Assessment guidelines SØK2009 fall 2019

The compulsory readings are chosen chapters from the textbooks "International Economics" by Krugman, Obstfeld and Melitz (11th edition) and "Economics of Monetary Union" by De Grauwe (12th edition), as well as lecture notes.

<u>Question 1</u>

The answer to question 1 is based on the Barro-Gordon model, covered by chapter 2.3 of the De Grauwe textbook. The relevant equations and graphical illustrations of the model must be presented and explained. The Barro-Gordon model consists of the Phillips curve (described by equation 2.7 and illustrated in figure 2.9) and the preferences of the monetary authorities with respect to inflation and unemployment (described by a welfare function and illustrated by indifference curves in figure 2.10). The model equilibrium should be illustrated graphically. The answers to the three sub-questions should be based on explanations and discussions of figures 2.12 (question 1a), 2.13 (question 1b), and 2.14 (question 1c).

<u>Question 2</u>

Question 2 should be answered by using a model combining the money market and the foreign exchange market, as described in chapters 14 and 15 in the Krugman et al. textbook. The foreign exchange market is described in chapter 14 (Figure 14-4 and related equations), the money market is described in chapter 15 (Figure 15-3 and related equations), and the complete foreign exchange – money market model is covered in chapter 15 (Figure 15-6). The relevant equations and graphical illustrations must be presented and explained, including the analytical solution for the equilibrium exchange rate. The impact of a negative shift in the income level on the exchange rate is analyzed as a negative shift in the money demand curve, which leads to lower interest rate and exchange rate depreciation. It is important to explain the economic intuition behind the effects. To have equilibrium in the money market after the negative income shift, the interest rate must decline. As money demand goes down, the demand for bonds increases, which increases the price of bonds, and thus reduces the return on bonds (lower interest rate). In the foreign exchange market, lower domestic interest rate implies lower return on dollar deposits, which increases the supply of dollar and decreases the price of the dollar (exchange rate depreciation).