Economics 104B, Section 1 **Prof. Steve Fazzari**
Homework Problems: Part 4 **Spring, 2013**

Note: These problems do not have to be turned in. But they are very important to your preparation for exam #2 on March 27. I strongly encourage you to write out answers to all the problems below before carefully reading the solutions that will be posted a few days before the exam.

1. Some economists and politicians are greatly concerned that if the Federal Reserve raises interest rates economic growth will decline over the next few quarters by reducing aggregate demand. Briefly describe why "demand-side" theory predicts that lower demand will slow economic growth. Then, identify <u>*three separate channels*</u> through which higher interest rates can reduce aggregate demand. In each case, briefly describe the reason that higher interest rates might reduce demand.

2.a) Suppose that a compact disc (CD) player sells for $240 in the U.S. while a comparable unit sells for 24,000 yen in Japan. Also suppose the initial exchange rate is 120 yen to the dollar. Explain why this situation <u>*is not*</u> consistent with purchasing power parity.

b) Starting from the situation described in part a, suppose that exchange rates are flexible. Explain why the dollar-yen exchange rate will change in response to the failure of purchasing power parity. Make sure to specifically state the direction of change for the value of the yen relative to the dollar. What exchange rate will give purchasing power parity? Explain briefly.

3. There was a dramatic move in the value of the U.S. dollar in late 1994 and early 1995. Prior to that time, U.S. GDP and income grew faster than the income of the major trading partners of the U.S. because some of these economies were stagnating or actually in recession. What effect is this situation likely to have on U.S. imports, exports, and the U.S. international trade deficit? Given these circumstances, which direction do you think the dollar moved? Explain your answer.

4. Suppose that the <u>*European*</u> central bank decides to raise interest rates. Answer the questions below about the economic effect of this action <u>*on the U.S. economy*</u>.

a) Predict the effect of higher European interest rates on the value of the U.S. dollar. Why does the value of the dollar change?

b) Explain how the change analyzed in part a) affects U.S. aggregate demand. Which direction does U.S. aggregate demand move? Which components of aggregate demand change as a *direct result* of the new exchange rate? Briefly explain the reasons for these changes.

5. Write two short paragraphs that assess the impact of exchange rates on the U.S. macro economy. In the first paragraph describe the sense in which a strong dollar a good thing for the U.S. economy and its citizens. In the second paragraph, summarize the ways in which a strong currency can damage the economy and hurt the welfare of its citizens.