ECON 3235 Practice quiz 2 graded automatically, so much for google quizzes, sorry about the way it graded the questions with multiple answers, there is a fix but it involves using Flubaroo, others have had this problem, and of course discussed it on the internet… they may fix it in the next version…

Answers and comments on practice quiz #1 (thank you for taking it! There were several technical problems that made some quizzes more difficult than others. Please take the quiz again but after we meet for class today. Thursday, in the meantime it you may want to review the discussion of the PPF in Mankiw Macroeconomics 3rd edition (or whatever edition you have). Please do read Chapter 21 of Sachs & Larrain look for my annotations and added text Mankiw on PPFs   Sachs and Larrain 1993 Chapter 21 annotated

Practice Quiz 1: My apologies for the technical problems with this google docs quiz. The problem was an option that changes the order of questions each time you take the quiz or open the post that has the quiz. This moves the questions away from the Figures, making the test different for different people. Also it seems some of the questions had circles (just one answer) where there should have been check boxes (check all that apply).

1. When $q = ep^*/p$ and $\Delta q = (\Delta e + \pi^* - \pi)$ assuming $\pi^* = \pi$ a significant increase in the local currency price of dollars or e (the nominal exchange rate) referred to as
   ☐ an external devaluation
   ☐ an internal devaluation
   ☐ a beggar thy neighbor policy
   ☐ a good neighbor policy...

Comments: could have been two questions. That said external devaluation to some extent reduces domestic unemployment at the expense of your trading partners. For example, whne Brazil devalued the Real in early 1999, Argentina either had to devalue its currency as well (risking inflation and violating its promise of peso dollar parity) or be swamped with cheap Brazilian imports (companies moved that could moved factories to Brazil). Generally however, if Mexico or Chile or Colombia (or even Canada) devalue their currency, or let it depreciate, not the U.S. barely notices… the TNT model is for a small open economy, that generally cannot affect world prices (p*) or unemployment rates in their major trading partners (not so for Argentina and Brazil, they are neighbors and rivals in many areas…). Had Brazil not devalued in 1998 Argentina's currency peg to the dollar may have lasted longer, though both are better off with flexible managed floats… we hope, Argentina just moved to a flexible rate regime in 2015 with the arrival of President Macri…

2. Since $q = ep^*/p$ and $\Delta q = (\Delta e + \pi^* - \pi)$ if e is fixed, the real exchange rate q appreciates when*
   o foreign inflation equals domestic inflation $\pi^* = \pi$
   o foreign inflation exceeds domestic inflation $\pi^* > \pi$
   o domestic inflation exceeds trading partners inflation $\pi^* < \pi$

3. Right now the only Puerto Rico's only options for creating a trade surplus to pay its external creditors is
   ☐ external devaluation
   ☐ internal devaluation
   ☐ Structural Adjustment or "supply side" policies (e.g. repeal the Jones Act)
   ☐ High unemployment to keep wages and prices low (stabilization)

Comments: what is the only option Puerto Rico does not have that countries like the Colombia, the Dominican Republic and Cuba do have?

4. Referring to the Figure 1, production at point C consumption at point B implies *
   - ○ balanced trade and full employment
   - ○ balanced trade with unemployment
   - ○ A trade surplus (capital outflows)
   - ○ A trade deficit (capital inflows)

