supply. (Make the usual assumptions: prices are sticky in the short run and flexible in the long run, and that uncovered interest rate parity holds.)

a) (10 points) Illustrate in graphs of the Indonesian money market and the foreign exchange market how this change affects the money and foreign exchange markets. Label your initial equilibrium point A, label the short-run equilibrium point B, and your long-run equilibrium point C. (You can put short run and long run on the same graphs.) Label all axes, and indicate curve shifts with arrows. (No explanations required.)

b) (6 points) Using set of time diagrams (time on the bottom axis), illustrate how the following variables change over time: exchange rate $E_{rupiah/p}$, Indonesian interest rate, and real exchange rate $q_{Indonesia/UK}$ (Indonesia goods per U.K. good). Be sure to indicate clearly the relationships between the initial, short run, and long run values. (No explanations required.)
c) (4 points) Is there any way to make a profit off of your analysis above? If yes, specify what you buy when, and what you sell when. If no, explain why not?