

The Internationalization of Finance: causes, consequences, contagion and tools.

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Text: *This Time is Different*, Reinhart and Rogoff

International Business Finance, Michael Connolly

Boomerang, Michael Lewis

The course reading list

Any good business news source- the Financial Times or the Wall Street Journal are best.

Course Objective/Content: The focus of this course will be on international movements of financial assets, the changing nature of these markets and the instruments used. We will begin with a discussion regarding the role of finance in economic growth and development. We will also start with some discussion regarding how we measure internationalization and what we mean by globalization. Measurement issues specific to international capital flows will then be introduced. The changing nature of capital flows will be examined and the causes and the implications of these changes for the macro-economy will be discussed. This discussion will be followed by an examination of various types of financial crises- exchange rate crises, banking crises and sovereign debt crises. Next we will take up the issue of exchange rate determination, the links between the internal and external sectors and the role of sterilization. We will then explore the tools, instruments and strategies of hedging exchange rate movements and discuss the differences between hedging, speculation and arbitrage in business. The course will close with thoughts and proposals to deal with the globalization of finance.

Prereqs: Principles of Microeconomics, Principles of Macroeconomics.

Grading Policy/ Course Metrics: We will have 3 exams including the final. The first exam will consist of T/F explain statements; the 2nd exam will consist of 3-4 “big think” essays; each of these exams will be worth 15% of your final grade and you will take them on consecutive class days around the mid term point. The final will consist of both forms of examination, is cumulative and will count 15%. If you miss exam 1 (the easiest), or 2 you will make up the missed percentage by reweighting it to the final which will be modified according to the missed material. The final is comprehensive and is NOT optional and will be given on the scheduled exam day and time. The other 55% of your grade will come from 2 papers and two class presentations. The papers will be 20% each and the presentation of the first paper is worth 10%. The paper prompts are outlined below. The remaining 5% of your grade will be based on your presentation and explanation of an assigned derivative product (e.g. CDSs, CDOs, Swaps, etc.)

ASSIGNMENT 1: Each student (or group of students) will produce a portfolio analysis of a country’s fiscal health with the intent of analyzing the creditworthiness of that country’s sovereign debt.

The country choices are Iceland, Ireland, Portugal, Spain, Italy, France, Greece, Cyprus which I will approve and/or appoint. Complete coverage will address debt to GDP ratio and changes over time, deficit to GDP ratio, maturity structure of debt, who holds the debt (domestic or foreign agents, individuals or governments or banks or the IMF), currency denomination of debt, foreign currency reserves, government spending relative to GDP, tax coverage and collection, private indebtedness, the housing market, the balance of payments, net external debt and any fiscal, currency, and/or labor market (e.g. pensions, regulation) complexities that are particular to that country. You will assess whether the country is experiencing a liquidity problem or a solvency problem as well as whether the country exhibits or is likely to exhibit *odious debt*. You will prepare a written paper and a class presentation. You will present your analysis of your country to the class and we will then have a discussion about which countries to invest in or not, why and at what maturities. Due Oct. 11.

ASSIGNMENT 2: Each student will produce a similar report for the U.S. taking into account all of the issues outlined above. In this assignment however the investment focus is strictly long term so the operational question is whether 10-30year maturities of US government bonds are a worthwhile investment and whether the US government is likely to experience a liquidity and/or solvency issue in the future. This means that you produce a snapshot of the US's current fiscal health and you will project the implications of that for the future. You will also compare the US situation to the country you profiled earlier in order to illuminate similarities and differences and why they matter. Due the last day of class.

All written assignments will be evaluated for both content and form. Generally, papers in economics start with an introduction and review of the relevant literature in order to capture the reader's interest and place the topic. Next, the research will outline the key points, theoretical issues, mechanism, etc. surrounding the debate. The model, methodology and/or data sections follow. The theoretical solutions will then be derived or the empirical results presented. This will be followed by a discussion of the findings. The conclusion will summarize the work and point out directions for further work, related issues, etc. Your written assignment will deviate from this format in the sense that there will be no modeling or data/methodology section. Instead you will jump to your conclusions based on the evidence and research you bring to bear on the topic.

