

Boston College  
Department of Economics  
Fall 2004  
Tuesday and Thursday 1:30 - 3:00  
Room: Carney 206

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## INTERNATIONAL FINANCE

EC372.01

### SYLLABUS

[http://www2.bc.edu/~lamberlu/ec372/syll\\_372.html](http://www2.bc.edu/~lamberlu/ec372/syll_372.html)

**Prerequisites:** Knowledge of basic microeconomic and macroeconomic principles. We will develop analytic tools and concepts.

**Course Requirements:** The grade for this course will be based on problem sets, midterm exam and final exam. These will receive weights of 20%, 40% and 40%, respectively, in the overall grade. Problem sets will be posted on my web page every week; the solutions will be posted after the problem sets have been turned in.

**Midterm:** October 19, 2004. Closed-book midterm will be held in class.

**Textbook (Required):** *International Economics: Theory and Policy*, 6th edition, by Paul Krugman and Maurice Obstfeld, Harper Collins ed, 2003, Chapters 12-22.

### Topics

1. **National Income Accounting and the Balance of Payments**, Chapter 12.

This section introduces accounting concepts used by economists to describe a country's level of production and its international transactions.

2. **Exchange Rates and the Foreign Exchange Market: An Asset Approach**, Chapter 13.

Here our goal is to understand how exchange rates are determined. Observed behavior of the exchange rate favors modeling it as an asset price rather than as a goods price. We study a model in which the exchange rate adjusts to equate expected returns on interest-bearing assets denominated in different currencies given expectations about exchange rates, and the domestic and foreign interest rate. This first building block of the model lays the foundation for subsequent chapters that explore the determination

of domestic interest rates and output, the basis for expectations of future exchange rates and richer specifications of the foreign-exchange market that include risk. We also consider the determination of forward exchange rates.

**3. Money, Interest Rates, and Exchange Rates, Chapter 14.**

This section introduces the domestic money market, linking monetary factors to short-run exchange-rate determination through the domestic interest rate. We begin with a discussion of the determination of the domestic interest rate; interest parity (studied in the previous section) links the domestic interest rate to the exchange rate. Dynamic considerations are introduced through an appeal to the long run neutrality of money that identifies a long-run steady-state value toward which the exchange rate evolves. The dynamic time path of the model exhibits overshooting of the exchange-rate in response to monetary changes.

**4. Price Level and the Exchange Rate in the Long Run, Chapter 15.**

This section develops a model of the long run exchange rate. The long-run exchange rate plays a role in a complete short-run macroeconomic model since one variable in that model is the expected future exchange rate. We begin with a discussion of the law of one price and purchasing power parity. A model of the exchange rate in the long-run based upon purchasing power parity is developed. A review of the empirical evidence, however, casts doubt on this model. The chapter then goes on to develop a general model of exchange rates in the long run in which the neutrality of monetary shocks emerges as a special case. In contrast, shocks to the output market or changes in fiscal policy alter the long run real exchange rate. We also discuss the real interest parity relationship that links the real interest rate differential to the expected change in the real exchange rate.

**5. Output and the Exchange Rate in the Short Run, Chapter 16.**

This section presents a macroeconomic model of output and exchange-rate determination in the short run. It first introduces aggregate demand in a setting of short-run price stickiness to construct a model of the goods market. The exchange-rate analysis presented in previous sections provides a model of the asset market. This model is used to examine the effects of a variety of policies. The analysis allows a distinction to be drawn between permanent and temporary policy shifts. This distinction highlights the importance of exchange-rate expectations on macroeconomic outcomes. Several case studies are discussed. The section concludes with a discussion of the links between exchange rate and import price movements.

**6. Fixed Exchange Rates and Foreign Exchange Intervention, Chapter 17.**

This section discusses exchange rate intervention by the central bank and the relationship of this policy to the money supply. This analysis is blended with the previous sections' short-run macroeconomic model to analyze policy under fixed rates. Another

topic discussed in this section is capital flight and balance of payments crises with an introduction to different models of how a balance of payments or currency crisis can occur. The analysis also is extended to a two-country framework to discuss alternative systems for fixing the exchange-rate as a prelude to subsequent sections.

