
ECO2507 – International Financial Markets Winter 2012

Instructor: Professor Julian di Giovanni

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Course Description

This course develops the principles of international finance to gain an understanding of exchange rate dynamics, international financial flows, and recent events in both developed and emerging economies. The course will be divided into two parts.

The first part will begin by presenting a standard open-economy macroeconomic model and international pricing relationships in order to study factors that impact the exchange rate (in the short and long run), external sustainability, and other issues relevant to the international macroeconomic and financial environments. Next, we will apply this theory to study countries' experiences over time, including currency crises in emerging market economies, as well as the present trouble facing the Euro area.

The second part of the course will take a more in depth look at international financial markets, capital flows and asset pricing relationships. Topics included will be empirical models of the exchange rate; international financial integration; portfolio diversification; pricing of and trading in the spot and the forward foreign exchange; foreign-exchange options and currency swaps.

Course Material

Cheol Eun, Bruce Resnick, and Don Brean (ERB), *International Financial Management: Canadian Perspectives*, (2nd edition, McGraw-Hill, 2008), ISBN: 0-07-096490-4.

Paul R. Krugman, Maurice Obstfeld, and Marc J. Melitz (KOM), *International Economics: Theory and Policy* (9th edition, Addison-Wesley, 2009), ISBN: 0-13-214665-7.

Further readings (such as academic articles) will be posted on the course website. Readings from the Financial Times, The Economist, and other press may also be assigned/posted on the website and discussed during the course. You will be responsible for any posted material annotated with ***** REQUIRED *****.

Grading Scheme

- Final exam: 50%
- Midterm test: 30%
- Project: 20%

Important Dates

January 10: First lecture

February 14: Midterm (in class)

February 20-24: Reading week (no class or office hours)

April 3: Project due and last lecture

Administrative Information

1. *Midterm*: You must alert me of missing the midterm **before** the test. If you miss the midterm you will be given a 0 unless you then present me a medical note **within one week** of the midterm, and I accept the note. In this case, a make-up mid-term will be given. Note that the **only medical note** that will be accepted is the University of Toronto Student Medical Certificate (<http://www.healthservice.utoronto.ca/pdfs/medcert.htm>), completed by a medical doctor, including her/his OHIP registration number. Furthermore, the **original** note will only be accepted (no scans, faxes, etc.), which will clearly state what illness you were suffering from.

Notes on make-up midterm:

- It may not be the same format as the midterm test itself.
 - Consistent with university policy, there is no “make-up” test for the make-up test. No medical excuses will be accepted, and grade of zero will be applied if a student fails to write the make-up test.
2. *Project*: An empirical project will be part of the course. It will be based on one or more topics covered during the semester, and will be due at the end of term. More details will be posted on Blackboard.
 3. *Academic misconduct*: I have a zero-tolerance policy for any form of academic misconduct. Academic offenses, such as plagiarism or cheating during exams are serious academic offenses and could result in punishments ranging from failing the course to suspension or expulsion from the university. Please review the University’s Code of Behaviour on Academic Matters regarding what constitutes academic misconduct (<http://www.governingcouncil.utoronto.ca/policies/behaveac.htm>).
 4. *Appealing an exam*: Appeals regarding the grading of a test must be submitted to me or the departmental assistant (so that it is time stamped) within **one week** that the

exam has been graded. You must include the test with your written appeal. I shall re-grade the **entire exam**; therefore this might result in a lower grade than the original.

5. *E-mail policy*: Please use e-mails only for appointments, administrative or urgent matters. I shall **not** answer e-mails concerning course material – this is what office hours are for. Please include ECO2507 in the subject heading of your e-mail, and use your UofT e-mail to avoid the possibility of the e-mail being quarantined or treated as spam.
6. *Class attendance and participation*: Class attendance is not compulsory, but you are responsible for all material covered during lectures. Class participation is encouraged and will count positively for marginal adjustments.
7. *Accessibility needs*: The University of Toronto is committed to accessibility. If you require accommodations for a disability, or have any accessibility concerns about the course, the classroom or course materials, please contact Accessibility Services as soon as possible: disability.services@utoronto.ca or <http://studentlife.utoronto.ca/accessibility>.
8. *UofT's Double-Sided Printing Initiative*: To conserve paper, please print double-sided (learn how at <http://printdoublesided.sa.utoronto.ca>).