Comments: remember the production and consumption of nontraded goods must be equal, this puts C and B on a horizontal line, the length of this horizontal line is the trade surplus or deficit (a deficit when in this case because at point B C_T greater than QT at point C).
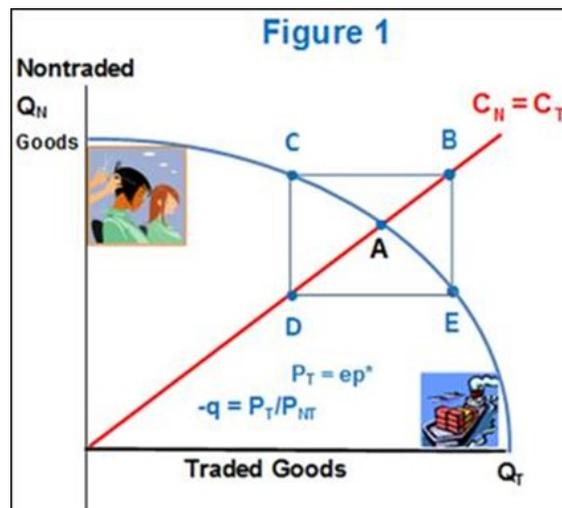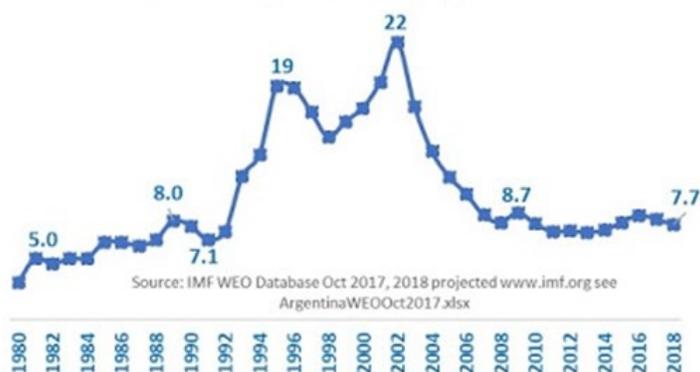
5. Referring to the Figure 1, production and consumption at point D implies *
   - ○ Balance trade and full employment
   - ○ balanced trade with unemployment
   - ○ A trade surplus (capital outflows)
   - ○ A trade deficit (capital inflows)

Comments: Here production and consumption is at D so both Q and C are equal for traded and nontraded goods, this may be confusing because consumption at D can also be associated with production at E creating a trade surplus with the same consumption of traded and nontraded goods... what is the problem with producing at point D? Right, there is unemployment because the economy is producing below its potential (production is not on the PPF). To dramatize the difference between producing at D vs. E, Larraine and Sachs, 1993 add an extra point X (see below). Perhaps we should do this too?

6. Referring to the Figures 1 and U-3, after Argentina fixed its exchange rate it was pushed

   toward point ___ (especially after Brazil devalued in 1998)
   - ○ Point E in Figure 1 Balance trade and full employment
   - ○ Point D with high unemployment trying internal deviation

Figure 1

Figure U-3 Argentina Unemployment Rate

Source: IMF WEO Database Oct 2017, 2018 projected www.imf.org see ArgentinaWEOOct2017.xlsx

Comments: Again, here we are producing and consuming below the PPF at D, the additional twist is that Argentina was trying to adjust by lower prices p where as usual $q = ep*/p$ this is another way to move down the PPF toward E. "Bad neighbor" Brazil devalued its currency sharply in 1998, putting it's MERCOSUR trading partners (Argentina and Chile) under great pressure to also devalue or be swamped with cheap imports from Brazil (what did Chile do?). However, Argentina (and Finance Domingo Cavallo) feared a return to high inflation, having adopted a Constitutional amendment guaranteeing there was a dollar backing every Argentine peso... the result was a sharp increase in unemployment, follow by a sharp nominal devaluation (and a debt default) in 2001... unemployment rose even more in 2002 then fell sharply as it took only two years for Argentina to return to pre-crisis levels. This devaluation and rising commodity prices (wheat and oil) during 2004 to 2012 contributed to very rapid growth in Argentina.

7. Referring to Figure 2, starting when q = 15 the country has a
   o trade surplus of C minus B or 150 - 100 = $50
   o trade deficit B minus C or 100 - 150 = - $50

[this question may have appeared twice, the answer was the same in both cases, sorry]

9, In Figure 2 structural adjustment ("supply side") adjustment moves PR toward point
   ☐ C lowering costs for exporters shifting the supply curve S to the right
   ☐ Shifts PRs supply curve to the left toward point A in Figure 2
   ☐ Move Puerto Rico down the import demand curve by lowering p* (the cost of imports)

This question should have had boxes, but apparently in some versions of the quiz it did not. Even with boxes it is more complicated that it should have been. Generally we separate movements along the supply and demand curves from shifts in the S or D curves. Stabilization policies shift the demand curve to the left. Structural adjustment policy shift the export supply curve to the right. Changes in q associated with e or p move you up or down the import demand and export supply curve.

