



**International Finance
Finance 319
Winter 2001**

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Office Hours: Monday 10:00a.m. - 12:00p.m.
Thursday 1:00p.m. - 3:00p.m. (or by appointment).

Schedule

Section	Day	Time	Room
001	MW	8:30am - 10:00am	E1550
Midterm: Take home			
Final: TBA			

Course Objectives

This course provides the analytical framework for understanding of the international financial system. An overview of international financial institutions will be provided. We will study the determinants of cross-border capital flows and explore different exchange rate regimes. We will analyze the reasons for financial crises and the mechanisms that are employed to overcome them.

Further, we will focus on the opportunities of international financial markets for risk-management and asset allocation objectives. We will examine analytical tools for portfolio management and hedging in an international context. The course will benefit students interested in a practical understanding of international financial arrangements, and seek careers in financial industry, or with corporate finance departments.

Grading and Requirements

This course will have three homework assignments, one case study a take-home midterm and a final exam. The written assignments and the midterm are due at the beginning of the class in which they are discussed. Students are encouraged to work together and turn in the written assignments, which are optimal: the

homework grade could be substituted by the class participation grade¹. Write-ups could reflect the work of up to 4 students.

Good questions are purposely written to be ambiguous. While there are no right answers, there are good and bad arguments. If you are uncomfortable with ambiguity you should reconsider taking this course, or prepare to deal with the subject where ambiguity is an essential feature.

Attendance: The subject of international finance is conceptually demanding and hardly could be mastered through an independent self-study. Thus, attendance of lectures is crucial to absorb the material. Attendance and promptness will be rewarded accordingly.

Midterm exam: (Take home)	30%
Final exam: (Take home)	30%
Homework / Class participation:	40%,

where the grade for the homework is calculated as an average of the home assignments (i.e. 20% of the total grade) and the case study (i.e. 20% of the total grade) grades. Students will have an option to re-weight the final at 60 % of the total grade (dropping off the midterm grade).

A handwritten 'cheat sheet' will be permitted on the Final exam. Also students could purchase extra exam time: its cost is 1 point reduction of their exam score per extra minute (the total score for each exam is 100, with up to 10 additional bonus points). No make-ups will be allowed, except with a formal excuse from the Academic Services Office.

Grade Appeals: Grade appeals are in writing only, and have to be submitted within 5 days after the date when the written work is returned.

Prerequisites: Fin 310 and CSIB 319 (can be taken concurrently)

Readings: The primary readings will come from an excellent textbook *International Financial Markets* by Richard Levich (McGraw-Hill) (further **Levich**), SECOND EDITION (2001). Lecture notes and relevant excerpts from various publications will supplement the textbook. Many readings will be posted as pdf files. Thus, students will need Adobe Acrobat Reader (see www.adobe.com/prodindex/acrobat/readstep.html). In order to disseminate the class materials efficiently, it is advisable to check the web site in advance (i.e. within 24 hrs) of each class. Most course materials will be distributed in class and posted on course web site, and linked to my home page at the URL <http://www.citi.umich.edu/~galka/319>

Introduction

Course Overview. Subject and structure of the course

¹ That is, 40% of a student's grade will be determined by *either* the student's homework or class participation grade – whichever is higher.

Summers, Lawrence, (2000), "International Financial Crises: Causes, prevention and Cures," *The American Economic Review*, Vol. 90, No. 2, pp. 1-27. **(S)**

"Shocking times in Throgmorton Street," 2000, *The Economist*, Sept, 2. **(S)**

International Financial System

The functions of money, Government and banks' role, Current Account, Balance of Payments Rules of the game: Gold standard, Bretton woods, Fixed and Floating exchange rate regimes, Recent developments

Levich: Chapters 1 & 2. **(R)**

"This Trade Deficit Was Made in the U.S.A," *Wall Street Journal*; New York, N.Y.; Aug 7, 2000. **(R)**

Millman, Gregory, 1995, *The Vandals' Crown: How Rebel Currency Traders Overthrew the World's Central Banks*, Free Press. (further **Millman**) *The golden vanity*, pp.65-94. **(S)**

Foreign Exchange Market Structure

Spot and Forward Contracts, Arbitrage, types of risk, Modern institutions, Controls

Levich: **Chapter 3. (R)**

International Parity Conditions

Purchasing Power Parity and Interest Rate Parity

Transaction costs, Limits of arbitrage, Purchasing power parity (PPP), Real exchange rate parity. Fisher effect

Levich, Chapters 4 and 5, **(R)**

Rogoff, Kenneth, (1996), "The Purchasing Power Parity Puzzle," *Journal of Economic Literature*, Vol. 34, No. 2. , pp. 647-668. **(S)**

