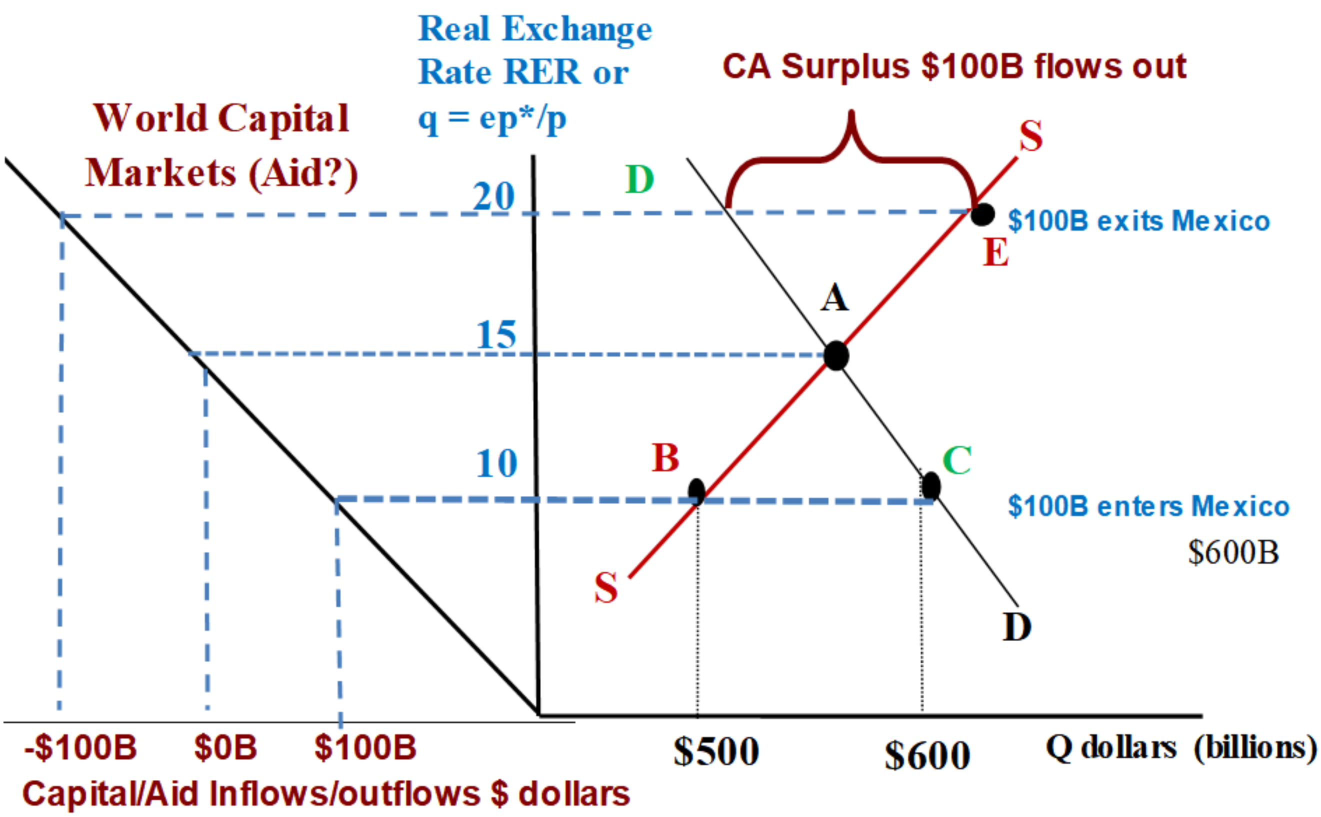
ECON 3235 Econ LatAm **Quiz 1 Post Review Session update (V3)** October 14th 2018

Quiz 1 will be will be at 5pm in class on October 16th Quiz one will focus mainly on these Figures MFD 1 and Figure 1 the TNT diagram. We will save shifts in the MFD supply and demand curves for Quiz 2, just because the RER inflation adjusted exchange rate is complicated. Back to Course Calendar

Here is the key equation for Quiz 1 **the RER is q = ep*/p which implies that $\Delta q = (\Delta e + \pi^* - \pi)$ but see also the** (but see also the TNT PPF below)

