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 **3 hours** for this homework.

The answers of the questions of **week 7** should be handed to me at the beginning of **Wednesday’s lecture of Nov 9th.** 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 7 in bold** at the beginning of your answers.

**WEEK 7**

**0. Two special questions about the dependence of investment on the rate of utilization of production capacity**

(The **2nd paragraph of page 4** of the following paper can help you answer these questions:

<https://www.tandfonline.com/doi/full/10.1080/09538259.2022.2062962>

One you are here, you should be able to get the article **through your ISEG proxy** or otherwise click the **pdf option** to enter into the paper and download it.)

**a)**“A major part of firms’ costs are **fixed.** This is one reason why investment depends on the rate of utilization of production capacity.” Do you agree? Explain.

**b)** Which factors do affect the level of investment? Explain.

**L13: Part II of the syllabus: Open ec. MACROECONOMICS**

**Ch. 1: Basic notions**

Notes: 1) the CB is always available to grant **any amount** of loans demanded by banks at a certain **fixed** interest rate.

2) Banks **want to hold** reserves (Rd) = 1% CD.

1. a) Explain how new CDs and new reserves are created when someone exchanges with a commercial bank a dollar for the local currency.

b) Explain how new CDs and new reserves are created when a bank extends a loan to a business.

2. a) What is the Inter-Bank Money Market (IBMM)?

b) Why can’t the interest rate of that market exceed the fixed rate at which the CB lends money to banks?

**II. The effects of a trade deficit on the M1 (= C +CD), MB (= C + Resbanks), M2 (= M1 + SD), internal debt (towards domestic banks), external debt (towards foreign banks) and CB’s $ reserves.**

**3.** Consider a trade deficit financed by loans obtained by businesses, households and the state (BHS or, to simplify, ‘people’) from **domestic** banks, who in turn get **$ from the CB.(Case 2)**

a) What is the effect of the trade deficit on the quantity of M1 in a first stage? Explain.

b) What is the effect of the trade deficit on the quantity of M1 in the end? Explain.

c) What is the effect of the trade deficit on the level of debt of BHS towards domestic banks (‘internal debt’) and on the quantity of SDs? Explain. Why does that make all the economic sense?

d) Compare that with what happens when people’s spending in excess of their incomes is funded out of past savings.

e) What is the effect of the trade deficit on the quantity of reserves held by banks in a first stage? Explain.

f) How do we know that at the end banks **want to hold** (Rd) the same amount of reserves as in the beginning?

g) What is the effect of the trade deficit on the interest rate of the IBMM? Explain.

h) What is the effect of the trade deficit on the quantity of reserves held by banks in the end? Explain.

h) What is the effect of the trade deficit on the quantity of dollar reserves held by the CB? Explain. Why does that make all the economic sense?

i) Compare that with what happens when people’s spending in excess of their incomes is funded out of past savings.

j) What are ‘importing (M) firms’?

l) What is the difference between banks’ reserves and CB’s reserves?

**4.** Consider a trade deficit financed by loans obtained by businesses, households and the state (BHS or, to simplify, ‘people’) from **domestic** banks, who in turn fund themselves through **dollar loans from foreign banks**. **(Case 3)**

a) What is the effect of the trade deficit on the quantity of M1 in a first stage? Explain.

b) What is the effect of the trade deficit on the quantity of M1 in the end? Explain.

c) What is the effect of the trade deficit on the level of debt of BHS towards domestic banks (‘internal debt’) and on the quantity of SDs? Explain. Why does that make all the economic sense?

d) Compare that with what happens when people’s spending in excess of their incomes is funded out of past savings.

e) What is the effect of the trade deficit on the quantity of reserves held by banks in a first stage? Explain.

f) How do we know that at the end banks **want to hold** (Rd) the same amount of reserves as in the beginning?

g) What is the effect of the trade deficit on the interest rate of the IBMM? Explain.

h) What is the effect of the trade deficit on the quantity of reserves held by banks in the end? Explain.

h) What is the effect of the trade deficit on the quantity of dollar reserves held by the CB? Explain. Why does that make all the economic sense?

i) Compare that with what happens when (i) people’s spending in excess of their incomes is funded out of past savings.

h) Compare h) with what happens when banks do not get funding from foreign banks.

**5.** a) Characterize the series of Pt trade deficits in 1999-2010.

b) How did Portuguese ‘people’ fund their spending in excess of their incomes?

b) What was the effect of that on the quantity of M1 in a first stage? Explain.

c) What was the effect on the quantity of M1 in the end? Explain.

d) What was the effect of the trade deficit on the level of people’s debt towards domestic banks (‘internal debt’) and on the quantity of SDs? Explain. Why does that make all the economic sense?

e) When a Pt importing firm paid VW with a cheque, what happened to the checking accounts of each? And **what happened to the amount of reserves held by the bank of the Pt importing firm and by VW’s bank?** Explain. Key question.

f) How did the Pt’s bank get the needed reserves?

g) What was the effect of the trade deficit on the amounts of reserves held by Pt banks and by German banks in a first stage? Explain.

h) How do we know that in the end Pt banks **wanted to hold** (Rd) the same amount of reserves as in the beginning?

i) What was the effect of the trade deficit on the quantity of reserves held by Pt banks in the end? Explain.

**Ch. 2: Fixed exchange rates**

**6.**Why does AD determine aggregate income?

**7.** What’s the difference between domestic demand and aggregate demand?

**8.** The trade balance is necessarily equal to the difference between output and which variable? Explain, using a numerical example.

**9.**  The TB is equal to the sum of the public sector’s balance and the private sector’s balance. Why?

**10.**Explain what the various types of IFI do.

**11.** Why can expectations of a depreciation in the future lead to a depreciation in the present.

**12.** Which factors do affect the level of investment? Explain.

**Key question requiring a long answer**

**13.** Starting from full-equilibrium, explain the effects of a decline in domestic demand on U, profits, wages, tax revenues, investment, consumption, trade balance, budget balance in fixed rates. Illustrate in a graph.

**14.** Why do IFIs require a risk premium to invest in Argentina?

**Slide 10 of L14 provides a clearer explanation than that of the lecture.**

**Another key question requiring a long answer:**

**15.** Consider again the position the economy finds itself in question 13 above.

a) Can the CB use monetary policy to move the economy back to full-employment? Explain.

b) Can the government use fiscal policy to move the economy back to full-employment? Explain.

c) Why may the government be instead forced to use restrictive fiscal policy in the aftermath of a decline in domestic demand?

d) What can you conclude about the effect of a decline in domestic demand on a country with fixed rates?