Wilfrid W. Csaplar Jr.   Open Economy Macroeconomics   Review Sheet for Exam 1

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 2/25 if you have questions, unless would prefer a different time for the extended hours.

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 $M = f(\overset{-}{i}, \overset{-}{i^*}, \overset{-}{EA}, \overset{+}{RP}, \overset{+}{Y}, \overset{+}{P}, \overset{+}{W})$. U
b through d in figure 15.5 behave like that given panel a as given.

Chapter 16 through Section 16.3: Understand how the balance of payments adjusts with flexible exchange rates. Know how to derive the supply and demand for foreign exchange from the supply and demand for imports and exports. Note that the demand for imported goods will result in a demand of the country's currency and a supply of the home currency. How do exchange rate changes affect the domestic income and prices? What is the *Dutch Disease*? (We are not talking about elms. It is where your economy grows so much that the terms of trade turn against your exports and your economy is hurt.)

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

1) (15 points) Why would expect absolute PPP to hold? Why would it expect it to fail?

2) (25 points) Explain the economics behind $D = f(\overset{+}{i}, \overset{-}{i^*}, \overset{-}{EA}, \overset{+}{RP}, \overset{-}{Y}, \overset{-}{P}, \overset{+}{W})$

3) (15 points) Why would we expect that $R = M_s k^* Y^* / (M^*_s k Y)$

4) (15 points) Explain why the exchange rate overshoots the equilibrium and then comes back down to the new higher equilibrium.

5) (30 points) Draw the supply and demand for an American export like wheat, with the price listed in Egyptian pounds (LE). Make sure you put a scale on the axes. Have the first lines represent the supply and demand when the exchange rate is \$0.20/LE. Illustrate the effects of a change in the exchange rate to \$0.10/LE. Explain why the curve(s) moved as drawn. Can you use this data to derive the supply or the demand for the LE? How can tell that is the curve you can derive? Use the diagram to determine two points on the curve. Plot them and briefly explain how you found them.