

INTERNATIONAL ECONOMICS: FINANCE

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Course: Econ 372-001

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Course Objective

Overview

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**.

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.

I also consider a commitment to upholding the **Academic Integrity Code for American University** to be prerequisite to participation in this course.

If you feel you may have violated this code of ethics, please talk with me immediately. In cases where there has

been a violation of the code of ethics, it will be far better if you contact me, rather than vice versa. I understand the pressure that you may experience in graduate school, and I will try to help you recover from self-reported mistakes.

Required Texts

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

Course Resources

This class will use the **Blackboard** courseInfo software. Look there for the syllabus, lecture notes, and homework. We will also use a listserv mailing list. For this course, you must subscribe to the class email list, econ-372-L. (Refer to the **subscription instructions**.) I recommend that you use your AU account to subscribe: you can always set your AU account to forward mail to your commercial account. All students are expected to monitor their course email, which may contain homework problems, reading assignments, and grade reports. All students are expected to adhere to **basic email etiquette**: be respectful, quote appropriately, and do not use HTML. (To repeat: please **turn off HTML formatting of your email**. I filter HTML messages a spam and may not receive them.)

Software

Each homework will be submitted as a [Google Doc](#) by “sharing” it with my TA at econ372@gmail.com. (Be sure to allow editing.) To complete the homeworks you will need the [gretl](#) econometric package.

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.

Your final grade will be based on the **total points** earned on graded work. 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 represents 25% of the total course points. The final represents 35% total course points. Homework represents 15% of total course points.

I will “weight improvement” when it is marked.

Exams

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 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.

MIDTERM EXAMINATIONS: 28 September 2009 and 2 November 2009

FINAL EXAMINATION: you will find the date of our final examination on the **final exam schedule**. (The AU schedule of classes **always** determines the date and time of the final, so please check your 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 [[walstad.becker-1994-aer](#)].

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.

The Balance of Payments

Topics

stocks vs. flows, double-entry book-keeping, national income accounting, balance of payments accounting, financial programming, current account sustainability,

Required Readings

KO 12; [[fieleke-1996-bop](#)];

Optional Readings

BEA's BoP data http://www.bea.doc.gov/bea/international/bp_web/simple.cfm?anon=21006&table_id=1&area_id=3, Higgins (2005), IMF (1996), Seskin and Parker (1998), [[bach-1999-scb](#)] <http://www.bea.doc.gov/bea/ARTICLES/INTERNAT/BPA/1999/0799bpr.pdf>,

Global Financial Markets

Topics:

Spot and forward markets. Covered interest parity and the pricing of forward contracts. Foreign exchange derivatives (futures, options, swaps, carry trade). Option pricing (Black-Scholes).

Required Readings:

KO ch.13 (including appendix) and ch.21;

Optional Readings

[cross-1998-fxmkt]_ (esp. ch 2,3,5) [milesi-2009-fandd]; Frankel (1993, ch.2)

Interest Rates and Exchange Rates

Topics:

Short-run exchange rate determination. Uncovered Interest Parity. Expected depreciation and expected asset returns. Interest rates, expectations and exchange rates. The role of exchange rate expectations in floating exchange rate regimes.

Required Readings:

KO ch.13

Optional Readings

Frankel (1993, ch.2)

Money and Exchange Rates I: Short Run

Topics:

Money market equilibrium (brief review). Money and exchange rates in simultaneous equilibrium. Policy effects on asset markets. Temporary and permanent shocks (first introduction). Long-run neutrality of money. Money and expectations. Exchange rate overshooting (first introduction).

Required Readings:

KO ch.14;

Optional Readings

[frenkel-1976-scanje] (on Reserve); [beaugrand-1997-imfwp];

Price Levels and Exchange Rates

Topics:

Money and prices in the long run. Prices and exchange rates in the long run. Commodity price parity. Price index construction. Absolute vs. relative purchasing power parity. Penn World Table. Nominal and real effective exchange rates. Nominal vs. real shocks to the real exchange rate. Long run PPP;

Required Readings:

KO ch.15; [pakko.pollard-1996-frbslr] <http://research.stlouisfed.org/publications/review/96/01/9601mp.pdf>,
[pakko.pollard-2003-frbslr] <http://research.stlouisfed.org/publications/review/03/11/pakko.pdf>,
[pakko.pollard-2003-frbslr]; <http://www.imf.org/external/pubs/ft/wp/wp9750.pdf>;

Optional Readings

Economist's Big Mac index, June 2005 http://www.economist.com/markets/bigmac/displayStory.cfm?story_id=4065603

Money and Exchange Rates II: Long Run

Topics:

Money, prices and exchange rates in the long run. Real interest parity. Monetary approach to the exchange rate. The role of inflation expectations in floating exchange rate regimes. Cross country evidence. Evidence from hyperinflations. Fisher effect. Magnification effect.

Required Readings:

KO ch.14, ch.15;

Optional Readings

[[beaugrand-1997-imfwp](#)]; [[neely.sarno-2002-frbslwp](#)];

Exchange Rates and Trade

Topics:

Marshall-Lerner condition. J-curve, Balassa-Samuelson effect, Houthakker-Magee critique. Exchange-rate pass through. New Keynesian thinking about the trade balance.

