International Financial System

Outline

1. International Monetary System

2. The Euro

3. China

- Textbook Readings: Ch. 19

International Monetary System

- Main episodes:
  - Gold standard (XIX to WWI)
  - Interwar period
  - Bretton Woods (1944-1971)
  - Post-Bretton Woods

Gold Standard

- Most central banks peg to the gold by end of XIX century
- Why?
  - UK at center of international financial system
  - UK was on gold
- Problem?
  - Impossible to fight deflation
- By mid-1930s, US abandoned the GS due to the Great Depression

Interwar Period

- Gold standard suspended during WWI
- Treaty of Versailles: Crippling war reparations
  - Keynes: The Economic Consequences of the Peace
- WWII
  - Europe, once again, devastated by war

Bretton Woods (1944-1971)

- Exchange rates fixed to the US dollar
  - IMF and World Bank were established

- Capital controls

- Problems?
  - Exchange rate adjustments
  - Difficult to maintain capital controls

Post-Bretton Woods

- In 1973, major currencies started to float against each another
- Free capital mobility
- No longer a 'system' (for managing exchange rates)
- Three important developments:
  1. Main advanced economies and euro area are floating
  2. Countries in the Eurozone are within a fixed exchange rate
  3. Some emerging markets maintain a fixed exchange rate

The Euro

- Economic integration, limit risks of another war
- Euro introduced in 1999
  - As of today 19 countries use the euro
  - Low borrowing costs due to German tough stance on inflation
- ECB conducts monetary policy ➞ Inflation target = 2%
  - German model for monetary policy (highly averse to inflation)
- Increased trade integration (moderately)

Competitiveness: Germany vs Italy

- How to measure competitiveness? Unit labor costs

	annual		
	growth rate	1985	1995
German Labor Productivity (output per hour)	2.0%	100	122
German hourly wage rates (D-marks per hour)	2.0%	10	12
German unit labor costs (D-marks per unit of output)		0.10	0.10
	annual		
	growth rate	1985	1995
Italian Labor Productivity (output per hour)	1.0%	100	110
Italian hourly wage rates (Lira per hour)	3.5%	10	14
Italian unit labor costs (Lira per unit of output)		0.100	0.128

- Germany has a long history of super-competitiveness

Euro Crisis: Competitiveness

- Unit labor costs continue to grow in Italy whereas they are stable in Germany
  - Before the euro, Bank of Italy devalued the lira to avoid becoming uncompetitive ➞ Cut wages through devaluation
- After the euro, Italy cannot devalue to regain competitiveness
  - Euro government bonds are no longer risk-free
- German competitiveness is a general problem for all other members of the Euro area

Euro Crisis

- Persistent competitiveness differentials
  - Labor costs adjusted for productivity (unit labor costs) have diverged
- External imbalances
  - Germany ➞ Current account surplus; GIIPS ➞ Current account deficits
- Government debt crisis (Greece 2009)
  - Government deficits increased since 2000 in GIIPS
- By 2013, crisis abated
  - But Italy seems to be turning on red lights

China

- Deng Xiaoping pushed for modernization after the damage from Mao’s cultural revolution
  - Recognized that cooperation with the West offered access to developed-world machines and know-how
  - Opened trade with the West lifting many hundreds of millions of Chinese people out of poverty

- China real GDP growth: A 30-year unprecedented boom
  - China’s exports to US ballooned and then to Europe

- Result?

Sustained, Strong Growth But Wildly Imbalanced

China versus	USA: GDP	Components
	China	**U.S.A.**
net exports G&S	4%	-4%
investment	49%	15%
govt	13%	20%
consumption	34%	69%
	100%	100%
	China	**U.S.A.**
exports G&S	31%	13%
imports G&S	27%	17%
health, total	5%	18%
public health	3%	8%