International Monetary Economics

*ECON S-1530, Summer 2009

MW, 12-3:00pm

Professor Aryeh Blumberg and Lecturer Daniela Kolusheva

Teaching Assistant Edmond Horsey

Required Sections: Th, 12 - 1:00 pm

COURSE DESCRIPTION

This course covers the institutions, historical context, and other topics that are essential for understanding the current international monetary system. We focus on the evolving interactions, currently in flux, between multinational corporations and banks, central banks, the International Monetary Fund, and the World Bank. The interactions among these institutions define the different regimes that have characterized international monetary organization, from the pre-World War I gold standard, the post-World War II Bretton Woods system of fixed exchange rates, and the regime of more or less market-determined exchange rates that superseded it in the 1970s. Students study how foreign exchange markets interact with markets for goods and services and with capital markets. This is tested by examining the relation between spot and forward exchange rates, interest rates, and inflation rates. Balance of payments accounts and net asset positions of countries are analyzed, as well as the relative effectiveness of monetary and fiscal policy under fixed and floating regimes. We also consider other timely topics, such as the recent worldwide financial crisis, the microstructure of foreign exchange markets, and globalization.

The conceptual framework and the analytical techniques required for insight into these issues require a strong emphasis on scientific method and empirical evidence. The course is useful preparation for graduate work in international economics and finance.

Prerequisites:
Pass proficiency examination. Econ. S-10ab or equivalent
Readings:

Eichengreen, B., *Globalizing Capital: A History of the International Monetary System*  

McKinnon, R. *The Rules of the Game: International Money in Historical Perspective* (Review article)

A set of additional readings will be distributed during the first week of class and throughout the course. All required readings should be completed prior to the lecture in which they will be covered.

Requirements:

1. **Two hourly examinations:** the first exam is on July 6, 12:00 - 1:00 pm, the second on July 22, 12:00 – 1:00p. Each hourly exam counts for 20% of the course grade for undergraduate students and 15% for graduate students.

2. **Problem sets** distributed Wednesdays and collected and discussed the following Thursday in section. These assignments will constitute 20% of the course grade for undergraduate students and 15% for graduate students.

3. For graduate students, a research paper accounts for 20% of the course grade.

4. **Final examination:** The exam is three hours, open book and open notes. The final exam counts for 40% of the course grade for undergraduates and 35% for graduate students.

OVERVIEW of the Course

The lectures focus primarily on the concepts and analytical methods that are essential for understanding the institutions that comprise the International Monetary System. In view of the once in a century global financial crisis, special attention will be given to understanding current events. Historical and institutional topics are an integral part of the course. Substantial portions of Barry Eichengreen’s *Globalizing Capital, A History of the International Monetary System*, selections from McKinnon’s Review article, and significant recent articles from the *Financial Times*, *The New York Times*, and *Foreign Affairs* on the economic crisis.

Final examination questions will test students’ ability to analyze passages from these readings using concepts and analytical methods covered in the lectures. Sample questions will be discussed in the weekly sections or distributed as handouts.

Most of the course relies on original lecture notes, journal articles, and some chapters from textbooks. These materials are distributed in class, and the lecture notes will be posted on the course website. The lecture notes are terse. We believe that live encounters are an important part of the learning process. The lectures are fast-paced. There are a total of 12 three hour lectures. Your performance will suffer if you miss lectures.

We begin with two fundamental principles of trade theory: (1) **the gains from exchange or trade**, and (2) **the principle of comparative advantage**.

These principles are the essential underpinnings of the monetary aspects of the course. From a systemic point view the monetary aspects “veil” the fundamental fact that it is really all about the exchange of goods and services between transactors, in the present  --spot transactions-- and over time, today’s goods for future goods, termed “intertemporal exchange,” i.e., borrowing and lending. We aim to penetrate the monetary veil in order to understand the “real” economy.
Whereas individual transactors or subsets of all transactors can exchange present for future goods and vice versa, all transactors, e.g., the world as a whole, cannot borrow from the future. It can only exchange what is available now. Applying conclusions of what is true for subsets of transactors to the system as a whole is termed “the fallacy of composition.” Practitioners, well informed about their own activities, are susceptible to commit this error. The central point is that we must distinguish between the perspective of individual units and the systemic view.

That does not mean that what we do today has no consequences. For example, if everything produced today is consumed today, including “capital consumption,” -- the wear and tear of existing real assets-- termed “depreciation,” tomorrow’s production cannot exceed today’s production. Therefore, we will always try to identify the transactors and focus on “who does what with whom.” This is the leitmotiv of the course.

Lectures 2 and 3 cover the fundamentals of monetary theory and monetary and fiscal policy in an isolated (“closed”) economic system, with emphasis on “operational” concepts. An “operational concept” means that in principle one can specify data that correspond to it. That is different from the issue of data availability. If “good” data are available, little empirical research would be necessary. One usually does not argue about telephone numbers or addresses; a telephone directory suffices.

Not all concepts of economic theory are “operational.” Nevertheless many concepts that do not meet the criterion of being “operational” provide insight.

