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Crises, Poverty and Adjustment in LDCs Review and Discussion Question Set #1C ECGA 5450 Fall 2012

*Please* <u>type</u> brief answers and use the a,b,c structure of each question; draw in equations or diagrams by hand. Sections marked with \* or in italics are optional and/or required for PhD students only. See also <u>CAP-1 lecture notes</u>....

**1.1. The market for dollars diagram:** Draw the market for foreign exchange diagram used in the lecture. a) Distinguish between the current account and the capital account as represented by in this diagram. Suppose capital flows are exogenous (Aid or determined private investors). Show how an increase in capital inflows affects q. From the point of view of export and import competing industries, is this capital flow likely be expansionary? Why or why not? b) Use this diagram to show how stabilization policy, structural adjustment, external devaluation and internal devaluation can reduce a current account deficit. Briefly review some advantages and disadvantages of each strategy. When current account deficits have to be reduced, why don't countries just devalue their currencies (let e rise)? Explain how each of these policies can be complementary, as opposed to alternative adjustment strategies. *C) Why is it important to use the real instead of the nominal exchange rate on the vertical axis? What happens when the RER appreciates in this diagram? Why might a RER appreciation slow growth? Show an RER appreciation that result from faster growth? What is the key difference between these two RER appreciations? (hint: shift vs. movement along...).* 

1.2 External adjustment in perspective: DeVries argues the 1946 Bretton Woods agreement made external balance a "policy" problem. (a) Use the market for dollars diagram to briefly explain how balance of payments adjustment takes place "automatically" under the gold standard or with floating exchange rates. Given that the vertical axis is  $q = ep^*/p$  or the real exchange rate, what "automatically" changes the real exchange rate in both cases? b) How do or did countries "break the rules" under both "automatic" adjustment systems? How for example how did the UK in the 19<sup>th</sup> century (under the gold standard) and now China manage their real exchange rates rather than let them adjust to market forces (hint: sterilization)? What is the objective of these interventions? c) How did the Gold Standard contribute to the great depression? (see Ben Bernanke, 2000, The Macroeconomics Of The Great Depression, Princeton Univ Press) the diagram to discuss the options Euro countries Greece, Ireland, Spain and Italy have to reduce external borrowing (i.e., move to a larger CA surplus). Why is this sort of adjustment so difficult? Argentina faced a similar situation in 1998-2000, what happened? What happened after that? What can the IMF do to help? (see Christine Lagarde on what the IMF at last year's Jackson Hole meetings-- she had just replaced DSK-did Europe follow her advice). (d) Why did the Bretton Woods agreement not return the world to a new gold standard or a system of floating exchange rates? What was the role of the IMF under the pre-1973 "par value" fixed exchange rate regime? What is its role under a floating exchange rate system? How is this role similar? How are the Euro countries are different (fixed vs. floating rates) different from non-Euro EU countries? d) Optional: After having almost no clients with conditional lending programs heading into 2008 the IMF now has many customers. What new approach to conditionality is the IMF using some developing countries (Mexico Colombia and *Poland for example)? Why these countries? What fx rate system and political characteristics do these* countries share? If all countries have floating exchange rates and open capital accounts would we still need an institution like the IMF? Why or why not? (hint: what did Brazil accuse the U.S. doing with QE2, what is QE3 doing to Germany and the other EURO economies?

**1.3 Getting to know the real exchange rate:** (see Elasticity's Approach handout) Defining the real exchange rate (RER) as  $q \equiv ep^*/p$  where e is the nominal exchange rate, p is a local price index for non-tradables, typically the CPI and p\* is an international dollar price index (a) What happens when to q when home prices, p, rise, but foreign prices and the nominal exchange rate (p\* and e) remain fixed? How can the real exchange rate appreciate or depreciate even with a fixed nominal exchange rate? (b) Wall Street

economists tend to define the real exchange rate as p/ep\*, why might this be better for them, but inconvenient for us? (think of the market for dollars diagram with 1/q or p/ep\* on the vertical axis or consider the nominal exchange rate 3 expressed as consider dollars per peso (any peso) or yuan or Naira or baht? (hint: only a few currencies are worth more than one dollar... the Euro, the pound, once and a while the Canadian or Australian dolller). (c) Current account reversals or "sudden stops" have become popular explanations of currency crises. Use the market for dollars diagram to show how a surge or a collapse in capital flows affects q. Contrast the impact of a surge or collapse in capital flows (or aid) assuming the nominal exchange rate, e, is fixed? Why is it easier to cope with a surge in capital inflows as opposed to sudden stop with a fixed rate (e)? (\*d) (Phd students) Write out an expression for  $\Delta q = q_t - q_{t-1}$  (use  $\pi$  and  $\pi^*$  for changes in p and p\*). What happens to the RER if home inflation is less than foreign inflation with e is fixed? How could Germany make it easier for Greece, Spain et al. to take advantage of this "internal devaluation" lite adjustment strategy? Why according to Krugman, 2012 is this much easier politically than deflation or reducing wages? Did Germany use this adjustment strategy 2003-2008 (according to Krugman, 2012)?