Required Readings:

KO ch.15, ch.16 appendix 1, 2, 3.

Optional Readings

Chinn (2004) [[quiggin-2004-ev](#)]; [[holman-2001-frbkcer](#)];

Monetary and Fiscal Policy in the Open Economy

Topics:

Aggregate demand in the open economy. The AA-DD model of the open economy. The effects of policy changes on goods and money markets. The effects of external shocks on goods and money markets. Temporary and permanent shocks (second introduction). Exchange rate overshooting (second introduction). The AA-DD model and the Mundell-Fleming model.

Required Readings:

KO ch.16;

Optional Readings

[[frankel-1979-aer](#)]; [[dornbusch-1976-jpe](#)] Cavallo et al. (2004)

Managed Exchange Rate Regimes

Topics:

Gold standard. Bretton Woods system. Fixed exchange rates. Mechanisms of sterilization. Internal and external balance. Reserve currencies. US Dollar/Euro competition. "Elasticity approach" to BoP; "Monetary approach" to BoP; "Keynesian" Mundell-Fleming model.

Required Readings:

KO ch.17,18;

Optional Readings

Bordo (1993); Grabbe (1996); Dueker and Fischer (2001).

Balance of Payments Crises and Contagion

Topics:

Capital flight. The causes and consequences of currency crises. Prospects for contagion. Currency crisis and IMF stabilization;

Required Readings:

KO ch.17 and ch.22;

Optional Readings

[[caprio.kunt.kane-2008-wps4756](#)]; Calvo and Mendoza (1996);

International Policy Coordination

Topics:

Automatic stabilizers. Macroeconomic interdependence. Destabilizing speculation. Policy coordination game.

Required Readings:

KO ch.19;

Optional Readings

Bretton Woods Committee (2003).

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

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

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.)

Study Strategies

- 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-jep](#)].
- Ask questions in class. Don't let your questions go unanswered!
- Don't reserve your studying for the weekends. I suggest an hour per day. Daily exposure is much better than cramming.

- Study at the library or someplace else that is not distracting.
- Do the required reading. I draw on the required readings for exam questions.
 - Don't read it just once.
 - **If you own the text**, read with a highlighter or pencil.
 - Outline the important points.
- Do any end of chapter problems. I often develop exam questions based on these problems.
- 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.
- Discuss readings and problems on the course mailing list. Don't let your questions go unanswered!
- 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!

References

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- Caprio, Jr. (2008) "The 2007 Meltdown in Structured Securitization: Searching for Lessons, Not Scapegoats". World Bank Development Research Group Policy Research Working Paper WPS4756. <http://siteresources.worldbank.org/INTFR/Resources/KaneCaprioDemirgucKunt-The2007Meltdown.pdf>
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- Frenkel, Jacob A. 1976. A Monetary Approach to the Exchange Rate: Doctrinal Aspects and Empirical Evidence. *Scandinavian Journal of Economics* 78, 200--224.
- Holman, Jill A. 2001. Is the Large U.S. Current Account Deficit Sustainable?. *Federal Reserve Bank of Kansas City Economic Review* , 5--23.
- Lane, Philip R, and Gian Maria Milesi-Ferretti. 2001. The External Wealth of Nations: Measures of Foreign Assets and Liabilities for Industrial and Developing Countries. *Journal of International Economics* 55, 263--294.
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- 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. <http://research.stlouisfed.org/wp/2002/2002-007.pdf>
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- Walstad, W, and W Becker. 1994. Achievement Differences on Multiple-Choice and Essay Tests in Economics. *American Economic Review* 84, 193--196.
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- 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>
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- 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
- 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>

Frankel, Jeffrey A. ****On Exchange Rates**** (MIT Press, 1993)

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
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>

Obstfeld, Maurice, 1994, "The Logic of Currency Crises" Cahiers Economiques et Monetaires. http://elsa.berkeley.edu/users/obstfeld/ftp/currency_crises/cc.pdf

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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>

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EMERGENCY PREPAREDNESS

American University has asked that all syllabi include the following text, which contains information about emergency preparedness in the event of a communicable disease epidemic.

In the event of a declared pandemic (influenza or other communicable disease), American University will implement a plan for meeting the needs of all members of the university community. Should the university be required to close for a period of time, we are committed to ensuring that all aspects of our educational programs will be delivered to our students. These may include altering and extending the duration of the traditional term schedule to complete essential instruction in the traditional format and/or use of distance instructional methods. Specific strategies will vary from class to class, depending on the format of the course and the timing of the emergency. Faculty will communicate class-specific information to students via AU e-mail and Blackboard, while students must inform their faculty immediately of any absence due to illness. Students are responsible for checking their AU e-mail regularly and keeping themselves informed of emergencies. In the event of a declared pandemic or other emergency, students should refer to the AU Web site (<http://www.prepared.american.edu>) and the AU information line at (202)885-1100 for general university-wide information, as well as contact their faculty and/or respective dean's office for course and school/ college-specific information.