

Place your name on the back of this sheet of paper and nowhere else. Staple your answers on the front of this sheet of paper. Failure to follow these directions will cost you 1 point. Your assignment will be typed, except graphs can be drawn by hand and mathematical equations can be done by hand. Failure to type it will cost you 10 points. If you use double-sided printing or print on the back of scrap paper, I will give you one additional point.

1) (15 points) Without drawing any graphs, explain the economic reason why the AD curve for a closed economy is steeper than the AD curve for an open economy with a fixed exchange rate. Make sure you mention why the IS curve moves when prices go up in an open economy, but not in a closed economy.

2) Figure 19.3 shows the derivation of the AD curve with a flexible exchange rate. On the next page, they say that it is possible for LM' and IS'' to cross at E* below H. They meant to say IS' not IS'' and E'' rather than E*.

A) (10 points) Explain how I know what they meant to say.

B) (35 points) Recreate Figure 19.3 with E'' below H. Explain why the curve(s) moved as drawn. How does this affect the relative slope of the AD for an open economy with a flexible exchange rate and one with a fixed exchange rate.

3) (40 points) Illustrate an increase in consumption on both the SRAS/LRAS/AD diagram and the IS/LM/BP diagram. Assume the country has a fixed exchange rate. Only show the immediate effects. Explain why the curve(s) moved as drawn.