If we focus on ending the Jones Act as our supply side policy, this becomes an (overly) complicated question. An early Puerto Rico question mentions the Jones Act in this context). In fact this is the supply side or structural adjustment policy I was I was thinking of. Unfortunately, the Jones Act is complicated because it both lowers the price of imports (p* in this case) and it lowers electricity rates, for example, by reducing the cost of imported oil. Lower import prices create competition for Puerto Rican firms (coffee producer profits may fall for example as the cost of imported coffee goes down, unless Puerto Ricans strongly prefer local coffee…). Implement the Jones act could reduce the cost of electricity dramatically if the Island could switch to natural gas (no American made ships are capable of delivering natural gas…). Solar power could also reduce the cost of electricity, shifting the export supply curve to the right… moving the economy toward a point C in Figure 2.

As it happens, repealing the Jones Act affect both traded and nontraded goods prices (or imports and exports in market for dollars diagram). Since shipping costs fall reduce p* and q = p*/p the cost of imports p* fall (e is always one as Puerto Rico uses the dollar, this is what creates the parallels with Argentina during the 1990s and Greece more recently).[1]

Why do we need both the market for dollars and the TNT diagram? In many ways they are complementary.

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[1]Did Puerto Rico ever have its own currency? Yes according to Wikipedia there was a Puerto Rican dollar after 1898 and Puerto Rican peso before that? In 1913 all Puerto Rican dollars were converted to U.S. dollars. The New York Federal Reserve Bank writes reports about Puerto Rico's economy (the Federal reserve as created on December 23rd 1912).
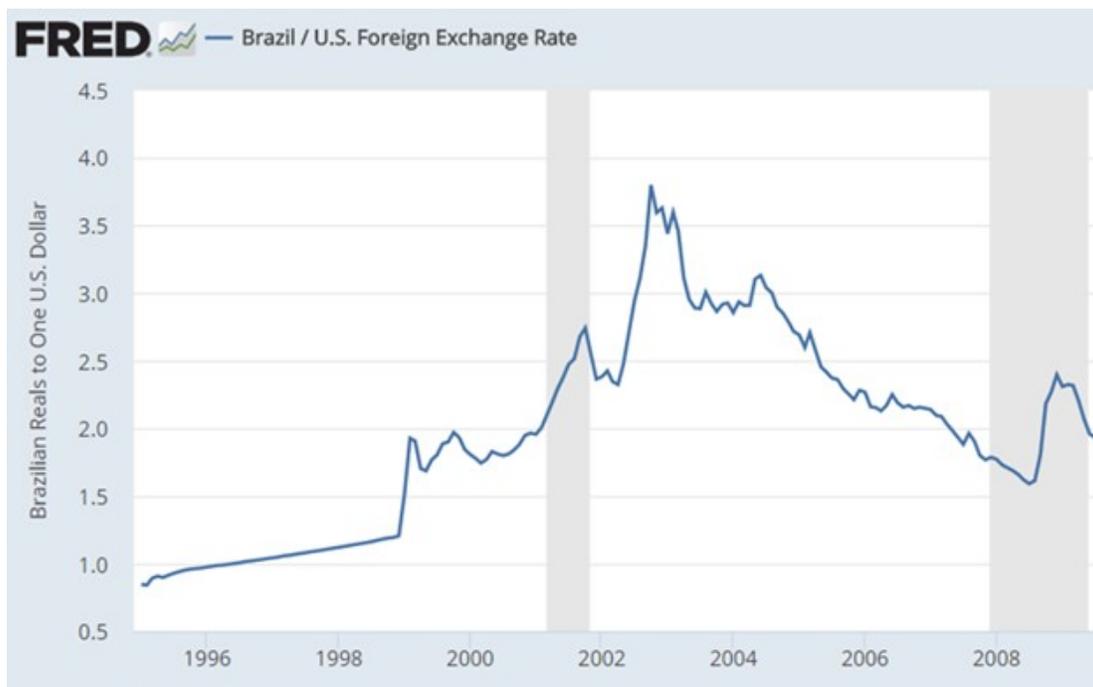
Brazil Nominal exchange rate reals per dollar: note the 1998 devaluation, blame it on Russia and Asia… either way it spelled trouble for Argentina. Argentina to its fixed rate until the end of 2001, but then move to a crawling peg with two exchange rates, the official rate and the "blue market" rate, a legal private but not "black market" rate for dollars offered (foreign exchange was rationed, but not as severely as in Venezuela). As part of his reform package in 2015 Mauricio Macri unified the exchange rates, but inflation is still in double digits, closer to 20% than 10% according to Inflation Verdad and the official INDEC numbers (August)

