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Class time, location	Tu,Th 1.15-3.05pm, Landau 140
TA:	??

## Econ 165: International Finance

**Course Description:** This class introduces basic models necessary to understand how different national economies are integrated with each other. 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, as well as providing a basis for additional coursework in international macroeconomics.

**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. No make-up exams will be offered. In marginal cases, class attendance will be taken into account.

**Final exam:** Thursday December 15, 7.00-10.00pm. If you know in advance that you cannot make this time, do NOT take this class.

**Readings:** There is no hard-copy textbook for this class. Extensive required readings are taken from the following online textbook: *International Macroeconomics*, by Schmitt-Grohé and Uribe (S&U). Lecture notes and links to required and recommended readings will be posted on the class webpage.

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

**Class presentations:** On occasion, the last 15 minutes of class will be devoted to discussion of a set topic of current interest. More details on this will be made available once enrollment has settled down.

**Instructor's office hours:** Unless otherwise announced, my office hours are Thursdays 11am-12pm sharp. Please e-mail me in advance if you plan to attend.

**Section:** Whether or not we will have section depends on enrollment. More details will be made available once enrollment has settled down.

## Frequently asked questions

- *How much math is used in this class?* Familiarity with basic algebra, calculus and elementary optimization 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 reading the lecture notes is no substitute for attending class. 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.
- *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). Legibility is appreciated. Please try not to submit problem sets in pencil, as there have been problems with this in the past.
- *Can I turn a problem set in late?* No. Problem sets are to be turned in in the lockbox in the Undergraduate Economics Office on Tuesdays, and the lockbox will be removed at 12 noon. If your problem set is not in the lockbox when it is removed, it will not be graded.
- *What if I cannot take the midterm?* There will be no make up exams. You should contact me in advance if you cannot make the midterm.
- *What material will be covered on the midterm and final exam?* The midterm will cover the material up to and including the previous class. 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. Note that exams written in pencil are not eligible for regrades.

# Schedule and Readings

## 1. Tuesday 27th September 2011: Introduction; Tools; Endowment economies

- (a) Review of budget sets, utility maximization and demand
  - (b) Homothetic preferences
  - (c) Autarky and free trade in a small endowment economy
  - (d) Trade and welfare in a 2-country endowment world
- **Key concepts:** Budget constraint, utility function, marginal rate of substitution, relative demand, homothetic preferences, 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)
  - **Problem set:** No problem set this week

## 2. Thursday 29th September 2011: Production economies

- (a) The production possibility frontier
  - (b) Autarky and free trade in a SOE
  - (c) Changes in the terms of trade and effects on production, trade and welfare
  - (d) What determines the terms of trade and why might it move around
  - (e) Footnote on trade policy
- **Key concepts:** Production possibility frontier, marginal rate of transformation, tariff
  - **Recommended reading:**
    - Hal Varian: *Intermediate Microeconomics* 7th edition, Chapter 32

3. **Tuesday 4th October 2011:** Intertemporal trade in an endowment economy

- (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&UChapter 1, Chapter 2

- **Recommended reading:**

- Hal Varian: *Intermediate Microeconomics* 7th edition, Chapter 10

- **Problem set 1:** Due at 12 noon on Tuesday 4th October

4. **Thursday 6th October 2011:** Intertemporal trade in a production economy

- (a) Introducing investment
- (b) A 2-country world with investment

- **Key concepts:** Investment, capital, diminishing marginal product

- **Required reading:**

- S&UChapter 3, Chapter 4

5. **Tuesday 11th October 2011:** Intertemporal trade and the government's role

- (a) The government budget constraint
- (b) Ricardian equivalence
- (c) The government, autarky prices and current accounts in an endowment world
- (d) The government, autarky prices and current accounts in a world with investment

- **Key concepts:** Ricardian equivalence, crowding out

- **Required reading:**

- S&UChapter 5

- **Problem set 2:** Due at 12 noon on Tuesday 11th October

6. **Thursday 13th October 2011:** Real exchange rates

- (a) One-period endowment model
- (b) Two-period endowment model
- (c) Real exchange rates and shocks

- **Key concepts:** TBA

- **Required reading:**

- S&UChapter 7, Chapter 8

7. **Tuesday 18th October 2011:** 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
- **Problem set 3:** Due at 12 noon on Tuesday 18th October

8. **Thursday 20th October 2011:** Facts about international capital markets

- (a) Why does capital flow from poor to rich countries?
- (b) Allocation puzzle
- (c) Feldstein-Horioka puzzle
- (d) Home bias in portfolios and recent increases in international financial integration
- (e) Composition of international capital flows

- **Key concepts:** TBA
- **Required reading:**
  - S&U Chapter 6, section 6.1
- **Recommended reading:**
  - Lucas, R., (1990), “Why Doesn’t Capital Flow From Poor to Rich Countries?” *American Economic Review* 80 (2), 92-96.
  - Feldstein, M. and C. Horioka, (1980), “Domestic Saving and International Capital Flows,” *Economic Journal* 90, 314-329.

