

ECO 2507 - INTERNATIONAL FINANCIAL MARKETS Winter 2011

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Overview

This course studies the assets and institutions of international financial markets. A key difference between these markets and others is the role of exchange rates relating the value of two or more national currencies.

The course will be organized in two general areas.

The first part will cover the international macroeconomic environment. We will start by introducing modern theories of exchange rate determination: purchasing power parity, balance of payments and portfolio theories. We will review the basic arbitrage conditions that are relevant for international financial markets and then apply them to the case of several recent product innovations. Finally, we will investigate the impact of macroeconomic policy (fiscal and monetary) on exchange rate determination to study the recent financial crises (Mexico and Asian crisis, Russia, Brazil, LTCM and, more recently, Argentina).

The second part of the course will study in more details market-making institutions, market conventions and market practices as well as the interrelationships between different assets, their pricing and their trading. Particular topics are: Pricing of and trading in the spot and the forward foreign exchange; foreign-exchange options and currency swaps; theory and practice of the Euromarket funding and lending.

Course material

- Cheol Eun, Bruce Resnick and Don Brean, “Title: International Financial Management (Canadian perspectives)”, Publisher: McGraw-Hill, ISBN-13: 9780070912281
- Paul R. Krugman and Maurice Obstfeld, "International Economics: Theory and Policy" (8th edition, Addison-Wesley, 2008), ISBN: 0-321-48883-0.
- You are responsible for all readings in the folder “*Required Readings*” in the course website even if they were not covered in class.

Marking Scheme:

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

The midterm test will be held on February 15.

The final exam will be held during the exam period. *The final exam* will draw on all the material covered in this course. Both the midterm and the final exam are closed book.

Missing a Midterm: There will not be a make-up test. If you miss the midterm test and present a valid medical justification within one week of the test then the weight of the midterm test will be added to the weight of the final exam.

The projects have to be handed in class on March 22. Further instructions will be posted on the class website in the following days.

Appeals regarding the grading of an exam must be submitted to me or to an Economics Department secretary in writing within one week of your receipt of the graded work. The original exam must accompany the appeal.

Class attendance is not required. However, the students are responsible for all material covered in class, in the textbook, and in the required readings posted on the class website.

Class participation is encouraged and will count positively on marginal adjustments

Plagiarism: I take academic honesty very seriously. Plagiarism is a severe academic offense. Please review the University's Code of Behavior on Academic Matters regarding what constitutes an academic offense. Please also note the following disclaimer:

"Normally, students will be required to submit their course essays to Turnitin.com for a review of textual similarity and detection of possible plagiarism. In doing so, students will allow their essays to be included as source documents in the Turnitin.com reference database, where they will be used solely for the purpose of detecting plagiarism. The terms that apply to the University's use of the Turnitin.com service are described on the Turnitin.com web site".

U of T Double Sided Printing Initiative: To conserve paper, please print double-sided (learn how at: printdoublesided.sa.utoronto.ca).

Detailed Syllabus

ERB below refers to the additional textbook for the course (Eun, Resnick and Brean).

KO below refers to the additional textbook for the course (Krugman and Obstfeld).

The contents of the syllabus are likely to change as we go along. You are urged to check regularly on the course website.

1. Introduction to the Foreign Exchange Market

Recommended reading:

ERB Chapter 4.

KO chapter 13.

Optional reading:

- Meese R. and K. Rogoff, “Empirical Exchange Rate Models of the Seventies”, *Journal of International Economics* 14 3-24, 1983

- Mark, N. 1995. Exchange Rates and Fundamentals: Evidence on long-horizon predictability. *American Economic Review* 85: 201-218.

- BIS Quarterly Review: Why has FX trading surged? Explaining the 2004 triennial survey (December 2004).

- Cheung, Yin-Wong, Menzie Chinn and Antonio Garcia (2005). “Empirical Exchange Rate Models of the 1990’s: Are Any Fit to Survive?”, *Journal of International Money and Finance*, Vol 24, No. 7.

2. Balance of payments; Intertemporal Approach to the Current Account

Recommended reading:

Lecture notes

ERB Chapter 3

KO Chapter 12.

Optional reading:

- Obstfeld Maurice and Ken Rogoff, “Perspectives on OECD Economic Integration: Implications for US Current Account Adjustment”, Federal Reserve Bank of Kansas City, Symposium, 2000.

- Obstfeld, Maurice and Ken Rogoff, “The Unsustainable US Current Account Position Revisited” NBER working paper 10869 (November 2004).

3. Monetary and portfolio theories of exchange rate determination

Recommended reading:

ERB Chapter 5

KO Chapter 14, 15, 16

Optional reading:

- Rogoff, Ken, “The Purchasing Power Parity Puzzle”, *Journal of Economic Literature*, June 1996.

- Engel Charles and John Rogers: “How Wide is the Border?” *American Economic Review*, December 1996.

- Milesi-Ferreti, Gianmaria and Phil Lane, “External Wealth, the Trade Balance, and the Real Exchange Rate”, *European Economic Review*, June 2002.

4. Monetary and fiscal policy with fixed and flexible rates: Fixed, pegged, floating, floating pegs, crawling pegs. How flexible are exchange rates?

Recommended reading:

KO Ch.17

Optional reading:

- IMF's Classification of Exchange Rate Arrangements, December 2004.
- Calvo, Guillermo and Carmen Reinhart, "Fear of Floating", Quarterly Journal of Economics May 2002, available as NBER WP 7993.
- Reinhart, Carmen and Ken Rogoff, "The Modern History of Exchange Rate Arrangements: A Reinterpretation", Quarterly Journal of Economics, February 2004.

