

Do not write your name on the assignment. Write your name only on the back of this sheet of paper and staple your answers on the front of this sheet of paper. Your assignment will be typed, except graphs can be drawn by hand and mathematical equations can be done by hand. Failure to follow these directions will cost you 1 point on the assignment and failure to type it will cost you 10 points.

1) (10 points) Explain why $KFA = -CA$.

2) (20 points each) Illustrate the following on the S/I diagram for a small open economy. Explain why the curve(s) moved as drawn, how you know whether the country had a KFA deficit or surplus to start, whether the KFA got larger or smaller, whether the country had a CA deficit or surplus, and whether the CA got larger or smaller.

A) Starting with a current account deficit, show an increase in the MPK^f for the country.

B) Starting with a capital-financial account deficit, show an increase in the government spending.

3) (35 points) Illustrate an increase in the rest of the world's tax on corporate revenue on the S/I diagrams for a large open economy and for the rest of the world. Assume the USA has a current account surplus. For both diagrams, explain why the curve(s) moved as drawn, how you know whether the country had a KFA deficit or surplus to start, whether the KFA got larger or smaller, whether the country had a CA deficit or surplus, and whether the CA got larger or smaller.

4) (15 points) What is meant by the "twin deficits"? Explain the economics as to why one will cause the other. You do not need to draw a graph.