Chapter 8 Review
The Open Economy

Readings  Chap. 8: all

Outline

I. Previously: Demand Adjustment in a Closed Economy

II. Introducing the foreign sector

III. Accounting Identities
   A. The Supply-Side (Resource Markets)
   B. Goods & Services Market Equilibrium
   C. Financial Market Equilibrium
   D. Foreign Sector

IV. The Adjustment Process in a Small Open Economy I:
   ∆r and ∆Capital Flows
   Assumption: no ∆Exchange Rates
   A. If r_{Autarky} > r_{World},
   B. If r_{Autarky} < r_{World}
   C. Ex. Fiscal Expansion with no net capital flows prior to fiscal the expansion
   F. What determines net exports? Part 1

V. Exchange Rates
   A. An alternative effect: Know how Savings, Investment, etc. affect exchange rates!
   B. e = ?
   C. What determines net exports? Part 2
   D. Modeling the foreign sector
   E. Fiscal Expansion Starting from balanced trade
   F. Ex. Fiscal Contraction starting from balanced trade
   G. Ex. Protectionist Policies (starting from balanced trade)

VI. Measuring Exchange Rates
   A. Measuring Exchange Rates: nominal vs real
   B. Nominal interest rates and ΔP: Know how relative inflation rates affect the nominal exchange rate.
   C. Purchasing Power Parity

Problems to Study (not graded)

1. p 222: Questions For Review # 1.
2. p 222: Questions For Review # 3.


5. p 222: Problems and Applications # 1. **Do not model the exchange rate graphically.**


7. p 222: Problems and Applications # 3.

8. p 222: Problems and Applications # 5.

9. p 222: Problems and Applications # 6. **Do not model the exchange rate graphically.**
   **Hint:** Think what this would do the world interest rate.


12. The nation of Ricardotopia currently has balanced trade (X-M). It is a small nation and therefore faces the world interest rate \( r = r_{\text{World}} \).
   a. Draw the nation’s initial situation on a graph with \( r \) on the vertical axis. Label this situation with the subscript 1 (ex. \( r_1, (X-M)_1, S_1, I_1, \text{etc.} \)).
   b. Draw the nation’s initial situation on a graph with exchange rates on the vertical axis. Label this situation with the subscript 1 (ex. \( \varepsilon_1, (X-M)_1, \text{etc.} \)).

   Now, assume that the federal government increases its spending without raising taxes.
   c. Draw this new situation on the graph with \( r \) on the vertical axis. Label this situation with the subscript 2 (ex. \( r_2, (X-M)_2, S_2, I_2, \text{etc.} \)).
   d. Draw this new situation on the graph with exchange rates on the vertical axis. Label this situation with the subscript 2 (ex. \( \varepsilon_2, (X-M)_2, \text{etc.} \)).
   e. Explain how the composition of Aggregate demand changed as a result of this (if it did change). What happened to capital flows? Can you explain these results more intuitively, i.e. without explicitly referring to the graphs?

13. The nation of Stolpernam currently has balanced trade (X-M). It is a small nation and therefore faces the world interest rate \( r = r_{\text{World}} \).
   a. Draw the nation’s initial situation on a graph with \( r \) on the vertical axis. Label this situation with the subscript 1 (ex. \( r_1, (X-M)_1, S_1, I_1, \text{etc.} \)).
   b. Draw the nation’s initial situation on a graph with exchange rates on the vertical axis. Label this situation with the subscript 1 (ex. \( \varepsilon_1, (X-M)_1, \text{etc.} \)).

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1 Ideally you will use the real exchange rate, \( \varepsilon \). However, if both countries are experiencing the same inflation rate, it shouldn’t matter whether you use \( \varepsilon \) or e.
Now, assume that the federal government decreases its spending and leaves taxes unchanged.

c. Draw this new situation on the graph with r on the vertical axis. Label this situation with the subscript 2 (ex. $r_2$, $(X-M)_2$, $S_2$, $I_2$, etc.).

d. Draw this new situation on the graph with exchange rates on the vertical axis. Label this situation with the subscript 2 (ex. $\epsilon_2$, $(X-M)_2$, etc.).

e. Explain how the composition of Aggregate demand changed as a result of this (if it did change). What happened to capital flows? Can you explain these results more intuitively, i.e. without explicitly referring to the graphs?

14. The nation of Hecksherstan currently has balanced trade $(X-M)$. It is a small nation and therefore faces the world interest rate ($r = r_{World}$).

a. Draw the nation’s initial situation on a graph with r on the vertical axis. Label this situation with the subscript 1 (ex. $r_1$, $(X-M)_1$, $S_1$, $I_1$, etc.).

b. Draw the nation’s initial situation on a graph with exchange rates on the vertical axis. Label this situation with the subscript 1 (ex. $\epsilon_1$, $(X-M)_1$, etc.).

Now, assume that the government raises tariffs and quotas on imported goods. Importers now have to pay a higher tariff and are allowed to ship fewer foreign goods in.

c. Draw this new situation on the graph with r on the vertical axis. Label this situation with the subscript 2 (ex. $r_2$, $(X-M)_2$, $S_2$, $I_2$, etc.).

d. Draw this new situation on the graph with exchange rates on the vertical axis. Label this situation with the subscript 2 (ex. $\epsilon_2$, $(X-M)_2$, etc.).

e. Explain how the composition of Aggregate demand changed as a result of this (if it did change). What happened to capital flows? Can you explain these results more intuitively, i.e. without explicitly referring to the graphs?

15. The nation of Rybczynski currently has balanced trade $(X-M)$. It is a small nation and therefore faces the world interest rate ($r = r_{World}$).

a. Draw the nation’s initial situation on a graph with r on the vertical axis. Label this situation with the subscript 1 (ex. $r_1$, $(X-M)_1$, $S_1$, $I_1$, etc.).

b. Draw the nation’s initial situation on a graph with exchange rates on the vertical axis. Label this situation with the subscript 1 (ex. $\epsilon_1$, $(X-M)_1$, etc.).

Now, assume that the government lowers tariffs and quotas on imported goods. Importers now pay a much lower tariff and are allowed to ship more foreign goods in.

c. Draw this new situation on the graph with r on the vertical axis. Label this situation with the subscript 2 (ex. $r_2$, $(X-M)_2$, $S_2$, $I_2$, etc.).

d. Draw this new situation on the graph with exchange rates on the vertical axis. Label this situation with the subscript 2 (ex. $\epsilon_2$, $(X-M)_2$, etc.).

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2 This might not be the most exciting addition you make to a graph this semester.
e. Explain how the composition of Aggregate demand changed as a result of this (if it did change). What happened to capital flows? Can you explain these results more intuitively, i.e. without explicitly referring to the graphs?

16. Label the following agents, markets, and dollar flows as precisely as possible.