Question A counts 1/4, question B 3/4.

Question A

Explain briefly what is meant by the following concepts:

1. Perfect capital mobility between currencies
2. Absolute purchasing power parity
3. Covered interest rate parity
4. Sterilization
5. Pricing to market

Question B

We are looking at a small open economy with a floating exchange rate. The supply of money is set exogenously by the central bank The economy is described by the four relations:

$$
\begin{aligned}
Y &= C(Y) + X(EP_*/P, Y, Y_*) && (1)\\
M/P &= m(i, Y) && (2)\\
\dot{P}/P &= \gamma(Y - \bar{Y}) && (3)\\
\dot{E}/E &= i - i_* && (4)
\end{aligned}
$$

Y is output, C the consumption function, X the net export function, E the exchange rate, P the price of home goods, P_* the price of foreign goods, M the quantity of money, m the money demand function, i the domestic interest rate, i_* the foreign interest rate, $\bar{Y}$ equilibrium output and $\gamma > 0$ a constant parameter.

1. Which variables will you treat as exogenous, which as endogenous? What are the assumptions behind equation (4)?
2. Explain with a graph how the time path of the exchange rate is determined in the model. State the assumptions you need on the behavioral functions ($C(\cdot)$, $X(\cdot)$, $m(\cdot)$).
3. Suppose the economy is initially in a stationary state. Discuss briefly the effect of an unexpected increase in the money supply on the time path of the exchange rate.
4. Suppose again that the economy is initially in a steady state. Then there is an upward shift in consumption demand (reduced propensity to save).What effect does this have on the values of i) the real exchange rate, ii) the price of home goods and iii) the nominal exchange rate in the stationary equilibrium of the model? What can you say about the transition from the old to the new stationary equilibrium?

5. Is the model well suited for discussing the long term effects of a reduced propensity to save or are important effects missing?