#### **7. The International Monetary System, Chapter 18.**

This section and the following one discuss various international monetary arrangements. They describe the workings of different exchange rate systems through the central theme of internal and external balance. The model developed in the previous section provides a general framework for analysis of gold standard, reserve currency, managed floating, and floating exchange-rate systems. This section chronicles the evolution of the international monetary system from the gold standard of 1870 - 1914, through the interwar years, and up to and including the post-war Bretton Woods period. This analysis illustrates the strengths and weaknesses of alternative fixed exchange rate arrangements.

#### **8. Macroeconomic Policy and Coordination Under Floating Exchange Rates, Chapter 19.**

This section focuses on recent experience under floating exchange rates. The discussion is couched in terms of current debate concerning the advantages of floating versus fixed exchange rate systems. The theoretical arguments for and against floating exchange rates frame two case studies, the first on the experience between the two oil shocks in the 1970s and the second on the experience since 1980. The transmission of monetary and fiscal shocks from one country to another is also considered. Discussion of the experience in the 1980s points out the shift in policy toward greater coordination in the second half of the decade. Discussion of the 1990s focuses on the strong U.S. economy from 1992 on and the extended economic difficulties in Japan. Finally, the section considers what has been learned about floating rates since 1973.

#### **9. Optimum Currency Areas and the European Experience, Chapter 20.**

Europe's switch to a single currency, the euro, is the subject of this section, and provides a particular example of a single currency system. The section discusses the history of the European Monetary System and its precursors. The early years of the E.M.S. were marked by capital controls and frequent realignments. By the end of the 1980s, however, there was marked inflation convergence among E.M.S. members, few realignments and the removal of capital controls. Despite a speculative crisis in 1992-3, leaders pressed on with plans for the establishment of a single European currency as outlined in the Maastricht Treaty which created Economic and Monetary Union (EMU). The single currency was viewed as an important part of the EC 1992 initiative which called for the free flow within Europe of labor, capital, goods and services. The single currency, the euro, was launched on January 1, 1999 with eleven original participants. These countries have ceded monetary authority to a supranational central

bank and constrained their fiscal policy with agreements on convergence criteria and the stability and growth pact. A single currency imposes costs as well as confers benefits. The theory of optimum currency areas suggests conditions which affect the relative benefits of a single currency. The section provides a way to frame this analysis using the GG-LL diagram which compares the gains and losses from a single currency. Finally, we examine the prospects of the EU as an optimal currency area compared to the United States and considers the future challenges EMU will face.

**10. The Global Capital Market: Performance and Policy Problems, Chapter 21.**

The international capital market is the subject of this section, which draws an analogy between the gains from trade arising from international portfolio diversification and international goods trade. There is discussion of institutional structures that have arisen to exploit these gains. The section discusses the Eurocurrency market, the regulation of offshore banking, and the role of international financial supervisory cooperation. It examines policy issues of financial markets, the policy trilemma of the incompatibility of fixed rates, independent monetary policy, and capital mobility as well as the tension between supporting financial stability and creating a moral hazard when a government intervenes in financial markets. The section also considers evidence of how well the international capital market has performed by focusing on issues such as the efficiency of the foreign exchange market and the existence of excess volatility of exchange rates

**11. Developing Countries: Growth, Crisis, and Reform, Chapter 22.**

This section discusses issues facing developing countries. It begins by identifying characteristics of the economies of developing countries, characteristics that include undeveloped financial markets, pervasive government involvement, and a dependence on commodity exports. The macroeconomic analysis of previous sections again provides a framework for analyzing relevant issues, such as inflation in or capital flows to developing countries. Borrowing by developing countries is discussed as an attempt to exploit gains from intertemporal trade and is put in historical perspective. Latin American countries' problems with inflation and subsequent attempts at reform are detailed. Finally, the East Asian economic miracle is discussed, and the East Asian financial crisis is examined. This final topic provides an opportunity to discuss possible reforms of the world's financial architecture.