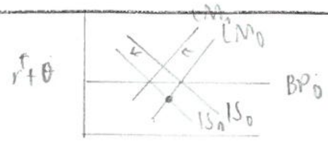

Student ID 6004640337

15

Quiz 4 IS-LM-BP (15 points / 3 points for each question)

Consider the IS-LM-BP model of an open economy with fixed exchange rates and perfect capital mobility. Suppose the economy is initially in a situation of internal and external balance and the government now implements contractionary fiscal policy. Explain whether the following statements appropriately describes the changes once the new equilibrium is achieved.

A) The domestic currency will appreciate.

3

This statement is false. At first, after contractionary fiscal policy, the balance of payment is deficit, indicating excess demand for foreign exchange. Since this economy use fixed exchange rate regime, the authority must protect the exchange rate against depreciation.

good

B) The foreign reserve of central bank will decrease.

3

This statement is true. Since there is an excess demand for forex, the authority must sell its foreign reserve in order to protect the exchange rate. Hence, its foreign reserve will decrease.

C) The money supply will increase.

3

This statement is false. Because the authority sell its foreign reserve (on the asset side of B/S), the monetary base for the economy (on the liability side of B/S) will also decrease. Hence, the money supply will drop instead.

good

D) The balance of the capital account will deteriorate.

3

This statement is false. At first, contractionary fiscal policy brings downward sloping on interest rate which brings capital account deteriorated. However, after a reduction in money supply, the interest rate rises up, which improves the capital account. Thus, these effects on interest rate are offsetting.

E) Both output and the interest rate will increase.

3

This statement is false. The effect on output is amplified by more reduction than an initial attempt. The interest rate remains at $r^f+\theta$ as the answer in d) explained.

Perfect

good

I like this one! clear!