Name: ______Solutions____

Cosumnes River College
Principles of Macroeconomics
Problem Set 8
Not Being Collected

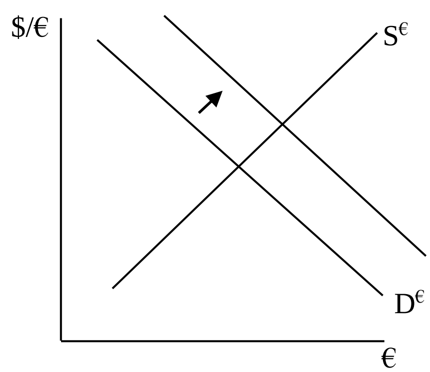
Spring 2017 Prof. Dowell

1. What is the difference between a government deficit and the debt?
The deficit is a flow and is the difference between government spending and taxes. Deficits are measured over the course of a single year. The deficit is a stock concept and is the accumulation of all past deficits and surpluses.

2. What is crowding out? Explain.
Crowding out occurs when an expansionary fiscal policy increases the interest rate and reduces private investment. Private investment is replaced with government spending.

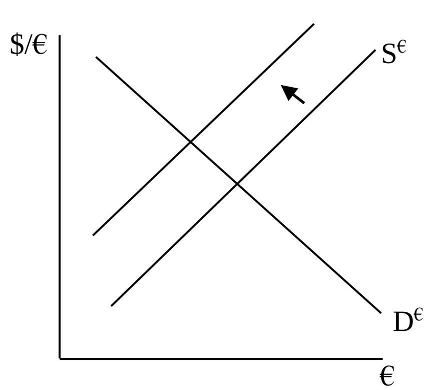
3. Use supply and demand diagrams and words in each of the following cases to explain whether the dollar will appreciate or depreciate relative to the euro and why in a system of floating exchange rates. Note: You need to indicate whether the dollar appreciates or depreciates and explain why.

   a. American investors are attracted by prospects for profit on the European stock market.



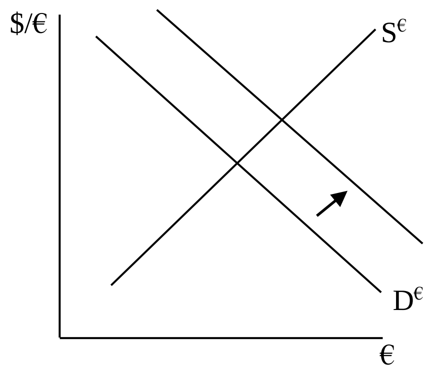
American investors demand more euros, shifting the demand curve to the right. This causes an increase in the dollar price of the euro or a depreciation of the dollar.

   b. A recession in Europe cuts European purchases of American goods.



Europeans buy fewer of our goods, demand fewer dollars and hence supply fewer euros, shifting the supply curve to the left. This causes an increase in the dollar price of the euro or a depreciation of the dollar.

c. Interest rates increase on bonds in Europe, but remain constant in the U.S.



Americans demand more European bonds and demand euros to purchase them. This increases the demand for euros, shifting the demand curve to the right. This causes an increase in the dollar price of the euro or a depreciation of the dollar.

3. Explain what would happen to the dollar-price of yen if there was an increase in the supply of dollars and an increase in the demand for Japanese yen?

   This would drive up the dollar-price of yen. The reason is that an increase in the supply of dollars is the same as an increase in the demand for yen in this two-country comparison.

4. What is the impact of expansionary fiscal policy on the exchange rate? Explain the process through which expansionary fiscal policy affects the exchange rate

   A fiscal expansion normally makes the exchange rate appreciate. A fiscal expansion pushes up interest rates. At higher interest rates, domestic securities become more attractive to foreign investors, who go to the foreign-exchange markets to buy domestic currencies with which to purchase them. This buying pressure drives up the value of the domestic currency.

5. Compare the effectiveness of monetary policy in an open economy with mobile international capital to monetary policy in a closed economy. Why is it different? Use an appropriate diagram to illustrate your answer.

   An appropriate diagram should resemble Figure 20-7 in the text. Monetary policy is more effective (that is, it has a larger effect on real GDP) in an open economy than it is in a closed economy. A change in monetary policy that is intended to raise aggregate demand to counteract recession will often lower interest rates. A decrease in interest rates will trigger a currency depreciation, which will increase net exports and, therefore, add an additional element to the outward shift in aggregate demand. The foreign exchange market effects further enhance the expansionary effects of looser monetary policy.