International Economics
February 9, 2020
Filippo Santi and Julian Hinz

Problem Set 9 - Exchange rate regimes, the OCA, and Crises in currency areas

Exercise 1: Financial Crises in Developing Countries

- **Explain why the different domains listed below might represent a source of distress for developing countries' financial stability.**

a. **Domestic trade policy**

Solution:

Governments often impose restrictions on trade. This might in turn reduce or even preclude the availability of certain goods and commodities. Prices are also higher.

b. **Wealthier economies trade policies**

Solution:

They might make harder for developing countries to export to larger markets, reducing the potential revenue from domestic production. Take for instance the Common Agricultural Policy in Europe and the Agricultural Policy in the US. Both among other things, are blamed to maintain domestic prices artificially low. This lead to an excess of production of agricultural products, and to fiercer price competition to foreign products (which also face tariffs and heavy standard requirements at the border: the latter are particularly relevant, as the WTO provisions excluding developing countries from MFN tariffs cannot help).

c. **Poor financial development and low banking activity**

Solution:

They make capital allocation inefficient, and discourage foreign investors. At the same time, they prevent internal saving and capital accumulation, that is needed to engage in more expensive but more remunerative activities. It often lead to clientelarism between entrepreneurs and bankers.

d. **Openness to capital inflows**

Solution:

In most developing countries we can often speak of capital control. Similarly to a reduced financial development, it causes misallocation of resources and reduces competition.

e. **Poor infrastructural endowment**

   Solution:

   It makes difficult for productive factors to move where they are needed the most. Also, it makes harder to trade, domesticaly as much as internationally, as bad infrastructure makes transportation costly and risky. Most developing countries infrastructure is old and limited to allow "extractive" trade. This also explains most of the recent enthusiasm (slightly fading) on the Chinese OBOR (One belt, one Road) initiative.

f. **Colonial inheritance and disfunctional institutions**

   Solution:

   This can be seen as the true root of most development limitations, and is specifically relevant for developing countries. Colonial inheritance is a specific case of a more generic institutional failure. With institutions, we mean a recognized, shared, valued and recurrent pattern of behaviour, which determines what can and cannot be done, as well as how it should be done. Institutions enable collective as much as individual action, channelling both toward a common goal. When institutions as dysfunctional or only shared by exclusive groups in a country, frictions emerge (that can also lead to social unrest and even open hostilities).

- **What is meant with "Original Sin"? Why do you think it is a sin in the first place?**

  Solution:

  With "Original Sin" it is meant to call the fact that most countries worldwide tend to make debt borrowing in currencies other than their domestic one.

  Even though borrowing in a strong currency is not a bad thing on its own, it might have bad consequences if the economic conditions of borrowing countries diverge too much from those of the borrowers. Think to a devaluation of the national currency with respect to the lending currency. If this happens, the value of both the asset and the liabilities labelled in non-domestic currencies increase, raising the cost of the debt (and the concurrent drop in local currency labelled assets - and liabilities as well).

  This phenomenon can trigger a chain reaction, with the crisis demanding for more borrowing to cover the service cost of the existing debt. This might eventually lead to default or the abandon of long term-beneficial economic strategies (which might be costly to implement). For instance, in 2021 Uganda had to direct 95% of its governemnt budget to interests and debt repayments

Exercise 2: **The current crisis in the Eurozone shed light on the limit of the current institutional setting within the EMS. Among all, one of the most debated issue concerns the possibility for the EMS to also become a fiscal -not just a monetary - union. Do you think that the lack of financial integration might currently represent a limit for the Eurozone? Motivate your answer**

Solution:

- It prevents a proper solidarity mechanism to be implemented: redistribution is made harder by the fragmentation of the fiscal domain.
- There is the risk for a rush to the bottom among member states for attracting Foreign "Uncle Scrooges" from abroad. An example for this can be found in the exemption granted to wealthy foreign citizens who move their residence to italy, or the favourable fiscal treatment granted to pension holder moving to spain and portugal.
- Related to the previous point: it introduces incentives for firms to relocate the official head quarters in countries with lower fiscal pressures for multinationals (e.g. Google and Microsoft having both legal HQ in Ireland, but providing services in the whole Eurozone, or the recent relocation of FIAT from Italy to the Netherlands).
- A fiscal union might enables EU institutions to adjust more rapidly to idyosyncratic shocks in member states.