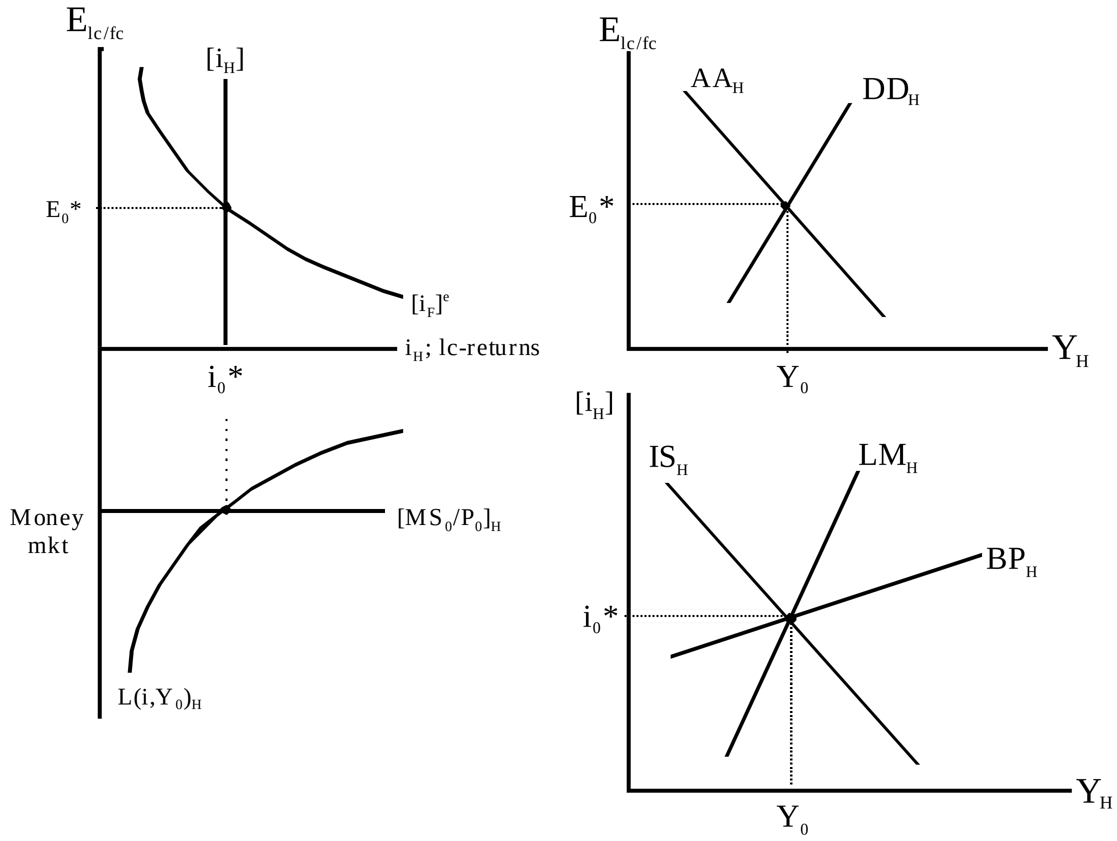
ECN320 Open Economy Macroeconomics

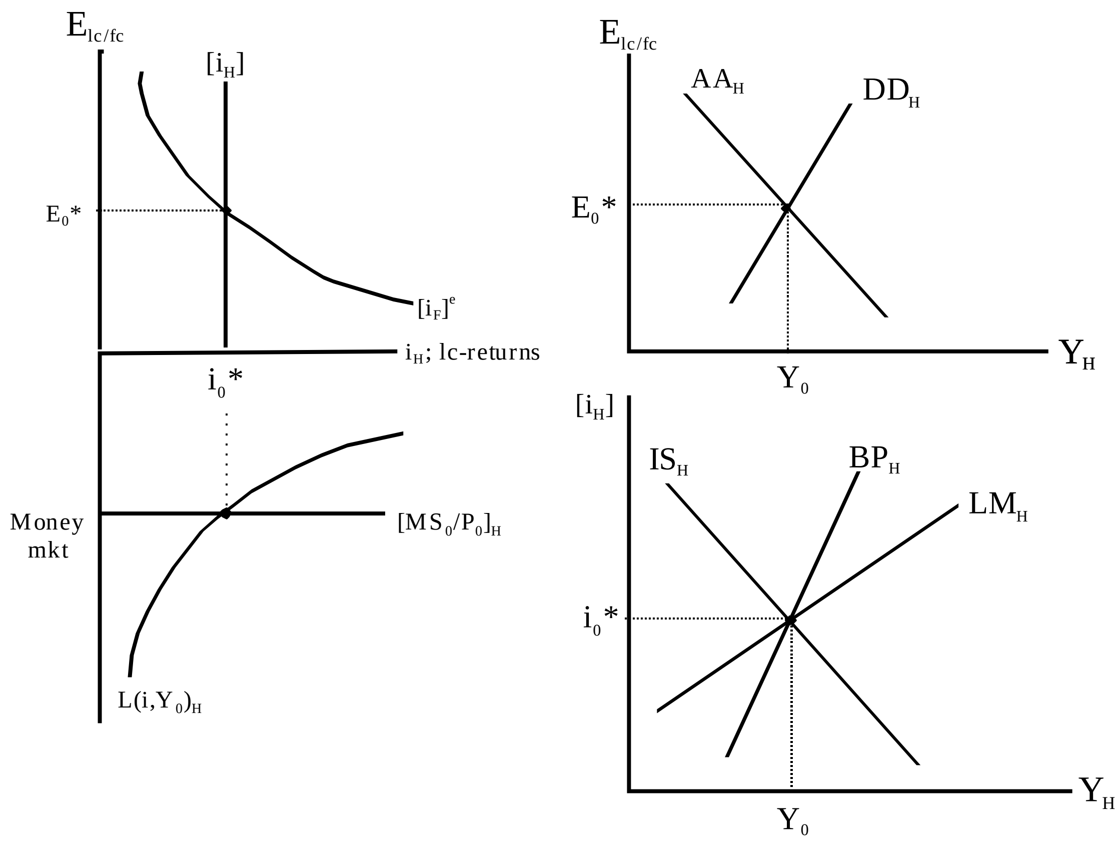
Exercise 2: Effectiveness of fiscal/monetary policy under different exchange rate regimes

Objective: This exercise is designed to reinforce the student's understanding of how the fiscal policy and monetary policy tools are available for a government and/or central bank to stimulate the economy under a fixed or flexible exchange regime under differing degrees of capital mobility.

Assignment: For each possible case, summarize your answers in a table (as presented below) by describing the short-term economic causes and effects (e.g., the causality chain of events) resulting from (1) expansionary fiscal policy and (2) expansionary monetary policy and conclude whether the policy is an effective tool or not under different assumptions on capital mobility. Let the short run represent a one-time fiscal/monetary policy change such that macroeconomic factors adjust to the policy change. Defend your answers using the AA-DD schedules (modeling the relationship between output and the exchange rate), the foreign exchange-money market model presented by Krugman, Obstfeld & Melitz (reserve reading, ROM), and the IS-LM-BP curves (modeling the relationship between interest rates and income) as presented by Appleyard and Field in the text.

