

Practice Problems Open Economy Loanable Funds Analysis
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1. Write the definition of private savings.
2. Write the definition of public savings.
3. Write the national income identity in terms of savings, investment and net exports.
4. Use the open economy national income identity to discuss the problems with a large and persistent current account deficit and current account surplus. In what ways are these CADs and CASs indications that the country will not be consumption smoothing?
5. **Large Open Economy:** Suppose net exports are initially zero. Draw the loanable funds diagram. Show what happens to the diagram if there is a trade deficit versus a trade surplus. Explain what happened to the real interest rate and why.
6. **Large Open Economy:** Use the loanable funds diagram to show what happens to the real interest rate during a sudden stop of capital flows.
7. **Large Open Economy:** In recent years the United States has been running increasingly large government deficits, but the real interest rate hasn't been rising. Use the loanable fund diagram to show first why one would expect interest rates to rise and, second, explain what else might be changing in market that has allowed interest rates to stay constant (for simplicity, suppose they are constant).
8. **Large Open Economy:** Traditionally US current account deficits are primarily financed by private capital flows. Recently, however, foreign central banks (mainly in Asia) have been financing our CADs. This has led many to worry about what will happen if those governments decide to stop buying our debt (i.e., lending us money). All else equal, analyze the effect of this on the real interest rate using the loanable funds diagram and on the domestic economy using Aggregate Supply – Aggregate Demand analysis.
9. What is the Twin Deficits Hypothesis? Is it true? Explain.
10. **Small Open Economy:** Suppose net exports are initially zero. Draw the loanable funds diagram. What are you assuming is true about the world interest rate?
11. **Small Open Economy:** Suppose net exports are initially zero. Draw the loanable funds diagram.
 - a. Suppose there is an increase in domestic consumer optimism. Show the effects in the loanable funds market. Be sure to explain what happened to the domestic real interest rate, the world real interest rate, the domestic

quantity of savings, the domestic quantity of investment, NX, CA, and FKA.

- b. Suppose there is an increase in domestic government deficits. Show the effects in the loanable funds market. Be sure to explain what happened to the domestic real interest rate, the world real interest rate, the domestic quantity of savings, the domestic quantity of investment, NX, CA, and FKA. Don't forget there are two cases here.
- c. Suppose there is an increase in domestic investor optimism. Show the effects in the loanable funds market. Be sure to explain what happened to the domestic real interest rate, the world real interest rate, the domestic quantity of savings, the domestic quantity of investment, NX, CA, and FKA.
- d. Suppose there is no change in the domestic economy, but there is a wave of consumer optimism in the rest of the world. Show the effects in the loanable funds market. Be sure to explain what happened to the domestic real interest rate, the world real interest rate, the domestic quantity of savings, the domestic quantity of investment, NX, CA, and FKA.
- e. Suppose there is no change in the domestic economy, but there is a wave of investor optimism in the rest of the world. Show the effects in the loanable funds market. Be sure to explain what happened to the domestic real interest rate, the world real interest rate, the domestic quantity of savings, the domestic quantity of investment, NX, CA, and FKA.
- f. Suppose there is a global wave of consumer optimism (both at home and abroad). Show the effects in the loanable funds market. Be sure to explain what happened to the domestic real interest rate, the world real interest rate, the domestic quantity of savings, the domestic quantity of investment, NX, CA, and FKA.
- g. Suppose there is a global wave of investor optimism (both at home and abroad). Show the effects in the loanable funds market. Be sure to explain what happened to the domestic real interest rate, the world real interest rate, the domestic quantity of savings, the domestic quantity of investment, NX, CA, and FKA.