AP Macroeconomics

Review Sheet

Section 6 and 8

1.21.16

**Know all Graphs. Money market, Foreign Exchange Market and AD/AS**

Topics Covered

* **Module 31 – Monetary Policy and the Interest Rate**
  + - Target federal funds rate:
    - The effects of an increase in the Money Supply on the Interest Rate
      1. Drives the interest rate down. Incentivizes people to hold on to money not invest it because of low return
    - Monetary policy that shifts the AD curve to the right is expansionary monetary policy
    - Monetary policy that shifts the AD curve to the left is contractionary monetary policy
    - Actual Monetary policy tries to ensure price stability: low (though usually not zero) inflation and trying to fight recessions
    - **Definition of Inflation targeting**
* **Module 32 – Money, Output, and Prices in the Long Run**
  + - Know the short run and long run effects of an increase in the Money Supply (page 316)
    - Definition of monetary neutrality
    - Know the graphs from the pages 308, 310, 316, 317

I expect about ¼ to a 1/3 of the exam to be on these to modules. Knowing module 31 will be very helpful when it comes to looking at foreign exchange markets and putting the three graphs we most recently worked on together.

* **Module 41 – Capital Flows and the Balance of Payments**
  + - Definition of the balance of payments account
    - Know what makes up the current account
      1. Sales and purchases of goods and services
      2. Factor income
      3. Transfers
    - Financial Account
      1. Official asset sales and purchases
      2. Private sales and purchases of assets
    - Know whether it’s a payments from foreigners or a payment to foreigners and the net
    - Definition of balance of payments on goods and services!
    - Know the relationship that should always exist between the current account and the financial account
    - Know how to model the financial account
      1. Graphs from pages 416 and 417
         * Surplus and deficit and capital flows
* **Module 42 – The Foreign Exchange Market**
  + - Know what is traded on the foreign exchange markets
    - The prices at which currencies trade are known as \_\_\_\_\_\_\_\_\_\_\_
    - Know what causes a currency to appreciate vs. depreciate
    - Know what happens to exports and imports when a currency depreciates or appreciates
      1. Appreciates – exports rise and imports fall but know why this is the case
      2. Depreciates – imports rise and exports fall but know why this is the case
    - Graph from page 423 and 424
    - Know how to calculate the real exchange rate using price level
    - Definition of purchasing power parity
    - Know that the current account only responds to changes in the real exchange rate not the nominal exchange rate
* **Module 43 – Exchange Rate Policy**
  + - Fixed Exchange rate regime – target/peg
    - Floating exchange rate regime – market determined
    - Know a few examples of countries that have each of these
    - Know the three ways that governments can try and maintain the fixed exchange rate
      1. Exchange market intervention
      2. Attempt to shift the supply and demand curves by changing the interest rate
      3. Foreign exchange controls – not really used because residents and foreigners hate governments that put these controls on
    - Fixed
      1. Pros
         * Stability
         * Easier trade
         * Gov’t cannot partake in inflationary policies because it would destabilize exchange rate
      2. cons
         * Bad if gov’t has to change
         * Can cost a lot of reserves to maintain
         * Cannot partake in inflationary policies
* **Module 44 – Exchange Rates and Macroeconomic Policy**
  + - Devaluation and Revaluation of fixed exchange rate
      1. Act as tools of monetary policy
    - Devaluation – makes foreign goods more expensive and domestic goods cheaper to foreigners – leads to higher exports and lower imports which increases GDP (expansionary MP) – Current account Surplus
    - Revaluation – makes foreign goods cheaper but domestic goods more expensive – leads to higher imports and lower exports which decreases GDP (contractionary MP) – reduction in Current account but not always to point of deficit
  + **Monetary policy under a floating exchange rate regime**
    - Know how monetary policy is used to affect the interest rates which effects everything (three graphs)
    - **In an open economy with a floating exchange rate, the interest rate reduction leads to increased investment spending and consumer spending, but it also increases aggregate demand in another way: it leads to a currency depreciation, which increases exports and reduces imports, further increasing aggregate demand.**
    - Vice versa for a raise in interest rates.
    - Advocates say that one of the benefits of a floating exchange rate regime is that it insulates countries from recessions originating abroad – not always true but usually
    - Know the graph from page 439