Regrade policy: If you would like your test regraded, please submit a written statement to explain why. Your entire test will be regraded, so there is a possibility that points could be lost not gained.

Multiple Choices:
1) a  2) a  3) d  4) d  5) b  6) a  7) c  8) c

Problem 1. National Accounts

a) The net foreign assets rose by $2 billion (-FA account); they acquired foreign assets.
b) CA = -FA = $2 billion.
c) NFIA = GNI – GDP = $9 bil = $10 bil = -$1 bil.
d) TB = CA – NFIA = $2bil – (-$1bil) = $3 bil.
e) The fact that GDP exceeds GNI indicates that this country has experienced a lot of capital inflow in the past, and foreigners own many assets in the country. Ireland is an example, which has received a lot of investment from foreign companies.

Problem 2: ISLM Model

a)

b) Output rises, interest rate falls, E rises (yen depreciation), investment rises, trade balance rises.

c) Under fixed exchange rates, all the variables listed above would not change from their initial values. (This is because the money supply must fall with money demand to maintain the fixed exchange rate.) Japan would be losing foreign reserves.

Problem 3: Intertemporal theory

Here are the main points that should be covered:

According to the intertemporal theory, the possible benefits of a current account deficit are (1) to help smooth a consumption over a temporary fall in income, and (2) to take advantage of an investment opportunity without having to unsmooth consumption and raise domestic saving. The cost is that the country must run a trade surplus in future years to pay interest on the debt accumulated. (You can also mention the benefit of risk sharing, but trading equities does not require any current account imbalance, so you do not have to mention anything about this third benefit of financial globalization).
The U.S. current account deficit appears to arise mainly out of a fall in private saving. Interpretation of this fact might vary among students, but it is generally hard to see any evidence in the US case of the two benefits discussed above -- since output is not temporarily low, and investment is not temporarily high.

Note that it would not be correct in the context of this model to say that a cost of the U.S current account deficit would be higher interest rates. In the intertemporal model, the saving of a small open economy can be below its investment without a rise in the interest rates; this is a distinction with the usual closed economy macroeconomic model.