



Agenda

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Review

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The German Hyperinflation – Part 1

Microeconomics

Quantitative and precise

vs.

Macroeconomics

Lots of theories to explain trends

Quantity Theory of Money

$MV = P(Q) (T)$, Assume M is constant

During inflation V increases (so P increases)

During deflation V decreases (so P decreases)



The German Hyperinflation – Part 2

How to Stop Inflation

Fiscal Policy – Raise taxes, cut spending

Monetary Policy – Shrink money supply, raise interest rates (i)

How to Stop Hyperinflation

Fiscal Policy and Monetary Policy don't work

Need some symbolic gesture to restore confidence in currency

Random Note on Inflation

Inflation is not bad or good, people just think it is bad



The Great Depression – Part 1

Deflation

Deflation is bad

Always wait to make a purchase

By holding cash you decrease V

Real interest rates and real value of debt increase

Real wages increase

Cause of Depression

Bank failure – like runaway inflation has to do with a loss of confidence

Cure for Depression

Monetary policy does not work during deflation, the only way to battle persistent deflation is through a massive fiscal stimulus – government spending is better than a tax cut



The Great Depression – Part 2

Make sure you know what each variable below means and how it changes:

$$Y = C + I + G + (X-M)$$

Be aware of the multiplier and investment accelerator



The Reagan Plan

Phillips Curve

Theory that inflation and unemployment are inversely related. Mostly true, but in true macroeconomic fashion can't explain everything

Crowding Out

$$\mathbf{S-I = (X-M) + (G-T)}$$

trade deficit gov't budget deficit

If $X-M = 0$ and $G-T = 0$, you only invest what you save

If you run a trade deficit ($X < M$), you can invest more than savings

If you run a gov't deficit ($G > T$), you must invest less than savings



Singapore

Productivity

Easy way to measure: output/hours

Correct way to measure: output/index of inputs (cap., lab., Natural Resources)

Complicated equation simplified: $\text{Output} = K^\alpha L^\beta$

$a+b=1$ constant returns to scale

Just think about capital intensive (European Ski slopes) or
labor intensive (agriculture in most countries)

Steps 1 and 2 in developing countries:

- 1) Mobilize resources (capital or labor)
- 2) Invest in skills and education



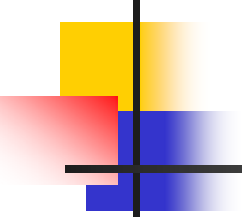
Chile – Part 1

Comparative Advantage

How efficiently you produce one product compared to another product. Key point is that with CA trade almost always improves efficiency.

Exchange Rates

Factor in country A	Change	Effect on Country A's currency
Interest rate in A	Increase	Appreciate
Inflation rate in A	Increase	Depreciate
Demand for A's goods	Increase	Appreciate
Country A output growth	Increase	Appreciate



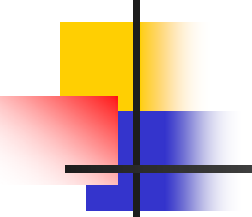
Chile – Part 2

Solution for Chilean problem

- 1) Privatize
- 2) De-Regulate
- 3) Run a budget surplus
- 4) Set up a Provident Fund
- 5) Free up trade
- 6) Free up exchange rate

What are these two items?

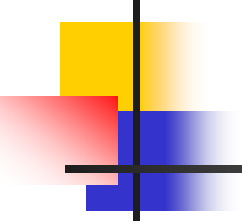




Mexico – Part 1

What do you do when are running out of foreign exchange reserves?

