NAME: STUDENT ID:

Economics 161 — Fall 2004

Latin American Economic Development

Final Exam

December 7, 2004

Time: **120 minutes**
Total score: **120 points**

Student Consent For Release Of Student Information (Buckley Waiver)

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Signature Date

1 Comparative Advantage: 10 minutes

Think of labor as the only factor of production in Chile and Ecuador. Think of the two countries as equal in size. Chile's workers can either manufacture 100,000 cars or grow 5,000 tons of wheat, or a mix of the two. Ecuador's workers can either manufacture 30,000 cars or grow 10,000 tons of wheat, or a mix of the two.

What are Chile's and Ecuador's opportunity costs of cars in terms of tons of wheat? How many cars will Chile produce under free trade with Ecuador? How many cars will Ecuador produce? What will the pattern of trade be? What additional information would you need to infer the exact volume of trade?

2 Gains From Trade: 10 minutes

Do the classic (Ricardian and Heckscher-Ohlin) models of trade support the idea that trade itself can close the income gap between industrialized and developing countries? [You may but need not use a graph for either trade model (Ricardian or Heckscher-Ohlin) to convince yourself and illustrate your answer.]

3 Productivity Growth and Trade: 10 minutes

Peru's main trading partners experience productivity growth in their *export* sectors.

How do Peru's terms of trade change? How do Peru's trading partner's terms of trade change? Why? Are Peru's gains from trade smaller, larger, or is it ambiguous? Are Peru's trading partner's gains from trade smaller, larger, or is it ambiguous? Why?

4 Factor Reallocation after Trade: 10 minutes

Suppose Paraguay is relatively low-skill labor abundant and Chile is relatively high-skill labor abundant. Tobacco farming is relatively low-skill labor intensive, while electronic manufacturing is relatively high-skill labor intensive.

When Paraguay and Chile expand trade relations with one another, what does Heckscher-Ohlin trade theory predict about the reallocation of factors across sectors *in Paraguay* after trade expansion? Will there be full employment? Will the two sectors *in Paraguay* employ a larger or a smaller share of low-skilled labor after trade expansion? Discuss the applicability of this theory *to Paraguay and Chile* in the presence of an informal sector. [You may use the table below to substantiate your argument.]

Informal Sector Size (select South American countries)

% of urban employment

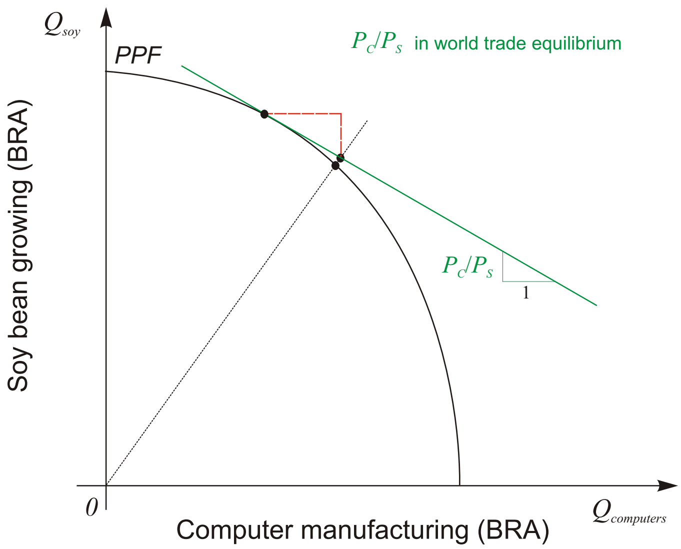
Country[a]	Total informal economy	Employment in Microenterprise[b]	Domestic Employment
Large informal economy			
Bolivia (urban)	65.5	17.0	3.6
Paraguay	57.1	19.3	9.3
Colombia	55.9	20.6	4.5
Ecuador	53.9	17.9	5.0
Intermediate informal economy			
Brazil	46.6	12.5	8.4
Mexico	43.6	19.6	3.6
Small informal economy			
Argentina	41.4	19.6	5.1
Chile	37.3	13.3	5.9

[a] Estimates based on data from 1996, 1997 or 1998. [b] Five or less employees.

5 Protection: 10 minutes

Consider Brazil, a large country.

Explain how Brazil, an exporter of soy beans, can increase its gains from trade by imposing a tariff on its imports of computers. Give a brief explanation of why this argument for protection may be short-sighted. [You may but need not substantiate your argument in the following graph.]



6 International Capital Markets: 10 minutes

Open capital markets allow countries to reap two further types of gains from trade beyond the gains from trade in commodity markets.

Give a brief description of each of the further gains from trade in capital markets. Offer a reason why these gains may be dampened.

7 Equity Investment: 10 minutes

The bulk of Latin America's capital inflows are in the form of equity investment.

List the two types of equity investment into Latin America. Offer two benefits and two pitfalls for each type of investment.

8 Default Risk: 10 minutes

Suppose investors only care about average (expected) returns.

