

Practice Problems: Open Economy AS/AD Model

Econ520. Spring 2021. Prof. Lutz Hendricks. April 29, 2021

Also see the exercises in Ch. 21 of Blanchard / Johnson, Macroeconomics, 6th ed.

1 Fiscal Policy

In an economy with a fixed exchange rate, how does a fiscal expansion affect investment and net exports?

Is there still crowding out, as in the closed economy?

1.1 Answer

Medium run: $Y = Y_n$ and $i = i^*$, so I is unchanged. Since $G \uparrow$ and C, I are unchanged, NX must fall one-for-one with G .

Short run: $Y \uparrow$ and $i = i^*$, so $I \uparrow$. $NX \downarrow$ because $Y \uparrow$ and $P \uparrow$.

2 Supply Shock

Consider the effects of a supply shock, represented by higher m in the AS/AD model. What happens in the medium run and short run to Y, P, M ? Assume a fixed exchange rate.

2.1 Answer

Medium run: $Y = Y_n \downarrow$. $P \uparrow$ (moving along AD). The change in M is ambiguous. From $M/P = YL(i^*)$ we know that M/P must fall, but P also falls.

Short run: $Y \downarrow$ and $P \uparrow$ as AS shifts up. M is again ambiguous.

3 Exchange Rate Regimes

You should be able to explain:

1. Why does the Fed lose control over the money supply under fixed exchange rates?
2. What are the main benefits / drawbacks of exchange rate regimes?
3. Why are currencies vulnerable to speculative attacks?

Answers are in the slides.
