Lesson 1

Introduction to International Finance

The significance of Bretton Woods:
- It sought to end economic isolationism
- It created an international financial system
- It put the world back on track toward globalization
- It was an intentional effort to create institutions that would enable people to better exploit the gains from economic cooperation

There is a curious notion that the protection of national interest and development of international cooperation are conflicting philosophies—that somehow or other men of different nations cannot work together without sacrificing the interests of their particular nation....Yet none of us has found any incompatibility between devotion to our own country and joint action.

– Henry Morgenthau, July 22, 1944
• The Bretton Woods Conference was motivated by the obvious failure of uncooperative behavior.
• The world had been globalizing rapidly before World War I.
• But after the war, globalization was reversed, with dismal results.
• Between the World Wars, we gave up the advantages of dealing with strangers.

There are three fundamental advantages from expanding the number of people in a society:
1. The gain from specialization
   - Comparative advantage
   - Economies of scale
2. The potential for risk reduction
   - Economies of scale
3. The expansion of knowledge
There are three fundamental advantages from expanding the number of people in a society:

1. The gain from *specialization*
   - Comparative advantage
   - Economies of scale

2. The potential for risk reduction

3. The creation of knowledge

*These three advantages are mutually reinforcing!*

Mutually reinforcing components of globalization:

- International trade — Knowledge
- Risk reduction — International trade
- Specialization — Technological progress
- Knowledge — Risk reduction

Interaction with strangers has many dangers. The survival of the human species and the maximization of individual welfare has always required a careful balance between interaction and isolation. The recent improvements in human welfare, longevity, and quality of life are the result of our improved ability to reduce the propensity for humans to exploit, steal, and kill. It seems to have become easier and safer to deal with strangers.

Paul Seabright (2004) describes the "great experiment."

- Human evolution during the extended period of hunters and gatherers has only partially prepared us for dealing with strangers.
- "To manage the hazards imposed on us by the actions of strangers has required us to deploy a different skill bequeathed to us by evolution for quite different purposes, the capacity for abstract symbolic thought..."

In order to capture the gains from specialization, risk sharing, and knowledge creation, we must create institutions that make human beings, who are hard-wired to be suspicious of strangers, willing to deal with strangers [Douglass North]

- “…almost all of the institutions of modern society can be understood as dedicated to an utterly unnatural division of labor between strangers.”
- Humans have struggled to get the institutions right.

If the objectives of those players in a position to shape their destiny are met, it is possible to say that society has created a consistent set of institutions.

- "improvement has been a trial and error process of change with lots of errors, endless losers, and no guarantee that we will continue to get it right in spite of the enormous accretion of knowledge over those centuries.”
Douglass North suggests that the frequent inconsistencies between people’s objectives and society’s actual outcomes are caused by:

(1) the lack of accurate information on how the world actually is and how it functions

(2) the resistance to change by certain people and groups of people because they prefer the status quo to further change.

The acceleration of economic growth over the past several centuries suggests that we have been “getting it right” more often.

- Data from the World Trade Organization show that total merchandise exports exceeded US$ 9.0 trillion in 2005.
- Exports and imports of services, such as airline travel, hotel rooms, and insurance, amounted to another US$ 2.0 trillion.
- The sum of the two is over 25 percent of world GDP in 2005.
- That is, on average, countries export about one-fourth of everything they produce, and they import about one-fifth of all the goods and services sold in their economies.

### World Exports and Per Capita Gross Domestic Product: 1820-1998

<table>
<thead>
<tr>
<th>Year</th>
<th>World Exports (milions 1990$)</th>
<th>World GDP (Milions 1990$)</th>
<th>Exports as % of World GDP</th>
<th>Per Capita GDP ($1990)</th>
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</thead>
<tbody>
<tr>
<td>1820</td>
<td>7,255</td>
<td>694,442</td>
<td>1.0%</td>
<td>667</td>
</tr>
<tr>
<td>1870</td>
<td>50,345</td>
<td>1,101,369</td>
<td>4.6</td>
<td>867</td>
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<td>1913</td>
<td>212,425</td>
<td>2,704,782</td>
<td>7.9</td>
<td>1,510</td>
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<tr>
<td>1929</td>
<td>334,408</td>
<td>3,696,156</td>
<td>9.0</td>
<td>1,806</td>
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<tr>
<td>1950</td>
<td>295,621</td>
<td>5,336,101</td>
<td>5.5</td>
<td>2,114</td>
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<tr>
<td>1973</td>
<td>1,690,648</td>
<td>16,059,180</td>
<td>10.5</td>
<td>4,104</td>
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<tr>
<td>1990</td>
<td>3,456,762</td>
<td>27,076,007</td>
<td>12.8</td>
<td>5,154</td>
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<td>1998</td>
<td>5,817,080</td>
<td>33,725,635</td>
<td>17.2</td>
<td>5,709</td>
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<tr>
<td>2004</td>
<td>11,069,000</td>
<td>40,671,000</td>
<td>27.2</td>
<td>6,000</td>
</tr>
</tbody>
</table>


### Services Trade Is Also Growing Rapidly

**Improved Communications**

**Rising Levels of Education Abroad**

**International Competition**

This phenomenon is often referred to as outsourcing or “offshoring,” but it is just continued growth of international trade.
The growth of trade is not uncontroversial:

- The growth of specialization and trade implies a more rapid turnover of jobs.
- The growth of trade increases competition.
- There have been calls for “protection” from foreign competition.
- Policymakers have often complied.
- New types of protectionism have arisen even as international agreements have reduced trade barriers.