5. The International Monetary System: Historical background on the International Monetary system.

Recommended reading:

ERB Chapter 2

KO chapter 18.

Optional reading:

- Eichengreen Barry and Nathan Sussman: "the International Monetary System in the (very) Long Run", IMF working paper, March 2000. Summary version also available in the World Economic Outlook, May 2000, Chapter 5.
- Eichengreen, Barry. 2004. "The Dollar and the New Bretton Woods System" text of the Thornton Lecture, December.
- Krugman, Paul "What Do We Need to Know about the International Monetary System?" Princeton Essays in International Finance, 190, 1993.
- Obstfeld M. and A. Taylor, "Globalization and Capital Markets", NBER Working Paper 8846, March 2002.
- Rogoff, Ken, "International Institutions for Reducing Global Financial Instability", Journal of Economic Perspectives, Fall 1999.

6. Empirical Models of Nominal Exchange Rates

Recommended reading:

- Fama, Eugene 1984. Forward and spot exchange rates. Journal of Monetary Economics, vol. 14, 319-338.
- Froot K. and R. Thaler, 1990. Anomalies: Foreign Exchange. *Journal of Economic Perspectives* 4: 179-92.
- Evans M. and R. Lyons, 2001. Order Flow and Exchange Rate Dynamics, NBER WP7317, and *Journal of Political Economy*
- Froot K. and T. Ramadorai, 2001. "Currency Return, Institutional Investor Flows and Exchange-Rate Fundamentals"
- Gourinchas P-O and H. Rey, "The Intertemporal Approach to the Financial Account", mimeo Princeton University 2006.

Optional reading:

- Lewis K., 1989. Changing beliefs and systematic rational forecast errors with evidence from foreign exchange, *American Economic Review* 79: 621-36.
- Frankel J. and K. Froot, 1989. Forward discount bias: is it an exchange risk premium? *Quarterly Journal of Economics*.
- Gourinchas P. and A. Tornell, "Exchange Rate Dynamics, Learning and Misperception," mimeo Princeton University, July 2001.
- Flood R. and A. Rose, 1995. Fixing exchange rates: A Virtual Quest for Fundamentals", *Journal of Monetary Economics*, 36: 3-37.
- Frankel J and A. Rose, "Empirical research on Nominal Exchange Rates", in Handbook of International Economics, Gene Grossman and Ken Rogoff, ed, North Holland, 1995 also NBER WP 4865.
- Lyons R, 2001. The Microstructure Approach to Exchange Rates, MIT Press, chapter 7.

7. Financial Crises and Capital ControlsRecommended reading:

- Obstfeld, Maurice "Models of Currency Crisis with Self-Fulfilling Features", *European Economic Review*, April 1996.
- Flood, R. and P. Garber (1984). "Collapsing exchange-rate regimes: Some linear examples", *Journal of International Economics* 17, 1-13.

Optional readings:

- Edwards, Sebastian "Exchange Rate Regimes, Capital Flows and Crisis Prevention" in Feldstein, Martin (Ed.): *Economic and Financial Crises in Emerging Market Economies* 2003
- Krugman, Paul. "Crises: The Price of Globalization?" Federal Reserve Bank of Kansas City, *Economic Review* 2001.
- Krugman, Paul "It's Baaack: Japan's Slump and the Return of the Liquidity Trap", *Brookings Papers on Economic Activity*, Vol. 1998, No. 2. (1998), pp. 137-187.
- Jeanne, Olivier, "Currency Crisis, A Perspective on Recent Theoretical Developments", *Special Papers in International Economics*, Princeton University, March 2000.
- Giancarlo Corsetti, Paolo Pesenti and Nouriel Roubini, "What Caused the Asian Crisis: A Macroeconomic Overview", *Japan and the World Economy*, 1999.
- Kaminsky, Graciela, Carmen Reinhart The Twin Crises: Causes of Banking and Balance-of-Payments Problems, *American Economic Review*, June 1999.
- Kaminsky, Graciela, Carmen Reinhart, Carlos Végh The Unholy Trinity of Financial Contagion, (with Carmen Reinhart and Carlos Végh), *Journal of Economic Perspectives*, Fall 2003.
- Higgins, Matthew and Thomas Klitgaard 2004 "Reserve Accumulation: Implications for Global Capital Flows and Financial Markets" *Current Issues in Economics and Finance* (Sept/Oct) vol.10 no.10

8. Eurocurrency, International Bond Markets and International Equity Markets

Recommended reading:

ERB Chapter 6, 7, 8.

9. Futures, Options and Interest Rate Swaps

Recommended reading:

ERB Chapter 9, 10.

10. ICAPM and International Portfolio Investment.

Recommended reading:

ERB Chapter 11.

Optional reading:

- Lewis K., "Puzzles in International Financial Markets" in Handbook of International Economics, Gene Grossman and Ken Rogoff, ed, North Holland, 1995 also NBER WP 4951.
- Lewis K., "International Home Bias in International Finance and Business Cycles", NBER WP #6351, January 1998, or with the title ""Trying to Explain Home Bias in Equities and Consumption" *Journal of Economic Literature* 37, June 1999, 571-608.
- Tesar L. and I. Werner, 1995, "Home Bias and High Turnover", *Journal of International Money and Finance* 14 (August): 467-92 1995.
- French K. and J. Poterba, 1991, "Investor diversification and international equity markets", *American Economic Review* 81, 222-226.
- Adler M and B. Dumas, "International Portfolio Choice and Corporation Finance: a Synthesis", *Journal of Finance*, 38, 925-984