

2. Country X and Country Y are trading partners, and both produce furnaces and solar panels. The countries can produce the following amounts using equal amounts of resources.

Country X: 6 furnaces or 8 solar panels

Country Y: 6 furnaces or 12 solar panels

- (a) Which country has an absolute advantage in producing solar panels?
 - (b) Calculate the opportunity cost of a furnace in Country Y.
 - (c) Which country has the comparative advantage in producing furnaces? Explain.
 - (d) If the terms of trade were that 2 furnaces are exchanged for 1 solar panel, should Country X produce solar panels domestically or import solar panels from Country Y?
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3. Exchange rates and interest rates are important for macroeconomic decision making.

- (a) How does an increase in Japan's government budget deficit affect each of the following?
 - (i) The real interest rate in the short run in Japan. Explain.
 - (ii) Private domestic investment in plant and equipment in Japan
- (i) Supply of euros. Explain.
- (ii) Yen price of the euro
- (c) To reverse the change in the yen price of the euro identified in part (b)(ii), should the European Central Bank buy or sell euros in the foreign exchange market?

STOP

END OF EXAM