1.4 The best use of foreign aid: (see Chapters 1-4 of Gupta, Sangeev et al. 2005) (a) Using Table 2 on page 12 briefly outline the four alternative scenarios for the use of foreign aid in poor developing countries. From the point of view of macroeconomic stability, discuss the pros and cons of each scenario (ask in class if you are confused, it is confusing sometimes). Which scenario do the IMF and donors favor? When might donors and the IMF disagree? Which scenario do local governments tend to favor? Is there ever a case for not absorbing or spending aid? (b) Discuss why surges of aid raise the specter of the Dutch Disease? Why does the RER almost have to appreciate if the country is to "absorb" aid (think about what happens to the price of imports when the RER appreciates). (\*c) Using the MAPB handout to discuss how "sterilization" can be used to counteract the effect of aid surges? Show how sterilization works by solving for inflation in this framework. Is accumulation of reserves a form of national savings? As such what are its limits, and what are its advantages for poor aid receiving economics?

**1.5 The Absorption Approach** (see the end of the MABP handout for a review) a) Distinguish the term "absorb aid" from the "absorption" as in A = C + I + G and the "absorption approach" to external adjustment: how are these three concepts related, how are they different? What does the absorption approach focus on that the elasticity and TNT approach ignore or overlook? Using standard national accounts notation ( $Y = C + I + G + X - M - r^*eD^*$ ) short that under certain assumptions CA surplus equals S-I. Briefly summarize in words what CA = S - I says about CA imbalances. b) Mexico's 1948 crisis illustrates the basic insight of this approach, how (De Vries) c) Defining absorption A = C + I + G, explain the common IMF argument that a country with a current account deficit is "living beyond its means." In what sense is this an over simplification? What must happen for the CA surplus to rise or the CA deficit to fall? Why did Alexander think this equation meant CA adjustment was bad news for the poor (later we will use the TNT model to confirm this point). Ultimately, why can't the burden of CA adjustment be put on the rich (better yet, suggest some ways that it can, using the large U.S. CA deficit—as an example if you like).

**1.6 Financial Programming** (aka the <u>Polak or Monetary Approach to the BoP model</u>): Using the <u>MABP</u> class handout, <u>DeVries</u> and/or <u>Agenor Chapter 9 section 3</u> (slightly more complicated): (a) Discuss the causes of balance of payments (currency) crises from the point of view of the financial programming or monetary approach to the balance of payments developed by Polak et. al. in the late 1950s. (b) What basic "one size fits all" policy prescription does this model seem to imply? What simplifying assumptions does financial programming make in order to get simple, universal conditionality targets for the money supply, government spending and reserves? (c) Briefly provide a rationale for each target. What happens if the IMF underestimates future inflation? Why does lead to overkill, an excessively large recession and rise in

R? (d) The IMF became and to some extent remains a short term crisis lending facility, a revolving fund financed by member countries. How is this short term (1-3 year) perspective influence the focus of conditionality and the IMF approach to balance of payments adjustment? What happens if countries do not repay the IMF? Many countries complain about the IMF, some do not repay their loans on time, but countries rarely leave the IMF permanently (Zimbabwe and Argentina are examples, both have restored their IMF member status). Why don't more countries leave the IMF, form regional bailout facilities (the EU?) or create alternative institutions to the IMF? What have the big Asian countries do to avoid going or returning the IMF, post 1990s financial crisis? Is this a good thing for them and the World economy or not? Would the world be a better place if Asia and Latin American held lower levels of fx reserves (mainly dollars)? E) Jacques Polak (2001) distinguishes to monetary approaches to the balance of payments: Keynesian and Johnsonian, what are the major differences? What does Agenor's "extended framework" or the World Bank RMSM add to the financial programming framework? (chapter 9, section 3.2 and section 4) What is the main advantage of these "extended" models?

1.7 (a) The <u>World Bank GDF 2011</u> has a chart showing rising external debt in China (in 2009) why is this figure a little misleading? What does it suggest China and investors did to copy with the 2008-09 crisis? Why was China able to expand so recover so rapidly from the 2008 crisis, actually borrowing more on international markets? Hint: see part (d) below, once you answer it. (b) Further evidence of China's role in mitigating the global crisis is the World Bank's <u>Global Economic Prospects update in June 2011</u>. What do Figures 2 and 3 pages 6 and 7 suggest about China's role during the 2009 -2011 recovery? Has developing country industrial production recovered to precrisis levels? What about China? What about the advanced countries? (c) What happened to commodity prices during the 2008-2009 crisis? Why was this a problem for many developing countries? What is happening to commodity prices now (in the last few weeks)? Why? (d) use the IT approach to the CA (the Metzler diagram's) to discuss what would have happened during the pre-crisis boom if China had a savings boom but kept it's CA balanced? (wait until we discuss this question in class).

1.8 What does <u>Goldstein</u> argue caused the Asian currency crisis of 1997-98? (see also reader excerpts and the Commanding Heights <u>Episode 3 chapters 9-14 on the 1990s crisis</u> in Asia and LatAm). (a) Use the elasticities approach to discuss how a decline in exports and capital inflows affected Asia's current account. (b) Use the absorption approach to explain how the investment boom in countries like Indonesia affected the current account. (c) Use financial programming and TNT approach to discuss how rapid credit expansion affected real estate prices and the real exchange rate. (c) Use the intertemporal approach to the current account to explain the role of lower interest rates in Japan in the early 1990s. How did large short-term borrowing by banks contribute to the severity of the crisis in Korea, Thailand and Indonesia? (d) Three "generations" of currency crisis models are discussed by Eichengreen Appendix B. Based on what you know so far, which model best fits the Asian crisis. What do these models add to traditional adjustment models?