

The key for ECON 463 Spring 2007 Final Exam is in error in question 2(c). I read the wrong question as I was writing the key.

The question is

2. (20%) Consider two large economies that depend on trade with each other. The Home country is below full employment and the Foreign country is not. Relying on your answers in (1) above, use an HH-FF diagram to explain the following scenarios. What happens to aggregate demand in each country, the balance of payments or the exchange rate between them, and inflation in each?

c) Suppose that both central banks are committed to a bilateral fixed exchange rate, as in the European Union before monetary union. Foreign now decides to engage in expansionary fiscal policy combined with tight monetary policy.

The right answer is:

An expansionary fiscal policy by Foreign combined with a tight monetary policy would increase R^* , reduce E^* , and have an ambiguous effect on Y^* . But you have to remember that Foreign is also trying to have fixed exchange rates, and this would create a BOP surplus for Foreign and a BOP deficit at Home. Foreign would have to buy Home's currency and increase its money supply, while Home would have to sell some of its Foreign currency reserves and reduce its money supply. The HH shifts left, and the FF shifts up in spite of Foreign's intentions. AD falls at Home, and rises in Foreign, though there is some ambiguity introduced by the effects of Foreign's income on Home's exports, and vice-versa. Inflation is likely in Foreign, but deflation is possible at Home.