

Answer Outline

ECONOMICS 353 (SECTION 2)
EXERCISE 11: 6 POINTS TOTAL

L. Tesfatsion/Spring 04
DUE: Tuesday, April 13, 2:10pm

****IMPORTANT REMINDER: LATE ASSIGNMENTS CANNOT BE ACCEPTED – NO EXCEPTIONS****

EXERCISE INSTRUCTIONS:

- Please **fill in your name and student ID number** on Side 1 of your bubble sheet and write **353-2 Exercise 11** in the top margin of Side 1.
- Use a number 2 pencil to **mark your answers** on Side 1 of the bubble sheet to the first **FOUR** questions Q1 through Q4, below, which are in multiple choice format.
- The fifth question Q5 is a **TWO-POINT** Web-Browse Exercise. Please put your **name and student ID number** at the top of your answer sheet for Q5 along with **353-2 Exercise 11** and **separately** hand in your answer sheet for Q5 in addition to your answer bubble sheet for questions Q1 through Q4.
- Each question Q1 through Q4 is worth 1 point, and question Q5 is worth 2 points.

Q1. In GDP accounting for a two country world (HC and ROW), ROW saving in relation to the HC is defined to be _____ minus _____, where all amounts are measured in HC currency units.

- A. HC imports; HC exports
- B. ROW GDP; ROW consumption
- **C.** Total income received by ROW from the HC; HC exports
- D. Total income received by the HC from ROW; HC imports

Q2. According to U.S. national income accounting principles, which item below would be directly entered as an item in the U.S. CAPITAL account KA for 2004:

- A. A purchase by U.S. citizen Donald Trump from the U.S. Boeing Corporation of a used jet plane (built in 2001).
- B. Interest income received in 2004 by U.S. holders of a Kenyan bond issue.
- C. U.S. government foreign aid to Iraq in 2004.
- **D.** A Russian citizen's purchase of a U.S. Treasury bond in 2004.
- E. A purchase in 2004 by U.S. citizen Donald Trump of a newly produced jet plane from the Boeing corporation.

- Q3.** If the HC is running a current account DEFICIT, then HC national saving _____ HC total investment, and the HC is _____ ROW.
- A. is greater than; a net lender to
 - B. is greater than; a net borrower from
 - C. is less than; a net lender to
 - **D.** is less than; a net borrower from
- Q4.** Suppose the world is divided between HC and ROW, and all international reserves take the form of ROW currency reserves held by the HC central bank. If the HC is in a balance of payments EQUILIBRIUM, this means
- A. the HC central bank is undertaking official reserve transactions to ensure demand equals supply in the foreign exchange market.
 - **B.** ROW currency demand equals ROW currency supply without the need for HC central bank official reserve transactions.
 - C. HC government expenditures are equal to HC tax revenues.
 - D. in net terms the HC is neither borrowing from nor lending to ROW.

**SEE NEXT PAGE FOR QUESTION Q5
(TWO-POINT WEB-BROWSE QUESTION)**

Q5. (TWO-POINT WEB-BROWSE QUESTION)

Triple-Take on the International Monetary Fund

Two key mandates of the International Monetary Fund (IMF) are: (1) to make loans to countries experiencing balance-of-payments difficulties, as long as they abide by IMF rules; and (2) to monitor the compliance of borrowing countries with IMF rules.

Despite the prosaic sound of these mandates, the role of the IMF in global financial markets has been increasingly criticized in recent years from both the left and the right. This question asks you to consider the nature of this criticism by focusing specifically on the relationship between the IMF and Argentina, which experienced a severe balance-of-payments crisis in 2001-2002.

As discussed by Mishkin (Chapter 20, pp. 477-478), concerns arose in Argentina in 2001 that a deteriorating fiscal situation could lead to a printing of pesos, the domestic currency, to finance the deficit. The resulting inflationary fears (too many pesos chasing too few goods) increased the expectation that a devaluation of the peso would occur in the near future (as people switched away from the peso) and led to a self-fulfilling speculative attack against the peso (a switch away from pesos into other currencies such as U.S. dollars).

