International finance
Problem set 7

1. Consider the simplified version of the Dornbusch model introduced in the lecture. Prices are fixed in the first period and perfectly flexible from period 2 onwards. Derive the response of the nominal and real exchange rates to the following shocks:

   (a) a permanent increase in the rate of money growth μ.

   (b) a permanent increase in the full employment output level $\bar{y}$. Distinguish between the case in which η, the elasticity of desired expenditure to the real exchange rate is: (i) equal to one; (ii) less than one.