

Mid-Term
15.014
Spring 2004

Name: _____

Section: 8:30 or 10:00

Date: _____

The objective of this exam is to help in the learning process and to become a source of future jokes. Therefore, think of it just as another problem set.

It describes a fictitious economy and asks some questions. There are a couple of things you should know:

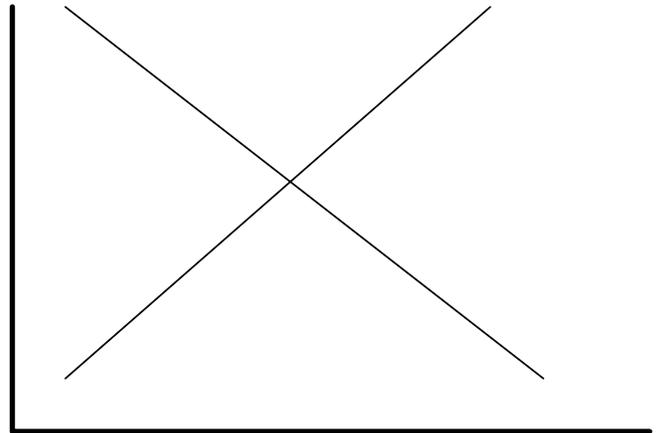
- This is a closed book, phone and computer.
- There are no trick questions. If something sounds like a trap, it is just because I do not know English or you have no idea how to read Spanglish – clearly your fault.
- However, if something is confusing, just state your assumption and we will grade accordingly.
- In all the figures I provide the axis, but you are responsible for indicating what each **AXIS** represents (e/w, y, i, etc.) Please do so.
- Finally, answer in the space provided. If you need more, you are probably answering the wrong question. If you really need more space you can use the back of the pages, but I cannot imagine you would.

You have **1:20** minutes. **1:20???** YES, **1:20**.

Although, I'm quite sure you will finish before that. Good luck

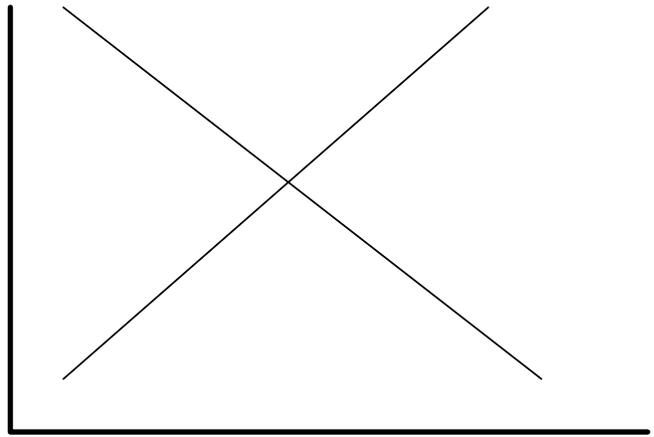
Once upon a time, in a far, far away land, happy consumers lived in the country of **Neverlies**. The macroeconomic figures showed that the economy was enjoying a current account surplus, and full employment. Furthermore, everybody was happy, so happy, that it felt almost as we were all members of Kerry's presidential campaign. Tourists that adventured in **Neverlies** usually said "*What a happy place!*", "*Everything looks so organized, so beautiful, nothing can go wrong in this place*", or so they thought....

1.- [10 pts] Give a diagnostic of the current situation of the economy in the BB-NN map (no explanation is needed). Draw the social peace line. The original point where the economy is located should be denoted as *A*.

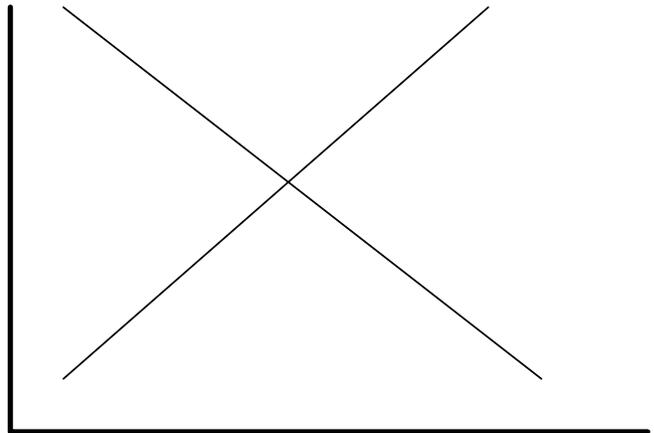


2.- [10 pts] Suddenly, people realize that the President of the country, **Falsetes Timony**, has been lying to them. “*Outrageous!*” In fact, the reality is that there is a huge current account deficit and unemployment is almost 20 percent – way larger than the natural rate of unemployment of 5 percent. Notice that the schedules do not move! The lie was about where the economy was located!

