

Do not write your name on the assignment. Write your name only on the back of this sheet of paper and staple your answers on the front of this sheet of paper. Your assignment will be typed, except graphs can be drawn by hand and mathematical equations can be done by hand. Failure to follow these directions will cost you 1 point on the assignment and failure to type it will cost you 10 points.

1) (10 points) Explain $S = I + NX + NFP$.

2) (40 points) Illustrate on the S/I diagrams for the USA and the rest of the world, a negative supply shock in the USA. Start with the USA having a trade deficit and assume we are a large country. Explain why the curve(s) moved as drawn. What happens to the interest rate, current account deficit in the USA, capital-financial account in the USA, and the levels of investment and savings in the two “countries”? What is the economic reason for those variables to change as described?

3) (40 points) Illustrate on the S/I diagrams for the USA and the rest of the world, a positive supply shock in the rest of the world. Start with the USA having a capital-financial account deficit and assume we are a large country as is the rest of the world. Explain why the curve(s) moved as drawn. What happens to the interest rate, current account in the USA, capital-financial account deficit in the USA, and the levels of investment and savings in the two “countries”? What is the economic reason for those variables to change as described?

4) (10 points) If we are a large country and the government is running a record budget deficit, then what will happen to the growth rate of the world in the future? Explain your logic.