

International Economics

Brief review for final exam

Note that not all material covered in lecture is mentioned here. You should be able to do the problems from all chapters (my answers to chap. 18 problems are not online, but similar problems on covered interest arbitrage are, and answers to selected problems are in the back of the book).

Chapter 16 -- Payments among Nations

Review Balance of Payments accounting and terminology;

distinguish between current account, capital account and official settlements.

Within the current account, distinguish the balance on merchandise trade, services, and incomes received from or paid to foreigners.

Explain the relation of the current account and the capital (= financial) account.

What is the relation between the capital account and the international investment position of a country?

What happens when a country on a floating exchange rate has a current account deficit?

What happens if it has a fixed exchange rate?

Why are statistical discrepancies in the balance of payments so large?

What are US international reserves and how are they tied into the banking system?

Make sure you know the macro meaning of the current account and its relation to national saving:

$$\text{GDP} = C + I + G + X - M$$

$$\text{GDP} - \text{Taxes} = C + I + G - T + X - M \quad (\text{defines disposable income and the govt budget deficit})$$

$$\text{Private saving} + \text{public saving} = I + \text{NX}$$

What impact will an increase in the government budget deficit have on the current account deficit, other things equal? What happens to the current account deficit if private savings then increase to pay the anticipated higher taxes later?

Chapter 17 -- The Foreign Exchange Market

Define and distinguish spot, forward and swap transactions. What is each likely to be used for, and what are the relative sizes (roughly) mentioned in the Bank of International Settlements report?

Distinguish depreciation and devaluation, appreciation and revaluation of a currency.

Define triangular arbitrage and (of course) be able to show how to make a profit by it given exchange rate misalignments.

Chapter 18 -- Forward exchange and International Financial Investment

Distinguish the forward rate from the future spot rate and from the expected future spot rate.

What is a forward premium or discount?

How can you hedge using the forward market? How can you speculate?

What is covered interest arbitrage and how does it work?

What is the expected relation between international interest differences and the forward premium or discount on the currency?

Note that the relation interest differential = forward premium or discount is only approximate -- be able to explain why.

Distinguish covered and uncovered interest arbitrage.

Which holds better in practice -- covered interest parity or uncovered interest parity?

Chapter 19 -- What determines exchange rates?

Distinguish the asset market or portfolio approach to exchange rates, the purchasing power parity theory of exchange rates, and the monetary approach to exchange rates.

Which approach holds best in the short run?

What is the law of one price? How does it differ from purchasing power parity?

Distinguish absolute and relative purchasing power parity. Which holds better for industrialized countries (OECD)? which holds better for developing countries?

What are the limits of the purchasing power parity doctrine?

How is the monetary approach related to the purchasing power parity approach? What new factors does it bring in?

Why do exchange rates overshoot their equilibrium value?

What is the evidence on the predictability of exchange rates in the short run? in the long run?

Distinguish real and nominal exchange rates.

Chapter 20 -- Government policies toward the FX market

Define fixed, floating, fixed-but-adjustable (Bretton Woods) exchange rates, as well as some intermediate types: currency boards, adjustable peg, crawling peg, clean float, managed float.

What are the pros and cons of fixed and floating exchange rates ? See chapter 25, p. 607 and the section "Key issues in the choice of exchange rate policies", pages 606-618.

How does a country defend its fixed exchange rate in general (p. 454) -- market intervention, exchange control, interest rate policy, macroeconomic adjustment, devaluation or change to floating system.

How does a country defend against depreciation or appreciation, and what impact will this have on its money supply?

Is a defense against temporary disequilibrium welfare-improving? Against permanent disequilibrium?

What are the effects of exchange control (462-5)?

What were the major characteristics of the Gold Standard era? How well did it function before 1913?

How well did it function in 1922-1931 ?

Was the interwar period characterized by instability? (yes) Was Ragnar Nurkse right to see destabilizing speculation as the villain?

What were the main features of the Bretton Woods era? Why did it break down?

[No problems online; most at end of chapter is definitional and descriptive material]