

Economics 462
Quiz 3

November 8, 2007
Professor Parker

Time: 30 minutes.
Quiz 3

Consider the incentives to save and invest in a country with good growth prospects and a relatively high return on investment, but with strong preferences for current consumption. The country produces two goods, X and Y , with a comparative advantage in X . There is free trade in goods.

1. Using a two-period model of intertemporal trade (i.e., with PPFs and indifference curves), with current consumption on the horizontal axis, show the amount of savings and investment if the country is autarkic in savings and investment. Then show how savings and investment would change if free trade in savings were suddenly allowed. Which way would savings flow? How does the flow of savings affect future output and the interest rate? How does the flow of savings affect the trade balance (i.e., net exports) in both the current and future periods?
2. Assuming again that the country is autarkic in savings, show the country's current free trade equilibrium for the current period using PPFs and indifference curves, with good X on the horizontal axis. Then show the effect of allowing international savings flows as in (1), assuming there is no effect on the terms of trade. Show how this transfer affects current consumption of both goods, assuming both X and Y are normal.
3. Using a supply and demand graph for the foreign exchange market, show how the savings transfer above would affect the direct foreign exchange rate E , i.e., the price of one unit of foreign currency. How would this change in E affect exports in the current period? What would you expect to happen to the foreign exchange rate in the future?