Wilf Csaplar Jr. Economics 260 Homework #10 **Due Friday 12/1**

Place your name on the back of this sheet of paper and nowhere else. Staple your answers on the front of this sheet of paper. Failure to follow these directions will cost you 10 points. Your assignment will be typed, except graphs can be drawn by hand and mathematical equations can be done by hand. Failure to type it will cost you 10 points. If you use double-sided printing or print on the back of scrap paper, I will give you one additional point.

I think the explanation of the Phase Diagram (Figure 15-3 and others) is hard to understand. Therefore, I will explain it some. (The graphs before it are not really necessary for this course.) Absorption is the domestic demand for goods (C + I + G). If it increases, then we will import more. To maintain balance for trade, we need the relative price of traded goods to go up, so we import less. The relative price of traded goods is what this book calls the real exchange rate. (Other books use that term for other things.) That is why the EB curve slopes up and why to the right of it is a deficit. For internal balance, if we demand more goods (large absorption), that will cause prices to go up unless imports are cheaper (Relative price of traded goods going down.) That is why the IB (internal balance) curve slopes down. That is also why outside of it is inflation and inside is recession. One other confusing part of the book is the definition of e. They choose the standard notation of e = foreign currency/$. However, they then are looking at the graphs for the foreign country. Therefore, e increasing is the currency getting weaker and e decreasing is the currency getting stronger. (In my opinion, it is more standard to have the currency of country you are analyzing in the denominator, so increase is more valuable.)

1) (20 points) If the economy is up/left of the EB line, then is that a trade surplus or a trade deficit? How do you know? What causes the economy to go back to the EB line in this situation? Explain your logic. You can discuss either a fixed or a flexible exchange rate, whichever is easier for you. I suggest the flexible given that you have not had the S/D diagram for foreign exchange in any of your classes. That makes it hard to understand what happens under the fixed exchange rate. (Ironically, we just covered that material in ECON 350.) Hint: If we import more than we export, we send out too many of our currency, that causes it to lose value, i.e., e increases.)

2) (20 points) If the economy is up/right of the IB line, then is that a trade surplus or a trade deficit? How do you know? What causes the economy to go back to the IB line in this situation? Explain your logic.

3) (20 points) Explain why at Point 3 on Figure 15-6, we need to have both e and A increase. Also, explain what it means to have e and A increase.

4) (20 points) Draw the EB/IB Phase Diagram. Illustrate the effects of an increase in debt service. Explain why the curve(s) moved as drawn.

5) (20 points) Draw the EB/IB Phase Diagram. Illustrate the effects of debt relief. Explain why the curve(s) moved as drawn.