- 1) Let currency float
- 2) Raise interest rates to entice savings back in (reduces investment in ST)
- 3) Increase government budget surplus (gov't is increasing capital supply)
- 4) Tight monetary policy (#2) and fiscal policy (#3) drive you into a recession, you can't afford imports, and you correct your balance of payments



Mexico – Part 2

Anatomy of a crisis

1. Unsustainability (asset price bubble, BOP deficit, etc.)
2. Cannot and will not last
3. Time and Trigger unknown
4. Insiders will run first
5. Asset prices will fall
6. Collateral melts because of #5
7. Good loans default because of #6 → banks call loans
8. Banks will stop rolling over loans
9. Supplier credit disappears
10. Wealthy people will leave → value of currency decreases → real debts increases → more firms default and go broke



Asian Crisis – Part 1

Exchange Rate Systems

Least Flexible – Dollarization

Currency board

Fixed exchange rate

Crawling peg

Dirty flexible rate

Clean flexible rates

Depreciation = Market lowers value of currency

Devaluation = Government lowers value of currency that they were trying to hold fixed



Asian Crisis – Part 2

Strategy for Asian countries

Japan has highly skilled workforce and a lot of technology

China has a huge, inexpensive labor force

Strategy #1- Go upscale and try to do technology (have to compete with Japan)

Strategy #2- Lower wages (have to compete with China)

Strategy #1 probably trumps #2, China will force 3rd world countries to go for import substitution



Argentina

Use as review case



Russia

Capitalism is hard to start (even in a developed country)

1. Must go down before you go up
2. Property rights must be set up (people usually get killed over this)
3. Need a legal system and a system to enforce laws
4. Need a tax system
5. Need a banking system
6. Need a social welfare system
7. Need an accounting system
8. Need infrastructure

When transitioning from communism, you need to generate both sides of a trade, since the government was always the buyer or seller before



China

What was their strategy

1. Mobilized Labor
2. Focused on exports (Japanese model)
 1. Foreign companies invest in China and export products to rest of world (these guys make money)
 2. Foreign companies invest in China and sell product in China (these guys hope to build a brand and make money in 20+ years)

Random Notes

1. Don't always believe the #s, check the source and look for consistency in the data
2. Electricity grows @ 1.1X GDP



Uganda

Checklist for developing countries

1. Mobilize resources
2. Invest in skills (education)
3. Invest in infrastructure
4. Develop technology

Problem here is that before you can even do #1 you need to be organized



European Monetary Union

Free trade areas versus common markets

All free trade areas collapse. Why?

1. You get a crisis and it is easy to defect
2. Leveling down
3. Only goods move, not labor

EU common market:

Works because participants were all roughly equal going in

Harmonization: Safety, taxes, health&environment, labor market

Current issue: widening vs. deepening

Try to apply lessons from EU to other trade zones and agreements



France – Unemployment – Part 1

3 Easy ways to reduce unemployment

1. Set monetary and fiscal policy to stimulate demand
2. Reduce the labor supply
3. Lower wages

Thurow's solution

Cut payroll tax to zero (which of the above 3 ways is this?)

Increase the VAT to make up the shortfall

Factor Price Equalization

Companies move production facilities to achieve the lowest possible cost of factor inputs

If countries want the companies back then factor prices must adjust (e.g. wages decline)



France – Unemployment – Part 2

EU vs. US in terms of factor inputs

EU is a capital intensive system

US is a labor intensive system

Labor market flexibility (LMF)

With limited LMF small companies cannot grow big (they can't survive the inevitable downturns in the economy)

Role of unemployment

1. Lower wages
2. Forces people to move



Japan

Post WWII

1. Mobilized capital
2. Organized labor
3. Purchased technology
4. Strategy of follow the leader (US)
5. Government controlled banking system directing investment
6. Export-led model

Why can't they clean up the current mess?

Won't admit failure, no rules for bankruptcy, don't send people to jail, haven't felt enough pain, bureaucracy, labor market inflexibility, fiscal stimulus too small (need massive) and no more monetary policy possible since $i = 0$



Globalization

Over time there will be no more corporate taxes, countries will start paying companies to locate there

Problem with globalization

Race to the bottom (similar to leveling down)

Issues with globalization

Environment

Local culture

Intellectual Property Rights

Labor standards(child labor, safety, etc.)

Health

Income inequality

Random notes

superior vs. inferior goods, crisis of the common



Wage Inequality

Wage inequality comes with capitalism

Possible explanations for wage inequality

1. Inheritance
2. Hard to lose all of your wealth
3. Winner takes all
4. Bureaucracy
5. Compounding of talents
6. Luck

Why doesn't the system collapse?

People who have a lot of money give money back to those who don't