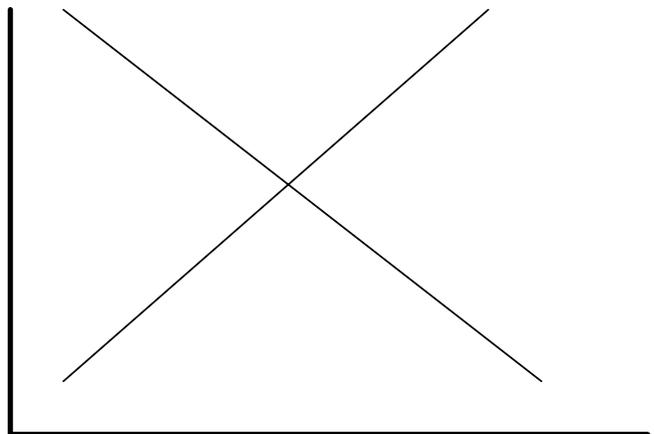
- a. Draw the new situation in the BB-NN. Call this point B and draw it relative to A.
- b. What would you do if you want to return immediately to the equilibrium (Hint: use only policies)?
- c. What happens if you do nothing? Explain.



3.- [10 pts] From the previous question choose ONE policy (either fiscal or monetary) and explain, according to the ISLM, what is the cost of that policy in terms of inflation and interest rates. Draw your answer in the ISLM

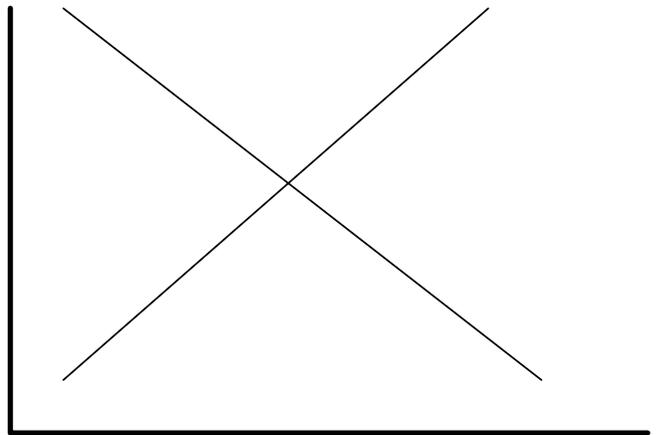


4.- [10 pts] People realizing that the government has lied to them get totally upset. The opposition party: *NIMROD: National Infiltration Movement for the Raiders Of Deception* – a very honest group of guys (yeah, right!) takes advantage of the situation. Its leader (a Dutch descendant), **Fraud Van Dalism**, announces the ultimatum “*If things do not change, we will organize riots to take over the government.*” Draw the economy in its initial point (B) and indicate what is happening. Explain.



5.- [10 pts] How can you modify your program to help the current situation? (ONLY fiscal, monetary and exchange rate policy).

6- [10 pts] Tell me one policy or reform (ONLY ONE) that might solve the problem if fiscal and monetary policies are not enough. What happens in the BB-NN?

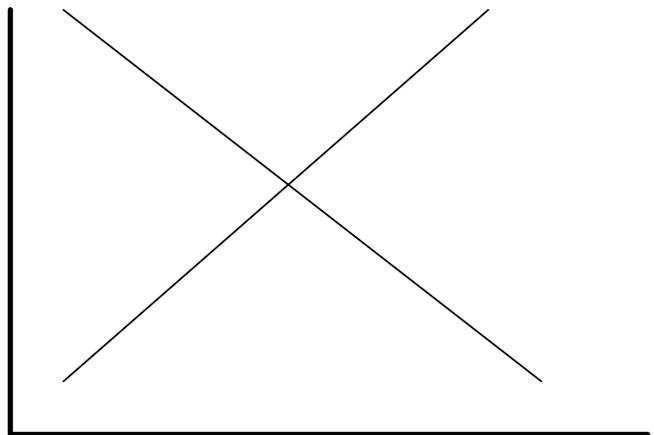


What is your advice in terms of fiscal, monetary and exchange rate policy given the policy/reform you have chosen? How the current situation in terms of unemployment, standards of living, and current account looks like (in comparison to before)? (Draw point B and the social peace.)

7.- [20 pts] Before the country is able to implement the policy/reform you advised in the previous question, tourists – the major source of exports of services of the country – are appalled by what is going on with the continuous lies.

The Minister of Tourism, (a Greek descendant) **Hypo Crite Fibber**, reflecting the concerns of the tourists says: “*This is horrible. Almost like Colombia. And that... is the end of the story*”. Yes, there was the rumor among tourists that the Colombian government had *confused* their citizens in the past – but there is no hard evidence of such shameful act. “*We are not returning to this dump!*” one upset tourist said on his way to American Airlines.

What is the implication, in the BB-NN, of this drop in the demand for tourism? Explain how would you change your proposal from the previous question?



8.- [20 pts] Just before your new proposal was going to be voted in congress, the miserable-despicable-dreadful Mr. **Dalism** returns to the country after spending a month in France – not only learning French but learning economics there! He eloquently opposes your program in congress.

*“Mon cher camarade,
ze prropossál frrom your conseillor should no be àpprové.
Pour quoi? Parcequ’I’l oppose.”*

Obviously, he didn’t learn as much French as hoped. Nevertheless, the translation of his speech is as follows:

*“My dear comrades,
the proposal from your advisor should not be approved.
Why? Because I oppose.”*

Evidently, the arguments against the program are economically sound. Mr. **Dalism**’s speech was so fantastic that congress is not going to approve a single reform, and is thinking of removing you from the country. As a punishment, congress is sending you to Belgium, Bhutan, Brazil, Bolivia, Belize, or any other country that starts with B (although it is not necessarily related to your grade).

The renew problems scare tourists even further, and does not allow you to implement a single reform. Explain (clearly) what is going to happen in the economy.