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. All regrade requests must be submitted within one week of exams first being returned.

Multiple Choice:
Version A: 1) c 2) a 3) b 4) c 5) a 6) d 7) a 8) d 9) a 10) b
Version B: 1) b 2) c 3) a 4) d 5) b 6) c 7) c 8) d 9) d 10) a
Version C: 1) a 2) b 3) c 4) b 5) d 6) a 7) b 8) c 9) b 10) c

Question 1:
a) Using UIP: \((E_e^{\$/peso} - E_{$/peso})/ E_{$/peso} = i_\$/peso - i_{peso} = 2\% - 4\% = -2\%\)
b) Using RPPP: \((E_e^{\$/peso} - E_{$/peso})/ E_{$/peso} = \Pi^{\$/US} - \Pi^{\$/Mex} = 2\% - 1\% = 1\%\)
RPPP says the real exchange rate is constant at some value:
c) Using CIP together with UIP, F = E^e, so \((E^e - E)/E = (F-E)/E = 3\%\)

Version A: 11) b 12) b 13) d 14) d 15) c 16) c 17) a
Version B: 11) a 12) c 13) e 14) a 15) a 16) b 17) b
Version C: 11) d 12) a 13) b 14) d 15) c 16) a 17) b

Question 2:
a) Borrow dollars now at 4% interest, convert them to yuan at the current spot exchange rate, and invest them in a Chinese yuan account for one year. Also make a forward arrangement now to convert these yuan back to dollars a year from now (at rate 1/8 dollars per yuan). A year from now withdraw your yuan from the Chinese account and execute the forward transaction you set up at the beginning.

While it is not required in the question to compute your profit, it is easy to compute. You should borrow as many dollars as the bank allows you, say X$. So you will purchase 10X yuan in the foreign exchange market. At the end of the year you will have 1.03 x 10X yuan. After you execute the forward contract you will have 1.03 x 10 /8X dollars. And after you repay your U.S. loan, you will have profit left over in the amount of:
\((1.03 x 10 /8 - 1.04)X = 0.25X\).
b) This profit opportunity represents a failure in covered interest rate parity (1 point). It can occur if a country uses capital controls to prevent people from taking advantage of the profit opportunity. (Note that there is no exchange rate risk premium here since the forward rate eliminates uncertainty about future exchange rates.)

Question 3:
The rise in money demand for any given interest rate shifts the real money demand curve right. The foreign returns curve shifts left in the short run and long run because the monetary approach says a rise in home real money demand lowers the expected future exchange rate \((E_{$/peso}^{fut})\) for all future periods (higher value of the dollar), which lowers the expected foreign returns curve for any given current exchange rate level.
The real money supply line shifts right in the long run, because the price level falls in the long run, raises the real value of the given nominal money supply.

Note: $E$ overshoots in the short run compared to its long run value; and the long run value differs from the initial value. In contrast, the real exchange rate returns in the long run to its initial value. This is because $q = \frac{E_{P_{UK}}}{P_{US}}$, and the percentage fall in $E$ and $P_{US}$ in the long run are the same, thus canceling out.

**Question 4:**
The monetary approach in percent change form (this is the version that includes inflation rates):

\[
\text{(% dollar depreciation)} = \text{U.S. inflation rate} - \text{foreign inflation rate} \\
= (\text{U.S. money supply growth rate} - \text{foreign money supply growth rate})
\]
If a country fixes its exchange rate to the dollar, then the % dollar appreciation in the equation above is zero, and the equation implies that foreign inflation equals U.S. inflation. In other words, if the U.S. increases its money supply, this requires that the foreign country increase its money supply at the same rate (when there is no change in money demand growth rates).

The foreign inflation can be stopped very simply if the country holds its money supply constant. But the equation above indicates this requires that the % dollar deprecation be positive, that is, the foreign currency rises in value. So it requires that the country abandon its commitment to a fixed exchange rate.

So both statements are correct. As for who is the cause of the problem, U.S. inflation or Chinese exchange rate policy, this is debatable. On one hand, maybe the U.S. should take into consideration the effect its monetary policy has on countries pegging to it; on the other hand, whether to peg or not is a choice for which the pegging country is responsible.