

Quiz 4: *Use graphs together with 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 and the current account balance if the central bank was committed to maintaining a fixed exchange rate.

2. Using the AA-DD diagram, show and explain how an open-market purchase of domestic bonds would affect the money supply, the balance of payments, and real GDP if the central bank was committed to maintaining a fixed exchange rate.

3. Using the AA-DD diagram together with the E-R-M diagram, show and explain how a sudden, unexpected, and one-time devaluation (an increase in the fixed foreign exchange rate) would affect the current account balance, the balance of payments, real GDP, interest rates, and the money supply.

4. Using the AA-DD diagram together with the E-R-M diagram, show and explain how your results in (3) would be different if (a) the market expected the devaluation, (b) the central bank did not want to devalue, and was willing to defend the currency, and (c) investment demand is a downward-sloping function of the interest rate.