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## LILIA COSTABILE AND ROBERTO SCAZZIERI

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Costabile L., Scazzieri R. () *Social Models, Growth and Key Currencies*. In: Costabile L. (eds) *Institutions for Social Well-Being*. Palgrave Macmillan, London.

This paper explores the relationship between economic growth and the welfare state. Is there a trade-off between social protection and economic growth? One is to pretend that the French social model is still valid, that no trade-off exists between social protection and economic growth, that France can close the shutters and shelter from global capitalism, that all the blame belongs to with outside forces – whether globalization, America or Brussels. But Tony Atkinson, reviewing ten cross-country studies, reported that four of these studies found a positive association between social security expenditures and growth rates, four found a negative coefficient on the transfer variable, and two found that the coefficient was insignificant. Atkinson concluded his thorough analysis by arguing that empirical evidence on the issue is inconclusive. Moreover, different predictions derive from alternative theoretical models. One factor which is certainly relevant in this context are the macroeconomic policies which different countries have been implementing in the recent years. In section 2 we propose an analysis of how this institutional setting may influence growth differentials between Europe and the United States<sup>4</sup>. We argue that the institutional constraints set by the international monetary system may be at least as effective determinants of growth differentials between countries as the different dimensions of their welfare states. Having made the first point, we start from the fact that a group of countries in our case, twelve European countries have been able, through monetary unification to re-shape – though certainly not abolish – the constraints binding their policy options. On this basis, we raise our basic questions concerning the relationship between welfare and growth: We argue that, even within the international constraints, Europe is facing a choice between alternative models. The choice will depend on the preferred definitions and measures of growth, wealth and welfare. Flexibility and discipline in the international monetary system. Current accounts surpluses and deficits. To keep things simple, we start with a world inhabited by only two open economies: From the function of international means of payments assigned to USD, and from the non-<sup>4</sup> We take for granted that supply side factors exert a powerful influence on growth; nevertheless, in this paper we focus on the international monetary system, in order to enquire whether it may exert an independent influence on growth differentials. The only thing B can give in exchange is the goods that it produces, since its own currency – not being a means of international payments – is worthless for country A. In addition to selling goods to A, in an intertemporal perspective country B may try and sell claims to its future income, by convincing international investors to make direct and indirect investment in B. If country B is growing and, consequently, is involved in an increasing volume of international transactions, its demand for reserves grows over time. Thus, country B runs into systematic current account trade surpluses, and correspondingly country A runs into systematic trade deficits<sup>6</sup>. The international monetary system has a built-in mechanism whereby goods are transferred from country B to the country issuing the international means of payments though this tendency might be offset by counteracting flows on either side of the balance of payments. The fundamental national accounting equation for open economies tells us that, for both countries: The only difference between them is that the sign on both sides is positive for country B, negative for A. Thus, a current account deficit is always matched by an equal financial account surplus. With reference to the current US external deficit, for instance, it has been noticed that: Private saving also collapsed, so there was no net improvement in the current account prior to the recent <sup>4</sup> Call this Asymmetry 1. Country A buys the excess of externally produced goods by issuing USDs. As the world economy grows, it is a good thing for both countries if the international means of payment grow correspondingly, thus avoiding liquidity constraints on international transactions. Country B may benefit or loose as a result, but is not in a position to make an independent monetary policy as far as the international currency is concerned remember that country B is the sum of many uncoordinated small countries. Call this Asymmetry 2. Given its structural current account

