**Final Exam Review**

**ECON 252**

*Note: This file only includes a review of materials that have not yet been included on an exam. The final exam will cover everything that has been done in class. This review should be used in combination with the previous exam review materials when studying for the final.*

***Key definitions***

**Net capital outflow (NCO):** The purchase of foreign assets by domestic residents minus the purchase of domestic assets by foreign residents.

*NCO is always equal to net exports (NX). In an open economy, Y=C+I+G+NX, or alternatively Y=C+I+G+NCO. Rearranging, we get Y-C-G = I + NCO, or Savings = Investment + NCO. A negative NCO implies that a country is a net borrower, and such a country invests more than would be possible using just domestic savings.*

**Nominal exchange rate (e):** The rate at which a person can trade the currency of one country for the currency of another.

**Appreciation:** An increase in the value of a currency as measured by the amount of a foreign currency it can buy.

**Depreciation:** A decrease in the value of a currency as measured by the amount of a foreign currency it can buy.

**Real exchange rate:** The rate at which a person can trade the goods and services of one country for the goods and services of another.

*The real exchange rate is calculated as: , which we write as*

*, where e is the nominal exchange rate, p is the domestic price level, and p* ***\*****is the foreign price level.*

**Purchasing power parity:** A theory of exchange that says a unit of any currency should be able to buy the same quantity of goods and services in all countries.

*Purchasing power parity implies that e = the domestic currency appreciates at a rate equal to foreign inflation - domestic inflation.*

**The law of one price:** A theory suggesting that a good should sell for the same price at all locations.

**Arbitrage:** The process of taking advantage of price differences for the same good in different markets.

**Aggregate demand curve:** A curve that shows the quantity of goods that households, firms, the government, and foreign customers want to buy at each level.

**Aggregate supply curve:** A curve that shows the quantity of goods and services that firms choose to produce at each price level.

*There are two types of aggregate supply curve, the long run aggregate supply curve (LRAS) and short run aggregate supply curve (SRAS).*

*P*

AD

SRAS

LRAS

Q

**Natural level of output:** Production of goods and services that an economy achieves in the long run at the natural rate of unemployment. The quantity of output indicated by the LRAS is at the natural level of output.

**An important equation:** Y = YN + a\*(P - Pe) where Y is the output level, YN is the natural level of output, a is a positive number that measures how much output responds to unexpected price level changes, P is the price level and Pe is the expected price level.

**Stagflation:** A period of falling output and rising prices. A decrease in AS will always result in stagflation, all other things equal.

**The Phillips curve:** A curve showing the short run trade-off between inflation and unemployment.

*There is also a long run Phillips curve. The Phillips curve slopes downwards, to indicate that there is a tradeoff between inflation and unemployment in the short term. The long run Phillips curve is a vertical line at the natural rate of unemployment (UN), illustrating the idea of monetary neutrality or the quantity theory of money.*

Long run Phillips curve

Inflation

UN

Phillips Curve

Unemployment

**Expansionary monetary policy:** An increase in the money supply by the central bank.

**Contractionary monetary policy:** A decrease in the money supply by the central bank.

**Expansionary fiscal policy:** An increase in government spending or decrease in taxation.

**Contractionary fiscal policy:** A decrease in government spending or increase in taxation.

**Marginal propensity to consume (MPC):** The portion of extra income spent on consumption.

*MPC is calculated as .*

**Multiplier:** . This is the amount that each $1 of increased government spending shifts AD to the right by, in the absence of other effects.

**Sacrifice ratio:** The percentage of annual output that is lost from reducing inflation by 1%.

**The misery index:** The inflation rate + unemployment rate

**Rational expectations:** The theory that people use optimally all the information they have.

***Example Problems:***

1. A computer costs $1200 in the U.S. The nominal exchange rate is $1 per .75 euros. How much must a computer cost in Europe for purchasing power parity to hold? What is the real exchange rate?

**Purchasing power parity necessitates that e = ⇒ .75 = ⇒ p\* = 900.**

**The real exchange rate is = = 1.**

***When purchasing power parity holds, the real exchange rate is always equal to one, since   
 = = = 1.***

1. If income is increased by $100, and as a result aggregate demand increases by $150, what is the marginal propensity to consume?

**The multiplier is 1.5 ⇒ 1.5 = ⇒ 1.5 - 1.5\*MPC = 1 ⇒ MPC = .**