

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 an open market purchase of domestic government bonds by the Home country's central bank.
- B. If the Home country's central bank is required to use its foreign exchange reserves to compensate for any surplus or deficit in the balance of payments, in order to maintain a fixed exchange rate, what does the AA-DD model predict will be the effect of the open market operation?
- C. Assume instead that the Foreign central bank will take responsibility for the balance of payments in order to keep the exchange rate fixed. Use the HH-FF model to show how the Home country's open market operation will affect aggregate demand in both countries.
- D. If the Home country was in a recession but the Foreign country was not, how would (C) affect inflation in both countries?
- E. Suppose that the exchange rate is now floating. Use the AA-DD and HH-FF models to show how the open market operation in (A) would have a different effect than under the fixed rate cases.