Problem 1. Consider the country of Nilfgaard, whose currency is the *floren*.

- This year it invests 400 floren in domestic investment, and its previous investments generated 15 floren in capital gains this year.
- It purchases 160 floren worth of foreign assets, and sells 120 floren worth of domestic assets to foreigners.
- Valuation effects lead to a total 5 floren in capital gains.

Supposing KA $= 0$, answer the following things.

(a) What is the change in external wealth?

(b) What is the current account?

(c) What is the total change in wealth?

(d) What is the amount of domestic savings?

Problem 2 (Sample Midterm 2, Question 3). Suppose that in a typical year, a country produces $Q = 50$ output with $C = 50$ and $I = G = 0$. The country has no initial wealth, and the world interest rate is $r^* = 10\%$.

(a) There is an unexpected drop in output in year $t = 0$, so output falls to 39 and is then expected to return to 50 in every future year. If the country desires to smooth consumption, how much should it borrow in period $t = 0$? What will the new level of consumption be from then on?

(b) There is an unexpected war in year $t = 0$, which costs 11 units and is predicted to last one year. If the country desires to smooth consumption, how much should it borrow in year $t = 0$? What will the new level of consumption be from then on?

(c) Following on from part (b), the country wakes up in year $t = 1$ and discovers that the war is still going on and will eat up another 11 units of expenditure in year $t = 1$. If the country still desires to smooth consumption looking forward from year 1, how much should it borrow in year $t = 1$? What will the new level of consumption be from then on?