Problem Set 4

1. (Chap 17). Suppose the economy starts from the long run equilibrium with output equal to the full-employment output level. Suppose there is a permanent fall in world demand for a country's output (which also reduces the relative demand of home-produced goods to that of foreign-produced goods).

(a) What is the effect on the output of the home economy and the exchange rate of the home currency in the short run and the long run?

(b) What government policy response would you recommend?

Hints: Compare this with a permanent decrease in government spending.

2. (Chap 17). A new government is elected and announces that once it is inaugurated, it will increase money supply permanently.

(a) Use the DD-AA model to study the economy's response to this announcement. (Hint: the announcement is news about future, so it does not change the current economic conditions)

(b) What is the further effect (short-run and long-run) on the economy when the monetary expansion is actually implemented as promised?

3. (Chap 18). Show how a temporary increase in government spending ultimately affects the central bank's balance sheet under a fixed exchange rate. How are the central bank's transactions in the foreign exchange market reflected in the balance of payments accounts? Assume that the current account is constant, and ignore the capital account and statistical discrepancy.

4. (Chap 18).

(a) Explain why temporary and permanent fiscal expansions do not have different effects on output and employment under fixed exchange rates, as they do under floating.

(b) What are the differences in terms of the impact on current account and composition of the aggregate demand between temporary and permanent fiscal expansions under fixed exchange rate regime?

5. (Chap 18).

In a three-country world, a central bank fixes one exchange rate but lets the others float. Can it use monetary policy to affect output? Can it fix both exchange rates?