

Quiz 3: *Use both graphs and a short written explanation to answer each of the questions below. Be clear and precise. Answer below, and on back of page if necessary.*

1. Using Krugman & Obstfeld's AA-DD diagram (and adding an XX curve), show and explain how an increase in government purchases would affect real GDP, the foreign exchange rate, and the current account balance.
2. Using the E-R-M diagram, show how this increase in government spending should affect money demand, domestic interest rates, and the foreign exchange rate.
3. Now suppose that forward exchange markets adjust to the expectation that the increase in government spending is permanent. How would this affect the E-R-M and AA-DD diagrams? How would this affect the effectiveness of the fiscal stimulus?