1. (2 points) Traders in asset markets suddenly learn that the interest rate on dollars will decline in the near future. Use the diagrammatic analysis in Chapter 13 to determine the effects of the current dollar/euro exchange rate, assuming current interest rates on dollar and euro deposits do not change.

2. (2 points) Suppose the European Central Bank (ECB) does not like the movements in the dollar/euro exchange rate in Question 1. What can the ECB do to undo the movements in Question 1? Explain using a diagram.

3. (2 points) Imagine that everyone in the world pays a tax of $\tau$ percent on interest earnings and on any capital gains due to exchange rate changes. How would such a tax alter the analysis of the interest parity condition? How does the answer change if the tax applies to interest earnings but not to capital gains, which are untaxed?

4. (2 points) What is the short-run effect on the exchange rate of an unexpected increase in domestic real GNP, given expectations about future exchange rates? Discuss using a diagram displaying foreign exchange market and money market.

5. (2 points) Suppose the central bank dislikes the movements in exchange rate in Question 4. What kind of monetary policy can the central bank implement in the short-run in order to remove the exchange change movements? Explain using a diagram.