Course Outline

Lectures will be based on the recommended textbooks (EBR, KOM), but will also be supplemented by additional readings, and other material presented on lecture notes and slides. The contents of the syllabus are likely to change as the course goes along, and **all course material** will be posted on the course website, so please visit it frequently during the semester.

1. *National Income Accounting and the Current Account*

- Extend national income accounts to the open economy in order to incorporate international transactions. Study an intertemporal model of the current account.

Readings

- ERB, Ch. 3; KOM, Ch. 13; Lecture Notes
- Blanchard, Olivier, and Gian Maria Milesi-Ferretti, "(Why) Should Current Account Imbalances Be Reduced?" IMF Staff Discussion Note No. SDN/11/03, March 2011.
- Chinn, Menzie D., Barry Eichengreen and Hiro Ito, "A Forensic Analysis of Global Imbalances," NBER Working Paper No. 17513, October 2011.
- Corsetti, Giancarlo and Gernot J. Müller, "Twin Deficits: Squaring Theory, Evidence and Common Sense," *Economic Policy* 21(October 2006): 597–38.
- Nason, James M. and John H. Rogers, "The Present Value Model of the Current Account Has Been Rejected: Round Up the Usual Suspects," *Journal of International Economics* 68 (January 2006): 159–87.
- Obstfeld, Maurice, and Kenneth Rogoff, "Global Imbalances and the Financial Crisis: Products of Common Causes," *Federal Reserve Bank of San Francisco Asia Economic Policy Conference Proceedings* (October 2009): 131–72.

2. *The Foreign Exchange Market and Exchange Rate Models*

- Presents models of how exchange rates are determined. Extends the model to understand how exchange rates behave in the long run.

Readings

- ERB, Ch. 4, 5; KOM, Ch. 14, 15, 16; Lecture Notes
- Dornbusch, Rudiger, "Expectations and Exchange Rate Dynamics," *Journal of Political Economy* 84 (December 1976): 1161–76.
- Engel, Charles, and Kenneth D. West, "Taylor Rules and the Deutschmark-Dollar Real Exchange Rate," *Journal of Money, Credit, and Banking* 38 (August 2006): 1175–94.

- Engel, Charles, and John H. Rogers, “How Wide is the Border?” *American Economic Review* 86 (December 1996): 1112–25.
- Rogoff, Kenneth, “The Purchase Parity Puzzle,” *Journal of Economic Literature*, 34 (June 1996): 647–68.
- Rogoff, Kenneth, “Dornbusch’s Overshooting Model after 25 Years,” *IMF Staff Papers* 49 (Special Issue 2002): 1–34.

3. *Exchange Rate Regimes and Stabilization Policy*

- Study how output is determined by combining models of exchange rate determination with a theory of output determination in the short run. Examine how exchange rate regime choice impacts this relationship.

Readings

- KOM, Ch. 17, 18
- di Giovanni, Julian and Jay C. Shambaugh, “The Impact of Foreign Interest Rates on the Economy: The Role of the Exchange Rate Regime,” *Journal of International Economics*, 74 (March 2008): 341–36.
- Fischer, Stanley, “Distinguished Lecture on Economics in Government: Exchange Rate Regimes: Is the Bipolar View Correct?” *Journal of Economic Perspectives* 15 (Spring 2001): 3–24.
- Klein, Michael W. and Jay C. Shambaugh, *Exchange Rate Regimes in the Modern Era* (MIT Press, 2010).
- Mundell, Robert A., “Capital Mobility and Stabilization Policy under Fixed and Flexible Exchange Rates,” *Canadian Journal of Economics and Political Science* 29 (November 1963): 475–85.
- Obstfeld, Maurice and Kenneth Rogoff, “The Mirage of Fixed Exchange Rate Regimes,” *Journal of Economic Perspectives* 9 (Fall 1995): 73–96.

