Question 1 (40%)

The equilibrium in the money market and the foreign exchange market, respectively, is given by the following two equations:

(1) $\frac{M^S}{P} = L(R,Y)$

(2) $R = R^* + \frac{E^e - E}{E}$

The notation is as explained in the textbook and the lecture notes.

a) Explain the two equations, show the equilibria graphically, give economic intuition behind the slopes of all curves involved, and explain how the two markets reach their equilibria.
b) Analyze how a temporary expansionary monetary policy influences the interest rate and the exchange rate and discuss factors that affect the size of the effects.
c) Explain how the equilibrium in the money market and the foreign exchange market generates a relationship between output and the exchange rate (known as the AA-curve). Give economic intuition behind the slope of the AA-curve.
d) How does an increase in the expected exchange rate affect the AA-curve? Explain the economic intuition and illustrate graphically.

Question 2 (60%)

Use a two-country model to discuss how asymmetric demand shocks can be a challenge in a monetary union.