Answers to Questions for Review

28.1  (a) Your painting is sold to a foreigner, so credits under ‘trade in goods’ rise by £500. But the overseas student’s UK deposit falls, so credits under ‘loans and deposits’ fall by £500.

(b) Your payment adds to debits under current transfers. But the charity will give your £50 to a bank, in exchange for the currency it wants, and the bank concerned will probably deposit the £50 in the UK, adding to credits under ‘loans and deposits.’

(c) Opening your Australian deposit adds £1,000 to debits under ‘loans and deposits’. But your bank will probably take the dollars from a deposit it has in Australia, so debits under ‘loans and deposits’ will fall by the same amount. Effectively, £1,000 worth of dollars has simply been transferred from a UK bank (yours) to a UK citizen (you).

28.2  (a) The German firm will demand sterling, so its value should rise against the euro.

(b) This will increase the demand by UK citizens for imports, and so increase the supply of pounds as they buy more foreign currencies. It will also reduce the demand by eurozone citizens for UK exports, and so reduce their demand for pounds, assuming their demand for UK goods is elastic. So sterling will fall against the euro.

(c) People will want to sell sterling before it falls, and this will at once reduce its value against other currencies including the euro.
28.3 Assume \( r \) is initially at the levels abroad. A Bank Rate rise shifts the money supply curve to the left and so initially raises \( r \). This rise in \( r \) reduces \( C \) and \( I \), and it also attracts capital inflows which raise the exchange rate, so that \( X \) falls and \( M \) rises. All of this reduces \( AD \) and \( Y \), so reducing money demand and reducing \( r \), and in turn raising \( C \) and \( I \) again and reducing the exchange rate again. If people expect the final exchange rate to persist, then \( r \) must return to its initial level, which is the level abroad, so \( C \) and \( I \) will also return to their original values. But the exchange rate will end up higher than it was initially, and so \( X \) will be lower and \( M \) higher. In turn \( AD \) will be lower, as will \( Y \). Note that \( Y \) must end up lower to ensure that money demand curve shifts left, so that \( r \) can return to its original value despite the leftward shift in the money supply curve which results from the higher Bank Rate.

28.4 Assume \( r \) is initially at the levels abroad. A rise in taxes to cut \( C \), or a fall in \( G \), initially reduces \( AD \) and \( Y \). The fall in \( Y \) reduces money demand and so reduces \( r \); this leads to a capital outflow and so to a fall in the exchange rate, s. o \( X \) rises and \( M \) falls, raising \( AD \) again. In turn, \( Y \) rises again, and so raises money demand, \( r \) and the exchange rate. If people expect the final exchange rate to persist, then \( r \) must return to its initial level. This means that money demand and, in turn, incomes, output, and \( AD \) must return to their original levels. So the lasting effects are a lower exchange rate which raises \( X \) and cuts \( M \) enough to offset the fall in \( C \) and \( G \), so leaving \( AD \) and \( Y \) where they started.