Econ 520 (Spring 2007)

Problems for Chapter 20

Masao Ogaki

1. Mishkin's Problems

Mishkin, p.528, Questions and Problems: 2, 4

2. Short Answer/Essay Problems

(1) Take the United States as the home country. Imagine tha the domestic interest rate falls, while the expected exchange rate and the foreign interest rate are constant. What will happen to the exchange rate? Explain your diagram and answer whether the dollar appreciates or depreciates.

(2) Take the United States as the home country. Imagine tha the foreign interest rate falls, while the expected exchange rate and the domestic interest rate are constant. What will happen to the exchange rate? Explain your diagram and answer whether the dollar appreciates or depreciates.

(3) Take the United States as the home country. Imagine tha the dollar is expected to depreciate in the next year, while and the domestic and foreign interest rates are constant. What will happen to the exchange rate? Explain your diagram and answer whether the dollar appreciates or depreciates.

(4) Suppose that the U.S. money supply has been constant, and the U.S. economy has been in the long-run equilibrium. Imagine that the money supply unexpectedly decreases today and is expected to stay at the new level from now on forever. The European economy has been and is expected stay at the long-run equilibrium. The price level does not change today, but is expected to adjust to the long-run equilibrium level in one year.

(4.a.) Use the diagrams for the money market and the expected returns for one year ago $(t-1)$, today (t) and one year from now $(t+1)$ in order to explain the exchange rate overshooting phenomenon. Explain your diagrams and answer whether the dollar appreciates or depreciates.

(4.b.) Draw diagrams for the time paths of the U.S. money supply, dollar interest rate, the U.S. price level, and the Dollar/euro exchange rate.