

This review sheet is intended to cover everything that could be on the exam; however, it is possible that I will have accidentally left something off. You are still responsible for everything in the chapters covered except anything that I explicitly say you are not responsible for. Therefore, if I left something off of this sheet, it can still be on the exam. There will be no multiple-choice questions. Most of the questions will be like the ones in the homework assignments, and possibly a few definition questions, but I am more likely to ask questions that make you use the definitions rather than recite them.

The review session will probably be Sunday, 3/10, at a time and place to be determined. You will be given a pair of equations and asked to explain one of them. The equations at the end of the chapters will help you prepare for this part of the exam.

Chapter 4: What determines desired savings and desired consumption? What is the **MPC** and why is it important? How do current income, expected future income, wealth, and r affect consumption? What is $r_{a,t}$ and why does it matter? How do government spending and taxes affect national savings? Why might they not affect it? What determines uc_K ? What will move that curve? Why is where it crosses MPK^f the desired level of K ? Why is there an “ b ” on the MPK ? What moves the MPK^f line? How does K^* relate to I ? Why might a change in the depreciation rate have uncertain effects upon investment? Why might the market take time to adjust? What moves the S^d and I^d lines on the graph? Why should they yield the equilibrium level of S and I ?

Chapter 5: What is the **current account (CA)**? How is it calculated? What is the **capital financial account (KFA)**? Why should the $CA + KFA = 0$? How do **NFP** and **unilateral transfers** enter the equation? Do not worry about *official reserves* or *official settlements balance*. Note that the summary on page 175 does a great job of showing how all the terms relate to each other. Why does $S^d = I^d + CA$ or more easily put $S^d + KFA = I^d$? Be able to manipulate the S/I diagram for **small open economies**. Be able to show what moves the curves, and know how to find a CA deficit or a KFA deficit. Personally, I think that you can figure out KFA easier and more directly because if there is excess savings, what do we do with it? We buy foreign stocks and bonds. If we have excess investment, how do we finance it? We export bonds and stocks, i.e., we borrow from abroad. Know how government policy and shocks affect the diagram. Be able to manipulate the S/I diagram for **large open economies**. Be able to show what moves the curves, and know how to find a CA deficit or a KFA deficit. Personally, I think that you can figure out KFA easier and more directly because if there is excess savings, what do we do with it? We buy foreign stocks and bonds. If we have excess investment, how do we finance it? We export bonds and stocks, i.e., we borrow from abroad. Know how government policy and shocks affect the diagram. How are the **twin deficits** related?

Non-graded Assignment #4A to be reviewed with Assignment #4.

- 1) (15 points) Draw the S/I diagram for a small country with a capital-financial account deficit. Explain how you know your diagram shows a capital-financial account deficit. Illustrate the effects of an increase in the income tax rate, assuming Ricardian Equivalence does not hold. Explain why the curve(s) moved as drawn. What happens to the interest rate, level of savings, level of investment, and the capital-financial account deficit?
- 2) (15 points) Draw the S/I diagram for a small country with a current account deficit. Explain how you know your diagram shows a current account deficit. Illustrate the effects of an increase in the corporate tax rate, assuming Ricardian Equivalence does not hold. Explain why the curve(s) moved as drawn. What happens to the interest rate, level of savings, level of investment, and the current account deficit?
- 3) (25 points) Draw the S/I diagram for a large country with a capital-financial account surplus. Explain how you know your diagram shows a capital-financial account surplus. Illustrate the effects of an increase in the price of capital in the foreign country. Explain why the curve(s) moved as drawn. What happens to the interest rate, level of savings, level of investment, and the capital-financial account surplus?
- 4) (25 points) Draw the S/I diagram for a large country with a current account surplus. Explain how you know your diagram shows a current account surplus. Illustrate the effects of an improvement in technology in the foreign country. Explain why the curve(s) moved as drawn. What happens to the interest rate, level of savings, level of investment, and the current account surplus?
- 5) (20 points) Draw the S/I diagram for a small country with balanced trade. Use it to explain where the “twin deficits” get their name.