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Mon–Wed, 9–10:50  
Classroom 106, Economics

## **ECONOMICS 265**

### **INTERNATIONAL FINANCE AND OPEN ECONOMY MACROECONOMICS**

This course begins by focusing on the organization of the foreign exchanges mainly in a microeconomic context. How do banks make the foreign exchange market, and how do exporters and importers or international investors select currencies of invoice and hedge against exchange risk? The key role of the U.S. dollar for facilitating trade and the clearing on international payments is emphasized. The “rules of the game” for the international money machine to work satisfactorily are discussed historically and currently.

Then the macroeconomics of the balance of payments and exchange rate determination are considered. What is the link between a country's exchange rate, total spending, and balance of trade? How do monetary and fiscal policies work themselves out in an open economy under differing sets of expectations about future exchange rate movements? Why have floating exchange rates been so unexpectedly volatile?

Finally, if time permits, we take up some highly topical current issues. What are alternative models of how currency crises—attacks on a country's currency forcing either a depreciation or appreciation—arise? China now is a leading case of a country being pressured to appreciate its currency. Why has there been a boom-bust cycle in capital flows to emerging markets, and what can be done about it? The United States has had large current account and trade deficits for over 20 years. Are these sustainable?

Unfortunately, money—let alone international money—has not been satisfactorily incorporated into general-equilibrium theory in economics. So this course emphasizes extensive book-based reading to master historical and institutional perspectives on the evolving international monetary system. The lectures will point out many specific small-scale macro models and associated concepts, for which students are responsible. But full-scale macroeconomic inter-temporal optimization models in the modern mode are generally avoided. In this vein, students should follow international economic issues in such periodicals as *The Financial Times*, *The Economist*, and *The Wall Street Journal*.

In winter quarter 2006, Professor Peter Henry will teach a complementary course, Open Economy Macroeconomics (E611) in the GSB, which covers more formal inter-temporal models missing from this course. Econ Ph.D. students with an international or development interest are strongly advised to also take Henry's course. Other recommended and complementary courses, also taught in winter quarter, are Econ 267 (special topics in international trade), to be taught by Professor Galena Hale, and Econ 269 (international financial markets), to be taught by Professor John Taylor.

Students taking Econ 265 solely for course credit are responsible only for the in-class, closed-book final exam on December 16, 2005.

Students wanting comprehensive credit in international economics must also complete Econ 266 (international trade). The final course grades in Econ 265 and 266 will be averaged to determine the tentative comprehensive grade. In order to actually receive the comprehensive grade, however, a term paper on any of the subjects covered in Econ 265 and 266 is required. A paper from Econ 267 or Econ 269 or GSB E611 could also be acceptable. The paper is due June 1, 2006. To encourage students to write their papers sooner and get more feedback on their research progress, the paper itself is not averaged into the comprehensive grade, but is a necessary condition for getting comprehensive credit.

Note that readings listed in the following Course Outline are too extensive to be read in detail. The outline is more of a reference list. However, in classroom lectures, I shall provide a reader's guide as to what is important for the exam.

### Texts Available in the Stanford Bookstore

Hallwood, Paul, and Ronald MacDonald. *International Money and Finance*. 3<sup>rd</sup> ed. (paperback). Oxford and Cambridge, Mass.: Blackwell, 2000.

McKinnon, Ronald I. *Exchange Rates under the East Asian Dollar Standard: Living with Conflicted Virtue*. Cambridge, Mass.: MIT Press, 2005.

Williamson, John. *Curbing the Boom-Bust Cycle: Stabilizing Capital Flows to Emerging Markets*. Washington, DC: Institute for International Economics, July 2005.

### Course Reader (CR), Available in the Stanford Bookstore

Now out of print, the McKinnon book *Money in International Exchange: The Convertible Currency System* (Oxford University Press, 1979) is copied in the Course Reader. It will be used extensively in the first part of the course. Also included is a closely related work on the dollar standard that updates the book.

