EC201 Macroeconomics 2, Term 1 2025
University of Warwick
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Support and Feedback Class 3 (week 5)
Intertemporal Theory of the Current Account
Current Account Adjustment to Shocks

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. **News Shocks:** Indicate weather the following statement is true, false or uncertain. Explain your reasoning.(**This question requires the material from week 5 so ignore it until you have seen the production economy**).

   Good news about future productivity leads to a trade deficit today.

2. **Debt Forgiveness:** Consider a small open economy where households live for two periods and have logarithmic preferences,

$$\ln C_1 + \beta \ln C_2,$$

   where the subjective discount factor β equals $\frac{10}{11}$. Suppose that households receive a constant endowment over time equal to 10, $Q_1 = Q_2 = 10$. Suppose that households start period 1 with debt including interest equal to 5, $(1 + r_0)B_0 = -5$ and that $r_0 = 0.1$. Finally, assume that the country enjoys free capital mobility and that the world interest rate is 10 percent, $r^* = 0.1$.

   (a) Calculate the equilibrium values of consumption, the trade balance, and the current account in period 1.

   (b) Suppose now that foreign lenders decide to forgive all of the country's initial external debt including interest. Calculate the effect of this external gift on consumption, the trade balance, and the current account in period 1. Provide an intuitive explanation of your findings.

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

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