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, 3/15 if you have questions.

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 $M = f(\overset{-}{i}, \overset{-}{i^*}, \overset{-}{EA}, \overset{+}{RP}, \overset{+}{Y}, \overset{+}{P}, \overset{+}{W})$. 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.

Chapter 16: 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.) 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.

Non-graded assignment #5A to be covered with assignment #5.

1) (15 points) Our models assume that there are no income taxes. What would happen to the size of the multiplier if there is an income tax? Explain your logic.

2) (25 points) Suppose that C = 200 + 0.8(Y-T), I = 300, G = 500, X = 400, M = 0.16Y, and T = 0.3Y. What is the value of the multiplier? Show all work and explain how you derived the equation.

3) (20 points each) Illustrate each event on the Keynesian Cross, a.k.a. 45° diagram for the USA. Explain why the curves moved as drawn.
A) An increase in government spending.
B) Increase in the GDP of Canada.
C) The marginal propensity to import increases.