1. Assume that the exchange rate between the U.S. dollar ($) and the Mexican peso (P) is pegged by Mexico at $1/P4. Assume that, initially, this exchange rate corresponds to equilibrium in the foreign exchange market.
   a. Illustrate the initial situation in the dollar-peso foreign exchange. Label your graph carefully.
   b. The United States now undertakes an economic policy that puts upward pressure on the interest rate on dollar-denominated deposits. Mexico follows an economic policy that puts downward pressure on the interest rate on peso-denominated deposits. Explain and illustrate the effects of the two countries policies in the foreign exchange market graph above. If the exchange rate between the peso and the dollar had been flexible rather than fixed, what would have tended to happen? Why?
   c. If Mexico maintains its commitment to hold the exchange rate at $1/P4, what actions must the Mexican central bank take? Explain.
   d. If the United States and Mexico continue to follow the economics policies outlined above, how might participants in the foreign exchange market adjust their expectations of the future dollar price of the peso? What effect would this have on the foreign exchange market? Would it make the Mexican central bank’s job easier or more difficult? Why?

2. Many arguments are made in support of barriers to trade. One such argument is that in the case of externalities.
   a. What are externalities?
   b. Provide an example of a positive production externality.
   c. In this case, how are barriers beneficial to the domestic economy?
   d. Is there a better option? Explain.

3. Define the different types of foreign direct investment. What causes each to arise. How does each relate to trade?

Suggestions for the test (same as before):
Definitions (in your own words is fine – probably better)
Diagrams – be able to draw any
Understand how each model fits into the overall picture

Literature – about half of the exam.
  What is the question?
  How do they answer it?
  What do they find?