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Advanced Studies in International Economic Policy Research
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Problem Set 2 (revised)
Exchange Rate Economics

Mark textbook, Chapter 3, Questions 1-3.

Mark textbook, Chapter 8, Question 3.

a. What is the instantaneous effect on the exchange rate of a shock to aggregate demand? Why does an aggregate demand shock not produce overshooting?

b. Suppose that output can change in the short run by having aggregate demand equal output (so D/Y=1), and replacing the price adjustment rule in equation 8 by:

$$\dot{p} = \pi(y - \bar{y})$$

where the bar indicates long run value, and long run output is given by:

$$\bar{y} = u + \delta(e - p) + \gamma\bar{y} - \sigma r$$

Under what circumstances is the overshooting result (in response to a change in money) robust?