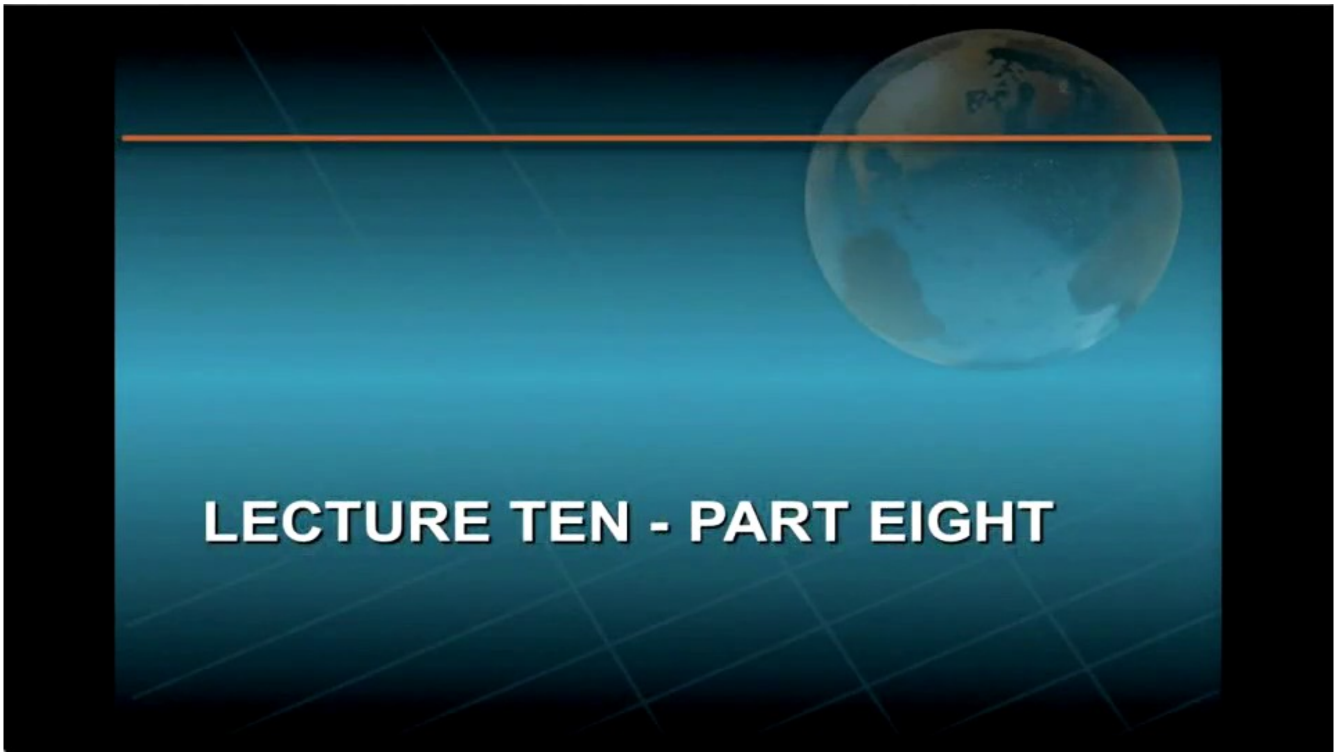
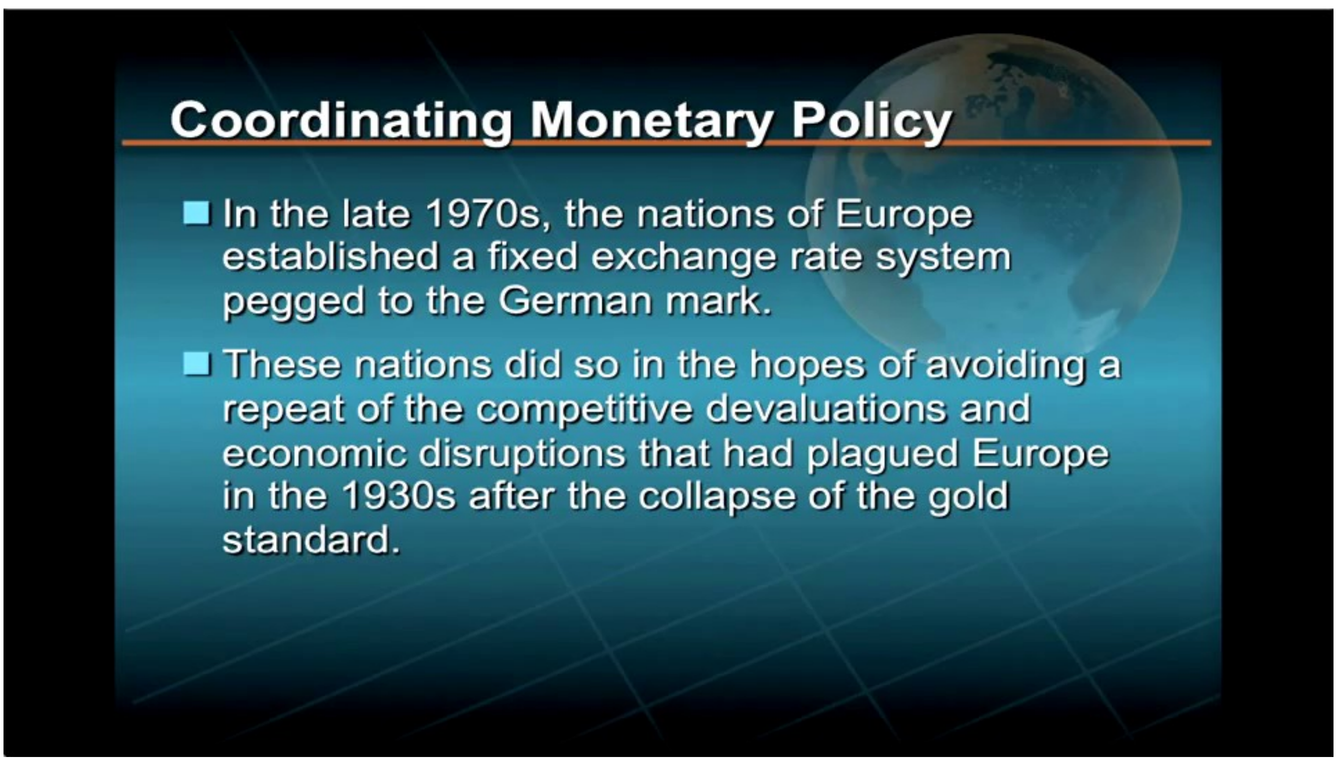

