

*These questions draw on the first two lectures and related handouts. Please type brief answers to questions 1-5 for Sept. 24th using the a,b,c structure of each question; equations or diagrams can be drawn by hand. Sections marked with * or in italics for PhD students only.*

1. 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 hand out 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 economies?

2. External adjustment in perspective or why the IMF hates inflation: [DeVries](#) argues the 1946 Bretton Woods agreement made external balance a "policy" problem? a) Briefly explain how balance of payments adjustment takes place "automatically" under the gold standard or with floating exchange rates. b) How do countries “break the rules” under both “automatic” systems? (hint: consuls and dirty floats). b) 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 are these roles similar? How are they different? c) *Why does the IMF have so few clients right now? Why don't OECD countries (apart from Mexico) generally need to borrow from the IMF any more? If everyone had floating exchange rates and open capital accounts would we still need an institution like the IMF?*

3. Getting to know the real exchange rate: 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 is this confusing in graphs and diagrams for us but clearer for them? (Consider the market for dollars diagram with $1/q$ or p/ep^* on the vertical axis). (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 e fixed? (*d) (Phd students) Write out an expression for $\Delta q = q_t - q_{t-1}$ (use π and π^* for changes in p and p^*). What happens to the RER if home inflation exceeds foreign inflation and e is fixed?

4. The Absorption Approach 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 current election debates in the U.S.—vaguely related to the big U.S. CA deficit—as an example if you like).

5. 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 and devaluation can reduce a current account deficit. Briefly review a few advantages and disadvantages of each adjustment 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 could be complementary, as opposed to alternative adjustment strategies.*

6. Financial Programming (aka the Polak or MABP model): Using the class handout and the [DeVries](#) reading: 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? Why is does this simple prescription appear to be so universal? c) What simplifying assumptions does this approach make in order to get simple and universal policy formula? Why are these assumptions acceptable in the short run, and perhaps more so during the Bretton Woods era?

6. Global inflation is falling and converging, despite a recent financial crises and a trend toward more flexible exchange rates in several countries with a history of high inflation (for example, Russia, Argentina and Brazil). Private capital flows remain high compared to official flows (GDF figure 1) and capital and current accounts remain open despite the misgivings of many economists regarding capital account liberalization. Rich OECD countries, especially the U.S. are borrowing (running current account deficits) while many developing countries are running big current account surpluses (figure 2) and accumulating nearly one trillion in U.S. dollar reserves. Finally, the use of the dollar as alternative currency continues at high levels in many countries. Finally, spreads on bond yields have begun to decline (figure 3) and the Argentine crisis has been more or less isolated to Argentina. a) Discuss the potential connections between these trends. Give a positive/negative, short/long term interpretation of these trends if you can.

7. What does Goldstein argue caused the Asian currency crisis of 1997-98? Use the elasticities approach to discuss how a decline in exports and capital inflows affected Asia's current account. Use the absorption approach to explain how the investment boom in countries like Indonesia affected the current account. Use financial programming to discuss how rapid credit expansion affected real estate prices and the real exchange rate. 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? 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?

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? How might a RER appreciation result from faster growth? What is the key difference between these two RER appreciations?

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? How might a RER appreciation result from faster growth? What is the key difference between these two RER appreciations? 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? How might a RER appreciation result from faster growth? What is the key difference between these two RER appreciations?