Final Exam Suggested answers

1. Following are several scenarios. Explain what underlying shocks could be driving them.

   (a) The exchange starts to appreciate, output is increasing and the current account is increasing. Looks like a right-shift in the AA curve. This could happen because $E^e$ increases (expected future increase in $M$, say), risk premium rises, or current $M$ increases.

   (b) Looks like a right shift in the DD curve. This could be because $G$ increases, $T$ decreases, the consumption function shifts up, there is an increase in investment.

2. (a) Initially, output is at full employment. Rise in $P$ shifts DD curve left. The rise in expected future $M$ implies that $E^e$ goes up. The current rise in $P$ shifts AA left. The current rise in $E^e$ shifts it right. The net effect is unclear, because it depends on the interest elasticity of demand. It is possible, though, that the shift left in the $DD$ curve dominates, so that output falls. Transition to long run equilibrium involves the price level and everything else returning to previous equilibrium.

   (b) they could increase $M$ today and shift the AA curve right by enough so that it intersects DD at full employment.

   (c) Monetary authority may be tempted to go for b. if so, then private expectations have become self-fulfilling.

3. Raise one-week interest rate by 5 percentage points. no cost in standard model, because there $R$ does not enter agg demand. only $E$ does and that is being held fixed. big cost in interest sensitive model because rise in $R$ shifts DD left.

4. With bad banks, the net worth of the banks is close to zero or perhaps already negative. A high interest rate, by slowing down the economy, may cause bankruptcies and cause bank assets to become non-performing. This could make net worth go negative, placing the
government in a dilemma: either go through the politically costly step of raising taxes and bailing out the bad banks. Or, let the banks continue, but by running a Ponzi scheme which shuts out borrowing for financing investment (i.e., this shifts DD left).

legislature may like the fixed exchange rate regime because they think it gives the government an incentive to keep the banks sound by properly regulating them. the incentive to keep the banks sound stems from the huge cost that occur, because of the risk of currency crisis, under a fixed exchange rate regime when banks are bad. the legislature may not like the fixed exchange rate regime precisely because they fear banks might go bad and the crisis that can then occur.

5. cb has two tools when $\rho$ is as assumed in this question. they can therefore hit two targets. problem is that there is little the central bank can do to have a meaningful impact on $B^d/B$. The numerator and the denominator are just too big.