LECTURE TEN - PART EIGHT


Coordinating Monetary Policy
In the late 1970s, the nations of Europe established a fixed exchange rate system pegged to the German mark.
These nations did so in the hopes of avoiding a repeat of the competitive devaluations and economic disruptions that had plagued Europe in the 1930s after the collapse of the gold standard.

The European Monetary System

- This “European Monetary System” worked reasonably well for over a decade.
- However, in 1990, the reunification of Germany resulted in large budget deficits as West Germany subsidized East German industry.

Germany Raises Rates

- To cope with the resultant inflationary pressures, the Bundesbank – the German equivalent of the Federal Reserve – significantly raised interest rates.

An Uncoordinated Policy

- Here, German monetary policy was clearly uncoordinated with that of its neighbors.
- It was being used for *domestic* macroeconomic management without regard to its impact on Germany's trading partners!

An Ever-Deepening Recession

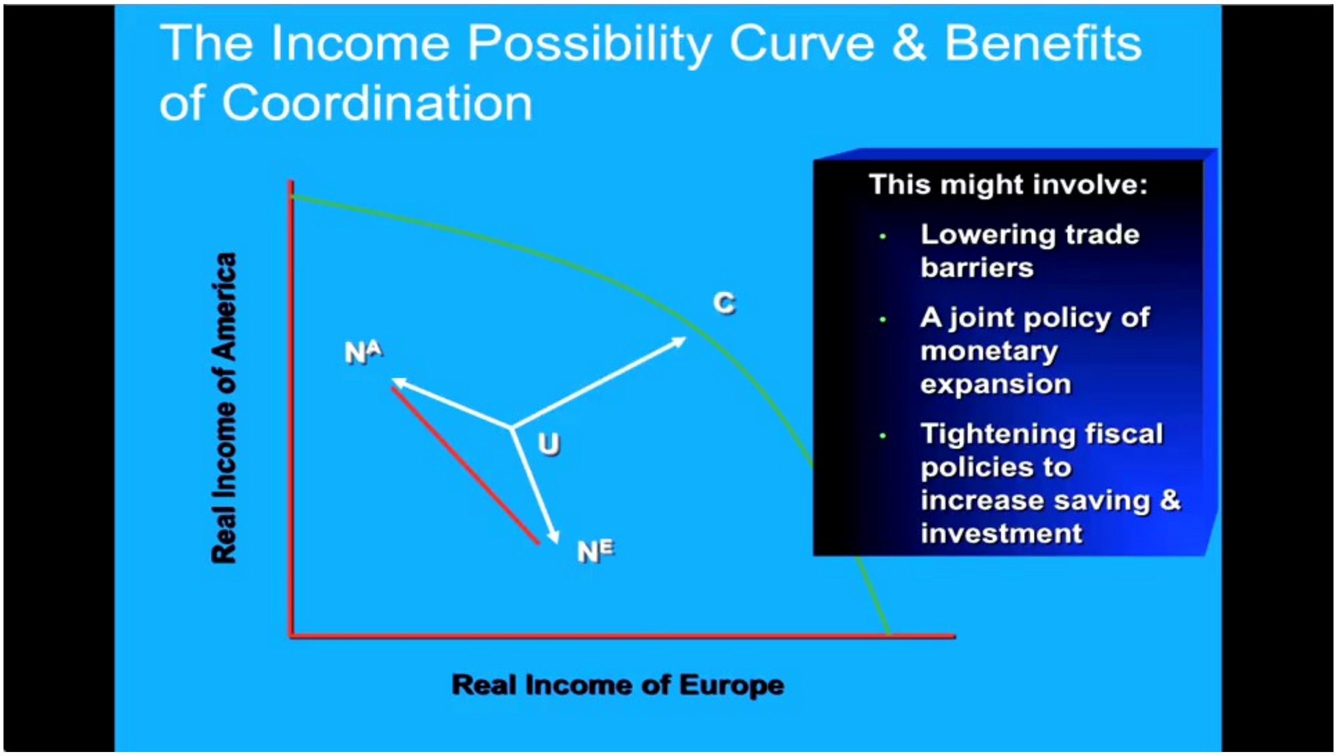
- The results were severe.
- Other European countries had to raise their interest rates to prevent their currencies from depreciating against the German mark.
- These interest-rate increases, along with a world-wide recession pushed Europe outside of Germany into an ever-deepening recession.

