2. A movement toward a unified monetary policy within the European Union has led to an increase in real interest rates in member countries, but not in the United States. Explain how this increase in real interest rates will affect each of the following.

   (a) Purchases of United States financial assets by foreigners
   (b) The international value of the United States dollar
   (c) United States exports
   (d) United States imports

3. Janet Smith deposits $1,000 of her cash holdings in her checking account at First Federal Bank. The reserve requirement is 20 percent and the bank has no excess reserves.

   (a) What is the immediate effect of her deposit on the money supply? Explain why.
   (b) What is the maximum amount of money First Federal can initially loan out? Explain how you determined this amount.
   (c) What is the maximum amount of money the entire banking system can create? Explain how you determined this amount.
   (d) Give one reason why the money supply may not increase by the amount you identified in (c).

END OF EXAMINATION

Question 2

Correct answer:

Foreigners will increase their purchases of the higher-yielding European Union assets and reduce their purchases of U.S. financial assets. As a result, there will be a reduced demand for the U.S. dollar, and the dollar will depreciate. (Alternatively, there is an increased supply of dollars to purchase EUROs, appreciating the EURO and depreciating the dollar.) With the depreciation of the dollar, U.S. exports will increase as they will now be less expensive in the European markets. U.S. imports will decrease as they become more expensive.

1+1+1+1= 4 points

(a) **1 point** With relatively higher real interest rates in Europe (relatively lower real interest rates in the U.S.) there will be **fewer purchases** (less demand) *for U.S. financial assets.*

(b) **1 point** The **dollar depreciates** because of the **reduced demand for U.S**. **dollars** (or increased supply of dollars to buy EUROs).

- Must have dollar depreciation linked to the decreased demand for $ (or increased supply of dollars to buy EUROs). **(NO Assertions Accepted)**

For parts (c) and (d):

Even if (b) is incorrect, students may earn points in (c) and (d) for consistency.

(c) **1 point** U.S. exports **increase**, because **they are now less expensive** to foreigners.

- Must give an explanation beyond the “change in the value of the dollar”
- Explanation **must reflect the relative price effect** caused by the change in the value of the dollar. Acceptable arguments include:
  - American goods have become **relatively inexpensive**.
  - American goods **cost less** than European goods.
  - American goods **are relatively more affordable** than European goods.
  - American goods **are cheaper** than European goods.
- explanations *not accepted*:
  - **Weak currency**
  - **Depreciated dollar**

Question 2 (cont.)

(d) **1 point** U.S. **imports** decrease because **foreign goods are now more expensive.**

- Must give an explanation beyond the "change in the value of the dollar".
- Explanation **must reflect the relative price effect** caused by the change in the value of the dollar. Acceptable arguments include:
  - European goods have become **relatively more expensive**.
  - European goods now **cost more** than American goods.
  - European goods **are now relatively less affordable** than American goods.
  - American goods **are cheaper** than European goods.
- explanations *not accepted*:
  - **Weak currency**
  - **Depreciated dollar**