

Econ 8510/Chatterjee

Assignment 2

Due on: Wednesday, September 26 (in class)

Total Points: 100

Question 1

Answer the following questions with reference to the Keynesian models of the open economy discussed in class.

- i. In what respects do the Keynesian open economy models differ from their classical (monetary) counterparts? Explain clearly.
- ii. What aspects of the data or predictions of the monetary model do the Keynesian models seek to explain or refine?
- iii. What is "over-shooting"? Explain the circumstances under which it may occur and discuss why this might be considered "stabilizing" behavior.

[7+7+6=20]

Question 2

In class we discussed the effects of monetary policy on the nominal exchange rate in the context of the Mundell-Fleming and the Dornbusch "over-shooting" models. In this exercise, you will be required to analyze the effects of a *fiscal shock*, say a permanent increase in government spending, on the nominal exchange rate. Your answers must include (a) an algebraic exposition, (b) a graphical illustration, and (c) a clear intuitive explanation.

What would be the effect of a permanent increase in government spending on the long-run nominal exchange rate and its dynamics in the following scenarios:

- i. In the Mundell-Fleming model, when the exchange rate regime is (i) fixed, and (ii) flexible. Clearly compare your answers in each scenario with those for a monetary shock.
- ii. In the Dornbusch "over-shooting" model. Compare your results with those of a monetary shock.

[25+25=50]

Question 3

Refer to the following article for this question:

Charles Engel and Kenneth West, "Exchange Rates and Fundamentals." *Journal of Political Economy*, 2005, vol. 113, no. 3.

Write an essay (typed, please) summarizing the contribution of this article to the research on exchange rate forecasting using monetary fundamentals. In your essay, focus on the value-added of this paper relative to both the earlier (pre-1995) and recent literature on this issue (post-1995). Feel free to elaborate on any critical comment that you might have on this paper or the issue in general. Provide a list of references you consulted for this essay.

[30]