

## Study Questions

### ***THE BASIC TOOLS OF MACROECONOMIC MANAGEMENT***

#### **I. The German Hyperinflation and the Velocity Theory**

After Germany lost World War I, the democratic Weimar republic replaced the empire of William II. The new government was faced with a series of difficult choices—and its decisions led to a traumatic period of hyperinflation which framed German economic policy for decades. The case 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? 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. Alan Greenspan, Monetary Policy, and the IS-LM Model**

This class focuses on the United States to provide a more detailed analysis of how monetary policy is conducted in most countries today. Much of the reading focuses on Alan Greenspan—his life, his approach to monetary policy, his decisions during uncertain periods, and his legacy. The recent transition from Greenspan to Bernanke as Chairman of the Federal Reserve Board raises a number of questions about how monetary policy is best conducted in developed economies—such as the role of inflation targeting, transparency, and asset prices.

How does the U.S. Federal Reserve affect interest rates? How would you rate Greenspan's legacy? What should be the primary goals of a central bank? For example, should a central bank target inflation, deflation, growth, employment, stock prices and/or housing prices? If a central bank always "bails out" investors when asset prices fall, does this lead to excess risk-taking? Is inflation targeting a good policy for the United States? What about other countries?

#### **III. 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 compares the historic legacy of Keynes with that of Friedman. 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 from the Great Depression? 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 current U.S. government as Keynesian or Classical?

#### **IV. The U.S. Recession in 2001, National Income and Balance of Payments Accounting**

When President George W. Bush took office in 2001 the U.S. had just experienced a bursting of the high-tech bubble and the economy was entering a recession. Risks to the economy continued to increase after the terrorist attacks of 9/11, a series of corporate governance scandals, slow growth abroad, and wars in Afghanistan and Iraq. The Bush Administration passed an aggressive series of tax cuts to ensure an economic recovery and also to raise long-term economic growth. Underlying some of these tax cuts was a belief in "supply-side" economics. This reading 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 Bush took office in 2001?  
Were the tax cuts an appropriate response? What other options would you have recommended?  
What supply-side assumptions implicitly support the tax cuts? Are they valid?  
What long-term affects will these policies have on the U.S. balance of payments (i.e., trade deficit)?

### ***DEVELOPMENT STRATEGIES***

#### **V. 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 today? If so, how?  
Could Singapore's model of development be applied to other low-income countries? What characteristics are necessary for it to succeed?

#### **VI. Zambia and Natural Resource Dependence**

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. A short article also provides a brief overview of Botswana's development—another African country with abundant natural resources. Zambia's current situation provides a striking contrast with the prior case of copper-exporting Chile.

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 crises?

## **VII. Chile, Exchange Rates, and the Open Economy IS-LM Model**

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, following the tenets of the "Chicago boys". These policies covered all aspects of the economy, from trade to social security to banking system reform. The result was a period of spectacular economic growth—making it the star performer of Latin America—although this growth did come with costs.

What were the key components of Pinochet's economic strategy? How did it differ from Zambia's development strategy under Kaunda?

What exchange rate regimes did Chile follow? How did these affect economic performance?

Which policies created a macroeconomic environment attractive for business and investment?

How did Pinochet reform social security in Chile? How does this affect growth performance?

What lessons can other countries learn from Chile's economic development?

## **VIII. Currency Unions, Optimal Currency Areas and E.U. Expansion**

The first reading provides an overview of the different exchange rate regimes and monetary arrangements that currently exist around the world—helping put the individual country examples of different exchange rates in a broader context. The case describes the evolution of European integration (and can be skimmed), and the challenges of currency union in the region. The third article discusses the GCC and its plans for a currency union. The final reading focuses on European enlargement more broadly, and the substantial benefits to new member countries.

What are the Maastricht criteria? Why are they important for the formation of a currency union? What are the implications of the general disregard (and recent reform) of the fiscal deficit criteria?

Which countries gain the most from European integration? Which countries gain the least?

Should Turkey adopt the euro (assuming that the EU voted yes)?

Should East Asia form a currency union?

## **IX. China and the Inconsistent Trinity**

The first reading provides a succinct evaluation of China's economic progress, the drivers of its success and its immediate challenges. The longer case traces China's program of gradual reform in much more detail (and the historical section can be skimmed). The case focuses on China's ongoing dilemma on whether and how to adjust its pegged exchange rate. The final article discusses China's massive accumulation of foreign currency reserves related to its current exchange rate policy.

