FX markets

<u>Complete the following tasks on separate sheets of paper.</u>

1. Draw correctly labeled graphs of the foreign exchange market for € in terms of US$ and, next to it, for US$ in terms of €. Assume a starting exchange rate of $1.25 per € and 0.80€ per US$.

2. Explain how S&D and the equilibrium exchange rate would be affected by the following changes.

   a. The income of workers in the US increases
   b. The Fed decreases US interest rates to stimulate the economy
   c. The US launches a major tourism advertising campaign in Europe
   d. The ECB raises interest rates to their highest levels ever and commits to keeping them high until inflation falls
   e. Economists forecast the US dollar will continue to rise over the next year
   f. Inflation falls faster in the US than in Europe
   g. Europe recovers faster that the US from the recession
   h. A fad for Italian fashion sweeps the US

3. Assume that the U.S. and Japan operate under a flexible exchange rate system and that the interest rate in both nations is the same.

   I. Using a correctly labeled graph of the FX market for yen, indicate the equilibrium exchange rate of the yen in terms of the dollar.

   II. If the Federal Reserve sells bonds on the open market:

      a. Explain how this will affect interest rates.

      b. Indicate on the graph how the change in the interest rates will affect the value of the yen.

      c. How will imports of U.S. products by the Japanese be affected?