Course Outline

* indicates required reading

1.)Intro/ Why is international finance different? Aug 28,30

Boomerang Discussion- the role of culture

Chapter 1 Connolly

2.) Measuring Globalization, Sept 4

Measuring Globalization, Foreign Policy, Jan./Feb 2001

3.)Why finance matters/Introduction, Sept 6

**Stock Markets, Banks and Economic Growth*, AER June 1998, Levine and Zervos.

**Financial Development and Economic Growth: Evidence from 10 New EU Members*, Caporal, Rault, Sova and Sova, DIW Berlin Discussion Paper 940, Oct 2009.

What Drives Stock Market Development in Emerging Markets- Institutions, Remittances or Natural Resources, Billmeier, Emerging Market Review 2008

**Quantifying the Impact of Financial Development on Economic Development*, Greenwood, Sanchez, Wang, Feb 2010

Access of Finance: An Unfinished Agenda, Beck & Demirguc-Kunt, World Bank Economic Review 22, 2008

**How Do Trade and Financial Integration Affect the Relationship between Growth and Volatility?* FRBSF WP 2004-29, Kose, Prasad and Terrones.

Development of Financial Markets in Central Europe: the case of the CE4 Countries, Adarov & Tchaidze, IMF Working Papers #WP/11/101

4.) Balance of Payments: Chapter 1, Connolly and lecture Chapter 19, International Economics Appleyard, Field & Cobb

Current Account, Sept 11

Capital Account, Sept 11

Components of Capital Flows, Sept 11

Optimal External Balances, Sept 11

Accommodating Disequilibrium, Sept 13

Twin Deficits, Sept 13

The Changing Nature of Capital Flows, Sept 18

Presentation #1 of derivatives- Sept 18, 20

Readings:

The Current Account and Capital Account:

Viewing the Current Account Deficit as a Capital Inflow, M. Higgins & T. Klitgaard, FRBNY Current Issues, Dec 1998.

**Resolving the Global Imbalance: The Dollar and the US Saving Rate*, Feldstein, J of Economic Perspectives, Summer 2008

**Global Imbalances: In Midstream?*, Blanchard & Milesi-Ferretti, "Seoul Papers", Dec 2009.

Will Global Imbalances Persist as the Recession Ends?, Ellis, Univ of Birmingham 2010.

The Unstable Current Account Revisited, NBER WP# 1086, Oct. 2004, Obstfeld and Rogoff

Multicointegration Analysis of the Sustainability of Foreign Debt, J of Macro, Spring 2000, Leachman and Francis

The Twin Deficit Issue:

Twin Deficits: Apparition or Reality? Applied Economics 2002, Leachman and Francis

The Sustainability of the US current Account Deficit: Revising Mann's Rule, Lizardo & Mollick, Global Economic Journal, Vol. 9 #4, 2009

Possible Economic Consequences of Large Future Federal Government Deficits, Ray Fair, Cowles Foundation DP#1727
Fiscal Deficits and Current Account Deficits, Kumhof and Laxton, IMFWP/09/237

The changes in international Capital Markets:

**Are World Financial Markets More Open? If So, Why and With What Effects?* R. Zevin

**Global Capital: Two financial Booms Compared*, B. Pollin

**Serial Default and the Paradox of Rich to Poor Capital Flows*, Reinhart and Rogoff, NBER WP 10296 Feb 2004

The Four Benchmarks of Sovereign Wealth Funds, Ang, Sept. 2010.

