

## Two exercises for student discussion on April 17

A)

Consider the following version of a Mundell-Fleming type model with perfect capital mobility:

*IS*-curve:

$$Y = C(Y - T, W_p, i) + I(i) + G + X(EP/P_*, Y, Y_*) \quad (1)$$

Definition of private wealth

$$W_p = \frac{M_0 + B_0 + EF_{p0}}{P} \quad (2)$$

Interest parity condition:

$$i = i_* + e_e(E) \quad (3)$$

Money market equilibrium:

$$\frac{M}{P} = m(i, Y) \quad (4)$$

The price level  $P$  is predetermined.

- 1) Compare the output effect of a fall in the foreign interest rate under fixed and floating exchange rates. In each case, list which variables you will treat as endogenous. State the assumptions you rely on.
- 2) What options do the authorities have if they want to avoid that the fall in the foreign interest rate has an output effect? Distinguish between the case with fixed and floating exchange rates.
- 3) How does the result in question 1) compare to the immediate output effect of a fall in  $i_*$  in the Dornbusch overshooting model? Is it possible to reconcile the results from the two models of floating exchange rates?
- 4) Compare also to the output effect of a fall in the foreign interest rate in the model of inflation targeting from lecture 9.

B

Assume a credibly fixed exchange rate. Compare the output effect of an increase in the nominal wage rate in the Mundell-Fleming model of exercise A and in models with traded and non-traded goods as in chapter 7.1 of Rdsseth (2000). What are the crucial factors that determine the magnitude of the output effects in the two cases?