

Study Guide for the Final Examination

This study guide focuses on material covered after Exam 2. The final exam will be cumulative, so you should also review the items on the study guides I posted before each of the two midterm exams.

The usual disclaimer applies.

Chapter 6/17 (the portion covered after Exam 2)

- What is the expected return on an asset?
- How does diversification reduce risk?
- Your portfolio contains assets from several different countries. The expected return to each country's assets is the same, and equals the expected return on the portfolio. Rank the risk (or likely variability) of the portfolio's return in each of the following scenarios:
 - A) shocks affecting countries and their stock markets are positively correlated (if one country has a positive shock, another country is more likely to have a positive shock)
 - B) shocks affecting countries and their stock markets are negatively correlated (if one country has a positive shock, another country is more likely to have a negative shock)
 - C) shocks affecting countries and their stock markets are uncorrelated (whether one country has a positive or negative shock has no relation to the likelihood that other countries will have positive or negative shocks)
- Let f = foreign assets as a share of your overall portfolio. For example, $f = 0.10$ means that 10% of your portfolio consists of foreign assets, while 90% consists of domestic assets. If $f = 0$, the portfolio contains only domestic assets, while $f = 1$ means the portfolio contains only foreign assets. Describe what happens to the riskiness of a portfolio as f rises from 0 to 1.
- What is home bias? What are some reasons why home bias exists?

Chapter 7/18

- Assumptions spelled out in Section 1: what are they? what difference do they make?
- Know the definition and know the variables that affect each of the following:
consumption, investment, government spending, the trade balance
- Marginal propensity to consume
- If disposable income increases by \$1, what happens to consumption, imports, the trade balance, and aggregate demand?

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- Keynesian Cross:
 - What equations comprise the Keynesian Cross model?
 - The KC graph has two curves. One shows aggregate demand ($C + I + G + TB$) as a function of income (Y). Is the slope of this line smaller than, equal to, or greater than 1? What causes this line to shift? The other curve is a 45-degree line from the origin. What does it represent?
 - In the KC model, how does income change if:
 - * government spending rises
 - * the government increases taxes
 - * households worry their jobs may not be secure so they cut back on spending
 - * firms decide to undertake more investment projects at each value of the interest rate
- The IS curve:
 - Define the IS curve.
 - What variables are measured along the axes of a graph of the IS curve?
 - What is true of all points on the IS curve? What is true of points off the IS curve?
 - How is IS connected to the asset market approach diagram of the exchange rate?
 - Why does the IS curve have a negative slope?
 - What causes the IS curve to shift?
- The LM curve:
 - Define the LM curve.
 - What variables are measured along the axes of a graph of the LM curve?
 - What is true of all points on the LM curve? What is true of points off the LM curve?
 - Why does the LM curve have a positive slope?
- In the IS-LM-FX model, which variables are endogenous and which are exogenous?
- For each exogenous variable, determine which curve shifts, and determine the short-run effects on all of the model's endogenous variables.
- Use the IS-LM-FX diagram to analyze the short-run effects on all endogenous variables in each of the following scenarios. Assume flexible exchange rates unless otherwise specified.
 - A negative shock to consumption (e.g., fall in stock prices or house prices make households feel poorer, or households perceive an increase in the probability they will become unemployed)
 - A negative shock to investment (e.g., the credit crunch makes it harder for firms to obtain funding for investment projects, or firms forecast a decline in future economic activity and do not want to be stuck with new factories they don't need)
 - The government increases its spending and/or cuts taxes. Do this experiment twice – first assuming flexible exchange rates, second assuming the central bank is committed to maintaining a fixed exchange rate.
 - The central bank increases the money supply. Do this experiment twice – first assuming flexible exchange rates, second assuming the central bank is committed to maintaining a fixed exchange rate.
- Compare and contrast fiscal policy under fixed vs. flexible exchange rates.
- Compare and contrast monetary policy under fixed vs. flexible exchange rates.