1. (2 points) The dollar-euro exchange rates are freely determined in foreign exchange market. Suppose that the Federal Reserve is expected to lower nominal interest rate next month. Use the IS-LM-FX model to illustrate the effects of such expectations on the following variables today: output (Y), nominal interest rate (i), exchange rate (E), investment (I) and trade balance.

2. (2 points) Suppose that the U.S. government respond to the shock in Question 1 by using fiscal policy to stabilize output. Use the IS-LM-FX model to illustrate the effects of the fiscal policy response on output (Y), nominal interest rate (i), exchange rate (E), investment (I) and trade balance (TB).

3. (2 points) Suppose the European Central Bank (ECB) dislikes the effect of the shock in Question 1 on exchange rate and has a goal to stabilize exchange rate. In other words, the ECB attempts to fix exchange rate at the level before market participants change expectations about future interest rate in the U.S. Use the IS-LM-FX model to explain how the ECB will achieve its goal. What kind of foreign exchange market intervention is necessary? What are the effects of foreign exchange market intervention on foreign exchange reserves and monetary base of the ECB?

4. (2 points) What is the N-1 problem of the gold exchange standard, such as the Bretton Woods system? Is there N-1 problem under the gold standard during 1870-1913?

5. (2 points) Use the Trilemma in international finance to explain the breakdown of the Bretton Woods system during 1971-1973.