HW12: due on Dec. 3rd before class.

1. (Textbook, 7th e, chapter 12, question 1)

Use the Mundell-Fleming model to predict what would happen to aggregate income, the exchange rate, and the trade balance under both floating and fixed exchange rates in response to each of the following shocks.

a. A fall in consumer confidence about the future induces consumers to spend less and save more.

b. The introduction of a stylish line of Toyotas makes some consumers prefer foreign cars over domestic cars.

c. The introduction of automatic teller machines reduces the demand for money.

2. (Textbook, 7th e, chapter 12, question 3)

The Mundell-Fleming model takes the world interest rate \( r^* \) as an exogenous variable. Let’s consider what happens when this variable changes.

a. What might cause the world interest rate to rise?

b. In the Mundell-Fleming model with a floating exchange rate, what happens to aggregate income, the exchange rate, and the trade balance when the world interest rate rises?

c. In the Mundell-Fleming model with a fixed exchange rate, what happens to aggregate income, the exchange rate, and the trade balance when the world interest rate rises?

3. (Textbook, 7th e, chapter 12, question 5)

Suppose that higher income implies higher imports and thus lower net exports. That is, the net exports function is \( NX=NX(e, Y) \). Examine the effects in a small open economy of a fiscal expansion on income and the trade balance under the following.

a. A floating exchange rate.

b. A fixed exchange rate.
4. (Textbook, 7th e, chapter 12, question 6)

Suppose that money demand depends on disposable income, so that the equation for the money market becomes \( M/P = L(r, Y-T) \). Analyze the impact of a tax cut in a small open economy on the exchange rate and income under both floating and fixed exchange rate.