

Rice University  
Department of Economics  
Fall 2006  
MWF 9:00-9:50 room BB 116  
Class Website:  
<http://www.ruf.rice.edu/~yossiya/econ421>

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## **International Finance**

### **(Econ 421)**

#### **Course Outline**

The course deals with macroeconomic analysis of open economies. We will emphasize the monetary side and a special attention will be devoted to the determination of exchange rates, which will be the topic for the most part of the semester.

The course is divided into two parts. In the first, we review the main concepts and national accounting identities of open economies. You may already be familiar with some of this material from previous macro classes; however, here we will put the national accounts definitions in the context of economic models.

In the second part of the course we will build a model that is designed to explain the behavior of the exchange rate. We first study a simple model where interest rates determine the exchange rate without taking into account any other considerations. We then add different pieces, such as the money and goods markets, one step at a time. By the end of the course we will have a full-blown macroeconomic model for understanding exchange rate determination.

#### **Textbook and Reading**

The textbook for the course is Paul Krugman and Maurice Obstfeld, *International Economics: Theory and Policy*, Seventh Edition (Addison-Wesley, 2005). The course will cover chapters 12 through 17.

Chapter 12 is complemented by an article from *The Economist*: "In defence of deficits" (Dec. 16, 1995), pp. 68-69. The article is available online through the Fondren library.

The lectures are also complemented by class notes. These are available at the class website: <http://www.ruf.rice.edu/~yossiya/econ421>

## **Requirements and Grading**

The grade for the course will be based on two midterms and a final. Each midterm will receive a weight of 25% in the overall grade; the final will count for the remaining 50%.

There will be 8 or 9 problem sets; these will be assigned S (satisfactory) or US (unsatisfactory) grades. To receive a satisfactory grade your work should demonstrate that you have put some effort and thought into it. You are required to submit *at least* 6 problem sets *on time* and with a satisfactory grade; failure to do so will result in a reduction of one letter grade from your course grade (from B+ to C+, for example).

*If you cannot submit your work on time let me know in advance. Explanations after the due date are unacceptable.*

## **Topics**

### **Part I: National Accounting in Open Economies**

1. Topic: National Income and Product Accounting  
Reading: Chapter 12 pp. 294-307 (6<sup>th</sup> edition) pp. 278-291 (7<sup>th</sup> edition).  
Review of accounting concepts describing a country's level of income and production.
2. Topic: The Balance of Payments  
Reading: Chapter 12 pp. 307-320 (6<sup>th</sup> edition) pp. 291-302 (7<sup>th</sup> edition).  
This section describes the accounting system of international transactions.
3. Topic: The Current Account in Detail  
Reading: "In defence of deficits" *The Economist* (12/16/95), pp. 68-69.  
We will discuss what the current account means, and whether a current account deficit is good or bad.

## **Part II: Exchange Rate Determination**

4. Topic: Interest Rate Parity.

Reading: Chapter 13.

We will take an asset pricing approach for the determination of the exchange rate in the short run, taking interest rates as given.

5. Topic: The Money Market.

Reading: Chapter 14.

This section discusses how interest rates are determined. We will also distinguish between short run and long run analysis.

6. Topic: Purchasing Power Parity (PPP).

Reading: Chapter 15 pp. 388-411 (6<sup>th</sup> edition) pp. 369-388 (7<sup>th</sup> edition).

This is a long run analysis that connects the exchange rate to prices of goods and services.

7. Topic: The Real Exchange Rate.

Reading: Chapter 15 pp. 411-425 (6<sup>th</sup> edition) pp. 389-400 (7<sup>th</sup> edition).

The real exchange rate measures the deviation of the economy from PPP. We will discuss the determinants of the real exchange rate, and its long run effect on the nominal exchange rate.

8. Topic: The Goods Market.

Reading: Chapter 16.

This section introduces the goods market to our model. By the end of this section we will have a complete macroeconomic model that combines the asset, money, and the goods markets to describe how exchange rates are determined.

9. Topic: Fixed Exchange Rate.

Reading: Chapter 17.

Some countries fix their exchange rate; in this case the exchange rate is determined by policy makers and not in the financial markets. This section explores the macroeconomic implications of such a policy.