Spring Semester '03-'04
Akila Weerapana

Lecture 1: International Finance and Macroeconomic Policy

I. INTRODUCTION

- Economics 213 is designed to introduce you to basic concepts in studying macroeconomics in an inter-connected world. It will provide you with tools and knowledge that builds on what you learned in Econ 102 and prepares you for the more rigorous analysis in Econ 313.

- Soon we may enter a world where there will be very little to distinguish macroeconomics from international macroeconomics. As the table below shows, there has been a veritable explosion in the flow of money between countries, whether it is for investing in stock markets or for investing in production in the latter half of the 1990s leading up to today.

FLOWS	**Industrial Countries**		**Developing Countries**	
Billions of $	Direct Investment	Portfolio Investment	Direct Investment	Portfolio Investment
Gross Outflows				
1973-78	28.6	11.8	0.4	5.5
1979-82	46.9	35.0	1.11	7.8
1983-86	88.2	126.5	2.3	-5.1
1989-92	201.3	274.6	10.4	10.3
1993-96	259.6	436.4	19.2	19.2
Gross Inflows				
1973-78	17.9	24.4	5.0	1.3
1979-82	36.6	51.0	14.6	3.1
1983-86	69.3	139.1	15.5	4.0
1989-92	141.9	343.0	37.8	27.5
1993-96	173.0	549.9	106.4	95.9

Source: Economic Report of the President

- This course will address many topics that you stumble across when you read newspapers and follow policy debates on television. The long-term success of this course will be determined partially by your ability to start intelligently assessing articles on current economic issues in publications like the Wall Street Journal and the Economist at the end of the quarter.

- Among the topics we study in the next 13 weeks are exchange rates, current and capital account deficits, the pros and cons of fixed and flexible exchange rate systems, the history of the international financial system, the role of the IMF, the creation of EMU, the East Asian currency crisis etc, the economic collapse of Argentina, recent fluctuations in the value of the dollar, should China revalue the yuan, etc.

- These are all topics that most of you have stumbled across at one point or another. For example, the currency crises in East Asia and Russia in the late 1990s were widely reported in the media, and may have even affected some of you personally. Most recently, the role of the IMF in the world economy was brought into sharp focus by the large protests that accompanied the annual meetings of the World Bank and the IMF earlier this year. 1999 also saw the creation of the European Monetary Union: perhaps the single most important economic development as we move into the new millennium.

- The topics are relevant to understanding economic developments that may not attract much publicity as well. For example, a few years ago Ecuador decided to use the U.S. dollar as their primary currency. Why did Ecuador make this decision to abandon their own currency? Why did they choose the dollar as the currency to adopt? What are the costs and benefits of this decision? These are all questions that you should be able to answer at the end of the semester.
- If these topics intrigue you, then this would be a good class for you to take. If they don't, then you will be doing yourself, and a student on the waiting list a huge favor by not taking the class.
- In deciding to take this class, therefore, you should be aware of the following:
  - This is a 200 level course: the material covered will be much more difficult than in 100 level Economics courses such as Econ 102.
  - This is an economics course that counts towards the IR major, not an IR course! I will teach, and you will be expected to learn, economic theory at a level comparable to other 200 level economics courses AND apply the material to understanding international macroeconomic issues.
  - I will cover history and political science related topics only in a very cursory manner - as an IR major you will therefore be expected to complement this course with appropriate history and poli sci courses if you really want to understand a topic.
  - You will find this course to involve a lot of work. Essentially, you will have to do a lot of homework to understand the core concepts and also learn how to apply these concepts in a VERY short time.
  - At the end of the semester, my goal is that you will walk away from this class confident in your ability to intuitively understand the tradeoffs associated with international economic policy decisions, even though the "right" answers may continue to remain elusive.

II. COURSE OUTLINE

- You should always be aware of the existence of a road map for this class: one that helps keep track of the big picture! Every lecture should be a logical progression from the lecture before and should lead into the next lecture.
- We begin with three lectures that introduce important basic concepts about exchange rates, discuss the types of exchange rate regimes that countries can have and discuss how exchange rates are determined.
- The next two lectures introduce you to the wonderful world of the Balance of Payments Accounts: the open economy section of National Income Accounting - as dramatically engaging as the regular version.
- We get a jump on Econ 202 by examining, over a course of four lectures, an open economy version of the IS-LM model; a model used to analyze short-run economic fluctuations. We will use this model to examine the role of fiscal and monetary policy in an open economy under both fixed and flexible exchange rates.

- The final accumulation of tools occurs in two lectures that compare the pros and cons of different exchange rate regimes and look at the behavior of the exchange rate in the long run. We will not introduce a model to look at long-run issues; that will be deferred until Econ 313.
- This concludes the tool accumulation portion of the class. Next comes the fun stuff, where we actually use these concepts to examine some real world issues. First, we study the evolution of the international financial system in order to understand how we arrived at the system we see today. We then look at the current system and try to understand the choice of exchange rate systems that some countries have made.
- The final 2 weeks of class focuses on real world events. First, we focus on a topical issue, namely the creation of the European Monetary Union. We trace the evolution of this system from the creation of the European Monetary System, a system where the EU countries fixed their currencies to that of the Deutsche Mark to the exchange rate crisis that hit the European economies in 1992.
- We will then study some of the features of the new system, the EMU and also look at some economic analysis that helps us understand when and whether such regional conglomerations are a good idea.
- The final section of the class looks at the nature of the international flows of money and the inherent benefits and risks associated with such risks. We will try to understand how currency crises, such as the crises in East Asia, Russia and in Latin America can occur.
- We will also try to understand what steps countries can take to reform their financial systems either in the aftermath or for prevention and finally discuss the role that the IMF can play in the world financial system.

III. THE BURNING QUESTIONS

- It is always nice to begin a class with a list of "burning questions" - questions that anyone interested in the topic would love to know the answers to.
- By the end of the class, you should be able to apply the ideas you learned over the course of the semester to answer these questions.
- Some of the burning questions for this class are:

  1. What causes a change in the value of a country's currency and what impact does this change have on that country's economy?
  2. What is a current account deficit and what are the implications of a current account deficit for the future health of an economy?
  3. Should a country have a fixed exchange rate system or a flexible one?
  4. When should countries group together and adopt a common currency?
  5. How do currency crises occur and how can economies either prevent them from occurring or recover from a crisis?