Econ 429 University of Illinois
Spring 2003/04 Willmann

Homework 2

due: Tuesday, Feb 26, in class

Problem 1: Consider the Keynes–Mundell–Fleming model. Assume perfect capital mobility and suppose (initially) that the country is small.

a) For each of the three curves of the KMF-model, write down the defining equation and determine the slope of the curve.

b) Graphically analyze the effects of a monetary expansion under flexible exchange rates.

c) Repeat b) for an expansionary fiscal policy. How does your result for this case change if the country at hand is large.

d) Analyze monetary and fiscal policy for two large countries. What is the effect of each policy on the other country?

Problem 2: The Monetary Approach.

a) Depict the uncovered interest parity and the money market equilibrium in a diagram with returns on the horizontal axis, the exchange rate to the North, and real money to the South. Define and explain all curves (and lines) in your diagram.

b) Analyze the effects that monetary policy (say an increase in the money supply) and fiscal policy (of the expansionary type) have on the exchange rate in the short run.

c) Suppose the central bank announces a permanent increase in the domestic money supply. Explain graphically how this policy leads to exchange rate over-shooting if prices are sticky.

d) Depict the time paths for money supply, the interest rate, the price level, as well as the exchange rate, and explain intuitively why the exchange rate over-shoots.