Writing Assignment 2

Open Economy

Econ520. Fall 2024

Professor Lutz Hendricks

UNC

See course website for due date

Name:	PID:

This assignment considers how monetary policy effects spill over across borders.

Specifically, consider the implications of tighter foreign monetary policy (higher i^*) on the domestic economy. Assume **floating** exchange rates.

1. Explain how a higher i^* shifts the domestic AD curve. What is the mechanism?
2. Explain what happens to the domestic economy in the **medium run** (Y, P, i, C, I, E, NX). Show that $i < i^*$, even though $i \uparrow$. Be sure to explain the sequence of events that lead to the changes in economic terms.
3. Now suppose that the Fed tries to avoid the crowding out that occurs in the medium run (the drop in I). What would the Fed have to do to stabilize medium run investment? What happens to the same variables in that case? Can the Fed fully neutralize the shock?
4. Finally consider the case where the Fed tries to stabilize the dollar instead. What would the Fed have to do to keep the exchange rate stable? What are the medium run implications for the domestic economy in that case?