

# MANAGING SHORT-RUN CRISIS IN AN OPEN ECONOMY: APPLICATIONS OF THE AUSTRALIAN MODEL

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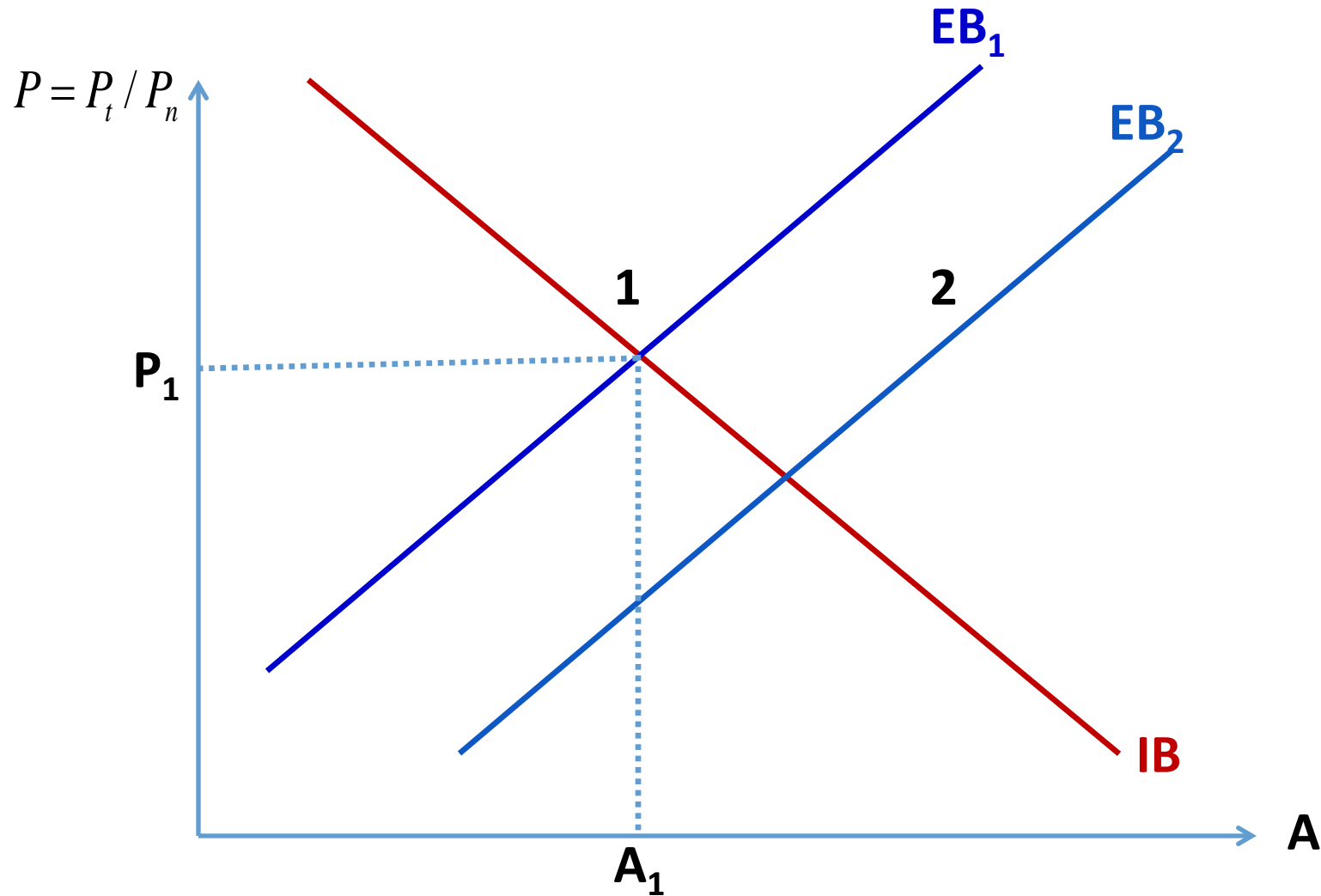
EE 462 Development Macroeconomics

Semester 1/2014

# Dutch Disease

- A country receives higher export prices or a larger inflow of foreign capital may end up worse off than without the windfall.
- Windfall in foreign reserves occurs:
  - EB shifts rightward, the economy is in surplus, leads to more expenditure.
  - Absorption rises.
  - The economy moves off its internal balance into inflation.
- Effects of a rise in  $P_N$ :
  - *Reduction in real absorption* (partially corrects the initial rise in A)
  - *Real appreciation of exchange rate* (assuming official rate is fixed)

