

Problem set:
exchange rates and
open-economy
macroeconomics



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ECONOMICS Suppose the government imposes a tariff on all imports. Use the DD-AA model to analyze the effects this measure would on the economy.

Analyze both temporary and permanent tariffs.

An imposition of tariff, whether temporary or permanent, on all imports will “ increase domestic money supply thereby affecting an upward shift or movement in the AA schedule without affecting the position of DD.”¹ And as such, generally it is perceived that “ an increase in the money supply causes a depreciation of the domestic currency, an expansion of output, and therefore an increase in employment.”² will be achieved the moment that a temporary tariff is imposed. This is so on the basis that the exchange rate depreciation creates an expectation that the home rates will soon appreciate plus the fact that it makes home products cheaper if compared with foreign products. As such what can be expected is “ a temporary increase in fiscal expansion and rise in output thereby resulting into currency appreciation.”³ But when it is a permanent tariff, initially one can expect an aggressive movement in the market resulting into employment. However, in the long-run, “ output returns to its initial level and all money prices rise in proportion to the increase in money supply.”

2. Suppose there is a permanent fall in private aggregate demand for a country's output (a downward shift of the entire demand schedule). What is the effect in the output? What government policy response would you recommend?

If there is a permanent fall in private aggregate demand for a country's output, there will be an increase in the supply of the output thereby lowering the price of the goods and services which posits a big problem to investors and the government. For such a scenario will possibly lead to bankruptcy of <https://assignbuster.com/problem-set-exchange-rates-and-open-economy-macroeconomics/>

industries resulting into unemployment, which is what we, are all avoiding. In a situation like this, I think what the government should do is to increase government spending in order to prop up the economy. But this should be only temporary until an equilibrium has been established since we do not want to have a “ crowding out” to happen to the country’s output for that may further aggravate the permanent fall in aggregate demand for a country’s output. At the same time, I will impose import tariffs in order to protect the domestic economy. It is indeed protectionism but I honestly think that such a scenario demands an aggressive response from the government.

3. Why does a temporary increase in government spending causes the current account to fall by smaller amount than permanent increase in government spending?

Current account balance (CA) is “ the demand for the country’s exports less that country’s own demand for imports is determined by two main factors: the domestic currency’s real exchange rate against foreign currency and domestic disposable income.” 4 Government spending affects current account because it has direct influence on exchange rates and it is here that we see the difference between a temporary increase in government spending vis-a vis that of a permanent increase.

In a temporary increase in government spending, it causes the CA to fall in smaller amount than when a permanent increase in government spending is performed because the temporary increase has a short run effect and it “ does not affect the expected future exchange rate” 5 which directly influences CA. Moreover, because of its immediate depreciation effect on the domestic currency, it makes “ domestic products cheaper relative to foreign
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products" 6 thus giving us an equilibrium. Further more, in the domestic scene " $CA = \text{export} - \text{import}$ " and being such it may act as a cushion for the temporary depreciation of domestic currency thereby giving a smaller fall in CA. However, when it is a permanent increase those effects are not observed in the long run. In fact, it does more harm to the economy because of its "crowding out" effect on domestic products.

BIBLIOGRAPHY:

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