

TIME: 4 Hours

MAXIMUM POSSIBLE SCORE: 240 points

IMPORTANT INSTRUCTIONS: This examination contains questions totaling 320 points. You are asked to answer questions of your choice, totaling 240 points. If you answer questions totaling L (an amount Less than 240 points), you will be scored on those questions, as usual. If you answer questions totaling M (an amount More than 240 points), you will be scored on all the questions you have answered, and your total score thus obtained will be multiplied by the factor $(240/M)$, to adjust it to a 240 point basis. In short, going beyond 240 points will not automatically add to your grade. It will do so only if the "added" answers help to pull up your average on your "earlier" answers. Also, it can similarly pull down your average.

I. (80 Pts. -- 6 2/3 Pts. Each -- NOTE that 3 TFUs = 20 Pts.) Indicate whether you consider each of the following statements to be TRUE, FALSE, or UNCERTAIN (TFU). In each case give a brief (e.g., 2 or 3 sentences) explanation of your answer. Your grade will depend heavily on your explanation.

1. The profile of a project should be expressed in real terms; that is, valuing each good and service as its price as of a chosen base year.
2. In dam projects with two or more purposes, the different aspects are substitutes (for each other) on the benefit side.
3. The opportunity cost of labor is obtained by estimating, for each worker, the salary that he would get in the highest paying opportunity that he faces in the labor market.
4. For projects whose profiles are independent (from each other) it is appropriate to work with a benefit-cost-ratio criterion, accepting all projects that have a ratio "present value of benefits/present value of costs" greater than or equal to one, and rejecting those where this ratio is less than one.
5. The benefit-cost ratio is not, in general, an adequate criterion, because one obtains different results depending on how current costs are treated.
6. When a highway project has benefits that increase with time, the proper time to construct that project is when its profile first yields a positive net present value.
7. The net present value of a project is maximized by choosing that scale at which the marginal (or incremental) internal rate of return is just equal to the opportunity cost of capital.

8. If there are no import tariffs, and no export taxes or subsidies, and no quantitative restrictions of any kind on imports and exports; the economic opportunity cost of foreign exchange will be equal to the market exchange rate.
9. In order to directly apply "separable components" analysis to a component of a project, the benefits of that component should be independent (i.e., neither substitutes nor complements) of those of the remainder of the project.
10. A project to extend the area served by a given irrigation dam should count as benefits the average productivity of water delivered to the hectares to be added, and as costs the marginal productivity of the water diverted away from the area previously served.
11. The economic opportunity cost of foreign exchange is lower in the case: a) where some of the foreign exchange in question is obtained by borrowing abroad than it is in the case b) where all of the foreign exchange is purchased in the market.
12. The internal rate of return of alternative investments is a valid criterion in the special case of capital rationing, in which the scarcity of capital funds (during which they have to be rationed) lasts only one period, and projects are independent of each other.

II. (20 Pts.) Explain the role of crises in initiating economic liberalization.

III. (40 Pts.) Choice of Exchange Rate Regimes -- In the aftermath of the recent currency crises in developing countries, there has been a renewed debate on the relative merits of flexible versus fixed exchange rate regimes. Write a short essay analyzing the pros and cons of different exchange rate regimes. Be sure to cover the following aspects:

- 1) What are the essential differences in the functioning of fixed versus flexible exchange rate regimes?
- 2) Does the desirability of exchange rate regimes depend on the type of shocks? Why?
- 3) Does the size and degree of openness of an economy matter for the choice of exchange rate regime?
- 4) Some analysts have recently argued that countries should choose either extreme: a) currency-board type arrangements or b) a freely floating exchange rate regime, but nothing in between. Do you agree or disagree? Why?
- 5) Suppose you were advising Hong Kong and Brazil. Would you recommend the same exchange rate regime to both countries? Why or why not?

IV. (40 Pts.) Many recent explanations of currency crises rely on “multiple equilibria” models. According to an IMF official:

“Single equilibrium models suggest a fairly benign view of capital flows... Models with multiple equilibria in financial markets are consistent with a more nuanced view of the benefits of the capital account liberalization, and have been used by some as an argument for limiting capital flows.”

Write an essay on how to model financial crises and contagion. Make sure to cover the following points:

1. Single vs. multiple equilibria models.
2. Speculation and crises.
3. Capital controls and crises.

V. (20 Pts.) Examine the theoretical and empirical validity of the proposal for a land reform which transforms large farms into smaller farms based on family labor.

VI. (20 Pts.) Fiscal Policy and the Real Exchange Rate -- When a country's currency (in real terms) is viewed as overvalued, it is often argued that a contractionary fiscal policy is called for. What is the rationale behind this policy recommendation? How is fiscal policy supposed to work in this context? From a quantitative point of view, is the effect on the real exchange rate likely to be important? All things considered, would you recommend such a policy?

VII. (20 Pts.) Develop a model of the effects of trade liberalization reform on the labor market. Does your model provide any insights regarding the sequencing of liberalization reform? Regarding the speed of reform? Explain.

VIII. (20 Pts.) Examine the relative merits of the “direct” and “indirect” routes to poverty alleviation.

IX. (20 Pts.) Discuss the question of how useful the concept of purchasing power parity (PPP) is for the analysis of economic problems in today's world. Under what circumstances do you think this concept would be put to its “best” use? Does it have significant weaknesses even under these “best-use” circumstances?

X. (20 Pts.) Current Account Deficits -- Suppose that a developing country has been running a current account deficit of above 5% of GDP for several years. Should policymakers worry about this? Why or why not? Should any policy measures be taken?

XI. (20 Pts.) “The debt crisis was due to the unwillingness rather than the inability-to-pay of sovereign borrowers.” Comment.