# Figure: Dutch Disease



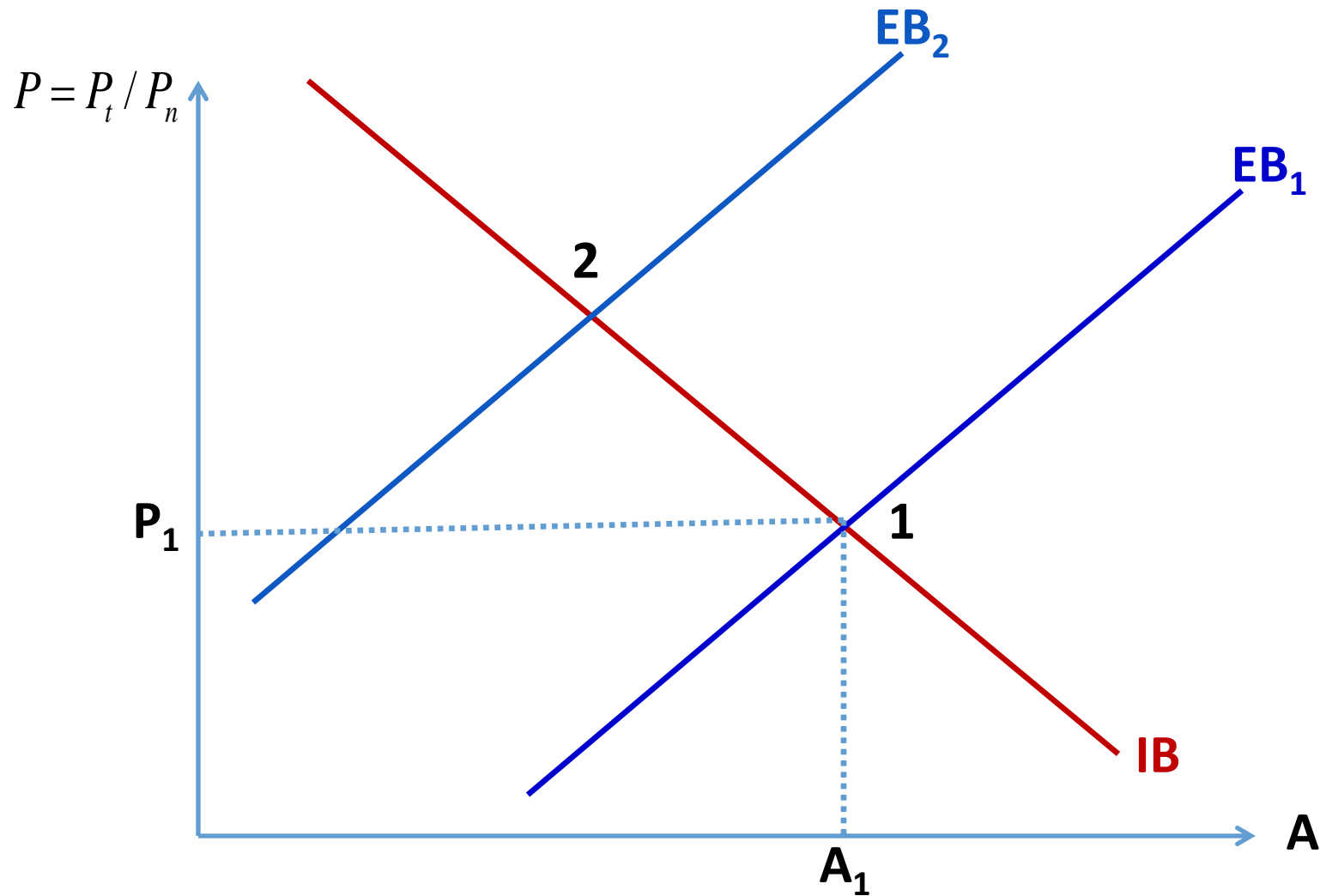
# Problems from Dutch Disease

- Such windfalls generally are temporary.
  - When export prices fall or the capital inflow dries up, the EB curve will shift back and a costly adjustment will be necessary.
- In shifting from the old to the new equilibrium, there have to be adjustments in the economy.
  - The *real exchange rate  $P$  is lower* ( $P_n$  rises), so  $S_t$  (tradables supply) has fallen and  $S_n$  (nontradables supply) risen.
  - *Unemployment* occurs when workers switch from tradables to nontradables production.
  - *Decline in tradables sector* → “disease”

# Debt Repayment Crisis

- It's a reverse of the Dutch Disease, a decline of terms of trade.
- Initially, the economy needs to find additional resources to repay its foreign debt or needs to adjust to falling terms of trade.
- EB curve shifts leftward ( $EB_1 \rightarrow EB_2$ ).
- If there is debt relief, then the curve shift rightward EB3.
  - Absorption is reduced due to falling foreign reserves and reduced expenditure.
  - To gain the new equilibrium at point 3, it is also necessary to devalue the currency.

