Question 1 (2 points): What accounts for the difference between GDP and GNP? Which one better summarizes the strength of the U.S. economy? Why?

Question 2 (2 points):
The Bush administration faces a record high budget deficit currently estimated at 4.4% of GDP. Meanwhile, the U.S. current account deficit is 5.6% of GDP. Do you think the administration is responsible for the twin deficits? Explain using current account identities.

Question 3 (2 points):
On January 21, 2005, the Wall Street Journal reported that “Federal Reserve Bank of Richmond President Jeffrey Lacker said that it’s likely the central bank will be able to continue to raise rates in a gradualist fashion this year.” What is the effect of Mr. Lacker’s remark on the exchange rate on January 21, 2005? Explain using a diagram.

Question 4 (2 points): In the lecture, we suppose unrealistically that there is no tax on interest earnings. Then suppose that the U.S. begins introducing a tax on interest earnings from today. How will this tax policy affect the current exchange rate? Explain using a diagram.

Question 5 (2 points): Using the data in Section 2 Handout, calculate the 3-month and 6-month forward premium on dollar against the British Pound. Compare them with the interest rate differentials between the U.K. and the U.S. Does the covered interest parity hold in these cases?