

Practice Problems: Monetary Regimes

Monetary/Exchange Rate Regimes

1. In the long run, what is the only thing monetary policy can truly influence? What about the short run? (Be sure to explain what “money neutrality” is and also use the quantity equation in “hats”.)
2. List and discuss the two most common monetary policy objectives and why they make sense in light of your answer to #1 above.
3. We discussed three main exchange rate/monetary regimes (Fix, Flex with a Monetary rule, and Flex with an interest rate rule). Discuss and explain each.

Open Market Operations under a FLEX

4. Suppose the central bank would like to increase the nominal money supply. Explain the open market operation it must conduct. Why might it want to do this?
5. Suppose the central bank would like to decrease the nominal money supply. Explain the open market operation it must conduct. Why might it want to do this?

Open Market Operations under a FIX

6. Suppose the central bank would like to increase the exchange rate (a “devaluation”). Explain the open market operation it must conduct. Why might it want to do this?
7. Suppose the central bank would like to decrease the exchange rate (a “revaluation”). Explain the open market operation it must conduct. Why might it want to do this?

Sterilization

8. Explain how sterilization works by conducting “open market operations” in two markets simultaneously.
9. Explain the problems with sterilization and why it shouldn’t work in a perfect world.
10. Explain why and how sterilization works to some degree in the real world.

FIXED Exchange Rate Regime

11. Consider a fixed exchange rate regime.
 - a. Does the central bank actively increase or decrease the money supply?

- b. Explain how an increase in the money supply occurs if market conditions change so that an increase in the nominal money supply is required. What happened to international reserves?
- c. Explain how a decrease in the money supply occurs if market conditions change so that a decrease in the nominal money supply is required. What happened to international reserves?

12. Consider the case of the foreign country increasing their interest rate.

13. Consider the case of the foreign country decreasing their interest rate.

Special Considerations for Open Economies

14. Discuss the benefits and problems with a fixed exchange rate regime.

15. Discuss why free capital mobility matters when conducting monetary policy in an open economy.

16. Discuss and explain the “open economy policy trilemma”.

17. Discuss and explain an Optimal Currency Area. Is the US an Optimal Currency Area? How about all of North America (i.e. a “NAFTA zone” including Mexico, the US and Canada)?