Economics 434 **Spring 1999**
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Review Questions: Volume II

1. Consider an economy with flexible exchange rates and imperfect capital mobility. Define internal balance as full employment, so that output is equal to the full employment level. Determine the exact combination of monetary and fiscal policies necessary to reach external and internal balance if the economy is in a situation of:

   (a) Balance of Payments deficit and overemployment.
   (b) Balance of Payments surplus and overemployment.
   (c) Balance of Payments surplus and unemployment.
   (d) Balance of Payments deficit and unemployment.

2. The government of a country operating with a flexible exchange rate and perfect capital mobility imposes a tariff on imports, distributing the tariff revenues back to the public in the form of tax rebate. What happens to the equilibrium levels of output, the rate of interest, the trade balance, and the nominal exchange Show your answer graphically. How would your answer change if the exchange rate were fixed?

3. How do flexible exchange rates insulate the domestic economy from external shocks? How extensive is this insulation?

4. Consider the following economy:

$$A = \bar{A} + a_1 Y - a_2 i$$
$$T + \bar{T} - mY + \tau\left(\frac{P^{*}e}{P}\right)$$
$$Y = A + T$$

where P* is the price level in the rest of the world, τ measures the effect of the real exchange rate on the trade balance ($\tau > 0$), and T now depends only on foreign income.

   (a) If the country is small, and there is perfect capital mobility (i.e., i = i*) find the expression for e as a function of Y and exogenous variables (i.e. the YY curve).
   (b) If the money stock is given, and money demand is:

$$L = m_0 + m_1 Y - m_2 i$$

   What is the equilibrium level of Y (Hint: remember Perfect Capital Mobility)?
   (c) Use your answer to (b) to determine the equilibrium exchange rate (via (a)).
   (d) If i* were to fall, what would happen to Y* and e*?

5. Analyze the effects of fiscal and monetary policy on Y, r and e for an economy under fixed exchange rates and imperfect capital mobility.

6. Why is monetary policy more potent under flexible exchange rates than under fixed exchange rates?

7. What is sterilization? Discuss the limitations to sterilization under various assumptions about capital mobility. Why might large countries be in a better position to sterilize than small countries? What conditions need to be met for effective sterilization? Why, if at all, is it important to be able to sterilize?

8. What is the Marshall-Lerner condition? Provide intuition for this result. Explain how if imports and exports demand are price inelastic, short run movements in the exchange rate might move in the "wrong" direction. Why does this occur? What implications does this have for the operation of flexible exchange rates?

9. Explain what is meant by the term "optimum currency area." How is this determined? What are the key considerations relevant to the determination of whether or not a group of countries ought to share a common currency?

10. Explain the key differences between a fixed exchange rate regime, a currency board, and a common currency area. How do each of these regimes purport to introduce credibility to monetary policy. Explain.

11. Carefully explain how is inflation can be imported into a country that has a fixed exchange rate regime.

12. Analyze the effects on a small open economy under fixed exchange rates of an increase in foreign income on domestic income and the trade balance. Assume that the price level is fixed. Now explain how your answer is changed if prices are fully flexible.