International investment has also expanded rapidly in recent decades:

- International investment is the acquisition of assets located in one country by citizens, firms, or governments of another country.
- But unlike trade, which has taken place for millennia, it has only been over the past two or three centuries that assets have been traded across borders in significant amounts.

International Investment

- The delay in the growth of international investment is, in part, due to the small level of wealth in the world for most of human history.
- Another reason for the delay is that the sophisticated institutions required for complex asset exchanges have only recently developed in many countries.
- For people to invest in assets, property rights must be well defined, contracts must be enforced, and unbiased legal recourse must be available.

International Investment

- International investment first grew rapidly at the end of the nineteenth century.
- In fact, when measured as a proportion of GDP, capital flows between some countries were larger towards the end of the 1800s than they were even during “globalization” of the 1990s.
- This first surge in international investment came to an end in 1914.

International Investment

- Since World War II, and especially over the past two decades, international investment has again grown rapidly.
- By the mid-1990s, cross-border sales of assets reached the proportions (of GDP) of 100 years earlier.
- Because the world is now much richer, the value of assets traded across borders is now much greater than ever before.
- International investment today also consists of a much greater variety of assets.

International Investment

- We own increasing amounts of foreign assets.
- Foreigners own increasing proportion of our assets.
- This has increased concern that “foreigners control our economy.”
- This fear is very seldom justified, but increasing foreign ownership does often raise a political issue that must be dealt with.
Economic Growth throughout History
In assessing economic growth over the past millennium, the economic historian Angus Maddison writes:

• From the year 0 to 1820 the advance in per capita income was a slow crawl—the world average rose about 50 percent.
• Most of the growth between 1000 and 1820 went to accommodate a fourfold increase in population.
• Since 1820, world economic growth has been much more dynamic.
• Per capita income has risen nearly ten-fold since 1820.


Real per Capita Gross Domestic Product: 0 - 2001

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<tr>
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<tbody>
<tr>
<td>0</td>
<td>231</td>
<td>103</td>
<td>445</td>
</tr>
<tr>
<td>1000</td>
<td>268</td>
<td>117</td>
<td>436</td>
</tr>
<tr>
<td>1500</td>
<td>438</td>
<td>248</td>
<td>566</td>
</tr>
<tr>
<td>1820</td>
<td>1,042</td>
<td>695</td>
<td>667</td>
</tr>
<tr>
<td>1870</td>
<td>1,271</td>
<td>1,113</td>
<td>875</td>
</tr>
<tr>
<td>1913</td>
<td>1,791</td>
<td>2,732</td>
<td>1,525</td>
</tr>
<tr>
<td>1950</td>
<td>2,524</td>
<td>5,330</td>
<td>2,111</td>
</tr>
<tr>
<td>1973</td>
<td>3,916</td>
<td>16,024</td>
<td>4,091</td>
</tr>
<tr>
<td>2001</td>
<td>6,149</td>
<td>37,194</td>
<td>6,049</td>
</tr>
<tr>
<td>2005</td>
<td>6,500</td>
<td>42,000</td>
<td>6,500</td>
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</tbody>
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Source: Angus Maddison (2003), The World Economy, Historical Statistics, Paris: OECD, Tables 8a, 8b, and 8c.

Growth of Real per Capita GDP: 0 - 2001

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<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>0 - 1000</td>
<td>0.01%</td>
<td>0.01%</td>
<td>0.00%</td>
</tr>
<tr>
<td>1000-1500</td>
<td>0.10%</td>
<td>0.15%</td>
<td>0.05%</td>
</tr>
<tr>
<td>1500-1820</td>
<td>0.27%</td>
<td>0.32%</td>
<td>0.05%</td>
</tr>
<tr>
<td>1820-1870</td>
<td>0.40%</td>
<td>0.93%</td>
<td>0.54%</td>
</tr>
<tr>
<td>1870-1913</td>
<td>0.80%</td>
<td>2.11%</td>
<td>1.30%</td>
</tr>
<tr>
<td>1913-1950</td>
<td>0.93%</td>
<td>1.82%</td>
<td>0.88%</td>
</tr>
<tr>
<td>1950-1973</td>
<td>1.92%</td>
<td>4.90%</td>
<td>2.92%</td>
</tr>
<tr>
<td>1973-2001</td>
<td>1.62%</td>
<td>3.05%</td>
<td>1.41%</td>
</tr>
<tr>
<td>1820-2001</td>
<td>0.98%</td>
<td>2.21%</td>
<td>1.21%</td>
</tr>
</tbody>
</table>


Economic Growth: 0 - 2000

Based on data from Angus Maddison (2001)

Are Globalization and Growth Related?

Figure A

World Economic Growth and Trade

Source: Angus Maddison (2001), Monitoring the World Economy (1900-1992), Paris: OECD, Tables 1 (c) p. 90 and Tables 1 (d) 1 (d) p. 256-256.
In 1776, Adam Smith wrote:

The greatest improvements in the productive powers of labour, and the greatest part of the skill, dexterity, and judgement with which it is anywhere directed, or applied, seem to have been the effects of the division of labour.

As it is the power of exchanging that gives occasion to the division of labour, so the extent of this division must always be limited by the extent of that power, or, in other words, by the extent of the market.


Let’s take stock:

- Globalization has accelerated.
- This implies we must be creating better institutions to deal with strangers.
- Among those institutions are those that guide the international financial system.
- Better institutions are the result of better understanding of how our world works.

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- Among those institutions are those that guide the international financial system.
- Better institutions are the result of better understanding of how our world works.
- What do we know about how our international financial system works?