

The extra credit consists of 3 parts. To obtain full credit you must do the 3 parts.

1. Graph the exchange rate between the US dollar and the currencies of Libya and Egypt around the time of the recent socio-political instability. Provide an explanation for the exchange rate behavior.
2. Monetary model of exchange rate determination.
 - a. Choose a currency from anyone country.
 - b. Obtain data on the exchange rate between the US dollar and the currency you selected in a.
 - c. Obtain data on the money supply for the US and the country from which you selected the currency.
 - d. Obtain data on interest rates in the US and the other country.
 - e. Run the following regression:

$$\ln e = \alpha_0 + \frac{\ln M_{usa}}{\ln M_f} + \frac{i_{usa}}{i_f}$$

Where $\ln e$ is the natural logarithm of the exchange rate, $\ln M_{usa}$ is the natural logarithm of the money supply for the US, $\ln M_f$ is the natural logarithm of the money supply for the foreign country, i_{usa} is the interest rate in the US and i_f is the interest rate for the foreign country.

- d. Discuss your results.
3. On October 22, 2008 the Federal Reserve released the following statement:

Press Release

FEDERAL RESERVE press release



Release Date: October 22, 2008

For release at 10:00 a.m. EDT

The Federal Reserve Board on Wednesday announced that it will alter the formula used to determine the interest rate paid to depository institutions on excess balances.

Previously, the rate on excess balances had been set as the lowest federal funds rate target established by the Federal Open Market Committee (FOMC) in effect during the reserve maintenance period minus 75 basis points. Under the new formula, the rate on excess balances will be set equal to the lowest FOMC target rate in effect during the reserve maintenance period less 35 basis points. This change will become effective for the maintenance periods beginning Thursday, October 23.

The Board judged that a narrower spread between the target funds rate and the rate on excess balances at this time would help foster trading in the funds market at rates closer to the target rate. The Board will continue to evaluate the appropriate setting of the rate on excess balances in light of evolving market conditions and make further adjustments as needed.

- a. Provide a clear interpretation of the statement, what does it mean? (you may want to draw a graph of the market for federal funds)
- b. Discuss the appropriateness of this measure given the current economic conditions in the US. Does it make sense?