Figure MFD-1 Market for dollars in Mexico



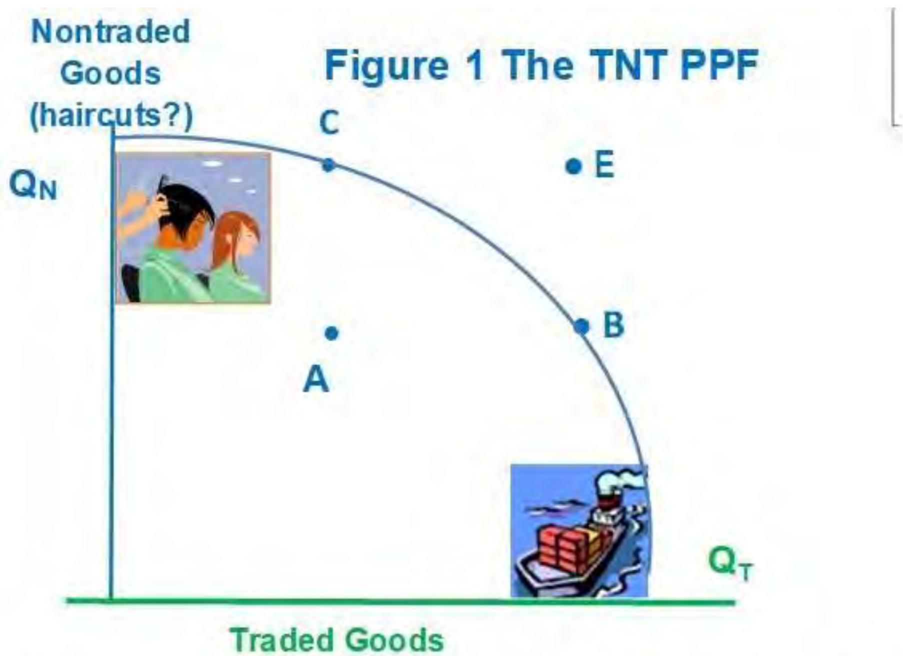
In a small open economy like Mexico causality runs from $US inflows to the RER & CA balance. Unless the peso appreciates in real terms Mexico cannot invest more that it saves, if foreign investors want to invest in Mexico the peso RER must appreciate so Mexico can run a CA deficit. But what if there is a "sudden stop"?

1. What is the "equilibrium" real exchange rate in Figure MFD-1? Answer: not there is no reason for capital inflows to be zero, they are far more likely to be positive or negative, see the discussion of current accounts and surpluses in (Devadas & Loayza, 2018). In what sense is A is for 'autarchy" in Figure MFD-1? Explain. Is balanced trade or CAD = 0 the norm*? EC: Why compute the CA deficits and surpluses as % of world GDP rather than national GDP? (hint: can the Earth have a CA deficit or surplus?)*

2. Recall that q = ep*/p which implies that $\Delta q = (\Delta e + \pi^* - \pi)$ where π^* is foreign inflation a change in p* and π is domestic inflation (a change in p). If $\pi^* = \pi$ (roughly) then in increase in the local currency price of $US (see the MFD diagram) is referred to as a real external devaluation. How have some countries tried to achieve a fall in q or a real depreciation with an internal devaluation? (hint deflation is dangerous and painful while letting e increase many increase inflation (unless the Central Bank does what?).

3. How have most LatAm countries (not all) managed to switch from internal to external devaluation. How does the current crisis in Argentina reflect the hazards of a flexible nominal exchange rate e : how does Argentina's case of situation illustrate the risks of external devaluation especially when U.S. interest rates are falling? Saving this for quiz 2: *Austerity or stabilization policy or a shift to left of DD in Figure MFD-1 is a substitute but has other costs and risks (hint* [*Caracazo in Venezuela 1989)*]

   4. **Use $q = ep^*/p$ and $\Delta q = (\Delta e + \pi^* - \pi)$** to explain why most LatAm countries' currencies buy only a tiny fraction of a dollar of put differently the dollar always costs more than one peso? (or yen or Rupiah, or Real) See for example Chile's real and nominal exchange rates in Figure RN-3 below. Chile pesos per $ exchange rate was 245 per dollar in the late 1980s, but is now in the 600s (as is the Colombian peso). How do these currency changes reflect the region's turbulent history through the 1990s?



Note: points C and B are on the PPF, A is below the PPF and E is above the PPF

5. Compare points C and B in Figure 1 what is the advantage of these two points? Is one better than the other. At points C and B the country must have balanced trade, why? What is the problem with point A? When did Argentina operate at a point like this one? (see their unemployment rate on the calendar?) What is the problem with point E? What is good about point E? Suppose a country could operate at point E and produce at point C, explain how this might work. What might fill the gap between C and E? Why might a country get stuck operating at point A (hint: Greece and/or Argentina in the late 1990s, see Figure U-3? Would there be full employment producing at point C and consuming at point E? How is this possible?

