Economics 5450 **Midterm Exam v4** **Crisis Adjustment & Poverty Spring 2018**

You should find the diagrams you need to answers these questions here. (Figure 1, etc. Start with this word file adding your answer in a different single-spaced type face. Keep answers brief and to the point, please clearly label and refer to points in diagrams. Sections in italics are optional. I should be able to fix my Blackboard problem by the due date (Sunday April 8th) Send any questions by email to mcleod@fordham.edu. If you need more time let me know as well. I would like to post an additional question Monday so do you best to finish.

M-1 A) **U**se the curved TNT diagram such as Figure 1 to show how private capital or aid inflows always lead to a real exchange rate appreciation. Briefly relate this to idea of “absorbing” aid inflows (who is helped and who is hurt by aid inflows?). Discuss why Uganda and Italy (post WWII) were reluctant to absorb aid inflows.

M1-B) Why do donors & the IMF worry if aid is not spent and/or absorbed? (hint: the Economist expresses similar concerns regarding borrowing) the economist expresses similar concerns regarding foreign borrowing). Write out the capital account using one of the IMF papers or the Aid handout especially Gupta et al. 2006).

M1-C) With a flexible exchange rates have some control over how this appreciation takes place. Using the nominal exchange rate e (pesos/rand/cedis per $) and the price level equation from S&L Chapter 21 w/notes page 673 to explain the potential inflationary impact of capital inflows. How does changing e temper inflation pressures during a commodity price boom?

M1-D) Another approach is to combine a sovereign wealth fund with a fiscal rule as Chile has done. Show how this rule works using the MFD and the TNT diagram. Use the TNT and the market for dollars diagram to show how Chile’s copper stabilization fund smooths consumption and investment. Simulate a rise/fall in copper prices as a shift in the supply of dollars curve, or as a shift in the PPF that mainly affects traded goods Why avoid RER adjustment? What does the TNT diagram promise countries if they can get their RER “right”?

M1-E) Suppose productivity increases faster in the tradables sector. How does this affect the real exchange rate? Use equation 21.6 to page 662 show exactly how this productivity effect works when a_N rises more slowly than AT. Should the government attempt to prevent this appreciation? Why not? This is referred to as the Balassa Samuelson effect. How does it affect real exchange rates over time?

M1-F) The third arrow of Abe Economics is reforms to encourage investment and productivity growth (Germany’s Hartz reforms for example). Use the TNT model to argue that countries that wish to temper the impacts of Aid inflows on inflation and RER should increase productivity in _____ goods while countries seeking to avoid deflation associated with capital outflows should focus on increasing productivity in________goods. Explain this intuitively and using the TNT diagram if possible.

M1-G) What does the IMF WEO Chapter 3 Oct 2017 find is the best insurance against climate shocks in developing countries? Why does this make sense in light of the above discussion? *M1-EC Use the Sustainable debt handout to show a secular appreciation reduces the costs of borrowing in dollars or Euros over time (sometimes referred to as “original sin”*

Here are the diagrams you may find useful for this question, please use Figure numbers and points on the diagram for your answers.

References (delete those you do not cite)

