

ECONOMICS 50133
International Monetary Economics
Study Questions for Semester (Fall 2009)

INSTRUCTIONS: These questions are to help guide your studying. Though these exact questions may not appear on your exams, **the tests will be based entirely on this list.** I've already answered all the questions (I have a PhD in this stuff!) and so as to give you an idea of how much you need to say I have told you how many words it took me to do each one. A really good method as you are working is to imagine that you are explaining to a classmate. Notes in parenthesis will be in the question if it's on the test. Notes in brackets will not.

Questions are grouped by their source. For examples, questions based on lecture material have *Lecture* before them, and then appear without spaces between them. For questions where answers can be found in the reading, the link is given and the questions are then grouped without spaces.

BACKGROUND

Lecture

1. Distinguish between validity and cogency. [25 words]
2. List the balance of payments accounts. [29 words]
3. What is a floating or flexible exchange rate system. [13 words]

The Basics of Foreign Trade and Exchange

<http://www.ny.frb.org/education/fx/foreign.html>

4. What may be necessary before you buy foreign goods or services, or to invest in other countries? [14 words]
5. What are the three main centers of trading, which handle the majority of all FX transactions? [3 places]
6. According to the Federal Reserve Bank of New York, what are the four types of foreign exchange market participants? Please describe each in a sentence. [81 words]
7. What are the three reasons participants in the FX market trade? [35 words]

Wikipedia: Foreign Exchange Market

http://en.wikipedia.org/wiki/Foreign_exchange_market#Financial_instruments

8. List and explain the five financial instruments available in the foreign exchange market (skip exchange traded fund). [117 words]

Wikipedia: Fixed Exchange Rate

http://en.wikipedia.org/wiki/Fixed_exchange_rate

9. What is a fixed or pegged exchange rate? [35 words]
10. Generally speaking, what does maintaining a fixed exchange rate entail? What, for example, might a government have to do if a rate drifts too far below the desired rate? [56 words]

NEOCLASSICAL EXCHANGE RATE THEORY

Background

Harvey: Currencies and Capital Flows..., Chapter Two- Neoclassical Approaches

<http://www.econ.tcu.edu/harvey/book/BookCh2.pdf>

11. Why, in terms of modeling techniques, do mainstream economists tend to rely heavily on deductivism? [53 words]
12. Why, logically, must capital flows play a passive role in the Neoclassical explanation of exchange rate determination? [46 words]
13. List the characteristics of Neoclassical economics and tell which element(s) tends to show up most in exchange rate theory and how. [137 words]

EXCHANGE RATE DETERMINATION: POST KEYNESIAN

Harvey: Currencies and Capital Flows..., Chapter One- Introduction

<http://www.econ.tcu.edu/harvey/book/BookCh1.pdf>

14. In the first few pages, what does Harvey appear to be arguing will be the key element of the Post Keynesian view in terms of what drives exchange rates? [37 words]
15. What does the Institutional influence on the book mean for foreign exchange? [120 words; three things]
16. In the Neoclassical or Mainstream model, what maintains the equality of investment and saving? [95 words plus graph]
17. In Keynes' model, what maintains the equality of investment and saving? [bunch of math plus explanation]
18. Briefly contrast the Neoclassical and Post Keynesian views of expectations (in terms of causation). [68 words]

Foreign Currency Market Structure

Harvey: Currencies and Capital Flows..., Chapter Three- Psychology and Decision Making

<http://www.econ.tcu.edu/harvey/book/BookCh3.pdf>

19. Which level of foreign currency activity essentially creates the demand for currency (while the other two accommodate)? Explain. [26 words]
20. Those wholesaling face a complex world. How do they make their money? What makes this easier said than done? [85 words]

Exchange Rates and Trade Imbalances

Harvey: Currencies and Capital Flows..., Chapter Four- Exchange Rates and Trade (Im)Balances

<http://www.econ.tcu.edu/harvey/book/BookCh4.pdf>

21. In what way does the exchange rate play a role similar to that outlined for interest rates (from the Neoclassical perspective) in chapter one? [48 words]
22. Be able to manipulate the exchange rate graph (be sure you can label the actual exchange rate, the balanced-trade exchange rate, imports, exports, capital inflows, capital outflows, the trade balance, and the capital account balance). [whatever!]