6. Use the opening discussion of Chapter 21 of Sachs and Larrain (1993) to distinguish between tradable and nontradable goods. Give some examples of each type of goods (hint: look at the pictures in Figure 1). So why is the PPF in Figure 21-1 straight while in Figure 1 above and in Mankiw is bowed outward? Why does the PPF get steeper or flatter at either extreme?

7. Except for a few writers at the WSJ, no one thinks Argentina should return to the currency board system it used from April 1, 1991, through January 6, 2002. During the review session we discussed the fact that Brazil

devalued in 1998 and let the Real depreciate a lot in the early 2000s [Before the Real there was the Cruzado, Real the name of their currency] depreciation

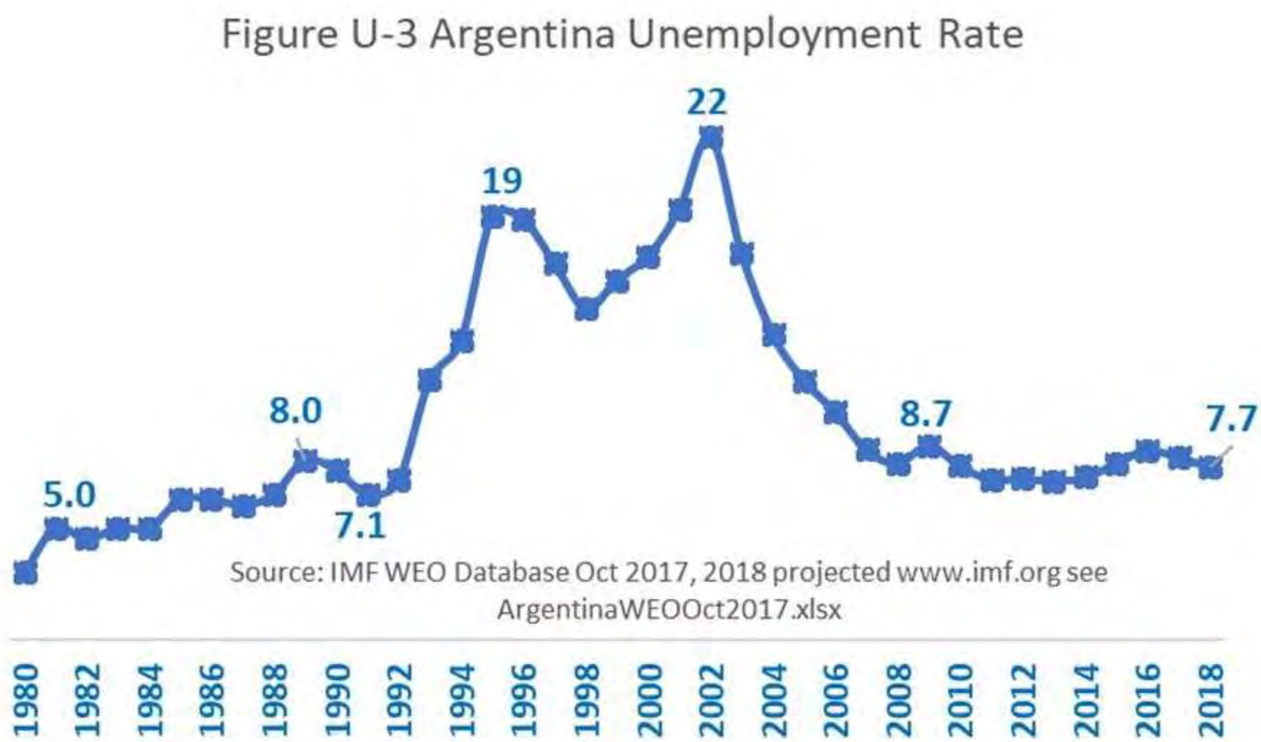
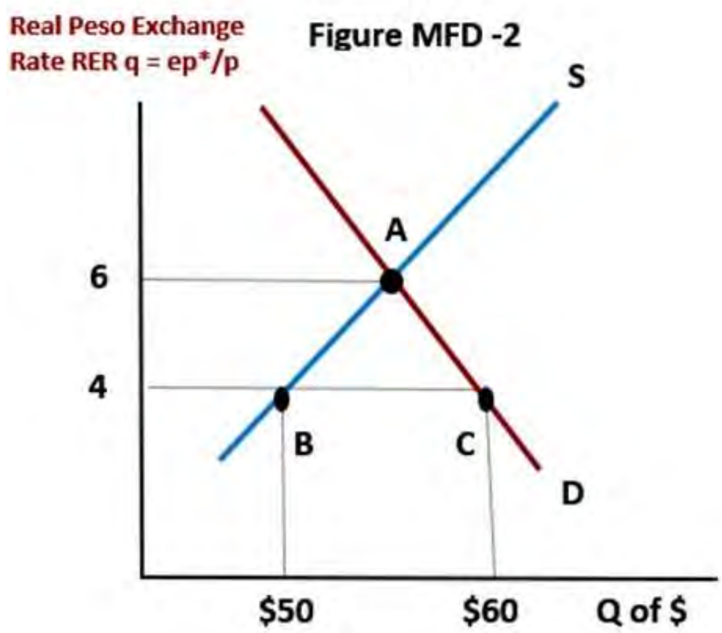