4. *International Monetary Systems*

- Presents a historical overview of the international monetary system, as well as their costs/benefits, and lessons for today’s world.

Readings

- ERB, Ch. 2; KOM, Ch. 19, 20
- Farhi, Emmanuel, Pierre-Olivier Gourinchas, and Hélène Rey, *Reforming the International Monetary System* (CEPR eBook: 2011).

- Feldstein, Martin S., “The Euro and European Economic Conditions,” NBER Working Paper No. 17617, November 2011.
- Giavazzi, Francesco, and Luigi Spaventa, “Why the Current Account May Matter in a Monetary Union: Lessons from the Financial Crisis in the Euro Area,” CEPR Discussion Paper No. 8008, October 2010.
- Mundell, Robert A., “A Theory of Optimum Currency Areas,” *American Economic Review* 51 (November 1961): 509–17.
- Obstfeld, Maurice, “The International Monetary System: Living with Asymmetry,” NBER Working Paper No. 17641, December 2011.

5. *Empirical Models of the Nominal Exchange Rate*

- Presents empirical work that has tested core empirical exchange rate models, as well as more recent work in the literature.

Readings

- Lecture Notes
- Berge, Travis, Òscar Jordà and Alan M. Taylor, “Currency Carry Trades,” *NBER International Seminar on Macroeconomics 2010*, eds. Richard Clarida and Francesco Giavazzi, (University of Chicago Press, 2011).
- Brunnermeier, Markus K., Stefan Nagel, and Lasse H. Pedersen, “Carry Trades and Currency Crashes,” *NBER Macroeconomics Annual 2008*, eds. Daron Acemoglu, Kenneth Rogoff, and Michael Woodford (University of Chicago Press, 2009).
- Chen, Yu-Chin, Kenneth S. Rogoff, and Barbara Rossi, “Can Exchange Rates Forecast Commodity Prices?” *Quarterly Journal of Economics* 125 (August 2010): 1145–94.
- Cheung, Yin-Wong, Menzie Chinn and Antonio Garcia, “Empirical Exchange Rate Models of the 1990’s: Are Any Fit to Survive?” *Journal of International Money and Finance* 24 (November 2005): 1150–75.
- Fama, Eugene, “Forward and spot exchange rates,” *Journal of Monetary Economics* 14 (November 1984): 319–38.
- Engel, Charles, Nelson C. Mark, and Kenneth D. West, “Exchange Rate Models Are Not as Bad as You Think,” *NBER Macroeconomics Annual 2007*, eds. Daron Acemoglu, Kenneth Rogoff, and Michael Woodford (University of Chicago Press, 2009).
- Engel, Charles, and Kenneth D. West, “Exchange Rates and Fundamentals,” *Journal of Political Economy* 113 (June 2005): 485–517.
- Froot, Kenneth A., and Richard H. Thaler, “Anomalies: Foreign Exchange,” *Journal of Economic Perspectives* 4 (Summer 1990): 179–92.
- Mark, Nelson C., “Exchange Rates and Fundamentals: Evidence on Long-Horizon Predictability,” *American Economic Review* 85 (March 1995): 201–18.

- Meese, Richard A., and Kenneth Rogoff, “Empirical Exchange Rate Models of the Seventies,” *Journal of International Economics* 14 (February 1983): 3–24.
- Verdelhan, Adrien, “The Share of Systematic Risk in Bilateral Exchange Rates,” mimeo, MIT, 2011.

6. *Currency Crises*

- Presents different “generations” of currency crisis models, and discuss their applicability over different country experiences.