Open Economy Z-D Diagram

Harvey: Currencies and Capital Flows..., Chapter Five- PK Exchange Rate Models

<http://www.econ.tcu.edu/harvey/book/BookCh5.pdf>

23. Why is the D curve sloped as it is? [35 words]
24. What determines the intercept of the D curve? [8 words]
25. The Z curve is simply what (you don't need the equation)? [22 words]
26. Why does the Z curve get steeper? Be sure to explain in terms of sales and the payroll as well as marginal returns. [55 words]
27. What are the conclusions drawn from the equations used to derive the BTFX curve and how do they affect the latter's slope? [73 words]
28. What must be true when BTFX is flatter? [20 words]
29. Because we have a fractional-reserve banking system, money is created how? [28 words]
30. Explain how the demand for money can be broken into two distinct parts. [equation plus 55 words]
31. On the FXM curve, what forces are assumed to be driving net capital inflows (show by equation)? [equation]
32. Show the effect of a rise in investment or a fiscal stimulus on the open economy Z-D diagram. [graph plus schematic]
33. Show the effect of a rise in interest rates on the Post Keynesian open economy Z-D diagram. [graph plus schematic]
34. Show the effect of a fall in the expected value of the dollar in the Post Keynesian open economy Z-D diagram. [graph plus schematic]

Expectations and Decision Making

Harvey: Currencies and Capital Flows..., Chapter Three- Psychology and Decision Making

<http://www.econ.tcu.edu/harvey/book/BookCh3.pdf>

35. On what currency price does today's expectation of the future impact? [9 words]
36. List and explain the five stages of decision making. [81 words]
37. List and explain the three heuristics and include an example for each. [126 words without examples]
38. What are the forecast-construction biases introduced by the three heuristics? [62 words]
39. Explain why people prefer to follow conventional wisdom. [112 words]
40. List and explain Keynes' five observations regarding the workings of asset markets. [301 words]

41. Explain how volatility is created (seven factors). What stops it? [195 words]
42. Explain how bandwagons occur. [203 words]
43. What is the “mental model?” [106 words]

The Mental Model

Harvey: Currencies and Capital Flows..., Chapter Five- PK Exchange Rate Models
<http://www.econ.tcu.edu/harvey/book/BookCh5.pdf>

44. Explain the concept of medium-term expectations. [97 words]
45. Why are agents not as capricious as they could be in deciding what is important in exchange rate determination and what does their worldview recognize? [49 words]
46. What is the role of realized levels of (X-M), DFI, and PFI as foci in the expectations formation process? [46 words]
47. What are the “indicators” on the Mental Model diagram? [22 words]
48. What do agents prefer in terms of the sort of inputs they rely upon in the expectation formation process and what has this meant historically as far as what four variables being most important (please list in order)? [62 words]
49. What is considered to be a member of the set “indicators” may evolve over time, subject to the condition that what enters and leaves meets with the social sanction of the community of market participants. What four factors are associated with that evolution (please explain each in a sentence)? [99 words]
50. Draw the complete Mental Model diagram. Be sure you understand the logic underlying each of the nineteen links. [schematic]
51. What are the three tension points that may lead to a financial or currency crisis? Explain each in a sentence or two (this will take some work reading and then summarizing). [102 words]
52. Draw the complete currency crisis schematic and be sure you understand the logic underlying each of the links. [schematic]

Long Run versus Short Run

Harvey: Currencies and Capital Flows..., Chapter Five- PK Exchange Rate Models
<http://www.econ.tcu.edu/harvey/book/BookCh5.pdf>

