I. The increase in domestic money shifts M/P downward to (M/P)'. The domestic interest rate falls to R’. and the equilibrium exchange rate rises to E₁.

II. Monetary neutrality requires that the increase in money be accompanied by an increase in price in the long run. And an increase in price requires an increase in the exchange rate in the long run, also by monetary neutrality. Therefore, today’s expectation of the long-run exchange rate increases. The increase in E requires an increase in the exchange rate further to E₂.

III. In the long-run, monetary neutrality implies that the price level rises proportionately to the increase in the money supply so that M/P shifts back to its original position. The interest rate returns to its original value. The expected exchange rate in the long-run remains at the higher level created by the increase in M and P. The long-run value of the exchange rate is E₃. Since the exchange rate rises more in the short run than in the long run, we say that it overshoots its long-run value.
I. The increase in foreign money reduces R*, shifting R*+(E^e-E)/E left. The equilibrium exchange rate falls to E1.

II. By monetary neutrality, the increase in the foreign money supply increases the foreign price level and reduces the exchange rate in the long-run. Therefore E^e falls. The fall in E^e shifts the foreign return further left to (R*+(E^e-E)/E)’’. The exchange rate falls further to E2.

III. In the long run the foreign price level increases, reducing real foreign money back to its previous level. The foreign interest rate returns to its previous level. The expected future exchange rate remains lower. Together these changes shift the foreign return rightwards of its position at (R*+(E^e-E)/E)’’. We do not know exactly how large the shift is, but we do know that the exchange rate rises from E2. If the shift is to (R*+(E^e-E)/E)’, then the long-run exchange rate is E1. The short-run exchange rate overshoots its long-run since the short-run value is lower than the long-run value.
13. The increase in domestic output raises money demand, shifting L to L'. The equilibrium domestic interest rate rises to R'. The equilibrium exchange rate falls to E₁.