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.
MST $\uparrow$ shifts AA out, so $E^c \uparrow$ and $Y \uparrow$.

If permanent, $E^c \uparrow$ too to match, and AA shifts out again.

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

Inflation might result at Home, but not in Foreign.