1) Every week the Federal Reserve announces how quickly the money supply grew in the week ending
ten days previously (http://www.federalreserve.gov/releases/h6/Current/). There is a ten-day delay
because it takes that long to assemble data on bank deposits. Economists have noticed that when
the announced increase in the money supply is greater than expected, nominal interest rates rise just
after the announcement; and they fall when the market learns that the money supply grew more
slowly than expected. Two competing explanations of this phenomenon are:
(a) unexpectedly high money growth raises expected inflation and thus raises nominal interest rate
through the Fisher effect;
(b) unexpectedly high money growth leads the market to expect future Fed action to reduce the
money supply.
How would you use data from the foreign exchange market to decide between these two
hypotheses?

2) Between 1999 and 2001 the euro depreciated by 25% against the US dollar, the dollar then
depreciated against the euro by over 50% from 2002 through 2004. The decline in the value of the
dollar, however, did not produce a corresponding decline in the US current account deficit. Indeed
the US current account deficit continued to increase through 2006. Economists describe this initial
negative reaction of the current account to a depreciation of the home currency as the J-curve effect.
(a) How would you draw the DD-AA diagram when the current account's response to exchange
rate changes follows a J-curve?
(b) Use this modified diagram to examine the effects of a temporary change in fiscal and monetary
policy on the nominal exchange rate and output.
(c) How will permanent shifts in fiscal and monetary policy affect the nominal exchange rate and
output in the presence of a J-curve effect?

3) Explain why temporary and permanent fiscal expansions do not have different effects under fixed
exchange rates, as they do under floating rates.

4) Suppose the Bank of Japan (BOJ) wants to decrease the value of the yen relative to the US
Dollar. How might the BOJ intervene in the foreign exchange market to accomplish this? If the
BOJ wants to leave the Japanese money supply unchanged by the foreign exchange market
intervention, how will the BOJ conduct the operation? Describe intuitively and graphically how
such a yen-weakening sterilized intervention operation will ultimately influence the dollar/yen
exchange rate.

5) If domestic-currency denominated assets are imperfect substitutes for foreign-currency
denominated assets, then is it possible for a central bank to alter the domestic interest rate, while
holding the exchange rate fixed? Explain.