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Advanced Studies in International Economic Policy Research
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Problem Set 3
Exchange Rate Economics

1. Solve for the present value relation of the nominal exchange rate in the flexible price monetary model, assuming no bubbles, and that the fundamentals follow an AR(1) process. Show your work.

2. Briefly describe how, assuming rational expectations, you would implement an efficient estimation method of this present value/flex-price monetary model.

3. Frankel's simplified model, assuming representative investors, assumes:

$$\log\left(\frac{B_t}{S_t F_t}\right) = \alpha + \beta(i - i^* - s^e_{t,t+1} - s_t)$$

Show algebraically how expectations of future budget deficits might affect the current value of a currency. Explain the intuition of your result.