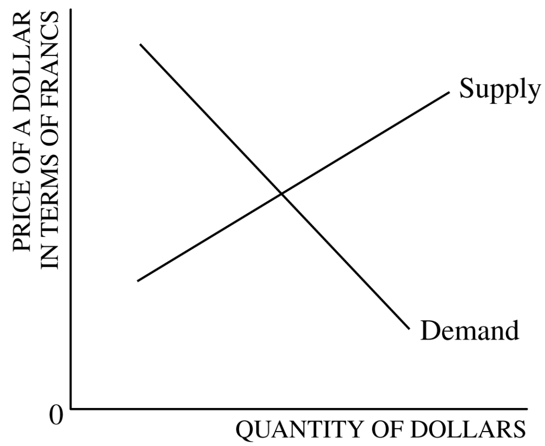
2. Assume that the United States and France are the only two countries in the world and that exchange rates between the two countries are flexible.



(a) Assume that there is an increase in the United States demand for French goods. Explain how this increase in demand will affect each of the following.

(i) The supply of dollars

(ii) The international value of the dollar

(b) Assume that there is an increase in real interest rates in the United States, but not in France. Explain how this increase in interest rates will affect each of the following.

(i) The international value of the dollar in the foreign exchange market

(ii) The quantity of dollars supplied in the foreign exchange market

3. Assume an economy with no international sector.

(a) Using a correctly labeled money-market graph, show how a decrease in the money supply will affect interest rates.

(b) Explain how the change in the interest rate you identified in part (a) will directly affect each of the three components of aggregate demand for this closed economy.

(c) Using a correctly labeled aggregate demand and aggregate supply graph, show how the change in the interest rate you identified in part (a) will affect each of the following in the short run.

(i) Output

(ii) Price level

END OF EXAMINATION