

## Final Exam

15.012

**Name:** \_\_\_\_\_

**Section:** \_\_\_\_\_

**Date:** \_\_\_\_\_

It was a pleasure to spend time with you guys this semester. I learned a lot from our discussions and I really appreciate all the time and effort you gave. The ugly part is my fault, and it is the exam. I hope that it will contribute to your learning process in the same way that the course has.

You have 1 hour and 20 minutes. The points of each question are indicated in *italic-bold* at the beginning of each of them. The total points in the exam are 100. Answer all questions in the space provided. I really do not think that you need more. However, if you need more space you can use the back of the pages.

I hope our paths will cross again (at least for a coffee) and remember that wherever your decisions might take you, I'm always an e-mail-away. It was an honor to share the room with you.

Good luck.

The exam describes a fictitious country that has some problems, and asks for your policy advice in several circumstances.

Bonnet\_land is a country that has performed appropriately in the last decades. Its major industry is the manufacturing of hats. The exports had been growing dramatically reflecting the increases in productivity that the industry had experienced in the past 30 years. The growth rate of the GDP per capital has also been quite acceptable. Moreover, all this growth has been achieved with very responsible fiscal behavior (deficits are usually smaller than 1 percent of GDP), and low unemployment. This has allowed the monetary authority to maintain a fixed exchange rate for a very long time. Since the seventies the economy has been characterized by low inflation, relatively low interest rates, and equilibrium in the current account (the current account has been consistently positive).

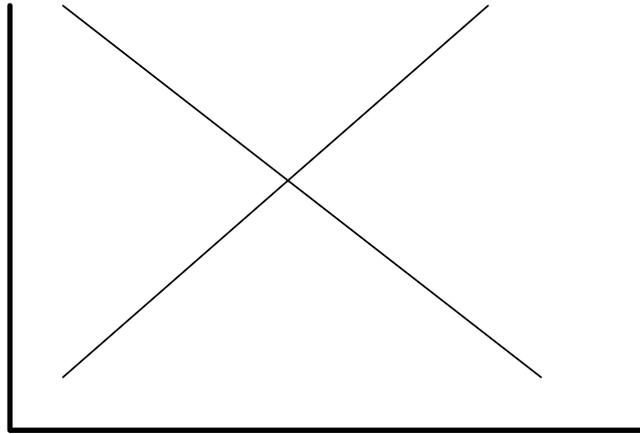
However, in the later part of the 90's growth has declined and unemployment has started to increase. The current account has also deteriorated and it is now barely positive. See table for all the data.

	1970's	1980's	1990-96	1997-98	1999
Growth (per capita)	3.1	2.3	1.9	0.1	-0.1
Unemployment	4.5	4.1	7.6	12.0	14.0
Current Account / GDP	1.0	1.5	1.7	1.1	0.5
Inflation	5.0	3.0	2.5	2.3	1.9
Interest Rates	7.0	8.3	6.5	7.2	7.1
Real wage growth	3.6	2.5	2.1	2.7	1.3
Fiscal deficits	-0.1	-0.5	-1.1	-2.6	-3.2

The increase in unemployment has been associated with the current welfare state and the decrease in the growth rate. In particular, several important economists in the country blame the unemployment insurance as the main source of the problem. Prof. Know\_a\_lot\_busch describes the situation as: "The current welfare state was designed for a growing economy. When this stopped, and real wages stagnated, and unemployment insurance became too attractive. Neither workers, nor firms, have incentives to create the necessary jobs to accommodate the unemployed"

A new president, Cap Boater, has taken office recently. He is crying for advice, and he has called you for help.

1.- [10 pts] Give a diagnostic of the current situation of the economy in the BB-NN map.



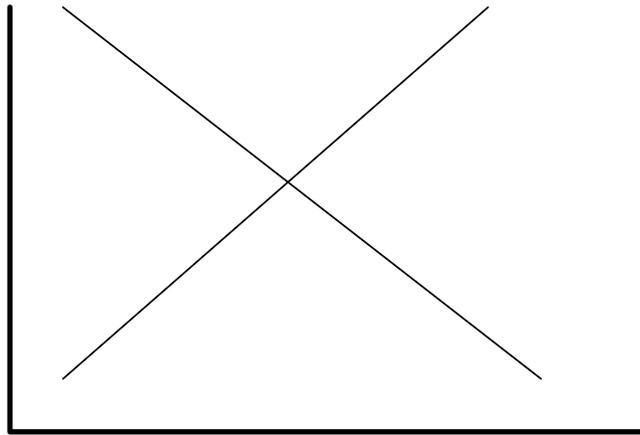
What would you do if you want to return immediately to the equilibrium (Hint: you will need at least two policies to move the economy directly to equilibrium)? Only describe fiscal, monetary and exchange rate policy. Do not indicate any reforms yet.

