

## **ECONOMIC POLICYMAKING (POLITICA ECONOMICA): 2011-2**

Professor Vittorio Corbo

Thursday: 15:10-18:20

Office hours: To be determined

### **I. OBJECTIVES**

The course integrates most of the theory you have learned. As a result, the principal aim of the course is not so much to teach new theory as to apply the theory you know to the main economic problems facing Chile, which, indeed, is what most of you will be called on to do once you enter the labor market, be it in the public sector (Central Bank, Finance Ministry, CORFO, etc.) or in the private sector (in the financial system, a consulting firm, etc.). **In short, in this course you will finally advance from simply analyzing problems to problem solving, proposing policies to solve them.**

Secondly, it is not just a question of applying the theories you have studied but to *question* them, to discover their limitations, relevance and domain, and to formulate new and alternative hypotheses more relevant for Chile and for developing economies. Hence, I invite you to challenge, doubt, question, discuss, evaluate and to arrive at your own conclusions (which much as it will bother me, will often not coincide with mine). It is this way because in most issues of economic policy, unanimity is rare; and even where there exist a broad consensus, there usually is a significant minority opinion(s).

The course has 3 core modules preceded by an extended introduction. The Introductory module will analyze the causes of the recent financial crisis and the ensuing “Great Contraction” that is affecting the world economy today and some of the lessons for regulatory and monetary policy emerging from this crisis. The following 3 core modules will deal with 1) macroeconomic policy issues; 2) development policy issues; and 3) policy issues concerning income distribution and social policies. An important part of these 3 core modules will center on student presentations of key policy issues and their proposals for dealing with them. In the light of the most relevant theory, your readings, and, possibly, interviews of key players, you yourselves must make and justify a **policy proposal** to deal with the issue in question and, as the case may be, show that the policy proposed not only goes in the right direction but that it makes a significant impact, more than alternative courses of action. Thus the course will require establishing **orders of magnitude** of effects. Your proposals will be critiqued by a fellow student(s), pre assigned with that task, after which the proposal will be opened to the whole class, followed by a brief synthesis at the end by the Prof. But the point of it all is that **one learns policymaking by doing it (or next best, simulating doing it)**. Hence, the more issues and policy proposals are discussed, the better one becomes at it. So **discussion and class participation are central to the success (your understanding) of the course.**

*\* **ENGLISH** As you know this is one of the courses the School requires to be taught in English, in order that you become familiarized with spoken and not just written English, for no one in today's Chile can hope for a successful career as an economist without a good working knowledge of English. Hence, the classes will all be in English. However, you may, if you wish, ask your questions or conduct the discussion in Spanish. For, even more than the English, it is important that you understand the economics. Your presentations can be in Spanish. However, in order to practice your spoken English, the critique must be in English. Thus all will improve their understanding of spoken English, and all will have to do some speaking in English.*

### **II. PROGRAM**

#### Introduction (2 sessions of 3 hours)

This introduction will examine the onset of the Global Financial Crisis, the main hypothesis and the policy and regulatory issues that have emerged for developed countries as well as the main challenges faced by emerging economies today.

Format: expository classes by the Prof, but with active class participation.

#### Module 1: Macroeconomic Policy Issues (4 sessions of 3 hours)

These sessions are dedicated to class presentations by the students (oral) of **their policy recommendations** to deal with selected macroeconomic issues. Students can choose any of the topics below or propose one of their own interests (subject to the Professor's approval) but it must **always** focus on policy recommendations by the students on how best to deal with the chosen issue. Some suggested topics follow: 1) What do you propose to reduce the probability of the repetition of the Global Financial Crisis in the future or to mitigate its effects? 2) Provide a critical assessment of the regulatory response in both the US and Europe 3) Analyze the proposals included in Basil III at the moment (main source: [www.bis.org](http://www.bis.org)) 4) Why did the sub prime crisis in the US produce a recession in Chile and what else could have been done to minimize its negative impact in Chile? 5) How could the international financial system be reorganize– for example, strengthen the IMF, clauses to automatically restructure sovereign debt, etc. - to mitigate future crises akin to the Asian crisis (this is the subject of a “new international financial architecture”)? 6) How might the Asian crisis have better been dealt with in Chile (but without “Monday morning quarterbacking” – that is, only with the information available to policymakers at each point in time)? 7) How best to deal with a heavily appreciated currency – such as today's Brazil, and discourage the entrance of foreign capital, including the possibility of capital controls on the entry or exit of capital? 8) ¿What is the most appropriate exchange rate policy for Chile (or, if you wish, some other country of interest) – programmed devaluation (as in pre 1999 Chile), free float (as today, with or without clauses for exception), dollarization (as in Ecuador and Panama)? 9) Would it be convenient as well as practical to change the target for the cyclically adjusted fiscal balance which within prescribed limits, could go up or down, to slow the economy when it was overheated, or to speed it when it was in recession, thus complementing discretionary monetary policy with discretionary fiscal policy? 10) Is inflation targeting (what Chile did as of the early 90s and many countries have done since) a new fashion which will soon pass or is it here to stay (say, recommend the US to adopt it) as a means to run monetary policy to keep price stability and creating a growth enabling framework, and how might it be improved, if at all, in Chile? 11) Should Central Banks not only target the inflation of the consumer price index or should they also target increases in asset prices (stocks and real estate)? 12) How might the current fiscal rule of Chile be improved? **I repeat I will accept other topics but only if they conclude in specific policy recommendations. We are not interested in simple diagnoses but in problem solving.**

