Topic 1- National Income Accounting & BOP

National Income Identity	gross domestic product is given by consumption expenditures, plus investment expenditures, plus government expenditures, plus exports, minus imports	$Y=C+I+G+CA$
National Savings	the amount of output that is not devoted to private consumption and government spending	$S= Y-C(Y-T)-G$ or $S= Sp+Sg$ or $S=I+CA$
Balance of Payments	records a country's international transactions with the rest of the world in a given time period- records its payments and recepits from foreigners and shows demand and supply of a country's currency in FEM	*every international transaction enters the BOP accounts twice, once as a credit and once as debit

Topic 1- National Income Accounting & BOP (cont)

Credit Entry	any transaction resulting in receiving payments from foreigners	exports of goods, services, assets
Debit Entry	any transaction resulting in making payments	imports of goods services, assets
Components of BOP Accounts	Current Account, Financial Account, Capital Account	CA+KAn-on+Cap-italAcc= -ORT
Current Account	shows the difference b/w exports and imports of goods and services plus net unilateral transfer	CA= EX-IM+ Net Unilateral Transfer
Financial Account	difference b/w sales & purchases of assets to foreigners	KA= KAnonr-es+ORT
Non-reserve Portion	the purchases & sales of assets by the private sector	
Reserve Portion	the purchases & sales of foreign assets by the country's monetary authority	foreign-currency denomi-nated assets held by central banks

Topic 4- Price Levels & Exchange Rate in LR

Purchasing Power Parity	explains movements in the exchange rate between two countries' currencies by changes in the countries' price levels	
Absolute PPP	identical basket of goods should be sold for same amount of money in diff countries when expressed in same currency	$E= P/P*$
Relative PPP	% Δ in exchange rate between 2 currencies over many period equals to the inflation rate differ-entials between 2 countries	$E^e-E/E= \pi-\pi*$
Monetary Approach to Exchange Rate	shows factors that affect MS and MD will play a role in determ-ining exchange rate	PPP holds, LR Model, shocks are permanent
	Equilibrium exchange rate	$E= (MS/MS) (L(Y,R)/(L(R,Y)$

Topic 4- Price Levels & Exchange Rate in LR (cont)

Domestic MS Increases	Exchange rate increases	DC **depreciates**
Foreign MS Increases	Exchange rate decreases	DC **appreciates**
Domestic Interest Rate increases	Exchange rate increases	DC **depreciates**
Foreign Interest Rate increases	Exchange rate decreases	DC **appreciates**
Domestic Output increases	Exchange rate decreases	DC **appreciates**
Foreign Output Increases	Exchange rate increases	DC **depreciates**

Topic 2- Asset Approach to Exchange Rate

Exchange Rate	the price of one currency in terms of another(DC/FC)	$E^{DC/FC}=1/E^{DC/FC}$
Forward exchange rates	the exchange rate that is contracted today for the exchange of currencies at a specified date in the future	$R= R^*+E^e-E/E$
Interest Parity Condition	the condition that the expected returns on deposits of any two currencies are equal when measured in the same currency	

Topic 2- Asset Approach to Exchange Rate (cont)

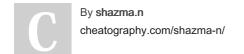|		
Covered interest Rate Parity	agents can lock in the future exchange rate by getting a forward contract & eliminating uncertainty	$R= R^*+ F-E/E$
Real Rate of Return	the rate at which its value expressed in terms of a representative output basket is expected to rise	
Expected ate of return	the rate at which the value of an investment in the asset is expected to rise over time	
Arbitrage	the process of buying a currency cheap and selling it dear	
Asset Approach	IPR holds & deals with financial capitals	
	Focused on money mkt shocks and impacts on exchange rate (SR & LR)	
R, domestic interest rate	return on DC deposits	

Topic 2- Asset Approach to Exchange Rate (cont)

E^e-E/E	annualized percentage change in the DC/FC exchange rate	
$R^*+E^e- E/E$	expecting DC return on FC deposits	
Increase in Domestic Interest	R curve shifts right, invest in DC Deposit	Capital **inflows** & DC **appreciates**
Increase in Foreign Interest	R* curve shifts right, invest in FC deposit	Capital **outflows** & DC **depreciates**
Expected Depreciation of DC	R* curve shifts right, invest in FC deposit	Capital **outflows** & DC **depreciates**
Forward Trading	parties agree to exchange currencies on some future date at a pre-negotiated exchange rate	
Spot Trading	trades are settled immediately	

Generalized Approach (real exchange rate, q)

Real exchange rate, q	measures the purchasing power of a country's currency relative to another country's currency	shows how many baskets of domestic goods are needed to exchange one basket of foreign goods $q= E(P/P^*)$
If q increases	real **depreciation** of DC	
If q decreases	real **appreciation** of DC	

Generalized Approach (real exchange rate, q) (cont)

q=1	Absolute PPP	q= E(P/P*)
q=0	Relative PPP	q^e-q/q=0
If AD increases-domestic	domestic goods are more valuable	PPP of DC increases and real **appreciation** of DC
If AD* increases-foreign	domestic goods are less valuable	PPP of DC decreases and real **depreciation** of DC
Generalized Approach	considers how changes in both monetary and real sides of the economy affect LR exchange rate	in the LR changes in q, changes in P and P* lead to a change in E

Topic 3- Money, Interest Rate & Exchange Rate

Money Supply	the total amount of currency and checking deposits held by households and firms	Currency in circulation+- Demand Deposit
Aggregate Money Demand	the toal demand for money by all households and firms in the economy	M^d= L(R,Y)
L(R,Y)	liquidity function	
R	nominal interest rate	opportunity cost of holding money

Topic 3- Money, Interest Rate & Exchange Rate (cont)

Y	real income= real GDP	when income increases, consumption increases, volume of transaction increases
	Interest rate-fisher	R= r+Π
Money market equilibrium	MS/P= L(R,Y)	R adjusts to ensure the money market is in equilibrium in SR
If MS increases	Pressure for R to fall to initial level	
If real income Y increases	Consumption increases and we hold more money	L(R,Y) increases and R increases
In the long run	P= MS/L(R,Y)	P= *MS*/L*(R,Y*)*
	Quantity Theory of Money	%Δ MS+%ΔV= %ΔP+%ΔY
	Level change in MS doesn't impact %Δ in MS	no change in MS means no change in Π
Exchange Rate Overshooting	immediate response to a disturbance is greater than its long-run response	

Topic 3- Money, Interest Rate & Exchange Rate (cont)

Exchange Rate Undershooting	the immediate depreciation of a currency to a shock is greater than its long run response

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