The Is-LM model in the open economy

Exercises

Economics II – Week 2

Lecturer: dr. Andrea Venegoni

Exercise 1:

Consider two countries, Alpha and Omega, that are identical except for the fact that the former operates in a flexible exchange rate regime while the latter in a fixed one. Suppose that an identical exogenous adverse shock reduces investments in the same way in the two economies:

- In which of the two would we observe the highest income (Y) contraction?
- On the base of the answer to the previous point explain how the effectiveness of fiscal policy changes according to the exchange rate regime adopted.

Exercise 2:

True or false

- A contractionary monetary policy causes an income drop under flexible exchange rates while leaves it unchanged under fixed exchange rates.
- A tax cut has an higher effect on income under fixed exchange rates than under flexible ones.

Exercise 3:

Consider a country that operates in a fixed exchange rates regime. Assume that the foreign interest rates increases due to some exogenous shock.

- How does the income change after such a variation?
- Can the central bank tame the effects on income previously discussed?
- Can the government intervene to tame such effects?
- How would your answers at the previous points change if the country was operating under a flexible exchange rates regime?

Exercise 4:

Let's consider an economy operating in a fixed exchange rates regime. Assume a contractionary fiscal policy, consisting in a government public expenditure cut.

- What effect does this have on the exchange rate? How does the central bank should intervene to restore the medium run equilibrium?
- How investment (I), consumption (C) and net exports (NX) vary?