Problem Set #6

Due Tuesday, November 21, 2006

Problem Sets MUST be word-processed except for graphs and equations.

QUESTIONS

1. Suppose that a country begins with both internal and external balance, has a fixed exchange rate, and relatively immobile capital.

   Use an IS-LM-BP model to clearly show what happens to equilibrium income and interest rates if there is a decrease in foreign income.

   Also provide a brief economic explanation of that is happening to equilibrium income, interest rates, and the central bank’s foreign exchange reserves.

   Finally, clearly show and briefly explain what, if anything, the monetary authorities can do to re-establish joint internal and external equilibrium.

2. Uforia is an open economy with a fixed exchange rate. The government is committed to maintaining the fixed exchange rate. The economy is characterized by highly mobile capital flows. The economy has achieved both internal and external balance although the unemployment rate is well above its natural rate. The government wants to examine the various policy options for returning the economy to full employment.

   a. Use an IS-LM-BP model to clearly show and provide a brief economic explanation of how the government would use fiscal policy alone to move the economy to its potential level.

      i. At the new level of output and interest rates, is the private balance of payments is surplus or deficit? Explain.

      ii. What actions will the government have to undertake to maintain the fixed exchange rate?

      iii. How long can the government maintain this policy? Explain.

   b. Use a separate IS-LM-BP model to clearly show and provide a brief economic explanation of the combination of monetary and fiscal policies necessary to move the economy to full employment and, at the same time, maintain private balance of payments equilibrium.

   c. Finally, the government wants to consider how to move the economy to full employment and maintain private balance of payments equilibrium without using monetary policy. Use a third IS-LM-BP diagram to clearly show and provide a brief economic explanation of what other policies the government could use to maintain private balance of payments equilibrium.