

INTERNATIONAL ECONOMICS: FINANCE

Course: Econ-372-001

Professor: Alan G. Isaac

email: aisaac@american.edu

Office Hours: MTh 12:45pm-3:45pm; by appointment

Term: Fall 2008

Office: 217 Roper Hall

Phone: (202)885-3785

Fax: (202)885-3790

Course Objective

This course covers the macroeconomic and monetary side of international economics. You will explore in detail the functioning of international financial markets. Other topics include the determination of the balance of trade and the balance of payments, and the effectiveness of monetary and fiscal policy in an open economy, and the nature and causes of currency crises. Macroeconomic models of open economies will be developed and applied to contemporary policy issues. We will also investigate the effectiveness of macroeconomic policy in the open economy, which depends heavily on the exchange rate regime. Our discussions of macroeconomic policy lead naturally into a discussion of the variety of exchange rate regimes, the evolution of debt crises, and the causes of currency crises.

Prerequisites

This course assumes that you have mastered an intermediate level course in macroeconomics and that you recall some basic statistics.

An intermediate level macroeconomics course (Econ-301, or equivalent) is prerequisite to this course; no exceptions. Basic Statistics (Stat-202, or equivalent) is strongly recommended. You will be expected to master some **basic statistics** and **regression concepts**. I also consider a commitment to upholding the **Academic Integrity Code for American University** to be prerequisite to participation in this course.

This course is part of the advanced sequence in international economics, which also includes a separate course on international trade (Econ-371). This course is intended primarily for Economics majors; non-majors are encouraged to take Econ-311 instead. Students who have taken Econ 311 are permitted to take this course, but there will be some overlap in the material covered. Only two of the three international economics courses (Econ 311, 371, and 372) may be counted toward a degree in economics.

Course Resources

All students are also expected to use [BlackBoard](#), which provides access to the course website. The website will include links to detailed lecture notes for this course (in PDF format). There is also a class email list: **econ-372-L**. You must subscribe to the class email list, using its listname. (See my [detailed subscription instructions](#).) All students are expected to monitor the class email list.

Required Texts

Krugman, Paul R. and Maurice Obstfeld, 2008, *International Economics: Theory and Policy* 8/E Addison-Wesley ISBN-10: 0321488830 ISBN-13: 9780321488831 (Referred to as KO in the readings.)

Grading

In order to obtain a grade of B, expect to spend at least two hours in study time outside of class for each hour of class time.

There will be two multiple-choice midterms (1 hour and 15 minutes each) and a comprehensive final exam (2 hours and 30 minutes). Each midterm grade constitutes 30% of the course grade, and the final constitutes the remaining 40%. However, I will "weight improvement" when it is marked.

Exams are taken without the aid of textbooks or of notes of any kind, and no collaboration is allowed on exams. I offer no extra credit, and there will be no makeup exams. (Exams may be missed with a doctor's excuse, of course. The grade will then be calculated from the remaining exams.) Exams presume a thorough knowledge of all homeworks and required readings.

Ongoing study groups are highly recommended. Study groups are an excellent means of mastering the course material. Besides, they are fun. I encourage you to discuss the problem sets with others, but there are strict terms for such collaboration. You must cite all of your collaborators at the front of your submitted solutions. (Legitimate collaboration does **not** reduce your grade!) Also, you must write up solutions on your own. **To repeat: your write-up of any problem solution must be entirely your own.** The use of pre-packaged sources of solutions to the assigned problems is not permitted. You may neither copy solutions nor provide solutions to be copied. Plagiarism, cheating, and other anti-intellectual behavior will be dealt with severely and can lead to dismissal from the university.

Testing

MIDTERM EXAMINATIONS: 2 Oct. and 13 Nov.

FINAL EXAMINATION: See the [AU final exam schedule](#), which **always** determines the date of the final. **Always**

check the schedule of classes.

The emphasis of my exams reflects the emphasis of my lectures, and lecture will sometimes cover ground not found in the readings. Be sure to take good notes, as they will be crucial to your performance on the examinations. I will also draw on required readings for exam questions. I therefore recommend attempting the end of chapter problems, when they are available.