Sovereign Wealth funds: form and function in the 21st Century, Clark & Monk, Nota di Lavoro #140.2010

The Absolute Returns of Hedge Funds, Tudor & Cao, Sept 2010

5.) Modern History of Foreign Exchange markets- Chapter 2 Connolly

Chapter 3 in Melvin's International Money & Finance

Exchange Rates, Sept 25

Exchange Rate Regimes, Sept 25

Bretton Woods/gold standard, Sept 25

Optimum Currency Areas, Sept 27

Vehicle Currencies, Sept 27

Currency Reserves, Sept 27

Readings:

**Exchange Rate Regimes in the Modern Era: Fixed, Floating and Flaky*, Rose CPER WP #7987

Exchange Rates: Fixed, Pegged or Float, C. Zarazaga, FRBD

**Exchequered Past...*, WSJ Jan 13, 1998.

**To Float or to Fix: Evidence of the impact of Exchange Rate Regimes on Growth*, AER Sept 2003, Levy-Yeyati and Sturzenegger.

**To Float or not to Float: Exchange Rate Regimes and Shocks*, Cavallo, FRBSF Economic Letter, Jan '05

**One World, One Currency: Exploring the Issues*, Starr, CEP, Oct. '06

**The Estimated Effects of the Euro on Trade: Why are they below historical effects of monetary unions on small countries?*, Frankel, NBER WP#14542, Dec 2008.

**Vehicle Currency*, Devereux & Shi, March 2009

**Is the International Role of the Dollar Changing?*, Goldberg, FRBNY Current Issues Vol. 16 #1 Jan 2010.

The Euro May Over the Next 15 Years Surpass the Dollar as Leading International Currency, Frankel and Chinn, RWP08-016 Harvard, 3/2008

The European Central Bank, the Euro and global Financial Markets, Dominguez, J of Econ Perspectives, Fall 2006

Don't Do It, the Economist, Dec 4, 2010, p16

Why the Dollar's Reign is Near an End, WSJ, March 2, 2011, c9
**Financial Stability, the Trilemma and International Reserves*, Obstfeld, Shambaugh, Taylor, American Economic J., vol 2, April 2010

6.) Contagion: Chapters 10, 14, 15 & 16 in “This Time is Different” Oct 2-4, Readings:

**Measuring Systemic Risk in Finance and Insurance Sectors*, Billo, Getmansky, Lo & Pelizzon, Mar 2010.
**Regional Financial Interlinkages and Financial Contagion Within Europe*, Arvi, Driessen & Otlar-Robe, IMF WP 09/6
**The Leverage Cycle*, Geanakoplos, Cowles Foundation Discussion Paper #1715
Market Run-ups, Market Freezes and Leverage, Bond & Leiter, FRBP WP Nov 2010
**Monetary Policy, Market Excesses and Financial Turmoil*, Ahrend, Courneade & Price, OECD Eco/WKP(2008)5
**Export Competition and Contagious Currency Crises*, FRBSF Economic Letter, Jan 16, 1998.
**Double Drain with a Cross Border Twist: more on the Relationship Between Banking and Currency Crises*, Miller, AER May 1998
Basel II and Banking Behavior in Local Markets, Falcone, Silipo & Trivieri, University of Calabria.
International Transmission of Bank and Corporate Distress, Chin, Gray, Diaye, Oura & Tamirisa, IMF WP/10/124.
Banking Crises, Financial Dependence and Growth, Kraszner, Laeven & Klingebiel, J of International Economics, Ap. 2007.
The Real Effect of Financial Crises in the European Transition Economies. Furciri & Zdzienicka, GATE UMR5824 du CNRS WP 09-20
The Financial Crisis in Europe: Evolution, Policy and Responses and Lessons for the Future, Goddard, Molyneux, Wilson,
Exchange Rates During Financial Crises, Kohler, BIS Quarterly Review, March 2010
**Transmission of the Financial and Sovereign Debt Crises to the EMU: stock prices, CDS spreads and exchange rates*, Grammatikos & Vermeulen, LSF WP #10-13, Dec 2010

7.) Sovereign Debt Crises: Chapter 4 -6 in “This Time is Different”, Oct.11 Readings:

**Fiscal Policy and Financial Markets*, Akitoby & Stratmann, The Economic Journal, Nov 2008.
**Serial Default and the Paradox of Rich to Poor Capital Flows*, Reinhart and Rogoff, NBER WP 10296 Feb 2004
**Sovereign Default Risk and the US Equity Market*, Jeanneret, Dec 2010
Debt Consolidation and Fiscal Stabilization of Deep Recessions, Corsetti, Kuester, Meier, Muller, CEPR WP #7649.
No Easy Exit, *the Economist*, Dec 4, 2010, pp87-88

How to resign From the Club, *the Economist*, Dec 4, 2010, pp88-89.

