

Homework #4: FT Chapter 7

Econ 160B: International Macroeconomics

Due November 20 in class

1. Suppose that Mexico experiences a shock that exogenously increases money demand. (Note, this is an exogenous shift in money demand, not an endogenous response to some other variable in the money demand function.) Study how this shock can cause a recession, and how policy makers can respond to it. Assume a flexible exchange rate.

For the scenarios below (a and b), show the effect of the money demand shock and the policy response to it. You should include the IS/LM, money market, and FOREX market diagrams.

Please label curves as follows:

- Point A: initial equilibrium
- Point B: effect of the money demand shock without a policy response
- Point C: effect of the money demand shock with a policy response.
- You must state the effect of the shock on the following variables (increase, decrease, no change, or ambiguous): Y , i , E , C , I , CA .

For simplicity, assume here that $MPC_F = 0$. This implies that the trade balance and current account are just a function of the real exchange rate and not income.

- a) Suppose that monetary policy is used as stabilization policy, which maintains the level of output at its initial value despite the money demand shock.
 - b) Now suppose that instead, a fiscal policy of a tax cut is used as stabilization policy, keeping the level of output fixed at its initial value. (No monetary policy used here).
If Mexico already has a current account deficit that it does not want to make worse, discuss whether you would recommend it use monetary or fiscal policy as stabilization policy here.
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2. Consider the case of France following World War II. It is beginning a temporary period of expansionary government spending as it rebuilds its damaged infrastructure. And it is considering whether to join the system of fixed exchange rates being set up at that time, called the Bretton Woods System.
 - a) Suppose first that France undertakes its temporary expansionary fiscal policy while maintaining a flexible exchange rate. State the short-run effects of the fiscal policy on France's output, interest rate, and exchange rate, using the IS-LM and Forex Market graphs to show this.
 - b) Suppose instead that France fixes its exchange rate and then undertakes the temporary expansionary fiscal policy. State the short-run effects on France's output, interest rate and exchange rate, using the IS-LM and Forex Market graphs to show this. Explain each curve shift. Compare the result to your answer in part (a).
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3. Suppose India is experiencing a recession. Suppose you also know that interest rates in India are falling, the value of the Indian currency is depreciating (rise in rupees/dollar), and the level of the Indian trade balance is falling. According to the open-economy IS-LM model, which of the following three shocks could be causing India's recession:
 - (1) an exogenous shock raising Indian money demand,
 - (2) exogenous shock lowering investment demand,
 - (3) an exogenous shock lowering foreign demand for Indian goods.(Name all shocks that apply and illustrate with an IS-LM graph.) For any shock you rule out as an explanation, explain what about its implications are inconsistent with the data above. (Assume that the marginal propensity to consume foreign imports is zero, $MPC_F = 0$.)
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