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.

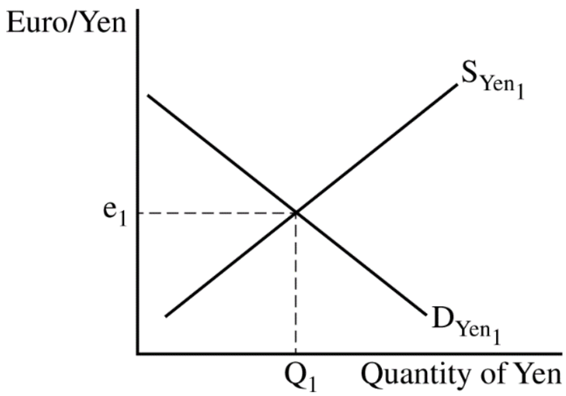
Begin your response to this question at the top of a new page in the separate Free Response booklet and fill in the appropriate circle at the top of each page to indicate the question number.

Question 3: Short — 5 points

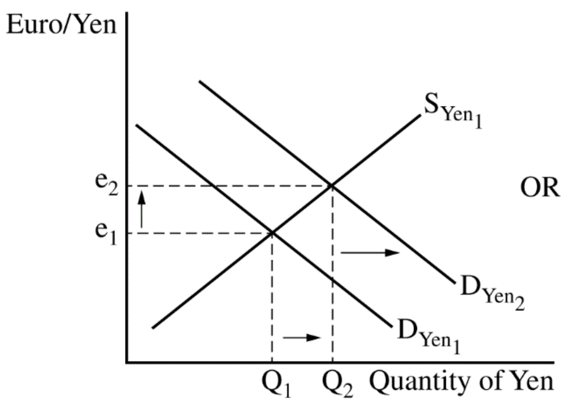
(a) State that the price of the coat is 12,000 yen. **1 point**

(b) State that net financial capital flows from Italy to Japan will increase. **1 point**

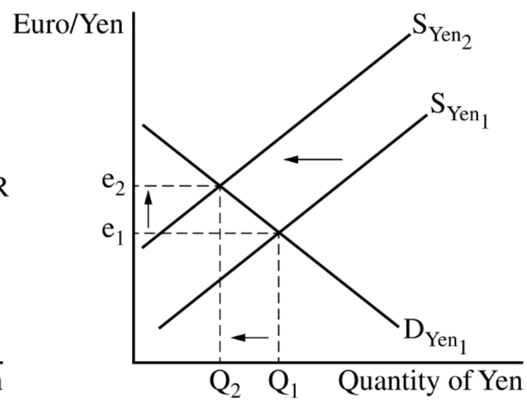
(c) Draw a correctly labeled graph of the foreign exchange market for the Japanese yen. **1 point**



For the second point, the graph must show a rightward shift in the demand curve for yen (or a leftward shift in the supply curve of yen), resulting in an appreciation of the yen. **1 point**



OR



Total for part (c) — 2 points

(d) State that Italy's exports will increase and explain that the appreciation of the yen makes Italian goods relatively less expensive than Japanese goods and/or makes Japanese goods relatively more expensive than Italian goods. **1 point**

Total for question 3 — 5 points