

Mr. Mutti
Carnegie 204
Office Hours: 2:30-3:30 MF, 10:00-11:00 TH or by appointment

Ecn 375
Fall 2008

International Finance Seminar

Seminar Scope

International financial events are closely related to a country's standard of living and prospects for political stability, as well as a student's job prospects. We hope to have a better understanding of these interrelationships through our reading and discussion this semester.

We will cover four blocs of material in this course:

1. An introduction to basic concepts and measures used in international finance, particularly exchange rates, risk and regulation in international financial markets, and balance of payments statistics;
2. An analysis of factors that determine a country's current account balance;
3. An evaluation of how government macroeconomic policy affects a country's balance of payments, allowing for the influence of international capital flows and trade;
4. Consideration of policy issues that influence the whole international monetary system, such as choosing an appropriate exchange rate standard, addressing financial crises, joining a currency union, or determining the proper role and scope for the IMF.

Textbook

There is no required textbook purchase for this course, although there is a textbook on reserve in the library to provide backup material for several of the topics we consider. It is indicated on the syllabus as CFJ (Caves, Frankel and Jones, *World Trade and Payments* 9th Edition). I will pass out some supplementary chapters from a textbook that I co-author. Also, note that Section 3 in part reviews material you have covered in intermediate macroeconomics. Many of our discussions will center on applications of general principles to current events, and therefore I expect you to subscribe to a newspaper (*Wall Street Journal*, *New York Times*, or *Financial Times*) or some comparable source of economic news for the semester.

Evaluation

Your grade will be based on the following items:

1. Individual class participation, presentation of material from the syllabus, response to material

- presented by others, debate, summary of your research project, and contributions to our listserv discussion (25 percent);
2. Participation as a group member responsible for preparing written homework assignments (10 percent);
 3. Individual paper of 12-15 pages that extends general principles we develop in the course or that applies them to the experiences of a specific country. Clear an outline with me before you start writing (October 28th), submit a draft (Nov. 25th), and turn in a final product (December 11th). (35 percent).
 4. An in-class written mid-term exam (October 16th) (30 percent).

Course Outline

Part I. Basic Concepts

A. The Foreign Exchange Market and Exchange Rate Determination

Important Short-Run Determinants of Exchange Rates - Capital Flows

- How do interest rates influence present and future exchange rates?
- What role does risk play in investment decisions?
- How are distinctions between systematic and nonsystematic risk relevant?
- Are world capital markets becoming progressively more integrated, and hence the benefits of diversification falling?

Sam Cross, All About the Foreign Exchange Market in the United States, New York Federal Reserve Bank, 1998, Chapters 5 and 6.

<http://www.newyorkfed.org/education/addpub/usfxm/>

Eugene Brigham and Michael Ehrhardt, *Financial Management*, 12th edition, Chapters 6 and 7

Andre Perold, 'The Capital Asset Pricing Model,' *Journal of Economic Perspectives*, Summer 2004, pp. 3-24.

Brenda Gonzalez Hermosillo, 'Investors' Risk Appetite and Global Financial Market Conditions,' IMF Working Paper WP/08/85, April 2008 (pp. 1-15 especially)

<http://www.imf.org/external/pubs/ft/wp/2008/wp0885.pdf>

Roberto DeSantis and Lucio Sarno, 'Assessing the Benefits of International Portfolio Diversification in Bonds and Stocks,' European Central Bank Working Paper Series 883, March 2008 (skip pp. 10-15).

<http://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp883.pdf>

Bill Francis, Iftexhar Hasan, and Delroy Hunter, 'Does Hedging Tell the Full Story? Reconciling Differences in U.S. Aggregate and Industry-Level Exchange Rate Risk Premia,' Bank of Finland Research Discussion Paper 14.2008

<http://ssrn.com/abstract=1138148>

Cigdem Akin and Ayhan Kose, 'Changing Nature of North-South Linkages: Stylized Facts and Explanations,' December 2007.

<http://ssrn.com/abstract=1075343>

Homework Assignment #1 - financial market operations

Financial Crises and the Regulation of Financial Institutions

- How can instability of the financial system be addressed?
- How have individual countries dealt with their own financial crises?

Secretariat of the Basel Committee on Banking Supervision, Overview of *The New Basel Capital Accord*, April 2003 at <http://www.bis.org/bcbs/cp3ov.pdf> (for an earlier explanation see <http://www.bis.org/publ/bcbsca01.pdf>)

T. Cargill, et. al., *The Political Economy of Japanese Monetary Policy*, MIT Press, 1997 Ch. 5 and 6. (an e-book that can be accessed from the library catalog)

Timothy Curry and Lynn Shibut, 'The Cost of the Savings and Loan Crisis: Truth and Consequences,' *FDIC Banking Review*, December 2000

http://www.fdic.gov/bank/analytical/banking/2000dec/brv13n2_2.pdf

Important Medium and Long-Run Determinants of Exchange Rates

- Are markets for goods well enough integrated internationally that prices in different countries must move together?
- What else besides trade in goods should be accounted for in predicting exchange rates?

