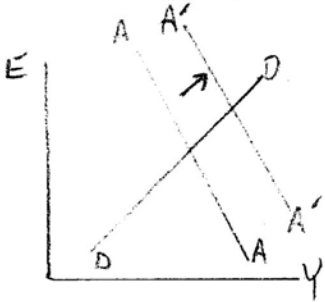


Assume that there are two countries, Home and Foreign. Both countries trade with each other; Home's exports to Foreign are a positive function of the price of Foreign's currency, and Home's imports from Foreign are a function of its own income. The same relationships apply, of course, for Foreign.

- 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.
- 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?
- 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.
- If the Home country was in a recession but the Foreign country was not, how would (C) affect inflation in both countries?
- 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.

3 points

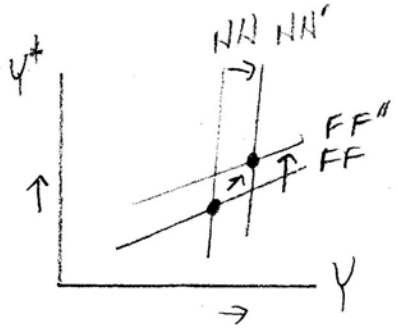


3 points

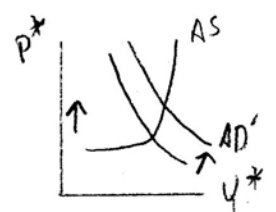
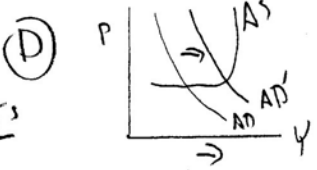
(B) A BOP deficit will result with fixed rates, forcing the HCB to sell Forex reserves. The Money Supply falls back, canceling out the effect.

4 points

(C) Foreign will run a BOP surplus, so FCB will buy Home's currency and $MS^* \uparrow$. AD rises in both countries.



4 points

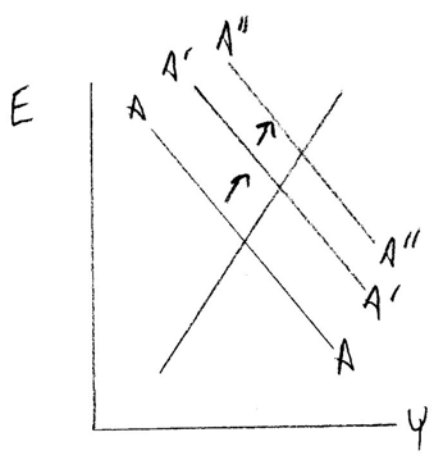


Home would not have much inflation, but Foreign would.

6 points

(E) on back

6 points



MST \uparrow shifts AA out, so $E \uparrow$ and $Y \uparrow$.
 If permanent, $E^e \uparrow$ too to match,
 and AA shifts out again.

In Foreign this reduces demand,
 since $E \uparrow$ means $NX \uparrow$ at Home,
 and $E^* \downarrow$, $NX^* \downarrow$ in Foreign.

Inflation might result
 at Home, but not
 in Foreign.