The Collapse

- Eventually, the European Monetary System was brought down by speculators.
- One by one, currencies came under attack—the Finnish mark, the Swedish crown, the Italian lira, the British pound, the Spanish peseta—and the system collapsed.

The Lesson Of This Crisis

- A country cannot simultaneously have fixed exchange rates, open capital markets, and an independent monetary policy.
- In the wake of this crisis, the major European countries resolved this dilemma by moving to a common currency--the “Euro”.


The Income Possibility Curve & Benefits of Coordination
This might involve:
Lowering trade barriers
A joint policy of monetary expansion
Tightening fiscal policies to increase saving & investment
Real Income of America
Real Income of Europe
C
N^A
U
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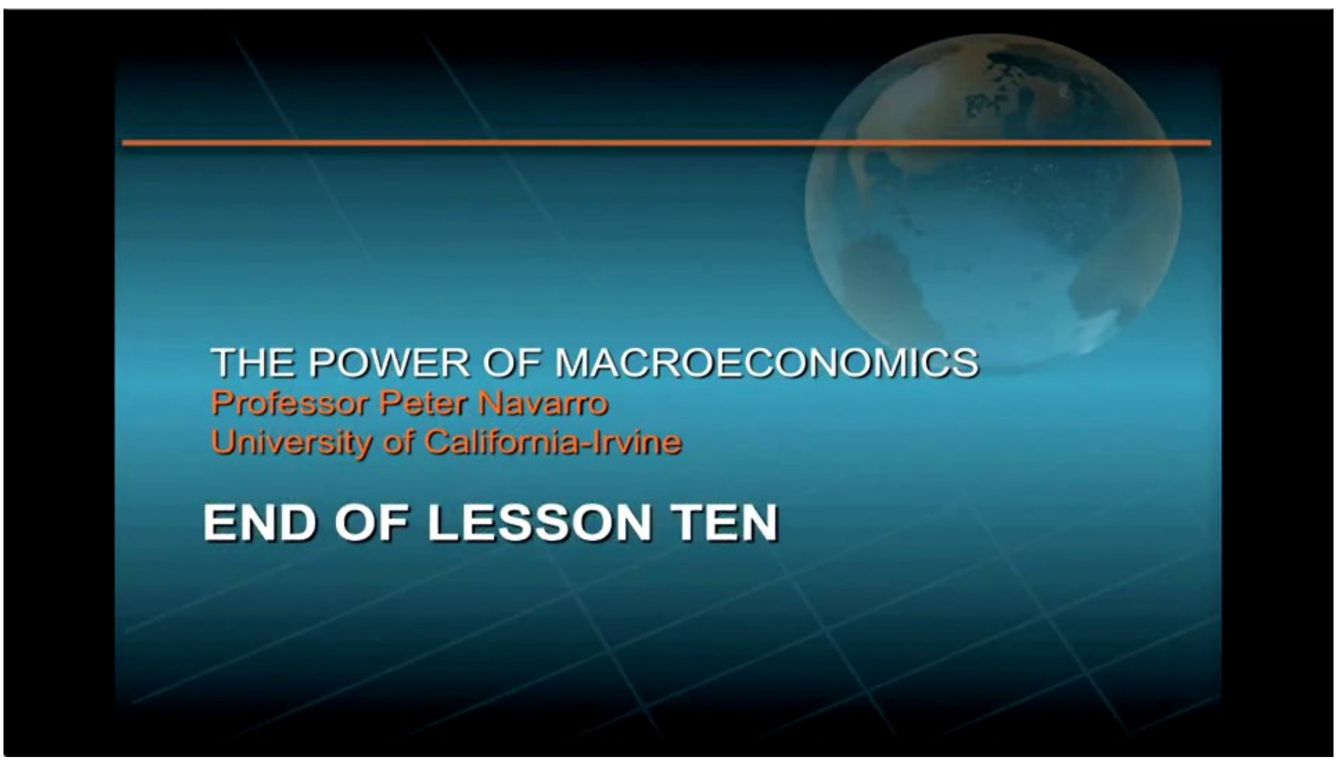
THE POWER OF MACROECONOMICS
Professor Peter Navarro
University of California-Irvine
END OF LESSON TEN


Coming Up Next!
Lesson Eleven:
The Economics of Developing Countries