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Economics 169/269 International Financial Markets and Monetary Institutions Spring 2003-2004

Prerequisite: Econ 165 (international economics) or the equivalent. But more general knowledge of economics—particularly on the financial side—is recommended.

Required texts available in the Stanford Bookstore:

De Grauwe, Paul, *Economics of Monetary Union* 4th Ed. Oxford University Press, 2000.

Levich, Richard, *International Financial Markets: Prices and Policies* 2nd Ed.
McGraw-Hill Irwin, 2001.

McKinnon, Ronald, *Money in International Exchange: The Convertible-Currency System*. Oxford University Press, 1979. (in course reader)

Unless otherwise noted, all the chapter references below will be to these three textbooks.

Undergraduates must take the course as Econ.169 with Econ 165 being the prerequisite. For all students, a term paper will count for 40% and a final exam for 60% of the grade. Economics graduate students may take the course as Econ 269 with the paper carrying potential credit toward the comprehensive field in international economics.

References in regular type are for everybody to read, while those in small-scale type are meant mainly for potential paper writers in the particular area in question. However, paper topics can also be chosen more broadly in international finance from, say, material covered in Econ 165 or 265. Students should submit a prospectus (or even a first draft!) of their proposed paper by April 23 to Serkan Arslanalp for discussion and (friendly) criticism. The final draft should be submitted by June 2.

All references *not* included in the two basic textbooks or in the course reader will be on reserve in the Economics Department's lounge on the 2nd floor of the Landau Economics Building. You may freely copy what you need. But to maintain the honor system, please quickly return all master copies to the lounge.

COURSE SYLLABUS

1. The Foreign Exchange Market: Introduction

McKinnon (1979) Ch.1, "The convertible currency system" (in course reader)

Levich, (2001), Ch.1, "International financial markets"

2. The Rules of the Game for Official Intervention: The Role of the U.S. Dollar

McKinnon, Ch. 2 and 11, "Central bank intervention in a world of N currencies" (in course reader).

Tavlas, George, "The International Use of the Dollar", Course reader. (Students not responsible for details.)

Krugman, Paul, "The international role of the dollar: theory and prospect" Ch.10 in P.Krugman *Currencies and Crises*, (MIT Press, 1992).

Levich, Ch. 2, "Overview of the evolving international monetary system", pp. 23-37 and 57-76.

McKinnon, "The World Dollar Standard and Globalization: New Rules for the Game?" (course reader)

Sarno, Lucio and Mark P. Taylor "Official intervention in the foreign exchange markets: is it effective and, if so, how does it work?" *Journal of Economic Literature*, Sept. 2001, pp. 839 to 868

Reinhart, Carmen, "The mirage of floating exchange rates", *American Economic Review*, May 2000. Pp 65-70.

Ghosh, A., A. Guilde, and H. Wolf, *Exchange Rate Regimes: Choices and Consequences*, 2002, MIT press Chs 2 and 4 "Classifying exchange rate regimes"

McKinnon, *The rules of the game: international money and exchange rates*, (MIT Press, 1996).Ch.1-5.

3. Exchange Risk, Hedging, and Covered Interest Arbitrage

McKinnon, Ch. 4 and 5, "Currency invoicing, trade credit, and forward covering"

Levich, Ch. 3. "Market structure and institutions"

Levich, Ch. 16, "Managing corporate foreign exchange exposure", pp 600-13 only

4. Purchasing Power Parity and the Law of One Price

McKinnon, Ch. 6, "Purchasing power parity"

Levich, Ch. 4, "International purchasing power parity"

Frankel, Jeffrey, and Andrew Rose, "A panel project on purchasing power parity: mean reversion within and between countries", Center for International Development and Economics Research, UC Berkeley, June 1995. Working Paper No. C95.

Rogoff, Kenneth, "The Purchasing Power Parity Puzzle", *Journal of Economic Literature* June 1996. pp 647 to 668.

Zussman, Asaf, "Real Exchange Rate Behavior in a Convergence Club", Stanford, Dec 2001.

