Some empirical puzzles:

1. There is very little international diversification of portfolios.
2. Consumption is less well correlated across countries than one might expect.
3. Exchange-rate systems seem to affect the behavior of real exchange rates.
4. Real and nominal exchange rates move together very closely.
5. Exchange rate movements are very persistent with little short-run dynamics (no mean reversion).
6. Forward exchange rates are poor and biased predictors of the future spot rate.
7. Why are international differences in interest rates so large and persistent?

Some other questions:

8. What are the causes of changes in exchange rates?
9. What are the effects of changes in exchange rates (or the shocks that caused them)?
10. What causes changes in the balance of trade (and current account)?
11. What are the allocative or distributional effects of alternative exchange-rate systems?
12. Under what conditions can we rank (or even compare) exchange-rate systems in terms of welfare?
13. Are business cycles transmitted from one country to another? Or are there common shocks across countries?

This course is divided into three sections. In Section I we will focus on the two roles that international financial markets (IFM) play for nations:

(i) Intertemporal trade: IFM allow a country to consume more in aggregate than it produces in any given time period. In other words, IFM permit borrowing and lending at the national level. (Trade across time)

(ii) International risk sharing: IFM permit countries to pool risk. (Trade across states)

In each of these contexts we want to understand the gains from trade on international financial markets. We want to know how a country's access to IFM is likely to affect welfare of its citizens and how it may influence production decisions of its firms. We will find that IFM will, in general, affect the pattern over time of aggregate consumption in a country, as well as investment, capital accumulation, and output.

In addition, we will examine current account dynamics to try to understand how different types of shocks -- productivity, preferences, or terms of trade shocks (for a small country) -- often create different behavior of the current account. We also want to understand the correlations among the current account and (real and nominal) exchange rates, consumption across countries, output across countries, etc.
In Section II we study the determination of exchange rates. We examine the empirical observations of the behavior of exchange rates in the modern floating rate period and we consider numerous models that attempt to explain this behavior. We also analyze the relative merits of fixed versus flexible exchange rates in theory and in practice.

In Section III we consider some topics which may include international business cycles, the so-called "international debt crisis," policy coordination, and capital controls.

Course Readings and Requirements

The most important readings on the list that follows are marked with an asterisk. Some of these will be discussed in class, although you are responsible for all of them unless otherwise noted. The remaining papers are provided as a reference for future research or for additional insight. In addition to these readings, I have prepared some supplementary notes which offer further explanation of some sections of the material. These will be made available. Papers marked with an asterisk and the supplemental notes will be placed in the filing cabinet in the third floor student lounge.

There will be two examinations in this course -- a midterm exam and a final exam. In addition, you will be required to write a paper: this may either focus on an original research idea or may be a comprehensive survey/critique of one area of the international finance literature of your choosing. A two-page topic description is due Monday, February 5. The topic is subject to approval. The final draft of the paper is due Monday, April 22. Paper presentations will take place during class the weeks of April 22 and April 29. Further details will be provided.

The Final Exam is scheduled for Friday, May 10, 11:30am - 2:30pm.
Reading List

I. INTERNATIONAL FINANCIAL MARKETS AND INTERTEMPORAL TRADE

I.0. General


I.1. Trade over Time (under Certainty)


**INCOMPLETE MARKETS**


**EVIDENCE**


II. EXCHANGE RATES

II.1 Models of Flexible Exchange Rates

GENERAL


EQUILIBRIUM MODELS


DISEQUILIBRIUM MODELS


BEHAVIOR OF EXCHANGE RATES


THE BUDGET DEFICIT, THE CURRENT ACCOUNT, AND THE DOLLAR


* Paul Evans, "Is the Dollar High Because of Large Budget Deficits?" *Journal of Monetary Economics* 18, No. 3 (November 1986), 227-50.

FORWARD EXCHANGE RATES


### EXCHANGE RATE REGIMES AND ALTERNATIVE MONETARY SYSTEMS


### III. SELECTED TOPICS

#### III.1 Devaluation and Related Issues


Vittorio Grilli, "Buying and Selling Attacks on Fixed Exchange Rate Systems," *JIE* 20, No. 1/2 (February 1986), 143-56.

Maurice Obstfeld, "Balance-of-Payments Crises and Devaluation," *Journal of Money, Credit and Banking* 16 (May 1984), 208-17.


### III.2 Sterilization, Official Intervention, and Monetary Policies


Maurice Obstfeld, "The Effectiveness of Foreign-Exchange Intervention: Recent Experience," NBER WP 2796 (December 1988).

### III.3 Exchange Controls, Capital Controls, and Commercial Policies


### III.4. Fiscal Policies


### III.5. International Transmission


III.6. Policy Coordination


III.7. International Debt


