ECO 102: Introduction to Macroeconomics
Problem Set #6
Lectures 11 & 12
Due Date: 14 August, 11AM
Total Points: 30

Problem 1: Exchange Rates [20 Points]

Suppose that there are only two countries in the world: Localia (which is us), that uses the "Localios" (LCL) as its currency, and Nearovia (our trading partner), which uses "Nearos" (NER) as its currency. For questions 1-3, assume that this exchange rate between the NER and the LCL is flexible.

Now consider the Supply & Demand market for domestic Localios. Suppose also that the Central Bank cuts interest rates at home in Localia.

1. What would we expect to happen to the exchange rate for LCL as a result of this rate cut? Explain using the Supply and Demand Figure for LCL and explain why any movements of any of the curves occur. [3 points]