

ITF-220 Economics of International Financial Policy
Cross-listed in FAS as Econ 1531
Syllabus, Spring 2009

Kennedy School of Government, Harvard University

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Times: Lectures: Mondays and Wednesdays, 2:40-4:00 p.m., L130, HKSG
Review session: Fridays,
Final exam: Wednesday, May 20, 2009, 9:00-12:00 a.m.

Prospectus

Topics covered: Should countries fix their exchange rates, or let them float? What is the role of monetary and fiscal policy in an open economy? What determines the balance of payments, the level of economic activity, and inflation? How does the globalization of financial markets affect these and other policy questions?

This course deals with international monetary economics, or the macroeconomics of open economies. The emphasis will be on models appropriate to major countries. Topics covered include the foreign exchange market, devaluation, and import and export elasticities; the simultaneous determination of the trade balance, national income, the balance of payments, money flows and price levels; capital flows and our increasingly-integrated financial markets; monetary and fiscal policy in open economies; international macroeconomic interdependence and policy coordination; supply relationships and nominal anchors for monetary policy; the determination of exchange rates in international money markets; and international portfolio diversification.

Nature of the approach: The course is a relatively comprehensive treatment of standard textbook models in the area of open-economy macroeconomics. Although real-world examples are sprinkled throughout, the course relies very heavily on algebraic and graphical analysis, as is customary in economics classes.

Who should take the course: Only those who are quite comfortable with algebraic and graphical analysis should enroll. This is not an appropriate course for students who want some basic general exposure to international economics.

Prerequisites: Familiarity with the principles of economics and with intermediate-level macroeconomics is necessary, particularly standard models of monetary and fiscal policy and their effects on interest rates and income. API-101 and API-121, respectively, satisfy the prerequisites for micro and macroeconomics, as do Econ 1010a (or 1011a) and 1010b (or 1011b) in FAS. Some knowledge of international trade theory and econometric techniques is also desirable, but definitely not essential. Students must be comfortable with algebra.

Problem Sets: Six quantitative problem sets are planned. For each problem set, students can choose whether to work alone or in groups, *but must indicate which* option they have chosen when handing in the problem set. Those who work alone will receive a small point boost on that problem set.

Grading: Problem sets -- 20%; mid-term exam -- 30%; final exam -- 50%.

Please check the dates for the exams, especially the final exam. If you cannot take the exams, you should not enroll in the course.

ITF 220 – Economics of International Financial Policy
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Course Outline

Prof. Jeffrey Frankel
 Kennedy School of Government. Harvard University

The required text is World Trade and Payments, by R.Caves, J.Frankel, and R.Jones (10th edition, Addison Wesley, 2007), available at the Coop or on reserve at the KSG library. Additional readings are available via links on the course webpage and in one short packet from the KSG CMO.

Topic	Chapter in WT & P	Lecture number and date	(approx.)
ELASTICITIES & THE TRADE BALANCE			
Balance of payments accounting	15	1	Jan. 28
Supply and demand for foreign exchange	16.1	2	Feb. 2
Export and import elasticities			
Empirical effects of devaluation on the trade balance	16.2	3	Feb. 4
THE KEYNESIAN MODEL			
National saving identity; fiscal multiplier in an open economy.	17.1-17.2	4	Feb. 9
Export multiplier; & the transfer problem.	17.3 } 17.4	5	Feb. 11
	[<i>Presidents' Day</i>		<i>Feb. 16</i>]
Large-country repercussions & Transmission of disturbances.	17.5-17.6 18.1	6	Feb. 18
Expenditure-reducing policies vs. -switching policies	18.2	7	Feb. 23
Monetary factors	18.3	8	Feb. 25
MONETARY APPROACH TO THE BALANCE OF PAYMENTS			
Reserve flows & the gold standard	19.1 } Appendix A	9	Mar. 2
Purchasing Power Parity	19.2-19.4	10	Mar. 4

