Fordham University | **Crises, Poverty and Adjustment in LDCs** | **ECGA 5450**
D. McLeod | **Problem Set #2 v3** | **Fall 2015**

Please read the revised version of the Elasticities Approach handout. *Sections in italics are optional,* sections in **red are for PhD students only.** If there is anything you do not understand in that handout please ask in class (E-530 starting at 7:15pm if possible just review questions until 7:30pm)

2.1 Exchange rate flexibility (fear of floating) question: a) Take a look at a few nominal exchange rates from country Groups A and B (listed below). What do you notice in general about the fx trends in these two groups? Why do these patterns matter (hint: graduation)? PhD students: relate these exchange rate movements to the Frenkel and Vegh's notion of graduation b) List at least one country where you can see the GFC or the Taper Tantrum (early 2013) in their exchange rate movement? What is that country or countries? (one or two are fine). What do these exchange rate movements signal? C) Why does the dollar cost more than one currency unit in most countries? An important exception is the Euro and the British pound (although for a time the Euro was 85 cents). Given the specter of secular stagnation why might it better to have a currency worth less than a dollar? D) The Brazilian Real and the Mexican pesos hit record lows recently. Is this good news or bad news for peopling living in these countries? (Original sin matters, but assume their net foreign asset positions are not that bad, which they are not). *Take a look at Brazil's and Mexico's exports on the MIT complexity site (see Brazil below). Which country is likely to benefit most from depreciation? Explain.* Which country has devalued the most in the past few months (compute the rough % change in the nominal rate) E) Briefly, why don't all countries just use devaluation (the 1st Arrow) cope with sudden stops and other debt or balance of payments problems?

2.2 Real vs. Nominal exchange rates a) Referring to Figure MX-1 below, why was the nominal peso rate depreciating while the RER appreciated from 1995 to 2003 (more or less)? At 17-18 per dollar in what sense has the peso reached a record low and in what sense has it not? B) When was the last record low for the Brazilian Real (see B-3 below) who was about to be elected that year? Relate this to the Sunday's election result in Greece. (hint: pensions).

2.3 The Absorption Approach (see the MABP handout for review) A) Starting with Y = A + X – M – r*eD* where A = C + I + G show that when Y – C = S + T and the government budget is balanced (G=T) the CA surplus equals S-I (where recall CA = X – M + r*eD*. Briefly summarize in words what S – I implies about CA deficits. B) How does Mexico's 1948 crisis illustrates the basic insight of this approach (De Vries) Defining absorption as A = C + I + G, explain the common 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 reducing a CA deficit (adjustment) was bound to be bad news for the poor? How can the burden of CA adjustment be shifted to the rich (hint Piketty)? *d) Distinguish the term "absorb aid" from "absorption" a with the "absorption approach" Y – A = CA. How are these concepts are related, how are they different? What does the absorption approach focus on that the elasticity approach assumes constant?*

2.4 Financial Programming (aka the Polak or Monetary Approach to the BoP model): Using the MABP class handout, and DeVries (a) What causes of balance of payments or currency crises according to 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 prescriptions does this model imply? What simplifying assumptions does financial programming approach make to get ceilings (targets) for the domestic money supply (L) and government spending (G) and a floor for reserves R? Briefly provide rationalize each target. C) What happens if the IMF underestimates future inflation? Why does this forecast bias lead to overkill, an excessively large recession and rise in R? *D) Phd students only 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? (E) The IMF to some extent remains a short term crisis lending facility, a revolving fund financed by member countries. How does this short 1-3 year perspective influence 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 did the BRICS and CAF countries form regional bailout facilities similar to the IMF? What have the large East Asian countries do to avoid returning the IMF? What about swap lines during the 2008 GFC. Would the world be better off if Asia and Latin American held lower levels of dollar reserves?*

2.5 T**he best use of foreign aid:** (look at the Aid and Adjustment in Africa lecture notes , the Marshal Plan and the Macroeconomics of Aid Handout and 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) *Use 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 economies*

Eichengreen, Barry, Ricardo Hausmann, and Ugo Panizza. "The pain of original sin." Other people's money: Debt denomination and financial instability in emerging market economies (2005): 13-47.
http://eml.berkeley.edu/~eichengr/research/ospainaug21-03.pdf

You don't need these right now, but the USDA ERS provides trade weighted real exchange rates using CPIs for both foreign and domestic prices and agricultural trade **weights** www.ers.usda.gov/data-products/agricultural-exchange-rate-data-set.aspx