#### Module 2: Policies aimed at speeding growth and productivity (4 sessions of 3 hours)

There will be an expository class by the Prof indicating the areas where reforms of policies and institutions could contribute to raise the rate of growth in general and, particularly, in Latin America. The subsequent sessions will analyze **specific policy proposals** by you the students to accelerate growth and productivity in Chile and the region to achieve a growth rate of the order of 6% per year for a prolonged period of time (with a contribution from productivity growth of 2.5-3% per year) so that Chile be a developed country by 2025. The following is a list of possible topics: 1) What policies can raise the national savings rate (and not just private or public savings at the expense of the other) so as to speed economic growth by 1% per year? 2) How to promote the entrepreneurial spirit in Chile and speed the creation of new firms? 3) What policies could be used to raise the quality of education? 4) What type of policies could contribute to improve the functioning of labor markets? 5) How to deepen the capital market – securitization, risk capital funds, angel capital funds, etc.- so as to widen access to capital, especially to new firms, and small and medium sized firms (PYMEs)? 6) How best promote exports, especially “pioneer” or non traditional exports to traditional markets or traditional exports to non traditional markets? 7) How modernize the State and improve the management and efficiency of the public sector? 8) How best to promote a more rapid transfer of technology (licenses, imitation, etc.) to Chile? 9) How attract more foreign direct investment to Chile? 10) Is there a role for industrial policy in Chile – focusing on hi tech clusters (as in Costa Rica), on clusters around natural resources (as suggested by the National Council on Innovation) on being a regional financial center, and how to promote and speed the formation of said clusters? 11) Should CODELCO be privatized?

#### Module 3: Social Policies and policies aimed at improving income distribution (3 sessions of 3 hours)

The highly unequal distribution of income is one of the “eyesores” besetting Latin America and the Chilean economy. After an expository session by the Prof on key issues of income distribution, the following sessions will be dedicated to student presentations on specific issues of income distribution and policy proposals to improve it significantly. Such topics could be, but are not limited to, the following: 1) What economic (not pedagogic ones) policies ought to be pursued to raise the quality of the primary and secondary education (and not simply spending more) that receive the two lowest quintiles? 2) How best improve the health system? 3) What reform ought to be made to the current financing/subsidization of higher education (be it Centro de Formación Técnica, Institute, Traditional or Non-traditional University) both to improve quality as well as to

improve income distribution? 4) To the extent that higher education is subsidized by the State, should the distribution of university professions be regulated and controlled by the State according to perceived future need or should this best be left to the market as now? 5) Should the minimum wage be replaced by a minimum income, whereby the State (and not the firm that hires the worker) finances the difference between a minimum family income and the going wage? 6) What reform would you suggest to the much criticized current severance system upon dismissal (of one month's salary per year worked in the firm with a maximum of 11 months of salary) which make more flexible the labor market while providing the laid off worker with adequate stability? 7) How would you reform the current tax system so as to increase the tax intake by 1% of GNP while improving its distributive impact? 8) What reforms would you suggest to the SENCE training subsidies so that most firms (and not 1/3 as now) train their workers, and not just in "specific" training but in "general" training?

### III. ORGANIZATION

As indicated before, a good number of the sessions will be dedicated to **presenting, criticizing and discussing student proposals for dealing with specific policy**. Debate is of the essence in policymaking for when it comes to policy there normally is not one single, clear answer. This is the case because not all theories are equally relevant to an issue; and even those that are relevant may have a different impact, so that even if the direction of impact is the right one, the impact is not that significant. Moreover, some policies may have undesirable side consequences. In other cases, the best technical decision may not be easy to administer – so that it fail in implementation. And, of course, some policies may simply not be feasible politically (though in this course, we will presume political feasibility). As a result this is a course, where you must and should discuss, for sound judgment more than certainty is the criterion.

