

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 1 point. 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.

1) (10 points) Explain  $NX = Y - (C+I+G)$

2) (15 points) Draw the S/I diagram for a small country with a capital-financial account deficit. Explain how you know it has a capital-financial account deficit. Illustrate the effects of an increase in government spending assuming that Ricardian Equivalence does not hold. Explain why the curve(s) moved as drawn. What happens to the level of saving, level of investment, and the size of the capital-financial account deficit?

3) (30 points) Draw the S/I diagram for a large country with a current account deficit. Explain how you know it is a current account deficit. Illustrate the effects of an increase in the future marginal productivity of capital in the rest of the world. Explain why the curve(s) moved as drawn. What happens to the level of saving in both countries, level of investment in both countries, and the size of the current account deficit?

4) (30 points) Draw the S/I diagram for a large country with a capital-financial account surplus. Explain how you know it is a current account deficit. Illustrate the effects of a negative productivity shock in the rest of the world. Explain why the curve(s) moved as drawn. What happens to the level of saving in both countries, level of investment in both countries, and the size of the capital-financial account surplus?

5) (15 points) Draw the S/I diagram for a country with a trade balance and a balanced government budget. Use it to explain the term "twin deficits." Explain why curve(s) moved as drawn and how the term comes about.