Regrade policy: If you would like your test regraded, please submit a written statement to explain why. Your entire test will be regraded, so there is a possibility that points could be lost not gained.

Multiple Choices:

|   | 1) a | 2) b | 3) c | 4) d | 5) b | 6) a | 7) c | 8) c |

Problem 1: Parity Conditions

a) Use uncovered interest rate parity:
\[ I_y - i_w = \left( E_{y/w}^e - E_{y/w} \right) / E_{y/w} \]
\[ 0.10 = \left( E_{y/w}^e - 10 \right) / 10 \]
\[ E_{y/w}^e = 11 \]
This is a won appreciation over time.

b) Use covered interest rate parity
\[ I_y - i_w = \left( F_{y/w} - E_{y/w} \right) / E_{y/w} \]
\[ 0.10 = \left( F - 10 \right) / 10 \]
\[ F = 11 \]

c) by real interest rate parity, the real interest rate difference is 0.

d) by real relative PPP, the inflation difference equals \( E_{y/w}^e - E_{y/w} \) = (11-10)/10 = 0.1. (This could also be solved by real interest rate parity)

e) PPP implies the real exchange rate is 1.0.

Problem 2: Monetary Approach

\[ \% \Delta E_{rubles/rupee} = \pi_{Russia} - \pi_{India} = (\mu_{Russia} - \mu_{India}) - (g_{Russia} - g_{India}) \]

a) \( (10\% - 2\%) - (0 - 0) = 8\% \)
Prices will rise 10% in Russia and 2% in India.

\[ \% \Delta E_{peso/real} = \pi_{Argentina} - \pi_{Brazil} = (\mu_{Argentina} - \mu_{Brazil}) - (g_{Argentina} - g_{Brazil}) \]

b) \( (5\% - 3\%) - (8\% - 3\%) = -3\% \)
Prices will fall 3% in Argentina and not change at all in Brazil.

c) Assumptions: 1) prices are flexible; 2) Purchasing Power Parity holds.

Problem 3: Overshooting

a,b) See next page.

c) The line for the exchange rate under the “flexible price case” rises immediately in the short run to its long run level (which is the same as the long-run level for the sticky price case), and it stays constant at this level over the time shown in the graph.

(10/18/07)
permanent fall in US money supply.

Short run ①

$M_S \downarrow \rightarrow MS$ curve shift left $\rightarrow \text{i rise to } i^2 \rightarrow DR$ curve shift up

$\rightarrow E_{t+p}^0 \text{ fall} \quad \rightarrow FR$ curve shift down

Taken together, $E_{t+p}^0$ fall a lot to $E^3$

Long run ②

$P \downarrow \rightarrow MS$ curve return to original position $\rightarrow \text{i returns to } i' \rightarrow DR$ curve shift back

Thus, $E_{t+p}^0$ moves to $E^3$ in between $E^2$ & $E^4$

(b), (c)