Second Midterm - Answer Key

Part I

Version 1 (A)

1b 2d 3b 4d 5a 6d 7c 8c 9d 10c 11c 12a 13a 14d 15c 16b 17b 18a 19b 20a 21b 22b 23c 24d 25b

Version 2(B)

1b 2c 3d 4d 5b 6c 7c 8c 9a 10b 11d 12b 13a 14d 15c 16b 17b 18a 19b 20a 21b 22b 23c 24d 25b

Part II

The crucial observation in that increased oil prices meant (as the ERP paragraph suggests) that savings in the “rest of the world” must have increased. This may be captured, e.g. by a shift in the ROW savings curve similar to panel (i) in the S-I diagrams of Figure 1. This, in turn, is captured by a shift in the ROW CA schedule in Figure 2. Since higher savings mean larger CA surpluses for any given rate of interest, the ROW curve must shift as in panel (iv) of Figure 2 (recalling that wider ROW surpluses are measured right to left).

Then you can see that the outcome is a lower world interest rate, a larger US CA deficit matched by a larger ROW CA surplus. Both implications (lower interest rate in the world and larger US deficit/ROW surplus) did agree with the stylized facts between 2000 and 2006. Hence the Report’s argument was quite compelling (and in fact it became prominent, being termed the “savings glut” hypothesis).

The lower interest rate leads to higher investment both in the US and the ROW, and lower savings in the US. Because the ROW CA surplus increases, the ROW savings must increase in equilibrium (note that this is a little tricky, since ROW savings increased because of oil prices but the interest rate falls in equilibrium).

We gave some credit to alternative hypotheses but please note that those other hypotheses are more questionable. For example, one might argue that increased oil prices may reduce the productivity of investment in the ROW, leading to a situation like panel (iv) in Figure 1, which would be associated with panel (iv) in Figure 2. That would also be consistent with the stylized facts (lower interest rate, larger US CA deficit/ROW surplus). But if high oil prices depress investment, the effect would be felt not only in the ROW but also in the US. Then the I schedule for the US would also move, and the US CA curve would move to the right (as in panel I of Figure 2). The effect on global imbalances would then be ambiguous (although the interest rate would clearly fall).