Each pair of students will choose a topic to present. This choice will be by August 11 so that you have time to prepare. Each pair of students will also critique at least one presentation (from a different module than his own presentation so that he acquire some direct expertise on at least 2 of the 3 modules). Once again the topic to be critiqued will be chosen (assigned) by August 11. And all presentations, including their critiques, are part of the course material, on which you will be examined, not just the expository sessions by the Prof.

As for the format of the presentation: it is **oral** (not written), typically in PowerPoint. It should last **20 minutes**. The presentations will be done by pairs of students. The presentation should include 4 sections: 1) the problem to be examined and why it is important; 2) the relevant, **key** data and empirical studies to understand the issue; 3) alternative proposals for dealing with the issue in question, with their differing pros and cons.; finally, and most importantly, 4) **your policy proposal and its justification (why it is better than the rest)**. I highlight this point because this is the central part of the presentation; allow at least 7 minutes to present and justify your proposals (therefore time yourself carefully). The lengthy bibliography which follows is to help you *get started* on your topic, but I expect students to widen the search for references and to include, where possible and useful, interviews with experts.

Each pair of students to critique the presentation will have 10 minutes to criticize the proposal, highlight its drawbacks and indicate better alternatives. They have to focus on the points of disagreement, not those of agreement (though these latter can be pointed out). The critique is NOT to be in PowerPoint (for normally you will not know the presenter's proposal in time to make such a presentation). Obviously the discussants must also consult and work up their bibliography. In a sense, theirs is a more difficult task, for they must prepare to criticize any of a number of possible proposals, not knowing until the last minute which the presenters are going to favor. Hence, they have to know their subject well and be flexible to be able to criticize any or several proposals (to be sure, you can meet beforehand with the presenters to learn what they are thinking).

The remaining 10 minutes will be open to questions and discussion from the class, with the Prof generally synthesizing the debate (if possible). Therefore, the total time assigned for each topic will be 40 minutes.

### IV. REQUIREMENTS

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|----|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------|
| 1. | 90% attendance                                                                                                                                                                                        | requirement to pass |
| 2. | Policy proposal                                                                                                                                                                                       | 30%                 |
| 3. | Critique                                                                                                                                                                                              | 10%                 |
| 4. | 2 Exams (in the middle and end of the semester) 50% (25% each). <b>Important: to pass one must average 4,0 on the exams; one cannot pass simply on the basis of a good presentation and critique.</b> |                     |

5. Quizzes (controles) – **every two weeks. Quiz dates are: August 18, September 1 and 22, October 6 and 20, November 3.** The simple average of quizzes represents a 10% of the course grade.

The first exam will cover the introductory module and the macro module (including the presentations made to that date). The second exam will cover the Growth and Income Distribution modules and their respective presentations. The exam will normally have three questions.

- a) At least one question with reference to the presentations and critiques
- b) 1 question about matter covered in class
- c) 1 question which asks you to apply the material learnt to a new issue, where emphasis will be on relevance, orders of magnitude and the ability to apply known theories to new material

## V. **BIBLIOGRAPHY**

One or the other of the following two books is recommended for purchase (though there are library copies). Both are excellent and the editors as well as the authors of each chapter (20 the first, 14 the second) are absolutely first rate. The first is largely of a center-right orientation; the second is center-left.

F. Larraín y R. Vergara (eds.) (2000), La Transformación Económica de Chile (Centro de Estudios Públicos, Santiago).

P. Meller ed. (2005), La Paradoja aparente: equidad y eficiencia, resolviendo el dilema (Taurus, Santiago).

The readings with an asterisk are the required readings for the course. The others are simply possible references for the different topic presentations and critiques. NBER working papers, those referred to here as well as all others, can be downloaded free of charge at [www.NBER.org/papers](http://www.NBER.org/papers). Moreover, <http://netec.wustl.edu/WopEc.html> permits you to download some 20.000 papers free of charge. Some references may be added as the course develops.

### Introduction

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M. Lewis ed. (2009), Panic: the story of modern financial panic pp. 283-293; 316-329; 332-340; 359-365

The Economist (2008), “When fortune frowned: a special report on the world economy (October 11, 2008)

The Economist (2008), “Blocked pipes: briefing on money markets” (October 4, 2008)

### **Quiz 1 up to here**

## Module 1: Macroeconomics

- \* Corbo, V., J.I. Desormeaux and K. Schmidt-Hebbel (2011). "Lecciones de la Gran Crisis Financiera". Próximamente en Estudios Públicos, Centro de Estudios Públicos, Chile.
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**Quiz 6 up to here**