Wilfrid W. Csaplar Jr. Open Economy Macroeconomics Review Sheet for Exam 2

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 3/31 if you have questions, unless would prefer a different time for the extended hours.

Chapter 16: Be able to tell if the exchange rate will be stable or unstable by looking at a graph and with the Marshall-Lerner condition. Understand why the economics of why Marshall-Lerner condition holds. What is meant by elasticity pessimism and the identification problem. What is the J-curve and how can the Marshall-Lerner condition be used to explain it? How do the economies adjust to improperly set exchange rates under the gold standard? Ignore the appendix; however, section A16.3 is easily understood and may help you to understand part of the chapter better.

Chapter 17: This chapter does not do a good job explaining the Keynesian model. It is best to just simplify it to the 45° diagram, a.k.a. Keynesian cross diagram, and ignore the S = I. However, when you do the moving line on the diagram, label it E = C + I + G + X - M. That line moves whenever any of those five variables change, unless that change is caused by a change in income. Note that most movements are parallel movements unless something marginal changes. That is because marginal in this context is Δsomething/ΔY. That is the definition of part of the slope of that line. Therefore, marginal things affect the slope. Increases in demand for any of the five variables will move the curve upwards. Do not worry about the mathematics of the various multipliers. Understand why the multiplier is smaller when we have an open economy than when it is closed, and know how to explain other similar scenarios. For example, be able to explain why when we are a big country, an increase in our exports will have a different effect than an increase in our investment, and why both of those are different from an increase in foreign investment. What causes the monetary adjustments and the automatic adjustments? Skip the appendix.

Chapter 18 up to **18.5**: Understand the Swan diagram and why each zone has the disequilibrium that is listed. Why do the IS, LM, and BP lines slope as drawn in the book? Understand how monetary and fiscal policies move the lines for both when the BP line is flatter than the LM line and when it is steeper, but only for fixed exchange rates. 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. 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?

Non-graded assignment #6A to be covered with assignment #6.

1) (20 points) Draw the IS/LM/BP diagram with all three lines crossing at one point and the BP line steeper than the LM line. Illustrate an increase in consumption if there is a fixed

exchange rate. Continue to move the curves until all three markets are in equilibrium. Explain why the curve(s) moved as drawn.

2) (20 points) Draw the IS/LM/BP diagram with all three lines crossing at one point and the BP line flatter than the LM line. Illustrate an increase in government spending if there is a flexible exchange rate. Continue to move the curves until all three markets are in equilibrium. Explain why the curve(s) moved as drawn.

3) (20 points) Draw the IS/LM/BP diagram with all three lines crossing at one point and the BP line flatter than the LM line. Illustrate an increase in the money supply if there is a fixed exchange rate. Continue to move the curves until all three markets are in equilibrium. Explain why the curve(s) moved as drawn.

4) (20 points) Draw the IS/LM/BP diagram with all three lines crossing at one point and the BP line steeper than the LM line. Illustrate an increase in the money supply if there is a flexible exchange rate. Continue to move the curves until all three markets are in equilibrium. Explain why the curve(s) moved as drawn.

5) (20 points) Explain why the IS curve, the LM curve, and the BP curve take their respective shapes.