

Assignment 4 Answers

Part A

1	A	6	C
2*	A	7	B
3	B	8	C
4	D	9	D
5	A	10	E

* Effect on imports depends upon the relative tradeoff of value and volume effects.

Part B

- 1a. Exports = H\$ 10, Imports = H\$ 9, so CA = H\$ +1. Since $ORT = 0 = BOP$, we must have equal and offsetting private foreign capital flows. Thus

$$BOP \text{ H\$ } (0) = CA \text{ Balance H\$ } (+1) + \text{Non-official FA Balance H\$ } (-1)$$

- b.

Balance Sheet of the Central Bank 12/31/2010		
	Assets	Liabilities
Domestic	H\$ 100 m.	H\$ 120 m.
Foreign	H\$ 20 m.	

There is no change in the Central Bank's assets and no change in the money supply. Under flexible exchange rates, the money supply is independent of the current account.

- c. With a fixed exchange rate and no private capital flows, the $ORT = \text{H\$}(-1)$. Thus $BOP = OSB = \text{H\$}(+1)$. So:

$$BOP \text{ H\$ } (+1) = CA \text{ Surplus H\$ } (+1) + \text{Non-official FA Balance H\$ } (0)$$

- d. Since $BOP = OSB = \text{H\$ } (+1)$, it must be that $ORT = \text{H\$ } (-1)$: the Central Bank's foreign reserve assets change by $\text{H\$}(+1)$. The Balance Sheet positions would be as follows:

**Balance Sheet of the Central Bank
12/31/2010**

	Assets	Liabilities
Domestic	H\$ 100 m.	H\$ 121 m.
Foreign	H\$ 21 m.	

- e. Because the shock to the current account increases Y at every exchange rate E . In other words, the DD curve will shift to the right.

It follows that this change alone will increase L , and therefore will also increase the equilibrium Humidorian interest rate, causing excess returns on H\$-denominated assets.

If no action is taken, the dollar will appreciate, i.e. E will decline. Under fixed exchange rate, the domestic and foreign interest rates must be equal. Thus, to maintain a fixed exchange rate, money supply will be required to increase. This action will prevent the interest rate from rising and the H\$ from appreciating. In sum, the AA curve will also shift to the right.

In your graph, both the DD and the AA curves shift to the right such that the equilibrium exchange rate is unchanged. Because the shocks in both the goods and the financial markets are expansionary, the equilibrium Y will now be higher. {This is of course true only in the short run}.