Figure B-1 Brazilian Reals per $US (its nominal fx rate "e")

Saved for quiz 2 *MFD-1 questions saved for Quiz 2*

6B. Why is it generally better to produce both traded and nontraded goods if the ppf is bowed outward? (challenge: why does the relative price of tradables over nontradables never change in Figure 21-1? In Figure 1 why does the price of price of nontradables rise as you approach zero production of tradables? EC: Cast this in terms of the skills and productivity of workers (assuming you only need workers to produce each good, as in the Figure 21-1). Write out the formula for the RER implied by Figure 21-1 why is it constant. Suppose $P_T = ep^*$ and $P_N = p$ (each countries CPI, why is this plausible. If nontraded goods were mainly services, why would this be plausible. What famous nontrable good caused Puerto Rico a lot of problems? Is solar power non-tradable? Is natural gas nontradable for Puerto Rico? Why? For a general review of the PPF see Mankiw on PPFs **as well as** Sachs and Larraine 1993 Chapter 21.

1. Use figure MFD-2 to discuss for ways a country can eliminate or reverse a CA deficit, moving to B or C or A (or even above A which would be a CA surplus). Why might a debtor country suffering from original sin have to turn a CA deficit into a surplus quite quickly (unless the IMF or someone else lends it more $$).



These short answer questions and Political Economy Questions for HW and/or midterm EC

2. What happened just before NAFTA was signed but not before NAFTA 2.0 of the USCA was signed... How did this affect Mexico's RER and CA deficit (see the WEO CA series data and RER diagram on the Calendar). *Did anything really good or really bad happen to your country lately?*
3. What pushed the Lawyers baby-sitter cooperative in Washington DC into a recession? What did what made sense for each couple individually not make sense at all for the group as a whole, that is, why did all these smart well-paid Washington Lawyers ("the swamp") stop going out? Why was the solution to this crisis "printing money" or helicopter money? Why didn't these lawyers just hire babysitters?
4. Speaking of fairy tales, relate the babysitting crisis to the 1896 populist revolt in America led by William Jennings Bryan "you shall not crucify mankind upon a cross of gold." Who was getting crucified, and why? In this sense how did the commodities boom from 2000 to 2015 boom redeem Latin America (and most other emerging market countries, what about your country during this period? Why did this boom fizzle somewhat with May 2015 Taper tantrum? Did this coincide with the begging of Brazil's long recession (see the Brazil case study page showing Brazil's growth rate

5. What happened to Brazil's nominal and real exchange rate before Lula was elected and to Mexico's RER just before NAFTA was implemented in 1995? Draw parallels between Mexico's election and Brazil's recent primary? Did Mexico really want a PhD economist as President? What country in Table 1A had a PhD economist for some time? *Did that work out well? How did Zedillo revolutionize Mexico's political scene? Compare this to what AMLO has managed to do?*
6. In what sense does Figure MFD-1 illustrate "Poor Mexico, so far from God, so close to the US" the rueful lament of "wily dictator Porfirio Diaz." *When did Porfirio Díaz take power, when did he exit? How did his victory in 1862 over the French lead to a well-known holiday celebrated more here in the United States than in Mexico (perhaps because he was a dictator?). The French attacked Puebla from Vera Cruz, why were they there? Originally U.S. and British ships were there too, to do what? Why did the U.S. and British ships leave, leaving the French to defeat the Mexican forces on their own? According to Why Nations Fail why was this a fateful decision for Mexico (hint: Nogales Mexico and Nogales Arizona).*

The Dark side of the "resource curse" from A&L Chapter 6 page 159, on the (which makes the Dutch Disease sound like a mild cold, or the flu? How can countries vaccinate themselves against the dutch disease "flu?" Hint Mexico, Chile, the Netherlands, Norway?.

