

# Econ 165: International Finance

Instructor: Doireann Fitzgerald  
Office: Landau 335  
e-mail: dfitzger at stanford dot edu  
Class time, location: M, W 1.15-3.05pm, 200-205  
TA: Yaniv Yedid Levi

**Course Description:** This class is organized around several questions of current interest to policy makers, business leaders and the general public. Basic models in international macroeconomics are presented and recent research on the empirical and practical relevance of these models is discussed. The aim is to give students the tools necessary to read critically and understand discussions of international economic policy found in popular media such as The Economist magazine, the Wall Street Journal and the Financial Times.

**Prerequisites:** Econ 52. I do not have discretion to waive this prerequisite. If you have not completed this class, contact the Economics Undergraduate Office. A strong background in microeconomics is also assumed.

**Assessment:** Problem sets (20%); In-class midterm (30%); Final exam (50%). Out of 6 problem sets, only your best 5 scores will contribute to the final grade. Late problem sets will receive a score of zero. Attendance at both the midterm and final exam is mandatory. No make-up exams will be offered. In marginal cases, class attendance will be taken into account.

**Final exam:** Wednesday December 10, 8.30-11.30am. If you cannot make this time, do NOT take this class.

**Readings:** There is no required hard-copy textbook for this class. Lecture notes and links to required readings will be posted on the class webpage. Many of these are taken from the following online textbook: [International Macroeconomics](#), by Schmitt-Grohé and Uribe (S&U). Some recommended readings will be taken from *International Economics*, by Paul Krugman and Maurice Obstfeld (K&O), and some from *Foundations of International Macroeconomics*, by Maurice Obstfeld and Kenneth Rogoff (O&R). These texts are on reserve at the library. Other recommended readings and resources will be made available through links on the class webpage.

**Webpage:** <http://coursework.stanford.edu>

**Discussions:** Where noted, on Wednesdays, the last 15 minutes of class will be devoted to general discussion of a set topic of current interest. Each week, 4 pre-chosen volunteers will speak for 2 minutes, followed by cold calling of other students. Volunteers will receive extra credit. What you say in the discussion will not affect your grade. Unexplained absences, however, may count against you.

**Instructor's office hours:** Unless otherwise announced, my office hours are Tuesdays 9am-11am sharp. Please e-mail me in advance if you plan to attend.

**Section:** Details on times and locations will be announced in the first week of the quarter.

## Frequently asked questions

- *How much math is used in this class?* Familiarity with basic algebra and calculus is assumed.
- *How much reading should I do?* Required readings have been kept to a minimum, but required

means required. Discussion readings are also required. If you are particularly interested in a topic, you are invited to explore the recommended readings.

- *When will lecture notes be posted?* In general, lecture notes will be posted shortly before class. But please do not complain if there is a delay. Note that class attendance is mandatory, and reading the lecture notes is no substitute for attending. I will not post the tablet slides from class. Please do not ask me to do so.
- *Will there be a break in the middle of class?* No. On occasion, class may finish 10 minutes early in lieu of a break.
- *Do I have to go to section?* Yes. Attendance will be taken, and in marginal cases, may count towards your final grade.
- *Can my friends and I work together on the problem sets?* Yes. The problem sets are intended to be learning experiences, so feel free to work in groups. However you may find it useful to attempt the problems on your own before working with others. Each student must submit their own problem set solutions. Doing the problem sets is the best way to prepare for the exams. If you copy another student's answers without understanding the material, your exam performance will suffer.
- *How are the problem sets graded?* The problem sets are graded on a scale of check plus, check, check minus and zero (if no problem set is handed in, or it is submitted late). Your TA appreciates legible problem sets.
- *Can I turn a problem set in late?* No. I have instructed the TA not to grade problem sets turned in after the deadline (12 noon on Mondays). Problem sets are to be turned in in the lockbox in the Undergraduate Economics Office, and the lockbox will be removed at noon.
- *What if I cannot take the midterm?* There will be no make up exams. You should contact me in advance if you cannot make a midterm.
- *What material will be covered on the midterm and final exam?* The midterm will cover the material up to and including the lecture of 27th October. The final will cover material from the entire quarter.
- *What do I do if a mistake was made in grading my exam?* Please see the Economics Department common course management policies.

