**Problem Set #1**

**Due Thursday, September 7, 2006**

Problem Sets **MUST** be word-processed except for graphs and equations.

**QUESTIONS**

1. **Assuming nothing else changes**, what would happen to investment, and why, if:
   
   a. Peace is declared and the defense budget is cut in half?
   
   b. Foreign countries mount an aggressive export drive aimed at selling more goods in the U.S.?
   
   c. In a patriotic fervor, consumers decide to “buy American,” changing the composition of their spending to include far more domestic goods and many fewer imported ones?

2. Saving and investment decisions are made by difference economic agents for very different reasons. Yet we know that actual savings **must** always equal actual investment. What other economic variable is changing in order to assure this equality?

3. In the mid- to late-1990s, there was a significant increase in investment in the United States. If private savings remained the same, then what can we say must have happened to the government budget balance and/or the current account balance? Provide an economic explanation.

4. Since 1990, Japan’s economy has stagnated. In an attempt to revive it, the government has significantly increased its spending on goods and services, greatly increasing the size of its budget deficit. Because the yen was very strong, exports fell relative to imports, greatly reducing the size of its trade surplus. Finally, in an attempt to maintain their living standards, households have greatly reduced their savings rate. Assume that the change in the budget balance, net exports, and private savings were of approximately the same order of magnitude.
   
   a. What happened to gross private domestic investment during this period? Provide an economic explanation.
   
   b. At the end of the period, what was the relationship (i.e., greater than, equal to, or less than) between private savings and gross domestic private investment? Explain.