Open Economy Macro: PS4

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1. (Choice of exchange rate regime under free capital mobility) Assume perfect capital mobility (NB! BoP line). The domestic economy is bombarded by two types of shocks, one originating in the financial/money market and the other in the goods market. For concreteness, think of the financia market shock as a sudden fall in the demand for (domestic) money and of the goods market shock as a sudden fall in net exports. The domestic policy maker can choose between a flexible and fixed exchange rate regime. The policy maker cares about output stability. So which, according to the Mundell-Fleming model, of the two exchange regimes is more efficient in stabilizing output, when the economy faces a) financial market shocks and b) goods market shocks?

2. (Devaluation) Assume fixed exchange rates. The policy maker decides to devalue the domestic currency. Use the Mundell-Fleming model to trace out what happens to the macroeconomic equilibrium of the home country. To what extent, if any, does the outcome depend on the degree of capita mobility?

3. (Foreign exchange reserves) We have assumed that under floating the central bank does not hold foreign exchange reserves. However, use the Mundell-Fleming model to analyze the macroeconomic consequences of the central bank wanting to accumulate foreign exchange reserves. (Hint: definition of money suppy in an open economy). The reason for such a desire could be that the domestic financial markets are not sufficienty well developed to provide strong financial buffers against different shocks.

4. (Foreign interest rates). What happens to macroeconomic equilibrium of the home country, when the foreign interest rate increases (according to the Mundell-Fleming model). What is the role of the exchange rate regime to the outcome of your analysis?