## Schedule and Readings

### Week 1

#### 1) **Monday 22nd September 2008:** Introduction

- a) What is international economics?
- b) Motivating facts and questions
- c) Review of budget sets, utility maximization and demand
- d) Special case of homothetic preferences and aggregation

• **Key concepts:** Budget constraint, utility function, marginal rate of substitution, relative demand, homothetic preferences

• **Required reading:**

- Martin Wolf in the *Financial Times* on the [costs and benefits of globalization](#)
- Dani Rodrik in Project Syndicate on [the Death of the Globalization Consensus](#)
- Kenneth Rogoff's address to the UN on [Globalization and Interdependence](#)

• **Recommended reading:**

- K&O Chapter 2
- Hal Varian: *Intermediate Microeconomics* 7th edition, Chapters 2-6 (or similar material in an alternative intermediate micro textbook)

• **Problem set:** No problem set this week

#### 2) **Wednesday 24th September 2008:** Endowment economies I

- a) Free trade vs autarky in a 2-good small open endowment economy

- b) A 2-country 2-good endowment world
- **Key concepts:** Small open economy, autarky, gains from trade, comparative advantage, terms of trade, relative abundance
- **Recommended reading:**
  - Hal Varian: *Intermediate Microeconomics* 7th edition, Chapters 2-6 and 31 (or similar material in an alternative intermediate micro textbook)
- **Discussion:** No discussion this week
- **Section:** No section this week

## Week 2

- 3) **Monday 29<sup>th</sup> September 2008:** Endowment economies II
- a) Empirical evidence on autarky prices and the direction of trade
  - b) Efficiency and the Edgeworth box
  - c) The redistributive effects of trade
  - **Key concepts:** Pareto efficiency, contract curve
  - **Required reading:**
    - Daniel Bernhofen and John Brown (2004), "[A Direct Test of the Theory of Comparative Advantage: The Case of Japan.](#)" *Journal of Political Economy* 112 (1) 48-67
    - Douglas Irwin (2005), "[The Welfare Cost of Autarky: Evidence from the Jeffersonian Trade Embargo.](#)" *Review of International Economics* 13 (4) 631-645
  - **Recommended reading:**
    - Hal Varian: *Intermediate Microeconomics* 7th edition, Chapters 31 and 32 (or similar material in an alternative intermediate micro textbook)
  - **Problem set:** No problem set this week
- 4) **Wednesday 1st October 2008:** Production economies I
- a) The production possibility frontier
  - b) The effect of terms-of-trade changes in the short and long run
  - c) Evidence on trade liberalization, shifts in production and welfare
  - **Key concepts:** Production possibility frontier, factors of production, production function, marginal rate of transformation
  - **Recommended reading:**
    - Hal Varian: *Intermediate Microeconomics* 7th edition, Chapter 32
    - K&O Chapter 5
  - **Discussion:** Should trade policy be used as a tool for domestic redistribution?
    - **Reading 1:** [White House statement on the steel industry](#)
    - **Reading 2:** [What to expect when you're free trading](#) – Steven Landsburg in the *NYT*
  - **Section:** TBA

## Week 3

- 5) **Monday 6th October 2008:** Production economies II
- a) What explains changes in the terms of trade?
  - b) Trade policy
  - **Key concepts:** Immiserizing growth, optimal tariff
  - **Required reading:**
    - Robert Baldwin (1989), "[The Political Economy of Trade Policy.](#)" *Journal of Economic*

*Perspectives* 3 (4), 119-135

- **First problem set:** Due at 12 noon on Monday 6th October
  
- 6) **Wednesday 8th October 2008:** Intertemporal trade I
  - a) Intertemporal preferences, budget constraint and prices
  - b) A small 2-period endowment economy
  - c) A 2-period 2-country world
  - d) The current account
- **Key concepts:** Discount factor, interest rate, elasticity of intertemporal substitution, trade balance, current account, net foreign assets
- **Required reading:**
  - S&U Chapter 1, Chapter 2, Sections 2.1 and 2.2
- **Recommended reading:**
  - O&R Chapter 1, Sections 1 and 2
  - Hal Varian: Intermediate Microeconomics 7th edition, Chapter 10
- **Discussion:** Does China's growth hurt the US?
  - **Reading 1:** [“China and Wal-Mart: the champions of equality.”](#) *Financial Times*
  - **Reading 2:** The *Economist* on [the economics of offshoring](#)
- **Section:** Review of national income accounting in an open economy