<u>Topic</u>	<u>Chapter in WT & P</u>	<u>Approx. lecture number and date</u>			
GLOBALIZATION OF FINANCIAL MARKETS					
Liberalization; spot & forward exchange market	21.1-21.3	11	Mar. 9	Prob- lem set	
Emerging markets; Pros & cons of financial opening	21.4 & 28.1 Ch. 21 Appendix	12	Mar. 11	4 <u>due</u>	
FISCAL AND MONETARY POLICY UNDER INTERNATIONAL CAPITAL MOBILITY					
Mundell-Fleming -- with exchange rate fixed	22.1-22.3	13	Mar. 16		
	Midterm	14	Mar. 18		
			[Spring break March 21 - 29]	=====	
Applications/problems of policymaking	22.4-22.7; 24.1	15	Mar. 30		
Mundell-Fleming model -- with the exchange rate floating.	23.1-23.2	16	Apr. 1		
Perfect capital mobility & Impossible Trinity	23.3-23.4	17	Apr. 6		
Crises in emerging markets	24.2-24.5, 24.7-24.9	18	Apr. 8		
INTERDEPENDENCE AND COORDINATION					
Effects of fiscal expansion in a large country	25.1				
Estimates of transmission	25.2	19	Apr. 13		
International policy coordination	25.3				
SUPPLY AND INFLATION					
Aggregate Supply and wages	26.1	20	Apr. 15	Prob- lem set 5	
Inflation and anchors for money	26.3-26.4			<u>due</u>	
Exchange rate regimes and OCAs	26.5-26.6	21	Apr. 20		
EXPECTATIONS AND THE DETERMINATION OF THE EXCHANGE RATE					
Interest parity conditions	27.1	}	22	Apr. 22	Prob- lem set
The monetarist model	27.2				6
Overshooting	27.4-27.6		23	Apr. 27	<u>due</u>
Exchange rate risk & intervention	27.3, 28		24	Apr. 24	

Final exam

Wednesday, May 20, 2009, 9:00-12:00 a.m.

Readings

The required textbook reading is the second half of *World Trade and Payments*, R.Caves, J.Frankel, and R.Jones, 10th ed. (Addison-Wesley), 2007. It's available at the Coop and on reserve at KSG library

Unless otherwise indicated, links to readings listed below are posted on the course webpage.

- * asterisk denotes recommended readings
- ** double asterisk denotes most highly required
- (L numbers correspond to scheduled lectures.)

The Trade Balance and the Exchange Rate

Balance of payments accounts and devaluation (L1-L3)

Paul Krugman, "Introduction," in *International Adjustment and Financing: The Lessons of 1985-1991*, C.F. Bergsten, ed., Institute for International Economics, Washington, DC, 1991: 3-12.**
CMO packet 1

Martin Feldstein, "A More Competitive Dollar is Good for America," *FT*, Oct. 15, 2007.
http://www.ft.com/cms/s/0/e682dc5c-7a64-11dc-9bee-0000779fd2ac.html?nclick_check=1 *

Maurice Obstfeld and Ken Rogoff "The Unsustainable U.S. Current Account Position Revisited," NBER Working Paper No. 10869; as summarized in *The NBER Digest*, Dec. 2004.
**

Richard Cooper, "Living with Global Imbalances: A Contrarian View," *Policy Briefs in International Economics*, Institute for International Economics, November 2005. **

or Debate on sustainability of the U.S. deficit. <i>Financial Times</i> . Nov 1, 2004. p. 19	
"America's current account deficit is not only sustainable, it is perfectly logical given the world's hunger for investment returns and dollar reserves," says Richard Cooper	"The US deficit problem is not only a domestic issue, but a global concern..." say Maurice Obstfeld and Kenneth Rogoff

"The Bretton Woods System: Are We Experiencing a Revival? Symposium Summary," FRBSF Economic Letter, 2005-32, Nov. 25, 2005. <http://www.frbsf.org/publications/economics/letter/2005/el2005-32.pdf> **

The US trade deficit viewed as a transfer problem in a two-country world (L4-L8)

Paul Krugman "Adjustment in the World Economy," *Group of Thirty Occasional Papers* 24, 1987, pp.1-40. Reprinted in *Currencies and Crises*, 1992, pp. 3-25. * CMO packet 1

"Global economic imbalances: When a flow becomes a flood," *The Economist*, Jan. 24, 2009. *

Fiscal Policy

"Global imbalances threaten the survival of liberal trade," Martin Wolf, *Financial Times*, Dec. 2 2008. **

"Budget deficits: Dicing with debt," *The Economist*, Aug. 23, 2003, p.11. *

Martin Feldstein, "The Role for Discretionary Fiscal Policy in a Low Interest Rate Environment," NBER WP No. 9203. In *Rethinking Stabilization Policy*, Federal Reserve Bank of Kansas City Annual Conference, 2003.

