

Readings: S&L Chaps 6 & 21 plus for PhD students [Frankel & Razin Chapters 5 and 17](#); [Obstfeld and Rogoff](#) *chapt 1 pp. 1-21* and see class handouts.

1. The TNT model stresses the adjustment problems created by movements of workers (and capital in the LR) between traded and non-traded goods sectors (a) Provide an intuitive discussion, using the curved TNT PPF (as opposed to the straight ones in S&L Chapter 21) to show and explain why a RER appreciation is required to get workers to move between traded and nontraded sectors. What motivates workers to switch jobs or sectors? Why is this potentially painful and slow? (b) Use a curved TNT PPF and the price level equations from S&L chapter 21 demonstrate that: with fixed nominal exchange rate “e” capital inflows are generally inflationary and reduce traded goods output. This effect on the tradable sector is sometimes referred to as the “Dutch Disease.” But is this really “disease” in the sense of being sub-optimal. (c) Aid can also cause the RER to appreciate. Demonstrate this using the bowed TNT PPF (see the class handout or the Gillis Appendix or S&L Figures 21-8 and 21-9). In this context explain how the TNT model can help explain the real estate boom that preceded Asia’s crisis in Thailand for example (see Goldstein chapter 2) (d) When capital flows out the price of non-traded goods relative to traded goods must fall. Explain and show if possible how this happen with a fixed nominal exchange rate (hint: Argentina in the late 1990s, what was the inflation rate? Finally, Argentina’s peso plunged in 2001, which sort of adjustment was more painful for workers? Discuss parallels between Argentina’s severe 2001 default and collapse and the problems that led to the collapse of gold standard (de Vries). What does this tell us about the viability of fixed exchange rates in countries such as Argentina whose neighbors have floating exchange rate (e.g., Brazil) ? (e) *optional: How quickly did Argentina recover from its 2001 crisis? (see [Calvo et al. 2006 on Phoenix recoveries](#) or the most recent [IMF WEO database](#) or the WB LAC [Virtuous Circles Volume Page 48](#))*
2. **Warning: tedious but somewhat helpful question:** Starting with the simplified current account surplus, $CA_t = TB_t - r^*D_{t-1} = D_{t-1} - D_t$, assuming the change in other private capital flows ΔF is zero). The current account deficit is $CAD = D_t - D_{t-1} = -CA$. Rewrite equations 6.1-6.7 in S&L for a net debtor nation using this CAD definition. (b) The IMF often claims countries that run CA deficits are “living beyond their means.” Show this using the absorption approach. How does the IT approach change our view of borrowing for the future? Use the IT budget constraint 6.2-6.24 to elaborate on this idea. Assuming capital inflows are invested in the traded goods, how does the IMF argument and S&L’s long term budget constraint have to be qualified? (c) Discuss the above arguments using the consumption augmenting (vs. smoothing and tilting) framework of Frankel and Razin Chapter 5.
3. Do the exercises included at the bottom of the sustainable debt handout. Be sure to write down in the formula you are using (show your calculations, not just the answer). Put your answers to the “does this make sense” test, check the formulas again and then ask in class. When working with percentages always use the decimal form (e.g. use .1 for 10%) to avoid units problems. (a) Which of the “sustainable” current account deficit formulas presented in the class handout is probably most relevant for developing countries and why. (hint: “original sin”) Explain intuitively why countries can run a current account deficit forever. How does rapid export growth and/or high traded goods productivity growth affect the sustainable CA deficits? (b) *Given the export track record of the East Asian countries, how might the Balassa effect reduce borrowing costs and contribute to the Asian financial crisis (see Goldstein or the ? What happens to “sustainable” current account deficits when export growth slows?*

4. (a) Use intertemporal (IT) current account (CA) two-period diagrams reviewed in lecture and S&L chapter 6 to discuss the costs of capital controls (use a diagram like S&L Fig 6-11 assuming the country on the left is the poorer country and the other is an OECD cty—Japan?). Show how a domestic investment boom affects CA balances in Figure 6.11. What would happen to a country who experiences a large investment investment boom with a closed capital account? Show this graphically. How does might this affect economic growth in the two countries? (b) Explain why countries might want to borrow or encourage incoming FDI, referring to the consumption smoothing, tilting and augmenting roles of capital inflows. Masters students should use S&L diagram with S,I and r while the Phd students should use the IT diagrams from [Frenkel and Razin chapter 5](#) or [Obstfeld and Rogoff Chapter 1](#). Which sorts of capital inflows fit each each purpose? (c) Why might capital inflows and access to credit markets be more important to poor countries as opposed to OECD cty's? {hint: Emerging Markets; LDC primary commodity exporters; low savings rates, low per capita incomes, and lots of young people}. (d) *Given that GDP and welfare costs of being excluded from international credit markets may high for poor countries, should poor countries be good credit risks? Explain using the IT CA framework. Have they been good credit risks? What happened to EMBI spreads during the five years prior to the current crisis (see the WB 2006 GDF Chapter 2 page 47)? What accounts for this trend? What happened in 2008 (see page GDF 2008, p. 133)? Were EM bond investors wrong? If yes about what (hint: where are problems loans in this crisis?).*

5. Cooper and Goldstein argue the Asian currency crisis of 1997-98 started with China's devaluation, others focus on a burst of capital inflows from Europe and Japan. a) Use the elasticities approach to the CA to discuss how a downward shift in exports affects Asian current accounts. Similarly, how would China's 1994 devaluation affect Thailand and Korea's current account assuming they compete in the same export markets? (b) Use the absorption and IT CA approaches to show how an FDI investment boom might have affected Indonesia and Thailand's current account. (c) Use financial programming to discuss how rapid credit expansion affected real estate prices and the real exchange rate when nominal exchange rates are fixed. Use this to help explain the IMF's obsession with inflation? Why might they be less obsessed today? (c) Use the IT approach to the CA to show how Japan's low interest rates might affect Thailand (other Asia) CAs during the 1990s. (d) *Tirole describes the 7 components of a typical currency crisis, and then lists the "seven pillars" of the consensus view on how to solve them (see Chapters 1&2). What does he say is wrong with the consensus view? Contrast his views, overall, with those of Eichengreen (see his Copenhagen Consensus paper). Optional: three "generations" of currency crisis models are discussed by Eichengreen Appendix B. How did large short-term borrowing by banks contribute to the severity of the crisis in Korea, Thailand and Indonesia? Based on what you know so far, which model best fits the Asian crisis?*