In this course, I rely primarily on multiple-choice examinations. I write my own questions, and I look for evidence of deep, detailed understanding rather than cursory exposure. Despite some popular prejudices, empirical tests as well as my own experience indicates that this is a very effective examination procedure.¹

Topics and Readings

The order of the topics is indicated below. The exact timing however varies with the interests and abilities of the class. Exams are primarily based on lecture. Each topic also includes recommended readings. When a recommended reading is discussed explicitly in class, I am likely to develop exam questions based on the classroom discussion. Detailed citation information for the readings is in the following section. Note that most articles are available online. Textbook readings (KO = Krugman & Obstfeld) are required. Also required are Higgins (2005) and Pakko and Pollard (2003). All other readings are recommended.

Topic	Readings	Session
The Balance of Payments Includes: stocks vs. flows, double-entry book-keeping, national income accounting, balance of payments accounting, financial programming, current account sustainability,	KO ch. 12; BEA's BoP data Higgins (2005) Holman (2001) IMF (1996) Fieleke (1996) Seskin and Parker (1998) Bach (1999)	1
Global Financial Markets Includes: spot and forward rates, interest parity concepts, foreign exchange derivatives (futures, options, swaps)	KO ch.13; Cross (1998) Frankel (1993, ch.2)	2-3
Floating Exchange Rates I: Equilibrium Includes: monetary approach to floating exchange rates, role of expectations, temporary vs. permanent shocks, money/price-level correlations, Fisher effect, evidence from hyperinflations	KO ch.14; Frenkel (1976 ScanJE); Beaugrand (1997)	4-6
Purchasing Power Parity Includes: commodity price parity, price index construction, "Big Mac standard", Penn World Table, PPP-based national income comparisons, long-run PPP,	KO ch.15; Pakko and Pollard (1996); Pakko and Pollard (2003); Economist's Big Mac index, June 2005	7
Trade Balance and Exchange Rates Includes: Marshall-Lerner condition, J-curve, Balassa-Samuelson effect, Houthakker-Magee critique, "classical" Mundell-Fleming Model	KO ch.16, Appendix III Chinn (2004) Quiggin (2004 EV)	8
Floating Exchange Rates II: Overshooting Includes: monetary and fiscal policy in the short run;	KO ch.16; Frankel (1979 AER);	9-10

real interest differential model and evidence;

Dornbusch (1976 JPE);
Cavallo et al. (2004)

Pegged Exchange Rates

Includes: gold standard; Bretton Woods; "elasticity approach" to BoP; "monetary approach" to BoP; "Keynesian" Mundell-Fleming model

KO ch.17,18
Bordo (1993)
Grabbe (1996)
Dueker and Fischer (2001)

12-13

The Small Open Economy Model

13

Monetary & Fiscal Policy in the Open Economy

Includes: "Keynesian" Mundell-Fleming model, regime-dependent policy effectiveness, optimum currency areas, EMU history

KO ch.16-20;
Kouparitsas (2003);

14

Balance-of-Payments Crises

Includes: capital flight, sterilized intervention, policy coordination, debt crisis and Brady plan, currency crisis and IMF stabilization; contagion

KO ch.17,22
Calvo and Mendoza (1996)
Bretton Woods Committee (2003)

15

SHOULD TIME REMAIN:

Exchange Rates and Risk

Includes: financial market efficiency; evidence for a risk premium in foreign exchange market; mean-variance analysis; portfolio balance