Swan Diagram

"Balancing the World," Goldman Sachs *Global Economics Weekly* 08/07, Feb. 20, 2008. **

The Monetary Approach to the Balance of Payments

The gold standard (L9)

Richard Cooper, "The Gold Standard: Historical Facts and Future Prospects," abridged in B.Eichengreen, *The Gold Standard in Theory and History* (Methuen: NY), 1995, pp.251-271.

Purchasing power parity (L10)

"The Big Mac Index: Sizzling," *The Economist*, July 7, 2007.

http://www.economist.com/finance/displaystory.cfm?story_id=9448015 **

Michael Pakko and Patricia Pollard, "Burgernomics: A Big Mac Guide to Purchasing Power Parity," Federal Reserve Bank of St. Louis *Review*, Nov/Dec 2003, 9-28. **

Rudiger Dornbusch, "Purchasing Power Parity." In J.Eatwell, M.Milgate, and P.Newman, eds., *The New Palgrave*, vol. 3 (Macmillan), 1987. Or in Dornbusch, *Exchange Rates and Inflation*.5.

The Globalization of Financial Markets

The growth of the forex market and other modern financial markets (L11-12)

"Finance: Trick or Treat?" *The Economist*, Oct. 23, 1999, p. 91-92.

"Future Perfect," *The Economist*, Nov. 27, 1999, p. 81-82.

Liberalization of capital flows & crises in emerging markets in the 1990s (L12 & L18)

Guillermo Calvo, Leo Leiderman and Carmen Reinhart, "Inflows of Capital to Developing Countries in the 1990s," *Journal of Economic Perspectives*, 10, no. 2, Spring 1996, 123-139. **

Barry Eichengreen and Michael Mussa, "Capital Account Liberalization and the IMF," *Finance and Development*, December 1998, Vol. 35, No. 4. *

Dani Rodrik and Arvind Subramanian, "Why Did Financial Globalization Disappoint?" March 2008, http://ksghome.harvard.edu/~drodrik/Why_Did_FG_Disappoint_March_24_2008.pdf.

Sebastian Edwards, "Capital Controls Are Not the Reason for Chile's Success," *Wall Street Journal*, April 3, 1998. *

The website run by Nouriel Roubini has all the commentary you could want on current issues in international finance. For a taste, see its "front page" at <http://www.rgemonitor.com/>. The Harvard libraries subscribe; to set up an account go to: <http://nrs.harvard.edu/urn-3:hul.eresource:rgemonit>.

The Mundell-Fleming model

J. Frankel "["Could the Twin Deficits Jeopardize US Hegemony?"](#) in *Journal of Policy Modeling*, vol. 28, no. 6, Sept. 2006, pp. 653-663. <http://ksghome.harvard.edu/~jfrankel/SalvatoreDeficitsHegemonJan26Jul+.pdf>

The Exchange Rate System

International Macroeconomic Policy Coordination (L19)

"Brown and Sarkozy seek fiscal boost," *Financial Times*, 12/8/08

at <http://www.ft.com/cms/s/0/e25fe1cc-c574-11dd-b516-000077b07658.html>

**

"Fingers in the dyke," *Economist*, 3/21/09 at: http://www.economist.com/displayStory.cfm?story_id=13325391 **

Thomas Willett, 1999, "Developments in the Political Economy of Policy Coordination," *Open Economies Review* 10, 221-253. *

Exchange rate regimes: Fixed vs. Flexible (L21)

"Economics Focus: The Euro, Trade and Growth," *The Economist*, July 12, 2003, p. 70. *

J. Frankel, *No Single Exchange Rate Regime is Right for All Countries or at All Times*, Essays in International Finance No. 215, Princeton University Press: Princeton, August 1999. **

Determination of Exchange Rates (L22-L23)

"Schools Brief: Why Currencies Overshoot," *The Economist*, Dec. 1, 1990, p.89-90. *
or "Rudiger Dornbusch," *The Economist*, Aug. 10, 2002, p. 72

Schools Brief: "Monopoly Power Over Money," and "Meddling in the Currency Market," *The Economist*, Nov. 20, 1999, p.95-96. *

Mark Taylor, "The Economics of Exchange Rates," *J. of Econ. Literature*, March 1995, 33, no.1. *

Bias in the Forward Exchange Market (L24)

J. Frankel, "Getting Carried Away: How the Carry Trade and Its Potential Unwinding Can Explain Movements in International Financial Markets," Nov. 2007, *Milken Institute Review*.

Ken Froot & Richard Thaler, "Anomalies: Foreign Exchange," *J.Ec.Perspectives* 4, no.3, Summer 1990, 179-192.