

ECON 463  
Spring 2005

### Quiz 5

Assume that there are two countries, Home and Foreign. Both countries trade with each other; Home's exports to Foreign are a positive function of the price of Foreign's currency, and Home's imports from Foreign are a function of its own income. The same relationships apply, of course, for Foreign.

A. Using the AA-DD model, show the effects on  $Y$  and  $E$  of a tax cut in the Home country, assuming the country follows a bilateral fixed exchange rate regime. Then show the effect of this policy in the HH-FF model, assuming both central banks take responsibility for maintaining fixed exchange rates. Does your answer differ from the single-country case?

B. Using the AA-DD model, show the effects on  $Y$  and  $E$  of a permanent tax cut by the Home country under floating exchange rates. Then show this effect of this policy in the HH-FF model. Does your answer differ from the single-country case?

C. Using only the HH-FF model [under floating rates] explain the effects on  $Y$ ,  $Y^*$ , and  $E$  of both Home and Foreign simultaneously cutting taxes. Does your answer differ from case (B) above?