Which of China's reforms were most important in driving its recent growth and development?

What are the major challenges China faces in the next decade?

Should China continue to maintain an exchange rate regime that basically pegs the yuan to the dollar? If not, what changes should China make?

What are the risks of maintaining the peg? What are the risks of allowing the exchange rate to float?

**X. Aid, Trade, Debt Relief and the Washington Consensus: What Should the World Be Doing to Fight Poverty?**

Tony Blair—with the help of many activists including U2’s Bono—put aid, debt relief and Africa at the top of the global agenda in 2005. This selection of readings presents a range of different views on these issues. The articles present different opinions on foreign aid, focusing on what role developed countries should play in fighting poverty in developing countries. The articles also include different arguments on how aid can be most effective—an issue critically important to gain political support for increased aid flows. There is no easy answer to these difficult questions—and the selection of readings is meant to present a range of opinions frequently heard in these heated debates.

Is the Washington Consensus the best model for development?

Should developed countries increase aid flows to developing nations? If so, are there better ways to provide aid to ensure that it is effective?

Should aid be provided to countries with high levels of corruption?

Should developed countries be focusing on other mechanisms—such as debt relief, trade liberalization, or fighting global diseases (such as AIDS)—instead of (or in addition to) providing aid flows?

## ***EMERGING MARKET CRISES***

**XI. The Mexican Peso Crisis and BB-NN Model**

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 outflows, 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?

**XII. The Asian Crisis, Moral Hazard, Speculative Bubbles, and Contagion**

The first reading discusses the series of crises that swept across Asia in 1997 and 1998—providing an overview of the countries affected by the crisis, the causes of the crisis, and a chronology of how events unfolded. The next article discusses how crises spread across countries, with a focus on the transmission of the 1997-98 crisis across Asia. The final article 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 inefficient 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?

Were the current account deficits in Asian countries (before the crisis) a cause of concern?

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?

### **XIII. The Argentine Crisis, Currency Boards, and Currency Mismatch**

At the end of 2001 Argentina abandoned its currency board, sharply devalued the peso and defaulted on its debt. Although this crisis had been widely expected—the situation deteriorated much faster and more dramatically than in other crisis countries. Argentina “pesofied” its economy and imposed limits on bank withdrawals and capital flows. Although Argentina has recently experienced several years of strong growth, the crisis of 2001 was far more devastating to the country and the economy than in most other recent crises. Argentina continues to set global precedents in its controversial debt restructuring.

What is a currency board? What are its advantages and disadvantages?

Could Argentina have prevented the crisis from occurring? If so, how?

Once the crisis started in Argentina, would you have recommended a different set of policies?

How will Argentina’s debt restructuring affect global debt markets for emerging nations?

Could the international investment community help mitigate the risks of future crises—such as issuing growth-indexed bonds or changing benchmarking structures?

### **XIV. Predicting and Avoiding Currency Crises, Capital Controls**

The first two readings discuss the advantages and disadvantages of capital controls. Capital controls are often discussed as a means of reducing vulnerability to currency crises—although they have only had mixed success and can generate substantial economic costs and distortions. The third article discusses Thailand’s recent (and brief) experiment with new capital controls. The final 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. Skim the historical material, but then carefully study each example and be prepared to discuss which countries you think will experience a crisis.

What are the costs and benefits of capital controls?

Why did Thailand recently implement controls on capital inflows?

Should China and India be lifting their capital controls more rapidly?

What statistics would you suggest monitoring as early indicators of a crisis?

Which of the countries in the last reading are most likely to have a crisis? Why?

## ***CHALLENGES FACING DEVELOPED COUNTRIES IN THE 21<sup>st</sup> Century***

### **XV. The U.S. Current Account Deficit and Global Imbalances**

The U.S. current account deficit was almost \$900 billion in 2006, equivalent to over 6.5% of GDP. This is the largest current account deficit that any country has ever run—although other countries have run larger deficits when measured as a share of GDP. This U.S. deficit is balanced by large current account surpluses in other economies—especially in Asia and oil-producing nations. Foreigners have been willing to finance this deficit at a low cost—so far. These current and capital account deficits and surpluses reflect imbalances between savings and investment in different countries. Many analysts are worried that this system of global imbalances can not go on, and that the adjustment process could involve a sharp economic slowdown, higher interest rates, and large currency movements in major economies around the world.

