1. Clearly and accurately draw and label a diagram of the Foreign Exchange Market.

2. Provide an economic explanation of the shape of the curve(s) in your diagram in #1.

The supply of the domestic currency curve represents domestic residents supply of the domestic currency to the foreign exchange market in exchange for foreign currency in order to buy foreign currency denominated goods, services, and assets. When the exchange rate rises, each unit of the domestic currency will buy more units of the foreign currency—alternatively, the foreign currency has become cheaper to domestic residents and foreign currency denominated goods, services, and assets are less expensive. This increases the demand for the foreign currency by domestic residents (which is also the supply of the domestic currency in the foreign exchange market).

The demand for the domestic currency represents foreign residents demand for the domestic currency in the foreign exchange market in exchange their own (foreign) currency in order to buy domestic currency denominated goods, services, and assets. When the exchange rate rises, each unit of the domestic currency will cost more units of the foreign currency—alternatively, the domestic currency has become more expensive to foreigner residents and domestic currency denominated goods, services, and assets are more expensive. This decreases the demand for the domestic currency by foreigner residents (which is also the supply of foreign currency in the foreign exchange market).
3. List the variables (and the direction of their change) that would shift the demand for the currency curve to the right.
   
   a. An increase in foreign output, $Y_{FOR}$.
   
   b. A decrease in the foreign real interest rate, $r_{FOR}$.
   
   c. An increase in the domestic real interest rate, $r$.
   
   d. A shift in rest of world demand towards domestic goods, services, or assets.

4. List the variables (and the direction of their change) that would shift the supply of the currency curve to the right.

   a. An increase in domestic output, $Y$.
   
   b. A decrease in the domestic real interest rate, $r$.
   
   c. An increase in the foreign real interest rate, $r_{FOR}$.
   
   d. A shift in domestic demand toward foreign goods, services, or assets.

5. Assume that the foreign exchange market is in equilibrium with flexible exchange rates. Now suppose that the foreign real interest rate decreases. Describe the adjustment process that takes place in the foreign exchange market as the exchange rate moves to its new equilibrium level.

   If the foreign real interest rate decreases, foreign assets become less attractive for both domestic and foreign residents.

   This will increase the demand for the domestic currency, shifting the demand curve to the right, because foreign residents would rather invest in the relatively higher yielding domestic assets.

   This will also decrease the supply of the domestic currency, shifting the currency supply curve to the left, because domestic residents would rather invest in relatively higher yielding domestic assets.

   After these changes have occurred, the quantity demanded of the domestic currency is greater than the quantity supply of the domestic currency at the initial exchange rate. This excess demand will cause the domestic currency to appreciate and the foreign currency to depreciate.