# Figure: Debt Repayment Crisis



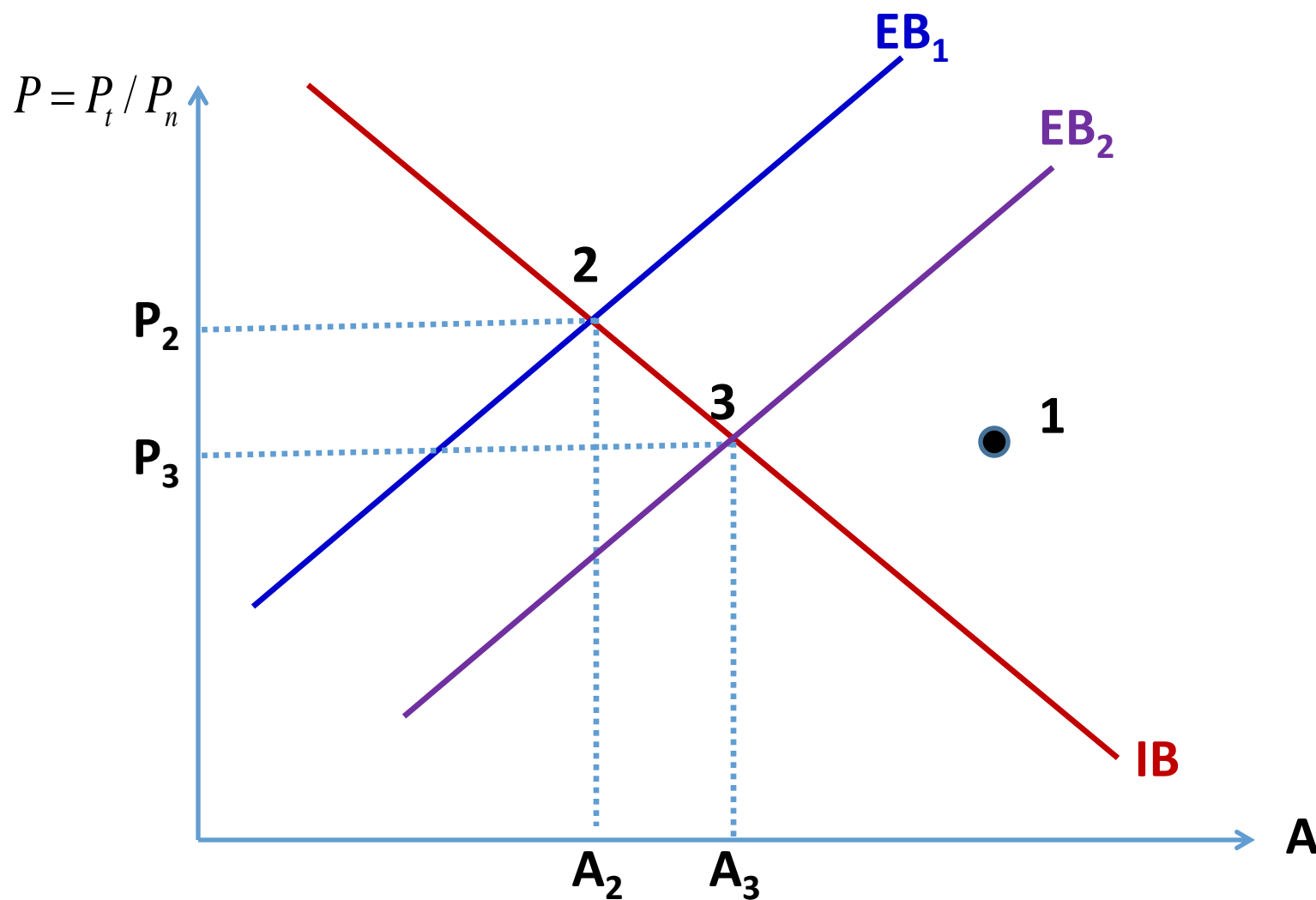
# Stabilization Package: Inflation and a Deficit (1)

- An economy has **budget deficit** and **inflation**. Private investors try to invest in nonproductive assets like land or to invest abroad, which deepens the external deficit.
  - IMF is called to make **stabilization program loans**.
- IMF stabilization programs:
  - **Reduction in government's budget deficit**
  - Programmed targets for domestic credit to **cap the growth of money supply** in order to **reduce absorption**
  - The package may require **devaluation** of exchange rate, to reach a new equilibrium and avoid unemployment.

