EC201 Macroeconomics 2, Term 1 2025
University of Warwick
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Support and Feedback Class 2 (week 4)
Current Account Sustainability and Determination

Pre-Class Review Questions

A. Pre-class Review Questions These review questions are designed to help you reflect on the lecture material and check your understanding. You must complete them before the support and feedback class. At the start of the class, you will need to show your answers to your tutor, who will record both your attendance and preparation. If you have any doubts about the questions, you can ask your tutor at the beginning of the session. Please note that review questions will not be discussed in detail during the class; however, brief answers will be posted on Moodle before the test and exam.

1. **Sustainability:** Indicate whether the following statements are true, false, or uncertain and explain why.
   (a) An economy that starts with a positive net international investment position will run a trade balance deficit at some point.
   (b) The fact that over the past quarter century the United States has run larger and larger current account deficits is proof that American household savings have been shrinking.
2. **CA and TB Determination:** Consider a two-period small open endowment economy populated by a large number of households with preferences described by the lifetime utility function:
$$U(C_1, C_2) = C_1^{\frac{10}{11}} C_2^{\frac{1}{11}}$$
where C_1 and C_2 denote, respectively, consumption in periods 1 and 2. Suppose that households receive exogenous endowments of goods given by $Q_1 = Q_2 = 10$ in periods 1 and 2, respectively. Every household enters period 1 with some debt, denoted B_0^*, inherited from the past. Let B_0^* be equal to -5. The interest rate on these liabilities, denoted r_0, is 20 percent. Finally, suppose that the country enjoys free capital mobility and that the world interest rate on assets held between periods 1 and 2, denoted r^*, is 10 percent.
   (a) Compute the equilibrium levels of consumption, the trade balance, and the current account in periods 1 and 2.
   (b) Assume now that the endowment in period 2 is expected to increase from 10 to 15. Calculate the effect of this anticipated output increase on consumption, the trade balance, and the current account in both periods. Compare your answer to that you gave for item (a) and provide intuition.
   (c) Finally, suppose now that foreign lenders decide to forgive all of the country's initial external debt. How does this decision affect the country's levels of consumption, trade balance, and current account in periods 1 and 2. (For this question, assume that $Q_1 = Q_2 = 10$.) Compare your answer to the one you gave for item (a) and explain.

B. In-class Question to be distributed in class by tutors

C. Self-study Question to be distributed in class by tutors