

## Practice Problems on Open Economy Basics

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1. State the national income identity and name each variable. Next, identify domestic absorption and rewrite the identity in terms of domestic production, domestic absorption, and net exports.
2. If net exports are zero, does this imply that the country is in autarky? Discuss.
3. Using the national income identity and the balance of payments identity, explain why trade deficits must be financed by borrowing or changes in reserves. Be sure to write and explain the equations you use.
4. Discuss what it means that normal trade deficits and surpluses are just an economy smoothing consumption over time.
5. Suppose a country's current account is in balance. Does this mean that their trade balance is zero as well? Explain.
6. When could it be possible for a country to have a trade deficit but a zero (or even positive) current account? Is this sustainable? Explain.
7. Explain what happens to a country's current account if, starting from a balance, everyone expects output to increase in the coming months. Discuss the effects short and longer-term as well as the likely impact on the various balance of payments accounts and the domestic economy. Show the impact on the domestic economy in an Aggregate Supply – Aggregate Demand framework.
8. Explain what happens initially to a country's current account if, starting from a balance, the economy's output slows but domestic residents and firms don't respond immediately. Discuss the effects short and longer-term as well as the likely impact on the various balance of payments accounts and the domestic economy. Show the impact on the domestic economy in an Aggregate Supply – Aggregate Demand framework (this is harder than the previous question).