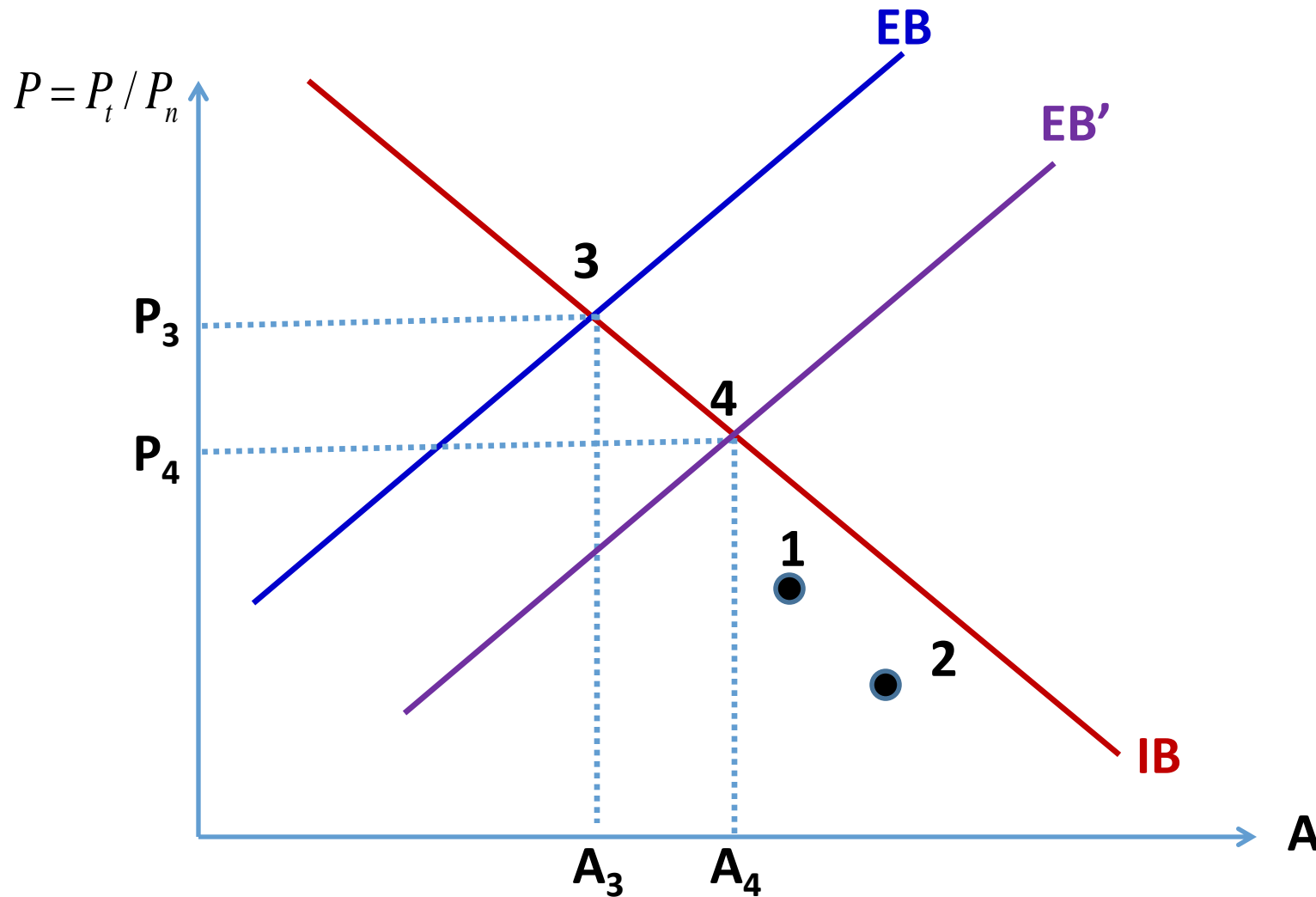
## Stabilization Package: Inflation and a Deficit (2)

- However, IMF programs usually come with substantial aid attached from IMF, World Bank and bilateral donors.
- The **aid package** would enable the country to have more foreign reserves to buy tradables.
  - EB shifts to the right → new equilibrium
- Two things happen for the package:
  - It reduces the need for austerity.
  - It reduces the need for devaluation of the exchange rate. But IMF and donors often insist on devaluation.

# Figure: Stabilization from Inflation and Deficit



# Figure: The Greek Debt Crisis, 2010-2012



# Drought, Hurricanes, and Earthquakes

- Starting from point 1, drought or another natural disaster reduces the capacity to produce both N and T, so both IB and EB curves shift to the left.
- Disaster relief from abroad helps by shifting EB to the right → new equilibrium (point 3).
- If the economy remains temporarily at point 1, it is inflationary.
  - The *absorption declines* due to a fall in incomes
  - At the same time government tries to spend more to relieve hunger, disease and other problems.
  - The outcome could be *continued inflation* (somewhere between points 1 and 3).

# Figure: Drought

