

This review sheet is intended to cover everything that could be on the exam; however, it is possible that I will have inadvertently overlooked something. You are still responsible for everything in the chapters covered except anything that I explicitly say you are not responsible for. Therefore, if I left something off of this sheet, it can still be on the exam. There will be no multiple-choice questions. Most of the questions will be like the ones on the homework assignments, and possibly a few definition questions, but I am more likely to ask questions that make you use the definitions rather than recite them.

There is no review session for this test. I will be available in my office from 7:00 until 8:30 on Monday 9/26 if you have questions. We will have to arrange a time for the exam.

Chapter 1: What are trade, balance of payments, foreign exchange, and protectionism? Why do we care about protectionism, disequilibrium in exchange rates, financial crises in emerging markets, high structural unemployment in Europe, economic stagnation in Japan, job downsizing in the USA, transitional economies, and poverty in some countries? In the appendix, what determines which countries trade the most with which other countries?

Chapter 2: What are absolute and comparative advantage? How do we determine them? Which determines trading patterns? Be able to find the PPF and CPF for the straight-line, constant opportunity cost, situations and show that both countries can gain from trade. Be able to find the supply and demand for the two goods.

Chapter 13: Know what debits and credits are. Be able to do the double entry bookkeeping for exports of goods, imports of goods, exports of services, imports of services, sales of assets abroad, purchases of foreign assets, and unilateral transfers. If I gave you a table like 13.1, be able to calculate the items in the memoranda. Know why the current and capital accounts should add to zero. What is the international investment position? Why does it matter?

Chapter 14: What are the spot and forward foreign exchange markets? How can we tell if a currency is appreciating, depreciating, revaluing, or devaluing? Be able to move the supply and demand for foreign exchange. Understand how two and three-point arbitrage work. (Three-point arbitrage is also known as triangular arbitrage.) What is meant by a forward discount or premium? How is it calculated? Why would you use a currency swap? When would you use a future or an option? What is meant by hedging and how is it achieved? When is speculation stabilizing and when is it destabilizing? What are uncovered and covered interest arbitrage? How can you tell if there is covered interest arbitrage parity using the covered interest arbitrage margin? What is the eurocurrency market? Note that it is not the currency called the Euro. Ignore the appendix.

Chapter 15: Understand how absolute purchasing-power parity (PPP) differs from relative PPP. Why should they hold and when might absolute PPP fail to hold? What is the monetary approach to the exchange rate? Why would it explain the exchange rate? What is the asset market approach? Be able to explain the economics behind the signs in the three equations like

$M = f(i, i^*, \bar{EA}, \bar{RP}, \bar{Y}, \bar{P}, \bar{W})$. Understand why panels b through d in figure 15.5 behave like that given panel a as given. Note that in the description in section 15.5B, page 526, the third paragraph should not say, "Thus, the US interest rate (i) now exceeds the foreign interest rate (i^*)."
It should say the opposite. Do not worry about section 15.6 or the appendix to the chapter.

Non-graded assignment #3A to be covered with assignment #3.

- 1) (20 points) Why would expect absolute PPP to hold? Why would it expect it to fail?
- 2) (28 points) Explain the economics behind $D = f(i, i^*, \bar{EA}, \bar{RP}, \bar{Y}, \bar{P}, \bar{W})$
- 3) (20 points) Why would we expect that $R = M_s k^* Y^* / (M_s^* k Y)$
- 4) (14 points) Explain why the exchange rate overshoots the equilibrium and then comes back down to the new higher equilibrium.
- 5) (18 points) Why would you expect relative PPP to hold?