Econ 434 Fall 2001

Review Questions II

1. The combination of a fixed exchange rate, an independent monetary policy, and a high degree of capital mobility has been called "the impossible trinity."

    (a) Why is it not possible for an economy to achieve this trinity? Explain.

    (b) Explain how an economy can achieve any two of the three parts of the trinity.

    (c) Suppose that an economy had a fixed exchange rate and tried to conduct an independent monetary policy when there is no capital mobility. How could it accomplish this? Why would an increase in capital mobility make this impossible?

2. What is *relative purchasing power parity*? What prediction does this theory make about the movement of exchange rates? Be specific. What are the key assumptions of the theory?

3. Analyze the impact on output, the rate of interest, and the exchange rate of an expansionary fiscal policy under flexible exchange rates. Assume that capital is perfectly mobile. Explain how your answers would change if capital was imperfectly mobile.

4. In what sense is an economy *insulated* from foreign shocks under flexible exchange rates? What types of shocks are they insulated from? Explain.

5. What is the *Marshall-Lerner* condition? Provide intuition for this result. Why is it important? Explain.

6. What is the difference between the *real* exchange rate and the nominal exchange rate? Why does the real exchange rate vary? How does the real exchange rate respond to:

    (a) a decrease in the relative demand for US goods

    (b) an increase in relative output supply in the rest of the world.

7. Consider the following economy:

$$A = \overline{A} + a_1 Y - a_2 i$$

$$T = \overline{T} - mY + \phi \left(\frac{P^* e}{P} \right)$$

$$Y = A + T$$

where P^* is the foreign price level, $\phi > 0$ measures the impact of the real exchange rate on net exports, and $\overline{T}$ depends only on foreign income. Assume that the country is small and that there is perfect capital mobility.

    (a) Derive the expression for e as a function of output and other variables.

    (b) If the money stock is given, and if money demand is given by $L = l_0 + l_1 Y - l_2 i$, derive an expression for the equilibrium level of income.

(c) Use your answer to (b) to determine the equilibrium exchange rate.

(d) What happens to income and the exchange rate if the world interest rate falls?

8. Why is monetary policy more potent than fiscal policy under flexible exchange rates? Explain.

9. Consider an economy with a flexible exchange rate. Will monetary policy be more potent under perfect capital mobility or imperfect capital mobility? Explain.

10. Capital mobility has increased dramatically during the last 25 years. Why? Provide several explanations for this.

8. 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?

9. What is the expression of real interest parity? Explain the intuition behind this condition. What does it imply?

10. How can a higher growth rate of productivity in Japan relative to the US explain the increase in the real value of the yen?