Note: given the fact that you’re ‘obliged’ to answer the weekly questions, try to profit the most from the task:

- Start by reading the lecture notes.

- Looking at them as little as possible, answer the questions.

Reserve **4 hours** for this homework.

The answers to the following questions should be handed to me **at the beginning of the written exam.** They should be **manuscript (not typewritten)**, **concise** and preferably based on schemes (as I do in the whiteboard). Keep a copy for yourself.

Please write **WEEK 12 in bold** at the beginning of your answers.

**WEEK 12**

**L21:**

**I. Trade imbalances in the EZ**

**1.**What happened to the trade balances in the Eurozone from 1995 and 2007?

**2.** What is the relation between a country’s output, a country’s expenditure and its trade balance?

**3.** The trade surplus of a country can be eliminated by a reduction of its domestic demand by the exact amount of that surplus. Do you agree? Explain.

**4.** The world is composed by the North and the South only. Assume that the propensity to spend of each region at home is 50% - the same as its propensity to spend abroad.

a) In this case a trade imbalance between the two regions can be eliminated if the deficit region reduces its domestic demand by the exact amount of its deficit, and the surplus region raises its domestic demand by the exact amount of its surplus. Do you agree? Explain.

b) What will happen to the levels of output as a result of that? Explain.

**5.** In the real-world the propensity to spend of each region at home is higher than its propensity to spend abroad. Why?

**6.** The fact that the propensity of the South to spend on South’s production is bigger than the propensity of the North to spend on South’s production implies that

a reduction in South’s domestic demand = a rise in North’s domestic demand

ends up leading to a reduction in South’s output and a worsening of South’s trade deficit. Why?

**II. The effects of international transfers of income: Keynes vs. Ohlin**

**7.** Present four historical examples of international transfers of income.

Consider the assumptions made in the lecture, in particular the price of one unit of output = $1 = (initially) 1DM = 1FF.

**8.** The transfer from Germany to Fr is now equal to $100 per year. Assume that the propensity to spend of each region at home is 50% - the same as its propensity to spend abroad.

What is the consequence of the transfer on:

1. G’s X and M and on its trade balance? Explain.
2. G’s domestic demand and output? Explain.
3. F’s X and M and on its trade balance? Explain.
4. F’s domestic demand and output? Explain.
5. The $100 annual transfer amounts to how the transfer of how many units of out from G to F? Explain.

**9.**The propensity of a country’s residents to spend at home is 80% while their propensity to spend abroad is only 20%. The transfer from Germany to Fr is equal to $100 per year.

What is the consequence of the transfer on:

1. F’s X and M and on its trade balance? Explain.
2. F’s domestic demand and output? Explain.
3. G’s X and M and on its trade balance? Explain.
4. Is the annual transfer sustainable for a long time in the context of that trade balance? Explain. Key question.
5. G’s domestic demand and output? Explain.
6. Is that change in output sustainable for a long time? Explain.10.

**10.** In the context of the previous question, explain how a devaluation of the German currency may solve:

a) G’s financial problem.

b) G’s unemployment problem.

**11.**Given the needed the devaluation, will the $100 annual transfer amount to a transfer of 100 units of output from G to F? Explain. Key question.

**L22: The Mexican crisis of 1995**

**12.** Explain the policy reforms advocated by the Washington Consensus

**13.** Why did Mexican budget deficit disappear after the 1980s?

**14.** a) What led to the economic expansion in Mexico in 1991-4? Explain.

b) What happened to the trade balance? Explain.

**15.**  Why did US banks reduce the amount of new loans to Mexican banks after 1993?

**16.**  Why did that lead to a capital flight out of Mexico?

**17.** How could a CB interest rate hike have stemmed the decline of the dollar reserves of the Central Bank?

**18.** How could a devaluation have stemmed the decline of the dollar reserves of the Central Bank?

**19.** What was the consequence of the 15% devaluation decided by the Mexican government?

**20.** Explain the two channels through which the 50% devaluation of Dec 94 affected the Mexican GDP in 1995.

**21.**Explain the three channels through which the increase in interest rates to 80% in 94 affected Mexican imports in 1995.

**22.**Explain how the 50% devaluation of Dec 94 affected Mexican GDP in in 1996-8.

**23.**Explain how the 50% devaluation of Dec 94 affected Mexican imports in 1996-8.