Practice Exam 2

- You have 75 minutes to complete this exam.

- You may use a calculator; you may **not** use any other device (cell phone, etc.)

- You may consult one page of notes (both sides); you may not use books, notebooks, etc.

- Show your work.

I understand that the honor code applies: I will not lie, cheat, or steal to gain an academic advantage, nor tolerate those who do.

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Signature

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Printed Name

1. [5 pts] Why is the IS curve downward sloping? Explain using the goods-market equilibrium diagram.

2. [5 pts] Does a current account deficit always imply a decrease in a nation's external wealth? Use an equation to support your answer.

3. [5 pts] Country one is operating the production function $q_1 = 10k_1^{0.3}$ and country two is operating the production function $q_2 = 10k_2^{0.3}$, where q_i is output per worker and k_i is capital per worker in country $i = 1, 2$. If $k_1 = 5$ and $k_2 = 8$, would you expect to see cross-border investment? If so, in which direction? Explain your answer.

4. [5 pts] We have observed several low-income economies accumulate large stocks of foreign assets, making their external wealth large and positive. These economies are not rich in natural resources. What would explain this behavior? Why would this behavior be more likely in a low-income country than in a high-income country?

Consider a world with two countries, home and foreign. Assume that prices are sticky and there are no international capital controls. The economy is initially in an equilibrium at (i_1, Y_1, E_1). Use the IS-LM-FX framework to answer the following questions.

5. [10 pts] The fiscal authority has temporarily lowered the corporate tax rate. What is the effect of this policy on the IS and/or LM curves? Explain your answer.

6. [15 pts] Use an IS-LM-FX diagram to show the effects of the change in the corporate tax rate.

Consider a world with two countries, home and foreign. Assume that prices are sticky and there are no international capital controls. The home country fixes its exchange rate against the foreign country at $\bar{E}$. The economy is initially in an equilibrium at $(i_1, Y_1, \bar{E})$. Use the IS-LM-FX framework to answer the following questions.

7. [15 pts] In response to political pressure to balance the government budget, the government temporarily raises income taxes. If the central bank does not respond, show the effects of this tax hike in an IS-LM-FX diagram. Label the new equilibrium (i_2, Y_2, E_2).

8. [20 pts] How should the central bank respond to the change in the corporate tax rate? In the space below, show the effect of the central bank's policy response in the money market. Add the effect of the central bank's policy response to your figures from question 7. Label the new equilibrium (i_3, Y_3, E_3).

For each of the following transactions, report the associated changes in the appropriate U.S. balance of payments account.

9. [4 pts] A Mexican firm purchases $1 mil. of software from Microsoft. It pays with a cashier's check from Banamex, a Mexican bank.

10. [4 pts] A U.S. citizen sends $100 in cash to a friend in Italy for their birthday.

11. [4 pts] Goldman Sachs receives $20,000 of U.S. T-bills from a German bank in exchange for $15,000 of Facebook stock and $5,000 worth of consulting services.

12. [3 pts] As a result of these transactions, by how much has the current account, the capital account, and the financial account changed?

13. [5 pts] *Challenging.* Consider a world with two countries, home and foreign. Assume that prices are sticky and there are no international capital controls. The economy is initially in an equilibrium at (i_1, Y_1, E_1). What combination of policies (fiscal, monetary) could the government use to increase the trade balance without changing the level of output? Show the effects of these policies on an IS-LM-FX diagram.

Extra Space

Clearly label the question number, and leave a reference to this page near the question.