

3. Italy and Japan are trading partners and have flexible exchange rates. The Italian currency is the euro and the Japanese currency is the yen.
- (a) Suppose that the exchange rate between the euro and the yen is 1 euro = 100 yen. What is the price of an Italian coat in yen if the coat costs 120 euros in Italy?
- (b) Assume that real interest rates increase in Japan. Identify what will happen to net financial capital flows between Italy and Japan.
- (c) Draw a correctly labeled graph of the foreign exchange market for the yen and show the effect of the increase in real interest rates in Japan on the value of the yen.
- (d) Based solely on the change in the exchange rate identified in part (c), what will happen to Italy's exports to Japan? Explain.

Begin your response to this question at the top of a new page in the separate Free Response booklet and fill in the appropriate circle at the top of each page to indicate the question number.

STOP

END OF EXAM