

## Problem set 2.

15.014.

### **MORE ISLM:**

Bonnet\_land is a country that has performed appropriately in the last decades (some growth). Its major industry is the manufacturing of hats. However, things are going bad lately. There is a recession, they have price deflation, nominal interest rates are low, but real interest rates (the difference between nominal rates and the inflation rate) are large. On top of everything, the fiscal accounts have deteriorated. The sovereign debt is increasing and the prognosis is bad.

You have just being elected to office.

- 1.- What is your priority? (Choose only ONE objective)
- 2.- Design a fiscal (expenditure and taxes) and monetary (interest rates) policy consistent with that objective. Explain your policy in the ISLM framework.
- 3.- What are the implications for the other variables that you have not considered as your objectives: Talk about output, inflation, interest rates, and fiscal deficit.
- 4.- Assume that the Central Banker in your Bonet\_Land suddenly pledges alliance to the Venezuelan Flag - which is a clear indication that he or she is crazy. Assume that right after that the Central Bank starts printing money without stop - so much that the economy is literally flooded. What could be done? (Other than kicking out the President of the Central Bank)

**BB-NN:**

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 capita 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).

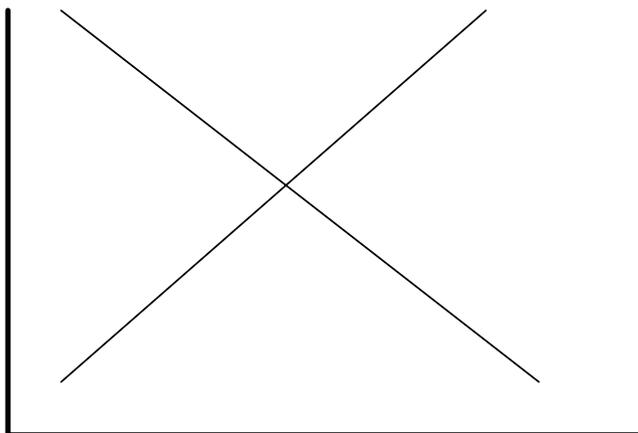
However, in the later part of the 90's growth has declined and unemployment has started to increase. The current account has also deteriorated and it is now barely positive. See table for all the data.

	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\_bon 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 advise, and he has called you for help.

1.- Give a diagnostic of the current situation of the economy in the BB-NN map.



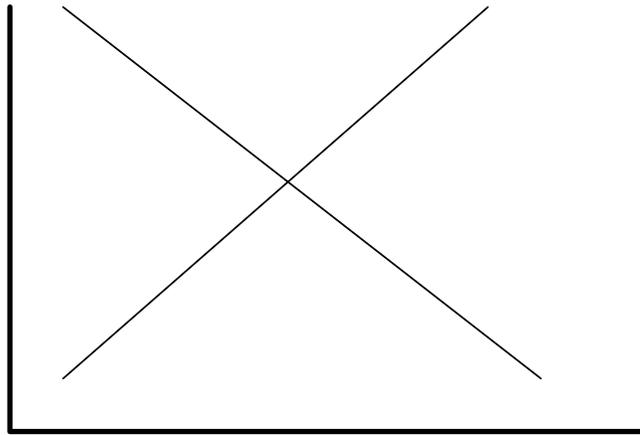
What would you do if you want to return immediately to the equilibrium (Hint: you will need at least two policies to move the economy directly to equilibrium)? Only describe fiscal, monetary and exchange rate policy.

2.- What are the benefits and costs of each of your policies: Explain what each one does.

3.- 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.



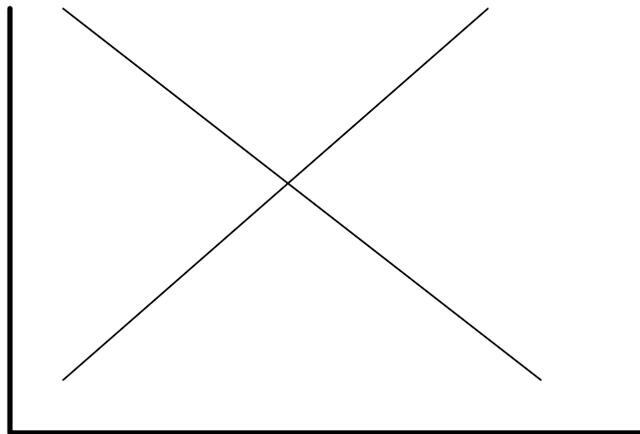
How you would change the policies you advised before (question 1)?

4.- 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. Iam Sodepres: "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? (remember that you have the social peace line from the previous question)



Policies: