Consider a two-period small open endowment economy populated by a large number of households with preferences given by the lifetime utility function
\[ C_1^\ddagger C_2^\ddagger, \]
where \( C_1 \) and \( C_2 \) denote, respectively, consumption in periods 1 and 2. Suppose that households receive exogenous endowments of goods given by \( Q_1 = Q_2 = 10 \) in periods 1 and 2, respectively. Every household enters period 1 with a negative asset position inherited from the past, \( B_0^* = -5 \). The interest rate on these liabilities, denoted \( r_0 \), is 20 percent. Finally, suppose that the country enjoys free capital mobility and that the world interest rate on assets held between periods 1 and 2, denoted \( r^* \), is 10 percent.

1. Compute the equilibrium levels of consumption, the trade balance, and the current account in periods 1 and 2.

2. Assume now that the endowment in period 2 is expected to increase from 10 to 15. Calculate the effect of this anticipated output increase on consumption, the trade balance, and the current account in both periods. Compare your answer to that for item 1 and provide intuition.

3. Finally, suppose now that foreign lenders decide to forgive all of the country’s initial external debt. How does this decision affect the country’s levels of consumption, trade balance, and current account in periods 1 and 2. (For this question, assume that \( Q_1 = Q_2 = 10 \).) Compare your answer to that given for item 1 and explain.