Readings

- KOM, Ch. 22, 23; Lecture Notes
- Flood, Robert P., and Peter M. Garber, “Collapsing Exchange-Rate Regimes: Some Linear Examples,” *Journal of International Economics* 17 (August 1984): 1–13.
- Frankel, Jeffrey A., Andrew K. Rose, “Currency Crashes in Emerging Markets: An Empirical Treatment,” *Journal of International Economics* 41 (November 1996): 351–66.
- Kaminsky, Graciela L., and Carmen M. Reinhart, “The Twin Crises: The Causes of Banking and Balance-of-Payments Problems,” *American Economic Review* 89 (June 1999): 473–500.
- Krugman, Paul R., “A Model of Balance-of-Payments Crises,” *Journal of Money, Credit and Banking* 11 (August 1979): 311–25.
- Morris, Stephen, and Hyun Song Shin, “Unique Equilibrium in a Model of Self-Fulfilling Currency Attacks,” *American Economic Review* 88 (June 1998): 587–97.
- Obstfeld, Maurice, “Models of Currency Crisis with Self-Fulfilling Features,” *European Economic Review* 40 (April 1996): 1037–47.

7. *Financial Integration and International Asset Markets*

- Examine the different types of international asset markets what caused their rapid growth over the past 50 years, and potential cost/benefits of integration.

Readings

- ERB Ch. 6, 7, 8; KOM, Ch. 21
- Lane, Philip R., and Gian Maria Milesi-Ferretti, “International Investment Patterns,” *Review of Economics and Statistics* 90 (August 2008): 538–49.
- Lane, Philip R., and Gian Maria Milesi-Ferretti, “The External Wealth of Nations Mark II: Revised and Extended Estimates of Foreign Assets and Liabilities, 1970–2004,” *Journal of International Economics* 73 (November 2007): 223–50.

- Milesi-Ferretti, Gian Maria, Francesco Stobbe, and Natalia Tamirisa, “Bilateral Financial Linkages and Global Imbalances: A View on the Eve of the Financial Crisis,” IMF Working Paper No. 10/257, November 2010.
- Milesi-Ferretti, Gian Maria, and Cédric Tille, “The Great Retrenchment: International Capital Flows During the Global Financial Crisis,” *Economic Policy* 26 (April 2011): 289–346.
- Obstfeld, Maurice, “Financial Flows, Financial Crises, and Global Imbalances,” mimeo, U.C. Berkeley, October 2011.
- Obstfeld, Maurice, and Alan M. Taylor, *Global Capital Markets: Integration, Crisis, and Growth* (Cambridge University Press: 2004).
- Portes, Richard, and Hélène Rey, “The Determinants of Cross-Border Equity Flows,” *Journal of International Economics* 65 (March 2005): 269–96.

8. Futures, Options and Interest Rate Swaps

- Presents different types of financial contracts used in international markets.

Readings

- ERB Ch. 9, 10
- Potential guest speaker (Russell Browne. Director, ScotiaMocatta, Scotia Capital, <http://www.scotiamocatta.com>)

9. ICAPM and International Portfolio Investment

- Presents portfolio theory in an international context, and discusses why observed investment behaviour may not always line up with model predictions.

Readings

- ERB Ch. 11
- Coeurdacier, Nicolas, and Hélène Rey, “Home Bias in Open Economy Financial Macroeconomics,” NBER Working Paper No. 17691, December 2011.
- French, Kenneth R., and James M. Poterba, “Investor Diversification and International Equity Markets,” *American Economic Review* 81 (May 1991): 222–26.
- Lewis Karen K., “Trying to Explain Home Bias in Equities and Consumption,” *Journal of Economic Literature* 37 (June 1999): 571–608.
- Tesar, Linda L., and Ingrid M. Werner, “Home Bias and High Turnover,” *Journal of International Money and Finance* 14 (August 1995): 467–92.