

# ITF-220 Economics of International Financial Policy

## Syllabus, Spring 2015

Harvard Kennedy School, Harvard University

**Staff: Professor:** Jeffrey Frankel Littauer 217, HKS  
Faculty Assistant: Minoo Ghoreishi Belfer 505 (617) 384-7329  
Teaching Fellow: Kay Kim

**Times:** Lectures: Mondays and Wednesdays, 2:40-4:00 p.m., Littauer 382  
Review session: most Fridays

Final exam: Monday, May 11, 2015, 2:00-5:00 p.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 the macroeconomics of open economies. The emphasis will be on models appropriate to major countries. Topics 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; currency unions, 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:** Seven 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

## Course Outline

Prof. Jeffrey Frankel, Harvard Kennedy School

Friday sessions will consist variously of reviews, extensions, applications, and questions and answers regarding the week's topic – usually conducted by the professor.

The required text is World Trade and Payments, by R.Caves, J.Frankel, and R.Jones (10th edition, Addison Wesley, 2007). Additional readings are available via links on the course webpage.

<u>Topic</u>	<u>Chapter in WT &amp; P</u>	<u>Lecture number and date</u>	<u>(approx.)</u>	
<b>ELASTICITIES &amp; THE TRADE BALANCE</b>				
Balance of payments accounting	15	1	Jan. 26	
Supply and demand for foreign exchange	16.1	2	Jan. 28	
Export and import elasticities				
Empirical effects of devaluation on the trade balance	16.2	3	Feb. 2	
<b>THE KEYNESIAN MODEL</b>				
National saving identity; fiscal multiplier in an open economy.	17.1-17.2	4	Feb. 4	Problem set 1 due
Export multiplier; & the transfer problem.	17.3 } 17.4	5	Feb. 9	↓ Problem set 2 due
Large-country repercussions & Transmission of disturbances.	17.5-17.6 18.1	6	Feb. 11	↓
Expenditure-reducing policies vs. -switching policies	18.2	7	Feb. 18	↓
Monetary factors	18.3	8	Feb. 23	
<b>MONETARY APPROACH TO THE BALANCE OF PAYMENTS</b>				
Reserve flows & the gold standard	19.1 } Appendix A	9	Feb. 25	Problem set 3 due
Purchasing Power Parity	19.2-19.4	10	Mar. 2	

<u>Topic</u>	<u>Chapter in WT &amp; P</u>	<u>Approx. lecture number and date</u>			
<b>GLOBALIZATION OF FINANCIAL MARKETS</b>				Prob- lem set 4	
Financial integration; spot & forward exchange market	21.1-21.3	11	Mar. 4	<u>due</u>	
Emerging markets; Pros & cons of financial opening	21.4 & 28.1 Ch. 21 Appendix	12	Mar. 9		
	<b><u>Midterm</u></b>	13	Mar. 11		
	[ <i>Spring break</i>		<i>March 14 - 22</i> ]		
<b>FISCAL &amp; MONETARY POLICY UNDER INTERNATIONAL CAPITAL MOBILITY</b>					
Mundell-Fleming -- with exchange rate fixed	22.1-22.3	14	Mar. 23		
Applications/problems of policymaking Mundell-Fleming model	22.4-22.7; 24.1	15	Mar. 25	Prob- lem	
-- with the exchange rate floating.	23.1-23.2	16	Mar. 30	set 5	
Perfect capital mobility & Impossible Trinity	23.3-23.4	17	April 1	<u>due</u>	
Crises in emerging markets	24.2-24.5, 24.7-24.9	18	April 6		
<b>INTERDEPENDENCE AND COORDINATION</b>					
Effects of fiscal expansion in a large country	25.1				
Estimates of transmission	25.2	19	April 8		
International policy coordination	25.3				
<b>SUPPLY AND INFLATION</b>				Prob- lem set 6	
Aggregate Supply and wages	26.1	20	Apr.13	<u>due</u>	
Inflation and anchors for money	26.3-26.4				
Exchange rate regimes and monetary unions	26.5-26.6	21	Apr.15		
<b>EXPECTATIONS AND THE DETERMINATION OF THE EXCHANGE RATE</b>				Prob- -lem	
Interest parity conditions	27.1	}	22	Apr.20	set
The monetarist/Lucas model	27.2				7
	27.3		23	Apr.22	<u>due</u>
Overshooting	27.4				
	27.5-27.6		24	Apr.27	
Forecasting	28.1				
Exchange rate risk & portfolio diversification	28.2-28.4		25	Apr.29	

