

Session 3: The M-F model and the Dornbusch model

The Mundell-Fleming model

1. According to the Mundell-Flemming model, an increase in the nominal interest rate leads to a currency appreciation. On the other hand, uncovered interest rate parity (UIRP) predicts that higher interest rates in any country will be associated with a depreciation of that country's currency over time (*expected* spot exchange rate). Does the Mundell-Flemming model rest on the violation of UIRP?
2. Under a flexible exchange rate system, a temporary decrease in the domestic supply of money
 - Worsens the current account, increases output and depreciates the currency
 - Improves the capital account worsens, the current account and decreases output
 - Worsens the capital account, improves the current account and decreases output
 - Either answer 2 or 3
3. What is the relationship between budget deficits and the exchange rate?

The Dornbusch model

4. What is meant by excessive volatility of the exchange rate. How does the Dornbusch model account for it?
5. Repeat question 13, c), of session 2. But in this case, assume that prices do not adjust immediately so that PPP may not hold in the short run. Do also describe the effects on the real interest differential over time.
6. What are the main advantage and the main shortcoming of the Dornbusch model?

Questions concerning all three exchange-rate determining models

7. If changes in e and i are positively related then you infer that most of the variability in i is mostly due to
 - Real interest rates
 - Expected inflation
 - Actual inflation
 - Cannot tell
8. Under what conditions can the government manipulate a country's international trade competitiveness? Can this be done in the long run?
9. Suppose that the volatility of the real exchange rate were very similar across fixed and flexible exchange rate regimes. What type of model would seem consistent with this finding? Why?
10. Is the variability of the nominal and real exchange rate related systematically to the degree of flexibility of the general price level? Explain.