

Econ 362, Macroeconomic Theory

Problem set on model of small open economy in the long run

Suppose Taiwan can be described by our model of a small open economy in the long run. Depict each event listed below on two graphs. On the left-hand side graph, show what happens to Taiwan's national saving and investment. On the right-hand side graph, show what happens to Taiwan's real exchange rate. For each event, assume everything I did not mention remains fixed. Label the "before" lines or variables with a subscript "0" (e.g.  $X_0$ ). Label the "after" lines or variables with a subscript "1" (e.g.  $X_1$ ). State whether Taiwanese net exports increase, decrease, or don't change. State whether the Taiwanese real exchange rate increases, decreases, or doesn't change.

**Assume that before each event,  $NX=0$ .**

1) There is an increase in the world real interest rate  $r^*$ .

Net exports: \_\_\_\_\_ Real exchange rate: \_\_\_\_\_

2) There is an increase in Taiwanese government spending on goods and services, with no change in Taiwanese taxes.

Net exports: \_\_\_\_\_ Real exchange rate: \_\_\_\_\_

3) A useful new kind of capital equipment becomes available in Taiwan, so that Taiwanese firms would want to engage in more investment spending at any given real interest rate.

Net exports: \_\_\_\_\_ Real exchange rate: \_\_\_\_\_

4) Foreign demand for Taiwanese products increases, so that Taiwanese exports would be greater at any given real exchange rate.

Net exports: \_\_\_\_\_ Real exchange rate: \_\_\_\_\_