End of classes, Friday, May 1

**Final exam**

Monday, May 11, 2015, 2:00-5:00 p.m.

## Readings

The required textbook reading is the second half of *World Trade and Payments*, R.Caves, J.Frankel, and R.Jones, 10<sup>th</sup> ed. (Addison-Wesley), 2007.

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.)

### **Balance of Payments Accounting** (Lecture 1)

[“Tourism and the Trade Balance: A Number of Great Import,”](#) *Economist*, Feb. 15, 2014. \*\*

### **The Trade Balance**

#### **The effect of currency depreciation on the trade balance (L2-L3)**

Paul Krugman, "Introduction," in *International Adjustment and Financing: The Lessons of 1985-1991*, C.F.Bergsten, ed. (Institute for International Economics), 1991: 3-12. \*

[“Petri-dish economies: Poland – Few woes in Warsaw,”](#) *Economist*, April 30, 2011, p. 83. \*\*

#### **Application of the marginal propensity to import to the Great Recession of 2008-09 (L4)**

M.Bussière, G.Callegari, F.Ghironi, G.Sestieri, & N.Yamano, 2013, "[Estimating Trade Elasticities: Demand Composition and the Trade Collapse of 2008-2009.](#)" *American Economic Journal: Macroeconomics*, 5(3), July, pp. 118-51. NBER WP 17712. [Summarized](#) in *VoxEU*, 2012. \*\*

### **Fiscal Policy and Keynesian Multipliers** (L5-7, L13-16)

Martin Feldstein, 2009, "[Rethinking the Role of Fiscal Policy,](#)" *American Economic Review* 99, no. 2, 556-559. \*

Ethan Ilzetzki, Enrique Mendoza, and Carlos Vegh, "[How Big \(Small?\) are Fiscal Multipliers?](#)," *Journal of Monetary Economics*, vol. 60(2), 239-254. [NBER WP 16479](#) or [IMF WP 1152](#), 2011. [Summarized in NBER Digest](#), 2011. \*\*

Oscar Jorda and Alan Taylor, 2013, "[Time for Austerity: Estimating the Average Treatment Effect of Fiscal Policy,](#)" NBER Working Paper no. 19414. [Summarized in Vox](#), July 20, 2013.

Olivier Blanchard and Daniel Leigh, 2014, "[Learning about Fiscal Multipliers from Growth Forecast Errors,](#)" *IMF Economic Review*, 62, 179–212.

[“Economics focus: Much ado about multipliers,”](#) *The Economist*, Sept. 26, 2009, p. 90.

[“A stimulating question: Can emerging economies now afford counter-cyclical policies?”](#) *The Economist*, Dec. 13, 2008, p. 90.

[“Chile’s Economy: Cashing in the fruits of rigor,”](#) *The Economist*, Feb. 19, 2009. \*

## **The Monetary Approach to the Balance of Payments** (L8)

### **The gold standard and Bretton Woods** (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.

["The global monetary system: Not floating, but flailing,"](#) *The Economist*, July 5, 2014, 57-58. \*

### **Purchasing power parity** (L10)

["Big Mac index: An indigestible problem – Why China needs more expensive burgers,"](#) *Economist*, Oct.14, 2010. \*

["Big Mac index: bunfight – Currency wars: the burgers verdict,"](#) *The Economist*, Feb.2, 2013. \*

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

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

## **The Globalization of Financial Markets**

### **The growth of forex trading and other financial markets** (L11)

["Finance: Trick or Treat?"](#) *The Economist*, Oct. 23, 1999, p. 91-92.

