Review question (No solution given!)

1. Explain the difference between a closed economy and an open economy. Explain also how the pursuit of internal equilibrium will be different between the two types of economies.

2. Consider the IS-LM-BP model of an open economy with a constant price level, perfect asset substitutability, and perfect capital mobility. The economy is initially in both internal and external equilibrium.

a. Explain why the BP curve is a horizontal line at $i = iF$, where i is the domestic nominal interest rate and iF is the foreign nominal interest rate.

b. Define the internal equilibrium and external equilibrium of the economy, respectively.

3. From question 2, suppose now that the domestic economy decides to reduce its money supply.

a. What are the initial effects of this monetary policy on the goods market, the money market, the foreign exchange market, and the balance of payments of the domestic economy? Which curve(s) will shift?

b. What is the adjustment mechanism under a fixed exchange rate regime? Illustrate and explain which curve(s) will shift during the adjustment, and then compare the new equilibrium with the initial equilibrium.

c. What is the adjustment mechanism under a flexible exchange rate regime? Illustrate and explain which curve(s) will shift during the adjustment, and then compare the new equilibrium with the initial equilibrium.

4. From question 2, suppose now that the domestic government decides to increase the government spending.

a. What are the initial effects of this fiscal policy on the goods market, the money market, the foreign exchange market, and the balance of payments of the domestic economy? Which curve(s) will shift?

b. What is the adjustment mechanism under a fixed exchange rate regime? Illustrate and explain which curve(s) will shift during the adjustment, and then compare the new equilibrium with the initial equilibrium.

c. What is the adjustment mechanism under a flexible exchange rate regime? Illustrate and explain which curve(s) will shift during the adjustment, and then compare the new equilibrium with the initial equilibrium.

5. If a country has a surplus balance of payments, what will be the appropriate government policy to restore the balance of payments back to equilibrium? What effects might this have on the country's income?

6. Imagine that we have a country with imperfect capital mobility and flexible exchange rate. What will happen with domestic income and interest rate if there is a decrease in foreign interest rate? Explain your answer.

7. Show graphically using the Mundell-Fleming model what impact will have an introduction of import restrictions (that improve net exports exogenously, irrespective of the exchange rate). Assume that we have a flexible exchange rate and a perfect capital mobility. Will the introduction of import restrictions improve net exports in equilibrium, as argued by many politicians?

8. Suppose that the government of the small open economy with perfect capital mobility and flexible exchange rate increases lump taxes. Please, compare the impact of such a policy on income, private savings, investment, real interest rate, trade balance and real exchange rate.

9. The small economy of Rokitkowo, due to outstanding economic policy run by president Rokitek stays at full employment. After another sleepless night, president Rokitek has decided to change the structure of demand in order to increase investment. What should be the mix of fiscal and monetary policy if there is no international mobility of capital and the economy has fixed exchange rates. Show your results drawing the necessary diagram.

10. What will be the impact of revaluation of domestic currency if we have an economy with imperfect capital mobility and fixed exchange rates? Would be the impact larger if we had a perfect capital mobility in this case?

11. Imagine that these days USA, the biggest trade partner of Thailand, is suffering from a deep economic slowdown. How would it influence Thai economy if we had to maintain the fixed exchange rates (there is an imperfect capital mobility)? Show the necessary diagram and provide the written justification.

12. The ungrateful citizens of Kalaland have decided to elect Mr. Lazyman as a new president. As a result, the government started to increase its spending and ran huge budget deficits. Yet, the time of economic slowdown arrived and there was a necessity to cut public spending sharply. How would it influence the economy of Kalaland if, for some reasons, Kalaland was forced to keep a fixed exchange rates? Assume that we start from equilibrium and there is an imperfect capital mobility.

13. Applying the Mundell-Fleming model analyse the impact on domestic income, interest rate, CA and KA of the following events:

(a) an increase of foreign interest rate;

(b) a fall of foreign demand on domestic goods.

Provide an analysis for two different countries: - country A with fixed exchange rate and perfect capital mobility - country B with flexible exchange rate and imperfect capital mobility

14. (Transmission under interdependence economy: Spillover effect)

14.1) Assume that the US government decides to increase its public spending. Use the IS-LM / AD-AS model to explain the dynamic of US macroeconomic variables followed from the spending program.

14.2) Suppose that Carlaland is a small open economy. Following the results in (14.1), use the Mundell-Fleming model and analyze the spillover effects of US policy on domestic income and interest rate of Carlaland. Suppose that Carlaland faces perfect capital mobility under the flexible exchange rate regime? What would happen with exchange rate and domestic exports? Explain.