Group A

Indonesia http://www.xe.com/currencycharts/?from=USD&to=IDR&view=10Y

Malaysia http://www.xe.com/currencycharts/?from=USD&to=MYR&view=10Y

Brazil http://www.xe.com/currencycharts/?from=USD&to=BRL&view=10Y

India http://www.xe.com/currencycharts/?from=USD&to=BRL&view=10Y

Poland http://www.xe.com/currencycharts/?from=USD&to=PLN&view=10Y

Mexico http://www.xe.com/currencycharts/?from=USD&to=MXN&view=10Y

Colombia http://www.xe.com/currencycharts/?from=USD&to=COP&view=10Y

Chile http://www.xe.com/currencycharts/?from=USD&to=COP&view=10Y

Nigeria http://www.xe.com/currencycharts/?from=USD&to=COP&view=10Y
Mozambiqu http://www.xe.com/currencycharts/?from=USD&to=COP&view=10Y

Israel http://www.xe.com/currencycharts/?from=USD&to=COP&view=10Y

Japan http://www.xe.com/currencycharts/?from=USD&to=JPY&view=10Y

Peru http://www.xe.com/currencycharts/?from=USD&to=PEN&view=10Y

Korea http://www.xe.com/currencycharts/?from=USD&to=KRW&view=10Y

South African Rand http://www.xe.com/currencycharts/?from=USD&to=ZAR&view=10Y

Dollars per Euro http://www.xe.com/currencycharts/?from=EUR&to=USD&view=10Y

Group B:

China http://www.xe.com/currencycharts/?from=USD&to=CNY&view=10Y

Dom Rep http://www.xe.com/currencycharts/?from=USD&to=DOP&view=10Y

Argentina http://www.xe.com/currencycharts/?from=USD&to=ARS&view=10Y

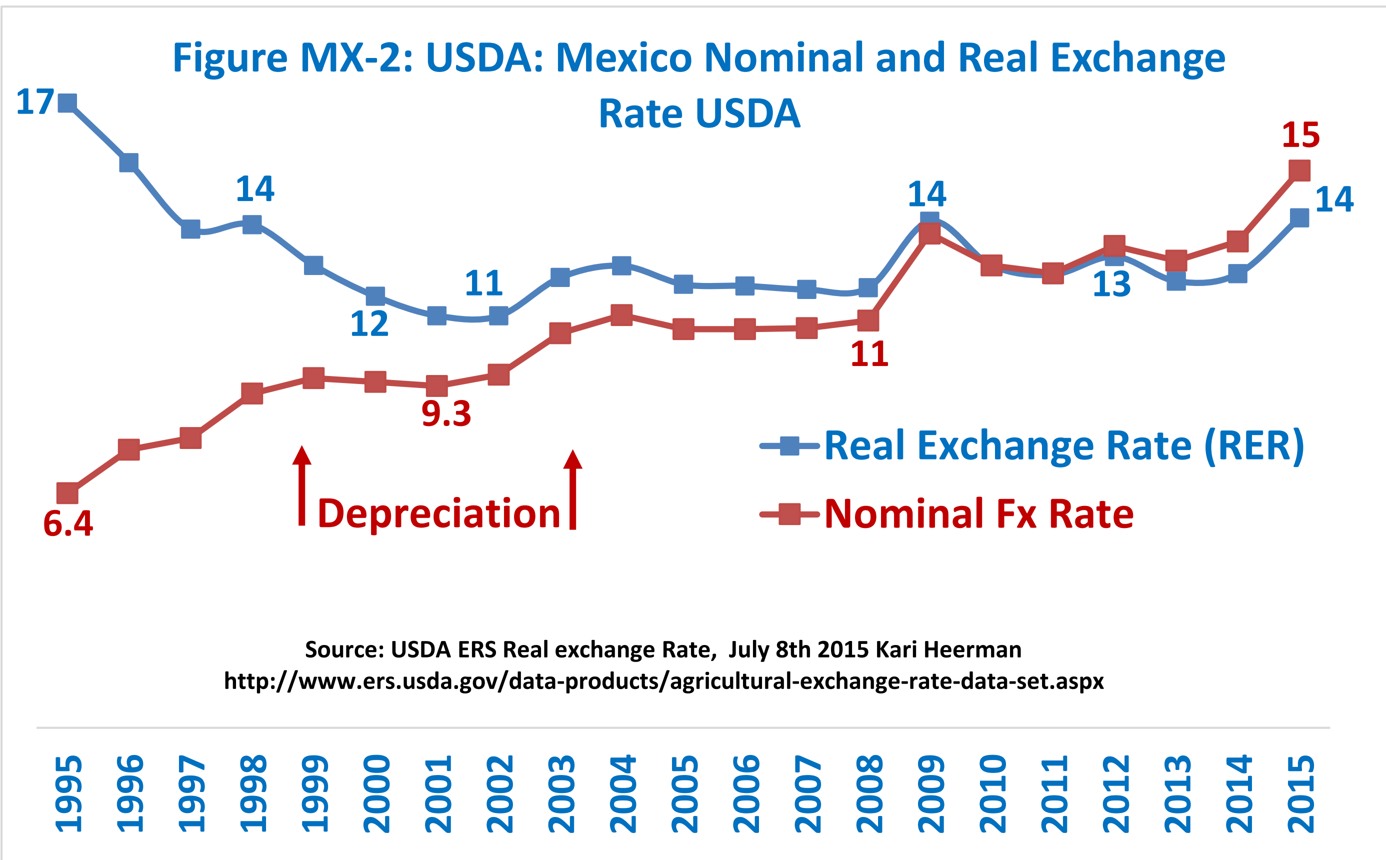
Venezuela http://www.xe.com/currencycharts/?from=USD&to=VEF&view=10Y