## Course Outline

### Abbreviations

*AER*: American Economic Review  
*EJ*: Economic Journal  
*IMF*: International Monetary Fund  
*JEL*: Journal of Economic Literature  
*JPE*: Journal of Political Economy  
*RIE*: Review of International Economics  
*QJE*: Quarterly Journal of Economics

Readings not in one of the assigned texts or the Course Reader will be copied and reserved in the second-floor lounge of the Economics Department. Students are encouraged to copy what they want, but to please return the master to the lounge within two hours. The honor code is important here.

### 1. The Interbank Foreign Exchange Market: The Role of the Dollar

- McKinnon (1979), chs. 1, 2, and 11.
- Hallwood and MacDonald (2000), chs. 1, 2, 16, and 17
- Tavlas, George (1997), *The International Use of the Dollar: An Optimum Currency Area Perspective*, CR.
- Krugman (1992), ch. 10, “The International Role of the Dollar: Theory and Prospect,” *Currencies and Crises*.
- Dowd, Kevin, and David Greenaway (1993), “Currency Competition, Network Externalities, and Switching Costs: Towards an Alternative View of Optimum Currency Areas,” *EJ*, September.

### 2. The Rules of the Game in Historical Perspective

- Levich, Richard (2001), ch. 2, “An Overview of International Monetary Systems,” *International Financial Markets: Prices and Policies*, 2<sup>nd</sup> ed.
- Sarno, L., and M. Taylor (2001), “Official Intervention in the Foreign Exchange Market: Is It Effective and How Does It Work?,” *JEL*, September, pp. 839–868.
- Ghosh, A., A. Gulde, and H. Wolf (2002), chs. 2 and 4, *Exchange Rate Regimes: Choices and Consequences*.
- Reinhart, Carmen (2000), “The Mirage of Floating Exchange Rates,” *AER*, May, pp. 65–70.
- Calvo, Guillermo, and Carmen Reinhart (2002), “Fear of Floating,” *QJE*, May, pp. 379–408.

- McKinnon, R. (2005), “The World Dollar Standard and Globalization, New Rules for the Game?”, CR.

### 3. Exchange Risk, Hedging, and Covered Interest Arbitrage

- McKinnon (1979, chs. 4, 5, and 9.
- Hallwood and MacDonald (2000), ch. 3.
- Eichengreen, B., and Ricardo Hausmann (2005), chs. 1 and 2, “The Pain of Original Sin,” *Other People’s Money*, ed. by Eichengreen and Hausmann, pp. 3–37.
- McKinnon (2005), ch. 2 (with G. Schnabl), “The East Asian Dollar Standard, Fear of Floating, and Original Sin.”

### 4. The Law of One Price and Purchasing Power Parity

- McKinnon (1979), ch. 6, “Purchasing Power Parity.”
- Hallwood and MacDonald (2000), ch. 7, “Purchasing Power Parity.” (Students may omit econometric details.)
- Burstein, A, M. Eichenbaum, and S. Rebelo (2005), “Large Devaluations and the Real Exchange Rate,” *JPE*, Aug.
- McKinnon, Ronald I., and Kenichi Ohno (1997), ch. 3, “Exchange Rate Fluctuations and their Consequences,” *Dollar and Yen: Resolving Economic Conflict Between the United States and Japan*, Cambridge, Mass.: MIT Press.

### 5. Expectations and Exchange Rate Volatility

- McKinnon (1979), ch. 7, “Speculation.”
- Hallwood and MacDonald, (2000), chs. 8 (pp. 156–59 only), 9, 12, and 13, “The Monetary Approach and Forward-Looking Exchange Rates.”
- Frankel, J., and M. Chinn (1993), “Exchange Rate Expectations and the Risk Premium: Cross Section Test of 17 Currencies,” *RIE*, vol. 1 (2), June, pp. 136–144.
- Frankel, Jeffrey (1992), “Measuring International Capital Mobility: A Review,” *AER*, May, pp.197–202.

