Economics 222
Exercise D – Answer Key

1. (a) The future nominal exchange rate will be 0.7.

(b) Expected inflation must be 1.5% higher in Canada than in France.

(c) The real exchange rate is expected to rise by 1.5%.

2. (a) $e = 170$ and $NX = -25$.

(b) $e = 140$ and $NX = -10$.

(c) In the short run, M falls to 850, while Y falls to 875. In the IS-LM-FE diagram, the LM curve shifts up and to the left and the IS curve shifts down and to the left to a new short run equilibrium with lower Y but the same r.

(d) A flexible exchange rate is better in this case. When e is flexible, the fall in e and the resulting increase in NX exactly offset the fall in G.

3. (a) The fundamental value is $0.035 < 0.04$. The bhat is overvalued.

(b) The fundamental value falls to 0.027. Excess supply in the market will rise, putting increasing pressure on the government's supply of foreign reserves.

(c) Restricting transactions of domestic currency reduces access to foreign goods and credit, and is harmful to trade and foreign investment.

5. (a) $e = 90$ and $NX = -35$.

(b) $e = e_{nom} = 82$, $NX = -29$ and $Y = 320$.

(c) $e = 90$ and $e_{nom} = 90/1.087 = 82.8$.

6. (a) $\pi_t = 8.5\%$ and $\pi_{t+1} = 9.5\%$.

(b) $\pi_t = 8.5\%$ and $\pi_{t+1} = 9\%$.

(c) The government would prefer a low value for a. The more slowly inflationary expectations adjust, the less inflation needs to rise in period $t + 1$ to maintain the low unemployment rate.