["Future Perfect,"](#) *The Economist*, Nov. 27, 1999, pp. 81-82. \*

### **Pros and cons of open financial markets** (L12)

["Policing the frontiers of finance – Is foreign capital a luxury that poor countries can live without?"](#) [summary of Rodrik & Subramanian], *The Economist*, Apr. 12, 2008, p. 87.

["Economics Focus: Capital Bonanzas,"](#) [summary of Reinhart & Reinhart] *Economist*, Sept.27, 2008, p.92. \*\*

["Capital controversy,"](#) *The Economist*, April 14, 2012, p.86.

["An on-off relationship,"](#) *The Economist*, Dec. 13, 2014. \*

### **Emerging markets: inflows and crises** (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. \*

["Emerging-market debt: A run for your money,"](#) *Economist*, Aug.28, 2010, p.66.

["Brazil's economy: Wild horses – A soaring currency..."](#) *Economist*, Apr. 23, 2011.

["Economic epidemiology,"](#) *The Economist*, June 16, 2012.

["Asia's Great Moderation,"](#) *The Economist*, Nov. 10, 2012.

["India on the brink: How India got its funk,"](#) *The Economist*, Aug. 24, 2013, p.12. \*

["Financial indulgence,"](#) *The Economist*, April 5, 2014, p.69. \*

## **The Global Macroeconomic System**

### **International Macroeconomic Policy Coordination (L19)**

“[Brown and Sarkozy seek fiscal boost](#),” *Financial Times*, December 8, 2008. \*

“[Fingers in the dyke](#),” *The Economist*, March 21, 2009. \*

Olivier Blanchard, Jonathan Ostry, and Atish R. Ghosh, “[International Policy Coordination: The Loch Ness Monster](#),” *IMFdirect*, Dec.15, 2013.

Menzie Chinn, 2013, “[Global spillovers and domestic monetary policy](#)” BIS WP 436, Dec.

Charles Engel, 2014, “[International Coordination of Central Bank Policy](#),” U. Wisconsin, Aug.

### **Supply and Inflation (L20)**

“[Some like it hot: Which emerging economies are at greatest risk of overheating?](#)” *Economist*, July 2, 2011, p. 65. \*\*

“[Argentina’s inflation problem: The price of cooking the books](#),” *Economist*, Feb.25, 2012, 47-8.

“[Nigeria’s Central Bank Chief Warns on Independence](#),” *Financial Times*, June 7, 2012.

“[China drains cash to curb inflation](#),” *Financial Times*, Feb. 22, 2013.

“Steep Inflation Fuels Egyptian Anger,” *Wall Street Journal Europe*, July 1, 2013.

Mario Blejer, 2013, “[Political Central Banking: Get ready for the end of central bank independence](#),” *The International Economy*, 27, no.2, spring, pp. 32-33.

## **Exchange Rates**

### **Monetary Union (L21)**

“[The euro: Beware of falling masonry](#),” *The Economist*, Nov 26<sup>th</sup>, 2011.

Jay Shambaugh, 2012, “[The Euro’s Three Crises](#),” *Brookings Papers on Economic Activity*, Spring, 157-211. [Summary](#).

J. Frankel, “[The Euro Crisis: Where to From Here?](#)” [pdf](#), AEA meetings Jan. 3, 2015. forthcoming in *Journal of Policy Modeling*, May/June 2015. [HKS RWP13-015](#). \*

### **Monetary 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, 2008, “[Carried Away](#),” *Milken Institute Review*, Q1. Or, with references: “[How the Carry Trade and Its Potential Unwinding Can Explain Movements in International Financial Markets](#),” \*

Ken Froot & Richard Thaler, 1990, “Anomalies: Foreign Exchange,” *JEP* 4, no.3, Summer, 179-92.