International finance
Problem set 10

1. Consider the two-country model introduced in Lecture 9 and 10. Derive the effect of the following shocks on the equilibrium - nominal and real (assume expected inflation equals to zero) - interest rate and the equilibrium real exchange rate. Specify which of the following shocks can be accomodate purely by a change in the nominal exchange rate and which require a change in prices. If prices have to change indicate whether a boom or a recession is required in the short run (when prices are sticky) in the UK or Germany and whether the ability to change the nominal exchange rate is useful or not.

   (a) A shift in consumer tastes from cars produced in the UK to German cars.

   (b) A shift in consumer tastes from alcoholic drinks to cars.

   (c) An increase in saving in both the UK and Germany.

   (d) An increase in saving in the UK alone.

   (e) An increase in investment in Germany.

2. How would your answers above change if prices were perfectly flexible in Germany.