KO ch.21 + "postscript" pp.728ff

11

LDCs in the International Financial System

CFJ 9, 20;
Krugman 4, 9, 11, 13

Review and General Discussion

References

- Bach, Christopher L., 1999, "U.S. International Transactions, Revised Estimates for 1982-98", Survey of Current Business, July 1999, pp. 60-74. <http://www.bea.doc.gov/bea/ARTICLES/INTERNAT/BPA/1999/0799bpr.pdf>
- Beaugrand, Philippe, 1997, "Zaire's Hyperinflation, 1990--96", IMF Working Paper WP/97/50 (IMF: Washington, DC) <http://www.imf.org/external/pubs/ft/wp/wp9750.pdf>
- Bordo, Michael D., 1993, "The Gold Standard, Bretton Woods and Other Monetary Regimes: A Historical Appraisal" Federal Reserve Bank of St. Louis Review, March/April 1993 Vol. 75, No.2 http://research.stlouisfed.org/publications/review/93/03/Gold_Mar_Apr1993.pdf
- Bretton Woods Committee, 2003, "Sovereign Debt Restructuring Mechanism: Way Forward or Unnecessary Detour?" Critical Issues Forum <http://www.brettonwoods.org/SDRMcriticalissue.htm>
- Calvo, Guillermo A. and Enrique G. Mendoza, "Mexico's Balance-of-Payments Crisis: A Chronicle of Death Foretold" International Finance Discussion Papers 1996-545 Board of Governors of the Federal Reserve <http://www.federalreserve.gov/pubs/ifdp/1996/545/ifdp545.pdf>
- Cavallo, Michele and Kate Kisselev and Fabrizio Perri and Nouriel Roubini, 2004, "Exchange Rate Overshooting And The Costs Of Floating", presented in April 2004 at the Federal Reserve Bank of San Francisco conference on Emerging Markets and Macroeconomic Volatility. <http://www.frbsf.org/economics/conferences/0406/Perri.pdf>
- Chinn, Menzie D., 2004, "Incomes, Exchange Rates and the U.S. Trade Deficit, Once Again" Working Paper: University of Wisconsin, Madison, revision of NBER Working Paper #9521. http://www.ssc.wisc.edu/~mchinn/tradebal_intfin1.pdf
- Cross, Sam Y., 1998, *All About ... The Foreign Exchange Market in the United States* <http://www.newyorkfed.org/education/addpub/usfxm/>
- Dornbusch, R., 1976, "Expectations and Exchange-Rate Dynamics," *Journal of Political Economy*, Vol. 84, December, pp. 1161--1176.
- Dueker, Michael J. and Andreas M. Fischer, 2001, "The Mechanics of a Successful Exchange Rate Peg: Lessons for Emerging Markets" Federal Reserve Bank of St. Louis Review, September, pp.47--56. <http://research.stlouisfed.org/publications/review/01/09/0109md.pdf>
- Fieleke, Norman S., 1996, "What Is the Balance of Payments?" Federal Reserve Bank of Boston Special Report No. 3 <http://www.bos.frb.org/economic/special/balofpay.pdf>
- Frankel, Jeffrey A., 1979, "On the Mark: A Theory of Floating Exchange Rates Based on Real Interest Differentials," *American Economic Review* 69, Sep. 1979, 610--22. (Reprinted as ch. 3 of Frankel 1993. Available on JSTOR.)
- Frankel, Jeffrey A. *On Exchange Rates* (MIT Press, 1993)
- Frenkel, Jacob, 1976, "A Monetary Approach to the Exchange Rate: Doctrinal Aspects and Empirical Evidence," *Scandinavian Journal of Economics* 78 (1), May, 200--224. (Reprinted in: J. Frenkel and H. G. Johnson (1978).)
- Frenkel, J. and H. G. Johnson (eds), 1978, *The Economics of Exchange Rates*, (Reading, Mass: Addison-Wesley, 1978)
- Grabbe, J. Orlin, 1996, "The Rise And Fall Of Bretton Woods" http://www.orlingrabbe.com/bretton_woods.htm (online version of his Chapter 1, International Financial Markets, 3rd edition, 1996 Prentice-Hall, Inc., a Simon & Schuster Company, Englewood Cliffs, New Jersey. ISBN 0-13-206988-1.)
- Higgins, Matthew and Thomas Klitgaard and Cédric Tille, "The Income Implications of Rising U.S. International Liabilities", Current Issues in Economics and Finance Volume 11, Number 12, December 2005. URL: http://www.newyorkfed.org/research/current_issues/ci11-12.pdf.
- Holman, Jill A., 2001, "Is the Large U.S. Current Account Deficit Sustainable?" Federal Reserve Bank of Kansas City *Economic Review*, First Quarter, pp.5--23. URL: <http://www.kc.frb.org/publicat/econrev/PDF/1q01holm.pdf>
- International Monetary Fund, 1996, *Balance of Payments Textbook* (ISBN 1-55775- 570-1)
- Kouparitsas, Michael A., "International Business Cycles Under Fixed and Flexible Exchange Rate Regimes" Federal Reserve Bank of Chicago Working Paper WP2003-28. <http://www.chicagofed.org/publications/workingpapers/papers/wp2003-28.pdf>
- Neely, Christopher J. and Lucio Sarno, 2002, "How Well Do Monetary Fundamentals Forecast Exchange Rates?" Federal Reserve Bank Of St. Louis Working Paper 2002-007A, May. <http://research.stlouisfed.org/wp/2002/2002-007.pdf>
- Obstfeld, Maurice, 1994, "The Logic of Currency Crises" Cahiers Economiques et Monetaires. http://elsa.berkeley.edu/users/obstfeld/ftp/currency_crises/cc.pdf
- Obstfeld, Maurice and Kenneth Rogoff, 1995, "The Mirage of Fixed Exchange Rates", Journal of Economic Perspectives 9, 73--96.
- Pakko, Michael R. and Patricia S. Pollard, 1996, "For Here or To Go? Purchasing Power Parity and the Big Mac", Federal Reserve Bank of St. Louis *Review* 78 (1) pp. 3--21. URL: <http://research.stlouisfed.org/publications/review/past/1996>
- Pakko, Michael R. and Patricia S. Pollard, 2003, "Burgernomics: A Big Mac™ Guide to Purchasing Power Parity", Federal Reserve Bank of St. Louis *Review* 85 (6) pp. 9--27. URL: <http://research.stlouisfed.org/publications/review/03/11/pakko.pdf>
- Quiggin, John, 2004, "The Unsustainability of U.S. Trade Deficits", *The Economists' Voice* 1(3), Article 2. <http://www.bepress.com/ev/vol1/iss3/art2>