Presentations- Paper #1, Oct 16,18

Mid Term exams, Oct. 23, 25

8.) Exchange Rates and their Determination: Chapter 3 Connolly, Oct30, Nov1,6,8

Purchasing Power Parity

Interest Rate Parity

Synthesis- Portfolio Balance Theory

Elasticity of ER Demand and Supply: J curve

Sterilization

Readings:

Chapter 1 in *International Finance and Open Economy Macroeconomic*, p1-15

**China's Exchange Rate Policy Dilemma*, Goldstein and Lardy, AEA Papers and Proceedings, May '06.

**China's Exchange Rate Policy...* Goldstein and Lardy, Peterson Institute 2007

**Surfing the Waves of Globalization:... context of the Trilemma*, Aizerman, Chinn & Ito, March 2010 SSRN WP.

**Portfolio Reallocation and Exchange Rate Dynamics*, Ding & Ma, April 2010

**The Euro's Effect on Trade Imbalances...*, Berger & Nitsch, IMF WP 10/226, Oct 2010

The Real Effects of European Monetary Union, Lane, JEP Fall '06

9.) Spot, Forward, Futures Markets and Hedging: Chapters 3 & 4 Connolly, Nov. 13,15,20,27

Speculation, Hedging and Arbitrage

ER Markets

Carry Trade

Guest Lecture- John Caccavale, currency trading Nov 27/29?

Readings:

WSJ March 2, 2011-(1) *Foreign Exchange gone Wild*,(2) *Exposed!*, pg c10

**The impact of Derivative Markets on financial Integration, Risk and Economic Growth*, Haiss & Sammer, WP Aug 2010

**Determinants of Corporate Exchange Rate Exposure and Implications for Investors: Evidence from Chilean Firms*, Hansen & Hyde, Manchester Business School WP# 606, 2010

Managing Credit Risk with Credit Derivatives, Broll, Gilroy & Lukas, ISSN 1438-4620, Univ. Paderborn, July 2005

**Macro Hedging for Commodity Exporters*, Borenztein, Jeanne & Sandi, NBER WP # 15452, Oct. 2009

Mitigation of foreign Direct Investment Risk and Hedging, Wahl & Broll, Dresden Discussion Paper in Economics # 13/09.

**Currency Hedging for International Portfolios*, Schmittmann, IMF WP/10/151, June 2010

Liquidity Constrained Exporters: Trade and Futures Hedging, Broll & Wahl,
Dresden Discussion paper # 17/09
Over the Hedge..., Raddatz, World Bank WP 5590, March 2011
The Carry Trade:
**Carry Trade, forward Premium Puzzle and Currency Crisis*, Kaizojo, 2010, Int'l
Christain Univ.
The impacts of Macroeconomic Surprises on the Carry Trade, Hutchison &
Sushko, Sept 2010

**10.) A Global Financial Framework?: Chapter 17 in “This Time is Different”, Nov
29**

**High Leverage Finance Capitalism, the Economic Crisis, Structurally Relate
Ethics Issues and Potential Reform*, Nielson, 2008 Society for Business Ethics
**Building a Framework to Address the failure of Complex Global Financial
Institutions*, Arner & Norton, WP2009
**Fiancial Globalization and Economic Policies*, Kose, Prasead, Rogoff & Wei,
Brookings Paper #34, ,global Economy and Development
**Integrating Reform of Financial Regulation with Reform of the International
Monetary System*, Goldstein, Peterson institute WP 11-5, Feb 2011
Robust Capital Regulation, Acharya, Mehtran, Schuermann, Thakor, FRBNY
Current Issues, vol 18, 2012

**11.) International Financial Management, Chapter 5 Connolly (if time permits and
there is interest)**

Final- regular exam scheduled time.