5. Open Interest Parity and Exchange Market Efficiency

- Levich, Ch. 5 “Fisher effects: open interest parity”
Levich Ch. 6, “Spot exchange rate determination” pps. 183-204. (Only students writing papers on empirical exchange rate models need read Ch. 6, pp. 205–223, and Ch. 7.)
McKinnon, Ch. 7, “Speculation”
Frankel, Jeffrey, “Measuring international capital mobility: A review” *American Economic Review*, May 1992, pp. 197-202.
Levich, Ch. 17, “Giving direction to international financial markets”

6. Moral Hazard in International Capital Flows: Original Sin and Conflicted Virtue

- The following chapters are in Ronald McKinnon, *Exchange rates under the East Asian dollar standard: Living with conflicted virtue*, 2004 (in lounge)
Ch. 1 “The East Asian Dollar standard, fear of floating, and original sin” (with Gunther Schnabl)
Ch. 6 “The overborrowing syndrome and economic liberalization” (with Huw Pill)
Ch. 5 “ China: a stabilizing or deflationary influence in East Asia? The problem of conflicted virtue” (with Gunther Schnabl).

Readings on Currency Crises in Mexico and East Asia:

- Federal Reserve Bank of New York, “Lessons from recent crises in Asian and other emerging markets”, *Economic Policy Review* ,6(3), Sept. 2000.(special issue).
Edwards, Sebastian, “The Mexican peso crisis”, *The World Economy*, Jan.1998. pp.1-30.
Pill, Huw, “Mexican reform, crisis, and retrenchment”, Harvard Business School, *Case Study*, N9-797-050, Feb. 24, 1997.
Eichengreen, Barry, and Ricardo Hausmann. 1999. “Exchange rates and financial fragility.” Pacific Basin Conference, Sept., *NBER Working Paper* 7418.
(2003) “The mystery of original sin” (unpublished)

7. The Theory of Optimum Currency Areas

- De Grauwe (2001), Ch.1 “The costs of a common currency”
Ch.2 “The theory of optimum currency areas: a critique”.
Ch.3 “The benefits of a common currency”.
Ch.4 “Costs and benefits compared”
Ch 5 “The fragility of incomplete monetary unions
McKinnon, Ronald I. “Optimum currency areas and key currencies: Mundell I versus Mundell II”, 2004, (in course reader) from R.McK. *Exchange rates under the East Asian dollar standard* op.cit. .

Frankel, Jeffrey, “No single currency regime is right for all countries or at all times”, Princeton *Essays in International Finance*, no.215, August 1999.
Frankel, Jeffrey, and Andrew Rose, “Estimating the effects of currency unions on trade and output”, Harvard and UC Berkeley, Draft, October 21, 2000.

8. European Monetary Union (EMU)

Levich, Ch.2, “The European Monetary System (EMS)” pp. 37 to 45.

De Grauwe, Chs 6-7 and Ch. 10, “European monetary union”. (Beyond these assigned chapters, the De Grauwe book provides excellent material for papers on EMU.)

McKinnon, Ronald I., “EMU as a device for collective fiscal retrenchment”, *American Economic Review*, 87(2), pp. 227-29.

9. The Dollar Standard: Bretton Woods and the New Millennium

Dooley, M., D. Folkerts Landau, and P. Garber, (2003) “ An essay on the revived Bretton Woods system” Deutsche Bank, Sept. (Course Reader)

Despres, Emile, Charles Kindleberger, and Walter Salant. 1966. “The Dollar and World Liquidity: A Minority View.” *The Economist*, February 5, p 526–29

Bisignano, Joseph, “Machlup was right: Despres, Kindleberger, and Salant, briefly revisited”(2004) BIS (Course Reader)

McKinnon, Ronald (2001) “The International Dollar Standard and the sustainability of the U.S. current account deficit” *Brookings Papers on Economic Activity I* : pp. 217-26.

_____, “Rationalizing the dollar standard in East Asia: living with conflicted virtue” (2004) Ch. 8 in *Exchange rates under the East Asian dollar standard*, op. cit.

For potential student papers, additional readings

From Levich:

Any of Ch. 9 (the eurocurrency market), Ch 10 (the eurobond market), Ch 14 (international bond portfolios), and Ch.15 (international equity portfolios) could be an excellent starting point for a term paper. Those students more quantitatively inclined, and familiar with the finance literature on derivative securities, might want to consider Ch.11-13 on futures, options, and swaps.

From De Grauwe:

Chapters both cited and not cited above including chapters 8 and 9 on monetary and fiscal policies in Euroland.

From McKinnon (2004):

See forthcoming book *Exchange rates under the East Asian dollar standard: Living with conflicted virtue* in the lounge The whole table of contents is attached to list of paper topics. Of particular note, chapters 3 and 4 deal with Japan’s deflationary slump from 1991 through 2002.