CFJ 19.2, 19.3

Kenneth Rogoff, "The PPP Puzzle," *Journal of Economic Literature*, June 1996, pp. 647-654

<http://links.jstor.org/sici?sici=0022->

[0515%28199606%2934%3A2%3C647%3ATPPPP%3E2.0.CO%3B2-S](http://www.ssrn.com/abstract=1079242)

Peter Isard, Equilibrium Exchange Rates: Assessment Methodologies, IMF Working Paper WP/07/296, December 2007.

<http://ssrn.com/abstract=1079242>

Alexander Chudik and Joannes Mongardini, 'In Search of Equilibrium: Estimating Equilibrium Real Exchange Rates in Sub-Saharan African Countries,' IMF Working Paper WP/07/90, April 2007 (pp. 1-8, 14-16)

<http://ssrn.com/abstract=986818>

B. Balance of Payments Accounting

- What inferences can we draw from a country's current account position?
- How do you expect a country's overall balance to differ if it maintains a fixed exchange rate versus a flexible exchange rate?
- Does a country's balance of payments give information that would help us predict future exchange rate changes, such as the decline of the dollar from 2002 into 2008?

CFJ: 15

Homework #2 - evaluation of a country's balance of payments position

Part II. Current Account Adjustments

- How is the current account affected by saving and investment?
- How is a country's balance of trade affected by changes in income and prices?
- What makes a balance of trade deficit sustainable?
- What difference does it make to current account adjustment if a country can borrow in its own currency rather than a foreign currency?

CFJ: 16, 17

Issues from the 1990s and beyond

Dean Baker, "Double Bubble: The Implications of the Over-Valuation of the Stock Market and the Dollar," June 2000 at http://www.cepr.net/documents/publications/double_bubble.htm

Catherine Mann, *Is the U.S. Trade Deficit Sustainable?*, IIE, 1999, Ch. 10

Richard Cooper, "Is the U.S. Current Account Deficit Sustainable? Will It be Sustained?" *Brookings Papers on Economic Activity* 1, 2001, pp. 217-226.

<http://links.jstor.org/sici?sici=0007-2303%282001%292001%3A1%3C217%3AITUCAD%3E2.0.CO%3B2-A>

Ronald McKinnon, "The International Dollar Standard and the Sustainability of the U.S. Current Account Deficit," *Brookings Papers on Economic Activity* 1, 2001, pp. 227-237.

<http://links.jstor.org/sici?sici=0007-2303%282001%292001%3A1%3C227%3ATIDSAT%3E2.0.CO%3B2-O>

Homework #3 – current account adjustments

Midterm Exam – October 16th

Part III. Income Determination, Asset Markets and Balance of Payments Adjustments-the Outlook for a Single Country

- With greater international capital mobility, has the ability of countries to stabilize their economies declined?
- Is targeting prices an appropriate goal for monetary policy, or should central banks also pay attention to asset prices?

CFJ: 22, 23

IMF Article IV consultations with member countries

<http://www.imf.org/external/country/index.htm>

Homework #4 - interpreting a country's macroeconomic policy options

Part IV. Current Issues in the International Monetary System

A. Fixed Exchange Rates, Flexible Exchange Rate and Alternatives

- Can a country maintain a fixed rate, have an independent monetary policy, and allow international capital mobility?

CFJ: 26.5

Stanley Fischer, "Exchange Rate Regimes: Is the Bipolar View Correct?" *Journal of Economic Perspectives*, Spring 2001, pp. 3-24.

<http://www.imf.org/external/pubs/ft/fandd/2001/06/fischer.htm>

- Sacrificing exchange rate stability?

Maurice Obstfeldt and Kenneth Rogoff, "The Mirage of Fixed Exchange Rates," *Journal of Economic Perspectives*, Fall 1995, pp. 73-96, at <http://www.jstor.org/stable/2138391>.

- Sacrifice capital mobility?

