Problem Set 4

Due in lecture on Monday, May 4th. Be sure to put your name on your problem set. Put “boxes” around your answers to the algebraic questions.

1. Consider an economy on a flexible exchange rate, and described by the IS-LM-UIP framework in Chapter 20 of the textbook (this model assumes perfect capital mobility).
   1.1 Suppose autonomous investment collapses. Using the IS-LM-UIP diagrams, show what happens to interest rates, output, and the exchange rate.
   1.2 What could monetary policy do to restore output to pre-shock levels?

2. Consider a small open economy with a fixed exchange rate, and imperfect capital mobility.
   2.1 Suppose the US interest rate rises. Interpret the impact on the economy using an IS-LM-BP=0 graph; assume the central bank sterilizes.
   2.2 Should the government devalue the currency or raise interest rates? Explain your answer using IS-LM-BP=0 graphs, and explicitly indicating the goals of policy underpinning your answer.
   2.3 How does your answer change if the country (firms, the government) has a big outstanding debt borrowed in US dollars?