Economics 442
Spring 2016
University of Wisconsin-Madison

Menzie D. Chinn
Social Sciences 7418

Problem Set 4

Due ***in lecture*** on Monday, May 2nd. 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 foreign output 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? What would be the implications?

1.3 Suppose 1.1 occurs, but domestic interest rates are already at zero. Show what happens. How would expansionary monetary affect the outcome?

2. Consider a small open economy with a fixed exchange rate, and *imperfect capital mobility*. Initially, the economy is in internal and external balance.

2.1 Suppose the exogenous component of exports falls. Interpret the impact on the economy using an IS-LM-BP=0 graph; assume the central bank sterilizes.
2.2 What are two policies that could stabilize foreign exchange reserves? Explain your answer using IS-LM-BP=0 graphs.
2.3 What is your preferred option? *Why?*
2.4 How does your answer change if the country (firms, the government) has a big outstanding debt borrowed in US dollars?