Public Policy 542 FINAL EXAM QUESTIONS

The PP542 final exam will consist of two questions. The first question will be chosen from among the three listed below; the second question will not be available in advance. Each question will be worth 50 points. The final exam will be offered on Wednesday April 14th during our regularly scheduled class time. Please come to the exam with only a pen or pencil (rulers and dictionaries are also allowed). Students are not permitted to consult notes, books or any other materials during the exam.

You are welcome to work with other members of the class on pre-exam preparation. These questions do not require you to use any diagrams or equations, but you may find it helpful to avail yourself of the various analytical constructs we have developed in class in your answers. If you do include diagrams or equations in your answer, please also provide a detailed explanation of how they answer the question. For example, providing a diagram and a list of variables with linking arrows will not be considered a sufficient answer. Effective answers will be concise, well-organized and focused.

1) Charmlandia has a history of low inflation, low unemployment and current account surpluses. Charmlandia is currently in recession. The government of Charmlandia is considering permanently increasing its expenditures in order to help lift the economy out of recession. Charmlandia allows its currency to freely float.

(a) Describe the likely short-run effects of the permanent fiscal expansion on the nominal value of the currency, and output.
(b) Describe the likely long-run effects of the permanent fiscal expansion on prices, the nominal value of the currency, the current account, and output.
(c) Given your answers to parts (a) and (b), under what circumstances would you advise the government of Charmlandia to go ahead with the fiscal expansion?

2) Confronted with a decline in foreign demand for domestically produced automobiles, the government of an automobile-exporting country considers the following policy options:

(a) allow the exchange rate to float;
(b) restore external (current account) balance by fiscal and monetary restraint (contraction).
Assuming full employment and a fixed exchange rate initially, compare and contrast the macroeconomic effects of each of the above approaches.

3) You are part of the economic consulting team at Pubpol542 Inc. The country of Atlantis has employed you to advise the newly elected President (a UM graduate) on economic reforms. The inflation rate in Atlantis is over 30%. Atlantis has a fixed exchange rate system, and the domestic currency is severely over-valued.

(a) If Atlantis plans to maintain its fixed exchange rate, what monetary and fiscal policies should it pursue in order to bring down the inflation rate?
(b) Should Atlantis consider devaluing its currency? Explain the costs and benefits of a devaluation.