In lecture 4, we build on the foundations of the first three lectures by specifying a simple international framework. Then the relation between exchange rates, spot and forward, interest rates and inflation rates is analyzed. This yields the “parity conditions” between the four variables. Empirical tests are presented in keeping with our emphasis on evidence. This is followed by two lectures on Balance of Payments Accounting and Analysis—a “moving picture” -- and the Net Asset Position, often termed the International Indebtedness Position—a “snap shot” concept. We take a close look at actual data, and their limitations.

The Mundell-Fleming model is presented to provide insight into the relative effectiveness of monetary and fiscal policy under fixed and floating exchange rates, followed by a lecture on globalization.

The course concludes with an overview of current research on foreign exchange markets, specifically, what can be learned from the microstructure of currency markets, which takes a close look at actual foreign exchange trading data.

There are other areas of international monetary economics that cannot be covered in one, albeit, intensive course. We have chosen to focus the course on fewer topics, opting for rigor and emphasis on empirical evidence and how scientific methods can be applied to the topics covered.

We aim to challenge you intellectually and set a tone and pace appropriate to a first-rate university.
SCHEDULE of LECTURES

WEEK 1

LECTURE 1: MONDAY, JUNE 22

Introduction to the International Monetary System and the financial crisis.
The Ricardian Model; the gains from trade, the principle of comparative advantage

REQUIRED:
- Samuelson, P., Appendix to Chapter 34, Comparative Advantage Amplified and Qualified in Economics
- Ricardian Model Handout
- Eichengreen, B., Chapters 1, 2, 4, *The Rules of the Game: International Money in Historical Perspective*

RECOMMENDED:

LECTURE 2: WEDNESDAY, JUNE 24

Essentials of Monetary Theory: Money, Prices and Interest Rates.
The Quantity Theory of Money.

REQUIRED:
- Blumberg, A., Lecture Notes on the Quantity Theory of Money.

WEEK 2

LECTURE 3: MONDAY, JUNE 29

Monetary economics of an isolated economy with a fractional reserve banking system.
Central banking; monetary and fiscal policy.

REQUIRED:
- Blumberg, A., "The Analytics of an Isolated Monetary Organization", Lecture Notes, Section I and Additional Notes and Exercises to Section I.

LECTURE 4: WEDNESDAY, JULY 1

Simple International Model
Introduction to the institutional framework of foreign exchange.
The Bretton Woods System and its breakdown.

REQUIRED:
- Eichengreen, B., Chapters 5, 6, *The Rules of the Game: International Money in Historical Perspective*
- The *Economic Report of the President*, 2009 (Selected data pertaining to the monetary sector and national debt).
- Blumberg, A., "The U.S. Dollar/Franc Model", Lecture Notes, Section II.

WEEK 3

LECTURE 5: MONDAY, JULY 6

First Hourly Exam. 12:30 -1:30 pm
Introduction to Foreign Exchange Markets and Parity Conditions.

REQUIRED:
- Lecture Notes

LECTURE 6: WEDNESDAY, JULY 8

Parity Conditions (continued): The relation between spot exchange rates, forward exchange rates, interest rates, and inflation rates.

REQUIRED:

RECOMMENDED:
- Blumberg, A., "Trading in Foreign Exchange Markets", Testimony Before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, December 1978, pp.120-178.

WEEK 4

LECTURE 7: MONDAY, JULY 13

Practical applications of parity conditions

REQUIRED
- See readings after Lecture 6.
- Handout of practical application problems

LECTURE 8: WEDNESDAY, JULY 15


REQUIRED:
- Blumberg, A., "Notes on Balance of Payments", Lecture Notes, Section III.
- Blumberg, A. and Owers, J., Direct Foreign Investment in the U.S., particularly pp. 2-4.
- Catherine Mann, International Capital Flows and the Sustainability of the Current Account Deficit, January 2009
- Mankiw, Macroeconomics, Chapter 7-1.
WEEK 5

LECTURE 9: MONDAY, JULY 20

Practical applications of the balance of payments.

REQUIRED
- Blumberg, A., "Notes on Balance of Payments", Lecture Notes, Section III.
- The Economic Report of the President, 2009 (Selected data on balance of payments and net asset position).

LECTURE 10: WEDNESDAY, JULY 22

Second Hourly Exam, 12:30-1:30 pm
Monetary Policy in an Open Economy under Fixed and Floating Exchange Rates: The Mundell-Fleming Model.

REQUIRED:
Lecture Notes

WEEK 6

LECTURE 11: MONDAY, JULY 27

Reflections on Current Perceptions and History of Globalization
Monetary and Financial Aspects of Globalization

REQUIRED

RECOMMENDED:

LECTURE 12: WEDNESDAY, JULY 29

Foreign Exchange Markets: Views from Currency Market Microstructure

REQUIRED:

RECOMMENDED:
Osler, C. L., Macro Lessons from Microstructure, Brandeis University, Manuscript, November 2005.

WEEK OF AUGUST 3 – AUGUST 7 (DEPENDING ON REGISTRAR'S SCHEDULE)
Final exam, Open Book.