The Argentinian central bank attempted to support the official peso exchange rate (pegged 1-for-1 to the U.S. dollar since 1991) by using international dollar reserves to buy pesos (thereby increasing peso demand). However, in the face of a continued loss of dollar reserves (as well as a full-blown bank panic, a default on IMF loans and on government debt held by pensioners and other private investors, and a cumulative three-year decline in output of 20 percent, the Argentinian authorities ultimately made the decision in late 2001 to devalue the peso. This devaluation was officially implemented on January 6, 2002.

The International Monetary Fund (IMF) has a long history with Argentina. It has issued loans to Argentina nine times since 1983, including successive expansions and releases of “standby” loans to Argentina during 2001 in an unsuccessful attempt to stave off a balance-of-payments crisis. Although Argentina defaulted on these IMF loans, they have since been paid back. In Fall 2003 the IMF approved a new loan to Argentina even though pensioners and other private creditors are still waiting for Argentina to pay back the \$82 billion owed to them.

SEE NEXT PAGE FOR QUESTION 5 PARTS A, B, C

Part A (1 Point): Argument from the Center

On March 31, 2004, Anne Krueger (new acting manager of the IMF) released a statement on the role of the IMF in Argentina, titled “Argentina: Remaining Economic Challenges.” This article is accessible at “Web Sites Related to Mishkin Chapter 20” linked to the on-line Econ 353 syllabus. Briefly summarize (300 words or less) her argument in *support* of the IMF’s interventions in Argentina.

Answer Outline for Part A: Krueger notes (p. 2) that the IMF shares a common objective with the Argentina government and the international community. “We all want to see what is still one of Latin America’s richest economies enjoy sustainable and rapid growth.” To make significant progress towards this goal, however, new investment will need to be funded by new inflows of capital investment at reasonable borrowing costs. This will only come about if potential investors are confident in the safety and productivity of their investments, which in turn requires a stable macroeconomic framework. The IMF should help Argentina attain the needed stable macroeconomic framework. The evidence from other countries (Turkey, Brazil, etc.) overwhelmingly establishes that the IMF’s blueprint for structural reforms, including prudent and sustainable fiscal policies, helps countries secure stable macroeconomic frameworks.

Part B (1/2 Point): Argument from the Right

On March 9, 2004, the Cato Institute (a conservative think-tank) published an article titled “IMF: A Political Institution” (by Ian Vasquez) that strongly criticizes the IMF’s role in Argentina. This article is accessible at “Web Sites Related to Mishkin Chapter 20” linked to the on-line Econ 353 syllabus. Briefly summarize (200 words or less) this article’s argument *against* the IMF’s interventions in Argentina.

Answer Outline for Part B: Vasquez argues that the IMF is primarily a political institution, not an economic one. He particularly criticizes the IMF policy requiring debt repayments to the IMF to be senior to repayments to private sector creditors, arguing that this creates “a perverse set of incentives.” The official creditors “who always get paid back” can then base their lending on political considerations with little or no market accountability. He argues that Argentina would be better off if it “began dealing seriously with its private creditors and told the IMF that its loans were no longer a priority.”

Part C (1/2 Point): Argument from the Left

In 2002 the *Green Left Weekly* published an article titled “Argentina: What Caused the World’s Largest Default” (by Eva Cheng) that strongly criticizes the IMF’s role in Argentina. This article is accessible at “Web Sites Related to Mishkin Chapter 20” linked to the on-line Econ 353 syllabus. Briefly summarize (200 words or less) this article’s argument *against* the IMF’s interventions in Argentina.

Answer Outline for Part C: Cheng argues (p. 2) that the IMF’s requirements for “tight fiscal management” have led to sweeping social spending cuts in Argentina over the period of time

Argentina has received IMF loans. Although Argentina grew in the early 1990s, it was “amid gross inequalities and intense social contradictions.” Cheng argues that repeated attempts by Argentina to satisfy IMF-imposed fiscal targets have destabilized the economy, leading (among other things) to bank runs and capital flight. Cheng views the IMF as part of an “international class battle” helping rich foreign capitalists to make lucrative profits (obtaining compensatory premiums for high risk investments) while offloading costs onto Argentina’s workers in the form of high unemployment and cuts in wages and pensions.