

Study Guide for Exam 2

Disclaimer: I can't really fit everything we've covered since Exam 1 on two pages, but I've tried to highlight as many of the important items as possible here. It's always a good idea to review all your notes from class, assigned readings, handouts & worksheets, homeworks, homework answer keys, and probably also the answer key to Exam 1 questions on the monetary & asset approaches.

Chapter 4/15

- Use the combined monetary and asset approach to exchange rates to determine how various shocks affect endogenous variables in the long run, short run, and transition from short run to long run. The shocks include: a temporary increase or decrease in income/GDP, and a temporary increase or decrease in the nominal money supply.
- Even though we covered the monetary and asset approaches separately, as self-contained models, before Exam 1, each of them is an important part of the combined monetary/asset approach that we covered after Exam 1. Therefore, you will need to know these approaches for Exam 2 (and of course, for the comprehensive final exam).

Chapter 5/16

- GDP, GNE, GNI, and GNDI: Know the definitions, what they mean, and the differences between them.
- Current account: know the components that sum up to the current account, and know the definition of the current account and each of these components. Be able to provide or identify examples of each of these components.
- National saving, private saving, public saving.
- The relationship between the current account, national saving, and investment.
- In the equation $GDP = C + I + G + TB$, I = investment. Know this definition of "investment."
- External assets, external liabilities, and external wealth.
- Financial account:
 - definition
 - why "exports of assets" is the same as foreign lending to the home country, which causes external liabilities to rise and external wealth to fall
 - why "imports of assets" is the same as home country lending to ROW, which causes home's external assets and external wealth to rise
 - why FA essentially means net borrowing from ROW
- Capital account: the book's definition
- Be able to determine which parts of the Balance of Payments would be affected as a result of a given transaction.

Chapter 6/17

- What is present value? Know the formula that allows you to compute the present value of a future sum, and be able to apply it.
- Know that the value of a stock or bond equals the present value of any payments its owner will receive.
- What is the household's intertemporal budget constraint?
- What is "consumption smoothing"? Why do most households prefer their consumption to be "smooth" rather than volatile? How do financial markets allow households to intertemporally reallocate their consumption so as to achieve consumption smoothing in the face of volatile income?
- How does the household adjust its spending and saving in response to temporary income shocks? What about permanent shocks?
- At the country level, what concepts corresponds to household income, household expenditure, and household saving?
- What is the budget constraint for a closed economy? What is the budget constraint for an open economy?
- How does an open economy achieve consumption smoothing in the face of variable income (i.e. positive income shocks in some years, negative shocks in other years)?
- How would an open economy respond to an income shock that is: temporary and country-specific? permanent and country-specific? temporary but affects all countries?
- What does it mean for a country to be a "small open economy"?
- What is the source of the supply of loanable funds? How does the supply of loanable funds depend on the real interest rate? Know all the things that would cause the supply curve to shift, and be able to briefly explain each of them.
- What is the source of the demand for loanable funds? How does the demand for loanable funds depend on the real interest rate? Know all the things that would cause the demand curve to shift, and be able to briefly explain each of them.
- In a closed economy, what variable adjusts to ensure the equality of national saving and investment?
- In a closed economy, what determines the equilibrium real interest rate?
- In a closed economy, use the loanable funds model to determine the effects on S , I , and r of each of the things that causes the supply and demand curves to shift.
- In the small open economy loanable funds model, what determines the real interest rate?
- In the small open economy loanable funds model, what are the endogenous variables? How do they respond to each of the things that shifts the supply or demand curves?
- What is the marginal product of capital (definition)?
- What is the efficient level of investment in an open economy? What condition must hold for the country to be at this efficient level of investment? Explain the intuition for the condition.
- NOTE: We will postpone the gains from diversification of risk (section 4) until after Exam 2.