Romer, David, 1993, "Do Students Go to Class? Should They?" *Journal of Economic Perspectives* 7(3), Summer, pp.167--74.

Seskin, Eugene P. and Robert P. Parker, 1998, "A Guide to the NIPA's" Survey of Current Business, March, 26--68. URL: <http://www.bea.doc.gov/bea/ARTICLES/NATIONAL/NIPA/1998/0398niw.pdf>

We may also view the following instructional videos: Exchange Rates, Capital Flight, and Hyperinflation (VHS 2869) , Billion Dollar Day (VHS 297), Managing Currencies and Policy Coordination (VHS 2868). We may not have time for these, but you may view them in the library if you wish. (This is not required.)

Further Reading

I am listing a few books that are not required but which I will refer to in lecture. If you borrow these from a library, please note that I consider any marking, underlining, or writing in pencil, pen, or highlighter on any library materials to be defacement of library property, a violation of academic integrity, and grounds for a reduction in your final grade. Please treat all library materials as precious intergenerational resources that you are privileged to share.

Corden, W. Max, *Too Sensational: On the Choice of Exchange Rate Regimes* MIT Press, 2002. ISBN: 0-262-03298-8

Caves, Richard E., **Jeffrey A. Frankel**, and Ronald W. Jones, *World Trade and Payments: An Introduction* 8th Edition (New York: Addison Wesley, 1998) (referred to as "CFJ")

Ghosh, Atish R. and Anne-Marie Gulde and Holger C. Wolf *Exchange Rate Regimes* MIT Press 2003 ISBN: 0-262-07240-8

MacDonald, Ronald and Ian Marsh, 1999, *Exchange Rate Modelling* (Kluwer) isbn0-7923-8668-X

Frenkel, J. and H. G. Johnson (eds), 1978, *The Economics of Exchange Rates*, (Reading, Mass: Addison-Wesley, 1978)

Rivera-Batiz, Francisco L, and Luis A. Rivera-Batiz, 1994, *International Finance and Open Economy Macroeconomics* (New York: Macmillan)

Study Strategies

1. Attend class and take good notes. Good notes will be crucial to your performance on the examinations. And studies indicate that attendance improves performance (**Romer 1993 JEL**).
2. Ask questions in class. Don't let your questions go unanswered!
3. Don't reserve your studying for the weekends. I suggest an hour per day. Daily exposure is much better than cramming.
4. Study at the library or someplace else that is not distracting.
5. Do the required reading. I draw on the required readings for exam questions.
 - a. Don't read it just once.
 - b. **If you own the text**, read with a highlighter or pencil.
 - c. Outline the important points.
6. Do any end of chapter problems. I often develop exam questions based on these problems.
7. Discuss the readings and problems in a study group. Student who use them tell me that study groups are very helpful. Make up problems in your study group as part of exam preparation.
8. Discuss readings and problems on the course mailing list. Don't let your questions go unanswered!
9. If you feel timid about stating your question on the course email list, be sure to email it to me directly. Don't let your questions go unanswered!

¹ See for example W. Walstad and W. Becker, "Achievement Differences on Multiple-Choice and Essay Tests in Economics," *American Economic Review* 84(2), May 1994, 193-196. Also: Bridgeman, B. (1989) College Board Report No. 89-2, "Comparative Validity of Multiple-Choice and Free-Response Items on the Advanced Placement Examination in Biology" New York: College Entrance Examination Board. (ERIC Document Reproduction Service No. ED 308 228)