Bangladesh http://www.xe.com/currencycharts/?from=USD&to=BDT&view=10Y

Ghana http://www.xe.com/currencycharts/?from=USD&to=BDT&view=10Y

Bolivia http://www.xe.com/currencycharts/?from=USD&to=BDT&view=10Y

Vietnam http://www.xe.com/currencycharts/?from=USD&to=VND&view=10Y



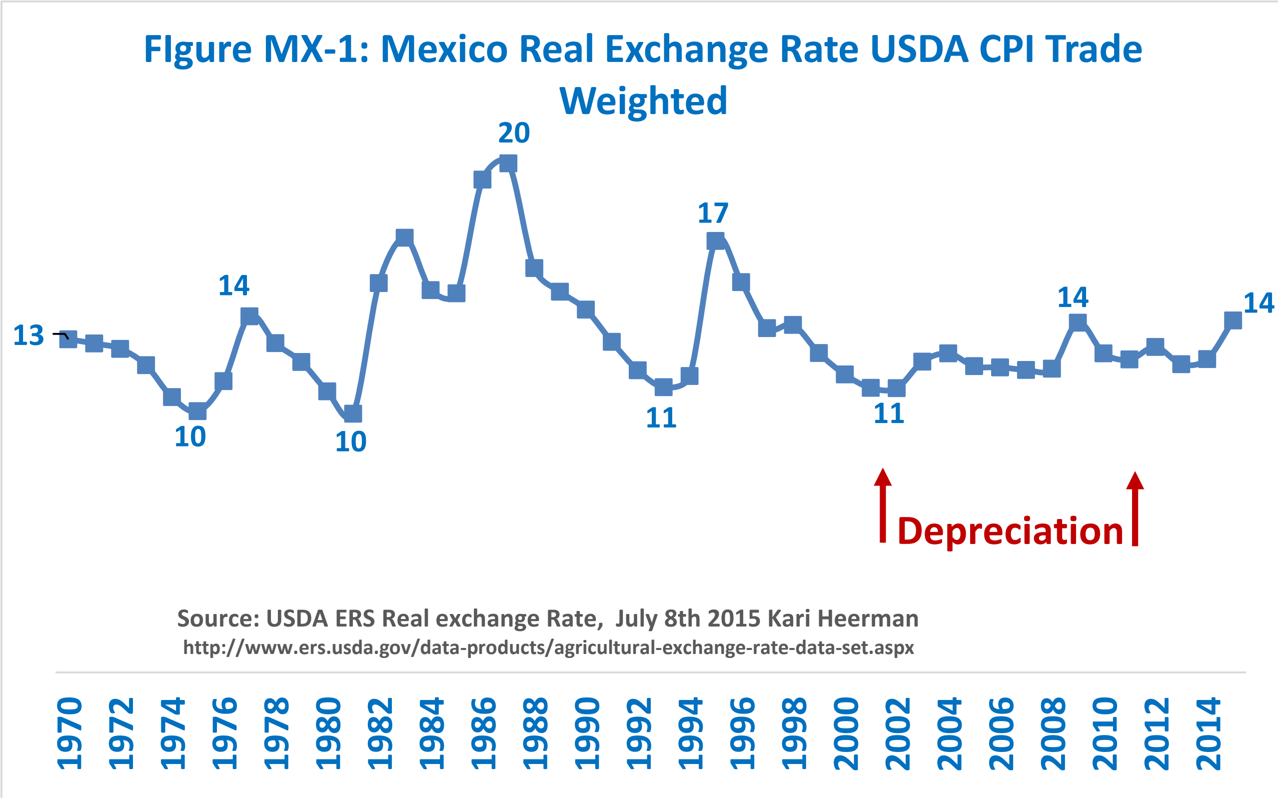


FIgure MX-1: Mexico Real Exchange Rate USDA CPI Trade Weighted
20
17
14
14
14
13
10
10
11
11
Depreciation
