

**Final Exam**

**15.012**

**Name:**

**Section:**

**Date:**

## Final Exam 15.012

### Sections A & B

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, of course, 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.

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

Good luck.

- 1) **[6 pts]** If an economy has a high level of unemployment, the following might help to solve the problem in the short run? (circle the appropriate policy)
- |                            |            |        |                 |
|----------------------------|------------|--------|-----------------|
| a) Government expenditure: | Increase   | Reduce | Does not matter |
| b) Interest rates:         | Increase   | Reduce | Does not matter |
| c) Payroll taxes:          | Increase   | Reduce | Does not matter |
| d) Unemployment benefits:  | Increase   | Reduce | Does not matter |
| e) Firing and hiring laws: | Strengthen | Relax  | Does not matter |
| f) Power of unions:        | Increase   | Reduce | Does not matter |

2) *[8 pts]* When can we say that the current real exchange rate is appreciated? (circle the appropriate conditions)

Indicate **yes** if you are sure that the conditions unambiguously imply a real appreciation, **no** if they unambiguously do not imply a real appreciation, and **maybe** if there are some situations in which the real exchange rate might be appreciated under those circumstances. If your choice is maybe, please explain when the situation is considered a real exchange rate appreciation.

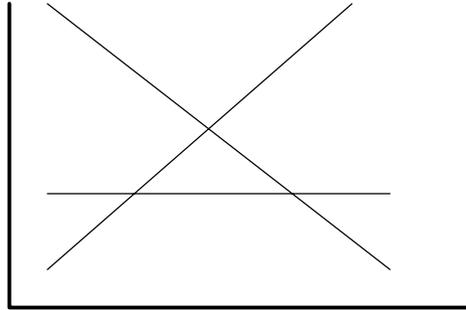
a) Current account deficit and Unemployment                      Yes      No      Maybe

b) Current account deficit and Overheating                      Yes      No      Maybe

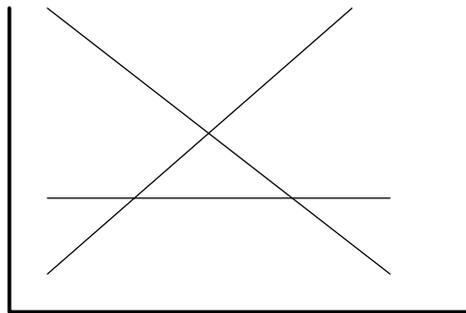
c) Current account surplus and Unemployment                      Yes      No      Maybe

d) Current account surplus and Overheating                      Yes      No      Maybe

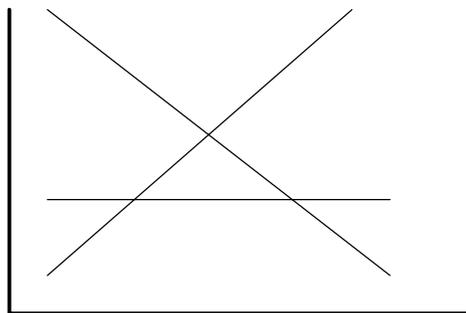
- 3) [14 pts] In the BB-NN model, assume a Latin American country is at the IMF equilibrium of the Latin Triangle. Show where the economy is? Show the three ways in which the problem can be solved, and in each case explain what is happening?



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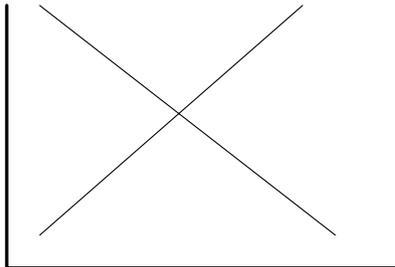
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4) Currently Argentina has a current account deficit (not too large) and a large unemployment. On the other hand, US has overheating with a current account deficit (not too large).

a) [2 pts] Indicate in the BB-NN model where these economies are located:



b) [3 pts] Assume the countries are completely independent. What are the optimal policies for the US if you want to move toward the equilibrium point?

|      |                |          |                        |         |
|------|----------------|----------|------------------------|---------|
| i)   | Taxes          | Increase | Decrease               | Nothing |
| ii)  | Interest rates | Increase | Decrease               | Nothing |
| iii) | Exchange rate  | Devalue  | Revalue (overvalue it) | Nothing |

c) [3 pts] What are the optimal policies for Argentina if you want to move toward the equilibrium point?

|      |                |          |                        |         |
|------|----------------|----------|------------------------|---------|
| i)   | Taxes          | Increase | Decrease               | Nothing |
| ii)  | Interest rates | Increase | Decrease               | Nothing |
| iii) | Exchange rate  | Devalue  | Revalue (overvalue it) | Nothing |

d) [2 pts] Now assume that capital flows freely between the countries, and that Argentina is dollarized. Assume the US implements the monetary policy (interest rate) that you have chosen in the previous questions. What is going to happen in Argentina?

|     |                     |          |              |         |
|-----|---------------------|----------|--------------|---------|
| i)  | The current account | improves | deteriorates | nothing |
| ii) | Unemployment        | improves | deteriorates | nothing |

e) [4 pts] From part (d), what happens to the interest rate in Argentina and why?

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5) A country is deciding to reform.

The situation of the economy is the following: The country is coming from years of governmental intervention (import substitution) and the industrial park is completely inadequate for today's global conditions.

The fiscal deficit is huge (8% of GDP) and the current account is also in deficit (3%) and reserves are decreasing rapidly. Measures of poverty are incredibly bad and deteriorating in the last 10 years. Education attendance is low and illiteracy is high. Finally growth has stopped and today the recession is rampant (so is unemployment).

There are capital controls that have been extremely effective (but they have implied a large interest rate) and the import substitution policies have been accompanied by high tariffs. The exchange rate for the moment, is a currency board fixed to the US dollar.

The country has a long history of stable democracy, and there has been recently effort to decentralize health and education.

Choose what would be the objective of your policy? This should be maintained through out all the question.

- a) Growth
- b) Encourage FDI
- c) Solve the problem of the balance of payments and unemployment
- d) Solve the problem of the balance of payments and implement policies to solve poverty
- e) Take care of growth, employment and poverty

**[10 pts]** What policies would you choose (only 5) that are consistent with the objective you indicated above.

i) \_\_\_\_\_

ii) \_\_\_\_\_

iii) \_\_\_\_\_

iv) \_\_\_\_\_

v) \_\_\_\_\_

.... continue from question 5.

**[12 pts]** Given the experiences of China, Mexico, Uganda and Russia, how would you classify the following conditions in the country (helping or not the process of reform, and briefly explain why).

- The country has a long history of stable democracy, however there have been recently important efforts to decentralize.

Help

Does not help

Does not matter

- There are important restrictions to capital inflows as the result of previous speculative attacks the country suffered. They are mainly short run restrictions.

Help

Does not help

Does not matter

- The exchange rate regime is currently a currency board.

Help

Does not help

Does not matter

- 6) **[36 pts]** What are the benefits and costs of fixing the exchange rate (or the promise to fixing it in the future)? Indicate three of each and then briefly explain why it is a cost or benefit.

Benefits:

a) \_\_\_\_\_  
why?

b) \_\_\_\_\_  
why?

c) \_\_\_\_\_  
why?

Costs:

d) \_\_\_\_\_  
why?

e) \_\_\_\_\_  
why?

f) \_\_\_\_\_  
why?