9. **Tuesday 25th October 2011:** Moral hazard and underinvestment

(a) Motivation

(b) Moral hazard in international lending

- **Key concepts:** Moral hazard

- **Recommended reading:**

- O&R Chapter 6, Sections 1 and 2

- Gertler, M. and K. Rogoff (1990), "North-South Lending and Endogenous Domestic Capital Market Inefficiencies," *Journal of Monetary Economics* 26, 245-266.

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

10. **Thursday 27th October 2011:** Midterm exam

11. **Tuesday 1st November 2011:** Limited commitment and sovereign debt

- (a) A 2-state model with full commitment
- (b) Absence of commitment
- (c) Lack of commitment and sanctions
- (d) Why do countries repay their debts?
- (e) Investment and sanctions

- **Key concepts:** Commitment, incentive compatibility, reputation

- **Recommended reading:**

- O&R Chapter 6, Sections 1 and 2

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

12. **Thursday 3rd November 2011:** Sovereign default

- (a) A model of default in equilibrium
- (b) Debt overhang
- (c) Debt buybacks

- **Key concepts:** TBA

- **Required reading:**

- S&U Chapter 9, Section 9.4

- **Recommended reading:**

- Bulow, J. and K. Rogoff (1988), “The Buyback Boondoggle,” *Brookings Papers on Economic Activity*: no. 2, 1988, 675-698

- Bulow, J. and K. Rogoff (1990), “Cleaning Up Third World Debt Without Getting Taken to the Cleaners,” *Journal of Economic Perspectives* 4, 31-42.

13. **Tuesday 8th November 2011:** Crises arising from maturity mismatch

- (a) Maturity mismatch
- (b) Multiple equilibria
- (c) Bailouts, deposit insurance and moral hazard
- (d) Two applications

- **Key concepts:** Multiple equilibria

- **Required reading:**

- Douglas Diamond, "Banks and Liquidity Creation: A Simple Exposition of the Diamond Dybvig Model," "Banks and Liquidity Creation: A Simple Exposition of the Diamond Dybvig Model," *Federal Reserve Bank of Richmond Economic Quarterly*, 93(2).

- **Recommended reading:**

- Douglas Diamond and Philip Dybvig (1983), "Bank Runs, Deposit Insurance and Liquidity," *Journal of Political Economy* 91 (3), 401-419.

- **Problem set 4:** Due at 12 noon on Tuesday 8th November

14. **Tuesday 10th November 2011:** Leverage, contagion and systemic risk

- **Key concepts:** Leverage, contagion

- **Recommended reading:**

- N. Sacasa, "Preventing Future Crises," *Finance and Development*, December 2008
- K. Rogoff and C. Reinhart, "This Time is Different: A Panoramic View of Eight Centuries of Financial Crises," "This Time is Different: A Panoramic View of Eight Centuries of Financial Crises," mimeo, Harvard University.
- M. Brunnermeier, "Deciphering the Liquidity and Credit Crunch 2007-08," *Journal of Economic Perspectives*, 23 (1), 77-100.
- G. Kaminsky, C. Reinhart and C. Vegh, "The Unholy Trinity of Financial Contagion," *Journal of Economic Perspectives*, 17 (4), 51-74.

15. **Tuesday 15th November 2011:** Nominal exchange rates and monetary and fiscal policy I

- **Key concepts:** TBA
- **Required reading:**
  - S&U Chapter 10, Section 10.1
- **Problem set:** No problem set this week

16. **Thursday 17th November 2011:** Nominal exchange rates and monetary and fiscal policy II

- **Key concepts:** TBA
- **Required reading:**
  - S&U Chapter 10, Section 10.2

17. **Tuesday 29th November 2011:** Nominal exchange rates and monetary and fiscal policy III

- **Key concepts:** TBA
- **Required reading:**
  - TBA
- **Problem set 5:** Due at 12 noon on Tuesday 29th November

18. **Thursday 1st December 2011:** Currency crises

- **Key concepts:** TBA
- **Required reading:**
  - TBA

19. **Tuesday 6th December 2011:** Currency unions

(a) TBA

- **Key concepts:** TBA
- **Problem set 6:** due at 12 noon on Tuesday 6th December

20. **Thursday 8th December 2011:** Review