

Support and Feedback Class 6 (week 8)

Questions from Past Tests

This class will have a different structure than usual because we will work through past test questions to help you prepare for the upcoming test. You are encouraged to try answering these on your own before class.

Part A. Multiple Choice Questions

1. Consider an infinite horizon model in which in each period the country can lend/borrow in the international market. Which of the following statements is true? Select one:
 - (a) If the country starts with a negative net foreign asset position, it cannot run perpetual current account deficits.
 - (b) If the country starts with a negative net foreign asset position, it can run perpetual trade balance deficits.
 - (c) The current account in this economy, at a given time t , is equal to the national income minus domestic absorption (defined as the sum of private consumption, government consumption, and investment).
 - (d) The no-Ponzi game condition states that the level of assets has to be strictly positive when time goes to infinity.
 - (e) The trade balance of the country in this economy cannot be positive.

2. Pancraziland is a two-period small open economy that specializes in the production of pizza. Agents living in Pancraziland have an increasing and concave utility function. Pancraziland starts with zero assets. In period 1 researchers discover a new delicious pizza sauce that, however, could be only produced in period 2, but that surely will generate an increase of pizza sales. How will the period 1 current account of Pancraziland vary in response to this new discovery?

Select one:

- (a) The current account in period 1 deteriorates.
- (b) The current account in period 1 improves.
- (c) The current account in period 1 is unaffected, because the discovery will be fruitful only in period 2.
- (d) There is not enough information to determine the sign of the current account change in period 1.
- (e) The current account in period 1 is necessarily zero.

3. Consider a two-large country model. Assume that the domestic economy experiences an increase in saving desire. Which of the following statements is true? Select one:
- (a) The current account in the domestic economy deteriorates, but by more than if the domestic economy were a small-open economy.
 - (b) The current account in the domestic economy improves, but by more than if the domestic economy were a small-open economy.
 - (c) The current account in the domestic economy deteriorates, but by less than if the domestic economy were a small-open economy.
 - (d) The current account in the domestic economy improves, but by less than if the domestic economy were a small-open economy.
 - (e) The current account is not affected in any case.
4. Which of the following statements is true.
- (a) The No-Ponzi condition is derived from the optimal behavior of maximizing agents.
 - (b) The No-Ponzi condition rules out the possibility that debt grows too much and that it is never repaid.
 - (c) The No -Ponzi condition depends only on the amount of debt in the country and on nothing else.
 - (d) The No-Ponzi condition is satisfied only with concave utility function.
 - (e) The No -Ponzi condition is always satisfied when countries run current account deficits.
5. Consider two large open economies, as studied in class. Denote the two countries as country A and country B. These are the only two countries in the world. Assume there is an investment surge in country B. How is the current account in country A affected? Select one:
- (a) The current account in country A improves because of a movement along its CA schedule.
 - (b) The current account in country A deteriorates because of a movement along its CA schedule.
 - (c) The current account in country A does not change.
 - (d) The current account in country A improves because of a shift to the right of its CA schedule.
 - (e) The current account in country A deteriorates because of a shift to the left of its CA schedule.

6. The country Pancraziland imports a large quantity of pizzas and does not import any good or service. Also, Pancraziland has invested in foreign assets and has no international liabilities. Finally, Pancraziland does not hold any assets, its net international compensation of employees is zero, and its net unilateral transfers are zero. Which of the following statements is true?
- (a) Pancraziland has a negative current account and a negative trade balance.
 - (b) Pancraziland's current account is surely positive.
 - (c) Pancraziland's current account is, in absolute value, larger than its trade balance
 - (d) Pancraziland's current account is surely equal to zero.
 - (e) None of the above.
7. To be defined as “small” an open economy needs to:
- (a) Be small in terms of population size.
 - (b) Be small in terms of geographical size.
 - (c) Be small in terms of political influence.
 - (d) Be small in terms of absolute size of the NIIP.
 - (e) None of the above.
8. A firm seeks to maximize its intertemporal profits over two periods. The production function in the second period depends on the investment made in the first period, and the firm must also repay a loan taken in the first period to finance this investment. Which of the following factors influence the firm’s optimal investment decision in the first period?
- (a) The firm will invest only enough in the first period to cover the debt repayment in the second period, without considering the marginal productivity of investment or future returns.
 - (b) The firm will base its investment decision solely on current-period revenues, ignoring future returns and the cost of debt servicing
 - (c) The firm will consider the marginal productivity of investment in the second period and the interest rate on the loan to determine the optimal investment level so that profits are maximized.
 - (d) The firm will avoid borrowing to finance investment in the first period, as the interest rate on the loan exceeds the expected marginal productivity of investment in the second period.
 - (e) The firm will make a large investment in the first period, regardless of the interest rate or debt repayment, due to an expectation of high returns in the second period.
9. Consider a small open endowment economy. The agents have utility equal to $U(C_1, C_2) = \log(C_1) + \log(C_2)$. The country starts with zero assets. The world's interest rate is zero. The economy receives an endowment of 10 units of good in each of the two periods. What is the optimal combination of consumption in the two periods?

- (a) $C_1 = C_2 = 10$
- (b) $C_1 < 10$ and $C_2 > 10$
- (c) $C_1 > 10$ and $C_2 < 10$
- (d) $C_1 > 10$ and $C_2 > 10$
- (e) Any combination of C_1 and C_2 such that $C_1 + C_2 = 20$

Part B. Essay Questions

1. Consider an infinite-horizon small open economy. Explain under which conditions a perpetual current account deficit is sustainable.
2. Consider a two-period small open economy with uncertainty. Assume that in period 1 uncertainty about future (period 2's) output increases. Discuss what are the effects of this increase in uncertainty on the current account in period 1, describing in words what precautionary savings are as well as what is the role of utility function in determining them.
3. Explain what the term Global Saving Glut refers to, and discuss which historical phenomenon it describes. Discuss what are the two hypotheses that were identified as possible explanation for that phenomenon. Explain how you can test the two different hypotheses. Which view do the data support?
4. You are a minister of Pancraziland, a small-open economy. During a cabinet meeting another minister says: “Our CA this year has been negative. Although the official numbers are not yet been released, we should be certain that our NIIP has therefore deteriorated.” Provide a clear and complete argument about whether you agree or do not agree with that statement.