53. Post Keynesians see the long run as what? [6 words]

Applying the Model to History

Harvey: Currencies and Capital Flows..., Chapter Six- Applications

<http://www.econ.tcu.edu/harvey/book/BookCh6.pdf>

54. During Bretton Woods Collapse and Adjustment (1970-79), what happened to the dollar (rise or fall)? What were the major factors responsible for this movement both on the mental model schematic and the open economy Z-D diagram (go as far to the left as possible when appropriate)? How did the U.S. trade balance change? Note that there will be 4 mental model factors and 2 Z-D shifts (note that the bandwagon and medium-term exchange rate bias count in this total). You need not mention “ignored” variables (though they are very interesting!). [79 words]
55. During Dollar Run Up (1980-February 1985), what happened to the dollar (rise or fall)? What were the major factors responsible for this movement both on the mental model schematic and the open economy Z-D diagram (go as far to the left as possible when appropriate)? How did the U.S. trade balance change? Note that there will be 5 mental model factors and 2 Z-D shifts (note that the bandwagon and medium-term exchange rate bias count in this total). You need not mention “ignored” variables (though they are very interesting!). [100 words]
56. During Dollar Reversal (March 1985-April 1995), what happened to the dollar (rise or fall)? What were the major factors responsible for this movement both on the mental model schematic and the open economy Z-D diagram (go as far to the left as possible when appropriate)? How did the U.S. trade balance change? Note that there will be 5 mental model factors and 2 Z-D shifts (note that the bandwagon and medium-term exchange rate bias count in this total). You need not mention “ignored” variables (though they are very interesting!). [75 words]
57. During the Last Days of the Mark (1995-1998), what happened to the dollar (rise or fall)? What were the major factors responsible for this movement both on the mental model schematic and the open economy Z-D diagram (go as far to the left as possible when appropriate—can’t quite do it on one, but you’ll see)? How did the U.S. trade balance change? Note that there will be 3 mental model factors and 3 Z-D shifts (note that the bandwagon and medium-term exchange rate bias count in this total). You need not mention “ignored” variables (though they are very interesting!). [51 words]
58. During the Euro Decline (1999-2001), what happened to the dollar (rise or fall)? What were the major factors responsible for this movement both on the mental model schematic and the open economy Z-D diagram (go as far to the left as possible when appropriate)? How did the U.S. trade balance change? Note that there will be 4 mental model factors and 2 Z-D shifts (note that the bandwagon and medium-term exchange rate bias count in this total). You need not mention “ignored” variables (though they are very interesting!). [59 words]

59. During the Euro Recovery (2001-2007 or 8), what happened to the dollar (rise or fall)? What were the major factors responsible for this movement both on the mental model schematic and the open economy Z-D diagram (go as far to the left as possible when appropriate)? How did the U.S. trade balance change? Note that there will be 4 mental model factors and 3 Z-D shifts (note that the bandwagon and medium-term exchange rate bias count in this total). You need not mention “ignored” variables (though they are very interesting!). [62 words]
60. In terms of the Mexican Financial Crisis (1994), offer a sentence or two to explain how each of the three tension points contributed. What appears to have initiated the process (historically)? [87 words]
61. In terms of the Asian Financial Crisis (1997), offer a sentence or two to explain how each of the three tension points contributed. Which one broke first? [62 words]

Policy

Harvey: Currencies and Capital Flows..., Chapter Seven- Problems and Policies

<http://www.econ.tcu.edu/harvey/book/BookCh7.pdf>

62. In general, what is it that Post Keynesians want (and what is also desirable)? [14 words]
63. How does the international monetary system as designed frustrate the Post Keynesian goals for the economy (list only)? [words]
64. Briefly explain what it means to say that currency prices are mis-determined because they are driven by short-term time horizons instead of long. [173 words; this will take some hard work!]
65. Briefly explain what means to say that currency price volatility reduces the expectation of profit from investment and, therefore, the level of aggregate demand. [34 words]
66. Briefly explain what it means to say that currency price mis-determination and volatility reduce the level of world trade. [33 words]
67. Briefly explain what it means to say that currency markets contribute to developing countries’ woes. [44 words]
68. Briefly explain what it means to say that the manner in which the international monetary system operates tends to create contraction and unemployment. [57 words]
69. Where does the core of any successful international monetary reform lie? [2 words]
70. Why would a tax on exchange rate transactions be unlikely to help control financial capital flows? [58 words]
71. What are the central features of a Chilean-style policy and how did it properly discriminate between types of capital flows? [53 words]
72. Why would making all clearing through the central bank be helpful (be sure to mention the potential problem as well as how this would help)? [59 words]
73. In general, what is a trip wire and what is a speed bump? [24 words]
74. In terms of the open economy, Z-D diagram, how does placing the burden of adjustment on surplus countries work and how does it contrast to placing the burden on the deficit nation? [43 words]