2.- [10 pts] What are the benefits and costs of each of your policies:

3.- [15 pts] Assume that no policies have been implemented yet. When you arrive to the country to advise the government, suddenly, there is a riot in the Capital. In fact, the current situation of large unemployment has driven a drop in the wage in dollars and people are starting to complain.

The head of the Union, Pissed My Hood, is quite frustrated with the situation of their workers: "We cannot find a place to work, our wages are coming down, the people are dying, the people are hungry. What you expect them to do? Their economic situation is so bad that they are moving to Shirt\_land" (Shirt\_land is a really crummy country East of Bonet\_land)

Draw the situation of the economy and the social peace line.



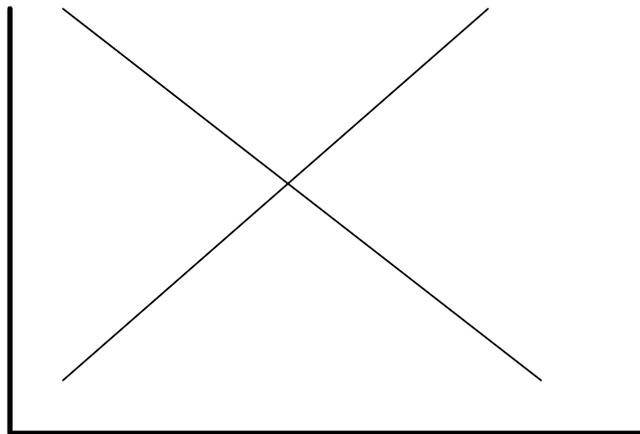
How you would change the policies you advised before (question 1)?

4.- [20 pts] Assume that we are in the original situation (before any policy, but with the riots) and assume that an earthquake hits the country. Half of the capital is lost and production drops dramatically. The current account turns into a severe deficit.

Several analysts have indicated that the current account deficit is dangerous for the viability of the country. As was mentioned by Prof. Parrot\_man: "The current account deficit, together with a slow down in growth, and an increasing fiscal deficit indicates that this economy is going to hit the wall. When? I do not know, but they are going to hit it hard."

Draw in the BB-NN what is the implication of the natural disaster (assume the lines in the diagram are the original lines before the earthquake).

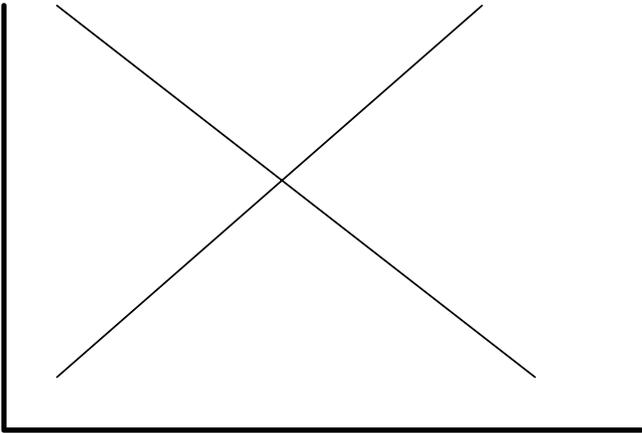
What are your policy recommendations in terms of monetary, fiscal and exchange rate policies (No reforms yet)?



Policies:

5.- [25 pts] If you have the chance to make ONE reform, what would you do? What would be the impact of it in the BB-NN? Please, only ONE reform.

Reform: \_\_\_\_\_



Explain:

6.- [20 pts] The earthquake has clearly debilitated the image of the country abroad and the interest rates have increased dramatically. The Prof. Know\_a\_lot\_busch has said that the solution should be to move to Dollarize the economy. The Prof. Parrot\_man has said that the devaluation and the shift to a flexible regime are the only viable policies.

What would you do?

Explain indicating the benefits and costs of your policy.