Econ 182 Fall 1999
Suggested Questions for Review
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My Review Session for sections 102 and 105 is on Wednesday, December 15, 3.30-5.30p.

1 Review the Sample Exam

Make sure that you understand all questions of the Sample Exam extremely well. Answer at least seven of them most carefully for yourself. The questions in the final are likely to be of a very similar kind.

2 Further Sample Questions

If you want to train yourself more for the analytical part of the exam, you can try yourself with the following questions.

1. This first question asks you to compare *permanent* demand-side shocks from the goods-market (real shocks) with *permanent* demand-side shocks from the money market (monetary shocks).
   Consider our AA-DD version of the Mundell-Fleming model. (Remember that investment I does not depend on the interest rate in this model.)

   (a) Suppose domestic demand for domestic output, $C(\cdot)$, falls autonomously (that is, consumption falls for any level of disposable income). Is the effect on domestic output stronger under a fixed or under a floating exchange rate?

   (b) Suppose domestic demand for money, $L(\cdot)$, rises autonomously (that is, money demand increases for any level of the domestic nominal interest rate R and domestic output Y). Is the effect on domestic output stronger under a fixed or under a floating exchange rate?

   (c) Take your answers to (a) and (b) together. If most shocks to an economy come from the demand-side, would you recommend to fix or to float the exchange rate?

Note: Your answer should be a variant of the general statement that floating exchange rates are more appropriate when real shocks dominate and that fixed exchange rates are more appropriate when monetary shocks dominate.

2. Consider a model of two large open economies (where domestic and foreign investment, I and I^*, are independent of the interest rate as usual).

   (a) Suppose there is a *transitory* (autonomous) fall in money demand at home (that is, domestic money demand falls for any level of the domestic interest rate R and domestic output Y).

   - What is the effect on the domestic interest rate R?
   - What is the effect on the HH schedule?
   - Depict three possible responses of the FF schedule (relative to the HH schedule) in which domestic output and foreign output each rise or fall.

   (b) If there was a *transitory* (autonomous) rise in domestic investment, what are the effects on

   - the domestic interest rate R,
   - the HH schedule, and
   - the FF schedule

   now? Do you have to distinguish three cases again?

   Consider a model of two large open economies (where domestic and foreign investment, I and I^*, are independent of the interest rate as usual).

3. Jose Ernesto has recommended the following list of question from the book to his students. So do I. Try the ones where you believe to gain most insight. Especially try the ones that are related to a topic from the Sample Exam that you would like to answer in the final (if it came up).

   - Chapter 13: Problem 13
   - Chapter 14: Problems 1, 3, 10
   - Chapter 15: Problems 1, 3, 7, 10, 12

- Chapter 16: Problems 1, 6, 8, 13, 14
- Chapter 17: Problems 7, 10, 14, 15
- Chapter 18: Problems 5, 7
- Chapter 19: Problems 1, 5
- Chapter 22: Problem 5

3 Readings

1. For the essay part, you might want to read especially carefully:

   (a) Krugman/Obstfeld p. 524-630 for arguments on Optimum Currency Areas

   (b) Krugman/Obstfeld p. 572-580 and 598-604 for arguments in favor and against floating exchange rates

2. If you have not been to the last lecture, you might want to read the introduction and part I.A. of the article by Olivier Blanchard: "Theoretical Aspects of Transition" for a supply-side explanation of the transition problems and Ch. 23 in Krugman/Obstfeld for a demand-side explanation.

3. The only further reading I would recommend (if asked) is Maurice Obstfeld and Kenneth Rogoff: "The Mirage of Fixed Exchange Rates," p. 73-82.

4 Additional questions

If you still want to prepare more, you can try yourself with these questions. I happen to like them quite a bit, but they are advanced. Too advanced for the final exam, probably.

1. Forms of Purchasing Power Parity

   (a) Can *Absolute PPP* hold if there is overshooting? Base your argument on a temporary monetray expansion. (Hint: Draw two diagrams, one for the change of the nominal exchange rate over time, and one for the change of the domestic price level over time. You can assume that the foreign price level is unaffected. How does the real exchange rate behave over time?)

(b) Knowing the answer to the question in (a), can you infer anything about the *Law of One Price*?

(c) Can *Relative PPP* hold if there is overshooting? (Hint: Reconsider the graphs from part (a).)

2. If the volatility of an exchange rate increases, we say exchange rate risk increases. Discuss the statement that “higher exchange rate volatility reduces international trade.”

   (a) What arguments could support the statement?

   (b) What does empirical evidence suggest?

   (c) Do you know a theoretical argument against the hypothesis?