Lessons from Heterodoxy

Several lessons from heterodoxy stand out. First, a wage and price freeze that directly deals with the issue of equity through an incomes policy is valuable in achieving disinflation. By itself, however, it is not enough. Without fiscal consolidation, the disinflation is not viable, and with a boom, it does not even last long.
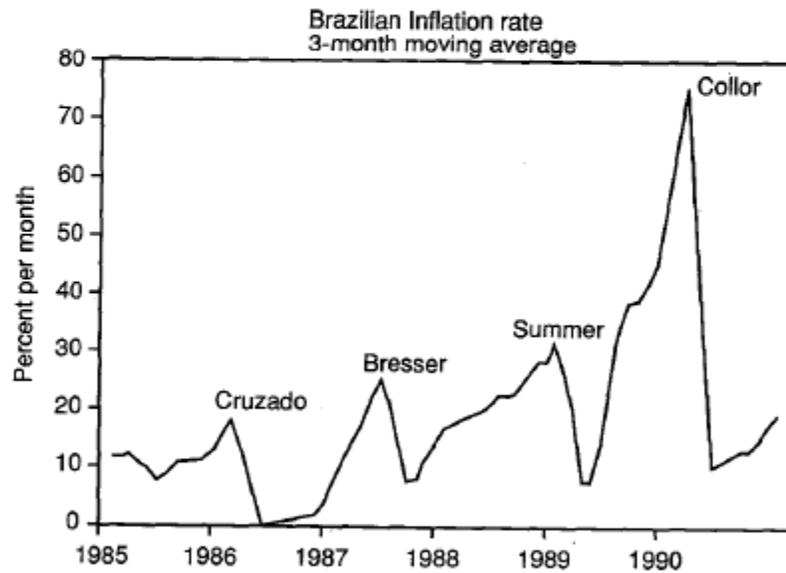
Figure 7.1
Brazil's stabilization plans, 1985–1990.
Source: Fudação Getúlio Vargas, *Conjuntura Economica*, various issues.
Rio de Janeiro: Fudação Getúlio Vargas.

Table 7.1
Inflation rates in Latin American countries with successful and failed stabilization in the 1980s (percentage per year)

| | 1960–1979[a] | 1980–1985[a] | December- December | | | | | |
			1985	1986	1987	1988	1989	1990[b]
Successful stabilization								
Bolivia	11	2,252	8,170	66	11	22	17	18
Chile	99	24	26	17	22	13	21	29
Mexico	9	15	64	106	159	52	20	30
Failed stabilization								
Argentina	78	336	385	82	175	388	4,924	1,833
Brazil	38	142	228	58	366	993	1,765	2,360
Peru	18	97	158	63	115	1,723	2,777	8,292
Nicaragua	16[c]	42	334	747	1,347	33,603	1,690	8,500
A recent case								
Venezuela	4	7	6	12	40	36	81	32

a. Average in the period.
b. Preliminary data.
c. 1973-1979.
Source: ECLAC, *Preliminary Overview of the Economy of Latin America and the Caribbean, 1991* (New York: ECLAC, 1991). International Monetary Fund, *International Financial Statistics* (Washington, D.C.: IMF, various issues).