

Problem Set #7: The Real Exchange Rate

1. Problems from the textbook

Solve problems 3 and 7 in chapter 15 pp. 400-401 (7th edition), pp. 426-427 (6th edition).

2. Government spending and the exchange rate

Government spending often falls mostly on domestic products. In what follows you are asked to analyze the effects of a permanent increase in government spending.

Assume for simplicity that $R = R^*$, and that money, M , does not grow over time. Also, home and foreign economies are initially in their long run equilibrium.

- (a) In the long run, how does the increase in government spending affects each of the following:
- i. Supply of domestic goods relative to foreign goods.
 - ii. Demand of domestic goods relative to foreign goods.
 - iii. The real exchange rate, q .
 - iv. Nominal interest rate, R .
 - v. The price level.
 - vi. Nominal exchange rate, E , and exchange rate expectations, E^e .
- (b) Assuming that output does not change throughout the analysis, show that in the short run both nominal and real exchange rates adjust immediately but no other changes occur.