Chapter 15: Questions 4, 6, 9, 10, 13;

4. The theory of purchasing power parity states that exchange rates between any two currencies will adjust to reflect changes in the price levels of the two countries. If one country’s price level rises relative to another’s, its currency should depreciate (the other country’s currency should appreciate). This theory predicts that the value of the yen will fall 5% in terms of dollars.

6. If one country becomes more productive than other countries, businesses in that country can lower the prices of domestic goods relative to foreign goods and still earn a profit. As a result, the demand for domestic goods rises, and the domestic currency tends to appreciate. Even though the Japanese price level rose relative to the American, the yen appreciated because the increase in Japanese productivity relative to American productivity made it possible for the Japanese to continue to sell their goods at a profit at a high value of the yen.

9. The Indian rupee will appreciate. The announcement of tariffs will raise the expected future exchange rate for the rupee and so increase the expected appreciation of the rupee. This means that the demand for rupee-denominated assets will increase, shifting the demand curve to the right, and the rupee exchange rate therefore rises. (You should draw a graph similar to 15.6.)

10. The dollar will depreciate. A rise in nominal interest rates but a decline in the real rate implies a rise in expected inflation that produces an expected depreciation of the dollar that is larger than the increase in the domestic interest rate. As a result, the expected return on dollar assets falls at any exchange rate, shifting the demand curve to the left and leading to a fall in the exchange rate. Your graph should look like the graphs in this animated graph.

13. The dollar will depreciate. The drop of expected inflation in Europe, which leads to a decline in the foreign interest rate (which is smaller than the drop in expected inflation), leads to a decline in the relative expected return on dollar assets, because the expected euro appreciation is greater than the decline in the foreign interest rate. The result of the decline in the relative expected return on dollar assets, a leftward shift of the demand curve and the equilibrium U.S. exchange rate falls. This question leads to the same result as in problem 13 except that in this case, the increase in the relative expected return on foreign assets is the result of a drop in expected inflation in Europe rather than an increase in expected inflation at home (like in problem 10). Note that you get the same result any time the movement in the relative expected return is the same, regardless of the source of that