Econ 371 Spring 2006: Problem Set 3
(Chapter 15-16)

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Due date: March 6, 2005

Part 1: Answer the following questions. Depict a diagram as required. (2 points each)

1. Discuss the effects of an unexpected permanent reduction of money supply in the U.S. on exchange rate, in the short run, the medium run and the long run. Will we observe exchange rate overshooting? Explain using a diagram. Show the time path of exchange rate.

2. Suppose the Fed announces the policy in Question 1 one year in advance. How will your answer change? Will we observe exchange rate overshooting? Explain using a diagram. Show the time path of exchange rate.

3. Use the AA-DD framework to explain the effects of a temporary tax cut in the US on the dollar-euro exchange rate in the short run. What are the effects on the US current account and output of the US trading partner?

Part 2: Answer whether the following statements are true or false. When you think it is true, write ”T” in front of the question. Write ”F” otherwise. (0.5 point each)

1. The relative purchasing power parity predicts that real exchange rate is always one.

2. The monetary approach predicts that the euro-dollar exchange rate is not affected when the Fed and the ECB expand money supply at the same rate, all else equal.

3. According to the monetary approach, economic growth in the export sector causes real exchange rate to appreciate.

4. According to the general theory, output expansion causes real exchange rate to appreciate.
5. According to the general theory, output expansion causes nominal exchange rate to appreciate.

6. According to the Balassa-Samuelson hypothesis, economic growth in the export sector causes real exchange rate to appreciate.

7. A temporary fiscal expansion and a temporary monetary expansion have the same effect on nominal exchange rate.

8. According to the aggregate demand theory, the Fed can improve the US current account by expanding money supply.