Exercise Sheet 6: Short Solutions

Exercise 1

Fixed exchange rate: Demand for domestic exports increases. Therefore output increases for a given interest rate i -> the IS curve shifts right. This increases the domestic interest rate. The increase in the interest rate would lead to an appreciation of the domestic currency (capital inflow). Since this is not possible under a fixed exchange rate, the domestic money supply is increased. The LM-curve shifts right such that the domestic interest rate equals the world interest rate. Domestic output increases.

Floating exchange rate: Again, the IS-curve shifts right. The increase of the domestic interest rate above the world interest rate leads to a capital inflow and an appreciation of the domestic currency. The appreciation increases demand for imports and decreases demand for exports (net exports decrease). This shifts the IS-curve left again, until the old equilibrium is reached. Domestic output is not changed. The increased computer exports are "crowding out" exports of other goods.

Exercise 2

Fixed exchange rate: The BP-curve shifts down. The domestic interest rate is now above the world interest rate which would lead to an appreciation of the domestic currency. Since this is not possible, the money supply is increased until the domestic interest again equals the world interest rate (the LM-curve shifts right). Domestic output increases.

Flexible exchange rate: The BP-curve shifts down. Since the domestic interest rate is now higher than the world interest rate, the domestic currency appreciates. This decreases net exports. The IS-curve shifts left until the domestic interest rate equals the world interest rate. Domestic output decreases.

(graphs are shown in the exercise session).