

Business Conditions Analysis

ECON 736

Analytical Assignment #4

Professor Yamin Ahmad

Instructions:

Read these instructions very carefully!! You will be held to these expectations.

The purpose of this analytical assignment is to allow you an opportunity to demonstrate your fluency with the economic concepts and models that we have covered to date in the class. In particular, it requires you to demonstrate your ability to apply the models for analysis and inference. You may only submit this assignment once. **Make sure not to hit the submit button until you are ready to do so.**

Assignment Expectations:

There are sixteen questions in this Analytical Assignment. You should answer all of them. For essay questions, please **answer ONLY what the question asks**, as points are not awarded for verbosity!

You may use your lecture notes and the textbook.

One of the questions (question 3) will ask you to upload a figure/diagram. Only the following file types are accepted for the upload: jpeg, jpg, png, and pdf.

PLEASE NOTE:

Collaboration is NOT allowed on this assignment

In this Analytical Assignment, all work must be done independently. You will be asked to sign the following agreement in with your solutions at the end of the assignment (see next page):

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Agreement: I attest that all of the work on this assignment has been done independently by myself, **without consulting any other students in the class or faculty in other classes**. As presented in class, the essays may be done with a referral to formulae, but all of the written material in the essay is original, "synthetic" independent work, with no copying of published or unpublished material. I attest that this assignment has not been copied or distributed in any part or form.

Name (Please print): _____ ; Student id #: _____

Signature: _____ ; Date: _____

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1. (10 points) What are the key channels by which fiscal policy affects output in a closed versus open economy (- write down the sequence of variables by which changes in fiscal policy are transmitted to output in the economy)? Using the models studied in class, discuss what is meant by “crowding out”, and how the crowding out effect works in an open economy. How does this effect differ from the way it works in a closed economy? To what extent does the efficacy of fiscal policy (i.e. in affecting output) depend on the type of exchange rate regime?

Note: There are four parts to this question. Make sure to answer all the parts to get the points.

Trade Deficit

Questions (2) – (4) are worth a total of 10 points and pertain to the following statement.

Suppose that in the data, the trade deficit appears to be procyclical (- take this as a statement of fact).

2. (4 points) Define what is meant by:

- (i) a country running a trade deficit;
- (ii) the trade deficit exhibiting procyclical behavior.

3. (4 points) **Using one of the open economy models studied in class**, use a diagram to outline a possible explanation for the procyclical behavior of the trade deficit. Please upload your diagram here. Acceptable file types include: jpeg, jpg, png and pdf.

4. (2 points) Provide a brief explanation to accompany your diagram that you uploaded in question 3 above to detail the mechanism by which we are able to obtain a procyclical trade deficit.

Reasons for Trade

For the questions that follow (questions 5 – 11), use this table below to answer the questions. There is a total of 10 points for these questions.

France and Poland each have one worker whose monthly linear Production Possibility Frontier indicates the following production possibilities:

	Poland	France
Computers (C)	24	6
Grain (G)	4	3

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5. (1 pt) France's opportunity cost of G in terms of units of C equals _____ ?
- 6) (1pt) Poland's opportunity cost of G in terms of units of C equals _____ ?
- 7) (1 pt) Poland's comparative advantage is in _____ ...
- 8) (1 pt) ... because [provide a brief answer for your answer in question 7 above]:
- 9) (2pt) If France and Poland decide to trade, _____ will be the exporter of G while _____ will be the importer ...:
- 10) (1pt) ... because [provide a brief answer for your answer in question 9 above]:
- 11) (3 pts) If the economies choose to trade, the world relative price of goods must be _____ in order for trade to be mutually beneficial, because: [fill in the blank and provide an explanation]
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Exchange Rate

In the following problem, assume that the UK currency is the pound sterling (PST) and the currency in the rest of Europe is the Euro (EUR). Suppose that the PST appreciates relative to the EUR.

- 12) (3 pts) Please indicate what happens to the variables below by stating whether they: **increase, decrease, or stays the same.**

(1 pt each) **In the UK:**

- How would the export demand change?
- How would the import demand change?
- How would net exports change?

- 13) (3 pts) Please indicate what happens to the variables below by stating whether they: **increase, decrease, or stays the same.**

(1 pt each) **In the rest of Europe:**

- How would export demand change?
 - How would import demand change?
 - How would net exports change?
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Nominal Exchange Rate Movements

Suppose that the central bank in the UK (The Bank of England) decides to raise interest rates because it is worried about high inflation. As a result, **interest rates in the UK become higher**

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than interest rates in the REST OF EUROPE. This acts as an incentive for EUROPEAN investors to increase the amount of funds they invest in British (UK) interest bearing assets. In order to increase their purchases of those UK assets, which are priced in PST, EUROPEAN investors have to convert EUR into PST. This conversion, in turn, increases the demand for PST.

Based on the above information, please explain:

14) (1pt) Given that interest rates in the UK are now different than that in Europe, what equation/condition may be used to explain this behavior of the (**nominal**) exchange rate. (**Note: you just need to state the name of the equation or condition that may be used**).

15) (1 pt) What will happen to the EUR----PST exchange rate. In other words, will the increased demand for PST, make PST gain value (appreciate) or lose value (depreciate) against the EUR? (Please indicate your answer by picking one of the following: Appreciate/Depreciate/Stay the same.

16) (2 pts) Why? Please give a brief explanation using the equation or condition that you chose in question 14 to illustrate why the exchange rate will move the way that you indicated in question 15.