#### Week 4

- 7) **Monday 13th October 2008:** Intertemporal trade II
  - a) Introducing investment
  - b) A 2-period 2-country world with investment
- **Key concepts:** Investment, capital, diminishing marginal product
- **Required reading:**
  - S&U Chapter 3, section 3.1, Chapter 4
  - [Economic Report of the President](#) (2006), Chapter 6: The U.S. Capital Account Surplus, pp. 125-147
- **Recommended reading:**
  - O&R Chapter 1, Sections 2 and 3
- **Second problem set:** Due at 12 noon on Monday 13th October
  
- 8) **Wednesday 15th October 2008:** Intertemporal trade and the government's role
  - a) Current account adjustment to temporary vs permanent shocks
  - b) Government consumption and the current account
- **Key concepts:** Marginal product; Diminishing marginal product
- **Required reading:**
  - S&U Chapter 2, section 2.3, Chapter 3, section 3.2, Chapter 5
- **Discussion:** Is the US current account deficit sustainable?
  - **Reading 1:** The *Economist* [“Stop Worrying and Love the Deficit”](#)
  - **Reading 2:** Ken Rogoff in Project Syndicate [“America's perpetual Christmas”](#)
- **Section:** TBA

#### Week 5

- 9) **Monday 20th October 2008:** International risk sharing

- a) Preferences over uncertainty and the demand for insurance
- b) A small endowment economy
- c) A 2-country endowment world
- d) Portfolio composition
- **Key concepts:** Expected utility, risk aversion, risk neutrality, contingent assets, equities
- **Recommended reading:**
  - Hal Varian: Intermediate Microeconomics 7th edition, Chapter 12, Chapter 37, section 7
- **Third problem set:** Due at 12 noon on Monday 20th October

10) **Wednesday 22nd October 2008:** No class

- **Section:** TBA

### Week 6

11) **Monday 27th October 2008:** Puzzles in international capital markets

- a) Home bias in portfolios & a model with non-traded goods
- b) Consumption correlations
- c) Why doesn't capital flow from rich to poor countries?
- d) Feldstein-Horioka puzzle
- **Required reading:**
  - S&U Chapter 6 section 6.1
- **Fourth problem set:** Due at 12 noon on Monday 27<sup>th</sup> October

12) **Wednesday 29th October 2008:** Sovereign debt II

- a) Investment and sanctions - debt overhang
- b) Debt buybacks
- **Key concepts:** Moral hazard
- **Required reading:**
  - S&U Chapter 9, section 9.4
  - Jeremy Bulow and Kenneth Rogoff (1990), [“Cleaning Up Third World Debt Without Getting Taken to the Cleaners.”](#) *Journal of Economic Perspectives* 4, 31-42.
- **Recommended reading:**
  - O&R Chapter 6, Sections 1 and 2
- **Discussion:** Understanding the current financial crisis
  - Reading 1: [Rob Shimer in Greg Mankiw's blog](#)
  - Reading 2: [Doug Diamond and Anil Kashyap in Freakonomics, I](#)
  - Reading 3: [Doug Diamond and Anil Kashyap in Freakonomics, II](#)
  - Reading 4: [John Cochrane in Freakonomics](#)
- **Section:** Review for the midterm

### Week 7

13) **Monday 3rd November 2008:** Midterm exam

- **Problem set:** No problem set this week

14) **Wednesday 5th November 2008:** Sovereign debt I

- a) A 2-state model with full commitment
- b) No commitment case
- c) Lack of commitment and sanctions

