Wilfrid W. Csaplar Jr. Open Economy Macroeconomics Review Sheet for Exam 3

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.

The review session for this test will be Wednesday, starting at 7:30.

Chapter 18 starting with 18.5: Know how to manipulate the IS/LM/BP diagram with flexible exchange rates. Note that I may require the BP line to be flatter than the LM, or I may require that it be steeper than the LM curve. Why does the BP become horizontal when there is perfect capital mobility? For the graph of internal and external balance under fiscal policy and monetary policy, know how to determine where there is inflation, unemployment, external deficit, and internal deficit.

Chapter 19: Why do the LRAS, SRAS, and AD curves take their shapes for a closed economy? How does the AD curve for a closed economy differ from the AD of free trade with a fixed exchange rate and/or with a flexible exchange rate? Why is it different? Note that either of the two exchange rate regimes can result in the flatter AD curve. The flexible exchange rate need not yield the flatter AD curve as the book draws it. Know how to manipulate the LRAS/SRAS/AD diagram with the IS/LM/BP diagram for different events and different assumptions about the exchange rate regime. Events could include money supply changes, government spending, technology changes, etc.

Chapter 20: This chapter can be summed up in one question. What are the advantages and disadvantages of the different exchange rate regimes? Basically, knowing the advantages and disadvantages of fixed exchange rate regimes like Bretton Woods, and the advantages and disadvantages of flexible exchange rates will help you to understand all of the other regimes. These other regimes include: currency board arrangements, dollarization, fixed exchange rate with a band, adjustable peg with or without a band, crawling peg with or without a band, and a managed float, a.k.a. dirty float. Why might speculation be stabilizing or destabilizing? Do not worry about the specifics of the transition to the Euro; however, if I gave a restriction the countries must meet, like debt less than 60% of GDP, then you should be able to tell me why the countries must meet that. Note that on page 716, the last line in the blue is wrong. Page 716 has an error. Going from 1 peso/$ to 3.5 pesos/$ is a 250% depreciation not 350%.

Chapter 21: Understand what the IMF, SDRs, and seigniorage are. What are some of the problems facing developing countries with regard to the exchange rates, currency flows, and financial stability? Understand the basic problems of the different exchange rate regimes of the past. Understand what the IMF and World Bank do. Why have emerging economies had some financial crises?

Non-graded assignment #10A to be covered with assignment #10.

1) (25 points) Some economists say that fixed exchange rates can only work when the economies are relatively stable. Why might this be the case? Did the gold standard and the Bretton-Woods System fall apart because of the instability?

2) (20 points) Currency boards are designed to give credibility to the goal of a fixed exchange rate and good monetary policy. How do they do that? After the Bulgarian hyper-inflation of 1996(?), the Bulgarian government switched to a currency board. However, the citizens in 2003 still did not believe the government would keep inflation down. Do you have any guesses as to why they might feel this?

3) (15 points) Several countries have dollarized. What is the big disadvantage of it?

4) (20 points) Jagdish Bagwati says that developing countries should have free trade in goods, but trade restrictions on international capital flows. He points to how a financial crisis in one developing country can cause an artificial crisis in another country. How do you think this could occur?

5) (20 points) When would a country want a crawling peg? Explain your reasoning.