2. The European Union and the United States are trading partners.

   (a) If the current account balance is zero, will an increase in United States real income result in a current account surplus, deficit, or no change? Explain.

   (b) Draw a correctly labeled graph of the foreign exchange market for the euro. On your graph, show the effect of the increase in United States real income on the value of the euro relative to the United States dollar.

   (c) Now assume interest rates increase in the European Union.

   (i) What is the effect of the increase in interest rates in the European Union on the demand for the United States dollar? Explain.

   (ii) Based on your answer to part (c)(i), what is the effect on the value of the United States dollar relative to the euro?

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3. Sweden and Norway use equal quantities of resources to produce food and capital goods. The table below shows the maximum possible production of food OR capital goods for each country.

Country	Food	Capital Goods
Sweden	50	100
Norway	30	120

   (a) Draw a correctly labeled graph of the production possibilities curve for Sweden. Place food on the horizontal axis and capital goods on the vertical axis. Plot the relevant numerical values on the graph.

   (b) On your graph in part (a), indicate the following.

   (i) A point that represents an efficient level of production, labeled E

   (ii) A point that represents an inefficient level of production, labeled I

   (iii) A point that represents an unattainable level of production, labeled U

   (c) Assume Sweden moves from producing 20 units of food and 60 units of capital goods to producing 30 units of food and 40 units of capital goods. What will happen to economic growth in Sweden in the future?

   (d) Which country has the comparative advantage in the production of capital goods? Explain.

   (e) Based on the table above, identify a specific number of units of capital goods that could be traded for 10 units of food and be mutually beneficial.

STOP

END OF EXAM

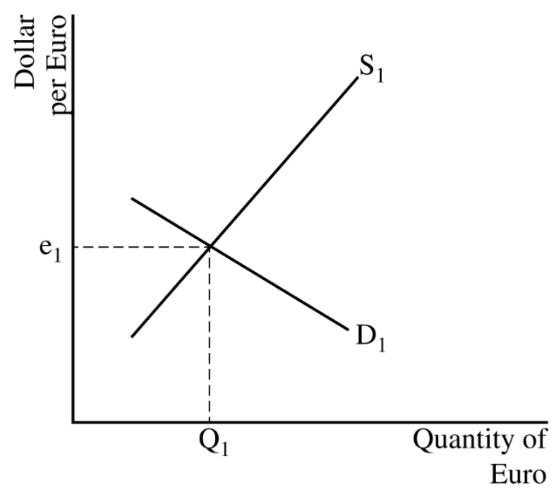
Question 2

5 points (1 + 2 + 2)

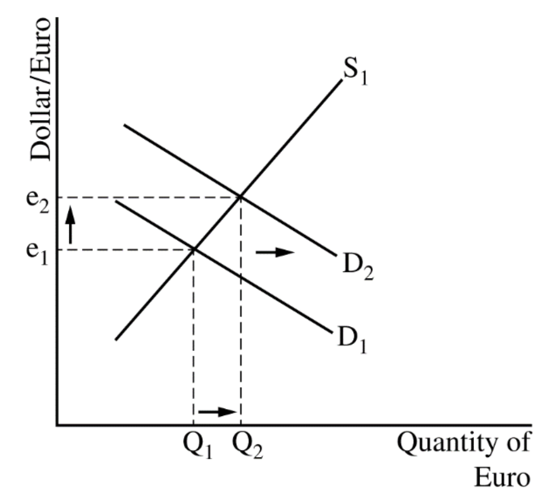
(a) 1 point

- One point is earned for stating that the U.S. current account will be in deficit and for explaining that an increase in the U.S. real GDP increases the U.S.'s demand for European goods and services, which increases imports.

(b) 2 points



- One point is earned for drawing a correctly labeled graph of the foreign exchange market for the euro.



- One point is earned for shifting the demand curve for the euro to the right and showing an increase in the value of the euro relative to the U.S. dollar.

Question 2 (continued)

(c) 2 points

- One point is earned for stating that the demand for the dollar will decrease and for explaining that capital flows from the European Union to the U.S. will decrease.

- One point is earned for stating that the dollar will depreciate.