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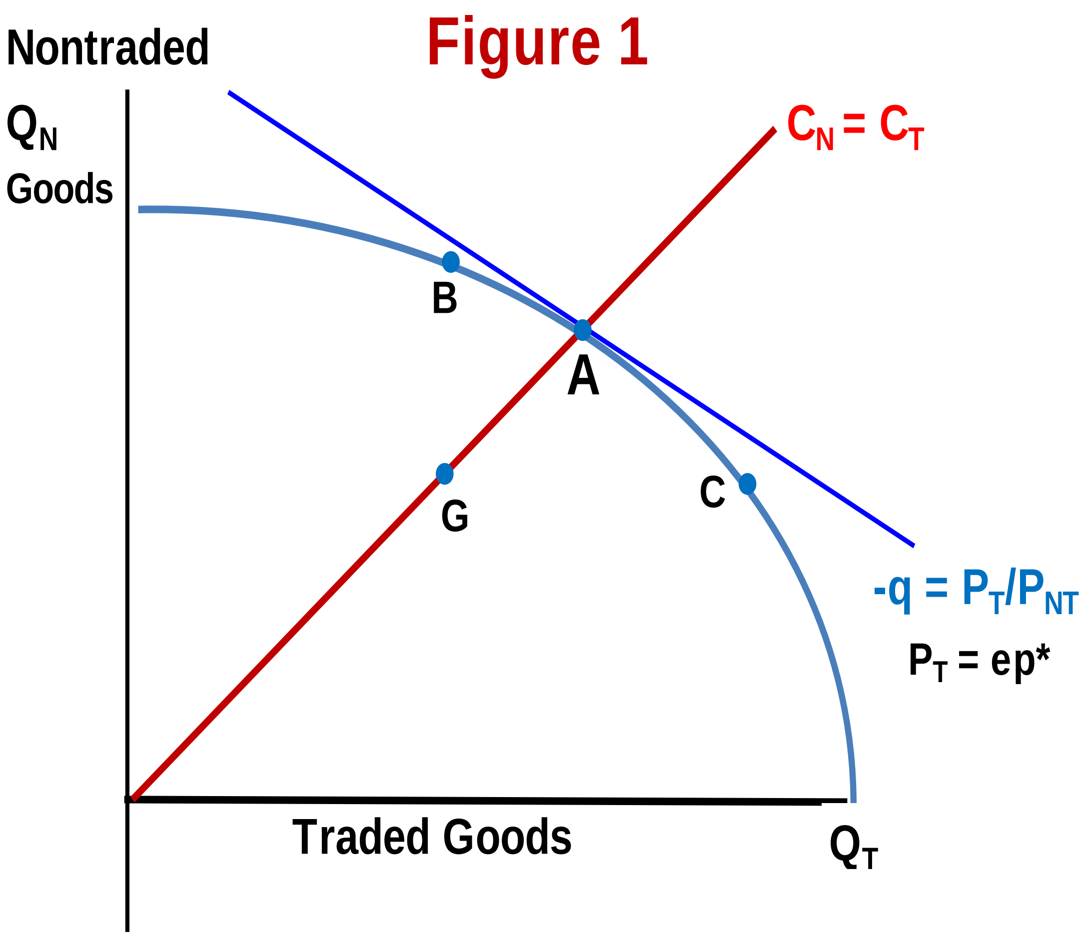

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The Road to Redemption: Policy Response to Crises in Latin America

Yang, Yongzheng, Robert Powell, and Sanjeev Gupta. Macroeconomic challenges of scaling up aid to Africa: A checklist for practitioners. International Monetary Fund, 2006.

Galiani, Sebastian, Stephen Knack, Lixin Colin Xu, and Ben Zou. "The effect of aid on growth: Evidence from a quasi-experiment." Journal of Economic Growth 22, no. 1 (2017): 1-33.

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Exchange rate regimes (sterilization)

See Barry Ickes for this quote *http://class.povertylectures.com/forex1BarryIckes.pdf*

Friedman on Flexible Rates: If internal prices were as flexible as exchange rates, it would make little economic difference whether adjustments were brought about by changes in exchange rates or by equivalent changes in internal prices. • The argument for flexible exchange rates is, strange to say, very nearly identical with the argument for daylight savings time. Isn't it absurd to change the clock in summer when exactly the same result could be achieved by having each individual change his habits? All that is required is that everyone decide to come to his office an hour earlier, have lunch an hour earlier, etc. But obviously it is much simpler to change the clock that guides all than to have each individual separately change his pattern of reaction to the clock, even though all want to do so. The situation is exactly the same in the exchange market. It is far simpler to allow one price to change, namely, the price of foreign exchange, than to rely upon changes in the multitude of prices that together constitute the internal price structure.

Post-conflict Aid, Real Exchange Rate Adjustment, and Catch-up Growth Ibrahim Elbadawi and Linda KaltaniKlaus Schmidt-Hebbel January 1, 2007 World Bank Publications

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