Answers to Chapter 18 Practice Questions (note I got #6 wrong, for all the right reasons….)

Question 1

Suppose a Latte Grande costs $9 in Oslo Norway, $4.50 in New York and $3 in Mexico City. This means the real exchange rate for Oslo and Mexico City relative to New York is [___] and [___] respectively. Use fractions not decimals here, though on the real exam you can use either.

Specified Answer for: ___ 2
Specified Answer for: ___ 2/3

Correct Answers for: ___

Correct Answer

Pattern Match

Evaluation Method

Correct Answer

Exact Match

Evaluation Method

Response Feedback: Use whole numbers or fractions not decimal equivalents here, though on the real exam you can use either.

• Question 2

In 2012, total U.S. trade with foreign countries was $4.9 trillion. This consisted of $2.2 trillion in exports and $2.7 trillion in imports of goods and services making the U.S. the world’s third largest exporter after the EU and China and the second largest importer (the EU is the world’s largest import market). This implies U.S. net exports (NX) in 2012 was about

Answer

Correct Answer: -$500 billion

Response Feedback: By some measures, China is already the largest economy in the world, though by banding together the EU has created a large internal market as well.

• Question 3

Suppose real interest rates fall in Japan relative to real interest rates in other countries making Japanese investor

Selected Answers: purchase more bonds abroad, increasing portfolio investment and net capital outflows from Japan

purchase more bonds outside Japan, weakening Japan’s real exchange rate

Correct Answers: purchase more bonds abroad, increasing portfolio investment and net capital outflows from Japan

purchase more bonds outside Japan, weakening Japan’s real exchange rate
Response Feedback: be sure to distinguish between Foreign Direct investment and foreign portfolio investment, not in this question, but generally.

- **Question 4**

  Net exports can be positive or negative and by definition is equal to

  Selected Answers: ✔ net capital outflows
  ✔ the current account balance
  ✔ Y - C - G - I
  ✔ S - I where S is national savings and I is domestic investment

  Correct Answers: ✔ net capital outflows
  ✔ the current account balance
  ✔ Y - C - G - I
  ✔ S - I where S is national savings and I is domestic investment

Response Feedback: Negative net exports or a CA deficit must be financed with other peoples money, if our net exports are positive, we are financing some other countries imports in excess of exports

- **Question 5**

  Net capital outflows (NCO) is more or less equal to the "current account balance" and Bloomberg reports quarterly CA balances for the U.S. but not NCO

  Answer
  Selected Answer: ✔ True
  Correct Answer: ✔ True

Response Feedback: Net exports actually includes payments for services, including interest on U.S. bonds held by foreigners and earnings on overseas investment by U.S. firms, what is left is the current account which must equal the capital account, what ever we purchase in excess of all our earnings must be financed by borrowing. Recall that the U.S. can "borrow" $40-50 billion per year by printing currency. This is analogous to writing someone a check for something you want (goods or services) and then having them never cash the check. To the extent that they could cash the check (or buy something with the $100 bill) at some point makes this an interest free loan. Since 3 month treasuries are yielding just about zero, these are interest free loans as well (though they will need to be repaid in 3 months).

- **Question 6**

  0 out of 1 points
If citizens of a particular country don’t save much, may be advisable to

Answer

Selected Answer: 

increase NCO to encourage foreigners to invest our country

Correct Answer: 

lower NCO to maintain higher investment levels since NCO = S - I

- **Question 7**

If the nominal exchange rate $e$ is foreign currency per dollar, the domestic price is $P$, and the foreign price is $P^*$, then the real exchange rate is defined as

Answer

Selected Answer: 

$e(P/P^*)$

Correct Answer: 

$e(P/P^*)$

Response Feedback: 

To check this formula, think for example Euros/$US then multiply by U.S. prices (in $) and then compare these prices in Euros to the price level in the EU (which is also in Euros). You have to compare Euros to Euros or dollars to dollars, so the real exchange rate converts the numerator and the denominator into the same currency. So all you have to remember is that $P^*$ is in some other currency, while $P$ is in our currency and you have the formula.

- **Question 6**

If citizens of a particular country don’t save much, may be advisable to

Answer

Selected Answer: 

increase NCO to encourage foreigners to invest our country

Correct Answer: 

lower NCO to maintain higher investment levels since NCO = S - I
Correct Answers for Chapter 19 Practice Quiz

• Question 1

Over the past three decades, the United States has

Answer

Selected Answer: ✔ persistently had a trade deficit.
Correct Answer: ✔ persistently had a trade deficit.

• Question 2

In the open-economy macroeconomic model, the demand for loanable funds includes

Selected Answer: ✔ the sum of domestic investment and net capital outflow.
Correct Answer: ✔ the sum of domestic investment and net capital outflow.

Response Feedback: When answering this question, remember the difference between the Metzler diagram which determines \( S = I \) and the loanable funds diagram which sets \( S = I + NCO \) or \( S = I + CA \).

