15.012, Spring 2003 **Prof. Forbes**

Study Questions

THE BASIC TOOLS OF ECONOMIC MANAGEMENT

I. The German Hyperinflation, Monetary Policy and the Velocity Theory

After Germany lost World War I, the democratic Weimar republic replaced the empire of William II. This case is a compilation of articles describing this inter-war period in Germany. It provides an introduction to monetary policy and the tradeoffs facing governments with significant budget deficits and debt burdens. The case also shows the costs of hyperinflation and the difficulty ending an inflationary spiral. Much of the critical information can be found in the exhibits at the end.

What different strategies could the Weimar republic have used to finance (or reduce) its budget deficit?
What are the problems with each of these strategies? In particular, what is the problem with printing money?
How did the German government finally stabilize the economy?
If you ran a branch office of a large multinational firm in a foreign country, how could you modify operations to adapt to high inflation?

II. The Great Depression, Fiscal Policy, and the AS-AD Model

The first case discusses causes of the Great Depression and the muddled response of the Hoover administration. The second article discusses the Keynesian strategy for ending the Depression and introduces the philosophy underlying Keynesian economics. The third article places this philosophy in the context of today's situation in the U.S. This series of articles introduces fiscal policy and the different assumptions underlying Keynesian and Classical economics.

What did Hoover do to promote a U.S. recovery?
What would a Keynesian economist recommend to promote a recovery? What would a Classical economist recommend?
What are the advantages of tax cuts versus increased government spending versus easing monetary policy? What are the disadvantages of each?
Would you characterize the U.S. government in the year 2003 as Keynesian or Classical?

III. The Reagan Plan, National Income and Balance of Payments Accounting

When Reagan took office in 1981, he faced an economy with high inflation, high unemployment, high interest rates, and low growth in income and productivity. He proposed an aggressive set of programs to address each of these problems. Underlying his policies was a belief in "supply-side" economics. This case provides an excellent summary of monetary and fiscal policy as introduced in the proceeding two lectures. It also provides a platform for introducing national income accounting and balance of payments accounting.

What were the major problems with the U.S. economy when Reagan took office in 1981? (Use the exhibits at the end).
Would expansionary monetary or fiscal policy have been effective in 1981? Why or why not?
What assumptions implicitly support Reagan's supply-side proposals? Are they valid?
Is the Bush administration's current tax proposal a supply-side policy? Why or why not?

Study Questions (cont.)

DEVELOPMENT STRATEGIES

IV. Singapore, Productivity Growth, and Solow Growth Accounting

This case reviews the economic and political performance of Singapore from independence through the summer of 1992, when Goh Chok Tong replaced the dynamic Lee Kuan Yew as Prime Minister. It highlights the various roles that the state can play in economic development and the importance of savings and investment in Singapore's impressive growth performance. The technical note discusses various measures of productivity and the role of capital accumulation vs. technological progress in Singapore's growth.

What factors and policies drove Singapore's "miraculous" growth performance since 1965?
What was the role of technological progress in Singapore's development? Why is this important?
Should Singapore's government change its strategy in August of 1992? If so, how?
Could Singapore's model of development be applied to other low-income countries? What characteristics are necessary for it to succeed?

V. Zambia, Natural Resource Dependence and Import-Substitution Policies

During the 1960's, Zambia's import-substitution, state-controlled approach to development appeared successful. When the world price of copper fell in 1971, however, problems with this strategy quickly became apparent. Real GDP per capita halved between 1974 and 1991 and Zambia became one of the world's most indebted nations. Since the 1970's, Zambia has frequently been on the brink of crisis. This case describes a number of challenges faced by countries with abundant natural resources. The short article describes Zambia's current situation and reflects the long-term effects of its earlier policies.

What were the key tenets of Kaunda's development strategy from 1968-74? Why did this strategy fail?
What was the role of copper in Zambia's development? Did this abundant natural resource help or hinder Zambia's progress?
What different exchange-rate regimes did Zambia adopt? How did these affect economic performance?
Are countries with abundant natural resources destined to grow slowly and experience frequent financial crises?