Fischer, "Capital Account Liberalization and the Role of the IMF," IMF, Sept. 1997 at <http://www.imf.org/external/np/speeches/1997/091997.htm>

S. Edwards, "How Effective are Capital Controls?" *Journal of Economic Perspectives*, Fall 1999, 65-84

<http://links.jstor.org/sici?sici=0895-3309%28199923%2913%3A4%3C65%3AHEACC%3E2.0.CO%3B2-5>

E. Kaplan and D. Rodrik, "Did Malaysian Capital Controls Work?" Feb, 2001

<http://ksghome.harvard.edu/~drodrik/Malaysia%20controls.PDF>

Jagdish Bhagwati, 'The Capital Myth,' *Foreign Affairs*, 1998, pp. 7-12 at:

[http://search.ebscohost.com/login.aspx?direct=true&db=aph&bquery=\(TI+\(+%22The%22+AND+%22Capital%22+AND+%22Myth%22+\)\)\)+and+\(AU+\(+%22bhagwati%22+\)\)&type=1&site=ehost-live](http://search.ebscohost.com/login.aspx?direct=true&db=aph&bquery=(TI+(+%22The%22+AND+%22Capital%22+AND+%22Myth%22+)))+and+(AU+(+%22bhagwati%22+))&type=1&site=ehost-live)

Peter Blair Henry and Diego Sasson, 'Capital Account Liberalization, Real Wages, and productivity,' Stanford Business School Research Paper No. 1988, February 2008.

<http://ssrn.com/abstract=1027544>

- Sacrifice an independent monetary policy?

K. Schuler, "Introduction to Currency Boards," at <http://users.erols.com/kurrency/intro.htm> and "Basics of Dollarization," at <http://users.erols.com/kurrency/basicsup.htm>

N. Roubini, "The Case Against Currency Boards: Debunking 10 Myths about the Benefits of Currency Boards," at

<http://www.geocities.com/Eureka/Concourse/8751/jurus/vs-cbs.htm>

Carmen Reinhart and Vincent Reinhart, 'Capital Inflows and Reserve Accumulation: the Recent Evidence,' NBER Working Paper 13842, March 2008

B. Interpretations of the Asian Financial Crisis

- Was the 1980s crisis in Latin America a useful guide to the Asian crisis of the 1990s?
- What major changes in financial policies have developing countries chosen in response to the Asian crisis?

Paul Blustein, *The Chastening*, 2001, chapters 2-5.

John Williamson, "A Short History of the Washington Consensus," at <http://www.iie.com/publications/papers/williamson0904-2.pdf>

John Williamson, 'The Years of Emerging Market Crises,' *Journal of Economic Literature*, September 2004, pp. 822-837 at <http://www.jstor.org/stable/3217254>.

C. Intermediate Choice Between the Poles

- When should a country peg its exchange rate relative to some currencies but let it float relative to others?
- Were EU pre-conditions on national macroeconomic policy prior to the introduction of a single currency reasonable?

CFJ: 23.3, 26.5

Philip Lane, 'The Real Effects of European Monetary Union,' *Journal of Economic Perspectives*, Fall 2006, pp. 47-66 at <http://www.atypon-link.com/AEAP/doi/pdf/10.1257/jep.20.4.47>.

Kathryn Dominguez, 'The European Central Bank, the Euro, and Global Financial Markets,' *Journal of Economic Perspectives*, Fall 2006, pp. 67-88 at <http://www.atypon-link.com/AEAP/doi/pdf/10.1257/jep.20.4.67>

HM Treasury, 'UK Membership of the Single Currency: An Assessment of the Five Economic Tests,' June 2003

http://www.hm-treasury.gov.uk/documents/international_issues/the_euro/assessment/report/euro_assess03_repexecsum.cfm

HM Treasury, 'Housing, consumption and the EMU,'

http://www.hm-treasury.gov.uk/documents/international_issues/the_euro/assessment/studies/euro_assess03_studdorset.cfm

Carlo Cottarelli and Julio Escolano, 'Assessing the Assessment: A Critical Look at the June 2003 Assessment of the United Kingdom's Five Tests for Euro Entry,' IMF Working Paper WP/04/116, July 2004

Ansgar Belke and Daneil Gros, 'Instability of the Eurozone? On Monetary Policy, House Prices and Labor Market Reforms,' IZA Discussion Paper 2547, January 2007

Mongelli, "New Views on the Optimal Currency Area Theory: What is EMU Telling Us?" European Central Bank Working Paper 138 at <http://www.ecb.int/pub/pdf/scpwps/ecbwp138.pdf>

D. Stability in the International Financial System - What Role for the IMF

- Is the IMF irrelevant in a world with highly mobile capital internationally, or more necessary than ever?
- Is it trying to do too much or not enough?

John Williamson, "A Short History of the Washington Consensus," at <http://www.iie.com/publications/papers/williamson0904-2.pdf>

Paul Collier and Jan Gunning, "The IMF's Role in Structural Adjustment," *Economic Journal*, November 1999, pp. F634-F651 at: <http://links.jstor.org/sici?sici=0013-0133%28199911%29109%3A459%3CF634%3ATIRISA%3E2.0.CO%3B2-I>

Morris Goldstein, *IMF Structural Conditionality: How Much is Too Much?* at <http://www.iie.com/publications/wp/2001/01-4.pdf>

Meltzer Commission, "Meltzer Commission Report," and the U.S. Treasury Response at <http://www.house.gov/jec/imf/meltzer.htm>