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deficit, country A may be at a risk of paying its arguably high propensity to import or, in a long run perspective, a high income elasticity of imports with a downward pressure on domestic production, since a high proportion of its income buys foreign rather than home-produced goods. But this risk can be reduced if other components of aggregate demand are high enough to pull home production up to compensate for the import-determined downward push. If private expenditures fail to do so, public expenditure is a good candidate, to the extent that it stimulates domestic production. By contrast, country B should adopt more severe fiscal policies, as expansionary fiscal policies may crowd out exports directly or via their impact on domestic consumption, thus impairing its ability to sustain the required external surplus. Call this Asymmetry 3. Does country A leave beyond its means? No, because it finances this excess by selling assets, i. On the other hand, it is certainly true that, starting from a balanced current account, an expansionary fiscal policy generates a current account deficit, if an ad hoc hypothesis of offsetting changes in consumption and investment is avoided such as the hypothesis that consumers are Barro- Ricardians. Thus, in order to give a more precise answer, we need to enquire further into the nature of these assets. The balance of payment: Let us start with some commonplace statements. Because A is a net importer of commodities, capital must flow into A from country B. It may be considered as a paradox that country B is lending to A, and not vice versa: It is certainly a paradox that emerging countries lend to the US and not the other way around. His analysis retains some interest in spite of the many changes undergone by the monetary system, and perhaps even more because of these changes. Bernanke observed that the bulk of the increase in the U. Obstfeld and Rogoff also noticed that dollar denominated reserves are held mostly by developing countries in Asia, followed by Russia, Mexico and Brasil. It is that when a country with a key currency has a deficit in its balance of payments "that is to say, the United States, for example- it pays the creditor country dollars, which end up in its central bank. But the dollars are of no use in Bonn, or in Tokyo, or in Paris. The very same day, they are re-lent to the New York money market, so that they return to the place of origin. Thus the debtor country does not lose what the creditor country has gained. So the key-currency country never feels the effect of a deficit in its balance of payments. And the main consequence is that there is no reason whatever for the deficit to disappear, because it does not appear. Let me be more positive: As Rueff confirmed in this passage, capital inflows to country A are determined by the very nature of the international monetary system. But then the next question is: But there is evidence that the correlation between long run interest rates and net foreign liabilities of industrialised countries country A in our model has been relatively weak for more than a decade IMF, , p. How could this further paradox be explained? This arrangement -the ingenious invention of a commercial people in this century- constitutes in fact a treasure for war, exceeding the treasures of all other States taken together. It can only be exhausted by the ensuing deficit of the exchequer, which may be long postponed by trade prosperity and its impact upon production and profits. This facility for waging war, combined with the inclination of rulers towards it an inclination that seems implanted in human nature is therefore a great obstacle to perpetual peace. A Philosophical essay, as quoted in Triffin, This line of thought also implies that a depreciating USD would sooner or later as the economy moves up on the rising arm of the J-curve restore current account equilibrium. However, the current account deficit in country A, and the corresponding capital inflow, have been sustained since the beginning of the Eighties, both with an appreciating and a depreciating USD. Moreover, and most importantly, country B, as an emerging country, has strong incentives to accumulate reserves in order to avoid an appreciation of the national currency USD depreciation , in order to sustain the competitiveness of its exports. Because B buys financial inflows by selling enforceable claims to its future wealth, the risk of default on its external debt imposes great financial prudence on B A high precautionary demand may be the result of having learned the lesson of financial crises, rather than a pure market phenomenon. Country B is in a less fortunate position: Home bias is incorporated in a recent model by Blanchard, Giavazzi, Sa, Another factor is the special international status of the U. Because the dollar is the leading international reserve currency, and because some emerging-market countries use the dollar as a reference point when managing the values of their own currencies, the saving flowing out of the developing

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world has been directed relatively more into dollar-denominated assets, such as U. The effects of the saving outflow may thus have been felt disproportionately on U. For example, the dollar probably strengthened more in the latter s than it would have if it had not been the principal reserve currency, enhancing the effect on the U. Call this Asymmetry 4. Thus, we bump into the long-run consequences of the debt-credit relations in the international monetary system. If a country is a systematic borrower its debt towards country B will cumulate over the years, as the growth in payments to factor service income to foreign investors accompanies the increasing holdings of assets by foreigners. In this case, capital gains from exchange rate adjustment may add a degree of flexibility. Why does country A benefit from a depreciation in its currency? As is well known, depreciation is necessary in order to restore current account equilibrium in country A. But depreciation also has the very convenient effect of improving its net foreign position thus also reducing the needed amount of trade adjustment Gourinchas and Rey, ; IMF, , p. There is another side to the valuation effect: This loss would be made more visible by reckoning the 14 Bernanke A related strategy has focused on reducing the burden of external debt by attempting to pay down those obligations, with the funds coming from a combination of reduced fiscal deficits and increased domestic debt issuance. Of necessity, this strategy also pushed emerging-market economies toward current account surpluses. Again, the shifts in current accounts in East Asia and Latin America are evident in the data *our italics*. According to recent empirical estimates this financial channel has historically i. These authors also show that exchange rate adjustments are predictable, and, therefore, should not be modelled as surprise events. Is country B in a position to resist the appreciation of its own currency relative to the USD? Only to the extent that it is willing and allowed to buy virtually unlimited amounts of dollars at the going price, thus exerting a stabilising influence on the exchange rate, i. On this and other distributional effects of money injections see Costabile and In the post Bretton-Woods system, the international currency is not anchored to gold, or to any other base. With inconvertibility, a pure debt-credit relationship among countries is established Quadrio Curzio, , p. This makes the discipline even weaker on country A, which may become more willing to run into sustained external imbalances because, faced with a heavy net external position, it may more easily resort to depreciation as an instrument for external adjustment. Call this Asymmetry 5. Macroeconomic policies and growth in an asymmetric world. Let us look at the consequences for growth of the five asymmetries indicated above. Firstly, macroeconomic policies have a different role to play in A and B. Thanks to the international status of the USD, plus other related, facilitating circumstances which are gaining momentum with globalization , country A enjoys a certain flexibility concerning its monetary policy, and both its external and public deficits.

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