• Question 3

In the open-economy macroeconomic model, the market for loanable funds identity can be written as

Answer

Selected Answers: ✔ \( S = I + CA \)

✔ \( S = I + NCO \)

Correct Answers: ✔ \( S = I + CA \)

✔ \( S = I + NCO \)

• Question 4

The slope of the supply of loanable funds reflects the fact that,

Selected Answer: ✔ national savings increases when the interest rate rises.
Correct Answer: ✔ national savings increases when the interest rate rises.

Response Feedback: Recall that the loanable funds diagram determines the interest rate, while the metzler diagram shows \( S, I \) and \( CA \) or \( NCO \) for a given interest rate. This is why we need both diagrams.

• Question 5
In the 3 panel diagram of the open economy model shown in Figure 4 of the text, an increase in the government deficit will...

[Here is a link to figure 4 in case you don't have your book or see below, handy, http://class.povertylectures.com/figure4Chapter19Page407.jpg]

Selected Answers:
- Shift the loanable funds curve show in panel A to the left
- causes a fall in NCO or the CA balance as interest rates rise in panel b
- Shift the dollar supply curve to the left panel c crowding out real U.S. GDP as the RER E appreciates and NX falls and NYC Lattes become more expensive for visitors from Brazil, China and the EU.

Correct Answers:
- Shift the loanable funds curve show in panel A to the left
- causes a fall in NCO or the CA balance as interest rates rise in panel b
- Shift the dollar supply curve to the left panel c crowding out real U.S. GDP as the RER E appreciates **and NX falls and NYC Lattes become more expensive for visitors from Brazil, China and the EU.

Figure 7 page 407 or see below or link above.

Response Feedback: Here is a link to Figure 4 just in case you don't have your book handy,

http://class.povertylectures.com/figure4Chapter19Page407.jpg

figure 7 page 407 or see below or link above.

Question 6
1 out of 1 points

In the open-economy macroeconomic model, the amount of net capital outflow (NCO or CA surplus) represents the quantity of dollars

Answer

Selected Answer: supplied for the purpose of buying foreign assets.
Correct Answer: supplied for the purpose of buying foreign assets.

Question 7
2 out of 2 points

During the past few years, the U.S. CA deficit of about __% equals China's net capital outflows of __%, down from about __% of GDP each during the 2006-07 boom

Answer

Selected Answers: about -2.5% and 2.5% down from a peak of about -6%/6% of GDP annually in 2005
- about -400B and $200B annually or about 2.5% of the U.S. and China's $16T and $8T
GDP respectively, down from a record -6.2% of GDP in the U.S. and over 6% of China's in 2005.

Correct Answers:

- about -2.5% and 2.5% down from a peak of about -6%/6% of GDP annually in 2005
- about -400B and $200B annually or about 2.5% of the U.S. and China's $16T and $8T GDP respectively, down from a record -6.2% of GDP in the U.S. and over 6% of China's in 2005.

Question 8

LATA When investors lose confidence in a country's bonds and currency, perhaps due to missed interest payments to bondholders caused by the U.S. debt ceiling or very high levels of domestic or external debt, then

Answer

Selected Answers:

- capital flight increases NCO shifting the NCO curve in panel b of Figure 7 to the right
- The demand for loanable funds may also shift to the right in panel a of Figure 4 as investors move funds from U.S. to foreign bonds... this raises the domestic real interest rates.
- shifts the supply curve of dollars to the right leading to a depreciation of the U.S. RER (E in panel c of Figure 4) raising NX and reducing U.S. unemployment

Correct Answers:

- capital flight increases NCO shifting the NCO curve in panel b of Figure 7 to the right
- The demand for loanable funds may also shift to the right in panel a of Figure 4 as investors move funds from U.S. to foreign bonds... this raises the domestic real interest rates.
- shifts the supply curve of dollars to the right leading to a depreciation of the U.S. RER (E in panel c of Figure 4) raising NX and reducing U.S. unemployment

Question 9

If the risk of buying U.S. assets rises because it is discovered that lending institutions had not carefully evaluated borrowers prior to lending them funds, then

Answer

Selected Answer:

- net capital outflow will rise and the real exchange rate will fall.

Correct Answer:

- net capital outflow will rise and the real exchange rate will fall.

Response Feedback:

This is similar to the capital flight question shown in Figure 7 of the text and discussed in lecture Monday.
In panel (a), the supply and demand for loanable funds determine the real interest rate. In panel (b), the interest rate determines net capital outflow, which provides the supply of dollars in the market for foreign-currency exchange. In panel (c), the supply and demand for dollars in the market for foreign-currency exchange determine the real exchange rate.

Figure 4
The Real Equilibrium in an Open Economy

(a) The Market for Loanable Funds

(b) Net Capital Outflow

(c) The Market for Foreign-Currency Exchange