Homework Assignment #4  
Due February 16 (Thursday)

Question 1:
Discuss how a temporary increase in output in a foreign economy affects the DD schedule.
   a. Discuss how a temporary rise in the foreign interest rate affects the AA schedule.
   b. The response of the interest rate and output for a closed economy to a fiscal expansion is:
   c. The response to a monetary expansion is:
   d. Compare the effects of a foreign fiscal expansion to a foreign monetary expansion. (Hint: You will need to use your results from Parts (a), (b), and (c). Do not worry about additional feedback effects from the domestic economy to the foreign economy.) In comparing these results, we find:

Question 2:
   a. Suppose the following headline appears in today’s newspaper: “Congress and President Agree to Tax Cut Next Year.” What would you expect the effect of this headline to be on output and the exchange rate today?
   b. Suppose this headline appears in today’s newspaper instead: “Federal Reserve Announces It Will Raise Money Supply Next Year.” What would you expect the effect of this headline to be on output and the exchange rate today?
   c. Suppose both of these headlines appear in today’s newspaper. Would you still necessarily expect to find an effect on output and the exchange rate?
Question 3:

Consider the following comment:
“The current account depends upon income and the real exchange rate. If income rises, consumption of imports is high, and the current account worsens. Thus, if monetary policy is the only tool that authorities can respond with quickly, a worsening of the current account due to a rise in income (for example, because of a temporary tax cut) requires a monetary contraction to moderate the rise in income and stop the deterioration of the current account.”

a. Use the DD-AA diagram on the next page to analyze the effects of a temporary tax cut on income and the current account.
b. Do you find that the current account worsens and that income rises, as suggested in the comment?

c. Now consider a monetary contraction. Use the following DD-AA diagram to show its effects on income and the current account.

d. Does this monetary policy response moderate the rise in income? Does it reverse the deterioration of the current account?

Question 4:

Many countries impose taxes or controls on holding foreign assets. One way to model this is to modify the interest parity equation by including a tax term. Since the after-tax return to foreign bonds is reduced by the tax, the domestic interest rate need not be as high as it would be if there were not a tax. The interest parity relationship would thus be modified as follows:

\[ R = R' + \left( E' - E \right)/E - T. \]

a. How does this modification in the interest parity relationship alter the DD-AA diagram?
b. Show the effects of a temporary increase in $T$, the tax on foreign assets, in the following diagram.