

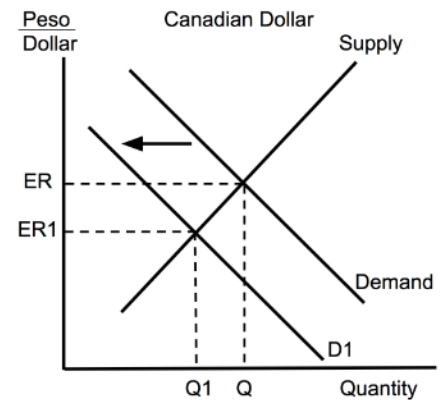


Macroeconomics Unit 6

Free Response Questions

FRQ #1- Assume that Canada and Mexico are trading partners and that incomes in Mexico increase. The currency in Canada is the dollar and the currency in Mexico is the peso. See video in [Ultimate Review Packet](#) for detailed explanations.

- (a) Answer each of the following based on the increase in incomes in Mexico.
- What will happen to net exports in Canada? Explain. **Net exports in Canada will increase. Canadian exports will increase as Mexicans have more income and can buy more Canadian products.**
 - Will the current account balance in Mexico move toward a surplus or toward a deficit? **Toward a deficit.**
 - Will the value of the Mexican peso appreciate or depreciate? Explain. **The peso will depreciate. The supply of pesos will increase since Mexicans will be buying more Canadian goods.**
- (b) Now assume that the inflation rate in Canada increases relative to the inflation rate in Mexico. Draw a correctly labeled graph of the foreign exchange market for the Canadian dollar and show the effect of the increase in inflation on the dollar price per Canadian dollar. See graph. ***Note* It is also correct to show an increase in the supply of Canadian dollars.**
- (c) Now assume that the government of Canada places high tariffs on Mexican goods. Based on the tariffs, answer each of the following.
- What will happen to the demand for pesos? Explain. **The demand for pesos will decrease. Canadians will buy fewer Mexican goods so Canadians will demand fewer Mexican pesos.**
 - What will happen to the value of the Canadian dollar? **The Canadian dollar will appreciate. Canadians will supply fewer dollars since they are purchasing fewer Mexican goods.**



FRQ #2- Assume that the real interest rate in Country X increases. See video in [Ultimate Review Packet](#) for detailed explanations.

- (a) What will happen to Country X's purchases of foreign assets? Explain. **Country X will buy fewer foreign assets because they will prefer to purchase domestic assets since they earn a higher rate of return.**
- (b) Draw a correctly labeled graph of the foreign exchange market for Country X's currency.
- Show the effect of the increase in real interest rates on the demand for Country X's currency. See graph.
 - Identify if the international value of Country X's currency will increase or decrease. **The value will increase.**
- (c) Based solely on your answer to part (b)(ii), what will happen to net exports in Country X? Explain. **Net exports will decrease. Since the value of the currency of Country X increased, Country X's goods are now relatively more expensive for foreigners. Foreigners are going to buy fewer goods from Country X.**
- (d) Now assume that Country X purchases factory equipment from Country Y. Will this transaction be recorded in Country X's current account (CA) or Capital and Financial Account (CFA)? Explain. **Current Account (CA). The current account includes all transactions of goods and services. Anything that is an export or import. It doesn't matter that the factory equipment is physical capital, it still counts as an import for Country X.**