- d) Why do countries repay their debts?
- e) Investment and sanctions
- **Key concepts:** Commitment, incentive compatibility, reputation
- **Required reading:**
  - S&U Chapter 9, sections 9.1 and 9.2
- **Recommended reading:**
  - O&R Chapter 6, Sections 1 and 2
  - Hal Varian: Intermediate Microeconomics 7th edition, Chapter 12, Chapter 37, section 7
- **Section:** TBA

## Week 8

### 15) Monday 10th November 2008: Crises in financial markets

- a) A motivation for having banks
- b) How a bank run can happen
- c) Preventing bank runs
- d) Moral hazard and deposit insurance
- e) Two applications
- **Key concepts:** Multiple equilibria
- **Required reading:**
  - The Economist: [The problems involved in stopping a bank run](#)
- **Recommended reading:**
  - Hal Varian: *Intermediate Microeconomics* 7th edition, Chapter 37, section
  - Douglas Diamond and Philip Dybvig (1983), "[Bank Runs, Deposit Insurance and Liquidity](#)," *Journal of Political Economy* 91 (3), 401-41
- **Discussion:** Should we forgive Third World debt?
  - **Reading 1:** William Easterly "[Debt Relief](#)," *Foreign Policy*, Nov-Dec 2001.
- **Problem set:** No problem set this week

### 16) Wednesday 12th November 2008: Price levels and the exchange rate in the long run

- a) Nominal and real exchange rates
- b) Theory of purchasing power parity
- c) Why PPP fails: Balassa-Samuelson effect
- d) Movements in the current account and exchange rates
- **Key concepts:** Nominal exchange rate, real exchange rate, appreciation, depreciation, law of one price, purchasing power parity, Balassa-Samuelson effect
- **Required reading:**
  - The Economist: "[McCurrencies](#)" (text only from [Proquest](#))
  - S&U Chapter 7 section 7.1
- **Recommended reading:**
  - K&O Chapter 15, pages 369-372, 379-388
  - Kenneth Rogoff, "[The Purchasing Power Parity Puzzle](#)," *Journal of Economic Literature* 34, June 1996, 647-68
- **Discussion:** Is foreign capital a luxury that poor countries can live without?
  - **Reading 1:** [Policing the frontiers of finance](#) from the *Economist* magazine
  - **Reading 2:** Kenneth Rogoff: [Are controls on international capital flows good for developing countries?](#)
- **Section:** TBA

## Week 9

- 17) **Monday 17th November 2008:** A model to analyze monetary and exchange rate policy I
- a) Some facts about foreign exchange markets
  - b) Uncovered interest parity
  - c) The exchange rate as an asset price
- **Key concepts:** Uncovered interest parity, risk premium
- 18) **Wednesday 19th November 2008:** A model to analyze monetary and exchange rate policy II
- a) Real vs nominal interest rates
  - b) Monetary policy and interest rates
  - c) Short run impact of monetary policy in an open economy
  - d) International competition or cooperation in monetary policy
  - e) The Taylor rule
- **Key concepts:** Fisher equation, open market operations, potential output, Taylor rule
  - **Discussion:** How should central banks respond to the current financial crisis?
    - **Reading 1:** *The Economist*: [When to bail out](#)
    - **Reading 2:** *Wall Street Journal*: [Spain's Bank Capital Reserves Offer a Model to Policy Makers](#)
  - **Fifth problem set:** due at 12 noon on Monday 17th November
  - **Section:** TBA

## Week 10

- 19) **Monday 1st December 2008:** Floating and fixed exchange rates
- a) Fixed vs floating exchange rates
  - b) Credibility and monetary policy
  - c) Currency crises
- **Key concepts:** Time inconsistency, rational expectations, multiple equilibria
  - **Sixth problem set:** due at 12 noon on Monday 1st December
- 20) **Wednesday 3rd December 2008:** A model to analyze monetary and exchange rate policy IV
- **Discussion:** Should there be a world currency?
    - **Reading 1:** [Some nations that spurned the Euro reconsider](#)
    - **Reading 2:** *The Economist* "[The Euro and Trade](#)"
  - **Section:** Review for final exam

## Final Exam

- **Wednesday 10th December 2008:** 8.30-11.30am, 200-205