With the construction of the complete IS-LM model, we now have at our disposal a simple and coherent model of the economy. More importantly, we have a model in which to pose various economic and policy questions and receive clear and mostly unambiguous answers.

In section IV of the course, we look more closely at the microfoundations of aggregate-demand. We start by looking at international trade and the determination of the real exchange rate. First, we distinguish between the different types of exchange rates. Second, we investigate how the exchange rate is determined both in the long-run and the short-run. Third, we examine the effect of expectations on the exchange rate and the implications on a fixed exchange rate system like the European Monetary Union.

The required readings in this section is chapter 14 from *Macroeconomics* by Olivier J. Blanchard, “Pennies from Hell” in *The Economist* (which are both distributed in class) and “The Euro after Two Years” by Jean-Claude Trichet (which is posted at the website). While you read the material, keep in mind the following questions:

1. What is the difference between the value of the dollar and the value of the yen? What is the difference between the nominal and real exchange rates?

2. The purchasing power parity (PPP) condition is based upon what law in economics. The condition implies that the nominal exchange rate must equal what in the long-run?

3. According to the interest rate parity (IRP) condition, what is the relationship between the dollar return on U.S. bonds and the dollar return on German bonds? How is this relationship expressed algebraically in equation (14.2)?

4. According to the interest rate parity (IRP) condition, what determines the current exchange rate? What role does the U.S. and German monetary policies play?

5. In a fixed exchange rate system, like the Bretton Woods system or the exchange rate mechanism (ERM) of Europe, how do two countries fix or peg their exchange rate?

6. How does speculation (or expectations) of a devaluation cause an exchange rate crisis? Is this speculation necessarily bad? Can a coordinated monetary policy prevent such a crisis? Ultimately, what kind of fixed exchange rate system can overcome the instability?

7. According to Trichet, why has the launch of the euro been “an indisputable success”? How then is the euro serving as a catalyst for further change?