

PROBLEM SET 5

DUE 23 OCTOBER

Question 1

Consider an economy caught in an economic downturn and a liquidity trap like Japan. You may assume that the IS curve is very steep as is the case when both consumers and investors are very foresighted. As in the analysis of the Clinton deficit reduction plan in the text, assume only two periods corresponding to current output and future output.

Assume that due to a sequence of negative shocks to consumer confidence and central bank reaction to these shocks by expanding the money supply, nominal interest rates are near zero. Evaluate the effectiveness of monetary policy, taking in to account whether expectations magnify or weaken the effect of a liquidity trap.

Question 2

In 1996 the residents of Wonderland engaged in the following transactions. They bought cars from the US for \$90 and toys from the UK for \$15. They sold apples to France for \$30 and oranges to Spain for \$40. Tourists from Wonderland spent \$25 in Italy and Dutch tourists spent \$10 in Wonderland. Wonderland got a grant of \$25 from the US government and made a contribution of \$5 to its poor neighbor. Wonderland borrowed \$60 from American banks and a German firm invested \$10 in Wonderland. A Wonderland businessman bought Japanese stocks for \$40. Wonderland banks received \$3 in interest payments on loans they had made to foreigners in earlier years. A Wonderland firm paid \$3 in dividends to its foreign stockholders.

Write the balance of payments of Wonderland for 1996. How did Wonderland pay for the excess of its imports over its exports?

Question 3

Suppose the US dollar depreciates. What is the effect on the price of the Japanese car that you were planning to buy? Is your vacation in Europe going to be cheaper or more expensive? If you were working in Japan and received your salary in US dollars, would the depreciation make you happier?

Question 4

Suppose a large number of a country's citizens work abroad. What can we say about its GNP relative to its GDP?