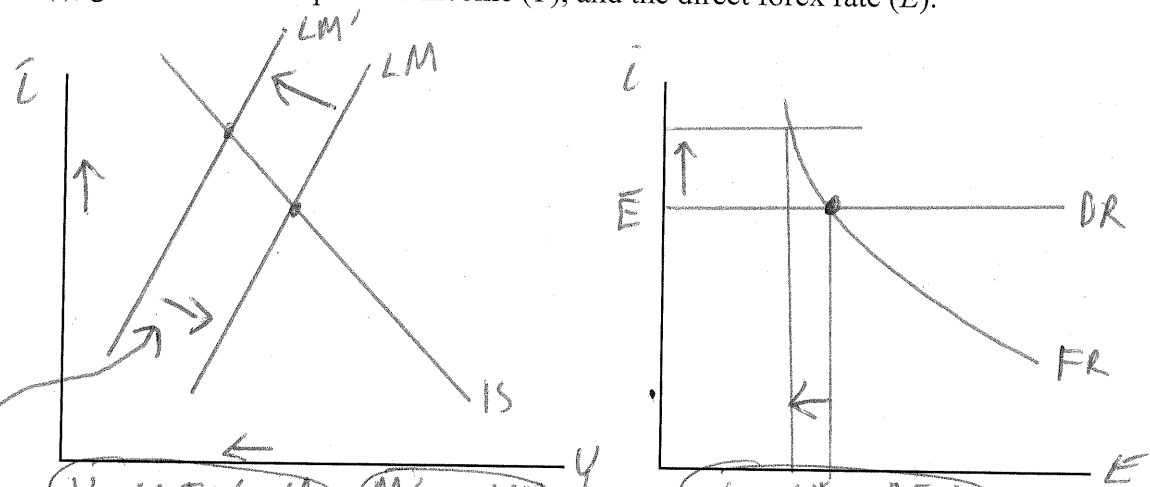


GROUP _____ NAME KEY

1. Use the ISLM-FX diagram to show equilibrium in the product market, money market, and foreign exchange market. Give the equations for each. Then show the effects of a decrease in the deposit expansion multiplier on the money supply (M), the interest rate (i), gross national disposable income (Y), and the direct forex rate (E).

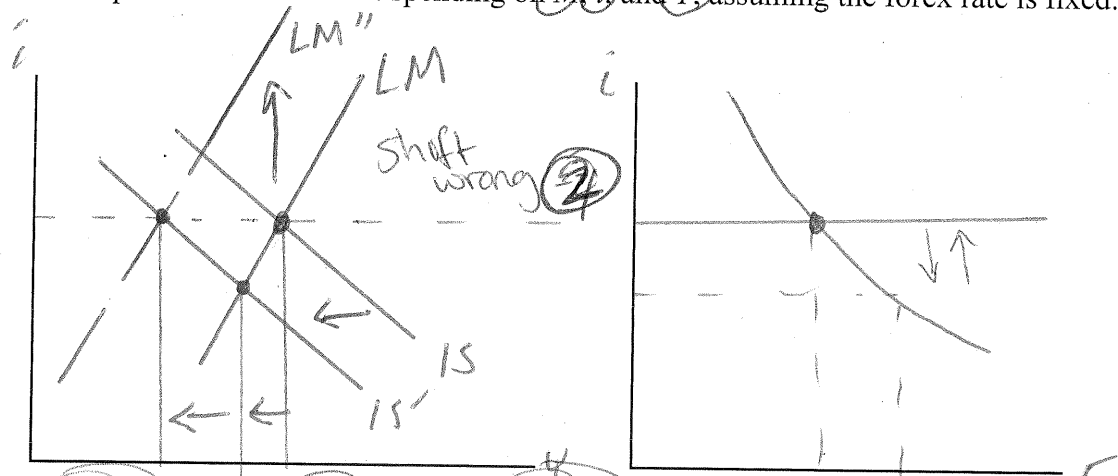


$V = C + I + G + CA$, $M/P = L(i, Y)$
 If $DEM \downarrow$, $M \downarrow$, LM shifts up, $i \uparrow$, $Y \downarrow$, $E \downarrow$

Under fixed rates, $BOP \uparrow$, CB buys Forex Reserve, $M \uparrow$, LM shifts back, $i \downarrow$, $Y \uparrow$, and E is fixed.

2. If the foreign exchange rate was fixed, how would the above shock affect the balance of payments? How would this in turn affect the central bank's forex reserves? Use the the above ISLM-FX diagram to show how this would affect M , i , and Y .

3. Use another ISLM-FX diagram below to show the effects of a decrease in government consumption and investment spending on M , i , and Y , assuming the forex rate is fixed.



SR $G \downarrow$ causes $i \downarrow$, $E \uparrow$, $Y \downarrow$

Gov't intervenes
 If E is fixed, BOP Deficit makes CB sell forex reserves, $M \downarrow$, $i \uparrow$, E returns to equilibrium, but $Y \downarrow$. \leftarrow must tighten ms (LR)