VI. Argentina, Currency Boards, and the IS-LM Model

This case begins with detailed historical background on Argentina's adoption of several different development models. The later half of the case focuses on Menem's aggressive reform strategy, centered on the "convertibility plan" to control inflation. The case shows the initial success of these policies, as well as the inherent vulnerabilities that helped precipitate Argentina's recent crisis.

What are the costs and benefits of fixed versus flexible exchange rates?
What is a currency board? How does it differ from a pegged exchange rate? What are its advantages and disadvantages?
How is dollarization different than a currency board?

Study Questions (cont.)

VII. <u>Chile, Floating Exchange Rates, and the Inconsistent Trinity</u>

This case surveys Chile's economic and political history in some detail. Under Allende, Chile followed an import-substitution, state-controlled approach to development. In 1973, however, Pinochet took control of the government and adopted a series of laissez-faire policies. These policies covered all aspects of the economy, from trade to social security, and initiated a decade of rapid growth and development. Since Chile was highly dependent on revenues from copper exports during its early stages of development, and is a neighbor of Argentina, Chile's success provides an excellent comparison with the experiences of Zambia and Argentina.

How were Allende's economic policies similar to those followed by Zambia? How were Pinochet's policies different from those in Argentina and Zambia?
What exchange rate regimes did Chile follow? How did these affect economic performance?
Which policies created a macroeconomic environment attract for investment and business growth?
How did Pinochet reform social security in Chile? How does this affect growth performance?
Does Chile’s experience prove the success of a “western consensus” model of development?

VIII. <u>China, Transition and Corruption</u>

After tracing China's turbulent history in some detail, this case describes the program of gradual reform launched by Deng Xiaoping in 1978. It outlines the major phases of these reforms and ends with a number of challenges facing China as it enters the 21st century. The case raises critical questions about the sequencing of economic liberalization, the priority of economic versus political reforms, and the means of creating capitalism in a non-market economy. An additional note discusses issues related to the transition from communism to capitalism, and the second note discusses how bribery and corruption can hinder growth and development.

What major reforms were undertaken by Deng Xiaoping? What beliefs drove this approach to reform?
What are the advantages and disadvantages of a “cold turkey” approach to transition versus the more “gradual” approach followed by China?
What challenges will this "gradual" approach to transition need to overcome in the future?
Is corruption harmful to growth? Why or why not?

EMERGING MARKET CRISES

IX. <u>The Mexican Peso Crisis and BB-NN Model</u>

This case describes the background to and direct aftermath of the 1994 Mexican peso collapse. After 1987, Mexico embarked on a program of macroeconomic stabilization and structural reform. Financial capital flooded into the country. In 1994, however, the government faced a severe financial crisis and was forced to devalue the peso. The resulting recession, capital outflow, and collapse in the value of the peso was much more severe than anyone predicted.

What caused the peso to collapse in December of 1994? How important were short-term external influences versus structural problems internal to Mexico?
Could Mexico have avoided the peso collapse in 1994? If so, how?
What could Mexico have done differently after the initial devaluation in December to minimize damage to the economy?

Study Questions (cont.)

X. The Asian Crisis, Moral Hazard, Speculative Bubbles, and Contagion

The first reading summarizes the timeline of the Asian crisis and presents several different opinions on what caused these events. The next article discusses how crises spread across countries, with a focus on the transmission of the 1997-98 crisis across Asia. The final series of (optional) articles discusses the longer-term impact of the crisis and the current situation in Asia. Most of these readings focus on financial causes of the crisis—such as related bank lending, moral hazard, and the role of speculation.

What caused the East Asian crisis? How important were short-term external influences versus structural problems internal to the region?
Why is the banking sector so important in preventing currency crises and minimizing their impact?
What causes speculative bubbles? Can anything be done to avoid them?
What is contagion? How are crises transmitted across countries? What countries (if any) were subject to contagion during the Asian crisis?

XI. Predicting and Avoiding Currency Crises, Capital Controls

The first reading provides a brief historical review of currency crises and then presents a description of several unidentified countries that could be vulnerable to a crisis. Carefully study each example and be prepared to discuss which countries you think will experience a crisis. The second reading discusses the advantages and disadvantages of capital controls. The final reading discusses several additional proposals to reduce country vulnerability to crises in the future.