Have initial endowments and exploitation of natural resources contributed to the new wave of populism in some Latin American regions? In our view, natural resource windfalls have facilitated the emergence of a new populist wave, especially in countries with weak economic and political institutions. Specifically, growth was not reignited during the 1990s in many Latin American countries, and the approximately ten-year period of reforms left a hostile and grim land, allowing populist leaders to put all the blame for poverty and inequality on corrupt politicians, oligarchs, and multinational corporations that had stakes in natural resources such as oil and mines.

Thus, the market-oriented reforms themselves were questioned by several academics. Nonetheless, most Latin American leaders resisted pressure and did not join the ranks of discontent. John Williamson, who coined the Washington Consensus reforms, namely, stabilization, privatization, and trade liberalization, has spelled out the mixed sentiments in the hearts of Latin Americans until 2003. (We analyze the Washington Consensus reforms in greater detail in chapter 7.) Williamson (2006) argues that on one side of the spectrum, Latin America in the twenty-first century was endowed with (superior) market-friendly institutions, which were Latin America's best bet to pull disadvantaged households from poverty. On the other side of the spectrum, however, Williamson witnessed how public opinion in many countries remained hostile to the market-oriented reforms of the 1980s and 1990s and that such hostility was turning populist, with consequential-and well-known-adverse effects on the middle class and the poor.

An alternative, less dark interpretation of A&L's argument is from Acemoglu, Daron Georgy Egorov Konstantin Sonin (2013) A Political Theory of Populism The Quarterly Journal of Economics, Volume 128, Issue 2, 1 May, Pages 771–805, https://doi.org/10.1093/qje/qjs077 ***Abstract:*** *When voters fear that politicians may be influenced or corrupted by the rich elite, signals of integrity are valuable. As a consequence, an honest politician seeking reelection chooses "populist" policies—that is, policies to the left of the median voter—as a way of signaling that he is not beholden to the interests of the right. Politicians that are influenced by right-wing special interests respond by choosing moderate or even left-of-center policies. This populist bias of policy is greater when the value of remaining in office is higher for the politician; when there is greater polarization between the policy preferences of the median voter and right-wing special interests; when politicians are perceived as more likely to be corrupt; when there is an intermediate amount of noise in the information that voters receive; when politicians are more forward-looking; and when there is greater uncertainty about the type of the incumbent. We also show that soft term limits may exacerbate, rather than reduce, the populist bias of policies. JEL Codes: D71, D74.*

SA Question: Rewrite this argument to fit Brazil's ongoing election, if it elects a right-wing populist instead of a left-wing populist. After the car wash and notebook scandals, center-right politicians may be perceived as less corrupt (in Argentina and Brazil and Peru)?

Misc references on Inflation Stabilization and the Dutch Disease:

Calvo, Guillermo A., and Carlos A. Végh. "Inflation stabilization and nominal anchors." Contemporary Economic Policy 12, no. 2 (1994): 35-45.

Cardoso, Eliana A., and Ann Helwege (1992) Latin America's economy: Diversity, trends, and conflicts. MIT Press. Chapter 6 and Chapter 7.

Collier, Paul, and Benedikt Goderis (2008) "Commodity prices, growth, and the natural resource curse: Reconciling a conundrum." (2008) Oxford University mimeo, the text references Collier's, 2010 book

Devarajan, Shantayanan, Gael Raballand, and Tuan Minh Le (2011) "Direct Redistribution, Taxation, and Accountability in Oil-Rich Economies: A Proposal." Center for Global Development, Wash DC.

*Frankel, Jeffrey (2011) A solution to fiscal procyclicality: The structural budget institutions pioneered by Chile. No. w16945. National Bureau of Economic Research, 2011.

*Frankel, Jeffrey A. "The natural resource curse: a survey of diagnoses and some prescriptions." (2012).

*Frankel, Jeffrey, Carlos Vegh, and Guillermo Vuletin (2011) "On graduation from procyclicality." NBER WP 17619.

Kiguel, Miguel A., and Nissan Liviatan. "When do heterodox stabilization programs work?: lessons from experience." The World Bank Research Observer 7, no. 1 (1992): 35-57.

Spiegel, Mark (2002) "Argentina's currency crisis: lessons for Asia" FRBSF Economic Letter. August 23rd 2002, Federal Reserve Bank of San Francisco.

*This google scholar url will take you to all of these publications, including pdfs if you want to read more.

How much does a dollar cost in Ecuador or Panama or El Salvador? EC *When was the Colon removed from circulation? Does it still exist? Does the Drachma or Lira or Puerto Rican dollar still exist?*