1 Export Demand Shock under a Floating Exchange Rate: 10 minutes

An economy with a floating exchange rate suffers a negative demand shock for its export goods. What effect does this have on the current account and aggregate demand in short-term equilibrium? Use a diagram that shows the nominal exchange rate, output and some current account target. [Hint: The exchange rate response in short-term equilibrium may cause a current account balance that is different from the initial current account response.]

Use the diagram to analyze how a temporary monetary intervention can restore the output level. Does the policy have to be contractionary or expansionary? Does the current account attain its target level? Answer briefly.

2 Monetary Shock under a Floating Exchange Rate Regime: 10 minutes

Show the effect of a negative monetary shock on the current account, interest rates and output under a floating exchange rate. Use a diagram that shows the nominal exchange rate and output. Distinguish between the short-term and the long-term equilibrium. Does it matter whether the negative monetary shock is temporary or permanent? Answer briefly.

3 Balanced-budget Rules and Stabilization Policy under Floating Exchange Rates: 10 minutes

Suppose the government of a country under a floating exchange rate regime wants to pursue a temporary fiscal expansion. However, the government’s budget has to be balanced. So, both spending and taxes need to increase so that \( \Delta G = \Delta T \). How large is the net effect on the economy? [Hint: The net effect is positive.]

Use a diagram that shows the nominal exchange rate, output and some current account target. What is the effect of this policy on the exchange rate, output and the current account? Would a permanent expansion be effective? Answer briefly.

4 Current Account Targeting: 10 minutes

Suppose a country under a floating exchange rate regime needs to raise its current account balance to meet foreign lenders’ concerns. Use a diagram that shows the nominal exchange
rate, output and the current account target to analyze how the change in the target level alters the country’s perspective on the current equilibrium.

Propose a temporary fiscal policy and show how it could achieve the current account target in the short run. Would a permanent fiscal policy be effective?