

Quiz 3: *Use both graphs and a short written explanation to answer each of the questions below. Be clear and precise. Treat each question as independent of the others, though they are clearly all related.*

1. Suppose that a financial crisis in the housing sector reduces the willingness of banks to lend money, reducing the deposit expansion multiplier. At the same time, domestic assets are seen as increasingly risky, so σ (the domestic risk premium) rises. How would these two things affect the E-R-M diagram, and in turn the AA-DD diagram? If your results are ambiguous, explain why.
2. Suppose that a persistent and growing current account deficit leads forex markets to a “Wile E. Coyote” moment, where they suddenly realize that the Dollar’s value is not sustainable. How would a significant rise in E^s affect the E-R-M diagram, and in turn the AA-DD diagram? Will there be any overshooting?
3. Suppose that a significant rise in international oil prices, combined with a depreciation of the domestic currency, leads to a significant rise in the expected rate of inflation. How would this affect the SRAS curve in the AD-AS diagram, and how would this affect real output and the price level?
4. During a recession, suppose the Fed increases the monetary base through open market purchases in the bonds market. At the same time, the Congress decides to provide a temporary tax cut. How would these two interventions affect the AA-DD diagram? Using the E-R-M diagram, how would they affect interest rates and the exchange rate? If your results are ambiguous, explain why. How would these two interventions affect the AD-AS diagram? If the economy were not in recession, how would these two interventions affect the AD-AS diagram?

ANSWER ON ATTACHED PAGES