

20 points

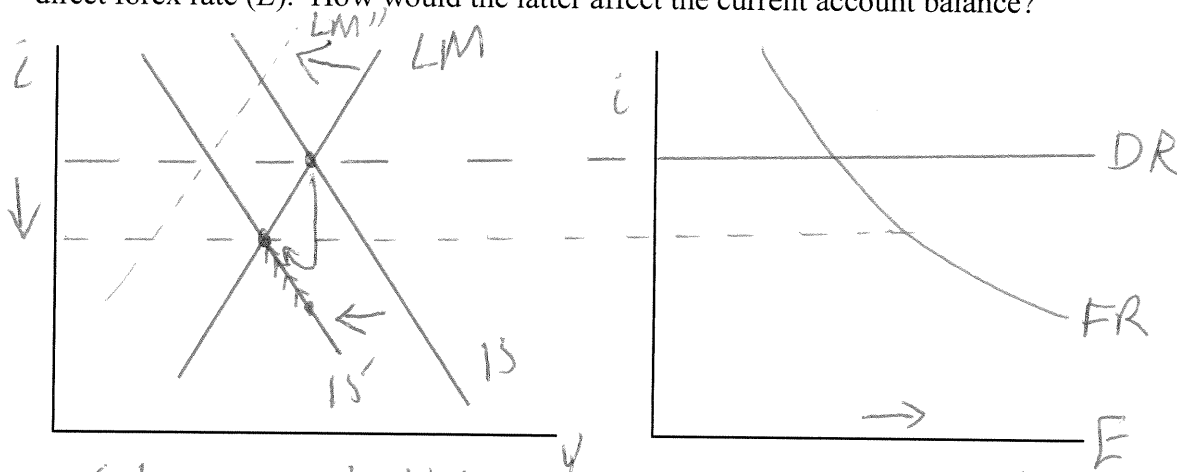
ECON 463 Quiz 4
April 28, 2009

Professor Elliott Parker

GROUP _____ NAME Key

4 pts.

1. Use the ISLM-FX diagram to show equilibrium in the product market, money market, and foreign exchange market. Then show the effects of a decrease in government investment spending on the interest rate (i), gross national disposable income (Y), and the direct forex rate (E). How would the latter affect the current account balance?



$G \downarrow$, so $i \downarrow$, $Y \downarrow$ (of course, there is overshooting of i, E)
 $E \uparrow$, so $CA \uparrow$ too.

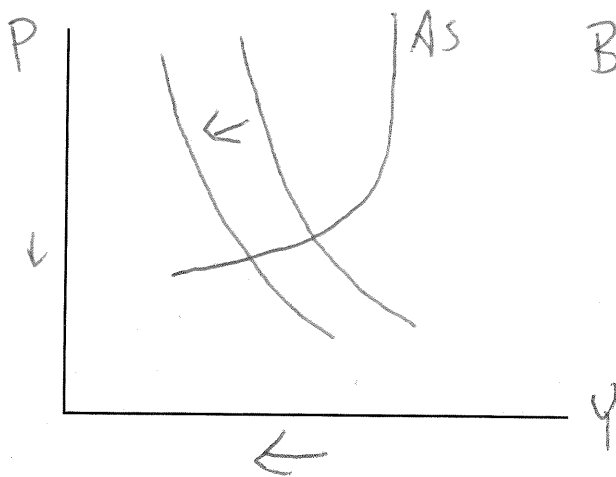
3 pts.

2. If the foreign exchange rate was fixed, how would the above shock affect the financial account and 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 .

FA, BOP Deficits. Forex reserves \downarrow , so $M \downarrow$.
LM shifts back (or up) until i and E return to where they were.
 Y falls more.

3 pts.

3. Use the AD-AS model to show how the combination of (1) and (2) would affect Aggregate Demand, real Y , and the price level (P) if the economy is below full-employment.

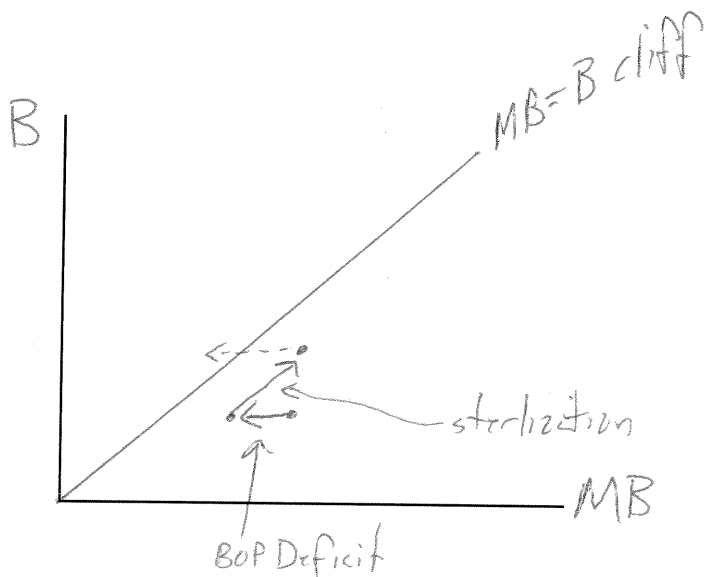


Big recessionary effect from the double whammy, plus some deflation.

4. If a central bank with a fixed exchange rate policy is facing a balance of payments deficit, how can it "sterilize" its required intervention in the forex market to prevent its money supply from decreasing? Explain, and show how this sterilization can bring the economy closer to the "cliff."

4 pts.

CB can buy bonds to offset sold Forex.
sterilization moves you diagonally to NE,
but BOP deficit moves you to West.



Whoops!

5. Assume a central bank takes the currency off the cliff. How will E change, and why? If the central bank or other borrowers in the economy have borrowed from abroad, and their debts are denominated in foreign currency, what happens then?

3 pts.

E must either float or rise significantly as
Home CB devalues currency. This increases amount
of foreign debt, leading to even bigger BOP deficits
and more devaluations.

6. Assume this economy decided to float its exchange rate. How would the effect of a decrease in government investment spending have been different?

3 pts.

If E floats, $G \downarrow$ makes $E \uparrow$ and $CA \uparrow$, which
offsets effect on AD. No BOP Deficit occurs,
so M does not fall to make it worse,
and there is no cliff.