

This is an open book and open notebook exam. You cannot look at somebody else's books or notes. You can take the whole class period, but you should not need it. This is worth 90 points towards the course grade. The point distribution is described below.

Suppose that you had complete control of both fiscal and monetary policy. The current unemployment rate is 5%. The current inflation rate is 4%. The current government has a small deficit and debt. The current nominal interest rate is 8%. There is a large current account deficit.

(20 points) What is the big problem in the economy described above: the unemployment rate, inflation rate, government deficit and debt, interest rate, or the current account deficit? Why do you think that? Explain why you do not think the others are “the big problem.”

(20 points) What fiscal and monetary policy would you implement? Why would you do that? If you choose not to use one of the policies, explain why you did not use it.

(50 points) How do the policies you described above affect unemployment, GDP, inflation, interest rates, and the government surplus? Use graphs to illustrate the effects described. Explain why your policies affect those variables in that manner. Remember, in the real world, solving one problem may worsen something else. If that occurs, explain why there is still a net benefit resulting from your policies, and how you may want to slightly change your policies, to improve the situation.