Is the U.S. current account deficit a problem? Why or why not?

Are current account surpluses in other countries a problem? Why or why not?

How has the financing of the U.S. current account deficit changed? Is this important?

How are national savings and investment rates related to global imbalances?

What policies should the major economies adopt to reduce global imbalances?

## **XVI. Iraq and the Transition to a Market Economy**

Under Saddam Hussein, Iraq's economy was dominated by the oil sector and largely government run, with most private sector employment in the informal (and unreported) sector. After the 2003 war, Iraq had the opportunity to rebuild its devastated economy—with the help of technical expertise from abroad, inflows of foreign capital, and debt relief. Before handing authority back to the Iraqis, the Coalition Provision Authority attempted to stabilize and reform Iraq's economy along market lines. Reconstruction efforts yielded some initial successes, but progress was continually hampered by the unstable security situation. Iraq's rebuilding provides a sobering example of the challenges in transitioning an economy from a state-run to market-based economy.

What were the key components of Hussein's economic development strategy?

What were the primary economic goals of the Coalition Provision Authority? What were the main challenges hindering these goals?

What should Iraq's current government be focusing on in order to strengthen Iraq's economy? In particular, should Iraq be taking steps to avoid the "Dutch Disease"?

## **XVII. Globalization and the Rise of China: What Does it Mean for the U.S.?**

China's emergence as a major economic player and participant in the global trading system is creating opportunities and challenges for the global economy. Inexpensive exports from China allow foreign consumers to buy more at lower prices—but simultaneously increase competitive pressures in some industries, especially for low-skill workers. Many companies have shifted production to China in order to reduce production costs, but this can create political problems at home. In the United States, it is politically popular to blame China for a host of problems—such as the U.S. trade deficit and manufacturing job losses. Although many of these claims are unjustified, China does have significant shortcomings in several areas—such as its weak protection of intellectual property rights and the environment. China's integration has accelerated the debate on the costs and benefits of globalization.

How has China's integration with the global economy affected global trading patterns?

Is China a major factor behind the U.S. trade deficit or manufacturing job losses in the U.S.?

Should trade policy be linked to labor policy and/or environmental policy?

What policies would you recommend to respond to globalization?

## **XVIII. Outsourcing, FDI and the Rise of India: What Does it Mean for the Global Economy?**

Over the last few years, there has been increased concern about jobs being "outsourced", "offshored", or "delocalized" to low-cost countries such as India. Although manufacturing jobs have been shifting abroad for decades, these concerns increased as white-collar jobs have also begun to move abroad. Although offshoring has increased—much of the public debate and popular arguments are based on misconceptions (as explained in the first reading). Often lost in the debate is the impact that offshoring can have on developing economies, such as India, that have welcomed these trends. Offshoring has also raised a number of concerns about the future sources of job creation in developed economies.

What is the magnitude of offshoring over the past few years? What is the likely impact in developed economies over the next decade?

What is the importance of "insourcing"? Should countries adopt policies to limit FDI?

How has offshoring affected the Indian economy? What do you expect the impact to be in the future?

If service jobs follow manufacturing jobs abroad, where will the new jobs come from?

What policies would you recommend to respond to public (and political) concerns about offshoring?

### **XIX. France, High European Unemployment, and the Philips' Curve**

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 much of Europe) 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. The problem of high unemployment continues to spark discontent in France—as evident most recently in the 2006 riots and looting in Paris.

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?

### **XX. Japan, Aging Societies, and Entitlement Reform**

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 lasted over a decade and was much more severe and prolonged than anyone predicted. The situation has finally improved, however, and reforms of the banking system and corporate structure are finally yielding benefits. Japan still faces significant challenges—including a large debt burden, normalizing monetary policy, and a rapidly aging population. Many other developed countries also face unprecedented demographic challenges as their populations age and governments are expected to provide pension and health care benefits—which have not been sufficiently funded.

What has helped drive Japan's recent recovery?

What fiscal and monetary policy would you recommend for Japan?

What causes deflation? Why are falling prices a concern? What can be done to end deflation?

How will aging populations affect growth and economic development? What should governments' be doing to prepare for aging populations?