What statistics would you suggest monitoring as early indicators of a crisis?
What other (potentially non-economic) factors are important determinants of a country's vulnerability to a crisis?
What are the costs and benefits of capital controls?
What other policies could reduce a country's vulnerability?

CHALLENGES FACING DEVELOPED COUNTRIES IN THE 21st Century

XII. European Monetary Union, Optimal Currency Areas and Pension Reform

This case describes the evolution of European integration. It discusses the various initiatives, acts, and agreements that have provided the framework for integration and explains how these acts have been implemented. It also evaluates some of the challenges facing European Union—and currency unions in general. The last article discusses one particular challenge – social security reform.

What is Europe trying to achieve through integration? What are the costs?
What are the Maastricht criteria? Why are they important? What will happen if countries do not observe the fiscal criteria?
Which countries gain the most from European integration? Which countries gain the least?
Should England adopt the euro? What factors affect this decision?
What are the costs and benefits of social security reform?

Study Questions (cont.)

XIII. <u>France, Unemployment versus Inequality, the Philips' Curve</u>

Until 1975, unemployment in France was very low and significantly lower than in the U.S. Since then, however, French unemployment has risen dramatically, remaining well over 10% during the 1990's. This case discusses the causes of high unemployment in France (and Europe as a whole) and the tradeoff between high unemployment and low wages. It traces the history of legislation meant to address this problem and shows the difficulty in gaining popular support for the necessary measures.

What are the primary causes of French unemployment?
What policies could the French government undertake to reduce employment? What are the advantages and disadvantages of each of these policies?
How does European integration affect unemployment in Europe? What is the effect of the euro?
Compare the U.S. social model to the European model. What are the advantages and disadvantages of each model? Where would you rather live? Where would you rather invest?
How are inflation and unemployment related? How do oil prices affect this relationship?

XIV. <u>Japan, Deflation, and Liquidity Traps</u>

After World War II, Japan followed a development strategy that led to thirty-years of unprecedented, rapid growth. Japan's strategy appeared to be a success until the "bubble burst" in the early 1990's. The resulting recession and loss of confidence has been much more severe and prolonged than anyone predicted. This series of article discusses Japan's current situation, the government's mixed record of reform, and the country's prospects for recovery.

What caused the economic crisis of the 1990's? Differentiate between short-term causes of the stock market crash, structural problems with the economy, and reasons why the recession has not ended.
What policies would you propose to facilitate Japanese recovery? What are the advantages and disadvantages of each of these measures?
What causes deflation? Why are lower prices a concern? What can be done to end deflation?

XV. <u>The U.S., the "New Economy", and Current Account Deficits</u>

This case discusses the recent economic performance of the U.S. and provides an excellent complement to the previous case on Japan. It presents a number of different views on the period of rapid productivity growth in the 1990's, and whether this "new economy" is sustainable. A brief article on poverty and inequality in the U.S. provides a sharp contrast to the European social model. The final reading discusses whether the large U.S. current account deficit is a serious concern.

What are the advantages and disadvantages of the U.S. versus the European social model?
How did the US economy grow so quickly in the later half of the 1990's with minimal inflation?
Is the U.S. today in a similar situation as Japan was in the early 1990's? Could the U.S. be on the verge of a prolonged recession? How are the situations similar and different?
What would you recommend if you were Greenspan? If you were Bush?
Is the U.S. current account deficit a problem? Why or why not?

Study Questions (cont.)

XVI. <u>Globalization and Trade</u>

Economies around the world are rapidly becoming more closely integrated through trade and financial markets. Companies are increasingly forced to think on a global scale. This series of readings addresses a number of costs and benefits of globalization. Free trade, working through comparative advantage, can improve the welfare of individuals around the world. Yet, as shown in the recent riots at Seattle and Prague, free trade can also generate unemployment, social dislocation, and environmental concerns. The debate on "free" versus "fair" trade has only begun.

Who gains from free trade? Who loses?
Could a large developing economy (i.e. China or India) gain from reducing global integration through policies such as tariffs and capital controls?
Should trade policy be linked to labor policy and/or environmental policy?
What should be the priorities on Bush's trade agenda for the U.S.?
Are the criticisms against globalization and the IMF justified?