### 6. The Balance of Payments and Domestic Macroeconomic Adjustment in Insular versus Open Economies: The Mundell-Fleming Model

- Krugman, Paul, and Maurice Obstfeld (2005), ch. 12, “National Income Accounting and the Balance of Payments,” *International Economics: Theory and Policy*, 7th ed.
- Hallwood and MacDonald (2000), chs. 4 and 5.
- McKinnon, R. (1981), pp. 531–546 only, “The Exchange Rate and Macroeconomic Policy: Changing Postwar Perceptions,” *JEL*, June. Reprinted in McKinnon (1996), *The Rules of the Game: International Money and Exchange Rates*, Cambridge, Mass.: MIT Press.

### 7. The Exchange Rate and the Trade Balance

- Hallwood and MacDonald (2000), [the elasticities approach], pp. 24–32..
- Corden, W. M. (1986), [the absorption approach], ch. 1 (including appendix), *Inflation, Exchange Rates, and the World Economy*, 3<sup>rd</sup> ed., The University of Chicago Press.
- McKinnon, R., and Ohno, K. (1997), chs. 6 and 7, “The Exchange Rate and the Trade Balance.”
- Qiao, Hong (2005), “Exchange Rates and Trade Balances under the Dollar Standard,” working paper, Stanford University, August.
- McKinnon, R. (2005), “Exchange Rates or Wage Changes in International Adjustment? Japan and China versus the United States,” working paper, Stanford, May.

### 8. Exchange Rate Overshooting

- Dornbusch, R. (1976), “Expectations and Exchange Rate Dynamics,” *JPE*, pp.1161–76.
- Hallwood and MacDonald (2000), ch. 9, pp. 188–193.
- McKinnon, R. (1990), “Why Floating Exchange Rates Fail: A Reconsideration of the Liquidity Trap,”

*Open Economies Review*, September, pp. 229–250; also reprinted in McKinnon (1996), ch. 17.

### 9. Generational Models of Currency Crises

- Krugman, P. (1992), [first generation], ch. 4, “A Model of Balance of Payments Crises,” pp. 61–76.
- \_\_\_\_\_, P. (1996) [second generation], “Are Currency Crises Self-fulfilling?”, with comments by P. Kehoe, M. Obstfeld, and P. Garber, NBER Macroeconomic Annual, MIT Press, pp. 345–407.
- McKinnon (2005) [third generation], ch. 6 (with Huw Pill), “The Overborrowing Syndrome and Economic Liberalization.”
- \_\_\_\_\_ (2005) [fourth generation], chs. 1, 3, 4, 5 and 8, “Conflicted Virtue.”
- \_\_\_\_\_ (2005a) “China’s New Exchange Rate Policy: Will it Follow Japan into a Liquidity Trap?”, Stanford working paper, May.
- Williamson, John (2005), *Curbing the Boom-Bust Cycle: Stabilizing Capital Flows to Emerging Markets*.

### 10. U.S. Current Account Deficits and the Sustainability of the Dollar Standard

- Obstfeld, M., and Rogoff, K. (2005), “The Unsustainable U.S. Current Account Revisited,” NBER Working Paper 1086, June.
- Bernanke, Ben, (2005), “The Global Savings Glut and the U.S. Current Account Deficit”, Federal Reserve, March.
- Dooley, Michael, David Folkerts-Landau, and Peter Garber (2003), “An Essay on the Revived Bretton Woods System,” Deutsche Bank (September), CR.
- \_\_\_\_\_ (2005), “Savings Gluts and Interest Rates: The Missing Link to Europe,” NBER Working Paper 11520, July.
- Roubini, N., and B. Setzer (2005), “Will the Bretton Woods 2 Regime Unravel Soon? The Risk of a Hard Landing, in 2005–2006,” New York University, February.
- Lane, P., and G. Milesi-Ferretti (2005), “A Global Perspective on External Positions,” NBER.
- McKinnon, R. (2005), “Trapped by the International Dollar Standard”, working paper, Stanford, March.