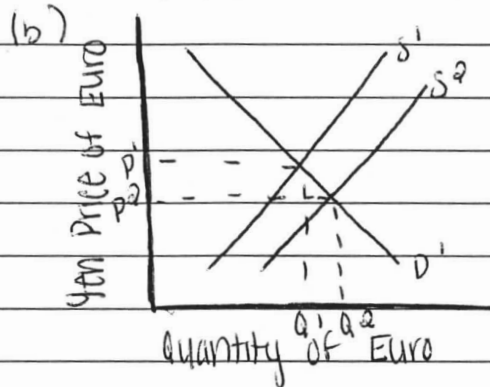


ANSWER PAGE FOR QUESTION 3

(a) i. Real Interest Rates in the short run will increase because an increase in government budget deficit spending causes the demand for loanable funds to shift right which ~~causes~~ causes real interest rates to increase.

ii. private domestic investment in plant and equipment, also known as business ~~investment~~ investment spending will decrease because interest rates are increased.



i. The supply of Euro in the foreign exchange market will increase because when real interest rates in Japan increased, people with euro's will want to invest in Japan's financial assets because they will see a higher return. To purchase Japan's financial assets, they will demand Yen from the foreign exchange market, leaving behind euro.

(c) The European Central Bank should buy euros in the foreign exchange market to reverse the change in the yen price of the Euro.

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