239116IK REVIEW QUESTIONS JUNE 2009
The Balance of Payments and Exchange Rates

(1)

Using either the IS-LM or AA-DD set of diagrams, discuss short-run equilibrium levels of output and interest and exchange rates under a fixed exchange rate regime. Then discuss the impact of both fiscal and monetary expansion on output, interest rates, and exchange rates.

(2)

(2.1) Explain the de Melo-Robinson model (the 123 model) of equilibrium in the traded and non-traded goods sectors using a diagram.
(2.2) Explain the impact that an inflow of foreign exchange will have on exports and the real exchange rate (measured as the relative price level for traded and domestic goods) in this model.
(2.3) Based on your answer to (2.2), discuss the impact that an increase in international borrowing by a country might have on the performance of the export sector and on prices.

(3)

Combine the graph showing the interest parity condition and one showing money demand and supply to demonstrate simultaneous equilibrium in the money market and the foreign exchange market.
How would an increase in the U.S. money supply affect the Dollar/Euro exchange rate and the U.S. interest rate? Illustrate your answer graphically and explain.

(4)

Using the DD-AA framework, show the phenomenon of overshooting following a permanent increase in the money supply. Explain the process.

(5)

What is contagion?

(6)

Use the interest parity conditions, and the relationship of spot exchange rates to interest rates (see question 3 above) to explain overshooting of exchange rates.