Purchasing Power Parity

Lecture

75. Explain purchasing power parity (especially how it affects exchange rates). [106 words]

Harvey: Currencies and Capital Flows..., Chapter Two- Neoclassical Approaches

<http://www.econ.tcu.edu/harvey/book/BookCh2.pdf>

76. What is the best that empirical studies can say regarding Purchasing Power Parity? About what is it universally agreed? [58 words]
77. Why does Harvey believe that Purchasing Power Parity does not work? [61 words]

Interest Rate Parity and Forward Currency Pricing

Lecture

78. Explain uncovered interest-rate parity (especially how it affects exchange rates). [121 words]

Harvey: Currencies and Capital Flows..., Chapter Two- Neoclassical Approaches

<http://www.econ.tcu.edu/harvey/book/BookCh2.pdf>

79. Write the equation bankers use in calculating the forward exchange rate. Explain how a premium and a discount work. [equation + 124 words]
80. What have some economists argued in terms of covered and uncovered interest-rate parity and the proxying of variables? What has been their justification (both in terms of the math and because of how their lives would be made easier)? [75 words]

Rational Expectations, Market Efficiency, and Rational Choice

Lecture

81. Explain rational expectations. [32 words]
82. Explain market efficiency. [54 words]
83. Explain rational-choice theory (also known as expected-utility theory). [40 words]

Harvey: Currencies and Capital Flows..., Chapter Two- Neoclassical Approaches

<http://www.econ.tcu.edu/harvey/book/BookCh2.pdf>

84. Show the equation used for tests of rational expectations and tell what should be found if rational expectations holds. Why would that support rational expectations?[equation and 42 words]
85. Show the test you can conduct using the error terms from an empirical examination of rational expectations (to test to see if all available information was used). Explain it briefly (including what should occur if the information would not have improved the forecast). [equation and 37 words]

The Fundamentals

Harvey: Currencies and Capital Flows..., Chapter Two- Neoclassical Approaches
<http://www.econ.tcu.edu/harvey/book/BookCh2.pdf>

86. In what way might referencing the determinants of exchange rates as “The Fundamentals” be an intelligent strategy? Strangely, how is it that Neoclassicals actually use The Fundamentals? [90 words]
87. How does Harvey define the Neoclassical concept, The Fundamentals? [13 words]

Fundamentalists versus Chartists

Harvey: Currencies and Capital Flows..., Chapter Two- Neoclassical Approaches
<http://www.econ.tcu.edu/harvey/book/BookCh2.pdf>

88. Who are the three groups of agents in the Fundamentalists versus Chartists model? Please define each. [59 words]
89. Explain why, despite the fact that the Fundamentalists versus Chartists model allows expectations to take a role in exchange rate determination, that it is still not a clean break with the premise that the financial side of the economy has no real impact. [82 words]

Additional Readings

Harvey: The Institution of Foreign Exchange Trading
<http://www.econ.tcu.edu/harvey/5133/InstitutionofFXTrading.pdf>

90. The article says that much of the problem with existing models is their treatment of the institution of the market. Please explain what is being argued there. [69 words]
91. From what perspective does this paper study foreign exchange trading? [6 words]
92. Explain the Veblenian dichotomy that forms the overall theme of the research. [54 words]
93. Why is it helpful to avoid more familiar, everyday language? [12 words]
94. What was the difference of opinion among tribal elders following the collapse of the agreement regarding fixed wampum values (and what is an elder?)? [44 words]
95. Under FXers Today, what new service emerged given the collapse of agreement over fixed wampum values? [6 words]
96. How does one gain prestige among FXers and in what way does the necessity of offering “good” rates affect that? In this context, what power separates successful FXers from the unsuccessful? [64 words]
97. In the struggle for achieved status, how does the Fxer view himself? [3 words]
98. What is the unseen force that Fxers believe moves currency prices? In response to what does this unseen force act? [5 words]
99. What radical group has gained favor withing Fxers and what is their view? [28 words]
100. Under Analytical View, it says that the typical view of foreign exchange trading assumes what? [17 words]
101. In what ways can international trade and investment be a positive force in the development of humanity? [24 words]
102. What does exchange rate volatility do and how has the post-Bretton Woods international monetary system affected it? [29 words]