	2.1. Fiscal policy effectiveness		2.2. Monetary policy effectiveness	
	2.1.1 Fixed exchange rate		2.2.1 Fixed exchange rate	
	(A) Relatively mobile capital	(B) Relatively immobile capital	(A) Relatively mobile capital	(B) Relatively immobile capital
Is the policy effective?				
Is the equilibrium stable in the short run?				
Does a slow price adjustment process matter?				
Does government-central bank coordination matter?				
Would you expect changes in private expectations to matter in the short run?				
	2.1.2 Flexible exchange rate		2.2.2 Flexible exchange rate	
	(A) Relatively mobile capital	(B) Relatively immobile capital	(A) Relatively mobile capital	(B) Relatively immobile capital
Is the policy effective?				
Is the equilibrium stable in the short run?				
Does a slow price adjustment process matter?				
Does government-central bank coordination matter?				
Would you expect changes in private expectations to matter in the short run?				


$E_{lc/fc}$
$[i_H]$
E_0*
$[i_F]^e$
i_H; lc-returns
i_0*
Money
mkt
$[MS_0/P_0]_H$
$L(i,Y_0)_H$
$E_{lc/fc}$
AA_H
DD_H
E_0*
Y_H
Y_0
$[i_H]$
IS_H
LM_H
BP_H
i_0*
Y_H
Y_0


$E_{lc/fc}$
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DD_H
E_0*
Y_H
Y_0
$[i_H]$
IS_H
BP_H
LM_H
i_0*
Y_H
Y_0