

**Assignment Five**  
**Due: April 8, 2004**

1. Use the IS-LM-BP model to answer the following questions.
  - a. Suppose the European Central Bank raises interest rates in Europe ( $r^*$  increases).
    - i. What is the effect on  $Y$ ,  $r$ , and  $\varepsilon$  (the real exchange rate) predicted by the model. Explain, in detail, how you arrive at your answers.
    - ii. Why does your answer make economic sense? I want an is explanation of the economic forces that produce the changes.
  - b. Suppose the government increases spending due to a military conflict.
    - i. What is the effect on  $Y$ ,  $r$ , and  $\varepsilon$  (the real exchange rate) predicted by the model. Explain, in detail, how you arrive at your answers.
    - ii. Why does your answer make economic sense? I want an is explanation of the economic forces that produce the changes.
    - iii. The dependence of net exports on  $Y$  is measured by sensitivity parameter  $n$ . Does the dependence tend to **offset or reinforce** the effect on  $Y$  of an increase in autonomous spending? Explain your answer in full detail.
    - iv. Why does your answer make economic sense? I want an is explanation of the economic forces that produce the changes.
2. Question 1, page 373, Mankiw.
3. Question 5, page 373, Mankiw.