103. Under Analytical View, what are the three factors outlined as being the source of problems in the currency market? Please explain each briefly. [65 words]

Harvey: The International Monetary System and Exchange Rate Determination: 1945 to the Present

<http://www.econ.tcu.edu/harvey/5133/IMSandFX1945.pdf>

104. By what have exchange rates been market and why is this problematic (be sure to cover the consequences fo the second issue completely)? [35 words]
105. The fixed-exchange rate system Bretton Woods collapsed in the early 1970s, but the spectacular growth of the capital market really began when? [4 words]
106. What did Keynes believe regarding capital flows with respect to defending parities? How long did he believe such policies should be in place? [31 words]
107. Who did Keynes think should be allowed to convert currency and what arrangement was actually adopted? [17 words]
108. How did the attempt to control capital flows by balkanizing the market backfire? [you'll have to work on this one a bit—it's there, but you have to draw it out; 26 words]
109. Please list the policy (2), exogenous (3), and endogenous (2) factors that have contributed to the growth of the capital market since the collapse of Bretton Woods. [34 words]

Quinn and Harvey: Speculation and the Dollar in the 1980s

http://www.econ.tcu.edu/harvey/5133/Spec_and_Dollar_1980s.pdf

110. What are institutionalist economists drawn to ask when studying economic phenomena and what do you think that must mean? [38 words]
111. What is the Neoclassical argument that justifies the operation of an unregulated asset market? [78 words]
112. What did Keynes and Veblen argue with respect to unregulated asset markets (not physical investment)? [63 words]
113. What sort of pattern has US exchange rate policy followed since WWII? [9 words]
114. What did the dollar do in the early 1980s and what was the reaction of the government? Why did their attitude change in the mid-1980s and what did they do? [38 words]
115. What core concepts did Neoclassical economics begin to test given the apparent irrationality of the dollar's fluctuations in the 1980s? [5 words]

Keynes: Chapter Twelve, General Theory of Employment, Interest, and Money

<http://homepage.newschool.edu/het/texts/keynes/chap12.htm>

116. What is the “outstanding fact” Keynes discusses early in the chapter?
117. Keynes suddenly shifts from talking about physical investment to portfolio investment. How does he justify his belief that the “daily revaluations of the Stock Exchange, though they are primarily made to facilitate transfers of old investments between one individual and another, inevitably exert a decisive influence on the rate of current investment?” [25 words]
118. Summarize Keynes’ first four factors that accentuate the precariousness of financial investment markets. [155 words]
119. What does Keynes mean by speculation? By enterprise? [24 words]
120. Why does Keynes think that Wall Street is basically a casino? [7 words]
121. What does Keynes think could be accomplished by his half sarcastic, half serious, suggestion that we should make the purchase of an investment permanent and indissoluble, like marriage, except by reason of death or other grave cause? [17 words]
122. What does Keynes mean by animal spirits? [8 words]
123. In terms of animal spirits/spontaneous optimism, what does Keynes say about slumps and depressions and prosperity? [58 words]
124. Is Keynes arguing that everything depends on waves of irrational psychology? Explain. [99 words]

Harvey: Psychological and Institutional Forces and the Determination of Exchange Rates

http://www.econ.tcu.edu/harvey/5133/psych_inst_fx.pdf

125. At the macro level, what do neoclassical approaches to exchange rate determination typically assume? In the long run, what drives currency prices and how? [15 words]
126. At the micro level, neoclassical economists view agents as what two things? How do social and cultural factors affect agents and why? [33 words]
127. What shift in focus took place within neoclassicism in response to exchange rate events of the 1980s and 1990s? [6 words]
128. What are the ultimate determinants of foreign currency prices? Which of the three do neoclassical economists view as most important? Which of the three do Post Keynesian/Institutionalist economists view as most important? [11 words]
129. Very briefly summarize the difference between the neoclassical and Institutionalist views of profit and capitalism. [29 words]
130. The culture of capitalism and particularly the subculture of international portfolio investment attracts and molds what sort of people? How do they feel about being in this subculture? [22 words]
131. Explain how trading rules can be profitable even without self-fulfilling prophecy. [52 words]