Source: USDA ERS Real exchange Rate, July 8th 2015 Kari Heerman
http://www.ers.usda.gov/data-products/agricultural-exchange-rate-data-set.aspx
1970
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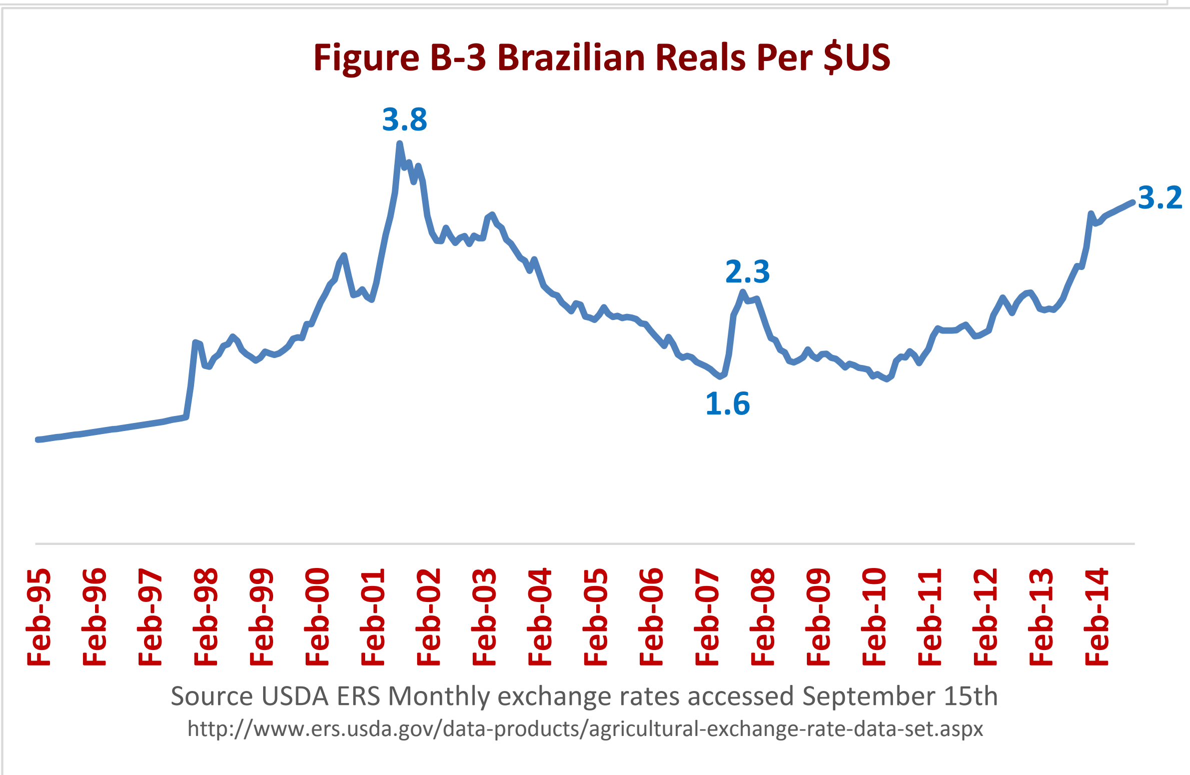
Figure B-3 Brazilian Reals Per $US
3.8
3.2
2.3
1.6
Feb-95
Feb-96
Feb-97
Feb-98
Feb-99
Feb-00
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Feb-03
Feb-04
Feb-05
Feb-06
Feb-07
Feb-08
Feb-09
Feb-10
Feb-11
