Overview: This is a course in applied international economics. It covers the theory of international monetary economics, international financial policy choices, and related topics at an intermediate level.

Objectives: The minimum objective for this course is that students acquire knowledge of the fundamental principles and issues in international finance. As such, students should be able to define basic terminology, to state important relationships and to identify the key issues in international finance. Moreover, students should be able to demonstrate their comprehension by describing important economic processes (e.g. the gains from international trade in financial assets and the pattern of international capital flows) and by comparing alternative economic systems (e.g. the effects of monetary and fiscal policy changes on exchange rates and international adjustment under pegged versus flexible exchange rates). Finally, since much of the emphasis in this course is on analytical models and since the theories have numerous practical implications, students should be able to formulate economic interpretations and explanations of current international events (e.g. proposals to abandon a fully flexible exchange rate system in favor of target zones or to adopt a common currency area).

Prerequisites: Previous coursework in Microeconomics, Macroeconomics, and International Trade are essential.

Assignments: Two problem sets will be assigned. The assignments should be handed in on Friday, August 20 for grading. Answers will be provided before the final examination.

Examinations: There will be a closed-book examination covering the entire course but concentrating on applications of concepts discussed through the class sessions.

Grading: The course grade will be determined as follows: Final exam 50%, problem sets 20% (10% each), Asia paper (20%) and class participation 10%.
Texts: The primary textbook for the course is:


In addition,


is recommended as an aid in studying the material in KO. The study guide has many exercises *not* contained in the text that give you a chance to test your understanding of the material and practice the analytical tools.

Course Outline and Reading List

The first half of the course covers principles of international finance including the calculation and interpretation of balance of payments statistics, exchange rate parity conditions, and the impact of macroeconomic events and policy changes on exchange rates in the short run and in the long run. The second half of the course focuses more on policy issues in international finance such as the policy choice between pegged exchange rate and floating exchange rate systems, the policy decisions to form a European Monetary System (EMS), to remain a member of the EMS, and to form a European Monetary Union (EMU).

All readings are required. The Krugman and Obstfeld book is a treasure chest of ideas; read it carefully! Please read or skim as many of the assigned chapters as you can before the class meeting. **[USE THE PERIOD FROM NOW UNTIL AUGUST 15 AS A READING PERIOD]** All of the text material will *not* be discussed in class. Even so, students will be held responsible for all of the assigned course materials on the examination.
The Balance of Payments: Concepts and Accounting

International trade in securities
  Inter-temporal trade, gains from trade, life cycle of consumption, savings and wealth.

Accounting conventions
  Current account: goods, services and unrequited (unilateral) transfers
  Capital account: non-official short-term and long-term capital flows
  The statistical discrepancy (net errors and omissions)
  Official settlements balance, official reserve account

Alternative definitions of "balance"
  Balance in the short-run and the long-run, sustainable and unsustainable balances, balance under floating exchange rates

International investment position
  Debtor and creditor nations

Readings: KO, Chapter 12, Chapter 21 (pages 650-653 only)

The Foreign Exchange Market

Organization and institutional features

Terminology
  Spot and forward contracts, European and American terms, appreciation/depreciation, premium/discount, brokers, dealers, hedging, speculation, arbitrage

Recent exchange rate behavior
  Nominal rates, effective rates, real effective rates

Introduction to spot and forward rate determination
  The asset approach: equalizing expected returns across currencies

Fundamental parity conditions
  Purchasing power parity, (uncovered) interest rate parity, covered interest parity.

Readings: KO, Chapter 13 (+ Appendix).
Session 2. Monday, August 16, a.m.

Macroeconomic Determinants of Exchange Rates in the Short Run and in the Long Run

Purchasing Power Parity
   Absolute and relative versions, PPP and the real exchange rate, reasons for deviations from PPP, modifying PPP to explain the long-run exchange rate

The Monetary Approach to the Exchange Rate
   Money and exchange rates when commodity prices are fully flexible (exchange rate behavior in the long-run), the neutrality of money
   Money and exchange rates when commodity prices are inflexible or rigid (exchange rate behavior in the short-run), exchange rate "overshooting"

Output and the Exchange Rate in the Short-Run
   Output, consumption and the current account
   The exchange rate and temporary changes to monetary and fiscal policy
   The exchange rate and permanent changes to monetary and fiscal policy

Readings: KO, Chapters 14, 15 and 16 (+ Appendix I and III).
Session 3. Tuesday, August 17, a.m.

Macroeconomic Policies and Adjustment Under Fixed and Floating Exchange Rates

Adjustment under fixed exchange rates
- The role of international reserves
- Central bank intervention, sterilized and unsterilized intervention
- Monetary and fiscal policies under fixed exchange rates
- The Gold Standard as a fixed exchange rate system

Adjustment under floating exchange rates
- The exchange rate as an automatic stabilizer
- The "J-curve" and exchange rate pass-through (Chapter 16)
- Exchange rate changes in response to permanent and temporary monetary and fiscal policies (Review)
- The experience with managed floating

Readings: KO, Chapters 17 (+ Appendix I, II and III) and 19 (+ Appendix)
(Skim Chapter 18 for background information)
Session 4. Wednesday, August 18, a.m.

Policy Choices for the International Monetary System

Policy goals: Meaning and importance of internal and external balance

Arguments for and against fixed and floating exchange rates
Intermediate systems: Managed floating, target zones

Policy options under alternative systems
The "Rules of the Game" concept
Experience with the classical Gold Standard
Policy options and conflicts under Bretton Woods
Costs and benefits of policy coordination under floating rates
Discretion versus rules, automatic adjustment mechanisms, exchange and capital controls

The theory of optimum currency areas
Costs and benefits from joining a currency area
Is Europe an optimum currency area?
Recent experience of the European Monetary System (EMS)
Prospects for European Monetary Union (EMU)

Readings: KO, Chapters 18 and 20 (+ Appendix).

Session 5. Friday, September 10, a.m.

Final Exam