



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.

- (a) Answer each of the following based on the increase in incomes in Mexico.
 - (i) What will happen to net exports in Canada? Explain.
 - (ii) Will the current account balance in Mexico move toward a surplus or toward a deficit?
 - (iii) Will the value of the Mexican peso appreciate or depreciate? Explain.
- (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.
- (c) Now assume that the government of Canada places high tariffs on Mexican goods. Based on the tariffs, answer each of the following.
 - (i) What will happen to the demand for pesos? Explain.
 - (ii) What will happen to the value of the Canadian dollar?

FRQ #2- Assume that the real interest rate in Country X increases.

- (a) What will happen to Country X's purchases of foreign assets? Explain.
- (b) Draw a correctly labeled graph of the foreign exchange market for Country X's currency.
 - (i) Show the effect of the increase in real interest rates on the demand for Country X's currency.
 - (ii) Identify if the international value of Country X's currency will increase or decrease.
- (c) Based solely on your answer to part (b)(ii), what will happen to net exports in Country X? Explain.
- (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.