Investing one dollar in safe assets yields a return of R and pays back the principal of one dollar. Investing in a risky project in Latin America yields the compensating interest rate R^{comp} with a chance of 50 percent but only the principal (no interest) with a chance of 50 percent (partial default).

$$R = .5 \cdot R^{comp} + .5 \cdot 0.$$

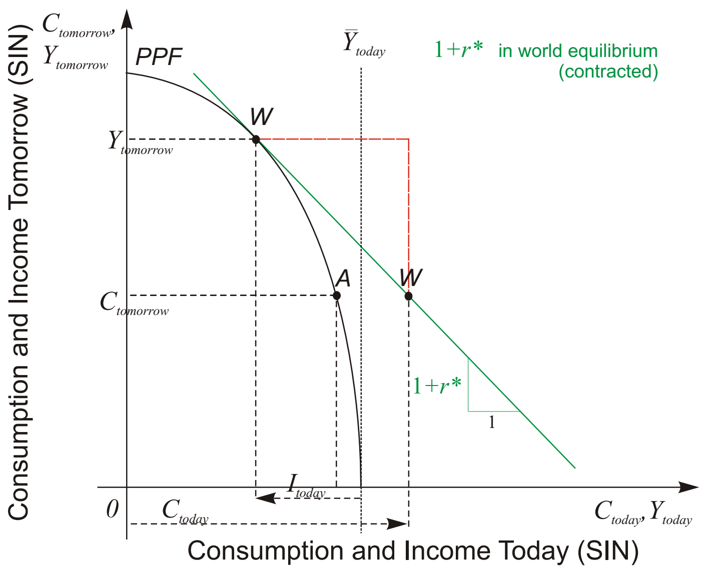
How large does R^{comp} have to be to entice lenders to invest in the risky project in Latin America?

Now suppose that the project yields the specified return R^{comp} with a chance of 50 percent but no payment whatsoever (neither principal nor interest) with a chance of 50 percent (complete default). How does the above relationship between R and R^{comp} change? Does R^{comp} now have to be smaller or larger than before? Why?

9 Sovereign Default Risk: 10 minutes

Sovereign default risk hinders the operation of international capital markets. It is often difficult for lenders to distinguish between countries that are truly *unable* to pay, and countries that are *unwilling* to pay and take hidden actions to make themselves unable to pay.

How do economists and practitioners in capital markets typically call hidden action problems like this? Describe how the Latin American country Sinnombre can both borrow and underinvest today to provoke its inability to repay its debt tomorrow. Explain how this provoked inability to repay affects Sinnombre's output tomorrow, consumption today and tomorrow, and its debt repayments, compared to a well-behaved borrower country. [You may, but need not, use the graph below to illustrate the relationships.]



10 Debt Monetization: 10 minutes

Define the terms money supply growth, inflation, and depreciation. Explain the following relationship between changes in money supply M, the price level P and the peso-dollar exchange rate level E in a Latin American country.

$$\frac{\Delta E}{E} = \frac{\Delta P}{P} = \frac{\Delta M}{M}.$$

Does the relationship also apply to exchange rate appreciation?

Consider the following statement.

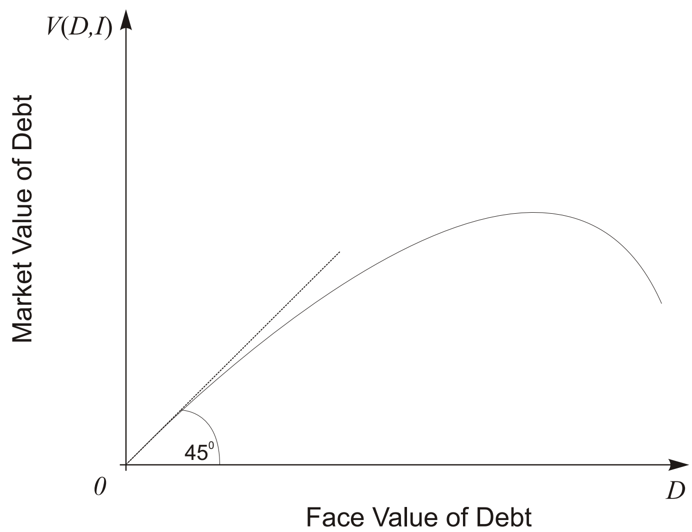
> *The monetization of a government's debt is at best a problematic solution for debt repayment.*

What is monetization? Do you agree? Why or why not? In your answer, refer both to the domestic price level and the exchange rate, or their changes.

11 Brink of Severe Debt Overhang: 10 minutes

The Latin American country Sinnombre has reached the maximum market value of its outstanding debt. Any further debt issuance (increase in the face value) will lower the total market value of debt.

Depict Sinnombre's position on the debt Laffer curve below. Why is there a maximum in the total market value of debt? Sinnombre's government considers the economy's expected debt service. At its current position (in the the debt Laffer curve maximum), does Sinnombre's government have an incentive to issue new debt? Would an international investor rationally choose to underwrite (buy) the new debt?



12 Adjustment Lending: 10 minutes

William Easterly criticizes the IMF's and the World Bank's lending practices. Easterly argues that the policies of adjustment lending did not create proper incentives for borrowing governments to pursue long-term development.

Briefly describe two of Easterly's key arguments in his critique of the IMF and World Bank lending strategies. Do you agree? Offer a reason why you do or why you do not consider the arguments compelling.