

Exercise Sheet 6

For exercises 1 and 2, use the IS-LM-BP model (also called the Mundell-Fleming model) with perfect capital mobility.

Exercise 1

The demand for a certain export product of the domestic economy suddenly increases (e.g. demand for computer exports increases because of a new chip design). Draw an IS-LM-BP diagram and show how domestic output changes. Do the analysis both for a fixed exchange rate and for a floating exchange rate and comment on the differences.

Exercise 2

The world interest rate decreases (e.g. because the central banks of the major countries follow an expansionary monetary policy). Using the IS-LM-BP diagram, show how this affects the output of the domestic economy. Perform the analysis both for a fixed and a floating exchange rate and comment on the differences.