Obstfeld, Maurice and Rogoff, Kenneth, 1995, "The Mirage of Fixed Exchange Rates," *The Journal of Economic Perspectives*, Vol. 9, No. 4., pp. 73-96. **(S)**

"Finance and economics: New solutions, new questions," 2000, *The Economist*, London, Aug 5. **(S)**

First Homework Assignment

Exchange rates

Analysis of supplies and demand for currency, Government policies

Levich, Chapter 6, p. 176, **(R)**

Second Homework Assignment

Efficiency

Foreign exchange market efficiency: theoretical considerations and real world constraints

Levich, Chapter 7. **(R)**

"Foreign exchange banks charge into online battle," 2000, Financial times, August 15.

Currency Crises

Inconsistent Optimal Policies, Commitment Constraint, Contagion

Summers, Lawrence, (2000), "International Financial Crises: Causes, prevention and Cures," *The American Economic Review*, Vol. 90, No. 2, pp. 1-27. **(R)**

North, Douglass C., 1991, "Institutions," *The Journal of Economic Perspectives*, Vol. 5, No. 1. (Winter, 1991), pp. 97-112. **(S)**, p. 102, first paragraph of the Section "Why Institutions do not evolve." **(R)**

Market pre- post crises markets' behavior, government policies and their limitations.

Krueger, Anne, 2000, "Conflicting Demands on the International Monetary Fund," *The American Economic Review*, Vol. 90, No. 2, pp. 39-42. **(S)**

Eaton, Jonathan, 1990, *The Journal of Economic Perspectives*, "Debt Relief and the International Enforcement of Loan Contracts," Vol. 4, No. 1, pp. 43-56. **(S)**

Recent Developments. Regulation

Recent developments of the international financial institutions and instruments, Sources and Costs of Information, Market Structure, Market Power, Regulation

Levich, Chapter 17, **(R)**

Millman, "Nuclear Finance," pp.195-225. **(S)**

Aliber, Robert, 2000, "Rules and Authorities of International Monetary Arrangements: The Role of the Central Bank," *The American Economic Review*, Vol. 90, No. 2, pp.43 – 47, **(S)**.

Woodford, Michael, 2000, "Monetary Policy in a World without Money," NBER paper #7853. Intro only, **(S)**.

Shultz, George P., 1995, "Economics in Action: Ideas, Institutions, Policies," *The American Economic Review*, Vol. 85, No. 2, pp. 1-8, **(S)**.

Take-home Midterm is distributed in class
Financial Information: Past, Present, Future

Sources of information, where does its bias come from?

Scholes, Myron, 2000, "Crisis and Risk Management", *The American Economic Review*, Vol. 90, No. 2, pp. 17-21. [The near crash 1998], **(S)**

Kho, Bong-Chan, Lee, Dong and Stulz, Rene, 2000, *The American Economic Review*, Vol. 90, No. 2, pp. 28-37. [The near crash 1998], **(S)**

Trillion Dollar Bet (2000), A documentary by Nova

Case Study is distributed (LTCM)

Exchange rate forecasting

Levich, Chapter 8. **(S)**

Offshore Financial Markets

Onshore and offshore markets: features and reasons for coexistence. Eurodollars, LIBOR and LIBID. Eurobond market. Policy matters: regulatory issues and European Union.

Levich: Chapters 9 and 10. **(R)**

International Financial Crisis

Derivative Securities

Currency and Interest Rate Futures, Options and Swaps. The reasons for financial innovation. The terminology, risk assessment: theory and practice.

Levich: Chapters 11, 12 and 13. **(R)**

Third Homework Assignment

International Asset Portfolios. Bond & Equity Portfolios

Levich: Chapters 14, 15 & 16, (R)

Financial Institutions and Hi-Tech

The impact of Hi-Tech on Financial System (past, present, future). International Financial Legalities and their future. Market pre- post crises markets' behavior, government policies and their limitations.

Conclusions and Summary

References

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

Millman, Gregory, 1995, *The Vandals' Crown: How Rebel Currency Traders Overthrew the World's Central Banks*, Free Press.

Millman, Gregory, 1990, *The Floating Battlefield: Corporate Strategies in the Currency Wars*, American Management Association

Mishkin, Frederic, 1998, 5th edition, *The Economics of Money, Banking, and Financial Markets*, Addison-Wesley.

Krugman, Paul R. and Maurice Obstfeld, 2000, 6th edition, *International Economics: Theory and Policy*, Addison-Wesley.

Solnik, Bruno, 1996, *International Investments*, Addison-Wesley.