Economics 2 | Professor Christina Romer
Spring 2020 | Professor David Romer

PROBLEM SET 6

DUE BY 2 P.M. PDT ON THURSDAY, APRIL 30TH

You may work together on the problems, but your answers must be ***in your own words*** and ***handwritten***. You also must ***list the other students with whom you worked***.

For all questions be sure to explain your answers and to use graphs whenever appropriate.

1. What would you expect each of the following developments to do to the price of dollars in euros?

- **a.** There is a shift in American tastes away from European clothes, cars, and food.
- **b.** Concerns about the impact of the pandemic on the European financial system make investors in both the United States and Europe want to buy fewer European stocks and bonds and more American ones.
- **c.** Inflation is lower in Europe than in the United States.

2. Suppose that the economy begins in long-run equilibrium: output is at potential and, as a result, inflation is steady. Now, suppose there is a permanent upward shift of the Federal Reserve's reaction function.

- **a.** What does this change in the reaction function imply that the Fed will do to the real and nominal interest rates in the short run? Will this involve the Fed buying or selling government bonds?
- **b.** What will be the short-run effect of the change on GDP?
- **c.** Sketch how GDP returns to its potential level. (*Hint*: What will happen to inflation after a while? How will the Federal Reserve respond to that?)
- **d.** When Y is back to Y*, is inflation higher, lower, or the same as it was initially (or is it not possible to tell)?
- **e.** When Y is back to Y*, is the real interest rate higher, lower, or the same as it was initially (or is it not possible to tell)?