

Study Guide for Exam 1
(revised March 7 – new items in *bold & italic*)

Chapter 2/13

- the nominal exchange rate, appreciation, depreciation
- the effects of an exchange rate appreciation or depreciation (e.g., if the exchange rate appreciates, what happens to the country's imports and exports, and why? what happens to the foreign-currency value of foreign holdings of the country's financial assets?)
- compute the rate of depreciation of a country's exchange rate
- be able to compute the effective exchange rate from trade shares and bilateral exchange rates (my preference) or the trade-weighted rate of depreciation (the textbook's preference)
- use exchange rates to convert prices from one currency to another
- fixed (pegged) exchange rate regime vs. floating (flexible) exchange rate regime
- exchange rate crises
- spot exchange rate
- forward contract, forward exchange rate
- transactions costs / market frictions
- government actions in the FX market: intervention to influence exchange rates, and capital controls
- arbitrage, arbitrage with two or three currencies, no-arbitrage condition, cross-rates and vehicle currencies
- exchange rate risk (or, simply, exchange risk) of holding a foreign asset in one's portfolio
- using a forward contract to cover (eliminate) exchange risk
- covered interest parity
- the expected exchange rate
- uncovered interest parity
- a useful approximation/simplification for uncovered interest parity

Chapter 3/14

- the law of one price, and the circumstances when we would expect it to work
- purchasing power parity (definition, absolute vs. relative, the logic of PPP)
- the purchasing power parity exchange rate
- the real exchange rate, real appreciation, real depreciation
- when the real exchange rate is undervalued vs. overvalued
- convergence to PPP
- forecasting the nominal exchange rate when the real exchange rate is under- or over-valued (side bar and HW2 problem 5)
- the Economist's "Big Mac index"
- reasons why PPP doesn't hold
- what "money" means

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- the money supply
- the demand for money
- the variable “L”
- nominal vs. real money balances
- equilibrium in the money market
- the quantity theory of money: equation, variables, equation in growth rates, and relationship between the rates of inflation, money growth and real GDP growth
- what the book calls “the fundamental equation of the monetary model of the price level” and the simple and general versions of “the fundamental equation of the monetary approach to exchange rates” – I don’t require you to know these long names, but I do require you to know the equations, where these equations come from and the logic behind them
- the relationship between the growth rates of money, real GDP, inflation, and exchange rate depreciation
- the Fisher effect
- real interest parity
- why “L” and money demand depend on the nominal interest rate
- use both the simple model and the general model to show what happens to all variables if the central bank changes the money growth rate, or if the rate of real GDP growth changes. *Note that a change in the interest rate in the general model will cause discrete jumps in real money demand, the real money supply, the price level, and the nominal exchange rate at the moment the interest rate changes. (See class notes from Friday March 6.)*
- how a central bank can maintain a fixed exchange rate (peg) in the long run

Chapter 4/15

- what are the differences between the short run and the long run?
- the FX market model:
 - what are the endogenous variables? what are the exogenous variables?
 - FR curve: what relationship does it depict? as you move along the FR curve, what variables are held constant? why does it have a negative slope? how does a change in the expected exchange rate shift the FR curve? how does a change in the foreign interest rate shift the FR curve
 - DR curve: what relationship does it depict? as you move along the DR curve, what variables are held constant? why is it horizontal? how does a change in the domestic interest rate shift the DR curve?
 - equilibrium: what is special about the intersection of the two curves? what variable is determined in the model’s equilibrium?
 - experiments: use the model to determine the effect on the spot exchange rate if: the domestic interest rate rises; the foreign interest rate rises; the expected exchange rate rises.
- sticky prices / nominal rigidities

- the money market model in the short run:
 - why does real money demand depend negatively on the nominal interest rate?
 - how does an increase in real income (Y) shift the real money demand curve?
 - why is the real money supply curve vertical?
 - how does a change in the nominal money supply shift the real money supply curve?
 - how does a change in the price level shift the real money supply curve?
 - which variables are endogenous and which are exogenous (in the short run)?
 - experiments: use the model to determine what happens to the interest rate if: the central bank increases the money supply; real income rises; the price level rises. In each case, assume it is a one-time change with zero growth before and after the change.
- the asset approach to exchange rates: the FX and money market models together
 - draw both diagrams side-by-side, with the nominal interest rate measured on the vertical axis using the same scale in both diagrams (see Figure 4-7 or Figure 15-7 in section 3).
 - Suppose the Federal Reserve increases the U.S. money supply (but no other exogenous variables change). Use the model to determine the impact on the U.S. interest rate and U.S. exchange rate.
 - Instead, suppose that U.S. real GDP rises. Use the model to determine the impact on the U.S. interest rate and U.S. exchange rate.
 - Instead, suppose the foreign central bank increases the foreign country's money supply. Use the model to determine the impact on the endogenous variables.
- *For Exam 1, you will not have to do "long-run policy analysis" using the asset approach as it is shown in great detail in the textbook. However, you should know the basic idea: a permanent policy change can have two effects in the short run. First, there's the direct effect (e.g., an increase in the money supply reduces the interest rate and causes the exchange rate to depreciate in the short run). Second, there's an indirect effect: a permanent policy change has long-run effects (the monetary approach says that a permanent increase in the money supply leads in the long run to a higher price level and higher exchange rate); people immediately adjust their expectations to this new long-run reality, and the change in expectations can generate additional effects in the short run (e.g., if people expect the dollar to depreciate more than previously thought, they will sell dollars and buy foreign currency now, causing the spot exchange rate to rise now).*
- *For Exam 1, you need not know Section 5 "Fixed Exchange Rates and the Trilemma." We will cover that after Exam 1.*