ASSIGNMENT #1: INTERNATIONAL FINANCE : 100 points
Due Date: Tuesday 5th February, 10.00am in class.

QUESTION I. MACROECONOMIC REVIEW (5 points each)

1. Provide an algebraic statement of goods market equilibrium for a closed economy. Graphically depict goods market equilibrium, and explain how you derive this diagram from the algebraic model.

2. Provide an algebraic statement of money market equilibrium for a closed economy. Graphically depict money market equilibrium, and explain how you derive this diagram from the algebraic model.

3. Graphically depict general macroeconomic equilibrium (joint money and goods market equilibrium (general equilibrium) in an IS-LM diagram. Explain how you derive this diagram, and what it shows.

4. Illustrate the short-run effects for interest rates and output and prices of an expansionary monetary policy in the IS-LM diagram. Explain what is going on in the diagram, and the assumptions that you are making about the speed of price level adjustment.

5. Illustrate the short-run effects for interest rates and output of a decrease in government spending in the IS-LM diagram. Explain what is going on in the diagram, and the assumptions you are making about the speed of price level adjustment?

6. Using the aggregate production function, show algebraically the effects of an increase in oil prices for a) total factor productivity and b) labor productivity (assume that the aggregate production function is constant returns to scale – specifically, Cobb-Douglas). Show algebraically the effects of the increase in oil prices for aggregate output. State in words what these effects are, and explain.

QUESTION II. INTRODUCTION TO INTERNATIONAL MACROECONOMICS (5 points each)

1. Define the nominal exchange rate of a country. What happens to this exchange rate when the country's currency depreciates? Appreciates?

2. Define the real exchange rate of a country. What happens to this exchange rate when the country’s currency depreciates in real terms? Appreciates in real terms?

3. What is the law of one price? Define arbitrage. Explain how arbitrage trades lead to
the law of one price in equilibrium.

4. What are the theoretical assumptions needed for the law of one price to hold at all instants of time? For what types of goods does the law of one price hold best? Worst?

5. What do we mean by purchasing power parity (PPP)? Explain carefully. How is PPP a different concept from the law of one price?

6. Define the trade balance of a country. Define net exports. Define the current account. How are these three concepts different?

7. Define the capital account of a country. Explain in words how it is related to the current account.

8. Provide an algebraic statement of goods market equilibrium in an open economy. How does this differ from the analogous statement for a closed economy?

**ANALYTICAL SECTION (10 points each)**

1. Are current account deficits necessarily bad for a country? Explain carefully.
2. Is it necessarily bad for a country’s currency to depreciate? Explain carefully.
3. Is it necessarily bad for a country’s net factor payments from abroad to be negative? Explain carefully.