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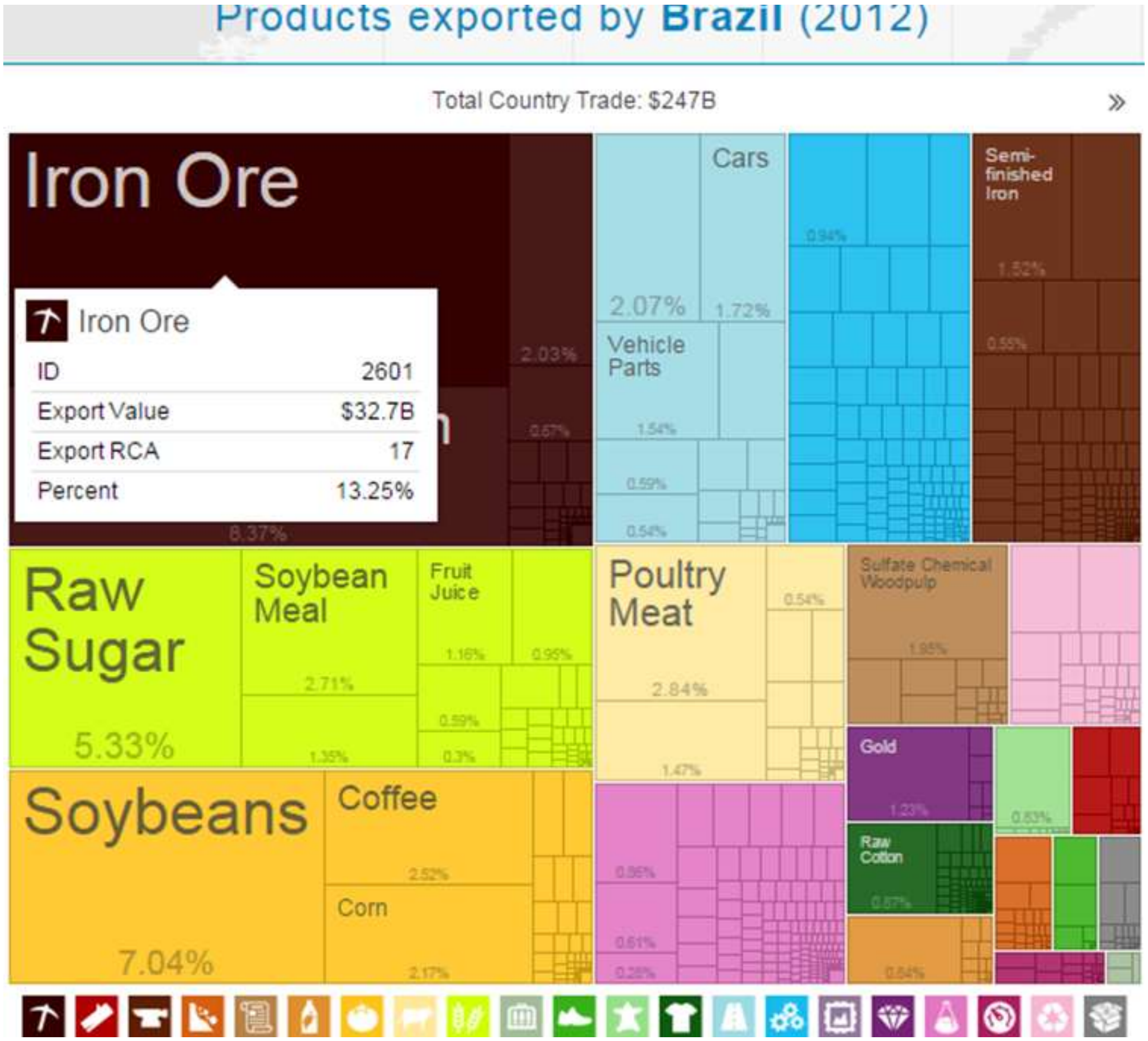
Feb-14
Source USDA ERS Monthly exchange rates accessed September 15th
http://www.ers.usda.gov/data-products/agricultural-exchange-rate-data-set.aspx



Brazil exports
https://atlas.media.mit.edu/en/explore/tree_map/hs/export/bra/all/show/2012/
Mexico Exports
https://atlas.media.mit.edu/en/explore/tree_map/hs/export/mex/all/show/2012/

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